

**RESOLUTION ADOPTED BY THE
HOUSE OF DELEGATES
OF THE
AMERICAN BAR ASSOCIATION
AUGUST 7-8, 2006***

RESOLVED, That the American Bar Association supports the preservation of the attorney-client privilege and work product doctrine in connection with audits of company financial statements.

FURTHER RESOLVED, That the American Bar Association urges the Securities and Exchange Commission, the Public Company Accounting Oversight Board, the American Institute of Certified Public Accountants, the legal and accounting professions, and other relevant organizations to adopt standards, policies, practices and procedures and take other appropriate steps to ensure that attorney-client privilege and work product protections are preserved throughout the audit process.

*Note: The Resolution, but not the attached Report, constitutes ABA policy.

REPORT

I. BACKGROUND OF THE TASK FORCE

The American Bar Association established its Task Force on the Attorney-Client Privilege in September 2004, to evaluate issues and recommend policy related to the attorney-client privilege and work-product doctrine.¹ The Task Force has been examining current developments regarding the privilege and work-product doctrine, the circumstances in which governmental agencies and others are asserting the need for privileged and work product protected information, and the extent to which preserving the privilege and work product protections or disclosing privileged information or attorneys' litigation work product in such circumstances harms the public interest. By examining and reporting on these and related issues, the Task Force hopes to inform the public and the legal profession of the importance of the privilege and work-product doctrine, relate each of these principles to the competing demands for access to protected information, and assist the ABA in developing policies that strike the right balance given these competing demands.

The Task Force began its work by identifying a variety of contemporary contexts in which attorney-client confidentiality has come under serious pressure, in light of changes in the law and changes in institutional practices by government agencies and others. The Task Force recognized that initially it would focus on the areas that seem to be producing the greatest tensions on the privilege and work-product doctrine. In light of its charge and its determination regarding the most pressing issues, the Task Force gave notice to the professional community that it would begin by focusing its attention on two substantial practices: (1) requests by prosecutors and government regulators for the production of material protected by the attorney-client privilege and work-product doctrine, and (2) requests by auditors of public companies for the production of material protected by the attorney-client privilege and work-product doctrine.

As part of its ongoing charge, the Task Force has reviewed scholarly articles and applicable law, conducted meetings, held public hearings, and received oral and written testimony from interested persons. These meetings and hearings have produced varied views and considerable information, some of which is noted in this Report and all of which is posted on the Task Force's website, which is located at <http://www.abanet.org/buslaw/attorneyclient>.²

1 Information about the Task Force and relevant materials assembled by it can be found on the Task Force's website: <http://www.abanet.org/buslaw/attorneyclient/home.shtml>.

2 The following is a list of the individuals and groups providing written or oral testimony to the Task Force on February 11, 2005: The American College of Trial Lawyers; David M. Brodsky, Corporate Counsel Consortium; Kenneth W. Gideon, ABA Section of Taxation; Steven K. Hazen, State Bar of California, Business Law Section, Corporations Committee; James W. Conrad, Jr., American Chemistry Council; Paul Rosenzweig, The Heritage Foundation; John Gamino, TXU Corporation; Ursula Weingold, University of St. Thomas School of Law (Minnesota); Brad Brian, ABA Section of

302A

After gathering and analyzing this information, the Task Force submitted a proposed resolution last year to the ABA House of Delegates, known as “Recommendation 111,” which expresses support for the privilege and work product doctrine and opposition to governmental policies that erode these protections. The resolution, which the ABA House of Delegates approved unanimously in August 2005, states as follows:

RESOLVED, that the American Bar Association strongly supports the preservation of the attorney-client privilege and work-product doctrine as essential to maintaining the confidential relationship between client and attorney required to encourage clients to discuss their legal matters fully and candidly with their counsel so as to (1) promote compliance with law through effective counseling, (2) ensure effective advocacy for the client, (3) ensure access to justice and (4) promote the proper and efficient functioning of the American adversary system of justice; and

FURTHER RESOLVED, that the American Bar Association opposes policies, practices and procedures of governmental bodies that have the effect of eroding the attorney-client privilege and work product doctrine and favors policies, practices and procedures that recognize the value of those protections.

FURTHER RESOLVED, that the American Bar Association opposes the routine practice by government officials of seeking to obtain a waiver of the attorney-client privilege or work product doctrine through the grant or denial of any benefit or advantage.

In addition to Recommendation 111, the Task Force also provided the ABA House of Delegates with a detailed Report discussing and analyzing the importance of the attorney-client privilege and the work product doctrine, as well as the various ways in which these protections have been eroded in recent years.³ In the Report, the Task Force detailed the reasons behind the Recommendation. Among other things, the Report demonstrated the overriding public benefit resulting from preservation of client confidentiality, including in the organizational context, and the way such benefit is attained through faithful application of the attorney-client privilege and the attorney

Litigation; United States Chamber of Commerce; The Law Society of Upper Canada; Steven R. Schell, Black Helterling LLP; Paul Rice, American University Washington College of Law; ABA Section of State and Local Government Law; Randolph Braccialarghe, NSU Law Center; and State Bar of California, Standing Committee on Professional Responsibility & Conduct. The following is a list of the individuals and groups providing written or oral testimony to the Task Force on April 21, 2005: Stephen A. Saltzburg, The George Washington School of Law; Susan Hackett, Association of Corporate Counsel; John Beccia III, The Financial Services Roundtable; Jonathan Bach, New York Council of Defense Lawyers; Elizabeth J. Cabraser, Lief, Cabraser, Heimann & Bernstein; Gerald B. Lefcourt, National Association of Criminal Defense Lawyers; Martin S. Kaufman, Atlantic Legal Foundation; W. Wayne Withers, Emerson; State Bar of California, Business Law Section, Corporations Committee; Federation of Defense & Corporate Counsel; and Section of International Law, Ad Hoc Task Force on Money Laundering and Professional Responsibilities.

³ Recommendation 111 and the related Report are available on the Task Force’s website at <http://www.abanet.org/buslaw/attorneyclient/>. The Recommendation, but not the Report, constitutes official ABA policy.

work-product doctrine. The key benefits of these protections identified in the Report can be summarized as follows:

- the protections foster the attorney-client relationship
- the protections encourage client candor
- the protections foster voluntary legal compliance
- the protections promote efficiency in the legal system
- the protections enhance the constitutional right to effective assistance of counsel

While those benefits focus on the role of the attorney, the direct beneficiary is the client. Furthermore, the failure to achieve those benefits has an adverse impact on society in general and the administration of justice in particular.

Recommendation 111 is consistent with a narrower policy adopted by the ABA House of Delegates in August 2004 opposing recent amendments to the Federal Sentencing Guidelines that encourage prosecutors to pressure companies to waive their attorney-client privilege and work product protections during investigations.⁴

Since August 2005, the Task Force has continued its efforts. For example, in an effort to help implement the ABA's August 2005 recommendations, the Task Force prepared a memorandum (the "Revised Memorandum") earlier this year suggesting specific changes to the Justice Department's privilege waiver policy as stated in its 1999 "Holder Memorandum," 2003 "Thompson Memorandum," and 2005 "McCallum Memorandum." The Task Force's "Revised Memorandum" recommends that the Department's policies be modified to (1) prohibit federal prosecutors from demanding, requesting, or encouraging, directly or indirectly, that companies waive their attorney-client privilege or work product protections during investigations, (2) specify the types of factual, non-privileged information that prosecutors may request from companies during investigations as a sign of cooperation, and (3) clarify that any voluntary decision by a company to waive the attorney-client privilege and the work product doctrine shall not be considered when assessing whether the entity provided effective cooperation. Subsequently, on May 2, 2006, ABA President Michael Greco sent a letter to Attorney General Alberto Gonzales urging the Department to revise its waiver policies in accordance with the principles outlined in the Task Force's Revised Memorandum.

4 In August 2004, the ABA adopted Recommendation 303, supporting five specific changes to the then-proposed amendments to the Federal Sentencing Guidelines for Organizations, including amending the Commentary to Section 8C2.5 to state affirmatively that waiver of attorney-client and work product protections "should not be a factor in determining whether a sentencing reduction is warranted for cooperation with the government." Recommendation 303 and the related Report are available at <http://www.abanet.org/poladv/report303.pdf>. The Recommendation, but not the Report, constitutes official ABA policy. After receiving extensive written comments and testimony from the ABA, other organizations, and numerous former senior Justice Department officials, the Sentencing Commission voted unanimously on April 5, 2006, to reverse the 2004 privilege waiver amendment to the Sentencing Guidelines. Unless Congress acts to modify or reverse the change, it will become effective on November 1, 2006.

The Task Force expects to continue its work to develop specific measures in furtherance of the resolutions adopted by the ABA House of Delegates in August 2005. Discussions are underway with representatives of various regulators, which will help guide the Task Force in determining potential solutions to the issues. It has been very gratifying to see lawyers from corporations, the private sector and government all working together in a constructive manner on these critical issues for our justice system.

II. NEED FOR ABA POLICY ON THE ATTORNEY-CLIENT PRIVILEGE AND WORK PRODUCT DOCTRINE IN THE AUDIT CONTEXT

The policy adopted by the ABA in August 2005 that is contained in Recommendation 111 focused mainly on the need to preserve attorney-client privilege and work product protections in the context of federal law enforcement and prosecution, with special emphasis on the practice of certain federal agencies requiring companies to waive these protections during investigations. The policy did not directly address the status of the attorney-client privilege in the audit area. In fact, Section VIII of the Report accompanying Recommendation 111 specifically stated that the Task Force had not yet gathered sufficient information to make recommendations to the House of Delegates in the audit area and would seek to do so in the future. For these reasons, the Task Force believes it is both appropriate and necessary for the ABA to adopt a new resolution that directly addresses erosion of the privilege and the work product doctrine in the context of audits of financial statements. Unless the ABA adopts such a policy, it will be unable to effectively pursue its dialogue and advocacy efforts with federal regulators and the accounting profession.

The current proposed Recommendation and Report were prepared by the Task Force to address issues surrounding the tension between preservation of the fundamental protections of the attorney-client privilege and work product doctrine and the need for reliable financial reporting and effective audits.⁵ The goal of the ABA should be to balance and reconcile these important competing public policies with a view to maintaining these fundamental protections while enabling effective audits of company financial statements. We believe this can be accomplished by defining auditing standards that identify information auditors need to obtain and retain for purposes of the audit in a manner that is entirely consistent with preserving these protections.

The importance of preserving attorney-client privilege and work product protections in the organizational context, as fundamental to our democratic values and system of justice, has been historically recognized in the accounting literature as part of generally accepted auditing standards. The ABA remains staunchly committed to preserving these fundamental values because they help protect the confidentiality of the

5 Not all members of the Task Force endorse every view expressed in this Report, but the Report taken as a whole reflects a consensus of the members of the Task Force. The views expressed in this Report have not been approved by the House of Delegates or Board of Governors of the American Bar Association and, accordingly, should not be considered as representing the policy of the American Bar Association.

attorney-client relationship and the essential candor of communications between client and counsel that are dependent on confidentiality. It is this confidentiality and the resulting candor of communications that permit lawyers to play a crucial role in encouraging legal compliance. The Task Force also is sensitive to the need for auditors to receive the information they reasonably need to conduct an effective audit and provide the reliable and transparent financial reporting upon which the credibility of our financial markets is based. This Report seeks to identify ways in which both goals might be achieved. It does so by identifying the information that we believe may properly be required in connection with an audit without undermining attorney-client and work product protections. It also addresses issues surrounding the extent to which information provided as part of the audit might be protected from further disclosure should that be considered a desirable outcome.

In furtherance of the foregoing objectives, the Task Force believes that it is advantageous for the ABA to adopt current policy that expresses its support for the preservation of the attorney-client privilege and work product doctrine in the audit context and encourages relevant regulatory and industry groups to take steps to ensure that these protections are preserved throughout the audit process. Accordingly, it is submitting the Recommendation and providing this Report to amplify the reasons for the Recommendation and actions the Task Force could take to implement it in cooperation with regulatory authorities and industry groups.

III. EXISTING ABA POLICY ON AUDIT DISCLOSURES

During the period 1975-76, the ABA and the American Institute of Certified Public Accountants (“AICPA”) adopted a policy endorsing a “Statement of Policy” regarding the appropriate scope of the lawyer’s response to the auditor’s request for certain privileged materials during the course of audits, including requests for disclosure of “contingent liabilities” that would violate the attorney-client privilege.⁶ This policy, which is commonly referred to as the “Treaty,” strikes a delicate balance between preserving the benefits arising from attorney-client and work product protections and other potentially competing policy considerations. Preserving this balance has been a hallmark of the interaction between the legal and accounting professions for over 30 years, and rationale for the Treaty remain valid today.

⁶ American Bar Association “Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests,” approved by the ABA Board of Governors in December, 1975, confirmed by the Board of Directors of the American Institute of Certified Public Accountants (“AICPA”) in January, 1976, ratified by the ABA House of Delegates in August 1976, and incorporated by the AICPA in March 1977 into its “Standards of Fieldwork” as Exhibit II of AU Section 337 (“Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments”) simultaneously with issuance of AU Section 9337 (Interpretations of Section 337). These standards and related interpretations have been adopted as interim auditing standards for public companies by the PCAOB in Rule 3200T. As noted below, there has been only one modification of these interpretations as it relates to tax opinions, and then the modification was carefully limited. A copy of the ABA/AICPA policy adopted in 1975-76 is available on the ABA Task Force’s website at <http://www.abanet.org/buslaw/attorneyclient/policies/aicpa.pdf>.

The Preamble to the Treaty explains these important policy considerations in pertinent part as follows:

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

* * * * *

It is also recognized that our legal, political and economic systems depend to an important extent on public confidence in published financial statements. To meet this need the accounting profession must adopt and adhere to standards and procedures that will command confidence in the auditing process. It is not, however, believed necessary, or sound public policy, to intrude upon the confidentiality of the lawyer-client relationship in order to command such confidence. On the contrary, the objective of fair disclosure in financial statements is more likely to be better served by maintaining the integrity of the confidential relationship between lawyer and client, thereby strengthening corporate management's confidence in counsel and encouraging its readiness to seek advice of counsel and to act in accordance with counsel's advice.⁷

IV. AUDITING PRACTICES AFFECTING THE ATTORNEY-CLIENT PRIVILEGE AND WORK PRODUCT DOCTRINE

The collapse of Enron in late 2001 and the disclosure of other corporate and financial irregularities in early 2002 led to enactment of the Sarbanes-Oxley Act of 2002 ("SOX"). Shortly thereafter, the government caused an indictment to be filed against Arthur Andersen, a prominent accounting firm, in connection with the Enron matter and that firm ultimately ceased providing professional services. SOX created the PCAOB and charged it with authority, among other things, to inspect the performance of auditors and issue reports on those inspections. At the same time, civil liability claims against auditing firms and resulting settlements and judgments have continued to escalate. The combination of these factors has had a direct impact on the relationship between corporations and their auditors and, in turn, on the attorney-client relationship and related protections in a number of ways regularly identified by corporations and their internal and external counsel, including the following:

⁷ Preamble to ABA "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests".

- auditor requests for a much broader range of documents in the possession of the audited company, often in the view of the client with limited relevance of the requested documents to the audit;
- auditor requests for documents covered by the protections notwithstanding other possible sources of the relevant information or other potential ways of satisfying audit needs;
- departures from the Treaty and an increase in non-standard requests;
- expansive treatment of documents in the files of an audited company as being “audit documentation”/“work papers” even though it is not clear that they actually document the audit process; and
- efforts to review protected materials not necessary for the audit of the financial statements in order to provide the internal controls certification required under SOX Section 404.

Auditors have sometimes pointed to the regulatory requirements of the PCAOB and the SEC as justification for these actions; in the view of many knowledgeable observers, this claimed justification is unwarranted.

V. EXAMPLES OF POTENTIAL IMPLEMENTATION ACTIONS

The Task Force believes that adoption of the Recommendation as official policy of the ABA will facilitate efforts of the Task Force to initiate dialogues with appropriate regulatory authorities, including the SEC, the PCAOB and the AICPA, as well as with representatives of the accounting profession with a goal of resolving the issues associated with preservation of the protections in the audit context.

In the Task Force’s view, these regulatory authorities could substantially alleviate those issues by making clear what information auditors need, and more importantly do not need, for the proper conduct of the audit. This clarification would reaffirm the importance of the fundamental policy of preserving attorney-client privilege and work product protections as a priority and outline carefully the information that can properly be sought and still be consistent with preservation of these protections. The clarification could consist of both general principles, such as reaffirmation of the primacy of the protections, and specific guidance. We identify several areas in this Section of the Report to illustrate how this might work, beginning with one that auditing standards have already addressed and can serve as a model if properly applied. These are provided solely as examples and not as positions adopted by the Task Force, much less recommended for adoption as specific policies of the ABA.⁸

⁸ If adopted, only the Recommendation supported by this Report, not the Report itself and thus not the examples provided, will constitute official ABA policy.

The Task Force begins with the position, supported by several existing ABA policies, that preservation of the protections is vitally important. Thus, the circumstances for permitting information to be obtained that might implicate the attorney-client privilege or work product protections should be strictly limited to those where it is clearly necessary for purposes of the audit and not those where it merely would be convenient or would provide additional confirmation or comfort. In general terms, those circumstances should be limited to factual information that is not available from other sources or, solely when relied on by the client to justify its financial reporting position, applicable legal advice and opinions.

A. Tax Advice and Opinions

AICPA Standard of Field Work AU Section 9326.22 specifies that “[i]f the client’s support for the tax accrual of matters affecting it, including tax contingencies, is based upon 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.”⁹ In contrast to this measured approach, some accounting firms are reported to take the position that *all advice or opinions* received by the entity from outside tax advisors regarding the entity’s tax accounts or matters affecting such accounts or the related financial statements disclosures should be reviewed and retained. As a result, in the view of many, these accounting firms are requesting protected information unnecessarily. At least one accounting firm justifies its position on the grounds that use of the word “should” in the quoted text “is to be interpreted consistently with its use in [PCAOB] Rule 3101,” and that “it is mandatory that we obtain copies of opinions or advice provided by our client’s outside tax advisors.” Another firm justifies the position as required by AU Section 339 dealing with audit documentation.

In our judgment, that position is not supported by AU Section 9326.22 because it ignores its predicate condition that, before the opinion should be sought, the company must base its support for its tax position upon the opinion of counsel. It is only when the company seeks to justify its tax position on counsel’s opinion that the standard calls for the auditor to have access to the opinion. Furthermore, the conclusion reached from use of the word “should” is not necessarily supported by Rule 3101, which actually provides that use of the word “should” means that the auditor must follow the procedure “*unless* the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objective of the standard.”¹⁰ Indeed, AU Section 9326.22 specifically provides that the “audit documentation” retained by the auditor “*should include either the actual advice or opinions rendered by an outside advisor, or other sufficient documentation or abstracts supporting both the transaction or facts addressed, as well as the analysis and conclusions reached by the client and advisor.*”¹¹ The

9 Emphasis added. AU Section 9326 provides interpretations (in Q&A format) of AICPA AU 326. See note 18 and related text.

10 Rule 3101(A)(2).

11 Emphasis added.

interpretation goes on to state that “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.”¹² The term “evidential matter” refers to “underlying accounting data and all corroborating information available to the auditor.”¹³ The justification based on audit documentation is discussed further below in Section E.

Thus, in the area of tax advice and opinions of counsel, auditor’s requests should be limited to those circumstances in which the opinion or advice is asserted by the company as the basis for its tax position. In most circumstances, however, we believe it will be possible for the company to produce materials satisfying audit requirements that disclose the factual and legal bases for the tax position taken by the company without the need for inquiry by the auditor into the advice or opinion of counsel.¹⁴

B. Litigation Reserves

Litigation reserves represent the client’s quantification for financial reporting purposes of its loss contingencies. The quantification may be based upon a number of factors, one of which may be advice or assessments from counsel. Loss contingencies are the subject matter of the Treaty, which addresses the information counsel is to provide to the auditor in a manner that does not impair the attorney-client privilege and work product protections. This carefully constructed framework should not be undermined by the auditor’s seeking from the client protected information that, in conformity with the Treaty, is *not* to be obtained from counsel.

An exception to this principle could be made, similar to the tax opinion situation, if the client seeks to support its litigation reserve by reference to the opinion or assessment of counsel. That situation is not inconsistent with preserving the protections because, as has been recognized in other contexts, the client cannot both assert reliance on the advice of counsel and seek to protect that advice from disclosure.

It is important that all parties involved in the audit process recognize that factual information relevant to determining the proper amount of the reserve is not the subject of the protections and therefore should not be withheld by the company from its auditor, even if the factual information was compiled by counsel.

Furthermore, an auditor in appropriate circumstances may, if necessary, seek confirmation from the client that the client’s position on the litigation reserve is not inconsistent with the advice of its counsel.

¹² *Id.*

¹³ AU Section 326.15.

¹⁴ Tax advice and tax opinions inherently involve legal analysis and determinations intended to be covered by the protections. These protections are essential to permit taxpayers to receive effective tax advice and to have the benefits of an adversarial system in controversies with the government. Moreover, tax matters are uniquely within the expertise of accounting firms, thus reducing their need to obtain protected analyses of counsel.

Under these procedures, we believe that auditors can effectively audit client litigation reserves without encroaching on the protections.

C. Environmental Contingencies/Conditional Asset Retirement

Environmental contingencies, including those involving the future obligation to retire assets covered by FAS No. 143 and Interpretation No. 47, may involve considerations similar to those with respect to tax matters. Questions relating to the proper accounting for environmental contingencies can involve legal determinations, such as whether environmental laws require remediation or taking an asset out of service and the expected timing of such actions.

Consistent with the treatment of tax opinions, counsel's assessment of these matters would properly be sought by the auditor only if the client justifies its position on the contingency by use of counsel's advice. Other sources of confirmation, such as engineering analysis and the like, may be available to support the position. Also, factual information, such as environmental, as opposed to legal, assessments should be available to the auditor. As with other situations, the auditor may seek confirmation from the client that its position is not inconsistent with the advice of counsel.

D. Internal Investigations

Internal investigations provide special problems, in part because of the responsibilities imposed on the auditor under Section 10A of the Exchange Act and in part because of the potential relevance to the adequacy of the client's internal controls. However, procedures among companies, counsel and auditors have evolved that enable the auditor to obtain the information it needs for verification while preserving the attorney-client privilege and work product protections. For example, auditors can be provided with summaries of the factual information that has been developed, including access to transcripts of interviews that are not otherwise protected. We do not believe, however, that the auditor should have access to the investigating counsel's notes of interviews, legal assessments or legal advice to the client. The requirement by auditors that any of those materials generated by counsel be shared with it would unnecessarily impede the ability of counsel fully to investigate, report and advise the corporate client and potentially would interfere with and weaken the ability of corporations to engage in self-policing. Instead, we suggest that the auditor can rely on investigating counsel's provision of non-protected materials and its assurance, as contemplated by the Treaty, that counsel fulfills its professional responsibility in advising the client with respect to its disclosure obligations.

We believe that recognition of these procedures in auditing standards would (i) provide comfort to the auditor that it is following proper procedures, (ii) confirm to users of financial statements that following these procedures does not constitute inadequate auditing, and (iii) assist companies in resisting unnecessary requests that

could impair the protections and undermine the ability to conduct effective internal investigations.

E. Clarification of “Audit Documentation”

For the most part, issues concerning the attorney-client privilege and work product protections arise in audit-related matters in the context of furnishing documents to the auditor. Those documents might include letters, e-mails, faxes, legal opinions, and the like.

The PCAOB adopted Auditing Standard No. 3, “Audit Documentation,” to address documentation requirements.¹⁵ It subsequently adopted Rule 3101, providing definitions of certain terms used in Auditing Standard No. 3 and other auditing and related professional practice standards.¹⁶ As the Board indicated in its press release announcing Auditing Standard No. 3, its principal objective was to require “that auditors document procedures performed, evidence obtained, and conclusions reached.”¹⁷ Unfortunately, some have interpreted Auditing Standard No. 3 to establish new substantive documentation requirements. The PCAOB should clarify that Auditing Standard No. 3 does not establish the information required for an audit, but rather addresses the need to document the audit process and preserve that documentation, in part to support the PCAOB’s inspection process of audit work.

In this connection, documents evidencing advice of counsel to the audited company would not themselves appear to constitute “procedures performed, evidence obtained, and conclusions reached” by the auditor merely because they exist and may be used by the client in connection with the preparation of, as opposed to support for, its financial statements. Rather, the documents appear only to constitute “evidence obtained” to support the audit and, therefore, would be limited only to those appropriately obtained by the auditor as an integral part of the audit.

AICPA Standard of Field Work AU Section 326, Evidential Matter provides that “evidential matter supporting the financial statements consists of the underlying *accounting data* and all corroborating information *available* to the auditor.”¹⁸ In auditing literature, “audit documentation” is also frequently referred to as “audit work papers.” The “evidence obtained” thus does not appear to include documents prepared by others that might be used by the company in connection with presenting the components of the financial statement unless it was needed by the auditor as “corroborating information.” The PCAOB could appropriately clarify that the purpose of audit standards with respect to “audit documentation”/“audit work papers” is to preserve evidence of work done by

15 Public Company Accounting Oversight Board Bylaws and Rules – Standards – AS No. 3, as approved in SEC Release No. 34-50253; File No. PCALB-2004-05, August 25, 2004.

16 Public Company Accounting Oversight Board Bylaws and Rules – Professional Standard, as approved pursuant to SEC Release No. 34-50031; File No. Board-2004-06, September 8, 2004.

17 Board Release No. 2004-006, at p. 4.

18 AU Section 326, issued August 1980, at par. 5.

302A

the auditors, rather than to preserve the work of others that may have been used by the audited company but are not appropriately considered to be “corroborating information.”

F. Confirmation of Continued Application of the Treaty

The Treaty has worked well for 30 years as a practical approach to preserving attorney-client privilege and work product protections in the context of communications between lawyers and auditors of companies. At the same time, the Treaty makes clear that it does not eliminate the professional responsibility of lawyers to advise their clients with respect to the client’s disclosure obligations, which responsibility encompasses the client’s disclosure to its auditors and through them to the investing public. This underpinning of the Treaty is even more valid today in the wake of SOX and the SEC’s rules governing attorney professional conduct than it was when the Treaty was adopted. As such, the Treaty and the interpretations relating to it are key elements in recognizing the fundamental importance of the protections.

Because of the importance of the protections as a fundamental public policy matter, the PCAOB could issue a statement confirming the integrity and continuing application of the Treaty, including clarification that nothing contained in Auditing Standard No. 3 or Rule 3101 is intended to negate the provisions of the Treaty. The PCAOB also could issue a statement explicitly reaffirming that the principles of confidentiality recognized in the AICPA interpretations that have been adopted by the PCAOB as interim auditing standards are fundamental values entitled to respect.

G. Auditor Safe Harbor

Many have pointed to excessive exposure to extensive civil liability as a prime source of auditor requests for information beyond that necessary for the audit and as a significant impediment to restoring the proper balance in audit procedures to recognize the overriding importance of the attorney-client privilege and work product protections.

The SEC’s Advisory Committee on Smaller Public Companies in its final report dated April 23, 2006¹⁹ noted the impact on smaller public companies of the diminished use of professional judgment by auditors due in part to fear of second-guessing by regulators and litigants. To combat this, it recommended development of a safe harbor protocol for accounting for transactions that would protect well-intentioned preparers of financial statements from regulatory or legal action when the process is appropriately followed and results in an accounting conclusion that has a reasonable basis.

The Task Force supports continued attention to this issue and a detailed examination of whether it would be appropriate to develop such a safe harbor as a means of enabling auditors to follow auditing procedures that recognize the overriding importance of the protections with confidence that their doing so will not be second guessed.

¹⁹ Available at www.sec.gov/info/smallbns/acspc.shtml.

VI. CONFIDENTIALITY OF DISCLOSED INFORMATION

The foregoing approaches would define the limited circumstance under which information implicating the attorney-client privilege and work product protections could be requested by the auditor. That definition is essential to preserving the protections as historically recognized in the auditing standards. A separate question is the extent to which this information, as well as other information that a company may choose to share with the auditors in connection with the audit, will be protected from being accessible by third parties, such as governmental agencies and civil litigants, as a result of that disclosure.

Existing legal principles protect information disclosed to another party as attorney work product if there is a common legal interest between the parties.²⁰ There has been a difference among the courts in whether to recognize the company and the auditors as having a common legal interest so as to protect information shared by the company with its auditors in connection with the audit.²¹ The argument for finding a common interest is stated by the court in *Merrill Lynch* as follows:

[A]ny tension between an auditor and a corporation that arises from the auditor's need to scrutinize and investigate a corporation's records and book-keeping practices simply is not the equivalent of an adversarial relationship contemplated by the work product doctrine. Nor should it be. A business and its auditor can and should be aligned insofar as they both seek to prevent, detect, and root out corporate fraud. Indeed, this is precisely the type of limited alliance that courts should encourage. For example, here Merrill Lynch complied with Deloitte & Touche's request for copies of the internal investigation reports so that the auditors could further assess Merrill Lynch's internal controls, both to inform its audit work and to notify the corporation if there was a deficiency.

Merrill Lynch at 448. The court further stated regarding an auditor's involvement with a company's internal investigation:

[T]he aim should be for corporations to share information with their auditors to facilitate a meaningful review and, ultimately, the availability of more accurate information for the investing public. It is also important to encourage complete disclosure between a company and its auditor, so that auditors are not inadvertently shielded from complete frankness by corporate management, so that they can later claim that they had no knowledge of alleged malfeasance.

20 Another possible basis for protection, on which there is unsettled and conflicting authority, is "limited or selective waiver," especially when information is provided under a confidentiality agreement. For a discussion of these concepts, see Paper prepared by Latham & Watkins LLP on behalf of The Corporate Counsel Consortium (Dec. 22, 2004), available on the Task Force's website (*see* note 1).

21 Compare, e.g., *Medinol, Ltd. v. Boston Scientific Corp.*, 214 F.R.D. 113 (SDNY 2002), with *Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*, 229 F.R.D. 441 (SDNY 2004).

Id. at 449. It also noted that to find the auditor to be an adversary and thus for there to be a waiver of the work product protection “could very well discourage corporations from conducting a critical self-analysis and sharing the fruits of such an inquiry with the appropriate actors.” *Id.*

The argument against finding a common interest, as stated by the court in *Medinol*, is primarily based upon the auditor assuming a public responsibility in providing an independent opinion on the fairness of the company’s financial reports and thus not necessarily having interests that are aligned with those of the company.²² The court also noted that the “common interest” protection normally applied only in the context of sharing work product in connection with litigation.

If there is to be reliable protection in place for information shared by a company with its auditors in connection with an audit, the differences among the courts would need to be resolved because “an uncertain privilege . . . is little better than no privilege at all.”²³ The Task Force is not recommending at this time that the ABA take a position on the common interest issue. However, the Task Force believes that it would be useful for the SEC, the PCAOB, the AICPA and the accounting profession to examine whether those uncertainties should be eliminated in the audit context and ways in which that might be done while still maintaining the privilege and work product protections.

VII. CONCLUSION

For the reasons set forth in this Report, the Task Force respectfully requests the ABA House of Delegates to adopt the proposed resolutions included in the Recommendation.

Respectfully submitted,

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ABA Task Force on Attorney-Client Privilege

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²² See *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).

²³ See *Upjohn Co. v. U.S.*, 449 U.S. 383, 393 (1981).