



Conducting Self-Audits Without Creating a Roadmap for Plaintiffs' Attorneys: A Delicate Balancing Act*

I. Introduction

Employers increasingly recognize the potential liabilities and obligations that their employment practices and policies may create. Federal and state law often differ, and both evolve rapidly and sometimes inconsistently. An incorrect practice may expose the employer to major liability, depending on the nature of the violation and the number of employees affected, and result in costly and distracting litigation over wages and benefits, and other liabilities, including statutory penalties and attorneys' fees. In a climate of increased discrimination, "whistleblower," wage-hour and benefits claims, often brought as putative class or collective actions, or by the government,¹ employers often "self-audit" their own practices before employees threaten or file litigation. Audits are critical to ensure compliance with employment laws and to minimize exposure for violations. To determine whether an audit is appropriate, however, an employer should carefully explore issues regarding the discoverability and privilege protection of an audit. In addition, the employer must determine the appropriate focus and scope of the audit. Finally, once an employer decides to undertake an audit, it must take corrective action to remedy any problems or violations of the law uncovered during the audit.

Employers must recognize that discussions and notes used in self-audits may be subject to discovery in subsequent litigation. Litigants could use an audit as a "road map" to areas of weakness in the Company's policies, or even to prove liability. However, an employer may be able to use several privileges to limit access to audit information if it properly designs the internal audit. Nevertheless, as discussed below, these privileges apply in limited circumstances, and may be difficult to satisfy. An employer must therefore pay careful attention to detail in the planning and execution stages of the audit, as well as to the careful handling of supporting documents and the finished report. If the Company determines that the audit may involve highly-sensitive information, the audit team must act to ensure that the audit results will remain confidential at the outset (and consider the details that are committed to writing). This risk, coupled with a general erosion of the attorney-client privilege, suggests that outside counsel conduct and/or direct the audit.² If inside counsel conducts the audit, care must be taken to ensure that the attorney-client privilege applies. Even then, however, the underlying business records may be subject to discovery.

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¹ For example, Elaine Chao, the U.S. Secretary of Labor responsible for issuing regulations and guidelines to ensure compliance with the FLSA, reported that in 2004 the Wage and Hour Division collected over \$196 million in back wages, including overtime pay, for workers incorrectly classified. U.S. Department of Labor FY 2006 Budget Overview (www.dol.gov/sec/Budget2006/overview).

² See, e.g., In re Grand Jury Subpoena, 561 F. Supp. 1247 (E.D.N.Y. 1982) (communications with in-house counsel in business role, including as director or officer, not privileged).

This Article discusses the potential privileges that may protect employers' self-audits, and offers practical guidance for employers desiring to conduct self-audits without creating a "roadmap" for would-be litigants and the attorneys who represent them.

II. Potential Privileges to Protect Self-Audits

A. Attorney-Client Privilege

It may be possible to protect information obtained during an audit from being discoverable through application of the attorney-client privilege. The attorney-client privilege protects communications made (and kept) in confidence to an attorney by a client for the purpose of seeking or obtaining legal advice. Its purpose is to promote openness, and to encourage clients to be completely truthful so that the attorney can provide competent legal advice.

As noted recently by the ABA Section on Litigation:

The entire area of internal audits continues to be a troubling one for corporations, since the findings of such an audit . . . are not necessarily privileged. Companies conducting such audits would be well advised to attempt to structure the audit as a fact gathering with the purpose of giving legal advice. It is not certain that such structuring will be sufficient to erect a wall of privilege. Yet without it, it is fairly certain that the privilege will not apply.

The Attorney-Client Privilege and the Work-Product Doctrine, 53 (Edna Selan Epstein, ed., ABA 4th ed. Supp. 2004). As the federal district court noted in Seibu Corp. v. KPMG LLP, 2002 U.S. Dist. LEXIS 906 at *9-10 (N.D. Tex. 2002), the “critical inquiry is whether . . . any particular communication in connection with [the] investigation *facilitated the rendition of legal advice to the client.*” (Emphasis added.)

Importantly, the attorney-client privilege does not automatically attach simply because an attorney is involved in an audit. For example, merely providing the attorney with copies of documents generated by the company, or having an attorney review an audit report, will not invoke the privilege. See Wells Fargo Bank v. Superior Court, 22 Cal. 4th 201, 210 (2000) (“[A] client may be examined at deposition or at trial as to facts of the case, whether or not he has communicated them to his attorney”). In Hardy v. New York News, 114 F.R.D. 633 (S.D.N.Y. 1987), for example, the company's equal employment manager created documents regarding the employer's minority employment goals prior to the plaintiff's lawsuit. The company then hired a consulting firm, which analyzed the workforce and created drafts of affirmative action plans. After filing the lawsuit, the plaintiff requested these documents. The court refused to protect the documents from disclosure because an attorney did not prepare any of the documents, an attorney did not direct the preparation of any of the documents, and none of the documents were addressed to the company's outside counsel. Also, the company did not treat the documents as confidential because the company did not lock up the documents or mark the documents confidential or privileged, and the company mingled the documents with other personnel documents.

Cynthia Diane Deel v. Bank of Am., 227 F.R.D. 456 (W.D. Va. 2005), is a recent case that is particularly instructive here. The company conducted an audit of its payroll practices with regard to reclassifying some job codes that, according to the company's in-house counsel, was "prompted in part by the national proliferation in Fair Labor Standards Act litigation against businesses in general as well as the Bank in particular." *Id.* at 459. The litigation was an FLSA suit brought by employees in 2001, still pending at the time of the self-audit at issue. The plaintiff employees sought various documents related to the audit. Documents that the court held were protected by the attorney-client privilege included those that were sent to in-house and/or outside counsel to facilitate legal services, including documents that encompassed the company's desire to address the issue of reclassification, drafts of notice documents the company intended to distribute to employees who were to complete a questionnaire, and development of the questionnaire.

Critically, the attorney-client privilege did not protect the completed questionnaires. The court stated: "*The defendant's fatal flaw, however, was that it did not clarify to the employees completing the questionnaire that it needed the information to obtain legal advice.*" *Id.* at 461 (emphasis added). Additionally, the court found the company told its employees that business leaders (as opposed to in-house or outside counsel) would review the information gleaned from the questionnaires.³ Finally, the notice to employees about the questionnaire was silent regarding the level of discretion it expected of the employees. The court therefore concluded that the company did not maintain the level of confidentiality required for assertion of the attorney-client privilege. The plaintiffs thus obtained discovery of the questionnaires completed by the employees.

1. Requirements of the attorney-client privilege

In federal courts, the privilege generally applies: (1) when legal advice of any kind is sought, (2) from a professional legal advisor in his capacity as such, (3) the communications relating to that purpose, (4) made in confidence, (5) by the client, (6) are at the client's instance, permanently protected from disclosure by the client or by the legal advisor, unless the client waives the protection.⁴ Accordingly, to invoke the attorney-client privilege properly, the company should, at a minimum, do the following:

(1) A person within the company with sufficient authority to ask attorneys for legal advice and/or to act upon legal advice received (*e.g.*, the CEO, General Counsel or Director of Litigation) should request the assistance of counsel. The attorneys to whom the communication is made must be acting as counsel to the company at the time of the communication. Preferably, this is done through a short written communication to the attorney creating a record for the file of the precise date, after which all protected communications would be subject to the privilege. A letter from the company's General Counsel or a high-level manager

³ See also Henson By and Through Mawyer v. Wyeth Laboratories, Inc., 118 F.R.D. 584, 587 (W.D. Va. 1987) (holding that attorney-client privilege does not apply where attorney receiving communication acts as business advisor, or where communication is to obtain business, rather than legal, advice).

⁴ United States v. Martin, 278 F.3d 988, 999 (9th Cir. 2002); In re Richard Roe, Inc., 68 F.3d 38, 39 (2nd Cir. 1995).

is best. The letter should state that the purpose of the audit is to obtain legal advice with regard to the employer's compliance with employment-related laws. The letter also should authorize the attorneys to obtain the assistance of all necessary personnel to obtain required information.

(2) Once the company invokes the privilege, non-lawyer corporate managers within the company should report to the company's Legal Department or to outside counsel, taking instruction from counsel, or counsel's agents (*i.e.*, investigators, paralegals, etc.).

(3) It is useful to recite, from time to time, that the matter under consideration is proceeding pursuant to the need for legal advice. For example, auditors could begin or end written reports requesting counsel to advise what appropriate legal options exist in light of the developing facts. Similarly, counsel should direct the non-lawyer corporate auditor to gather appropriate facts to allow counsel to give appropriate legal advice to the company.

(4) Any reports prepared by attorneys should discuss the relevant legal principles and discuss the employer's conduct in light of those principles. These reports should be verbal if possible due to the risks of discoverability later.

(5) The communication must be kept confidential by both the company and the attorney. Disclosure thus should be limited to only those who have a true "need to know." Everyone should conspicuously label all documents to and from counsel as "Privileged and Confidential: Attorney-Client Privileged Communication." The company should limit distribution of copies and access to documents. Provided the company's document retention policy so permits, documents used to prepare audits should be destroyed (unless there is pending litigation or a legal requirement to retain the documents exists). If the company uses questionnaires or surveys, employers should inform (in writing) those completing such documents that they are confidential and are the company will use them for the purpose of seeking legal advice.

2. Attorney-client privilege protects communications, not underlying facts

It also is important to note that the attorney-client privilege protects only communications, and does not prevent the disclosure of underlying facts.⁵ See also Upjohn v. United States, 449 U.S. 383, 396 (1981) (client cannot "refuse to disclose any relevant fact within his knowledge merely because he incorporated a statement of such fact into his communication to his attorney"). In Upjohn, a corporation's General Counsel conducted an investigation regarding questionable payments made by one of the corporation's foreign subsidiaries to foreign government officials. His investigation included sending questionnaires to foreign managers seeking detailed information concerning the payments and conducting interviews with the managers and other corporate officers and employees. The Internal Revenue Service demanded production through a subpoena of the investigation notes and questionnaires. The corporation refused, relying on the attorney-client privilege and attorney work product

⁵ In re Six Grand Jury Witnesses, 979 F.2d 939, 944 (2d Cir. 1992) (communications between attorney and client regarding internal investigation into alleged fraud against government privileged, but factual information contained in written communications, including results of investigation, were not shielded from discovery).

protections. The United States District Court for the Western District of Michigan ruled that the subpoena was enforceable. On appeal, the United States Court of Appeals for the Sixth Circuit held that the attorney-client privilege did not apply to the extent that officers and agents not responsible for directing the corporation's actions in response to legal advice made the communications, because the communications were not those of the "client." On certiorari, the United States Supreme Court reversed and remanded, holding that the attorney-client privilege protected the communications between the corporation's employees and the General Counsel.

3. Waiver of the attorney-client privilege

In addition, the client may waive the privilege if it conveys privileged communications to third parties (other than those to whom disclosure would be in furtherance of the rendition of professional legal services to the client or those reasonably necessary for transmission of the communication). A client, as the holder of the privilege, may also waive the privilege if it discloses or produces a subset of the privileged document or information.

Attorneys are sometimes the best auditors, particularly where an understanding of complex legal considerations is critical to determining difficult compliance issues. However, where an attorney conducts an audit, the parties must recognize a risk that the court may deem the attorney to be acting in a role other than as counsel, and thus may hold that neither the attorney's efforts nor communications between the attorney and the company's management are legally privileged. Furthermore, an employer attempting to assert privilege with regard to an attorney's advice and opinions communicated to the company walks a narrow tightrope: A court could rule that the selective disclosure of investigatory actions has waived the privilege for all purposes. See Wellpoint Health Networks v. Superior Court, 59 Cal. App. 4th 110 (1997), discussed more fully below. If an attorney did not conduct the investigation, it may be possible for a defendant to claim partial waiver by disclosing some documentation that it did conduct an investigation, while attempting to maintain the privilege as to other materials.

Several California decisions highlight the legal tensions that arise when an attorney plays a role in an investigation and the employer seeks to present evidence of the investigation as a defense to liability while simultaneously shielding its attorney's work product and communications of legal advice and opinion from discovery. Although these cases arose in the context of sexual harassment investigations, they are nonetheless instructive with regard to the boundaries of the attorney-client privilege in the context of internal audits and investigations generally.

In Wellpoint Health Networks v. Superior Court, 59 Cal. App. 4th 110 (1997), the Court of Appeal held that an employer was not entitled to employ an attorney to conduct an investigation, cite the investigation as a defense, and then selectively produce only those portions of the investigation file that the employer deemed not to contain privileged material. The court held that the employer's disclosure of the attorney's investigatory actions created a broad waiver of the attorney-client privilege and work product doctrine extending beyond the attorney's purely

investigatory actions to subsequent deliberations and the formation and expression of legal opinions to the Company in the development of its defense to the claim in litigation.⁶

A similar troubling result occurred in McIntyre v. Main St. & Main Inc., 2000 U.S. Dist. LEXIS 19617 (N.D. Cal. 2000). After the plaintiff complained of sexual harassment by a coworker, the defendant-employer conducted an in-house investigation into her complaint. Thereafter, a law firm conducted a second, more comprehensive investigation into the plaintiff's allegations of sexual harassment and race and sex discrimination. The plaintiff argued that the defendant had waived the attorney-client privilege protection in relation to the investigation by asserting as an affirmative defense that it took prompt remedial action to prevent and correct the alleged unlawful behavior. The court held: "Plaintiffs are correct that defendant cannot rely on the investigation by outside counsel as part of its defense, while at the same time shielding the investigation from discovery. Any use of the investigation in its defense would waive the privilege." Id. at 9. Based on the fact that there were two investigations, however, and that defense counsel stated that defendant would only rely on the internal investigation and would not rely on the investigation by outside counsel, the court held that the defendant had not waived the attorney-client privilege. The court conditioned this ruling on the two investigations truly being separate. The plaintiffs' alternative argument in the case was that defense counsel had waived the attorney-client privilege by submitting a detailed letter regarding its internal investigation to plaintiffs. Interestingly, the court held that, "although the letter does hold considerable detail regarding defendant's findings of fact and conclusions, the Court is not convinced that defendant waived the attorney-client privilege." Id. at 12. The court at least partly relied on the fact that defense counsel had written the letter in response to an earlier demand letter by the plaintiffs, in part for purposes of responding to their settlement demand.

The flipside of this issue exists where the employer has used a non-attorney to investigate the employee's allegations, but has used counsel to review and critique the investigatory strategy employed, to review drafts of documents to be placed in the investigation file, and to provide advice regarding disciplinary alternatives at the conclusion of the investigation. That was the situation in Kaiser Found. Hosp. v. Superior Court, 66 Cal. App. 4th 1217 (1998). Kaiser involved four nurses alleging unlawful sex harassment and sex discrimination by a doctor at a Kaiser facility. After receiving an anonymous complaint, Kaiser brought in a non-lawyer human resources consultant. He interviewed more than ten witnesses, made notes of his interviews, and prepared an investigation report. He consulted with Kaiser corporate attorneys throughout his investigation, obtaining legal advice and keeping counsel informed of his progress and significant developments in the investigation.

The nurses filed a lawsuit under the California Fair Employment and Housing Act ("FEHA"), alleging that Kaiser was liable both because the doctor was a supervisor and because Kaiser had failed to take immediate and appropriate corrective action in response to their complaints. To support its claim that it had conducted a reasonable investigation, Kaiser produced portions of the investigation file. It did not produce several dozen pages of documents,

⁶ The Wellpoint court also noted that where an employer does not raise the investigation as an affirmative defense, a blanket rule compelling discovery of materials from an attorney-conducted investigation is inappropriate. Instead, a determination should be made as to whether the dominant purpose behind each communication or work product was or was not in furtherance of the attorney-client relationship. Id. at 122.

claiming that the attorney-client privilege and the attorney work-product doctrine protected them. The plaintiffs responded by bringing a motion to compel production of the documents withheld, arguing that Kaiser had placed in issue the scope and adequacy of its investigation and that this defense was inconsistent with assertion of the attorney-client privilege, as Kaiser could not “selectively produce” investigation documents. Id. at 1221.

Following a hearing on the plaintiffs’ motion to compel, the trial judge ordered Kaiser to produce the documents and rejected Kaiser’s assertion of privilege, relying on Wellpoint. Kaiser sought a writ of mandate from the Court of Appeal to immediately overturn the lower court’s order to produce the documents. The Court of Appeal granted the writ, holding that the earlier ruling in Wellpoint was confined to its particular facts, including the fact that the attorney there had conducted the investigation, then acted as counsel for the employer by issuing a letter rejecting the employee’s claims and asserting that the claims had been “fully investigated and taken seriously.” The court noted that Kaiser’s counsel had played an entirely different role from counsel in Wellpoint. Kaiser had not used an attorney to conduct the investigation, but instead had used a human resources consultant who obtained direction from counsel. Kaiser’s counsel did not conduct the investigatory interviews, but rather provided guidance and evaluated the outcome of the investigation. Nor did Kaiser attempt to blanket its entire investigation with the attorney-client privilege so as to protect it from scrutiny; instead, Kaiser produced the bulk of the investigation file and produced the investigator for deposition, and sought to protect a limited number of documents containing or reflecting discrete communications between Kaiser’s attorneys and Kaiser’s non-attorney investigators. The court found each of these areas of attorney involvement to be subject to the protections of the attorney-client privilege and/or the attorney work product doctrine.

Kaiser is a well-reasoned decision that provides guidance regarding the application of privileges in the context of an internal audit or investigation, at least where counsel has not conducted the actual investigative interviews.⁷ It also is notable for its application of partial waiver of the attorney-client privilege. The success of a partial waiver argument depends first on whether counsel or a non-attorney conducted the audit or investigation. If an attorney conducts the investigation, and when the defendant relies on the adequacy of the investigation as an affirmative defense, the defendant implicitly waives the attorney-client privilege and the investigation becomes discoverable.⁸ If the defendant does not raise the adequacy of the investigation as an affirmative defense, the contents of the investigation may still be discoverable, if the dominant purpose of the attorney communications or documents was not the provision of legal advice. If a non-attorney has conducted the investigation, the success of the partial waiver argument depends on issues of fairness. “Where the disclosure does not result in any obvious legal prejudice, courts have declined to find any waiver except as to the

⁷ Depending upon the circumstances of the particular case and the forum, the use of investigation efforts or results in support of an affirmative defense to liability in administrative and judicial actions may be deemed to waive the attorney-client privilege. See Harding v. Dana Transport, Inc., 914 F. Supp. 1084, 1096 (D.N.J. 1996) (noting that employer’s use of investigation both as defense to liability under Title VII and as aspect of its preparation for sexual discrimination trial waived attorney-client privilege); see also Payton v. New Jersey Turnpike Auth., 691 A.2d 321, 336 (1997) (“[D]efendant may have waived the protection of the doctrine by asserting the investigation as an affirmative defense”).

⁸ See Brownell v. Roadway Package Sys., 185 F.R.D. 19 (N.D. NY 1999); see also Harding v. Dana Transp., 914 F. Supp. 1084 (D.N.J. 1996).

particular document or testimony that has already been disclosed.”⁹ The following New York cases demonstrate these distinctions.

In McGrath v. Nassau County Health Care Corp., 204 F.R.D. 240 (E.D.N.Y. 2001), the defendant conducted an internal investigation through its outside counsel following allegations of sexual harassment by the plaintiff-employee. The plaintiff sought production of documents pertaining to the investigation that the defendant claimed were attorney-client privileged. The district court ruled that the magistrate judge did not abuse his discretion by ordering the production of the investigation documents because the defendant had placed those materials in issue¹⁰ when it claimed that its remedial response was sufficient in light of its investigation. Despite the fact that the defendant claimed never to have asserted this defense, the court nonetheless held that the adequacy of its response in light of the investigation was at issue in the case: “It would be unjust to allow [the defendant] to invoke the *Faragher-Ellerth* defense under these facts while allowing it to protect the very documents it relies on to assert that defense.”¹¹ Thus, the employer waived the attorney-client privilege by relying on its attorney-conducted investigation as a defense. However, the court did note that “the scope of any waiver is defined by the context of the waiver and the prejudice to the other party that limiting the waiver would cause. Therefore, ‘a more limited form of implied waiver may be appropriate where disclosure occurred in a context that did not greatly prejudice the other party in the litigation.’ [Citing United States v. Doe (In re Grand Jury Proceedings), 219 F. 3d 175, 183 (2d Cir. 2000)].

A successful attempt to maintain the attorney-client privilege occurred in Welland v. Trainer, 2001 U.S. Dist. LEXIS 15556 (S.D.N.Y. 2001), an age discrimination case that mirrors Kaiser, *supra*. The defendant, relying on Upjohn Co. v. United States, 449 U.S. 383 (1981), claimed that the attorney-client privilege protected some documents because the defendant’s in-house counsel directed the investigation (although he did not conduct it). A non-attorney investigator gathered and analyzed information for use by the defendant’s attorneys in providing legal advice to the defendant. The court held that “documents that relate to communications between the investigator and in-house and outside counsel are protected because defendant’s investigator was obtaining confidential, legal advice regarding the investigation . . . Therefore, the documents are protected by the attorney-client privilege.”¹²

⁹ Akamai Techs., Inc. v. Digital Island, Inc., 2002 U.S. Dist. LEXIS 13515, *24 (N.D. Cal. 2002), citing In re von Bulow, 828 F.2d 94, 102 (2d Cir. 1987).

¹⁰ Of course, if the employer is not asserting the sufficiency of the investigation as an affirmative defense, the attorney-client privilege remains intact. See Stoner v. The New York City Ballet Co., 1999 U.S. Dist. LEXIS 17464 (S.D.N.Y. 1999) (where defendant sought summary judgment on the ground that plaintiff could not make out a prima facie case, or alternatively, that there was a non-retaliatory reason for defendant’s refusal to promote plaintiff, there was no justification for invasion of the attorney-client privilege). See also Abdus-Sabur v. The Port Auth. of New York and New Jersey, 2001 U.S. Dist. LEXIS 14745 (S.D.N.Y. 2001) (where defendant’s defense that it had an adequate procedure for addressing complaints of discrimination but that plaintiff failed to avail herself of these procedures was “altogether different from saying that a [defendant] attorney fully and fairly investigated [plaintiff’s] complaint and that the investigation found no evidence of discrimination”).

¹¹ McGrath v. Nassau County Health Care Corp., 204 F.R.D. 240, 246 (E.D.N.Y. 2001). See also Jones v. Scientific Colors, Inc., 2001 U.S. Dist. LEXIS 10753 (N.D. Ill. 2001) (permitting deposition of employer’s investigating attorney where employer asserted reasonable and adequate investigation of plaintiff’s claims).

¹² Welland v. Trainer, 2001 U.S. Dist. LEXIS 15556, 8 (S.D.N.Y. 2001) (where defendant claimed affirmative defense of appropriate remedial action, but asserted that remedial action was plaintiff’s prompt removal from hostile work environment, and

Similar to raising an investigation of a sexual harassment claim as a defense is the option of waiving the privilege and raising the fact that the employer conducted an audit as a way to limit the amount of its damages. For example, the normal statute of limitations under the federal Fair Labor Standards Act ("FLSA") entitles employees to recover back wages beginning two years before they file a complaint and extending forward until the case is resolved. See 29 U.S.C. § 255(a). The statute of limitations is three years if the employer "willfully" or "recklessly" disregarded its FLSA obligations. Id. By demonstrating that the company conducted an audit, the company may use it as a defense to a would-be plaintiff's allegation that the company acted "willfully" or "recklessly" and be able to cap the statute of limitations at two years. Wolfslayer v. IKON Office Solutions, Inc., 10 Wage & Hour Cas. 2d (BNA) 430, *38 (2004) (company's audit policies to ensure company did not violate FLSA negated willfulness finding).

In Wolfslayer, the plaintiff requested overtime pay from her employer on the ground that it had erroneously classified her as exempt from the FLSA's overtime requirements. The plaintiff asserted that the job tasks she performed did not allow the company to classify her as exempt and that certain provisions of the company's compensation structure caused employees to be effectively treated as hourly workers entitled to overtime pay. The plaintiff also sought to extend the time period for which she could recover overtime pay by alleging that the company "willfully" violated the FLSA.

The Wolfslayer court found that the company's numerous compliance programs and audit policies defeated the plaintiff's claim of willfulness in light of the Third Circuit's requirement that an affirmative showing of a defendant's "stubborn non-compliance in the face of contrary judicial authority" is required to hold a defendant liable for the extra year of damages that willfulness allows. Id. at *38. The company's compliance policies included the following: "a process for determining whether jobs are exempt from FLSA's overtime pay requirements . . . Supervisors send staffing requisitions or job descriptions to the compensation department . . . After reviewing the documentation, the compensation department makes a FLSA classification decision. . . . If the documentation is not sufficient, the compensation department will contact the employee's manager and/or the local human resources representative to gather additional information. . . . Furthermore, [the company's] payroll department routinely audits payroll records to determine if an exempt employee was paid appropriately. . . . Finally, the human resources department circulates bulletins so that the human resources staff can stay informed of company policy changes or developments in the law." Id. at *36.

4. Erosion of the attorney-client privilege

Although the attorney-client privilege is probably the strongest protection against disclosure, erosion of it occurred over the last few years. Government agencies or federal prosecutors now often insist that a company waive its attorney-client privilege, to avoid indictment or in hopes of reducing a criminal sentence. Prosecutors view the corporate

that investigation conducted by law firm was solely to deal with anticipated litigation, court found defendant had implicitly waived attorney-client privilege and allowed discovery).

defendant's agreement to the waiver as a sign of cooperation. The recent investigations by New York State Attorney General Eliot Spitzer are prime examples. If a company decides not to cooperate with the Government and refuses to waive the attorney-client and/or attorney work product privileges, it risks being charged with more serious crimes and, if found guilty, being subject to a more severe penalty. If the company elects to secure preferential treatment by cooperating with the investigating agency, it almost inevitably will provide the Government with information the investigators may not have otherwise been able to obtain. However, a voluntary presentation or disclosure to government, even if intended to avoid or reduce charges, can waive the privilege.

The major risk associated with the decision to cooperate is that a court, in a subsequent proceeding, will rule that third-party litigants can have access to those privileged materials that an employer provided to the government agency for its investigation. Thus, companies facing such a situation must carefully balance their desire to cooperate with the Government with waiving the privilege and making the information discoverable by third parties in subsequent lawsuits. This is a difficult decision, and one made even more difficult due to unsettled law regarding waiver in this context.

Federal courts are currently split on the scope of waiver when privileged information is disclosed to a government agency ("selective" or "limited" waiver). See Diversified Indus., Inc. v. Meredith, 572 F.2d 596, 611 (8th Cir. 1978); United States v. Shyres, 898 F.2d 647, 657 (8th Cir. 1990) (corporation's disclosure of internal investigation report in conjunction with grand jury investigation did not waive attorney-client privilege protecting communications in report); United States v. Massachusetts Institute of Technology, 129 F.3d 681, 685 (1st Cir. 1997) (voluntary disclosure of privileged information to administrative agency waives privilege); In re Columbia/HCA Healthcare Corp. Billing Practices Litig., 293 F.3d 289, 294 (6th Cir. 2002) (extending rejection of selective waiver to work product protection); Burden-Meeks v. Welch, 319 F.3d 897, 899 (7th Cir. 2003) (nonparty governmental risk management agency waived privilege regarding investigation report by sharing it with defendant's mayor).

Companies also frequently negotiate confidentiality agreements with a government agency when disclosing information to it. Such agreements typically specify that the disclosure is not a waiver of any privilege. Such agreements do not, however, ensure protection of attorney-client privileged material because courts treat the waiver as overriding the agreement to maintain confidentiality. However, some federal Circuit Courts of Appeals have recognized that disclosure to a government agency of work-product protected information under a confidentiality agreement may not operate as a waiver of that privilege.¹³

B. Attorney Work Product

Separate from the attorney-client privilege is the protection of attorney "work product." See Fed.R.Civ.P. 26(b)(3); United States v. Rockwell Int'l, 897 F.2d 1255, 1266 (3d

¹³ In re Steinhardt Partners, L.P., 9 F.3d 230, 236 (2d Cir. 1993); Dellwood Farms, Inc. v. Cargill, Inc., 128 F.3d 1122, 1127 (7th Cir. 1997). Compare In re Columbia/HCA Healthcare Corp. Billing Practices Litig., 293 F.3d 289, 294 (6th Cir. 2002) (rejecting selective waiver despite confidentiality agreement); Westinghouse Elec. Corp. v. Republic of Philippines, 951 F.2d 1414, 1427 (3rd Cir. 1991) (same); Navajo Nation v. Peabody Holding Co., Inc., 209 F. Supp. 2d 269, 285 (D.D.C 2002) (same).

Cir. 1990). This doctrine protects from discovery the documents, reports, communications, memoranda, mental impressions, opinions, or legal conclusions counsel prepares in anticipation of litigation or for trial. The privilege accorded to "work product" is to some extent broader than the absolute attorney-client privilege discussed above. Although the "work product" may be, and often is, that of an attorney, the concept of "work product" is not confined to information or materials gathered or assembled by a lawyer. Further, a communication may be immune from discovery as work product even though a "client" of an attorney did not make or receive the communication.

One major hurdle in protecting information and documents as attorney work product is the "in anticipation of litigation" requirement. To meet this requirement, the threat of litigation must be real and imminent. See McCoo v. Denny's, Inc., 192 F.R.D. 675, 683 (D. Kan. 2000) ("[t]he inchoate possibility, or even likely chance, of litigation does not give rise to the privilege"). Note that investigations by regulatory agencies may present "more than a mere possibility of future litigation, and provide reasonable grounds for anticipating litigation." Garrett v. Metropolitan Life Ins. Co., No. 95 Civ. 2406, 1996 WL 325725 at *3 (S.D.N.Y. June 12, 1996).

A federal Circuit Court of Appeals, in Sprague v. Thorn Americas, Inc., 129 F.3d 1355 (10th Cir. 1997), held that a company could assert the attorney work product privilege for a memorandum prepared by in-house counsel addressing the company's alleged disparate treatment of women. The court found protection because an attorney prepared the memorandum while acting within the scope of his employment for the purpose of rendering legal advice. On the other hand, one troubling case is Diversified Indus., Inc. v. The Honorable James H. Meredith, 572 F.2d 596 (8th Cir. 1977). In Diversified, a corporation hired outside counsel to investigate the business practices of the company in the context of disclosures that the company made to the Securities and Exchange Commission in the course of prior, unrelated litigation involving alleged business violations. In subsequent litigation, the corporation attempted to prevent discovery of the investigation report, claiming both the attorney-client and work product privileges protected the information. The court held that the attorney-client privilege did not protect the report, observing that the law firm "was employed solely for the purpose of making an investigation of facts and to make business recommendations with respect to the future conduct of Diversified in such areas as the results of the investigation might suggest. The work that Law Firm was employed to perform could have been performed just as readily by non-lawyers aided to the extent necessary by a firm of public accountants. Thus Diversified has failed to satisfy one of the requisites of a successful claim of attorney-client privilege." Id. at 603. Significantly, the court found that the company did not hire the law firm to provide legal advice or to represent the company in any pending or potential litigation.

In addition, the Diversified court held that the attorney work product privilege did not protect the report. The court found that the company did not prepare the report in "anticipation of litigation" despite the fact that "all parties concerned must have been aware that the conduct of employees of Diversified in years past might ultimately result in litigation of some sort in the future." Id. at 603. The court explained that "the work product rule does not come into play merely because there is a remote prospect of future litigation" and found that the "investigation was not made and its report was not prepared because of any prospect of litigation

involving Diversified. Law Firm was employed simply because the Board of Directors of Diversified wanted to know what actually had been going on and wanted to frame policies and procedures that in the future would protect it against repetitions of the prior misdeeds, if any, of its employees committed in the past." *Id.*

A similar troubling result occurred more recently in *In re Royal Ahold N.V. Securities & ERISA Litigation*, 230 F.R.D. 433 (D. Md. 2006). Following revelation of alleged financial fraud and the commencement of an SEC investigation, the company retained outside counsel to conduct internal investigations into the matter. In addition to the SEC investigation, a class of shareholders brought twenty-one securities fraud and ERISA class actions against the company. The plaintiffs sought production of the outside counsel's work product generated as part of the internal investigation. The court analyzed whether the memoranda were created "because" of the prospect of litigation or whether there was another "driving force" behind the preparation of the requested documents. *Id.* at 435. The plaintiffs argued, and the district court agreed, that the company conducted the investigation to satisfy its outside accountants and to obtain necessary financing. The court noted: "Undoubtedly the company was also preparing for litigation, as the first class action was filed February 24, 2003, but the investigation would have been undertaken even without the prospect of preparing a defense to a civil suit." *Id.* Thus, the court held that the attorney work product privilege did not protect the investigative materials (including notes from more than 800 interviews).

These cases highlight the extreme care that employers must take to establish that they are engaging outside counsel to provide them with legal advice, and the benefit of conducting an investigation that is tied to a genuine prospect of litigation or to pending claims. To utilize the attorney work product privilege, counsel should conduct employee interviews, or at a minimum should prepare the witness questionnaires or interview outlines. Attorneys should also supervise the audit as closely as possible. Finally, counsel involved in the self-audit should conspicuously label all documents generated in connection with the audit as: "Privileged and Confidential—Attorney Work Product," and should treat such attorney work product accordingly by strictly limiting dissemination.

C. Self-Critical Analysis

The least reliable privilege to limit access to self-audit information is the "critical self-analysis" privilege. The self-critical analysis privilege is a qualified privilege that protects certain critical self-appraisals. Businesses may candidly assess their compliance with regulatory and legal requirements without creating evidence that future litigants may use against them. The rationale for the doctrine is that such critical self-evaluation fosters the compelling public interest in observance of the law. A corporation that knows its evaluations will remain confidential will be more likely to self-audit and therefore produce more candid and accurate evaluations. Accordingly, the company could proactively prevent (and/or "remedy") violations and discover minor infractions before they develop into major litigation exposure.

In *Bredice v. Doctor's Hosp. Inc.*, 50 F.R.D. 249 (D.D.C. 1970), the seminal case recognizing a self-critical analysis privilege, the court withheld from discovery certain hospital staff minutes, observing:

Confidentiality is essential to effective functioning of these staff meetings; and these meetings are essential to the continued improvement in the care and treatment of patients. Candid and conscientious evaluation of clinical practices is a *sine qua non* of adequate hospital care. To subject these discussions and deliberations to the discovery process, without a showing of exceptional necessity, would result in terminating such deliberations. Constructive professional criticism cannot occur in an atmosphere of apprehension Id. The court noted, however, that the privilege is a qualified privilege and that the party seeking disclosure could overcome it by a showing of need. Other courts have applied the rationale expressed in Bredice to protect self critiques designed to strengthen compliance with equal employment laws. See, e.g., Banks v. Lockheed-Georgia Co., 53 F.R.D. 283 (N.D. Ga. 1971) (refusing to "discourage companies . . . from making investigations . . . calculated to have a positive effect on equalizing employment opportunities").

In Banks, the company appointed a team of employees, including one of the employer's attorneys, to study the company's problems in the area of equal employment opportunities, and to determine the progress, if any, of the company's Affirmative Action Compliance Programs. Two years prior to the investigation, the company faced a discrimination suit, and at the time of the pending litigation, five other discrimination suits were pending against the company. From these facts, the district court concluded that the company reasonably could have investigated in preparation for trial. Furthermore, the court held that permitting discovery of the self-evaluative reports "be contrary to that policy to discourage frank self-criticism and evaluation in the development of affirmative action programs of this kind."

Despite the solid common sense at its core, the privilege has had difficulty gaining wide acceptance. The "privilege has led a checkered existence in the federal courts." Wimer v. Sealand Serv. Inc., 1997 U.S. Dist. LEXIS 9475, *1 (S.D.N.Y. 1997). Some courts have rejected the privilege outright. See, e.g., Holland v. Muscatine Gen. Hosp., 971 F. Supp. 385, 390-91 (S.D. Iowa 1997); Aramburu v. The Boeing Co., 885 F. Supp. 1434, 1441 (D. Kan. 1995). Other courts, while acknowledging the existence of the privilege in theory, have found numerous reasons not to apply it.¹⁴ Moreover, to the extent courts do recognize the privilege, they generally will only protect from disclosure evaluative materials, and not objective facts or

¹⁴ See, e.g., Coates v. Johnson & Johnson, 756 F.2d 524, 552 (7th Cir. 1985) (appellate court did not need to decide whether district court's decision refusing plaintiffs' request to discover self-critical portions of the company's affirmative action plans because company waived any qualified privilege by voluntarily using its affirmative action efforts at trial to prove nondiscrimination); Steinle v. The Boeing Co., 1992 WL 53752, at * 9 (D. Kan. Feb. 4, 1992) (after plaintiff complained that she was not in appropriate job classification and pay status for position she was performing, company conducted an internal investigation into matter. In subsequent litigation, plaintiff sought internal investigation records. The company refused, claiming self-evaluation privilege. A magistrate judge found the privilege is limited to subjective, evaluative materials prepared for mandatory government reports. On appeal, the court concluded the magistrate judge's interpretation was not "clearly erroneous," and agreed that the company had not demonstrated a sufficiently compelling reason to prevent the plaintiff from discovering the investigative materials.).

data such as statistics. See, e.g., Torres v. Kuzniasz, 936 F. Supp. 1201, 1214-15 (D.N.J. 1996); In re Crazy Eddie Securities Litigation, 792 F. Supp. 197, 205-06 (E.D.N.Y. 1992).

1. Application of the self-critical analysis privilege

In deciding whether to apply the self-critical analysis privilege, courts today typically use the criteria set forth in Dowling v. American Hawaiian Cruises, 971 F.2d 423 (9th Cir. 1992):

(1) whether the information sought in discovery results from a critical self-analysis by the party seeking protection;

(2) whether the public has a strong interest in preserving the free flow of the type of information sought;

(3) whether allowing discovery of the reports would curtail the free flow of information; and

(4) whether the party seeking protection intended to maintain the confidentiality of the information sought and has kept that information confidential.

Not all jurisdictions recognize the privilege, and most limit its application, performing a balancing test to determine whether a party's need for relevant evidence outweighs the risk that disclosure will impede self-evaluation.¹⁵ Thus, courts often will evaluate the privilege's application on a case-by-case basis, and will hold that plaintiffs can discover documents where the information is necessary to prove their case. This privilege thus depends on the court's discretion. See Trammel v. United States, 445 U.S. 40, 47 (1980) (purpose of Rule 501 is to "provide courts with the flexibility to develop rules of privilege on a case-by-case basis, and to leave the door open to change") (citation omitted); but see Cloud v. Superior Court of Los Angeles, 50 Cal. App. 4th 1552, 1557-59 (1996) (declining to adopt privilege under California law, finding that California Evidence Code does not recognize self-critical analysis privilege.) Courts have recognized the privilege in the context of hospital committee reports,¹⁶ certain internal investigatory reports,¹⁷ and various equal employment opportunity forms submitted to the government.

¹⁵ See Hardy v. New York News, Inc., 114 F.R.D. 633, 641-42 (S.D.N.Y. 1987).

¹⁶ Gillman v. United States, 53 F.R.D. 316 (D.N.Y. 1971); Bredice v. Doctors Hospital, Inc., 50 F.R.D. 249 (D.D.C. 1970).

¹⁷ Gray v. Bd. of Higher Educ. City of New York, 92 F.R.D. 87 (S.D.N.Y. 1981) (tenure committee votes subject to privilege); rev'd, 692 F.2d 901 (2d Cir. 1982); Lasky v. Am. Broadcasting Cos., Slip Op. 83 Civ. 7438 (S.D.N.Y. August 11, 1986) (documents analyzing broadcast protected by privilege); New York Stock Exchange v. Sloan, 22 Fed. R. Serv. 500 (S.D.N.Y. 1976) (documents regarding securities investigation); Richards v. Maine Cent. R.R., 21 F.R.D. 590 (D. Me. 1957) (documents pertaining to railway accident investigations).

2. Ninth Circuit and California recognition of the self-critical analysis privilege

It is unclear whether the Ninth Circuit recognizes the self-critical analysis privilege. In Dowling, 971 F.2d 423, 425-27 (9th Cir. 1992), the court stated "this circuit has not yet considered whether there exists a so-called privilege of self-critical analysis," yet performed an analysis of a claim under the self-critical analysis. Ultimately, the Ninth Circuit in Dowling concluded, "[e]ven if such a privilege exists, the justifications for it do not support its application to voluntary routine safety reviews." Id. at 426. Additionally, the federal district court for the Central District of California implicitly rejected the self-critical analysis privilege. In Griffith v. Davis, 161 FRD 687, 701 n.17 (1995), the court stated: "Although the Court in Dowling alternatively analyzed the claim of privilege by assuming the existence of the privilege, there has been no case in the Ninth Circuit that has explicitly adopted the self-critical analysis privilege nor has any court in this circuit found any document protected from discovery based upon that privilege."

One California Court of Appeal expressly rejected the common law self-critical analysis privilege. In Cloud v. Superior Court of Los Angeles, 50 Cal. App. 4th 1552, 1557-59 (1996), the court relied upon the language of the California Evidence Code to determine that California state law does not recognize the common law self-critical analysis privilege. The court stated: "[T]he privileges contained in the [California] Evidence Code are *exclusive* and the courts are not free to create new privileges as a matter of judicial policy." Id. at 1558-59 (internal quotations omitted) (emphasis in original). Finding that the California Evidence Code does not recognize the self-critical analysis privilege, the court declined to adopt the privilege. Id. at 1559.

In summary, the majority of jurisdictions that recognize a self-critical analysis privilege have codified it as it applies to medical peer-reviews, environmental audits, or both. Any expansion of the privilege is therefore likely to occur only through legislative action. See, e.g., Wells Dairy, Inc. v. American Indus. Refrigeration, Inc., 690 N.W.2d 38 (Iowa 2004) ("Our legislature has recognized the self-critical analysis privilege in the context of medical peer review committees. We decline to judicially extend the self-critical analysis privilege, and we leave it to the legislature to do so if it finds the competing policy concerns weigh in favor of such an extension of the privilege.").

D. Subsequent Remedial Measures/Part of Negotiated Settlement

Under the Federal Rules of Evidence, "when, after an injury or harm allegedly caused by an event, measures are taken that, if taken previously, would have made the injury or harm less likely to occur, evidence of the subsequent remedial measures is not admissible to prove . . . negligence . . . or culpable conduct." F.R.E. 407. The purpose of Rule 407 is to encourage people to take steps in furtherance of added safety.

Typically, courts apply the rule to product design defects or warnings. However, a parallel can be drawn to remedial measures taken by a company with regard to its employment or other policies. A company may be able to argue that evidence of such measures cannot be used to draw adverse inferences about the company's past practices, or knowledge of alleged

violations. But see Sav-On Drug Stores, Inc. v. Superior Court, 34 Cal. 4th 319, 330 n.4 (2004) (class action in which plaintiffs alleged misclassification as exempt employees; California Supreme Court noted: "[D]efendant's interrogatory responses indicate that during the class period it reclassified all [employees in particular job category included in plaintiff class] from exempt to nonexempt with 'no change in the job description or job duties.' *The court could rationally have regarded the reclassification as common evidence respecting both defendant's classification policies and the [employees'] actual status during the relevant period.*") (Emphasis added.)

Even once a plaintiff initiates litigation against an employer, the employer may still undertake remedial measures through either class settlement or consent decrees. Class settlement, negotiated with plaintiffs' counsel and approved by the trial court, provides a unique opportunity to institute remedial measures. Rule 408 of the Federal Rules of Evidence provides:

Compromise and Offers to Compromise: Evidence of (1) furnishing or offering or promising to furnish, or (2) accepting or offering or promising to accept, a valuable consideration in compromising or attempting to compromise a claim which was disputed as to either validity or amount, is not admissible to prove liability for or invalidity of the claim or its amount. Evidence of conduct or statements made in compromise negotiations is likewise not admissible. This rule does not require the exclusion of any evidence otherwise discoverable merely because it is presented in the course of compromise negotiations. This rule also does not require exclusion when the evidence is offered for another purpose, such as proving bias or prejudice of a witness, negating a contention of undue delay, or proving an effort to obstruct a criminal investigation or prosecution.¹⁸

When a court must approve a settlement, inclusion of remedial measures increases the attractiveness of the settlement to the judge, who will have additional reason to believe that the settlement protects the interests of the entire class. In addition, including remedial measures in a negotiated settlement agreement provides the employer, who may face internal opposition to major changes to its personnel policies, with justification for those changes. Consent decrees also provide an opportunity for an employer to undertake remedial measures.

III. Conclusion and Recommendations

A. Corrective Action

It is important to note that the audit report will usually only be the starting point for follow-up actions: It will identify problem areas whose solution will require further review by the employer, often in consultation with counsel. Once an audit has identified areas for improvement, the employer must implement solutions aimed at addressing those areas. In addition, re-auditing may be necessary to ascertain whether solutions proposed for previously

¹⁸ See also Cal. Evid. Code § 1152.

identified problems have succeeded. If solutions are not working, the employer must devise alternative methods for dealing with existing problems.

B. Practical Tips for Conducting an Effective Internal Audit

First and foremost, the auditor must have a thorough understanding of the laws and legal requirements in all of the jurisdictions where the employer has employees, to be able to determine whether the employer has complied with them and where problems exist. For example, federal and state law governing exemptions from overtime differ.

Employers seeking to maintain a privileged internal audit should clearly instruct all participants that the matter is strictly confidential and that they may not discuss it with others, and that the purpose of the audit is to obtain information to obtain legal advice to the company. Employers should consider instructing managers and supervisors not to create written material without discussing it with the designated lead counsel. The employer also should instruct all participants in the internal audit not to hold meetings or discuss the audit with anyone without notifying the designated lead counsel.¹⁹

Witness interviews are a critical component of an effective internal audit. Employers must take care to maintain applicable privileges, handle all witness interviews so as to ensure the candor and credibility of the witness, and avoid the impression that company counsel is representing the employee-witness. The employer should give all witnesses interviewed an Upjohn admonition. *See Upjohn v. United States*, 449 U.S. 383 (1981) (counsel represents company, not individual witness-employee; for purpose of legal advice; keep confidential; requested by senior management; attorney-client privilege applies).

C. Practical Recommendations

In light of the developing case law discussed above, the following are some practical recommendations for employers, to help safeguard against the discoverability of documentation and communications produced as part of a self-audit:

- (1) Assume that all documentation of an internal audit will eventually be discoverable.
- (2) Create written documentation seeking advice of counsel and cite to possible litigation risks and/or clarify that the Company is seeking legal advice.
- (3) Conduct as much of the audit verbally as possible. For example, if instructing human resource representatives regarding what to investigate, do so verbally.
- (4) Review must be at the direction and control of counsel. Consider hiring an outside expert to conduct the investigation, with counsel directing the investigation.

¹⁹ *See, e.g., Lucky Stores*, 803 F. Supp. 359 (N.D. Cal. 1992) (notes taken in compliance training used by plaintiffs as evidence of management's awareness of pattern of discrimination).

- (5) Ensure counsel is involved as early as possible.
- (6) Use outside counsel if possible. Outside counsel appears more objective to third parties and there is less risk of a court finding in-house counsel was wearing his or her "business" hat while conducting the investigation.
- (7) Instruct all employees to cooperate with counsel and to communicate in strictest confidence. Remind employees that the Company, and not its employees, is the attorney's client; therefore, although conversations between employees and counsel are privileged, the Company ultimately decides whether or not to waive the privilege and the privilege belongs to the Company in the case of a conflict of interest.
- (8) Consider conducting a limited sample audit, *i.e.*, audit a small group of employees in a particular unit. Consider creating an initial sample audit that is privileged, and following it with a more extensive audit that may (or may not) be discoverable. The initial audit can be used to help identify the scope of the issues in the subsequent, more comprehensive audit.
- (9) Control documents produced. Maintain the confidentiality of any documents, clearly marking them attorney-client and attorney work product privileged and confidential.
- (10) Take care in how and when the Company implements any changes as a result of the internal audit. Try to do so in small groups of employees, or after a new legal development.
- (11) Make sure management is committed to remedying any problems that are discovered.
- (12) If the Company discovers problems, remedy them immediately and document the remedial action.

By following the above guidelines, and carefully planning the self-audit to preserve the appropriate privileges, employers can conduct necessary self-audits while minimizing the risk that the audit results will be discoverable in later litigation.