ABA Section of Business Law
Audit Response Letters in the New Environment
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Stanley Keller, Chair

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Committee on Audit Inquiry Responses

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STATEMENT OF POLICY

AMERICAN BAR ASSOCIATION

Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information

Preamble

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.

Both the Code of Professional Responsibility and the cases applying the evidentiary privilege recognize that the privilege against disclosure can be knowingly and voluntarily waived by the client. It is equally clear that disclosure to a third party may result in loss of the "confidentiality" essential to maintain the privilege. Disclosure to a third party of the lawyer-client communication on a particular subject may also destroy the privilege as to other communications on that subject. Thus, the mere disclosure by the lawyer to the outside auditor, with due client consent, of the substance of communications between the lawyer and client may significantly impair the client's ability in other contexts to maintain the confidentiality of such communications.

Under the circumstances a policy of audit procedure which requires clients to give consent and authorize lawyers to respond to general inquiries and disclose information to auditors concerning matters which have been communicated in confidence is essentially destructive of free and open communication and early consultation between lawyer and client. The institution of such a policy would inevitably discourage management from discussing potential legal problems with counsel for fear that such discussion might become public and precipitate a loss to or possible liability of the business enterprise and its stockholders that might otherwise never materialize.

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

1 Previously published in The Business Lawyer, Vol. 31, No. 3 (April 1976). Editor’s note: The Board of Governors of the American Bar Association on December 8, 1975, approved the following ABA Statement of Policy. (The Statement had been approved in principle by the Section Council in Montreal in August 1975 and, as revised, in early December 1975.) A Statement on Auditing Standards, which coordinates with the approach set forth in the revised ABA Statement, was approved on January 7, 1976, by the AICPA Auditing Standards Executive Committee. A copy of the ABA Statement of Policy is hereinafter set forth.
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.

Consistent with the foregoing public policy considerations, it is believed appropriate to distinguish between, on the one hand, litigation which is pending or which a third party has manifested to the client a present intention to commence and, on the other hand, other contingencies of a legal nature or having legal aspects. As regards the former category, unquestionably the lawyer representing the client in a litigation matter may be the best source for a description of the claim or claims asserted, the client's position (e.g. denial, contest, etc.), and the client's possible exposure in the litigation (to the extent the lawyer is in a position to do so). As to the latter category, it is submitted that, for the reasons set forth above, it is not in the public interest for the lawyer to be required to respond to general inquiries from auditors concerning possible claims.

It is recognized that the disclosure requirements for enterprises subject to the reporting requirements of the Federal securities laws are a major concern of managements and counsel, as well as auditors. It is submitted that compliance therewith is best assured when clients are afforded maximum encouragement, by protecting lawyer-client confidentiality, freely to consult counsel. Likewise, lawyers must be keenly conscious of the importance of their clients being completely advised in these matters.

Statement of Policy

NOW, THEREFORE, BE IT RESOLVED that it is desirable and in the public interest that this Association adopt the following Statement of Policy regarding the appropriate scope of the lawyer's response to the auditor's request, made by the client at the request of the auditor, for information concerning matters referred to the lawyer during the course of his representation of the client:

(1) **Client Consent to Response.** The lawyer may properly respond to the auditor's requests for information concerning loss contingencies (the term and concept established by Statement of Financial Accounting Standards No. 5, promulgated by the Financial Accounting Standards Board in March 1975 and discussed in Paragraph 5.1 of the accompanying Commentary), to the extent hereinafter set forth, subject to the following:

(a) Assuming that the client's initial letter requesting the lawyer to provide information to the auditor is signed by an agent of the client having apparent authority to make such a request, the lawyer may provide to the auditor information requested, without further consent, unless such information discloses a confidence or a secret or requires an evaluation of a claim.

(b) In the normal case, the initial request letter does not provide the necessary consent to the disclosure of a confidence or secret or to the evaluation of a claim since that consent may only be given after full disclosure to the client of the legal consequences of such action.
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(c) Lawyers should bear in mind, in evaluating claims, that an adverse party may assert that any evaluation of potential liability is an admission.

(d) In securing the client's consent to the disclosure of confidences or secrets, or the evaluation of claims, the lawyer may wish to have a draft of his letter reviewed and approved by the client before releasing it to the auditor; in such cases, additional explanation would in all probability be necessary so that the legal consequences of the consent are fully disclosed to the client.

(2) Limitation on Scope of Response. It is appropriate for the lawyer to set forth in his response, by way of limitation, the scope of his engagement by the client. It is also appropriate for the lawyer to indicate the date as of which information is furnished and to disclaim any undertaking to advise the auditor of changes which may thereafter be brought to the lawyer's attention. Unless the lawyer's response indicates otherwise, (a) it is properly limited to matters which have been given substantive attention by the lawyer in the form of legal consultation and, where appropriate, legal representation since the beginning of the period or periods being reported upon, and (b) if a law firm or a law department, the auditor may assume that the firm or department has endeavored, to the extent believed necessary by the firm or department, to determine from lawyers currently in the firm or department who have performed services for the client since the beginning of the fiscal period under audit whether such services involved substantive attention in the form of legal consultation concerning those loss contingencies referred to in Paragraph 5(a) below but, beyond that, no review has been made of any of the client's transactions or other matters for the purpose of identifying loss contingencies to be described in the response.²

(3) Response May Be Limited to Material Items. In response to an auditor's request for disclosure of loss contingencies of a client, it is appropriate for the lawyer's response to indicate that the response is limited to items which are considered individually or collectively material to the presentation of the client's financial statements.

(4) Limited Responses. Where the lawyer is limiting his response in accordance with this Statement of Policy, his response should so indicate (see Paragraph 8). If in any other respect the lawyer is not undertaking to respond to or comment on particular aspects of the inquiry when responding to the auditor, he should consider advising the auditor that his response is limited, in order to avoid any inference that the lawyer has responded to all aspects; otherwise, he may be assuming a responsibility which he does not intend.

(5) Loss Contingencies. When properly requested by the client, it is appropriate for the lawyer to furnish to the auditor information concerning the following matters if the lawyer has been engaged by the client to represent or advise the client professionally with respect thereto and he has devoted substantive attention to them in the form of legal representation or consultation:

² As contemplated by Paragraph 8 of this Statement of Policy, this sentence is intended to be the subject of incorporation by reference as therein provided.
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(a) overtly threatened or pending litigation, whether or not specified by the client;

(b) a contractually assumed obligation which the client has specifically identified and upon which the client has specifically requested, in the inquiry letter or a supplement thereto, comment to the auditor;

(c) an unasserted possible claim or assessment which the client has specifically identified and upon which the client has specifically requested, in the inquiry letter or a supplement thereto, comment to the auditor.

With respect to clause (a), overtly threatened litigation means that a potential claimant has manifested to the client an awareness of and present intention to assert a possible claim or assessment unless the likelihood of litigation (or of settlement when litigation would normally be avoided) is considered remote. With respect to clause (c), where there has been no manifestation by a potential claimant of an awareness of and present intention to assert a possible claim or assessment, consistent with the considerations and concerns outlined in the Preamble and Paragraph 1 hereof, the client should request the lawyer to furnish information to the auditor only if the client has determined that it is probable that a possible claim will be asserted, that there is a reasonable possibility that the outcome (assuming such assertion) will be unfavorable, and that the resulting liability would be material to the financial condition of the client. Examples of such situations might (depending in each case upon the particular circumstances) include the following: (i) a catastrophe, accident or other similar physical occurrence in which the client's involvement is open and notorious, or (ii) an investigation by a government agency where enforcement proceedings have been instituted or where the likelihood that they will not be instituted is remote, under circumstances where assertion of one or more private claims for redress would normally be expected, or (iii) a public disclosure by the client acknowledging (and thus focusing attention upon) the existence of one or more probable claims arising out of an event or circumstance. In assessing whether or not the assertion of a possible claim is probable, it is expected that the client would normally employ, by reason of the inherent uncertainties involved and insufficiency of available data, concepts parallel to those used by the lawyer (discussed below) in assessing whether or not an unfavorable outcome is probable; thus, assertion of a possible claim would be considered probable only when the prospects of its being asserted seem reasonably certain (i.e., supported by extrinsic evidence strong enough to establish a presumption that it will happen) and the prospects of non-assertion seems slight.

It would not be appropriate, however, for the lawyer to be requested to furnish information in response to an inquiry letter or supplement thereto if it appears that (a) the client has been required to specify unasserted possible claims without regard to the standard suggested in the preceding paragraph, or (b) the client has been required to specify all or substantially all unasserted possible claims as to which legal advice may have been obtained, since, in either case, such a request would be in substance a general inquiry and would be inconsistent with the intent of this Statement of Policy.

The information that lawyers may properly give to the auditor concerning the foregoing matters would include (to the extent appropriate) an identification of the proceedings or matter, the stage of proceedings, the claim(s) asserted, and the position taken by the client.
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In view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either "probable" or "remote;" for purposes of any such judgment it is appropriate to use the following meanings:

(i) probable—(an unfavorable outcome for the client is probable if the prospects of the claimant not succeeding are judged to be extremely doubtful and the prospects for success by the client in its defense are judged to be slight.

(ii) remote—(an unfavorable outcome is remote if the prospects for the client not succeeding in its defense are judged to be extremely doubtful and the prospects of success by the claimant are judged to be slight.

If, in the opinion of the lawyer, considerations within the province of his professional judgment bear on a particular loss contingency to the degree necessary to make an informed judgment, he may in appropriate circumstances communicate to the auditor his view that an unfavorable outcome is "probable" or "remote," applying the above meanings. No inference should be drawn, from the absence of such a judgment, that the client will not prevail.

The lawyer also may be asked to estimate, in dollar terms, the potential amount of loss or range of loss in the event that an unfavorable outcome is not viewed to be "remote." In such a case, the amount or range of potential loss will normally be as inherently impossible to ascertain, with any degree of certainty, as the outcome of the litigation. Therefore, it is appropriate for the lawyer to provide an estimate of the amount or range or potential loss (if the outcome should be unfavorable) only if he believes that the probability of inaccuracy of the estimate of the amount or range of potential loss is slight.

The considerations bearing upon the difficulty in estimating loss (or range of loss) where pending litigation is concerned are obviously even more compelling in the case of unasserted possible claims. In most cases, the lawyer will not be able to provide any such estimate to the auditor.

As indicated in Paragraph 4 hereof, the auditor may assume that all loss contingencies specified by the client in the manner specified in clauses (b) and (c) above have received comment in the response, unless otherwise therein indicated. The lawyer should not be asked, nor need the lawyer undertake, to furnish information to the auditor concerning loss contingencies except as contemplated by this Paragraph 5.

(6) Lawyer's Professional Responsibility. Independent of the scope of his response to the auditor's request for information, the lawyer, depending upon the nature of the matters as to which he is engaged, may have as part of his professional responsibility to his client an obligation to advise the client concerning the need for or advisability of public disclosure of a wide range of events and circumstances. The lawyer has an obligation not knowingly to participate in any violation by the client of the disclosure requirements of the securities laws. The lawyer also may be required under the Code of Professional Responsibility to resign his engagement if his advice concerning disclosures is disregarded by the client. The auditor may properly assume that whenever, in the course of performing legal services for the client with respect to a matter recognized to involve an unasserted possible claim or assessment which may call for
financial statement disclosure, the lawyer has formed a professional conclusion that the client must disclose or consider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure and the applicable requirements\(^3\) of FAS 5.

(7) **Limitation on Use of Response.** Unless otherwise stated in the lawyer's response, it shall be solely for the auditor's information in connection with his audit of the financial condition of the client and is not to be quoted in whole or in part or otherwise referred to in any financial statements of the client or related documents, nor is it to be filed with any governmental agency or other person, without the lawyer's prior written consent.\(^4\) Notwithstanding such limitation, the response can properly be furnished to others in compliance with court process or when necessary in order to defend the auditor against a challenge of the audit by the client or a regulatory agency, provided that the lawyer is given written notice of the circumstances at least twenty days before the response is so to be furnished to others, or as long in advance as possible if the situation does not permit such period of notice.\(^5\)

(8) **General.** This Statement of Policy, together with the accompanying Commentary (which is an integral part hereof), has been developed for the general guidance of the legal profession. In a particular case, the lawyer may elect to supplement or modify the approach hereby set forth. If desired, this Statement of Policy may be incorporated by reference in the lawyer's response by the following statement: "This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any 'loss contingencies' is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement)."

[The accompanying Commentary is an integral part of this Statement of Policy.]

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\(^3\) Under FAS 5, when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment, disclosure of an unasserted possible claim is required only if the enterprise concludes that (I) it is probable that a claim will be asserted, (ii) there is a reasonable possibility, if the claim is in fact asserted, that the outcome will be unfavorable, and (iii) the liability resulting from such unfavorable outcome would be material to its financial condition.

\(^4\) As contemplated by Paragraph 8 of this Statement of Policy, this sentence is intended to be the subject of incorporation by reference as therein provided.

\(^5\) As contemplated by Paragraph 8 of this Statement of Policy, this sentence is intended to be the subject of incorporation by reference as therein provided.
Commentary to the Statement of Policy

Paragraph 1 (Client Consent to Response)

In responding to any aspect of an auditor's inquiry letter, the lawyer must be guided by his ethical obligations as set forth in the Code of Professional Responsibility. Under Canon 4 of the Code of Professional Responsibility a lawyer is enjoined to preserve the client's confidences (defined as information protected by the attorney-client privilege under applicable law) and the client's secrets (defined as other information gained in the professional relationship that the client has requested be held inviolate or the disclosure of which would be embarrassing or would be likely to be detrimental to the client). The observance of this ethical obligation, in the context of public policy, "... not only facilitates the full development of facts essential to proper representation of the client but also encourages laymen to seek early legal assistance." (Ethical Consideration 4-1).

The lawyer's ethical obligation therefore includes a much broader range of information than that protected by the attorney-client privilege. As stated in Ethical Consideration 4-4: "The attorney-client privilege is more limited than the ethical obligation of a lawyer to guard the confidences and secrets of his client. This ethical precept, unlike the evidentiary privilege, exists without regard to the nature or source of information or the fact that others share the knowledge."

In recognition of this ethical obligation, the lawyer should be careful to disclose fully to his client any confidence, secret or evaluation that is to be revealed to another, including the client's auditor, and to satisfy himself that the officer or agent of a corporate client consenting to the disclosure understands the legal consequences thereof and has authority to provide the required consent.

The law in the area of attorney-client privilege and the impact of statements made in letters to auditors upon that privilege has not yet been developed. Based upon cases treating the attorney-client privilege in other contexts, however, certain generalizations can be made with respect to the possible impact of statements in letters to auditors.

It is now generally accepted that a corporation may claim the attorney-client privilege. Whether the privilege extends beyond the control group of the corporation (a concept found in the existing decisional authority), and if so, how far, is yet unresolved.

If a client discloses to a third party a part of any privileged communication he has made to his attorney, there may have been a waiver as to the whole communication; further, it has been suggested that giving accountants access to privileged statements made to attorneys may waive any privilege as to those statements. Any disclosure of privileged communications relating to a particular subject matter may have the effect of waiving the privilege on other communications with respect to the same subject matter.

To the extent that the lawyer's knowledge of unasserted possible claims is obtained by means of confidential communications from the client, any disclosure thereof might constitute a waiver as fully as if the communication related to pending claims.

A further difficulty arises with respect to requests for evaluation of either pending or unasserted possible claims. It might be argued that any evaluation of a claim, to the extent based upon a confidential communication with the client, waives any privilege with respect to that claim.
COMMENTARY TO THE STATEMENT OF POLICY

Another danger inherent in a lawyer's placing a value on a claim, or estimating the likely result, is that such a statement might be treated as an admission or might be otherwise prejudicial to the client.

The Statement of Policy has been prepared in the expectation that judicial development of the law in the foregoing areas will be such that useful communication between lawyers and auditors in the manner envisaged in the Statement will not prove prejudicial to clients engaged in or threatened with adversary proceedings. If developments occur contrary to this expectation, appropriate review and revision of the Statement of Policy may be necessary.

Paragraph 2 (Limitation on Scope of Response)

In furnishing information to an auditor, the lawyer can properly limit himself to loss contingencies which he is handling on a substantive basis for the client in the form of legal consultation (advice and other attention to matters not in litigation by the lawyer in his professional capacity) or legal representation (counsel of record or other direct professional responsibility for a matter in litigation). Some auditors' inquiries go further and ask for information on matters of which the lawyer "has knowledge." Lawyers are concerned that such a broad request may be deemed to include information coming from a variety of sources including social contact and third-party contacts as well as professional engagement and that the lawyer might be criticized or subjected to liability if some of this information is forgotten at the time of the auditor's request.

It is also believed appropriate to recognize that the lawyer will not necessarily have been authorized to investigate, or have investigated, all legal problems of the client, even when on notice of some facts which might conceivably constitute a legal problem upon exploration and development. Thus, consideration in the form of preliminary or passing advice, or regarding an incomplete or hypothetical state of facts, or where the lawyer has not been requested to give studied attention to the matter in question, would not come within the concept of "substantive attention" and would therefore be excluded. Similarly excluded are matters which may have been mentioned by the client but which are not actually being handled by the lawyer. Paragraph 2 undertakes to deal with these concerns.

Paragraph 2 is also intended to recognize the principle that the appropriate lawyer to respond as to a particular loss contingency is the lawyer having charge of the matter for the client (e.g., the lawyer representing the client in a litigation matter and/or the lawyer having overall charge and supervision of the matter), and that the lawyer not having that kind of role with respect to the matter should not be expected to respond merely because of having become aware of its existence in a general or incidental way.

The internal procedures to be followed by a law firm or law department may vary based on factors such as the scope of the lawyer's engagement and the complexity and magnitude of the client's affairs. Such procedures could, but need not, include use of a docket system to record litigation, consultation with lawyers in the firm or department having principal responsibility for the client's affairs or other procedures which, in light of the cost to the client, are not disproportionate to the anticipated benefit to be derived. Although these procedures may not necessarily identify all matters relevant to the response, the evolution and application of the lawyer's customary procedures should constitute a reasonable basis for the lawyer's response.
As the lawyer's response is limited to matters involving his professional engagement as counsel, such response should not include information concerning the client which the lawyer receives in another role. In particular, a lawyer who is also a director or officer of the client would not include information which he received as a director or officer unless the information was also received (or, absent the dual role, would in the normal course be received) in his capacity as legal counsel in the context of his professional engagement. Where the auditor's request for information is addressed to a law firm as a firm, the law firm may properly assume that its response is not expected to include any information which may have been communicated to the particular individual by reason of his serving in the capacity of director or officer of the client. The question of the individual's duty, in his role as a director or officer, is not here addressed.

**Paragraph 3 (Response May Cover Only Material Items in Certain Cases)**

Paragraph 3 makes it clear that the lawyer may optionally limit his responses to those items which are individually or collectively material to the auditor's inquiry. If the lawyer takes responsibility for making a determination that a matter is not material for the purposes of his response to the audit inquiry, he should make it clear that his response is so limited. The auditor, in such circumstance, should properly be entitled to rely upon the lawyer's response as providing him with the necessary corroboration. It should be emphasized that the employment of inside general counsel by the client should not detract from the acceptability of his response since inside general counsel is as fully bound by the professional obligations and responsibilities contained in the Code of Professional Responsibility as outside counsel. If the audit inquiry sets forth a definition of materiality but the lawyer utilizes a different test of materiality, he should specifically so state. The lawyer may wish to reach an understanding with the auditor concerning the test of materiality to be used in his response, but he need not do so if he assumes responsibility for the criteria used in making materiality determinations. Any such understanding with the auditor should be referred to or set forth in the lawyer's response. In this connection, it is assumed that the test of materiality so agreed upon would not be so low in amount as to result in a disservice to the client and an unreasonable burden on counsel.

**Paragraph 4 (Limited Responses)**

The Statement of Policy is designed to recognize the obligation of the auditor to complete the procedures considered necessary to satisfy himself as to the fair presentation of the company's financial condition and results, in order to render a report which includes an opinion not qualified because of a limitation on the scope of the audit. In this connection, reference is made to SEC Accounting Series Release No. 90, in which it is stated:

"A 'subject to' or 'except for' opinion paragraph in which these phrases refer to the scope of the audit, indicating that the accountant has not been able to satisfy himself on some significant element in the financial statements, is not acceptable in certificates filed with the Commission in connection with the public offering of securities. The 'subject to' qualification is appropriate when the reference is to a middle paragraph or
Paragraph 5 (Loss Contingencies)

Paragraph 5 of the Statement of Policy summarizes the categories of "loss contingencies" about which the lawyer may furnish information to the auditor. The term loss contingencies and the categories relate to concepts of accounting accrual and disclosure specified for the accounting profession in Statement of Financial Accounting Standards No. 5 ("FAS 5") issued by the Financial Accounting Standards Board in March, 1975.

5.1 Accounting Requirements

To understand the significance of the auditor's inquiry and the implications of any response the lawyer may give, the lawyer should be aware of the following accounting concepts and requirements set out in FAS 5:

(a) A "loss contingency" is an existing condition, situation or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more events occur or fail to occur. Resolutions of the uncertainty may confirm the loss or impairment of an asset or the incurrence of a liability.

(b) When a "loss contingency" exists, the likelihood that a future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. There are three areas within that range, defined as follows:

(i) **Probable**—("The future event or events are likely to occur."")
(ii) **Reasonably possible**—("The chance of the future event or events occurring is more than remote but less than likely.""
(iii) **Remote**—("The chance of the future event or events occurring is slight.""

(c) **Accrual** in a client's financial statements by a charge to income of the period will be required if both the following conditions are met.

(i) "Information available prior to issuance of the financial statements indicates that it is **probable** that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be **probable** that one or more future events will occur confirming the fact of the loss." (emphasis added; footnote omitted)
(ii) "The amount of loss can be reasonably estimated."

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1 Citations are to paragraph numbers of FAS 5.
COMMENTARY TO THE STATEMENT OF POLICY

(d) If there is no accrual of the loss contingency in the client's financial statements because one of the two conditions outlined in (c) above are not met, disclosure may be required as provided in the following:

"If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable." (emphasis added; footnote omitted)

(Para. 10)

(e) The accounting requirements recognize or specify that (i) the opinions or views of counsel are not the sole source of evidential matter in making determinations about the accounting recognition or treatment to be given to litigation, and (ii) the fact that the lawyer is not able to express an opinion that the outcome will be favorable does not necessarily require an accrual of a loss. Paragraphs 36 and 37 of FAS 5 state as follows:

"If the underlying cause of the litigation, claim, or assessment is an event occurring before the date of an enterprise's financial statements, the probability of an outcome unfavorable to the enterprise must be assessed to determine whether the condition in paragraph 8(a) is met. Among the factors that should be considered are the nature of the litigation, claim, or assessment, the progress of the case (including progress after the date of the financial statements but before those statements are issued), the opinions or views of legal counsel and other advisers, the experience of the enterprise in similar cases, the experience of other enterprises, and any decision of the enterprise's management as to how the enterprise intends to respond to the lawsuit, claim, or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement). The fact that legal counsel is unable to express an opinion that the outcome will be favorable to the enterprise should not necessarily be interpreted to mean that the condition for accrual of a loss in paragraph 8(a) is met.

"The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of probability of an unfavorable
outcome must be assessed. The condition for accrual in paragraph 8(a) would be met if an unfavorable outcome is determined to be probable. If an unfavorable outcome is determined to be reasonably possible but not probable, or if the amount of loss cannot be reasonably estimated, accrual would be inappropriate, but disclosure would be required by paragraph 10 of this Statement."

(f) Paragraph 38 of FAS 5 focuses on certain examples concerning the determination by the enterprise whether an assertion of an unasserted possible claim may be considered probable:

"With respect to unasserted claims and assessments, an enterprise must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. For example, a catastrophe, accident, or other similar physical occurrence predictably engenders claims for redress, and in such circumstances their assertion may be probable; similarly, an investigation of an enterprise by a governmental agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress, and the probability of their assertion and the possibility of loss should be considered in each case. By way of further example, an enterprise may believe there is a possibility that it has infringed on another enterprise's patent rights, but the enterprise owning the patent rights has not indicated an intention to take any action and has not even indicated an awareness of the possible infringement. In that case, a judgment must first be made as to whether the assertion of a claim is probable. If the judgment is that assertion is not probable, no accrual or disclosure would be required. On the other hand, if the judgment is that assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph 8. If an unfavorable outcome is probable but the amount of loss cannot be reasonably estimated, accrual would not be appropriate, but disclosure would be required by paragraph 10. If an unfavorable outcome is reasonably possible but not probable, disclosure would be required by paragraph 10."

For a more complete presentation of FAS 5, reference is made to the attached Appendix A,2 in which are set forth excerpts selected by the AICPA as relevant to a Statement on Auditing Standards, issued by its Auditing Standards Executive Committee, captioned "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments."

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2 Print version only.
5.2 Lawyer's Response

Concepts of probability inherent in the usage of terms like "probable" or "reasonably possible" or "remote" mean different things in different contexts. Generally, the outcome of, or the loss which may result from, litigation cannot be assessed in any way that is comparable to a statistically or empirically determined concept of "probability" that may be applicable when determining such matters as reserves for warranty obligations or accounts receivable or loan losses when there is a large number of transactions and a substantial body of known historical experience for the enterprise or comparable enterprises. While lawyers are accustomed to counseling clients during the progress of litigation as to the possible amount required for settlement purposes, the estimated risks of the proceedings at particular times and the possible application or establishment of points of law that may be relevant, such advice to the client is not possible at many stages of the litigation and may change dramatically depending upon the development of the proceedings. Lawyers do not generally quantify for clients the "odds" in numerical terms; if they do, the quantification is generally only undertaken in an effort to make meaningful, for limited purposes, a whole host of judgmental factors applicable at a particular time, without any intention to depict "probability" in any statistical, scientific or empirically-grounded sense. Thus, for example, statements that litigation is being defended vigorously and that the client has meritorious defenses do not, and do not purport to, make a statement about the probability of outcome in any measurable sense. Likewise, the "amount" of loss—that is, the total of costs and damages that ultimately might be assessed against a client—will, in most litigation, be a subject of wide possible variance at most stages; it is the rare case where the amount is precise and where the question is whether the client against which claim is made is liable either for all of it or none of it.

In light of the foregoing considerations, it must be concluded that, as a general rule, it should not be anticipated that meaningful quantifications of "probability" of outcome or amount of damages can be given by lawyers in assessing litigation. To provide content to the definitions set forth in Paragraph 5 of the Statement of Policy, this Commentary amplifies the meanings of the terms under discussion, as follows:

"probable"—An unfavorable outcome is normally "probable" if, but only if, investigation, preparation (including development of the factual data and legal research) and progress of the matter have reached a stage where a judgment can be made, taking all relevant factors into account which may affect the outcome, that it is extremely doubtful that the client will prevail.

"remote"—The prospect for an unfavorable outcome appears, at the time, to be slight; i.e., it is extremely doubtful that the client will not prevail. Normally, this would entail the ability to make an unqualified judgment, taking into account all relevant factors which may affect the outcome, that the client may confidently expect to prevail on a motion for summary judgment on all issues due to the clarity of the facts and the law.

In other words, for purposes of the lawyer's response to the request to advise auditors about litigation, an unfavorable outcome will be "probable" only if the chances of the client prevailing appear slight and of the claimant losing appear extremely doubtful; it will be "remote" when the client's chances of losing appear slight and of not
winning appear extremely doubtful. It is, therefore, to be anticipated that, in most situations, an unfavorable outcome will be neither "probable" nor "remote" as defined in the Statement of Policy.

The discussion above about the very limited basis for furnishing judgments about the outcome of litigation applies with even more force to a judgment concerning whether or not the assertion of a claim not yet asserted is "probable." That judgment will infrequently be one within the professional competence of lawyers and therefore the lawyer should not undertake such assessment except where such judgment may become meaningful because of the presence of special circumstances, such as catastrophes, investigations and previous public disclosure as cited in Paragraph 5 of the Statement of Policy, or similar extrinsic evidence relevant to such assessment. Moreover, it is unlikely, absent relative extrinsic evidence, that the client or anyone else will be in a position to make an informed judgment that assertion of a possible claim is "probable" as opposed to "reasonably possible" (in which event disclosure is not required). In light of the legitimate concern that the public interest would not be well served by resolving uncertainties in a way that invites the assertion of claims or otherwise causes unnecessary harm to the client and its stockholders, a decision to treat an unasserted claim as "probable" of assertion should be based only upon compelling judgment.

Consistent with these limitations believed appropriate for the lawyer, he should not represent to the auditor, nor should any inference from his response be drawn, that the unasserted possible claims identified by the client (as contemplated by Paragraph 5(c) of the Statement of Policy) represent all such claims of which the lawyer may be aware or that he necessarily concurs in his client's determination of which unasserted possible claims warrant specification by the client; within proper limits, this determination is one which the client is entitled to make—and should make—and it would be inconsistent with his professional obligations for the lawyer to volunteer information arising from his confidential relationship with his client.

As indicated in Paragraph 5, the lawyer also may be asked to estimate the potential loss (or range) in the event that an unfavorable outcome is not viewed to be "remote." In such a case, the lawyer would provide an estimate only if he believes that the probability of inaccuracy of the estimate of the range or amount is slight. What is meant here is that the estimate of amount of loss presents the same difficulty as assessment of outcome and that the same formulation of "probability" should be used with respect to the determination of estimated loss amounts as should be used with respect to estimating the outcome of the matter.

In special circumstances, with the proper consent of the client, the lawyer may be better able to provide the auditor with information concerning loss contingencies through conferences where there is opportunity for more detailed discussion and interchange. However, the principles set forth in the Statement of Policy and this Commentary are fully applicable to such conferences.

Subsumed throughout this discussion is the ongoing responsibility of the lawyer to assist his client, at the client's request, in complying with the requirements of FAS 5 to the extent such assistance falls within his professional competence. This will continue to involve, to the extent appropriate, privileged discussions with the client to provide a better basis on which the client can make accrual and disclosure determinations in respect of its financial statements.
COMMENTARY TO THE STATEMENT OF POLICY

In addition to the considerations discussed above with respect to the making of any judgment or estimate by the lawyer in his response to the auditor, including with respect to a matter specifically identified by the client, the lawyer should also bear in mind the risk that the furnishing of such a judgment or estimate to any one other than the client might constitute an admission to be otherwise prejudicial to the client's position in its defense against such litigation or claim (see Paragraph 1 of the Statement of Policy and of this Commentary).

Paragraph 6 (Lawyer's Professional Responsibility)

The client must satisfy whatever duties it has relative to timely disclosure, including appropriate disclosure concerning material loss contingencies, and, to the extent such matters are given substantive attention in the form of legal consultation, the lawyer, when his engagement is to advise his client concerning a disclosure obligation, has a responsibility to advise his client concerning its obligations in this regard. Although lawyers who normally confine themselves to a legal specialty such as tax, antitrust, patent or admiralty law, unlike lawyers consulted about SEC or general corporate matters, would not be expected to advise generally concerning the client's disclosure obligations in respect of a matter on which the lawyer is working, the legal specialist should counsel his client with respect to the client's obligations under FAS 5 to the extent contemplated herein. Without regard to legal specialty, the lawyer should be mindful of his professional responsibility to the client described in Paragraph 6 of the Statement of Policy concerning disclosure.

The lawyer's responsibilities with respect to his client's disclosure obligations have been a subject of considerable discussion and there may be, in due course, clarification and further guidance in this regard. In any event, where in the lawyer's view it is clear that (i) the matter is of material importance and seriousness, and (ii) there can be no reasonable doubt that its non-disclosure in the client's financial statements would be a violation of law giving rise to material claims, rejection by the client of his advice to call the matter to the attention of the auditor would almost certainly require the lawyer's withdrawal from employment in accordance with the Code of Professional Responsibility. (See, e.g., Disciplinary Rule 7-102(A)(3) and (7), and Disciplinary Rule 2-110(B)(2).) Withdrawal under such circumstances is obviously undesirable and might present serious problems for the client. Accordingly, in the context of financial accounting and reporting for loss contingencies arising from unasserted claims, the standards for which are contained in FAS 5, clients should be urged to disclose to the auditor information concerning an unasserted possible claim or assessment (not otherwise specifically identified by the client) where in the course of the services performed for the client it has become clear to the lawyer that (i) the client has no reasonable basis to conclude that assertion of the claim is not probable (employing the concepts hereby enunciated) and (ii) given the probability of assertion, disclosure of the loss contingency in the client's financial statements is beyond reasonable dispute required.

Paragraph 7 (Limitation on Use of Response)

Some inquiry letters make specific reference to, and one might infer from others, an intention to quote verbatim or include the substance of the lawyer's reply in footnotes to the client's financial statements. Because the client's prospects in pending litigation
may shift as a result of interim developments, and because the lawyer should have an
opportunity, if quotation is to be made, to review the footnote in full, it would seem
prudent to limit the use of the lawyer's reply letter. Paragraph 7 sets out such a limitation.

Paragraph 7 also recognizes that it may be in the client's interest to protect
information contained in the lawyer's response to the auditor, if and to the extent
possible, against unnecessary further disclosure or use beyond its intended purpose of
informing the auditor. For example, the response may contain information which could
prejudice efforts to negotiate a favorable settlement of a pending litigation described in
the response. The requirement of consent to further disclosure, or of reasonable advance
notice where disclosure may be required by court process or necessary in defense of the
audit, is designed to give the lawyer an opportunity to consult with the client as to
whether consent should be refused or limited or, in the case of legal process or the
auditor's defense of the audit, as to whether steps can and should be taken to challenge
the necessity of further disclosure or to seek protective measures in connection therewith.
It is believed that the suggested standard of twenty days advance notice would normally
be a minimum reasonable time for this purpose.

**Paragraph 8 (General)**

It is reasonable to assume that the Statement of Policy will receive wide
distribution and will be readily available to the accounting profession. Specifically, the
Statement of Policy has been reprinted as Exhibit II to the Statement on Auditing
Standards, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and
Assessments", issued by the Auditing Standards Executive Committee of the American
Institute of Certified Public Accountants. Accordingly, the mechanic for its incorporation
by reference will facilitate lawyer-auditor communication. The incorporation is intended
to include not only limitations, such as those provided by Paragraphs 2 and 7 of the
Statement of Policy, but also the explanatory material set forth in this Commentary.
[Name and Address of Accounting Firm]

Re: [Name of Client] [and Subsidiaries]

Dear Sirs:

By letter dated [insert date of request] Mr. [insert name and title of officer signing request] of [insert the name of client] [(the "Company") or (together with its subsidiaries, the "Company") has requested us to furnish you with certain information in connection with your examination of the accounts of the Company as at [insert fiscal year-end].

[Insert description of the scope of the lawyer's engagement; the following are sample descriptions:]

While this firm represents the Company on a regular basis, our engagement has been limited to specific matters as to which we were consulted by the Company.

[or]

We call your attention to the fact that this firm has during the past year represented the Company only in connection with certain [Federal income tax matters] [litigation] [real estate transactions] [describe other specific matters, as appropriate] and has not been engaged for any other purpose.

Subject to the foregoing and to the last paragraph of this letter, we advise you that since [insert date of beginning of fiscal period under audit] we have not been engaged to give substantive attention to, or represent the Company in connection with, [material]\(^2\) loss contingencies coming within the scope of clause (a) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:

[Describe litigation and claims which fit the foregoing criteria.]

[If the inquiry letter requests information concerning specified unasserted possible claims or assessments and/or contractually assumed obligations:]

With respect to the matters specifically identified in the Company's letter and upon which comment has been specifically requested, as contemplated by clauses (b) or (c) of Paragraph 5 of the ABA Statement of Policy, we advise you, subject to the last paragraph of this letter, as follows:

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1. Illustrative forms of letters for full response by outside practitioner or law firm and inside general counsel for the auditor's inquiry letter. These illustrative forms, which are not part of the Statement of Policy, have been prepared by the Committee on Audit Inquiry Responses solely in order to assist those who may wish to have, for reference purposes, a form of response which incorporates the principles of the Statement of Policy and accompanying Commentary. Other forms of response letters will be appropriate depending on the circumstances.

2. **NOTE:** See Paragraph 3 of the Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.

Auditor's Letter Handbook
[Insert information as appropriate]

The information set forth herein is [as of the date of this letter] [as of [insert date], the date on which we commenced our internal review procedures for purposes of preparing this response], except as otherwise noted, and we disclaim any undertaking to advise you of changes which thereafter may be brought to our attention.

[Insert information with respect to outstanding bills for services and disbursements.]

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy and pursuant to the Company's request, this will confirm as correct the Company's understanding as set forth in its audit inquiry letter to us that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, we, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement.]

Very truly yours,
Illustrative Form of Letter for Use by Inside General Counsel

[Name and Address of Accounting Firm]

Re: [Name of Company] [and Subsidiaries]

Dear Sirs:

As General Counsel\(^3\) of [insert name of client] [(the "Company")], I advise you as follows in connection with your examination of the accounts of the Company as at [insert fiscal year-end].

I call your attention to the fact that as General Counsel\(^4\) for the Company I have general supervision of the Company's legal affairs. [If the general legal supervisory responsibilities of the person signing the letter are limited, set forth here a clear description of those legal matters over which such person exercises general supervision, indicating exceptions to such supervision and situations where primary reliance should be placed on other sources.] In such capacity, I have reviewed litigation and claims threatened or asserted involving the Company and have consulted with outside legal counsel with respect thereto where I have deemed appropriate.

Subject to the foregoing and to the last paragraph of this letter, I advise you that since [insert date of beginning of fiscal period under audit] neither I, nor any of the lawyers over whom I exercise general legal supervision, have given substantive attention to, or represented the Company in connection with, [material]\(^5\) loss contingencies coming within the scope of clause (a) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:

[Describe litigation and claims fit the foregoing criteria.]

[If information concerning specified unasserted possible claims or assessments and/or contractually assumed obligations is to be supplied:]

With respect to matters which have been specifically identified as contemplated by clauses (b) or (c) of Paragraph 5 of the ABA Statement of Policy, I advise you, subject to the last paragraph of this letter, as follows:

[Insert information as appropriate]

The information set forth herein is [as of the date of this letter] [as of [insert date]], the date on which we commenced our internal review procedures for purposes of preparing this response, except as otherwise noted, and I disclaim any undertaking to advise you of changes which thereafter may be brought to my attention or to the attention of the lawyers over whom I exercise general legal supervision.

\(^3\) It may be appropriate in some cases for the response to be given by inside counsel other than inside general counsel in which event this letter should be appropriately modified.

\(^4\) It may be appropriate in some cases for the response to be given by inside counsel other than inside general counsel in which event this letter should be appropriately modified.

\(^5\) NOTE: See Paragraph 3 of the Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.
This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy, this will confirm as correct the Company's understanding that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, I have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, I, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5 [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement.]

Very truly yours,
First Report of the Committee on Audit Inquiry Responses Regarding Initial Implementation of the Statement of Policy

Introductory Analysis and Guides

Following release by the AICPA Auditing Standards Executive Committee in late October 1975 of an Exposure Draft of a proposed Statement on Auditing Standards (as adopted in final form, the "AICPA Statement") dealing with "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," the ABA Committee on Audit Inquiry Responses and a Task Force of the AICPA Committee initiated discussions of the conflicting positions between the Exposure Draft and the previously published position of lawyers on this subject with a view to the development of a mutually acceptable accommodation. By late December, an approach was agreed upon which accommodates, to a considerable degree, the goals of the AICPA Statement and the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (as adopted in final form, including the accompanying Commentary which is an integral part thereof, the "ABA Statement").

To assist lawyers in the initial implementation of the ABA Statement, the following explanations and suggestions may prove helpful. This presentation is not intended to modify in any respect the ABA Statement nor does it constitute an interpretation thereof.

Pending or Threatened Litigation Matters

The AICPA Statement provides that the letter of audit inquiry from client to lawyer include a "list prepared by management (or a request by management that the lawyer prepare a list) that describes and evaluates pending or threatened litigation, claims, and assessments with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of the company in the form of legal consultation or representation." The AICPA Statement also provides that such letter include a "request that the lawyer either furnish... information or comment on those matters as to which his views may differ from those stated by management."

Because most lawyers would prefer to provide their own commentary as opposed to having to weigh the need to point out possible differences in approach to the description of a particular matter, lawyers should encourage their clients to request, in the letter of audit inquiry, that the lawyer prepare the subject list.

In this connection, the lawyer should emphasize to the client the desirability of establishing with the auditor realistic standards of materiality which will not require identification and discussion of insubstantial matters. This will avoid unnecessary waste of time and expense, waivers of the attorney-client privilege and prejudicial admissions.

Unasserted Claims or Assessments

The AICPA Statement provides that the letter of audit inquiry include: (i) a "list prepared by management that describes and evaluates unasserted claims and assessments that management considers to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome, with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of
the company in the form of legal consultation or representation”; (ii) "a statement by the client that the client understands that whenever, in the course of performing legal services for the client with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, the lawyer has formed a professional conclusion that the client should disclose or consider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5; and (iii) "a request that the lawyer confirm [as correct such client] understanding."

In connection with this approach to unasserted possible claims or assessments in audit inquiry letters, the following is important:

(1) Under no circumstances will the lawyer be required to communicate with the auditor concerning the existence or non-existence (i.e., negative assurance) of unasserted possible claims other than those matters specified by the client in the audit inquiry letter under (i) above (see Paragraph 5(c) of the ABA Statement).

Comment: The lawyer should not comment to the auditor concerning unasserted possible claims which have not been listed by management and should not confirm to the auditor the completeness of management's list or the accuracy of management's advice to the auditor concerning its disclosure of all unasserted possible claims advised as necessary by the lawyer (see (3) below). These matters must be worked out between the lawyer and the client, with due regard by the lawyer to his professional obligations (see Paragraph 6 of the ABA Statement).

(2) The lawyer will, however, be requested to confirm to the auditor as correct the client's understanding (set forth in the letter of audit inquiry) that whenever, in the course of performing legal services for the client with respect to a matter recognized to involve an unasserted possible claim or assessment which may call for financial statement disclosure, the lawyer has formed a professional conclusion that the client must disclose or consider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5 (“FAS 5” —see Appendix A to the ABA Statement).

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2 In accounting literature, the customary phraseology is “should disclose.” On the basis of discussions with those knowledgeable on the subject in the course of the preparation of the ABA and AICPA Statements, the Committee understands that, in context, this phrasing means, and is intended to mean, “must disclose” and may properly be so read. In this connection, the Committee has been advised that a prescription in accounting literature that something “should” be done is an admonition that it must be done unless the accountant is prepared to accept the considerable burden of justifying the departure from (generally accepted) standards. In any event the ABA Statement refers only to an understanding with the client based on and limited to this “must disclose” meaning and phraseology.

3 Print version only.
Comment: The lawyer’s obligation to consult with his client concerning unasserted possible claims does not require him to go out of his way to search out or develop facts regarding such possible claims other than those apparent to him from the legal work in which he is engaged or to carry on an investigation of such a matter beyond the point desired by the client when the matter is discussed. The obligation arises when, in the course of his other legal services, the lawyer recognizes a matter to involve an unasserted possible claim or assessment and, on the basis of the information he has derived in performing such services, has formed a professional conclusion that financial statement disclosure must be made or considered by the client.

(3) The client will be requested to confirm to the auditor that the client has disclosed to the auditor all unasserted possible claims that the lawyer has advised are probable of assertion and must be disclosed (as specified in FAS 5).

Comment: The ABA Statement contemplates that such advice will be given where in the course of the legal services performed for the client it has become clear to the lawyer that (i) the client has no reasonable basis to conclude that assertion of the claim is not probable (employing the concepts enunciated in Paragraph 5 of the ABA Statement) and (ii) given the probability of assertion, disclosure of the loss contingency in the client's financial statements is beyond reasonable dispute required.

(4) The auditor will communicate to the lawyer, either by means of the letter of audit inquiry or separately, that the client has given this assurance.

Comment: If the lawyer receives a letter (or other communication) from the auditor concerning management's assurances to the auditor about the advice management has received from its lawyers with respect to unasserted possible claims, but such reported assurances by management are broader or otherwise differ from the statement of this assurance in the AICPA Statement, the lawyer should advise the auditor that his discussion with management concerning legal advice received, and the form of the letter (or other communication), are not in conformity with agreed procedures. As a consequence, the letter (or other communication) should be withdrawn and corrected. The departure from the agreed upon procedures should be discussed with the client immediately to avoid possible violations of these procedures and compromise of the confidentiality of the attorney-client relationship. In this connection, both inside counsel and outside lawyers should urge management to use the exact words of the AICPA Statement in any such letters or other advice given to the auditor. Accordingly, the wording for this communication from the auditor to the lawyer should be:

"We are writing to inform you that (name of Company) has represented to us that (except as set forth below and excluding any matters listed in the letter of audit inquiry) there are no unasserted possible claims that you have advised are probable of assertion and
must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 in its financial statements at (balance sheet date) and for the (period) then ended."

(5) Reliance is placed upon the lawyer's giving consideration to such course of action as may be determined appropriate if the client does not disclose to the auditor an unasserted possible claim where advice to the effect described in (3) above has been given (see Paragraph 6 of the ABA Statement).

Retrieval

It is not intended that the lawyer, in order to respond to the letter of audit inquiry, undertake a fresh review of all matters upon which he has been consulted during the audit period for the purpose of determining whether or not the lawyer can form a view regarding the probability of assertion of any possible claims which might inhere in the matter so considered. In other words, lawyers need not make a review of unasserted possible claims at the time of each audit inquiry letter but can rely on their ongoing procedures to bring these matters to the client's attention as they arise and to identify for their own consideration at the time of the audit inquiry letter those matters as to which they have given advice that disclosure to the auditor is required.

Evaluation of Outcome

As contrasted with prior practice, which permitted a varied approach to evaluation, FAS 5 appears to limit evaluation, for purposes of financial accounting and reporting, to three discrete categories: an unfavorable outcome for the client is either "probable," "reasonably possible" or "remote." These concepts are imprecise and difficult to employ with respect to most legal matters. The ABA Statement examines considerations bearing upon a determination that an unfavorable outcome is "probable" or "remote"; if neither, an unfavorable outcome is, by the process of elimination, "reasonably possible." If the lawyer cannot advise that an unfavorable outcome is "probable" or "remote," he should state that he is unable to form such a judgment. Because of possible prejudice to the client, in terms of admission or waiver of privilege, the lawyer should not advise that an unfavorable outcome is "reasonably possible." The lawyer should give particular attention to the considerations examined in Paragraph 5 of the ABA Statement before expressing a judgment that an unfavorable outcome is either "probable" or "remote."

Estimate of Loss

Under FAS 5, it is necessary that a determination be made whether the amount or range of possible loss can be reasonably estimated—or, in the alternative, that such an estimate cannot be made. The ABA Statement cautions lawyers against undertaking estimates where the likelihood of inaccuracy is other than slight.

Assistance by Lawyer

If the lawyer is unable to conclude that an unfavorable outcome is "probable" or "remote," or to estimate the loss exposure on a pending or threatened claim, he may be able to provide information which may help the auditor, in light of information and views...
received from management and others, to assess the materiality of the matter for purposes of determining the need to qualify the auditor's opinion because of uncertainty. However, caution should be exercised that such information provided by the lawyer does not prejudice the client's defense of the claim, constitute admissions of the client, or impair the lawyer-client confidentiality against the client's interest.

**Lawyer's Procedures**

Lawyers should develop within their firms or legal departments procedures for identifying pending and threatened claims at the time of each audit letter response. They should also assure that all lawyers in the firm or department are alert to the professional responsibilities concerning unasserted possible claims and assessments (referred to above) which are to be met on an ongoing basis throughout the year.

Such procedures should enable them to identify, at the time of each audit inquiry, matters on which advice has been given to the effect that assertion of an unasserted possible claim is probable and its disclosure is required (see item (3) under "Unasserted Claims and Assessments" above). In this connection, the procedures contemplated by the ABA and AICPA Statements are not intended to place new responsibilities upon the lawyer to identify unasserted possible claims and assessments or to make lawyers accountable on "should have known" theories when unasserted possible claims and assessments are not identified; but, once a matter is recognized by the lawyer to involve an unasserted possible claim or assessment which may call for financial statement disclosure, the lawyer should assess whether the matter is one which the client must so disclose or consider for such disclosure.

**Procedures with Client**

Outside counsel should contact and work with inside counsel in respect of audit inquiry letters. Because of the impact of such letters on lawyer-client relationships and the client's legal affairs, they are not, therefore, solely of interest to the client's accounting or controller's department. It is expected that inside counsel will be consulted by the auditors in the selection of the law firms to receive such inquiries and the setting of appropriately realistic materiality standards. Inside counsel will often serve as the appropriate person within the client's organization to contact when outside counsel considers it necessary from time to time to consult on unasserted possible claims. Inside counsel may also be available to discuss with outside counsel specific audit inquiry letter replies which may raise questions of privilege or otherwise present problems of presentation.

**Application of the ABA Statement**

Because the ABA Statement will govern responses to auditors' inquiry letters of all lawyers who so elect (not just the responses of general counsel or lawyers advising with respect to securities law matters on an ongoing basis) (every lawyer who follows the ABA Statement should familiarize himself with Paragraph 6 of the ABA Statement, which discusses the lawyer's professional responsibility to his client to advise the client, in the circumstances outlined in Paragraph 6, concerning disclosure requirements applicable to unasserted possible claims. As may be noted in the illustrative forms of letters (see below), this is a matter of specific confirmation by the lawyer to the auditor.
Illustrative Form of Letter of Audit Inquiry

[Name and Address of Law Firm]

Dear Sirs:

In connection with an examination of the consolidated financial statements of [insert name of client] (the "Company") and its subsidiaries at [insert balance sheet date] and for the [insert fiscal period under audit] then ended, our auditors, [insert name and address of accounting firm], have asked that we request you to furnish them with information concerning certain contingencies involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company and/or any of its subsidiaries. (For your convenience, a list of such subsidiaries is attached.) This request is limited to contingencies which [insert standard of materiality to be used] and they therefore should be considered in connection with our audit.

Pending or Threatened Litigation (Excluding Unasserted Claims)

Please furnish to our auditors details relating to all matters of pending or threatened litigation your firm is handling on our behalf, which meet the standard of materiality stated above, including (1) a description of the nature of each matter, (2) the progress of each matter to date, (3) how the Company has responded or intends to respond (for example, to contest the case vigorously or to seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss. Your response should include matters your firm was handling at [insert balance sheet date] as well as new engagements undertaken during the period from that date to the date of your response.

[If one or more unasserted possible claims or assessments are to be listed in the inquiry letter, include the following paragraph. If not, the following paragraph (and caption heading) should be omitted for the reason that the lawyer should be apprised only that management has advised the auditor

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1 While not intended to be a part of the formal ABA Statement, the Committee on Audit Inquiry Responses has prepared, for the guidance of those concerned with initiating and responding to audit inquiries, sample forms of inquiry and response letters which give effect to the ABA Statement (including its incorporation by reference), the AICPA Statement, the foregoing suggestions and the illustrative letter appended to the AICPA Statement. The sample forms of response are set forth in Annex A to the ABA Statement. The sample form of inquiry is set forth below.

These illustrative forms are provided solely in order to assist those who may wish to have, for reference purposes, a form which implements the procedures and principles under consideration. The form of inquiry is provided to aid those layers (primarily inside counsel) who are actively involved with its preparation; its inclusion is not intended to preempt in any way the auditor, who must be satisfied that the inquiry fulfills applicable audit requirements. While the Committee believes that the illustrative form of inquiry provided comports with the procedures and substantive requirements and limitations set forth in the ABA and AICPA Statements, the election of either the client or the auditor to vary the form of inquiry letter in a manner which is in full compliance with the ABA and AICPA Statements would not preclude the lawyer from responding. Also, other forms of response letters will be appropriate depending on the circumstances.
that management has disclosed to the auditor all unasserted possible claims that the lawyer has advised are probable of assertion and must be disclosed (as specified in FAS 5).]

Unasserted Claims or Assessments

We have informed our auditors that the following unasserted possible claims or assessments, for which you have been engaged and to which you have devoted substantive attention on our behalf in the form of legal consultation or representation, are considered by management to be probable of assertion and which, if asserted, would have at least a reasonable possibility of an unfavorable outcome: [insert information as appropriate; ordinarily, management's information would include: (1) the nature of the matter, (2) how management intends to respond if the claim is asserted, and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss]. Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information including an explanation of those matters as to which your views may differ from those stated.

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment which may call for financial statement disclosure, if you have formed a professional conclusion that we must disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. Please specifically confirm to our auditors that our understanding is correct.

Please specifically identify the nature of and reasons for any limitation on your response.

[The auditor may request the client to inquire about additional specific matters; for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the Company, such as guarantees of indebtedness of others, for which the addressee of the letter of audit inquiry has been engaged and to which such addressee has devoted substantive attention on the client's behalf in the form of legal consultation or representation.]

[The letter may also state: "We have represented to our auditors that there have been disclosed by management to them all unasserted possible claims that you have advised are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 in the financial statements currently under examination." [or] "We have represented to our auditors that there are no unasserted possible claims that you have advised are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 in the financial statements currently under examination."]

Very truly yours,
The State Statement of Policy regarding Lawyers' Responses to Auditors' Request for Information ("ABA Statement of Policy") was officially adopted by the Board of Governors of the American Bar Association on December 8, 1975. The counterpart Statement on Auditing Standards No. 12 ("SAS No. 12"), entitled "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," was adopted by the Auditing Standards Executive Committee of the American Institute of Certified Public Accountants on January 7, 1976, and was generally available to the auditing profession, in printed pamphlet form, by the end of January, 1976. As a result, the new procedures established thereby were not available for implementation until the examination of 1975 financial statements by independent auditors was well under way. Nonetheless, the new procedures of SAS No. 12, and the interfacing ABA Statement of Policy, were adopted and followed by auditors and lawyers during the first half of 1976 to a substantial degree and, on the basis of experience to date, no major difficulties have been encountered.

The ABA Statement of Policy sets forth a detailed explication of the accounting terms and concepts set forth in the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 5 ("FAS 5"), as they apply to litigation, claims, and assessments, and relates them to the audit inquiry procedure. In the framework formulated, the ABA Statement of Policy does represent some modifications of positions traditionally held by lawyers. As a result, some areas of misunderstanding and concern arose during the initial period of implementation. These were addressed, in an initial Committee Report, by the Introductory Analysis and Guides prepared by the Committee (a presentation published in the April 1976 issue of The Business Lawyer (pp. 1737-1745)).

Several additional areas of uncertainty or concern have been brought to the Committee's attention and are the subject of the following comment. The balance of this Report supplements the Introductory Analysis and Guides referred to above. As in the earlier presentation, this Committee Report is not intended to modify in any respect the ABA Statement of Policy nor does it constitute an interpretation thereof.

A LAWYER'S PROFESSIONAL RESPONSIBILITY TO HIS CLIENT WITH RESPECT TO MATTERS RECOGNIZED TO INVOLVE AN UNASSERTED POSSIBLE CLAIM

The last sentence of Paragraph 6 of the ABA Statement of Policy provides as follows:

The auditor may properly assume that whenever, in the course of performing legal services for the client with respect to a matter recognized to involve an unasserted possible claim or assessment which may call for financial statement disclosure, the lawyer has formed a professional conclusion that the client must disclose or consider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will
consult with the client concerning the question of such disclosure and the applicable requirements of FAS 5.

This provision is reflected in the procedures established by SAS No. 12, and lawyers are usually requested in audit inquiry letters to confirm as correct a statement of the client's understanding to the foregoing effect. Concern has been expressed by a number of lawyers that an undertaking to comply with the foregoing standard of professional responsibility, if given by the lawyer, places on him unwarranted and unrealistic obligations in respect of unasserted possible claims. The Committee believes that such concern stems largely from misinterpretation of the above-quoted provision.

By way of preface to a discussion of the intended meaning of certain of the essential terms of this provision, the Committee recognizes that the ABA Statement of Policy was developed for the guidance of the legal profession and does not represent a prescription for lawyer conduct. Accordingly, no lawyer is obliged to enter into an understanding with his client conforming to the ABA Statement of Policy, nor is he obliged to confirm to auditors that such an understanding exists; indeed, if no such undertaking by the lawyer is seriously intended, it would be entirely wrong for the lawyer to do either. In such event, however, the auditor will normally seek some other means of obtaining from the lawyer or others, including other lawyers engaged or employed by the client, corroboration of the information furnished by management concerning unasserted possible claims, in order to satisfy himself concerning compliance by the client with FAS 5. The auditor is in many cases able to obtain the necessary corroboration from the lawyer who advises the client generally concerning disclosure matters.

The Committee also wishes to make clear that any lawyer who confirms an understanding with his client to the foregoing effect, but who does not believe that the above quoted provision is sufficiently clear in delineating the limited scope of his undertaking, is free to clarify this understanding to the client and the auditor in any reasonable manner (for example, see below). In view of the desirability of avoiding differing versions of the same basic undertaking, and recognizing the attendant risks of unintended differences in meaning being derived from differences in wording and phrasing, it is hoped that such ad hoc variations will be found unnecessary or kept to a minimum.

There follows a detailed analysis of the undertaking to comply with the standard of professional responsibility set forth in the last sentence of Paragraph 6 of the ABA Statement of Policy (hereinafter referred to as the "Undertaking"). This analysis does not concern, and is not intended to limit in any way, the lawyer's professional responsibilities discussed in Paragraph 6 of the Commentary to the ABA Statement of Policy, including the lawyer's responsibilities under certain circumstances to withdraw from employment in accordance with the Code of Professional Responsibility.

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2 Whether or not the lawyer confirms to the auditor the client's understanding, a response to a letter of audit inquiry stated to be in accordance with the ABA Statement of Policy permits the auditor to make the assumption set forth in the last sentence of Paragraph 6 thereof (quoted above).

3 Reference is made to Paragraph 4 of the Commentary to the ABA Statement of Policy and to Paragraph 13 of SAS No. 12 concerning a limitation on the scope of the audit, and the effect thereof upon the audit opinion, which may result from a refusal to respond to the audit inquiry.
1. Recognition of Matters Involving an Unasserted Possible Claim

As indicated by the Committee's Introductory Analysis and Guides, the Undertaking does not require the lawyer to go out of his way to search out or develop facts or other information regarding unasserted possible claims which do not otherwise become apparent to him from the legal work for the client for which he was retained and in which he is engaged. The Undertaking was not intended to place new responsibilities on the lawyer to ferret out unasserted possible claims or to make lawyers accountable on "should have known" theories.

The threshold requirement of the Undertaking is a subjective one: Does the lawyer recognize the existence of an unasserted possible claim in connection with a matter upon which he is working and that such claim may call for financial statement disclosure? The lawyer does not commit to the client that he will devote substantive attention to a search for such claims, or that he will recognize those claims which may call for financial statement disclosure, but only that he will not dismiss without consideration an unasserted possible claim if, in fact, he realizes that one is present in connection with the matter or matters with respect to which he is providing legal services to the client and recognizes that it may call for financial statement disclosure.

2. Recognition That an Unasserted Possible Claim May Call for Financial Statement Disclosure

The question of recognition by a lawyer that an unasserted possible claim "may call for financial statement disclosure" has apparently proven perplexing to some lawyers, who point out that lawyers are not usually well versed in the field of financial accounting and reporting. By including this element in the "triggering" considerations, it was not intended that the sweep of the Undertaking be expanded. On the contrary, it was included to limit the Undertaking to those matters recognized by the lawyer as having sufficient substance and merit so as to warrant some measure of focused attention, first by the lawyer and, if the lawyer concludes the matter must be brought to the attention of the client, then by the client. The Undertaking does not require the lawyer to bring to the client's attention unasserted possible claims which he regards to be frivolous or otherwise lacking in meaningful substance.

3. Form a Professional Conclusion That the Client Must Consider Disclosing an Unasserted Possible Claim

The Introductory Analysis and Guides also point out that the Undertaking does not require, once an unasserted possible claim is recognized as such and is recognized to be a matter which may call for financial statement disclosure, the lawyer to carry on an investigation by searching out or developing facts and information beyond such as are already available to him from the assigned legal work in which he is engaged. On the contrary, the lawyer's consideration of the matter, vis-à-vis advice (i.e. notification) to the client, is to be based on the facts and information at hand. On the basis of such facts and information, the lawyer must ask himself whether he can form a conclusion, as a lawyer,

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4 As discussed below, the procedure intended for the implementation of the Undertaking does not contemplate that the lawyer assume responsibilities for accounting decisions in the ordinary course.
that there is sufficient likelihood that (i) the unasserted possible claim is probable of assertion, (ii) if asserted, there is a reasonable possibility that the outcome will be unfavorable, and (iii) the unasserted possible claim is material to the client, so that the client must consider whether disclosure of the unasserted possible claim is required. The Undertaking does not require further action on his part unless, on the basis of his existing knowledge, the lawyer concludes the unasserted possible claim recognized by him appears to have a sufficient degree of likelihood of assertion and of materiality to the client and, assuming assertion, appears to have a reasonable possibility of an unfavorable outcome. For example, the Undertaking does not require the lawyer to speculate upon (and bring to the client's attention) the myriad unasserted possible claims which a fertile imagination, given unlimited time and free rein, might conjure up. The lawyer undertakes only to contact the client when, on the basis of the information in his possession, the lawyer has formed a professional conclusion that the client must—i.e., is required to—consider disclosure of the unasserted possible claim which the lawyer has recognized to be such and to be a matter which may call for financial statement disclosure.

4. Advising and Consulting with the Client Concerning an Unasserted Possible Claim

The lawyer's primary obligation to his client with respect to an unasserted possible claim, concluded by him to require consideration by the client for disclosure, is to bring the existence of the matter to the attention of a responsible officer or employee of the client (in many cases, inside counsel may provide a suitable channel of communication) so that the client may deal with the matter in such appropriate manner as the client may determine. The lawyer should satisfy himself that the officer or employee so notified is generally aware of the disclosure requirements of FAS 5 in respect of unasserted possible claims and understands the lawyer's view that the reported claim must be considered by the client in relation to such obligations.

The lawyer should also make clear to the person so notified his willingness, within the limits of his knowledge and training, to consult further with the client, or otherwise assist the client, in the client's consideration of the probability of assertion, the risk of unfavorable outcome, and the materiality to the client of the possible claim. It is likely that, in every case, the lawyer would consult with the client by describing the nature of the possible claim and why the lawyer felt it appropriate to call the matter to the client's attention. If the client also solicits the lawyer's views (such as those bearing on the probability of assertion of the claim or the dimensions of its possible materiality), the lawyer should, of course, consult with the client to the extent he is able to do so. If the lawyer does not normally advise concerning matters of disclosure and may not have sufficient training or experience to do so with confidence, he may note this to the client and offer to make himself available, if the client so desires, to consult with (i) a member of management familiar with financial accounting and reporting who would be in a position to interpret the disclosure requirements of FAS 5 as they relate to the matter at

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5 The client must determine whether or not the assertion of a claim not yet asserted is “probable”; as pointed out in Paragraph 5 of the Commentary to the ABA Statement of Policy, that judgment will infrequently be one within the professional competence of lawyers.
hand, and/or (ii) inside or outside counsel for the client who normally advise the client concerning questions of disclosure.

The lawyer has discharged his responsibilities to the client if he has notified an appropriately responsible officer or employee of the client concerning the existence of the unasserted possible claim which the lawyer has concluded must be considered by the client for disclosure, has satisfied himself that the person so notified understands the need to consider disclosure of such matter in relation to the requirements of FAS 5, and has provided such person with such information or views as the lawyer has on the basis of his professional competence and experience and of his presently available knowledge of the matter. If the client does not request the lawyer to proceed further, the lawyer need not do so, and he has no responsibility with respect to the client's consideration of and conclusions in respect of disclosure of the unasserted possible claim unless the lawyer has advised the client that the lawyer has concluded, as a matter of law, that the unasserted possible claim is probable of assertion and must be disclosed. If the client does not request the lawyer to proceed further, the lawyer need do so—and should do so—only to the extent that he has the professional competence and experience to assist in the client's further consideration of the matter.

5. Form of Advice to Client

There is no requirement that the lawyer advise the client concerning unasserted possible claims in any prescribed manner. Such advice may be oral as well as written. A lawyer may, however, find it useful, recognizing that a question might arise at a later date concerning performance of his undertaking to his client, to have some record of his having brought an unasserted possible claim to the client's attention.

6. Limitations on the Undertaking

The Undertaking, as set out in the illustrative forms of response to the audit inquiry included in Annex A to the ABA Statement of Policy, is couched in terms of the future (i.e., the lawyer "will advise" and "will consult"). While the Undertaking, cast this way, may be appropriate for the lawyer representing the client on a regular basis, it may not make sense for the lawyer retained to act in a limited capacity, such as special counsel in a lawsuit or other matter where there is no expectation on the part of either the client or the lawyer that a relationship will be maintained following its disposition.

In such circumstances, consideration should be given by the client to omitting the Undertaking from the letter of audit inquiry addressed to such lawyer. If the lawyer is requested to confirm the Undertaking, it would be appropriate for him to comment upon the practicality of his future involvement with unasserted possible claims against the client due to the limited scope of his engagement (which may have been completed when the audit inquiry is made).

Depending upon the circumstances, the lawyer may wish to refer back to the description of his engagement or provide other clarifying comment to communicate to the auditor (and his client) special circumstances or considerations bearing upon his confirmation of the Undertaking.

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See Paragraph 6 of the ABA Statement of Policy and of the accompanying Commentary; also see Paragraph 5d of SAS No. 12.
ADVICE CONCERNING DISCLOSURE DOES NOT REQUIRE THE LAWYER TO DETERMINE THE CONTENT OF FINANCIAL STATEMENTS

The ABA Statement of Policy does not require the lawyer to make determinations of what should be included in financial statements or to undertake interpretation of FAS 5 or other accounting requirements. It does recognize, however, that (i) in certain circumstances, as contemplated by the last paragraph of the Commentary to Paragraph 6 of the ABA Statement of Policy, the need for disclosure in the client's financial statements may have become clear to the lawyer and (ii) the lawyer may advise the client concerning the need for disclosure of loss contingencies which are directly relevant to the preparation by the client of its financial statements. A more detailed analysis follows:

1. Legal Advice Concerning Disclosure

As noted in Paragraph 6 of the ABA Statement of Policy, the lawyer may have as a part of his professional engagement the responsibility to advise the client concerning the need for advisability of public disclosure of a wide range of events and circumstances—totally separate and apart from financial statement presentation. The lawyer's role in this regard is not affected by the ABA Statement of Policy. As a practical matter, the initial consideration by such a lawyer of an unasserted possible claim, recognized by him or by another lawyer and referred for his consideration, will in all likelihood be in the context of advising the client concerning timely public disclosure in a press release, periodic report or registration statement filed with the Securities and Exchange Commission or otherwise.

Even lawyers who may not have been engaged to advise concerning public disclosure matters, and may not have sufficient training or experience to do so with confidence, have traditionally advised concerning required disclosure to third parties. For example, such lawyers often have occasion to advise clients on disclosure matters in dealings with third parties, such as governmental agencies, bank lenders or other parties having commercial relationships with the client, where the absence of disclosure would or could give rise to fraud. An unasserted possible claim which such a lawyer recognizes must be considered by the client for financial statement presentation (see discussion above) would, in most instances, involve the same types of matters as he would normally consider, as part of his professional duties, in the context of disclosure to a third party.

In sum, the recognition of an unasserted possible claim, and the consideration of the need for its disclosure (albeit not in the context of financial statement presentation), is a function with which lawyers have some measure of familiarity.

2. Interpretation of FAS 5
The relevant portions of FAS 5 have been made readily accessible to the lawyer by the publication of excerpts of FAS 5 in Appendix A to the ABA Statement of Policy. In addition, many lawyers, by reason of their training and experience, may be in a position to advise a client concerning the requirements of FAS 5. Neither the ABA Statement of Policy nor the professional responsibility undertaking stated in Paragraph 6 thereof, however, contemplates that the lawyer undertake any interpretation of FAS 5 as it may apply to a particular unasserted possible claim. Unless it has become clear to the lawyer that a disclosure in the client's financial statements is beyond reasonable dispute required, such professional responsibility undertaking requires only that the lawyer bring the existence of the matter to the attention of the client, satisfy himself that the client is aware that the matter must be considered in relation to FAS 5, and consult with the client concerning the matter. To the extent desired by the client, the lawyer may also provide such information and views as may be within his possession and competence in order to aid the client in its consideration of the need for disclosure in its financial statements.

3. Disclosure to the Auditor

When the ABA Statement of Policy refers to disclosure, in the context of financial statement presentation, the disclosure which is intended is whether or not the unasserted possible claim must or should be brought to the attention of the auditor by the client. It is not intended that the lawyer make a determination as to the need for the disclosure to be made in the client's financial statements as such, since such a determination is one to be made by the client (subject to review by the auditor). This is equally true with respect to those situations where the lawyer has formed a professional conclusion that the unasserted possible claim is probable of assertion and must be disclosed (i.e., must be disclosed to the auditor). Subject to the auditor's responsibility to evaluate conformity of financial statement presentation with generally accepted accounting principles, it is the client who should properly make the ultimate determination whether or not disclosure of an unasserted possible claim in the financial statements is required by FAS 5, and the client should look to and rely upon the auditor for interpretation of FAS 5. The lawyer's role in advising concerning timely public disclosure, separate and apart from financial statement presentation, should be distinguished; adequate public disclosure may be required, but this may often be accomplished in ways other than or in addition to disclosure in the client's financial statements.

TREATMENT OF PENDING INVESTIGATION INVOLVING A CLIENT WHEN NO CHARGES AGAINST THE CLIENT HAVE BEEN OVERTLY THREATENED

In many cases, the lawyer will have been engaged to represent the client in connection with a governmental investigation involving the client, such as a Federal Grand Jury impaneled to investigate possible antitrust violations or an investigation by the staff of the Securities and Exchange Commission concerning possible violations of the Federal securities laws. Where no charges have been made against the client or with respect to its conduct, such situations do not involve overtly threatened litigation, since
there has not been manifested to the client an awareness of and present intention to assert a possible claim or assessment as contemplated by Paragraph 5(c) of the ABA Statement of Policy; for that reason, doubt has been expressed whether it is proper for the lawyer to describe the matter to the auditor when the client has not specifically requested comment thereon in the inquiry letter.

The Committee believes that, if the client wishes the lawyer to report such investigations and similar matters to the auditor in a manner similar to reports by the lawyer of pending litigation which the lawyer is handling, it would not be improper for the lawyer to do so since a third-party inquiry (which may develop into the assertion of a claim or assessment) already will have been commenced. In most cases, however, the lawyer will not be able to provide any information to the auditor concerning the investigation other than the existence thereof and the fact of the client's involvement. Consideration of the possible assertion of one or more private claims by reason of the investigation, as suggested by Paragraph 5 of the ABA Statement of Policy, would usually be premature until such time as charges stemming therefrom are actually made against the client. Whichever approach is adopted for a particular client—regularly reporting such matters or only reporting those as to which the client has determined the matter to involve an unasserted possible claim considered to be probable of assertion and to have a reasonably possible chance of an adverse result—that approach should be consistently followed with respect to such client until the auditor has been advised of a change in approach.

**AUDIT INQUIRIES AND LAWYERS' RESPONSES DEALING WITH GAIN CONTINGENCIES**

Historically, the auditor's concern, in his inquiry directed to the lawyer, has been limited to contingent liabilities. With the advent of FAS 5, this focus has been upon litigation, claims and assessments which present loss contingencies. In this connection, the Financial Accounting Standards Board continued in effect the provisions of Accounting Research Bulletin No. 50 regarding contingent assets; paragraph 17 of FAS 5 provides:

a) Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization.

b) Adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization.

Given the orientation of the auditing and accounting professions to disclosure considerations as they relate to loss contingencies, the ABA Statement of Policy deals only with the subject of loss contingencies (i.e., litigation, claims and assessments where the client's involvement is as a defendant or prospective defendant). However, footnote 2 to SAS No. 12 does refer to the auditor's procedures with respect to gain contingencies; and, consistent therewith, some auditors have concluded that logic compels a better balanced presentation of contingencies, whether they are loss contingencies or gain contingencies, and have therefore solicited information, in the audit inquiry letter, with
SECOND REPORT

respect to matters in which the lawyer is acting in behalf of the client where the client is either plaintiff or defendant.

When the audit inquiry letter solicits such additional information, it is not improper for the lawyer to respond, but his response should be within the limits established by the ABA Statement of Policy. In this connection, it should be noted that there may be gain contingencies of such a material nature that they should be the subject of disclosure in financial statements and, in some cases, the auditor may conclude it appropriate or necessary to make the audit opinion "subject to" the uncertainty presented by such gain contingency.

August 1976
Report of the Subcommittee on Audit Inquiry Responses

Because of a recent court case and other judicial decisions involving lawyer's responses to auditor's requests for information, an area of uncertainty or concern has been brought to the Subcommittee's attention and is the subject of the following comment:

This Committee's report does not modify the ABA Statement of Policy, nor does it constitute an interpretation thereof. The Preamble to the ABA Statement of Policy states as follows:

Both the Code of Professional Responsibility and the cases applying the evidentiary privilege recognize that the privilege against disclosure can be knowingly and voluntarily waived by the client. It is equally clear that disclosure to a third party may result in loss of the "confidentiality" essential to maintain the privilege. Disclosure to a third party of the lawyer-client communication on a particular subject may also destroy the privilege as to other communications on that subject. Thus, the mere disclosure by the lawyer to the outside auditor, with due client consent, of the substance of communications between the lawyer and client may significantly impair the client's ability in other contexts to maintain the confidentiality of such communications.

Under the circumstances a policy of audit procedure which requires clients to give consent and authorize lawyers to respond to general inquiries and disclose information to auditors concerning matters which have been communicated in confidence is essentially destructive of free and open communication and early consultation between lawyer and client. The institution of such a policy would inevitably discourage management from discussing potential legal problems with counsel for fear that such discussion might come public and precipitate a loss to or possible liability of the business enterprise and its stockholders that might otherwise never materialize.

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.

Paragraph (1) of the ABA Statement of Policy, provides as follows:

(1) Client Consent to Response. The lawyer may properly respond to the auditor's requests for information concerning loss contingencies (the term and concept established by the Statement of Financial Accounting Standards No. 5,
promulgated by the Financial Accounting Standards Board in March 1975 and
discussed in Paragraph 5.1 of the accompanying Commentary), to the extent
hereinafter set forth, subject to the following:

(a) Assuming that the client's initial letter requesting the lawyer to provide
information to the auditor is signed by an agent of the client having apparent
authority to make such a request, the lawyer may provide to the auditor
information requested, without further consent, unless such information discloses
a confidence or a secret or requires an evaluation of a claim.

(b) In the normal case, the initial request letter does not provide the
necessary consent to the disclosure of a confidence or secret or to the evaluation
of a claim since that consent may only be given after full disclosure to the client
of the legal consequences of such action.

(c) Lawyers should bear in mind, in evaluating claims, that an adverse
party may assert that any evaluation of potential liability is an admission.

(d) In securing the client's consent to the disclosure of confidence or
secrets, or the evaluation of claims, the lawyer may wish to have a draft of his
letter reviewed and approved by the client before releasing it to the auditor; in
such cases, additional explanation would in all probability be necessary so that the
legal consequences of the consent are fully disclosed to the client.

In order to preserve explicitly the evidentiary privileges, some lawyers have
suggested that clients include language in the following or substantially similar form:

We do not intend that either our request to you to provide information to
our auditor or your response to our auditor should be construed in any way
to constitute a waiver of the attorney-client privilege or the attorney work-
product privilege.

If client's request letter does not contain language similar to that in the preceding
paragraph, the lawyer's statement that the client has so advised him or her may be based
upon the fact that the client has in fact so advised the lawyer, in writing or orally, in other
communications or in discussions.

For the same reason, the response letter from some lawyers also includes
language in the following or substantially similar form:

The Company [OR OTHER DEFINED TERM] has advised us that, by
making the request set forth in its letter to us, the Company [OR OTHER
DEFINED TERM] does not intend to waive the attorney-client privilege
with respect to any information which the Company [OR OTHER
DEFINED TERM] has furnished to us. Moreover, please be advised that
our response to you should not be construed in any way to constitute a
waiver of the protection of the attorney work-product privilege with
respect to any of our files involving the Company [OR OTHER DEFINED
TERM].
We believe that language similar to the foregoing in the letters of the client or the lawyer simply makes explicit what has always been implicit, namely, it expressly states clearly that neither the client nor the lawyer intended a waiver. It follows that non-inclusion of either or both of the foregoing statements by the client or the lawyer in their respective letters at any time in the past or the future would not constitute an expression of intent to waive the privileges.

On the other hand, the inclusion of such language does not necessarily assure the client that, depending on the facts and circumstances, a waiver may not be found by a court of law to have occurred.

We do not believe that the foregoing types of inclusions cause a negative impact upon the public policy considerations described in the Preamble to the ABA Statement of Policy nor do they intrude upon the arrangements between the legal profession and the accounting profession contemplated by the ABA Statement of Policy. Moreover, we do not believe that such language interferes in any way with the standards and procedures of the accounting profession in the auditing process nor should it be construed as a limitation upon the lawyer's reply to the auditors. We have been informed that the Auditing Standards Board of the AICPA has adopted an interpretation to SAS 12 recognizing the propriety of these statements.

Lawyers, in any case, should be encouraged to have their draft letters to auditors reviewed and approved by the client before releasing them to the auditors and may wish to explain to the client the legal consequences of the client's consent to the lawyer's response as contemplated by sub-paragraph 1(d) of the Statement of Policy.

December, 1989
[Third] Report of the Committee on Law and Accounting  
December 17, 1996

The Committee on Law and Accounting throughout its Subcommittee on Audit Inquiry Responses continues to monitor developments in the format and contents of audit inquiry letters and issues that are raised as a result thereof and the manner in which lawyers respond to such letters.

Recently, the Committee indicated its concern that certain language in audit inquiry letters addressed to lawyers might constitute a waiver of the Attorney-client privilege.

For example, a client might state the following:

We have represented to our auditors that there have been disclosed by Management to them all unasserted possible claims that you have advised are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No.5 in the financial statements currently under examination.

Or:

We have represented to our auditors that there are no unasserted possible claims that you have advised are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 in the financial statements currently under examination.

While it is not entirely clear that a responsive answer to an inquiry letter that employs this particular language would constitute a waiver of the attorney-client privilege in this area, the Committee felt it appropriate and prudent to err on the side of caution. Accordingly, it recommended that the lawyer's responses state the following:

Please be advised that pursuant to clauses (b) and (c) of Paragraph 5 of the ABA Statement of Policy and related Commentary referred to in the last paragraph of this letter, it would be inappropriate for this firm to respond to a general inquiry relating to the existence of unasserted possible claims or assessments involving the company. We can only furnish information concerning those unasserted possible claims or assessments upon which the company has specifically requested, in writing, that we comment nor can we comment upon the adequacy of the company's listing, if any, of unasserted possible claims or assessments or its assertions concerning the advice, if any, about the need to disclose same.

In using this disclaimer language, however, it is important to keep in mind that the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (12/19/75) and the understanding between the legal and accounting professions assumes that the lawyer, under certain circumstances, will advise and consult with the client concerning the client's obligation to make financial statement disclosure with respect to unasserted possible claims or assessments. Paragraph 6 of the ABA
Statement of Policy states this assumption explicitly. Accordingly, confirmation of this understanding should not be omitted.

Annex A to the ABA Statement of Policy contains the following illustrative language with respect to such confirmation in the lawyer's response letter to the auditors:

Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy and pursuant to the Company's request, this will confirm as correct the Company's understanding as set forth in its audit inquiry letter to us that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, we, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such Disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5.¹

Members of the Committee on Law and Accounting expressed their concerns about the attorney-client privilege to, and reviewed the recommendations set forth above with, the Auditing Standards Board of the AICPA. As a result, the Auditing Standards Board has adopted an interpretation to SAS12 accepting and approving the recommended language in the lawyer's response letter as set forth above.

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¹ The foregoing discussion and recommendations were published on page 64 of the September/October 1996 issue of *Business Law Today*. 
The following is a summary of topics raised on the listserv and a synthesis of responses:

- **Non-standard requests**
  - Request to confirm there are no unasserted claims.
    
    *This request is a clear departure from the ABA Statement of Policy which provides for commenting only on unasserted claims specifically identified. Firms universally do not respond to this request. Most firms include an express disclaimer that they are not responding because no claim was specifically identified for comment as contemplated by the ABA Statement of Policy.*
  
  - Request to confirm that all illegal activity of which counsel is aware has been reported to the audit committee and the auditors.
    
    *The request appears to emanate from one major auditing firm. The view of all is that it was not appropriate under the ABA Statement of Policy to respond to this request. Most suggest disclaiming a response expressly (e.g., “we are not responding to your request regarding...because a response would be beyond the scope of responses contemplated by the ABA Statement of Policy”). The experience so far has been that such a response has not resulted in problems.*
  
  - Sometimes, counsel is requested to render traditional opinions regarding such matters as due formation and capitalization (e.g., authorized shares, number and status of issued shares, compliance with securities law registration requirements).
    
    *These opinion requests are often resisted as inappropriate, unnecessary or too costly. In limited circumstances, certain of these requests may be acceptable but they should be handled as any third party opinion with respect to such matters separately from the ABA Statement of Policy.*

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* This report is intended only as a general indication of issues raised and views expressed during the period covered, and should not be considered authoritative for any purpose. It is not intended to be comprehensive either as to the issues raised or the range of views expressed.
• Inside counsel requests

• Standard requests

*It is not unusual for inside counsel to be asked to respond to a standard audit inquiry letter. A form of inside counsel response is included in the ABA Statement of Policy.*

• Management letters

*Inside counsel is sometimes asked to provide a management representations letter to the auditors (either by signing the general letter or a letter targeted to legal matters). Practice in addressing this request varies but it is often sought to be resisted. What is clear is that the nature of the representations and any response need to be carefully considered.*

• Law firm procedures

• Review procedures

*Most firms have in place procedures for handling audit inquiry responses. The procedures vary ranging from promulgation of procedures for checking and forms of response to second attorney or committee review of all audit response letters. Some firms fall in between, requiring review when there are particular issues, such as non-standard requests, or matters being disclosed.*

• Oral responses

*Oral updates tend to be treated with somewhat less formality depending on the situation although the internal review process is typically followed. Oral communications should not go beyond the written response or beyond what is contemplated by the ABA Statement of Policy.*

• Billing practice

*Practice on billing varies, but most seem to record and bill time spent substantively dealing with the response, although this can differ depending on the understanding with the client.*

• Requests related to a former client

*Most firms respond to a request regarding a former client by referring the auditor to successor counsel. There may be limited circumstances when a response related to a former client is appropriate, and firms ordinarily are willing to provide that response. However, absent some other understanding, a firm is entitled to be compensated for the response.*
• **ERISA Plan responses**

> These requests can involve particular issues, especially when the request identifies specific ERISA-related issues for a response. Like other non-standard requests, the general view was that an express disclaimer was desirable. One firm routinely includes a general disclaimer to the effect that it expresses no view as to the plan’s qualification under or operation in compliance with ERISA, the IRC or securities laws.

• **International requests**

> When requests are received identifying IAS No. 10 or the comparable Canadian standard, U.S. lawyers identify their response as being in accordance with the ABA Statement of Policy as contemplated by SAS No. 12 (addressing the subject matter of SFAS No. 5).

• **Litigation assessments**

> The ABA Statement of Policy clearly addresses the response to auditors regarding overtly threatened and pending litigation or specifically identified unasserted claims. It provides that a lawyer should refrain from expressing judgments as to outcome except when an unfavorable outcome is either probable or remote. Similarly, an assessment of potential loss if there is an unfavorable outcome, because of the probability of uncertainty, usually should be avoided. This, of course, does not relieve a lawyer of her responsibility to advise the client regarding its disclosure obligation or to exercise care in providing the client with assessments of the litigation as part of the representation. (The assessment may relate to settlement considerations or to establishment of adequate reserves.) In providing such an assessment, counsel and the client should be mindful of confidentiality and privilege concerns. These concerns can be implicated when the auditor seeks documentary support for the reserves in connection with its audit (see section on “Contingencies” in May 27, 2004 speech of SEC Deputy Chief Accountant Scott Taub). The lawyer also should have in mind SEC Rule 13b2-2(b) under §303 of SOX regarding misleading the auditor depending on the anticipated use of the assessment.

• **SAS 70 reports**

> Some firms have received requests from clients for a SAS 70 report (confirmation by a service provider, such as an out-sourced activity, regarding its control activities as part of a review of the customer’s internal controls). An appropriate response will usually be to state that the firm is not a service provider contemplated by SAS 70.
THE ATTORNEY-CLIENT PRIVILEGE AND WORK PRODUCT
IN THE POST-ENRON ERA

By

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I. PRIVILEGE, WORK PRODUCT AND CONFIDENTIALITY

A. The Attorney-Client Privilege

The attorney-client privilege is one of the oldest common law privileges protecting confidential communications. *Swidler & Berlin v. United States*, 524 U.S. 399, 403 (1998); see also *Wemark v. State*, 602 N.W.2d 810, 815 (Iowa 1999); *Doe v. Maret*, 984 P.2d 980, 982 (Utah 1999). It has now been widely codified. The privilege is intended to “ensure full disclosure by clients who feel safe confiding in their attorney.” *Lane v. Sharp Packaging Sys., Inc.*, 640 N.W.2d 788, 798 (Wis. 2002).


The right to assert the privilege belongs to the client. *OXY Resources Cal. LLC v. Superior Court*, 9 Cal. Rptr. 3d 621, 644-45 (Cal. Ct. App. 2004); *Boyd*, 88 S.W.3d at 213; *Lane*, 640 N.W.2d at 798. The privilege exists for the client’s benefit. *State ex rel. Polytech, Inc. v. Voorhees*, 895 S.W.2d 13, 14 (Mo. 1995). The privilege may be invoked any time during the attorney-client relationship, or after the relationship terminates. As a practical matter, it generally falls to lawyers to raise the privilege on their clients’ behalf.

There is no blanket privilege covering all attorney-client communications. *Wesp v. Everson*, 33 P.3d 191, 197 (Colo. 2001). The privilege must be claimed with respect to each specific communication at issue, and a court called upon to examine a party’s privilege claims must examine each communication independently. Of course, the party asserting the privilege bears the burden of establishing its application to a particular communication. *Id.* at 198. Nonverbal communications may be privileged just as are written and spoken ones. *See, e.g.*, *State v. Meeks*, 666 N.W.2d 859, 868-70 (Wis. 2003) (involving client’s nonverbal communications bearing on competence to stand trial).

A written or electronic communication does not have to be identified as being “privileged” or “confidential” for the attorney-client privilege to attach. *See Chrysler Corp. v. Sheridan*, No. 227511, 2001 WL 773099, at *3 (Mich. Ct. App. July 10, 2001) (involving the inadvertent disclosure of an e-mail that was not identified as “privileged” or “confidential”). On the other side of the coin, a party cannot shield a communication from discovery simply by branding it “confidential” or “privileged.” *Cf. Ledgin v. Blue Cross & Blue Shield of Kan. City*, 166 F.R.D.
496, 499 (D. Kan. 1996) (describing a party’s document stamp of “attorney work product” as a “self-serving embellishment” that did not preclude discovery). The test always is whether a communication satisfies the elements necessary to establish the privilege—not how the communication is identified or labeled.

The attorney-client privilege does not belong just to individuals; a corporation is entitled to assert the attorney-client privilege. *Hertzog, Calamari & Gleason v. Prudential Ins. Co. of Am.,* 850 F. Supp. 255, 255 (S.D.N.Y. 1994); *Shriver v. Baskin-Robbins Ice Cream Co.**, 145 F.R.D. 112, 114 (D. Colo. 1992). So is a partnership. See, e.g., *In re Bieter Co.,* 16 F.3d 929, 935 (8th Cir. 1994) (discussing the applicability of the attorney-client privilege in the partnership context). In the corporate context, the most common privilege problem is determining who among the corporation’s employees speaks on its behalf. Courts have traditionally applied two tests to analyze privilege claims: the “control group” test and the “subject matter” test. A few courts have adopted a third test that closely tracks the subject matter test.

Under the control group test, the communication must be made by an employee who is in a position to control or take a substantial part in the determination of corporate action in response to legal advice for the privilege to attach. Only such employees qualify as the “client” for attorney-client privilege purposes. The control group test essentially requires that the employee with whom an attorney communicates be a member of senior management for the communication to be privileged. The control group test has been severely criticized because of its chilling effect on corporate communications, because it frustrates the very purpose of the privilege by discouraging subordinate employees from communicating important information to corporate counsel, because it makes it difficult for corporate counsel to properly advise their clients and to ensure their clients’ compliance with the law, and because it yields unpredictable results. See *Upjohn Co. v. United States,* 449 U.S. 383, 391-93 (1981). Nonetheless, a few jurisdictions still adhere to this test. See, e.g., *Consolidation Coal Co. v. Bucyrus-Erie Co.,* 432 N.E.2d 250, 256-58 (Ill. 1982).

Under the subject matter test, a communication may be privileged if it is made for the purpose of securing legal advice for the corporation, the employee making the communication does so at a superior’s request or direction, and the employee’s responsibilities include the subject matter of the communication with counsel. The subject matter test also includes a “need to know” element; that is, the communication must not be disseminated beyond those persons who, because of the corporate structure, need to know its contents. See *S. Bell Tel. & Tel. Co. v. Deason,* 632 So. 2d 1377, 1383 (Fla. 1994). The subject matter test has the beneficial effect of allowing employees with direct responsibility for relevant tasks or areas to convey crucial information to counsel in legitimate service to the corporation.

The third test is for all intents and purposes indistinguishable from the subject matter test. This test is commonly referred to as the “modified Harper & Row test,” or the “Diversified Industries test,” after the cases from which it derives, *Harper & Row Publishers, Inc. v. Decker,* 423 F.2d 487 (7th Cir. 1970), and *Diversified Industries, Inc. v. Meredith,* 572 F.2d 596 (8th Cir. 1977). Under this approach, the privilege attaches to an employee’s communication if (1) the communication was made for the purpose of securing legal advice; (2) the employee making the communication did so at the direction of his corporate superior; (3) the superior made the request
so that the corporation could secure legal advice; (4) the subject matter of the communication is within the scope of the employee’s duties; and (5) the communication is not disseminated beyond those persons who, because of the corporate structure, need to know its contents. In re Bieter Co., 16 F.3d at 936 (quoting Diversified Indus., Inc., 572 F.2d at 609).

The modified Harper & Row or Diversified Industries test was crafted as an alternative to the subject matter test to focus more on why the attorney was consulted and to prevent the routine routing of information through counsel to prevent later disclosure. Deason, 632 So. 2d at 1383 n.10. Again, however, this test differs hardly at all—if at all—from the subject matter test in practice.

With respect to partnerships, it is generally the rule that all partners are considered to be the client in all attorney-client communications involving partnership affairs. 1 Paul R. Rice et al., Attorney Client Privilege in the United States § 4.49, at 266 (2d ed. 1999) (discussing general partnerships and distinguishing limited partnerships). Employees of the partnership may serve as its agents for purposes of making privileged communications. Whether a partnership employee’s communications with partnership counsel are in fact privileged is determined by any of the tests applied to corporations. See In re Bieter Co., 16 F.3d at 935-40 (applying modified Harper & Row test in case involving a partnership).


There is much the privilege does not protect. For example, the privilege ordinarily does not protect a client’s identity. United States v. BDO Seidman, 337 F.3d 802, 811 (7th Cir. 2003) (noting, however, that “the identity of a client may be privileged in the rare circumstance when so much of an actual confidential communication has been disclosed already that merely identifying the client will effectively disclose that communication”). Similarly, while the privilege protects the content of an attorney-client communication from disclosure, it does not protect from disclosure the facts communicated. Mackey v. IBP, Inc., 167 F.R.D. 186, 200 (D. Kan. 1996). Nor does the privilege shield from discovery communications generated or received by an attorney acting in some other capacity, or communications in which an attorney is giving business advice rather than legal advice.

The attorney-client privilege certainly is not absolute, and it may be waived either voluntarily or by implication. The burden of establishing a waiver is borne by the party seeking to overcome the privilege. Wesp, 33 P.3d at 198.
B. The Work Product Doctrine

“The attorney-client privilege and the work product doctrine are separate and distinct.” Elkton Care Ctr. Assocs. Ltd. P’ship v. Quality Care Mgmt., Inc., 805 A.2d 1177, 1183 (Md. Ct. Spec. App. 2002). Unlike the attorney-client privilege, which is the client’s to assert, work product immunity is held by the lawyer, OXY Resources, 9 Cal. Rptr. 3d at 645, Clausen, 730 A.2d at 138, although either the lawyer or the client may assert it to avoid discovery. In re Grand Jury Subpoena Duces Tecum, 112 F.3d 910, 924 n.15 (8th Cir. 1997).

The work product doctrine protects lawyers’ effective trial preparation by immunizing certain information and materials from discovery. The doctrine traces its roots to Hickman v. Taylor, 329 U.S. 495 (1947), in which the Supreme Court sought to foreclose unwarranted inquiries into attorneys’ files and mental impressions in the guise of liberal discovery. Id. at 510.

There are two categories or types of attorney work product: “fact” or “ordinary” work product, but better described as “tangible” work product; and “opinion” or “core” work product, sometimes termed “intangible” work product. Tangible work product includes memoranda, notes, witness statements, and the like. To qualify as tangible work product, the material sought to be protected must be a document or tangible thing prepared in anticipation of litigation by or for a party, or by for the party’s representative. Fed R. Civ. P. 26(b)(3). “Opinion” work product refers to an attorney’s conclusions, legal theories, mental impressions, or opinions.

The work product doctrine is codified in Federal Rule of Civil Procedure 26(b)(3) and its state counterparts.

Work product protection is not absolute. A party may discover its adversary’s tangible work product if it demonstrates substantial need of the materials to prepare its case and it is unable without undue hardship to obtain the substantial equivalent of the materials by other means. The discovering party must specifically explain its need for the materials sought. “Undue hardship” generally devolves into an issue of what it will cost the discovering party to obtain the same or comparable information by other means. Whether work product immunity will be abrogated in any particular case typically depends on available alternative sources of the information sought, the parties’ relative resources, and the need to protect the target party’s expectation of confidentiality.

Opinion work product, on the other hand, receives almost absolute protection against discovery. To discover an adversary’s opinion work product a party must demonstrate something far greater than the substantial need and undue hardship necessary to obtain tangible work product. Discovery of opinion work product may be permitted only where the attorneys’ conclusions, mental impressions or opinions are at issue in the case and there is a compelling need for their discovery. See Holmgren v. State Farm Mut. Auto. Ins. Co., 976 F.2d 573, 577 (9th Cir. 1992). A court that allows the discovery of tangible work product must be careful to ensure that it does not also expose to discovery the opinion work product of the lawyer from whom the discovery is sought. LaPorta v. Gloucester County Bd. of Chosen Freeholders, 774 A.2d 545, 548 (N.J. Super. Ct. App. Div. 2001) (quoting Hickman v. Taylor, 329 U.S. 495 (1947)). There is, for example, a significant difference between a witness’s statement and an
attorney’s notes concerning that statement, the latter being opinion work product and therefore strictly protected. *Rico v. Mitsubishi Motors Corp.*, 10 Cal. Rptr. 3d 601, 608 (Cal. Ct. App. 2004) (“While [a witness’s statement] may be discoverable, the [attorney’s notes are] protected from discovery based on [their] derivative or interpretive nature. These materials no longer consist solely of the witness’ statements, but they also expose the attorney’s impressions, including his evaluation of the strengths and weaknesses of the case.”) (footnotes omitted).

A key discovery issue may be whether information claimed to be work product was generated or prepared “in anticipation of litigation.” Unlike the attorney-client privilege, which is not limited to communications made in anticipation of litigation, *In re Tex. Farmers Ins. Exch.*, 990 S.W.2d 337, 340 (Tex. App. 1999), information must be generated or prepared in anticipation of litigation to qualify for protection as work product. *Wichita Eagle & Beacon Pub. Co. v. Simmons*, 50 P.3d 66, 85 (Kan. 2002); *Miller v. J.B. Hunt Transp., Inc.*, 770 A.2d 1288, 1291-93 (N.J. Super. Ct. App. Div. 2001). It is “not necessary that litigation be threatened or imminent, as long as the prospect of litigation is identifiable because of claims that have already arisen.” *Nat'l Tank Co. v. 30th Judicial Dist. Ct.*, 851 S.W.2d 193, 205 (Tex. 1993). Some courts state the “anticipation of litigation” requirement a bit differently, holding that work product immunity attaches only if there is “a substantial probability that litigation will ensue.” *Wichita Eagle & Beacon*, 50 P.3d at 85.

C. Lawyers’ Ethical Duty of Confidentiality

“It is axiomatic that among the highest duties an attorney owes a client is the duty to maintain the confidentiality of client information.” *Commonwealth v. Downey*, 793 N.E.2d 377, 381 (Mass. App. Ct. 2003). Lawyers’ ethical duty to maintain clients’ confidences is found in Rule 1.6(a) of the *Model Rules of Professional Conduct*, which states that a lawyer “shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is authorized to carry out the representation or the disclosure is permitted by [Rule 1.6(b)].” *Model Rules of Prof’l Conduct R. 1.6(a)* (2004) [hereinafter Model Rules]. In those few states still adhering to the *Model Code of Professional Responsibility*, lawyers’ duty of confidentiality is enforced by way of DR 4-101(B)(1), which provides that with few exceptions a lawyer “shall not knowingly . . . reveal a confidence or secret of his client.” *Model Code of Prof’l Responsibility DR 4-101(B)(1)* (1969) (footnote omitted) [hereinafter Model Code]. These rules are intended to encourage clients to trust their attorneys and to be candid with them. See *In re Disciplinary Proceeding Against Schafer*, 66 P.3d 1036, 1041 (Wash. 2003) (discussing Washington version of Rule 1.6).

Lawyers’ duty of confidentiality under Rule 1.6(a) and DR 4-101(B)(1), although not absolute, is very broad. *In re Bryan*, 61 P.3d 641, 656 (Kan. 2003). Any exceptions the rules provide are narrowly limited. *Id.* (discussing Kansas version of Rule 1.6). Lawyers’ duty of confidentiality continues after the conclusion of a representation. *Kala v. Aluminum Smelting & Ref. Co.*, 688 N.E.2d 258, 262 (Ohio 1998).

Rule 1.6 and DR 4-101 (B)(1) prevent the disclosure of information that is neither privileged nor work product. See *In re Gonzalez*, 773 A.2d 1026, 1031 (D.C. 2001) (“An
attorney’s duty of confidentiality applies not only to privileged ‘confidences,’ but also to unprivileged secrets; it ‘exists without regard to the nature or source of the information or the fact that others share the information.’”) (quoting Perillo v. Johnson, 205 F.3d 775, 800 n.9 (5th Cir. 2000)). “Confidential” is not synonymous with “privileged” or “immune.” See Doe v. Md. Bd. of Social Workers, 840 A.2d 744, 749 (Md. Ct. Spec. App. 2004) (stating that information “can be confidential and, at the same time, non-privileged,” and explaining that “privilege” is the legal protection given to certain communications and relationships, while “confidential” describes a type of communication or relationship). Thus, and by way of example, a lawyer’s duty of confidentiality prevents her from revealing a client’s identity or facts a that a client communicates, even though they are not protected by the attorney-client privilege or immune from discovery as work product. Moreover, lawyers are bound by their duty of confidentiality at all times, not only in situations where they face inquiry from others. Lawyer Disciplinary Bd. v. McGraw, 461 S.E.2d 850, 860 (W. Va. 1995).

Lawyers’ duty of confidentiality is especially broad in the many jurisdictions that have enacted versions of Model Rule 1.6(a). In these jurisdictions a lawyer’s duty of confidentiality attaches “not merely to matters communicated in confidence by the client, but also to all information relating to the representation, whatever its source.” State ex rel. Okla. Bar Ass’n v. McGee, 48 P.3d 787, 791 (Okla. 2002). Indeed, a lawyer may breach her duty of confidentiality under Rule 1.6(a) by revealing information that is publicly available. See, e.g., In re Anonymous, 654 N.E.2d 1128, 1129-30 (Ind. 1995) (holding that lawyer violated Rule 1.6(a) by revealing information “readily available from public sources”); McGraw, 461 S.E.2d at 861-62 (“The ethical duty of confidentiality is not nullified by the fact that information is part of a public record or by the fact that someone else is privy to it.”).

II. LOSING THE PRIVILEGE: “LET ME COUNT THE WAYS”

To borrow from a poem by Elizabeth Barrett Browning: “How do I love thee?  Let me count the ways.”

A. Express Waiver by Client or Client’s Lawyer

Clients can waive the privilege voluntarily. Restatement § 78. As to waiver of the work product doctrine, see § 91. The same sections provide that the client’s lawyer can waive the privilege or work product protection. Neither principle is controversial. But see Harold Sampson Children’s Trust v. The Linda Gale Sampson 1979 Trust, 679 N.W.2d 794, 803 (Wis. 2004) (concluding that “a lawyer, without the consent or knowledge of a client, cannot voluntarily waive the attorney-client privilege by voluntarily producing privileged documents (which the attorney does not recognize as privileged) to an opposing attorney in response to a discovery request”).

In the corporate context, a company’s board, in the face of allegations of misconduct, may choose to waive the privilege as a public relations strategy. The Enron board did this in the face of allegations that Enron had been responsible for the California energy fiasco. As a result, several law firms representing Enron saw their communications with and about Enron made

B. Crime/Fraud Finding

If the tribunal finds that at the time of the lawyer-client communication the client was participating in, or planning a fraud or crime, the tribunal can find that there is no privilege protection. RESTATEMENT § 81. As to the work product doctrine, see § 93. The lawyer’s knowledge, or lack thereof, of the misconduct is irrelevant; it is the client’s state of mind that controls. See RESTATEMENT § 81 cmt. c (as to privilege); id. § 93 cmt. c (as to work product). Historically, this has been the most widely used way method of obviating the privilege and work product immunity, and the cases are legion. We will not attempt to explore here the many facets of the cases on crime or fraud. Suffice it to say that if a lawyer is uncomfortable with a given situation, she had better get to the bottom of it, or her entire file may be subject to discovery.

C. Waiver by Trustee/Receiver/Examiner

Trustees in bankruptcy have the power to waive the privilege on behalf of the debtor under Commodity Futures Trading Comm’n v. Weintraub, 471 U.S. 343, 358 (1986).

In the late ‘80s and early ‘90s many banks and thrifts were taken over by regulators, and various agencies became receivers for the institutions. The agencies sued the institutions’ law firms for assisting institutional managers in looting or otherwise harming the institutions. Standing in the shoes of the institutions, the receivers demanded that the law firms turn over their entire files. In the face of a defense by the firms that these files contained privileged materials, the receivers declared that the privilege was waived, and in some cases the courts ruled that the law firms had to turn over everything. The issue, then, was who had control over the failed institution’s attorney-client privilege. In several cases the court said that because the agency was acting in its corporate capacity versus its fiduciary capacity, the agency had no power to assert or waive the privilege. See, e.g., FDIC v. McAtee, 124 F.R.D. 662, 664 (D. Kan. 1988); FDIC v. Amundson, 682 F. Supp. 981, 986-87 (D. Minn. 1988). In other cases the court ruled the agency did have the power. See, e.g., FDIC v. Cherry, Bekaert & Holland, 131 F.R.D. 202, 205 (M.D. Fla. 1990); Odmark v. Westside Bancorp., 636 F. Supp. 552, 554-56 (W.D. Wash. 1986). In several of these cases the court considered whether the receiver had the power to assert the institution’s privilege, the clear implication being that if it had the power to assert it, it had the power to waive it.

A more recent case, in which a different agency, as receiver, succeeded in waiving the privilege and getting the lawyer’s files is Commodity Futures Trading Comm’n v. Standard Forex, 882 F. Supp. 40, 44-45 (E.D.N.Y. 1995).

Even more recently, in the Enron bankruptcy, the court appointed an examiner to investigate whether various persons and entities, including Enron’s law firms, have liability for Enron’s problems. Included in the order appointing the examiner was a provision authorizing the examiner to waive the privilege whenever the examiner felt it appropriate, In re Enron Corp.,
ORDERED that the Examiner shall have the power to waive, on an issue-by-issue basis, the attorney-client privilege of the Debtors’ estates with respect to pre-petition communications relating to matters to be investigated by the Examiner hereunder. In making any such determination, the Examiner shall act in the best interests of the Debtors’ estates after consultation with Debtors and the Committee of Unsecured Creditors preserving the right in the Debtors and the Committee to make prompt objection to the Court on two business days’ notice. Such waiver shall be limited and not a general waiver; . . . .

D. Inadvertent Waiver by Client or Lawyer

This is dealt with in detail at Part III below.

E. Plea Bargain Condition

The Department of Justice has for several years been incorporating into plea agreements and civil penalty settlements a provision providing that the organizational respondent waives its attorney-client privilege. Thus, the organization’s lawyers must turn over to the government their entire files regarding the matter in question. This would, of course, include all E-mails within the law firm, as well as E-mails to and from the client. For a good overview of how the DOJ uses this technique, see John Gibeaut, Junior G-Men, A.B.A. J., June 2003, at 46.

On April 30, 2004, the United States Sentencing Commission submitted to Congress amendments to the Sentencing Guidelines for United States Courts. The Commentary to § 8C2.5 captioned “Application Notes” would be amended in Note 12 by adding the following:

Waiver of attorney-client privilege and of work product protections is not a prerequisite to a reduction in culpability score under subdivisions (1) and (2) of subsection (g) unless such waiver is necessary to provide timely and thorough disclosure of all pertinent information known to the organization.

Thus, federal courts making sentencing decisions may take into account whether the defendant was willing to waive its privilege to assist prosecutors pursue others suspected of wrongdoing. The clear implication for lawyers is that if their organizational clients are engaged in wrongdoing, they may have to reveal all to prosecutors, including materials that could be used to charge them with crimes.

F. Submitting Privileged Documents to Government – “Selective Privilege?”

In governmental investigations organizations may wish to cooperate. This may include giving privileged documents to government agencies or to law enforcement. Absent a confidentiality agreement all circuits but one addressing the issue have held that the organization has waived the privilege as to those documents, not just as to the agency in question, but for all

The exception is the Eighth Circuit, which went the other way in Diversified Industries, Inc. v. Meredith, 572 F.2d 596, 611 (8th Cir. 1978).

Can an organization accomplish a “selective waiver” by requiring the government entity to enter into a confidentiality agreement? Certainly not in the Sixth Circuit according to the court in Columbia/HCA. Cases holding that a confidentiality agreement results in a selective waiver are Saito v. McKesson HBOC, Inc., No. Civ.A. 18553, 2002 WL 31657622 (Del. Ch. Ct. Nov. 13, 2002), and Maruzen Co., LTD v. HSBC USA, Inc., No. 00 CIV. 1079(RO), 00 CIV. 1512(RO), 2002 WL 1628782 (S.D.N.Y. July 23, 2002). Such was not the case in McKesson HBOC, Inc. v. Superior Court, 9 Cal. Rptr. 3d 812, 819 (Cal. Ct. App. 2004) (finding a waiver).

What about a “Wells submission” to the SEC? In re Initial Public Offering Securities Litigation, 2003 U.S. Dist. LEXIS 23102 (S.D.N.Y. Dec. 24, 2003), is not a privilege or work product case, but is tangentially relevant, nonetheless. In that case, a company submitted to the SEC a document responding to a notice from the SEC that it was being investigated. The submission contained principally facts and argument to the effect that the company had behaved appropriately. The submission, as is common, contained an offer of settlement. In this securities litigation the plaintiffs sought to obtain the document. The company responded not that the document was privileged, but that it was a settlement offer, which is not admissible in evidence. The court rejected the company’s arguments and ordered the document produced.

G. Tax Shelters and Aggressive Tax Planning

United States v. Frederick, 182 F.3d 496 (7th Cir. 1999), was a harbinger of the more recent attempts by the IRS to learn from law firms the identities of their tax planning clients. The court ruled that the IRS right to see communications between tax-planning lawyers and their clients was broad. The court basically limited the attorney-client privilege and work product doctrine to situations in which the law firm was representing the client in an audit context, or in litigation, where the law firm was interpreting the law. As to other situations, “the taxpayer should not be permitted, by using a lawyer in lieu of another form of tax preparer, to obtain greater confidentiality than other taxpayers.” Id. at 501. More recently, in United States v. Jenkens & Gilchrist, P.C., 2004 U.S. Dist. LEXIS 6919 (N.D. Ill. Apr. 21, 2004), United States v. Sidley Austin Brown & Wood LLP, 2004 U.S. Dist. LEXIS 6452 (N.D. Ill. Apr. 20, 2004), and Doe v. KPMG, L.L.P., 2004 U.S. Dist. LEXIS 6191 (N.D. Tex. Apr. 4, 2004), the courts ruled that the identities of clients utilizing certain tax avoidance techniques were not privileged.

H. Reliance on “Advice of Counsel”

Section 80 of the RESTATEMENT provides as follows:

§ 80. Putting Assistance or a Communication in Issue
The attorney-client privilege is waived for any relevant communication if the client asserts as to a material issue in a proceeding that:

(a) the client acted upon the advice of a lawyer . . . .


I. Patent Opinions

This is an important sub-set of Section H above. For some time manufacturers or sellers of products, in the face of a potential patent infringement claims, have asked lawyers to opine on whether their product did infringe existing patents. If the opinion was that the product did not infringe, that opinion could be used in an infringement case to avoid a finding that the infringement was willful. This protocol was established in two cases: Underwater Devices Inc. v. Morrison-Knudsen Co., Inc., 717 F.2d 1380 (Fed. Cir. 1983); and Kloster Speedsteel A.B. v. Crucible Inc., 793 F.2d 1565 (Fed. Cir. 1986). The Federal Circuit has declared an intention to re-examine the role of lawyers’ opinions in willfulness determinations in Knorr-Bremse Systeme Fuer Nutzfahrzeuge GmbH v. Dana Corp., 344 F.3d 1336 (Fed. Cir. 2003).

A very recent case that discusses these principles and traces their history is Convolve, Inc. v. Compaq Computer Corp., 2004 U.S. Dist. LEXIS 9572 (S.D.N.Y. May 28, 2004). What is relevant about the case to this discussion is its treatment of a waiver of the privilege and work product doctrine by relying on such an opinion. The court held that where a party did so rely, the privilege was waived as to all communications with all counsel (not just opining counsel, and including trial counsel) on the subject of the patents in question. The reason for including all the lawyers was that any of their communications might have reflected the party’s willfulness, or lack thereof. The time period covering such communications was from the date the party first was aware of the patents until the alleged infringement ceased. As to communications between the party and trial counsel regarding the opinion and discussing “trial strategy and planning,” the court ordered submission of those communications for the court’s review. The court took a different approach to work product materials and ordered that only work product that was transmitted to the party during the period in question should be produced. The difference was that if the material was not transmitted to the party, it could not have affected the party’s willfulness, or lack thereof. The court cited other cases holding that reliance on non-infringement opinions waives the privilege; no purposes would be served by listing them here.

J. Communications with Testifying Experts

K. Audit Letter Responses

The American Bar Association Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests (1975) ("ABA Statement") has governed the way lawyers respond to audit letter requests on behalf of entity clients for almost thirty years. The ABA Statement is structured so that, except in rare cases, the lawyer is not required to state anything much other than is what is public record. Probably, for that reason, we are not aware of any case in which a court made a finding that the privilege or work product protection was waived by such a letter. This could all change with the implementation of Section 303 of The Sarbanes-Oxley Act of 2002 and the SEC regulation under Section 303, Rule 13b2-2(b), which make it unlawful to “mislead” an auditor. The SEC staff has steadfastly refused to state that compliance with the ABA Statement provides some sort of “safe harbor” for lawyers complying with it. Thus, we may see a new set of guidelines emerge that may require lawyers to respond to auditors’ requests with a level of detail heretofore not seen. That could provide hostile parties with ammunition to claim that the responses and subsequent disclosures by the auditors constituted a waiver of the privilege or work product protection.

L. “Cooperation Clause” in Insurance Policies


M. Public Relations Consultants’ Communications with Lawyers

Suppose, in a crisis, a lawyer decides that she needs to consult with a public relations consultant for ideas and strategies for managing responses to information being made public. In part, the lawyer wants to do this to aid the client in managing the client’s affairs. It may also be to help create a public atmosphere in which the opposition in litigation has a more difficult time taking unpopular positions against the client in the litigation. Can the opponent in civil litigation, or the government in a grand jury proceeding, obtain communications between the lawyer and the public relations consultant? The cases have not been uniform, but there are a few.
In the following cases the courts recognized either privilege or work product in communications between lawyers and public relations consultants: Federal Trade Comm’n v. GlaxoSmithKline, 294 F.3d 141, 148 (D.C. Cir. 2002), In re Grand Jury Subpoena, 265 F. Supp. 2d 321, 331 (S.D.N.Y. 2003), and In re Copper Market Antitrust Litigation, 200 F.R.D. 213, 219 (S.D.N.Y. 2001).


In analyzing the cited cases, it is difficult to find consistency. In re Grand Jury Subpoena involved a pending grand jury looking into Martha Stewart’s trade of ImClone stock. The court accepted Stewart’s contention that the purpose of the consultant was to create a public relations climate in New York City that would motivate prosecutors not to seek an indictment. The court in Haugh noted In re Grand Jury Subpoena, but was not impressed. In finding that the communications were not protected the court said:

There is no need here to determine whether In re Grand Jury Subpoenas was correctly decided. Haugh has not identified any legal advice that required the assistance of a public relations consultant. For example, she has not identified any nexus between the consultant's work and the attorney's role in preparing Haugh's complaint or Haugh's case for court. A media campaign is not a litigation strategy. Some attorneys may feel it is desirable at times to conduct a media campaign, but that decision does not transform their coordination of a campaign into legal advice.

Haugh, 2003 WL 21998674, at *3.

N. Communications with Close Relatives (and Certain other Third Parties)

United States v. Stewart, 287 F. Supp. 2d 461 (S.D.N.Y. 2003), is unique. Martha Stewart prepared an E-mail to her lawyers purporting to recap the circumstances surrounding her sale of ImClone stock. The next day she forwarded the very same E-mail to her adult daughter, Alexis. Prosecutors claimed that by doing so Martha waived the attorney-client privilege and work product immunity. The court flatly declared that the privilege was waived. However, the court found that work product immunity was not. The court cited cases that held that sharing work product materials with persons allied with the client did not waive work product immunity because the risk of the opposition obtaining the information was slight. The court said: “By forwarding the e-mail to a family member, Stewart did not substantially increase the risk that the Government would gain access to materials prepared in anticipation of litigation.” Id. at 469.

The court did not cite cases in which the client shared such materials with a close family member. Section 91(4) of the RESTATEMENT is consistent:

§ 91. Voluntary Acts
Work-product immunity is waived if the client, the client’s lawyer, or another authorized agent of the client:

* * *

(4) discloses the material to third persons in circumstances in which there is a significant likelihood that an adversary or potential adversary in anticipated litigation will obtain it.

O. In-House Lawyers Wearing Several Hats

Organizations employing in-house lawyers expect their lawyers to “know the business” of the organization, and in many cases they expect their lawyers to participate in business decisions. Which hat, then, is the lawyer wearing during the conversation, and how does that affect the privilege? Comment i to § 73 of the RESTATEMENT provides:

i. Inside legal counsel and outside legal counsel. The privilege . . . applies without distinction to lawyers who are inside legal counsel or outside legal counsel for an organization . . . . Communications 

predominantly for a purpose other than obtaining or providing legal services for the organization are not within the privilege . . . .


P. Outside Lawyer Serving on Board or as Officer of Entity

When is the lawyer rendering legal services or giving legal advice versus acting as a board member or officer? In one of the latter capacities, there is no privilege. Opinion 589 (1988) of the New York State Bar Association Committee on Professional Ethics provides that a lawyer in that position must advise the client of the danger that the privilege may not cover some communications. Cases in which certain lawyer/director's communications were deemed not privileged include: Securities & Exchange Comm’n v. Gulf & Western Industries, Inc., 518 F. Supp. 675 (D.D.C. 1981); FSLIC v. Fielding, 343 F. Supp. 537 (D. Nev. 1972); and United States v. Vehicular Parking, Ltd., 52 F. Supp. 751 (D. Del. 1943). In Deutsch v. Cogan, 580 A.2d 100 (Del. Ch. Ct. 1990), the court held that a law firm with a lawyer on the board of a client had fiduciary duties to certain shareholders. As a result there was no privilege as to certain communications between the law firm and the corporation. To a similar effect is Valente v. PepsiCo, Inc., 68 F.R.D. 361 (D. Del. 1975). A case in which a lawyer's serving on a board undercut indirectly the ability of the company to claim privilege is AOC Ltd. Partnership v. Horsham Corp., 1992 Del. Ch. LEXIS 110 (Del. Ch. Ct. 1992).
Q. Death of Client

For most purposes the majority rule is that the privilege does not terminate at the death of the client. A lawyer for a deceased client has a continuing obligation to assert the privilege. Restatement § 77 cmt. c. Cases recognizing this concept are: Swidler & Berlin, 524 U.S. 399 (1998) (construing federal evidence rules); State v. Macumber, 544 P.2d 1084 (Ariz. 1976); HLC Properties Ltd. v Superior Court, 4 Cal. Rptr. 3d 898 (Cal. Ct. App. 2003); In re John Doe Grand Jury Investigation, 562 N.E.2d 69 (Mass. 1990); and People v. Modzelewski, 611 N.Y.S.2d 22 (N.Y. App. Div. 1994).

In State v. Doe, 803 N.E.2d 777 (Ohio 2004), the court held that a surviving spouse could waive the privilege for the deceased client. Other cases holding that the personal representative or assignee of a decedent can waive the privilege are In re Estate of Colby, 723 N.Y.S.2d 631 (N.Y. Sur. Ct. 2001), and Mayorga v. Tate, 752 N.Y.S.2d 353 (N.Y. App. Div. 2002).

Section 81 of the Restatement states an exception:

§ 81. A Dispute Concerning a Decedent’s Disposition of Property

The attorney-client privilege does not apply to a communication from or to a decedent relevant to an issue between parties who claim an interest through the same deceased client, either by testate or intestate succession or by an inter vivos transaction.

The Reporter’s Note to § 81 cites no cases, but relies on treatises, the Revised Uniform Rules of Evidence, the Proposed Federal Rules of Evidence (the rule on privilege was not adopted), and the Model Code of Evidence. We will not detail them here.

R. Use of E-mail

In City of Reno v. Reno Police Protective Ass’n, 59 P.3d 1212 (Nev. 2002), modified at 2003 Nev. LEXIS 25 (Nev. May 14, 2003), the court held that the fact that a lawyer-client communication was sent via E-mail did not strip the message of its privileged status.

III. COMMON INTEREST ARRANGEMENTS

A. General

There are times that those who share common interests want to coordinate their efforts without destroying the privileged status of their communications with their respective lawyers. Thus, there is within the law of attorney-client privilege the “common interest doctrine,” which is an exception to the law of waiver. The common interest doctrine effectively widens the circle

Under the common interest doctrine, the sharing of privileged information that otherwise would constitute a waiver does not abrogate the privilege, so long as the parties maintain the confidentiality of the shared information. Although developed in the context of the attorney-client privilege, the common interest doctrine has expanded to protect against the waiver of work product immunity. *See Ariz. Indep. Redistricting Comm’n v. Fields*, 75 P.3d 1088, 1100-01 (Ariz. Ct. App. 2003).

The common interests protected by the doctrine may be factual, legal, or strategic. *Restatement §76 cmt. e.* Parties’ interests need not be “entirely congruent” for the common interest doctrine to apply, but they obviously cannot be adverse.

Finally, it is necessary to distinguish common interest arrangements from situations in which a single lawyer represents two clients with common interests. Where a single lawyer represents co-clients, communications between co-clients to their common lawyer are not privileged as between the clients unless the clients agree that separate communications may be kept confidential. *See Restatement § 75 cmt. d.* Under the common interest doctrine, on the other hand, the parties’ common interest does not imply an undertaking or agreement to share all relevant information. *Id. § 76 cmt. e.* “Confidential communications disclosed to only some members of the arrangement remain privileged against other members as well as against the rest of the world.” *Id.* (contrasting common interest and co-client relationships).

B. Joint Defense Agreements in Litigation

The common interest doctrine often becomes an issue where a plaintiff sues multiple defendants, who then share a common interest in defeating the plaintiff’s claims. The easiest way to present a unified defense would be for all of the defendants to hire a single lawyer. Because representation by a single attorney is often impossible, however, multiple defendants represented by separate lawyers often agree to coordinate their defense by way of a “joint defense agreement.” This has led to the announcement or invocation of a “joint defense privilege.” In fact, the joint defense privilege is not a new or separate privilege. *Gulf Islands Leasing, Inc. v. Bombardier Capital, Inc.*, 215 F.R.D. 466, 470 (S.D.N.Y. 2003). Rather, it is a common interest arrangement that, like all other common interest arrangements, assumes the existence of a valid underlying attorney-client privilege. A joint defense agreement itself does not create a common interest or joint defense privilege. *Ariz. Indep. Redistricting Comm’n, 75 P.3d at 1099 n.11; OXY Resources, 9 Cal. Rptr. 3d at 637-38; Brooklyn Navy Yard Cogeneration Partners, L.P. v. PMNC, 753 N.Y.S.2d 343, 345 (N.Y. Sup. Ct. 2002)* (quoting case).

The joint defense privilege also protects defense group members’ work product. *Ferko v. Nat’l Ass’n for Stock Car Auto Racing, Inc.*, 219 F.R.D. 396, 401 (E.D. Tex. 2003); *Lugosch v. Congel*, 219 F.R.D. 220, 240 (N.D.N.Y. 2003). For the joint defense privilege to apply to work product it must be shown that the information at issue falls within the ambit of the qualified immunity afforded by the work product doctrine. Again, the joint defense privilege protects

To assert the joint defense privilege, a party must establish (1) that the protected communications were made in the course of a joint litigation effort (such as within the confines of a joint defense group); and (2) that the communications were designed to further that effort. *In re Grand Jury Proceedings*, 156 F.3d 1038, 1042-43 (10th Cir. 1998). With respect to the first element, there must be pending litigation or a “strong possibility” of future litigation. *Metro Wastewater*, 142 F.R.D. at 479. The privilege does not attach if the communications to be protected were not made for the purpose of rendering legal service or advice. Some courts also require that a party asserting the privilege prove that it has not been waived. See, e.g., *Ageloff v. Noranda, Inc.*, 936 F. Supp. 72, 76 (D.R.I. 1996).

Of course, the communications to be protected must have been made in confidence, *Boyd*, 88 S.W.3d at 214, and must further the parties’ joint defense. If communications are not intended to further the parties’ joint defense, but instead relate to claims that the parties may have against one another, for example, they are discoverable. See, e.g., *Brooklyn Navy Yard*, 753 N.Y.S.2d at 345-46.

The joint defense privilege is not waived by one defendant asserting defenses or making claims that may be adverse to another joint defense group member. *Old Tampa Bay Enters., Inc. v. Gen. Elec. Co.*, 745 So. 2d 517, 518 (Fla. Dist. Ct. App. 1999). To find a waiver in such tepid adversity would render the privilege worthless. Furthermore, a waiver by one party to a joint defense agreement does not waive any other party’s privilege with respect to the same communications. *Sec. Investor Protection Corp. v. Stratton Oakmont, Inc.*, 213 B.R. 433, 436 n.3 (Bankr. S.D.N.Y. 1997). A waiver of the joint defense privilege requires the consent of all members of the joint defense group. See *Metro Wastewater*, 142 F.R.D. at 478.

Unless the parties to a joint defense agreement consent to terminating the privilege, it can only be waived by subsequent litigation between the joint defendants. *Stratton Oakmont*, 213 B.R. at 436. A joint defense group member who wants to keep information it shares with its attorney from being disclosed to other members of the joint defense group must request such confidentiality from counsel. Otherwise, it is assumed that any information exchanged as part of the joint defense effort can be freely disclosed to other members of the defense group and their counsel. *Ageloff*, 936 F. Supp. at 76-77.

Most joint defense problems involve successive client conflicts and the threatened disclosure of client confidences, coupled with the alleged revelation of those confidences to other members of the joint defense group. In the typical situation, counsel for one member of a joint defense group is found to have represented the plaintiff in the past. The plaintiff then alleges that its former attorneys possess its confidential information, claims that the attorneys have shared that information with the other members of the joint defense group or should be presumed to have done so, and argues that all defense counsel must be disqualified as a result. Alternatively, a lawyer that has received confidential information about his client’s co-defendants changes law
firms and later seeks to accept a representation that is directly adverse to his former client’s co-
defendants (but not the former client) in a matter where the confidential information is material.

Former client conflicts of interest are governed by Model Rule 1.9(a), which, as amended in 2002, provides:

A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person’s interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing.

The prior version of the rule was nearly identical, except that the former client was only required to consent “after consultation”; the principle that such consent had to be informed was implied rather than express, and there was no requirement that the consent be confirmed in writing. A.B.A., THE 2002 CHANGES TO THE ABA MODEL RULES OF PROF’L CONDUCT 37-40 (2003) (showing the 2002 amendments to Model Rule 1.9) [hereinafter THE 2002 CHANGES].

Rule 1.9 has as one of its primary purposes the protection of the former client’s confidences. Because it would be difficult for the former client to demonstrate that the attorney revealed its confidences to its detriment, most courts presume a breach of confidence once the potential for the disclosure of confidential information is shown. See, e.g., Bergeron v. Mackler, 623 A.2d 489, 494 (Conn. 1993); Chrispens v. Coastal Ref. & Mktg., Inc., 897 P.2d 104, 114 (Kan. 1995); Sullivan County Reg’l Refuse Disposal Dist. v. Town of Acworth, 686 A.2d 755, 758 (N.H. 1996); State v. Crepeault, 704 A.2d 778, 783 (Vt. 1997); State ex rel. McClanahan v. Hamilton, 430 S.E.2d 569, 573 (W. Va. 1993). Some courts further impute the disclosure of the former client’s confidences to other lawyers in the subject lawyer’s firm, thus disqualifying the entire firm. See, e.g., Flatt v. Superior Court, 885 P.2d 950, 954 (Cal. 1994); In re Guardianship of Mowrer, 979 P.2d 156, 159 (Mont. 1999); Bechtold v. Gomez, 576 N.W.2d 185, 190 (Neb. 1998); Nat’l Med. Enters., Inc. v. Godbey, 924 S.W.2d 123, 131 (Tex. 1996).

A lawyer may use information relating to the representation of a former client to that client’s disadvantage if the information is generally known. MODEL RULES R.1.9(c)(1). Thus, in IMC Global, Inc. v. Moffett, (Nos. Civ. A. 16387-NC, Civ. A. 16393-NC, 1998 WL 842312 (Del. Ch. Nov. 12, 1998), the court declined to disqualify two law firms who were parties to a joint defense agreement where the information obtained from other counsel who had once represented the plaintiffs was information to which all of the parties had access. Because the information at the center of the alleged conflict was generally known to the parties, the plaintiffs were not able to demonstrate how the potential conflict would “prejudice the fairness of the proceeding.” Id. at *3. The IMC Global court reasoned that fairness was best served by focusing on the substantive legal issues in the case, rather than disqualifying counsel on a superfluous matter.

Although courts should be reluctant to disqualify law firms representing joint defense group members who have not directly represented the member crying foul, double imputation and disqualification are very real threats. See, e.g., Nat’l Med. Enters., Inc. v. Godbey, 924 S.W.2d 123 (Tex. 1996).
C. Drafting Joint Defense Agreements

Although joint defense agreements need not be written, joint defense group members clearly should structure their relationship by way of a written agreement, for that document likely will be the focus of any judicial scrutiny of the parties’ relationship. Furthermore, the lack of a written agreement breeds confusion and may lead a court to conclude that no common interest arrangement exists. In *United States v. Weissman*, 195 F.3d 96 (2d Cir. 1999), for example, where there was no written agreement and the attorneys involved could not agree on whether such an agreement had been reached at the time of a key meeting, the defendant could not meet his burden to demonstrate that such an agreement existed. *Id.* at 99-100. The defendant’s damaging revelations at that meeting were therefore admissible in his criminal trial, and led to his conviction. *See id.* at 98-100. As the Weissman court observed, “[s]ome form of joint strategy is necessary to establish a [joint defense agreement], rather than merely the impression of one side.” *Id.* at 100.

All joint defense agreements ought to include certain essential provisions.

First, all defense counsel should represent in the agreement that they have completed thorough conflict of interest checks and that they know of no conflicts with the plaintiff. Although such a provision is no guarantee that an unknown or unsuspected conflict will not surface later, it may encourage more thorough conflicts inquiries by group members.

Second, the agreement should state clearly that each law firm represents its own client only and does not represent any other defendant. Defense counsel should expressly disavow an attorney-client relationship with any party other than their own client, and the agreement should clearly state that each party will look only to its own attorneys for advice. Such a provision is important because the existence of an attorney-client relationship is a question of fact, and all defense group members should want to prevent an attorney-client relationship from being implied between them. This disclaimer is also important because the existence of an attorney-client relationship sometimes turns on the subjective belief of the prospective client, and a party’s belief that it shares an attorney-client relationship with another party’s counsel in the face of an express provision to the contrary arguably is unreasonable. Douglas R. Richmond, *Joint Defense Agreements and the Attorney-Client Privilege*, in *THE ATTORNEY-CLIENT PRIVILEGE* 101 (Def. Research Inst. 2002).


Fourth, the agreement should provide that confidential information, privileged communications and counsel’s work product will not be revealed to third-parties absent the consent of all group members. It should also provide that information sharing between group members does not waive the attorney-client privilege and work product immunity with respect to third-parties. It may be wise to state that a voluntary or implied waiver of the privilege by one
defense group member will not bind or affect other group members. This provision should also permit consultants or experts retained by group members to review protected information so long as they execute written agreements in which they promise to maintain confidentiality.

Fifth, the agreement must state that the defendants have a common interest in the defense of the lawsuit, and that the agreement is intended to further that interest. The agreement need not specify the common interest in great detail. If, however, the agreement is entered into for some limited purpose, it should specify that purpose so that problems do not develop later regarding the scope of the agreement.

Sixth, the agreement should state that the parties agree to share and use confidential information in the subject case only, and only pursuant to the terms of the joint defense agreement. This provision should also include language which prohibits any group member from using any information outside the case at bar without the consent of all group members.

Seventh, the agreement should provide for group members’ withdrawals. Similarly, the agreement should address group members’ settlements or dismissal from the case.

Finally, the agreement should be signed by the parties, not just the defense attorneys. If nothing else, this forces client representatives to read the agreement, thus reducing the risk of subsequent problems. For example, a client that acknowledges that it will look only to its own attorneys for advice should not be able to argue later that it shared an implied attorney-client relationship with counsel for another defendant, or subjectively believed that it did so.

D. Common Interest Arrangements in Business Transactions Where Litigation is Anticipated

Parties may enter into business transactions that affect the interests or rights of others, thus exposing the parties to the transaction to related litigation. Sometimes these transactions require the parties to share information that they do not want to share with competitors or interested parties who may challenge their deal in subsequent adversary proceedings. The issue, then, is whether parties to a transaction can enter into a common interest arrangement that allows them to exchange privileged information without fear of waiver long before they are actually sued by a third-party. Indeed, that was the issue in a California case, OXY Resources California LLC v. Superior Court. 9 Cal. Rptr. 3d 621, 626-27 (Cal. Ct. App. 2004).

In OXY Resources, two companies, OXY Resources California LLC (“OXY”) and EOG Resources, Inc. (“EOG”), entered into a complex transaction in which they exchanged interests in a number of oil and gas producing properties, including property subject to a preferential purchase right held by Calpine Natural Gas LP (“Calpine”). Roughly six weeks before finalizing their transaction, EOG and OXY, and two of OXY’s affiliates or predecessors, entered into a joint defense agreement. The agreement recited that the parties intended to exchange certain assets; that they anticipated that the past and future ownership and operation of those assets would present various factual and legal issues common to them, and that as “anticipated potential defendants” they would share a common interest in defending claims by third-parties; that they
might wish to make joint efforts in preparing any defense to anticipated actions or proceedings; that the documents and information exchanged in the transaction, and associated communications, were privileged, immune, and otherwise exempt from discovery; and that no sharing of information between them would be deemed to waive any otherwise applicable privilege or exemption from disclosure. Id. at 628-29.

EOG and OXY publicly announced their transaction several days after it was completed. Calpine later sued them on a variety of theories, all related to the alleged deprivation of its preferential purchase right.

In discovery, Calpine sought the production of 202 documents from EOG and OXY, 30 of which were pre-acquisition communications, while the remaining documents were prepared after EOG and OXY completed their deal. EOG and OXY sought to shield all of the documents from discovery under their joint defense agreement. Seeking to compel production of the documents, Calpine argued that there is no joint defense privilege in California; that EOG and OXY could not retroactively invoke their joint defendant status to shield communications made long before the action was filed; and that they waived any privilege by disclosing communications “to an adverse party on the opposite side of a business transaction.” Id. at 630.

The trial court granted Calpine’s motion to compel as to the post-acquisition documents, but denied it with respect to the pre-acquisition documents. Both OXY and Calpine petitioned for writs of mandamus.

At the outset, the OXY Resources court noted that it was not free to create a new privilege; it could apply only those privileges created by California statutes. Id. at 634. Rejecting OXY’s characterization of its claimed “joint defense privilege” or “common interest privilege” as an extension of the attorney-client privilege, the OXY Resources court determined that “the common interest doctrine is more appropriately characterized under California law as a non-waiver doctrine, analyzed under standard waiver principles applicable to the attorney-client privilege and the work product doctrine.” Id. at 635 (footnote omitted).

With respect to EOG’s and OXY’s joint defense agreement itself, Calpine colorfully alleged that it was void as against public policy because it was “‘a premeditated and intentional plan to shield conspiratorial communications involving a transaction that directly and adversely affected [its] contractual rights.’” Id. at 638 (quoting Calpine’s brief). Though recognizing that there is a potential for abuse when parties rely on common interest arrangements to protect pre-lawsuit communications, the OXY Resources court explained that such concern did not render the agreement void, because the agreement could not shield non-privileged communications from disclosure. Id. Again, the common interest doctrine requires a valid underlying claim of privilege. Id. Thus, the court held that the trial court abused its discretion in denying Calpine’s motion to compel the production of thirteen documents withheld from it solely on the basis of the joint defense agreement. Id. at 638-39.

Turning next to the common interest doctrine generally, the court noted that the non-waiver principles expressed in the California Evidence Code were not limited in application to communications disclosed to others during litigation. Id. at 642. For example, section 912 of the
California Evidence Code provides: “A disclosure in confidence of a communication that is protected by [the attorney-client privilege] . . . when disclosure is reasonably necessary for the accomplishment of the purpose for which the lawyer . . . was consulted, is not a waiver of the privilege.” Id. at 635-36 (citations and footnote omitted). Furthermore, the need to share privileged information may arise in the negotiation of commercial transactions. Id. at 642. By refusing to find a waiver where parties share privileged information in commercial transactions, courts can create an environment in which businesses deal more openly with one another, and in so doing promote commerce generally. See id. (quoting Hewlett-Packard Co. v. Bausch & Lomb Inc., 115 F.R.D. 308, 311 (N.D. Cal. 1987)).

Having determined that the common interest doctrine protects otherwise privileged communications where litigation is not imminent, the OXY Resources court held that the trial court abused its discretion in denying Calpine’s motion to compel the production of the pre-acquisition documents at issue and in granting that motion with respect to post-acquisition documents. In short, the trial court’s findings in both respects rested on an inadequate evidentiary foundation. Id. at 641-44.

The OXY Resources court reached the correct decision. Businesses often need to share otherwise privileged or confidential information in order to make reasonable acquisition, merger and sale decisions, and they ought not have to enter into transactions blindly for fear that sharing such information with their deal partners will expose it to unfriendly others. Before seizing upon the OXY Resources holding to enter into similar arrangements, however, lawyers should keep a couple of things in mind. First, OXY Resources turned on the language of key sections of the California Evidence Code. The attorney-client privilege has been widely codified, and other states may have very different statutes or evidence rules.

Second, in OXY Resources, OXY and EOG could be virtually certain of litigation with Calpine by virtue of Calpine’s contractual right of first refusal in the disputed property. What if the likelihood of litigation is not so clear? In those jurisdictions that require existing litigation or the “strong possibility” of future litigation for joint defense agreements to be enforceable, see, e.g., Metro Wastewater, 142 F.R.D. at 479, the abstract possibility of litigation may not implicate the common interest doctrine.

For attorneys drafting documents memorializing common interest arrangements in connection with transactions, the principles that apply to preparing joint defense agreements once litigation is underway remain valid. The chance of future litigation should be phrased as being a strong possibility. If likely litigants can be identified at the time the agreement is drafted they should be identified and the reasons for their expected adversity specified, although the agreement should not be too limited in scope.
IV. LAW FIRM INTERNAL INVESTIGATIONS

A. Cases and Controversies

Law firms’ ability to protect the results of their internal investigations has been an issue since the 1980’s, when firms that represented failed financial institutions were targeted in litigation resulting from those institutions’ demise. See Douglas R. Richmond, *Law Firm Internal Investigations: Principles and Perils*, 54 SYRACUSE L. REV. 69, 77 (2004).

In *In re Sunrise Securities Litigation*, 130 F.R.D. 560 (E.D. Pa. 1989), for example, the law firm of Blank Rome, which had represented the insolvent Sunrise Savings and Loan Association, was sued by the Federal Savings and Loan Insurance Corporation (“FSLIC”) and Sunrise depositors. Blank Rome declined to provide four categories of documents to the FSLIC, citing the attorney-client privilege. After initially rejecting Blank Rome’s contention that a law firm can consult with its own attorneys as though they were traditional in-house counsel and thus obtain the protection of the attorney-client privilege on the basis that it is its own client, the court reconsidered its position. The court conceded the possible correctness of Blank Rome’s position. The *Sunrise* court further observed, however, that a law firm’s consultation with its own lawyers may give rise to conflicts of interest between the firm’s two clients, i.e., the firm itself and the original client. The question thus becomes whether the interest in protecting clients who may be harmed by such a conflict “affects the applicability of the attorney client privilege to a law firm’s communications with in house counsel seeking legal advice for the firm.” *Id.* at 595-96. The *Sunrise* court concluded that it does, relying on another federal case, *Valente v. PepsiCo*, 68 F.R.D. 361 (D. Del. 1975).

In *Hertzog, Calamari & Gleason v. Prudential Insurance Co. of America*, 850 F. Supp. 255 (S.D.N.Y. 1994), a New York federal court endorsed law firm’s ability to use its own lawyers as counsel in a short but strongly-worded opinion. The *Hertzog* court noted that a partnership, like a corporation, cannot appear in court pro se; it must appear through counsel. A corporation may appear through “in-house counsel on the corporate payroll,” and it is settled that the attorney-client privilege attaches to a corporation’s communications with its in-house counsel so long as the attorney is acting as such rather than as a participant in the underlying events. Thus: “No principled reason appears for denying a comparable attorney-client privilege to a law partnership which elects to use a partner or associate as counsel of record in a litigated matter.”

Both *Sunrise* and *Hertzog* involved privilege claims arising in the course of litigation. In *United States v. Rowe*, 96 F.3d 1294 (9th Cir. 1996), the issue was whether the firm’s internal investigation in anticipation of litigation could likewise be shielded from discovery. The *Rowe* court held that it could.

Although law firms’ ability to assert the attorney-client privilege with respect to communications with firm lawyers serving as loss prevention counsel or general counsel is well-settled, courts recently have taken aggressive and misguided approaches to finding that the privilege has been waived in cases where the firm is adverse to a current client. Courts have

B. Recommendations for Law Firms

First, law firms wanting to best ensure the confidentiality of their internal communications should first appoint a regular general counsel or ethics counsel charged with loss prevention and managing the firm’s compliance with professional standards. Most large law firms have already done so. Furthermore, it is advisable to designate more than one such lawyer in the event the firm’s primary counsel has once represented the aggrieved client, or is representing the client in the matter that has spawned the dispute. Under no circumstances should the firm’s in-house counsel charged with conducting an internal investigation or giving the firm legal advice about a dispute have a relationship with the client involved.

Second, when a professional liability or responsibility issue affecting the firm surfaces, firm management should specifically request that counsel act upon or investigate it for the purpose of providing legal advice to the firm. This request should be in writing, and should explicitly state that the firm requests legal advice based on the investigation undertaken.

Third, firm counsel should treat the investigation as though it were a client matter. She should open a file like she would open a file were she accepting a new matter from a regular client. She should account for her time spent on the internal investigation as though she was going to bill that time to the firm. Of course, in-house counsel should not bill the firm’s client for his time spent on behalf of the firm. Similarly, the lawyers involved in the subject client’s representation should not bill the client for time spent assisting the firm’s counsel in his inquiry.

Fourth, the firm’s counsel must be sure to safeguard the firm’s attorney-client privilege and his work product. He cannot discuss investigations with curious partners or associates, and written communications must be kept confidential. In-house counsel should report to the firm’s management committee or to its managing partner, depending on the firm’s structure. Counsel must confine his communications to only those lawyers in the firm’s structure who, because of their positions or responsibilities, need to know the information conveyed. Counsel must, in the course of any investigation, advise those attorneys or staff with whom he speaks that their communications are confidential and must be kept that way. Special caution is called for if counsel must interview former employees as part of his investigation, because communications with a former employee after the employee has left the firm will not be privileged.

Lawyers who are responsible for the firm’s representation of the client or who manage the client relationship must be instructed not to discuss the firm’s investigation with the client. If this recommendation seems obvious, it is important to remember that many lawyers develop friendships with their clients, and that friendship sometimes erodes discretion.
Fifth, the firm may want to consider withdrawing from the client’s representation. See Koen Book, 212 F.R.D. at 286 (suggesting this alternative). Although there are many cases in which this cannot be accomplished because of timing issues, or in which ceasing the representation is undesirable, withdrawal eliminates the conflict of interest problems that the Sunrise, Bank Brussels and Koen Book courts focused on. Even if the firm does not withdraw from a client’s representation altogether, it may wish to consider withdrawing from the particular matter out of which the complaint arose.

Sixth, a law firm that wishes to continue representing a client while conducting an internal investigation might seek a waiver of any potential conflict of interest from the client. See Koen Book, 212 F.R.D. at 286 (suggesting this alternative). This option obviously is more attractive where the client has called a problem to the firm’s attention, as compared to the situation where the firm has identified a potential problem of which the client may not be aware.

Finally, a firm may wish to engage outside counsel to conduct the investigation. This approach best insulates the attorney representing the firm against all claims of conflict of interest or common interest. Outside counsel may be required where firm lawyers are for some reason reluctant to cooperate in an internal investigation, or do not take an internal investigation as seriously as they should.

V. RECENT DEVELOPMENTS IN THE LAW OF INADVERTENT WAIVER

A. General

They are every lawyer’s nightmare—the letter to the client detailing litigation strategy inadvertently delivered to the adversary among a mountain of other documents produced in discovery, the letter faxed to another party in a transaction instead of being faxed to the client, the e-mail accidentally copied to recipients for which it was never intended. Over the years, many lawyers confronting these situations have desperately tried to shove the genie back in the bottle in the name of inadvertent disclosure, sometimes successfully, but often not. Of course, the lawyers on the receiving end of materials inadvertently disclosed are not without their own problem. That is, just what are they to do with the privileged or immune materials that have come into their hands? The wrong decision may mean their disqualification.

Courts struggle with determinations whether the inadvertent disclosure of privileged materials waives any protection that would otherwise attach. Courts confronted with inadvertent disclosures typically take one of three approaches to determining whether the disclosure waives any claims of privilege or work product immunity. See Elkton Care Ctr. Assocs. Ltd. P’ship v. Quality Care Mgmt., Inc., 805 A.2d 1177, 1183 (Md. Ct. Spec. App. 2002) (asserting that in cases of inadvertent waiver, any distinction between waiver of attorney-client privilege and work product immunity disappears) (quoting Hartford Fire Ins. v. Garvey, 109 F.R.D. 323, 328 (N.D. Cal. 1985)).
Under the “lenient approach,” the privilege must be knowingly waived, and the determination of inadvertence ends the analysis. *Harp v. King*, 835 A.2d 953, 966 (Conn. 2003). The lenient approach is subject to criticism because it provides little incentive for lawyers to maintain tight control over privileged material, and it ignores the importance of confidentiality in the privilege calculus. *Id.* (quoting *Gray v. Bicknell*, 86 F.3d 1472 (8th Cir. 1996)).

Under the “strict approach,” sometimes called the “absolute waiver rule,” any document produced, whether inadvertently or otherwise, loses its privileged status upon production. *See id.* This approach is to be faulted for sacrificing the value of protecting client confidences for the sake of certain results and for chilling attorney-client communications. *Id.* at 966 (quoting *Gray*).

Finally, there is the “middle” or “moderate” approach, which requires courts to make fact-specific waiver determinations on a case-by-case basis. *Elkton*, 805 A.2d at 1184. Courts applying this approach consider (1) the reasonableness of the precautions taken to avoid inadvertent disclosure; (2) the time taken to rectify the error; (3) the scope of the discovery; (4) the extent of the disclosure; and (5) whether the overriding interests of fairness and justice would be served by absolving the party of its error. *Lois Sportswear, U.S.A., Inc. v. Levi Strauss & Co.*, 104 F.R.D. 103, 105 (S.D.N.Y. 1985) (involving documents produced by defendant in lieu of answering an interrogatory). The first of these five elements typically is the most critical, *see id.* (focusing on this factor), although all of the factors are important and must be considered. *See Harp*, 835 A.2d at 969-70 (applying and discussing all five factors); *Elkton*, 805 A.2d at 1185 (same). The middle or moderate approach is the majority rule.

**B. Recent Cases and Opinions**

*Jasmine Networks, Inc. v. Marvell Semiconductor, Inc.*, 12 Cal. Rptr. 3d 123 (Cal. Ct. App. 2004), illustrates the danger of carelessness in communications. In that case, Marvell was negotiating with Jasmine to purchase a portion of Jasmine’s semiconductor business and to employ a group of Jasmine’s engineers. Three Marvell executives, including its general counsel and an in-house patent attorney, used a speakerphone to call a senior Jasmine executive. The executive was out and they got her voicemail. After leaving a message, they continued to talk among themselves, not realizing that they failed to hang up their speakerphone. Their conversation revealed that Marvell’s real intention was not to purchase anything, but rather to steal Jasmine’s technology and pirate away Jasmine personnel using purloined information about their compensation and stock options.

The Jasmine executive checked her voicemail and heard the entire conversation. That caused Jasmine to further investigate the intended transaction, and thus to discover more misconduct by Marvell.

Jasmine sued Marvell for trade secret misappropriation. Marvell moved for a preliminary injunction, seeking to enjoin Jasmine from using the recorded voicemail conversation. Marvell argued that because the conversation involved its attorneys, its contents were protected by the attorney-client privilege. Jasmine argued that Marvell had waived its privilege by disclosing the information in the voicemail message, and that the conversation fell within the crime-fraud exception to the privilege. *Id.* at 124. The trial court granted Marvell’s motion for a preliminary
injunction, concluding that the contents of the conversation were privileged, id. at 126, and further finding that Marvell had not waived the privilege because it did not intend to disclose the contents of the conversation. Id. at 127.

The appellate court concluded that the trial court erred when it found that Marvell had not waived the privilege. Under California law, an “intent to disclose is not required in order for the holder to waive the privilege through uncoerced disclosure.” Id. at 128. Although it is true in California “that an attorney’s inadvertent disclosure does not waive the privilege absent the privilege holder’s intent to waive,” id. (citing State Comp. Ins. Fund v. WPS, Inc., 82 Cal. Rptr. 2d 799 (Cal. Ct. App. 1999)), in this case a non-lawyer executive participated in the call and Marvell’s general counsel had business responsibilities unrelated to his legal function. Id. at 128-29. Accordingly, California inadvertent waiver rules that might have saved Marvell had only its lawyers been involved did not apply, see id. at 128, and the crime-fraud exception stripped the conversation of its privilege in any event. Id. at 132.

_Jasmine_ teaches, among other things, that technology is not always lawyers’ friend. Wholly ignoring the stupidity of the Marvell bunch, speakerphones may transmit background conversations that participants do not intend to share with others outside their office. “Mute” buttons on telephones may not work. The camera and microphone on videoconference equipment may be working when the lawyers in the room think they are off. There is plenty of opportunity for error in electronic communication, and abundant need for caution.

Although inadvertent waiver would appear to be of greatest concern to the party alleged to have waived its privilege, lawyers receiving privileged materials as a result of adversaries’ inadvertence must mind their own ethical obligations. In Formal Opinion 92-368, the American Bar Association’s Committee on Ethics and Professional Responsibility opined that a lawyer “who receives materials that on their face appear to be subject to the attorney-client privilege or otherwise confidential, under circumstances where it is clear that they were not intended for the receiving lawyer, should refrain from examining the materials, notify the sending lawyer and abide the instructions of the lawyer who sent them.” ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 92-368, at 1 (1992). In _Holland v. Gordy Co._ (Nos. 231183, 231184, 231185, 2003 WL 1985800 (Mic. Ct. App. Apr. 29, 2003), the Michigan Court of Appeals went so far as to state that the position expressed in Formal Opinion 92-368 binds ABA members. (Id. at *10 n.20 (citing _Resolution Trust Corp. v. First of Am. Bank_, 868 F. Supp. 217, 221 (W.D. Mich. 1994)). The court in _Resolution Trust Corp. v. First of America Bank_ (868 F. Supp. 217 (W.D. Mich. 1994), reached the same conclusion nearly a decade earlier, further suggesting the converse—that lawyers who are not ABA members are not bound by the opinion. Id. at 221 (“The ABA’s interpretations [in Formal Op. 92-368] are binding only on ABA members.”) (emphasis added).

The suggestion that ABA ethics opinions bind ABA members is nonsense. Lawyers are bound by the ethics rules of the states in which they practice, and by rules of conduct adopted by courts and regulatory authorities before which they appear. If lawyers are bound by the positions expressed in ABA ethics opinions then they presumably are also bound to accept or adopt the political or social positions taken by the ABA, and surely no court is willing to go that far. More fundamentally, it makes no sense to have one set of ethical duties for ABA members and another
set for lawyers who do not belong to the ABA, especially since ABA membership is not mandatory for lawyers to practice.

The ABA retreated from the guidance offered in Formal Opinion 92-368 when it created Rule 4.4(b) in 2002. Model Rule 4.4(b) provides: “A lawyer who receives a document relating to the representation of the lawyer’s client and knows or reasonably should know that the document was inadvertently sent shall promptly notify the sender.” According to the comment to Rule 4.4(b), whether a lawyer who receives a misdirected document is required to take additional steps, such as returning the document to the sender, is beyond the scope of the Model Rules. MODEL RULES R. 4.4 cmt. 2. If the law in a particular jurisdiction does not require a lawyer to return a document inadvertently sent to her, “the decision to voluntarily return such a document is a matter of professional judgment ordinarily reserved to the lawyer.” Id. cmt. 3.


[A] lawyer receiving a misdirected communication containing confidences or secrets (1) has obligations to promptly notify the sending attorney, to refrain from review of the communication, and to return or destroy the communication if so requested, but, (2) in limited circumstances, may submit the communication for in camera review by a tribunal, and (3) is not ethically barred from using information gleaned prior to knowing or having reason to know that the communication contains confidences or secrets not intended for the receiving lawyer. However, it is essential as an ethical matter that the receiving attorney promptly notify the sending attorney of the disclosure in order to give the sending attorney a reasonable opportunity to promptly take whatever steps he or she feels are necessary.

The New York Committee concluded that a lawyer who receives a misdirected communication may retain the communication for the sole purpose of submitting it to a tribunal for in camera review, if the lawyer (1) promptly notifies the sending lawyer about the mistaken transmission, and, if requested, provides a copy to the sending lawyer; (2) believes in good faith, and in good faith anticipates arguing to the tribunal, that the inadvertent disclosure has waived the attorney-client or other applicable privilege or that the communication may not appropriately be withheld from production for any other reason; and (3) reasonably believes disclosing the communication to the tribunal is relevant to the argument that privilege has been waived or otherwise does not apply. Id. at *8. This limited permitted use does not apply, however, if the sender notifies the receiving attorney of the inadvertent disclosure and demands the return of the documents without review before the receiving attorney actually gets them. In that circumstance there has effectively been no disclosure.
Attorneys who review or retain misdirected communications in circumstances when they know they should not may violate Rule 8.4(c), which prohibits lawyers from engaging in conduct involving dishonesty, and Rule 8.4(d), which provides that it is professional misconduct for a lawyer to engage in conduct that is prejudicial to the administration of justice. Lawyers also risk being sanctioned by the court in which the action is pending, or being disqualified from further representation.

A more difficult question arises where the receiving attorney reviews all or part of a communication before having reason to know that he is not the intended recipient. Suppose, for example, an attorney receives a one page facsimile transmission containing the other side’s confidential information. It is not reasonable to expect that lawyer to purge the information from his mind, or to be able to litigate or negotiate further as though he has never seen it. See NYC Eth. Op. 2003-04, at *8. To disqualify, sanction, or discipline the receiving lawyer in that situation would be unfair to the lawyer and to the client. See id. (“To put the attorney at ethical risk for using information that cannot be suppressed from knowledge potentially would penalize the innocent receiving attorney and their [sic] client for the error of another.”).

In summary, the law relating to lawyers’ obligations upon the receipt of confidential information inadvertently disclosed by the other side varies significantly between jurisdictions. In those jurisdictions where the law is unsettled, ABA Formal Opinion 92-368 is likely of little persuasive force given the promulgation in 2002 of Model Rule 4.4(b), even if Holland v. Gordy Co., Nos. 231183, 231184, 231185, 2003 WL 1985800 (Mich. Ct. App. Apr. 29, 2003), suggests otherwise.
The Auditor’s Need For Its Client’s Detailed Information
vs.
The Client’s Need to Preserve the Attorney-Client Privilege and Work Product Protection:
The Debate, The Problems, and Proposed Solutions

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I. INTRODUCTION

This paper addresses an emerging problem of vital public interest identified by a broad consortium of public companies. The role of independent auditors in detecting financial statement fraud within public companies continues to receive enhanced scrutiny, and companies are expected both to implement controls for dealing with alleged fraud internally and to provide their auditors with detailed information on a wide range of corporate issues, even where such information may include attorney-client privileged communications or work product.

Companies involve legal counsel, both external and internal, for all manner of inquiries and advice, from conducting comprehensive investigations of alleged fraud to inquiring about employment problems, answering questions about whistleblower letters, advising the Board on their duties in connection with an acquisition, or establishing the bases for tax positions. Views and advice on these and a myriad of other daily issues are now routinely being asked for by auditors to buttress their reliance on management representations. However, providing access to auditors to such privileged information causes companies to risk the waiver of privileges and, as a result, provides almost automatic access in civil lawsuits to adversaries lying in wait.

This situation poses a serious threat to the public interest in preserving the attorney-client privilege and work product protections, which companies have long expected will be maintained by the courts: If the privileges are lost, or even if there is an expectation that counsel’s work and advice may be exposed to adversaries, then companies may well be deterred from seeking the advice of counsel regarding the best way to comply with the law, or deterred from conducting thorough internal investigations of potentially illegal conduct with the goal of taking remedial action. That good corporate governance and full cooperation in the audit process would lead to this result is incongruous and a matter of serious concern. It is also, we believe, unnecessary; we will, therefore, propose a solution to this growing problem at the conclusion of this paper.

This paper proceeds from the propositions that auditors must continue to be provided with as much information as they deem necessary to perform their important public functions and that, at the same time, it is in the public interest to protect the ability of companies to maintain the confidentiality of attorney-client communications and attorney work product. Thus, this paper discusses these two vital public interests – the public company audit function and protection of the attorney work product doctrine and attorney-client privilege – as well as their intersection. While auditors have historically planned and performed their audits in such a manner that they can obtain reasonable assurance that a company’s financial statements are not materially misstated due to the existence of corporate fraud – and auditors continue to do so –
recent developments in federal law and policy have focused attention on strengthening the auditors’ vigilance. Sparked by the corporate scandals of 2001-2002, legislation, regulations of the Securities & Exchange Commission (“SEC”) and standards and rules of the Public Company Accounting Oversight Board (“PCAOB”) have impacted how generally accepted auditing standards (“GAAS”) are applied and have increased scrutiny on auditors’ procedures to verify company positions and representations.

The same developments in law and policy and the same corporate scandals are causing companies to step up their own efforts to maintain and bolster effective internal procedures for the conduct of their businesses so as to detect and respond to allegations of inappropriate conduct, wrongdoing, or even fraud. Companies retain counsel to redesign procedures, to advise of appropriate roles for officers and directors in corporate management and governance and, on occasion, to conduct investigations, all the time generating work product and communicating advice and results to the companies – in seeming confidence. Once auditors perform their planned procedures, and seek and then obtain access to the company’s privileged information regarding a variety of circumstances and issues, companies are increasingly losing any expectation that this information will remain confidential. Instead, companies now must expect that this sensitive information will find its way into the hands of litigation adversaries – merely because the company consulted with its attorneys, then cooperated with its independent auditors.

It is our perception that recent events have brought about a subtle but important change in how auditors carry out their responsibilities regarding public company oversight. The PCAOB’s and the SEC’s roles overseeing auditors’ compliance with GAAS in the detection of fraud and public companies’ compliance with securities laws have been strengthened. The auditors’ role in performing procedures regarding the fair presentation of a company’s financial statements has been spotlighted. It is the companies, however, that are charged with developing proper internal controls and cooperating with their auditors in the first instance. And yet, their reward may be vast exposure to civil litigations. As recognized whenever the attorney-client privilege and work product doctrine are debated, the kind of adventent, inadvertent and sometimes virtually compelled privilege waivers that companies are facing now serves to deny companies the effective assistance of counsel. While one public policy is being strengthened, one, therefore, is being weakened. The societal detriment caused by imprudent and unnecessary waivers of the privileges associated with the advice and involvement of counsel – a problem which has been highlighted by the shift in policy currently being experienced in the regulations surrounding Corporate America – is well-documented.

The waiver problem is very real. Judicial development in the law governing waiver of privileges is, at best, mixed, thus affording no assurance to companies that privileged information disclosed to auditors will remain protected from adversaries. The solution is not – and we emphasize that it is not the purpose of this White Paper to seek – that auditors back off from obtaining clarification or substantiation of facts from their corporate clients. Rather, the

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SEC Enforcement Director Stephen M. Cutler recently referred to auditors as one of the three principal “gatekeepers” in our capital markets, or “sentries of the marketplace.” See Stephen M. Cutler, Director of the Division of Enforcement at the SEC, Remarks at the UCLA School of Law, Los Angeles, CA (September 20, 2004), “The Themes of Sarbanes-Oxley as reflected in the Commission’s Enforcement Program” (transcript available at http://www.sec.gov/news/speech/spch092004smc.htm).
solution – as has already been recognized with regard to the SEC and the PCAOB – must be legislative protection of the privileges, recognizing that it is just as important for companies to furnish necessary information to their auditors while protecting it from disclosure to their adversaries as it is for auditors to seek what they need to fulfill their role as “gatekeepers.”

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

Whether or not the current political climate and regulatory developments constitute what could be considered changes to GAAS with respect to the detection of fraud – in other words, whether auditors are expected to apply more stringent standards to uncover corporate fraud, or whether there is simply greater public and government oversight of long-standing auditing standards – is debatable. Whatever the impetus, however, the consortium of public companies whose concerns prompted this paper cite a sharp increase in requests from independent auditors not simply for relevant factual information from the company, but also for privileged information, either as conditions of engagement or as requirements for completion of financial statement audits and reviews.

Given the regulatory trends discussed above, this reported increase in such requests is not particularly surprising. Recent comments by the SEC’s Deputy Chief Accountant, Scott Taub, pointedly suggest that auditors should seek out privileged information in support of audits of litigation loss and tax contingency accruals under FAS 5. Mr. Taub remarked as follows:

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

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

On August 26, 2004, in fact, the PCAOB released its first limited inspection reports on each of the four major accounting firms. The Board “cheerfully admit[ted] it is being harsh” in acknowledging that the reports appear to be “laden with criticism” and “an unflinching

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3 See Appendix A for a comprehensive analysis of the audit standards designed to detect fraud and the recent legislative and regulatory initiatives in this regard.
5 See id. (emphasis added).
6 Each of the four 2003 Limited Inspection Reports issued by the PCAOB are available at http://www.pcaobus.org/Inspections.
candour with firms about the points on which we see a need for improvement.” Among its limited inspection reports, the PCAOB criticized two firms for not having adequate support in one audit for contingent liabilities under FAS 5, including the analysis of counsel.

As members of the Corporate Counsel Consortium have reported, a company’s privileged information and the work product of its attorneys are increasingly being requested by auditors under various circumstances. Auditors are requiring clients to provide detailed information or open their files regarding whistleblower allegations, investigations and outcomes. For example, in connection with their obligation under Section 10A of the Exchange Act to follow “procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts,” auditors require public company clients to provide information about potential illegal acts and remediation efforts. Under the Section 10A structure, if an auditor becomes aware of information “indicating that an illegal act (whether or not perceived to have material effect on the financial statements of the issuer) has or may have occurred,” the auditor must take certain steps to inform itself, advise the issuer and ultimately satisfy itself that the company has appropriately remediated the matter. Companies and/or their audit committees typically launch internal investigations, led by legal counsel and resulting in an accumulation of attorney-client communications, witness interviews, advice of counsel and other legal work product and analyses. Thus, the information required by auditors frequently includes privileged attorney-client communications and work product.

Similarly, pursuant to Section 307 of the Sarbanes-Oxley Act (by which Congress directed the SEC to set forth “minimum standards of professional conduct for attorneys appearing and practicing before the Commission”) and the SEC’s implementing regulations which require attorneys to report “evidence of a material violation of securities law, or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or chief executive officer of the company,” corporate counsel is required – much like auditors under Section 10A – to report evidence of misconduct up the corporate ladder and to satisfy itself

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9 15 U.S.C. § 78j-1. Section 10A is modeled after the predecessor of SAS 82, a GAAS requirement that “[t]he auditor has a responsibility to obtain reasonable assurances about whether the financial statements are free of material misstatements, whether caused by error or fraud.” AICPA, Auditing Standard Board, Statement on Auditing Standards No. 82: Consideration of Fraud in a Financial Statement Audit (codified in AICPA Professional Standards, AU § 316). Section 10A imposes essentially the same auditing obligations, but adds a potential “reporting out” requirement to the SEC and explicitly exposes auditors to SEC sanctions for non-compliance.
that the company has taken appropriate remedial action.\textsuperscript{10} The Section 307 structure, therefore, also spawns internal investigations which generate attorney-client privileged communications and attorney work product. Auditors are requiring public company clients to disclose this internal investigation information, including whether corporate legal counsel has advised the company of evidence of any material violations of the law in the first place.

Such internal investigations frequently are undertaken by companies and their legal counsel, whether or not there is a parallel SEC investigation or proceeding. Indeed, companies’ roles in establishing the primary controls to detect and respond to allegations of fraud – through their audit committees – has grown considerably under the Sarbanes-Oxley Act. Pursuant to the Act, audit committees are charged with establishing procedures for receiving and handling complaints “regarding accounting, internal controls or auditing matters” and confidential submissions by corporate employees “regarding questionable accounting or auditing matters.”\textsuperscript{11} In implementing these responsibilities, many public companies and their audit committees have gone beyond the minimum requirements of the law and established procedures for receiving and investigating all whistleblower complaints, on any subject relevant to the company, from any source. Internal investigations are conducted pursuant to these procedures routinely in response to all disputes, whether or not litigation is involved, and attorney work product is generated as a result.

Auditors may require public company clients to disclose legal advice and analyses concerning other specific issues that could impact the financial statements of the company. As part of an audit of the company’s financial statement assertions regarding tax assets, liabilities and contingency reserves, auditors frequently require companies to disclose legal advice, analyses and judgments provided to the company concerning the potential tax consequences of transactions.\textsuperscript{12} In addition, as part of their audit inquiry into company loss contingencies pursuant to FAS 5, auditors ask that corporate legal counsel disclose their judgments and supporting information regarding potential outcome, range of loss and other issues resulting from litigation, claims and assessments against the company.

While in light of Mr. Taub’s comments and the criticisms levied in the PCAOB’s limited inspection reports, as discussed above, auditors may conclude that it would be imprudent in this climate not to demand expansive access to a company’s litigation files in these and other situations, this is neither entirely new nor \textit{per se} inappropriate. Certainly, this paper takes the position that the audit process has long been set up such that public companies have been giving their auditors access to the information that the auditors need – including sensitive information – to conduct their audits. The public interest in continuing and strengthening this system, in which auditors have access to all information required to conduct a proper audit, including inquiries

\textsuperscript{10} 17 C.F.R. Part 205.
\textsuperscript{12} Indeed, pursuant to an auditor’s obligations regarding loss contingencies for litigation, claims and assessments pursuant to FAS 5, GAAS provides that the “opinion of legal counsel on specific tax issues that he is asked to address and to which he has devoted substantive attention … can be useful to the auditor in forming his own opinion.” See AU §9326.17. The same standard warns further, however, that “it is not appropriate for the auditor to rely solely on such legal opinion” in conducting the audit regarding these issues. \textit{Id}. 
into corporate fraud, is laudable and undeniable. In other words, barring some notable exceptions, this is how the audit system has worked and should continue to work. And the exceptions should be, and are being, corrected. Fixing the problems which led to those exceptions, however, need not come at the expense of other public interests that are just as important.

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

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

A legal system that fails to assure public companies the protection of the attorney-client privilege and work product protection denies those companies the effective assistance of counsel when potentially illegal corporate behavior is discovered. As the Supreme Court has stated, impairment of these privileges and protections would “not only make it difficult for corporate attorneys to formulate sound advice when their client is faced with a specific legal problem but also threaten to limit the valuable efforts of corporate counsel to ensure their client’s compliance with the law.”

Absent assurance that attorney-client communications and work product can be protected as confidential, companies that seek the assistance of legal counsel would only do so in the face of an unacceptable risk that counsel will be converted “into a conduit of information between the client” and its adversaries.

13 See Appendix B for a comprehensive analysis of the historical significance of the attorney-client privilege and work product doctrine.

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


16 *See United States v. Chen*, 99 F.3d 1495, 1500 (9th Cir. 1996) (the “valuable service of counseling clients and bringing them into compliance with the law cannot be performed effectively if clients are scared to tell their lawyers what they are doing, for fear that their lawyers will be turned into … informants”); Joint Drafting Committee of the American College of Trial Lawyers, *The Erosion of the Attorney-Client Privilege and Work Product Doctrine in Federal Criminal Investigations* (March 2002), at 11. In addition, the Antitrust Law Section’s paper, discussed *supra*, makes the point that companies that cannot protect privileged information from litigation adversaries naturally will be deterred from conducting thorough
These concepts supporting the protection of attorney work product and privileged communications are not incompatible with the function of auditors and their ability to obtain the comprehensive information that they need to conduct proper audits. In 1975, the audit and legal professions debated the issue and reached an accord—“Treaty,” as it is sometimes called—regarding the waiver problem arising when auditors ask their clients for privileged information related to the judgments of company counsel regarding loss contingencies for litigation, claims and assessments. This “Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information,” as adopted by the ABA and consented to by the AICPA, struck a balance between two very important public interests: first, to promote confidence in the capital markets by assuring reliable financial reporting of loss contingency accruals and disclosures under FAS 5, and second, to encourage companies to consult freely with counsel by protecting the confidentiality of lawyer-client communications. The ABA Statement of Policy struck the balance by limiting the range of acceptable disclosures that lawyers may make to auditors with the client’s informed consent, and thus defined the scope of what the auditors may request from lawyers regarding confidential attorney information. In 1977, the AICPA affirmed this
protection and limitation regarding auditor access to confidential information and work product maintained by the client.  

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

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

Thus, while it is the auditors who require access to such attorney-client information – as part of their job of performing audits – they recognized the importance of the privileges enough to agree to a “Treaty” insisting that the public interest in protecting these privileges be upheld.

The SEC is also on record promoting work product protection for the internal investigation files of a public company’s counsel. The SEC recently argued in one case, United States v. Bergonzi, that its responsibilities would be frustrated if companies were deterred from sharing their work product from internal investigations with the SEC, and because of this concern, the SEC argued that such production “should not result in waiver of work-product

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21 See AICPA Professional Standards, AU § 9337 (4), Documents Subject to Lawyer-Client Privilege (March 1977). The interpretive release poses the question: “[SAS 12 states:] “Examine documents in the client’s possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.” Would this include a review of documents at the client’s location considered by the lawyer and the client to be subject to the lawyer-client privilege?” and answers as follows: “No. Although ordinarily an auditor would consider the inability to review information that could have a significant bearing on his audit as a scope restriction, in recognition of the public interest in protecting the confidentiality of lawyer-client communications, [SAS 12] is not intended to require an auditor to examine documents that the client identifies as subject to the lawyer-client privilege.” (Emphasis added)

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

23 Indeed, a Practicing Law Institute conference on securities litigation and enforcement held September 1, 2004 included a panel of attorneys who practice before the SEC who commented that internal investigations conducted by a company to respond to fraud allegations “may cause more harm than good” because the SEC now regularly demands waiver of privileges, and “[t]hat information is then discoverable by plaintiffs’ lawyers in civil litigation.” Conference Panelists Discuss Securities Litigation and Enforcement, SEC Today (CCH Sept. 16, 2004), at 1. One panelist suggested that “the waivers of attorney/client privilege will have a chilling effect on the information provided by clients to their lawyers, which is what the privilege is intended to protect.” Id. at 2.
protection because preserving work-product protection is in the public interest. . . .”\textsuperscript{24} The SEC pointed out that there are “significant benefits to the public” when a company can share its work product with the SEC, thereby allowing the SEC to fulfill its oversight function, without fear by the company that its work product will end up in the hands of its adversaries: “The choice is thus between disclosure only to government agencies, which will increase the effectiveness and efficiency of governmental investigations, and no disclosure at all – not a choice between disclosure only to government agencies and disclosure to all parties.”\textsuperscript{25}

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

IV. THE WAIVER PROBLEM

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

\textsuperscript{24} United States v. Bergonzi, 9th Cir. Case No. 03-10024, Brief of the Securities and Exchange Commission, 2003 WL 22716310 (Apr. 29, 2003), at *3-4. The ABA Section of Antitrust Law recently echoed this same argument, stating its belief that a waiver of these protections based upon disclosure by a company of its privileged or work product materials to the government “will reduce the availability of information from an organization’s management and employees, and impede the development and operation of effective compliance programs.” See Comments of the ABA’s Section of Antitrust Law, supra, at 2.

\textsuperscript{25} United States v. Bergonzi, SEC Brief, supra, at *16-17. The SEC also took the position that, “[t]he Commission cannot compel public companies to produce work product, and even cooperative companies generally will not produce work product for fear that production will waive work-product protection as to third parties.” Id. at *22-23 (as support for this position, which the SEC stated was the “likely” result, id. at *30, the SEC cited to pages of the record on appeal but did not describe the information therein). This paper disclaims any suggestion that, as to its auditors, companies do not provide requested work product; companies have a vested interest in ensuring that their auditors obtain the information that is needed to assess whether an unqualified audit opinion may be given.
A. CASE LAW REGARDING WAIVERS OF PRIVILEGES BASED UPON DISCLOSURE TO AUDITORS

The ABA Statement of Policy expressed the drafter’s expectation that judicial developments regarding disclosure of confidential information provided to auditors would not prejudice clients “engaged in or threatened with adversary proceedings,” but also provided that if judicial developments were adverse, revision of the ABA Statement might be needed. Indeed, the case law has been neither favorable nor consistent with respect to the protection of confidential information disclosed by clients to auditors.

With respect to the attorney-client privilege, courts generally hold that disclosure of attorney-client communications to auditors, as independent third parties, constitutes a waiver. Courts in some states, however – those states which, through legislation or otherwise, have created an accountant-client privilege – reach the opposite conclusion regarding the disclosure of attorney-client communications to auditors.

Regarding the work product doctrine, there is even less consistency among courts. Some courts hold that most work product disclosed by companies to their auditors was prepared in the ordinary course of business, not “in anticipation of litigation or for trial,” which is the language used to describe the work product protection in Federal Rule of Civil Procedure 26(b)(3), and thus is discoverable. Other courts hold that such work product is not discoverable because it does not constitute relevant evidence in a litigation. One court decided that the company’s disclosure waives the protection of the work product doctrine because there are no

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26 See Appendix C for a comprehensive analysis of the case law regarding waivers of the attorney-client privilege and work product protection based upon a company’s disclosure to its auditors.

27 ABA Statement of Policy, Commentary, par. 1 (“The Statement of Policy has been prepared in the expectation that judicial development of the law in the foregoing areas will be such that useful communication between lawyers and auditors in the manner envisaged in the Statement will not prove prejudicial to clients engaged in or threatened with adversary proceedings. If developments occur contrary to this expectation, appropriate review and revision of the Statement of Policy may be necessary.”). In 1989, following an early adverse court decision on the issue of waiver, another ABA committee sought to mitigate the risk of further waiver rulings. The committee issued a report advising lawyers to state expressly in their communications to auditors that neither the client nor the auditor intended any waiver of the attorney-client or work product privileges. See Subcommittee on Audit Inquiry Responses, Law and Accounting Comm., ABA Section of Business Law, Report by the American Bar Association’s Subcommittee on Audit Inquiry Responses (1989), reprinted in Lawyers’ Letters to Auditors, supra, at 381-84. As the committee said, such language “simply makes explicit what has always been implicit, namely … that neither the client nor the lawyer intended a waiver.” The AICPA agreed with the ABA committee in a 1990 interpretation of SAS 12 advising auditors that such language in a lawyer’s letter did not impose a scope limitation requiring a qualified audit opinion. See AICPA, Auditing Interpretation: Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments – Use of Explanatory Language about the Attorney-Client Privilege or the Attorney Work Product Privilege, J. Acct. (Feb. 1990), reprinted in Lawyers’ Letters to Auditors, supra, at 384-85.


29 Only fifteen states have any such statute and, of those, only seven have expressly extended the privilege to independent auditors by statute or judicial ruling. See Appendix C for further analysis.
“common interests” between an auditor and the client; other courts disagree.\textsuperscript{30} Many courts employ still other – and vastly different – lines of reasoning. The bottom line is that, while most authorities support the argument that disclosure of work product to auditors should not waive the protection as to adversaries, some courts affirmatively hold that disclosure constitutes a waiver. Because the case law is not uniform, companies have no guarantee that courts will protect attorney work product from waiver as to the companies’ adversaries if these materials are disclosed to auditors. This uncertainty completely undermines the purpose of the privilege: As the United States Supreme Court said, “[a]n uncertain privilege, or one which purports to be certain but results in widely varying applications by the courts, is little better than no privilege at all.”\textsuperscript{31}

To the extent that some courts have protected privileged information disclosed to auditors from discovery by third-party adversaries, as outlined on Appendix C, the lynchpin has been the auditors’ professional obligation to maintain the information in confidence.\textsuperscript{32} Certified Public Accountants are members of the AICPA and thus bound by AICPA Code of Professional Conduct Rule 301, which prohibits disclosure of client confidential information without “the specific consent of the client.”\textsuperscript{33} The only exceptions under Rule 301 are when disclosure is compelled by legal process (\textit{e.g.}, a subpoena), or required in connection with review of the auditor’s professional practice or with investigative or disciplinary proceedings conducted by the AICPA or another oversight body. In the latter circumstances, Rule 301 prohibits the AICPA and other oversight bodies from disclosing any auditor’s “confidential client information that comes to their attention in carrying out those activities.”\textsuperscript{34} Further, auditors have accepted the constraints on disclosure under the ABA Statement of Policy, which provides that a lawyer’s responses may be used by the auditor only in connection with the audit, and may not be quoted or referenced in the client’s financial statements, or filed with any government agency, or disclosed in response to any subpoena or other process without the lawyer’s consent or upon at least 20 days’ prior notice.\textsuperscript{35} The expectation of confidentiality safeguards in the audit system has been key to those decisions denying waivers by a company’s cooperation with its auditors.\textsuperscript{36}

\begin{itemize}
  \item \textsuperscript{30} Compare Medinol, Ltd. v. Boston Scientific Group, 214 F.R.D. 113, 115 (S.D.N.Y. 2002) with In re Pfizer, 1993 WL 561125, at *6; and Appendix C for further analysis of the cases.
  \item \textsuperscript{31} Upjohn, 449 U.S. at 392.
  \item \textsuperscript{32} Lawyers, of course, are bound by rules of ethics and professional responsibility not to reveal client confidences without client consent; hence, informed consent is a central feature of the ABA Statement of Policy. See Rule 1.6 of the ABA Model Rules of Professional Conduct, available at http://www.abanet.org/cpr/mrpc/rule_1_6.html.
  \item \textsuperscript{33} AICPA, Rules of Professional Conduct, ET Section 301: Confidential Client Information, Rule 301.01 (Jan. 1992, as amended) (“A member in public practice shall not disclose any confidential client information without the specific consent of the client.”)
  \item \textsuperscript{34} Id.
  \item \textsuperscript{35} ABA Statement of Policy, par. 7.
  \item \textsuperscript{36} Confidentiality agreements have, therefore, likewise been crucial in the handful of decisions finding non-waiver despite disclosure of work product to government investigators. See, e.g., Saito v. McKesson HBOC, Inc., 2002 WL 31657622, at *6, 11 (Del. Ch. Ct. Nov. 13, 2002) (“[P]ublic policy seems to mandate that courts continue to protect the confidentially disclosed work product in order to encourage corporations to comply with law enforcement agencies.”); Maruzen Co., Ltd. v. HSBC USA, Inc., 2002 WL 1628782, at *2 (S.D.N.Y. June 23, 2002) (denying motion to compel because defendants had
\end{itemize}
Unfortunately, however, the post-Sarbanes-Oxley Act world has weakened this expectation of confidentiality and thus brought even greater uncertainty regarding the discoverability of privileged information provided by companies to their auditors. Under the Sarbanes-Oxley Act, it is the PCAOB – not the AICPA – which is charged with establishing standards for auditing, attestation, quality control, ethics and independence with respect to public company audits, subject to SEC approval. In April 2003, the PCAOB adopted interim, transitional standards in each of these areas which generally directed public company auditors to continue to comply with AICPA standards. The interim ethics standards selectively identify only certain rules of the AICPA Code of Professional Conduct for adoption – not including Rule 301. While auditors should abide by Rule 301 as members of the AICPA, the rule has been given no force by the PCAOB. This omission may place public companies at greater risk that courts will find waivers when privileged information is disclosed to auditors.

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

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

**1. H.R. 2179**

The SEC will consider a company’s voluntary cooperation with an investigation as a mitigating factor in determining appropriate enforcement action, if any. The SEC has promulgated guidelines identifying factors that it will consider in assessing the quality of a company’s cooperation, and those guidelines emphasize the importance of a company’s decision to waive attorney-client privileges and work product protections. The threat of an enforcement

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action that might be avoided by cooperating fully places strong pressure on companies to waive privileges, which, in turn, risks further waiver and compelled disclosure to other adversaries.

Recognizing this serious dilemma for companies, the SEC has adopted the position that waiver of privileges in order to cooperate with the SEC should not result in a broader waiver as to other parties. This “selective waiver” concept, however, has been rejected by many courts which hold that a company’s production of privileged information to the SEC or another government agency constitutes a full waiver of all privileges and protections that otherwise might have applied against any other adversaries.

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

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

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


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

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

2. **Section 105 of The Sarbanes-Oxley Act**

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

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

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

Section 105(b)(5) addresses the same waiver problem that gave rise to H.R. 2179. It reflects Congress’ recognition that disclosure of confidential information by audit firms to an oversight body exposes the audit firm to waivers of privilege. This provision is designed to

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

47 A May 17, 2002 report by the General Accounting Office, based on a study by an agency then-charged with oversight of the public accounting profession, found that “[t]he self-regulatory system lacks the power to protect the confidentiality of investigative information regarding alleged audit failures or other
facilitate effective oversight by the PCAOB and cooperation by audit firms by assuring that confidential information will not be discoverable by others.

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

V. CONCLUSION

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

On the contrary, the objective of fair disclosure in financial statements is more likely to be better served by maintaining the integrity of the confidential relationship between attorney and client, thereby strengthening corporate management’s confidence in counsel and encouraging its readiness to seek advice of counsel and to act in accordance with counsel’s advice.48

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

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

48 ABA Statement of Policy, Preamble.
The SEC and PCAOB, joined by the corporate counsel community and the principal auditors of the vast majority of U.S. public companies, should propose and support federal legislation, modeled on H.R. 2179, that would permit companies to provide privileged attorney-client communications and work product to their auditors in connection with audits, reviews, attestations and compliance with Section 10A of the 1934 Securities and Exchange Act without waiving any privileges as to others.
APPENDIX A

“DETECTING” CORPORATE FRAUD: AUDIT STANDARDS, LEGISLATION AND RECENT REGULATORY INITIATIVES

Generally acceptable auditing standards have long recognized that auditors have particular responsibilities with respect to the discovery of corporate fraud during an audit. SAS 1, *Codification of Auditing Standards and Procedures*, in fact, provides that the auditor has a responsibility to plan and to perform financial statement audits in order to obtain “reasonable assurance” about whether the financial statements are free of material misstatement, whether caused by error or fraud.49 In October 2002, the Auditing Standards Board issued SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*.50 SAS No. 99 establishes standards for auditors to fulfill that responsibility as it relates to fraud in an audit of financial statements conducted in accordance with GAAS.

SAS 99, consistent with its predecessor, recognizes that “it is management’s responsibility to design and implement programs and controls to prevent, deter, and detect fraud.” The auditor’s “interest,” however, is in obtaining evidential matter regarding intentional acts that “result in a material misstatement of the financial statements.” Thus, the auditor is required to exercise professional skepticism when planning and performing the audit, to consider whether the presence of certain “risk factors” – *i.e.*, red flags – indicate the possible presence of fraud and, if risks of fraudulent, material misstatement are identified, consider the impact of this finding on the audit report and whether reportable conditions relating to the company’s internal controls exist and should be communicated to the company or its audit committee.51 An auditor’s obligations to gather evidential matter to satisfy itself regarding the presence of fraud includes making inquiries “about the existence or suspicion of fraud” to any appropriate personnel within the company, and SAS 99 suggests that the auditor “may wish to direct these inquiries” to the company’s in-house legal counsel.52

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

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

51 SAS 99, ¶¶ 5, 12, 31, 80.

52 *Id.* at ¶¶ 24-25. Other guidance found in GAAS suggests that an auditor may wish to obtain evidential matter through company counsel. For example, pursuant to an auditor’s obligations regarding loss contingencies for litigation, claims and assessments pursuant to FAS 5, GAAS states that the “opinion of
While GAAS, therefore, has outlined the obligations of auditors to obtain reasonable assurance that a company’s financial statements are free of material misstatement due to error or fraud, several recent developments have focused heightened attention on the function of the auditor in the discovery of public company fraud. In particular, the financial reporting scandals that have washed over the capital markets since 2001, leading to the Sarbanes-Oxley Act of 2002 and other laws and regulations, have placed new emphasis on assuring accurate financial reporting. Further, in today’s political and regulatory environment, audit firms and individual auditors are exposed to vastly greater risk of draconian liability and professional sanctions for shortcomings in the performance of audits and reviews.

This renewed emphasis is apparent through legislative and regulatory creations. For example, Section 10A of the 1934 Securities & Exchange Act,53 which was added by the Private Securities Litigation Reform Act of 1995 (“Reform Act”), requires auditors to employ procedures, in accordance with GAAS, designed to provide “reasonable assurance of detecting illegal acts” that would have a material effect on the financial statements. Like SAS 82, auditors are required to report evidence of fraud up the corporate ladder to management and to the audit committee under certain circumstances, but Section 10A added a requirement that the auditor report not only up, but out to the SEC if – after investigation of evidence of an illegal act uncovered during an audit – the auditor determines that (1) the audit committee or board is adequately informed of the illegal act, (2) the illegal act has a material effect on the financial statements, (3) the illegal act has not been appropriately remediated and (4) as a result, the auditor will be required to issue a qualified audit opinion or resign.54 Because auditors face potential civil liabilities imposed by the SEC under Section 10A for mere negligence – there is no scienter requirement for proceedings brought under Section 10A – this provision has grown, through the scandals of 2001, as a regulatory tool for increasing scrutiny of the performance of audits.

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

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

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53 15 U.S.C. § 78j-1. Section 10A was modeled after SAS 53, the predecessor to SAS 82.
of confidence in our accounting firms and the audit process is a burden our capital markets cannot and should not bear.\textsuperscript{55}

This proved to be more than rhetoric. The Sarbanes-Oxley Act, enacted later that year, directed the SEC to study enforcement actions over the prior five years to identify areas of financial reporting most susceptible to fraud.\textsuperscript{56} The SEC’s review, presented in a January 2003 report to Congress (the “704 Report”), showed that of 515 enforcement actions in total, 18 actions were filed against audit firms and 89 against individual auditors.\textsuperscript{57} In the vast majority of these actions, auditors were sanctioned, in the SEC’s words, for “failing to gain sufficient evidence to support the issuer’s accounting, failing to exercise the appropriate level of skepticism in responding to red flags, and failing to maintain independence.”\textsuperscript{58} The 704 Report concludes that “audit failures most often arise from auditors accepting management representations without verification, truncating analytical and substantive procedures, and failing to gain sufficient evidence to support the numbers in the financial statements.”\textsuperscript{59}

Administrative and enforcement actions filed in 2003 and 2004 reflect even greater scrutiny of the work of auditors who failed to catch fraud by their clients.\textsuperscript{60} Recent

\begin{itemize}
  \item \textsuperscript{56} The Sarbanes-Oxley Act, Section 704, 107 P.L. 204, Title VII, Section 704, 116 Stat. 745.
  \item \textsuperscript{58} \textit{Id.} at 3.
  \item \textsuperscript{59} \textit{Id.} at 40.
  \item \textsuperscript{60} For example, in \textit{Matter of Barbara Horvath, CPA}, Admin. Proc. File No. 3-10665, Accounting and Auditing Enforcement Release No. 1483 (Dec. 27, 2001), the SEC censured a Deloitte & Touche auditor for placing reliance on management representations as her principal source of audit evidence for the company’s capitalization of expenses which, it turned out, were fraudulent. The SEC contended that she should have demanded more supporting documentation and followed up on “red flags.” The SEC imposed a two-year suspension from practice upon another auditor (involved in the same audit) for sampling too few items when auditing the company’s contract acquisition costs. \textit{See In the Matter of Jeffrey Bacskik, CPA}, Admin. Proc. File No. 3-10664, Accounting and Auditing Enforcement Release No. 1482 (Dec. 27, 2001). The SEC’s enforcement record includes numerous similar cases. \textit{See, e.g.}, \textit{In the Matter of PricewaterhouseCoopers LLP}, Admin. Proc. File No. 3-11483, Accounting and Auditing Enforcement Release No. 2008 (May 11, 2004) (corporate fraud) (action against PwC in connection with audit of the Warnaco Group’s financial statements from 1998 and alleged failure to correctly characterize the cause of an inventory overstatement as resulting from internal control deficiencies as opposed to changed accounting rules, as misrepresented by Warnaco in a press release); \textit{In the Matter of Grant Thornton LLP, et al.}, Admin. Proc. File No. 3-11377, Accounting and Auditing Enforcement Release No. 1945 (Jan. 20, 2004) (corporate fraud) (administrative proceeding against Grant Thornton for aiding and abetting fraud and violating Section 10A, by allegedly failing to obtain sufficient audit evidence despite “red flags” that client failed to disclose material related party transactions); \textit{In the Matter of Carroll A. Wallace, CPA}, Admin. Proc. File No. 3-9862, Accounting and Auditing Enforcement Release No. 1846 (Aug. 20, 2003) (probable corporate fraud) (KPMG auditor suspended for one year for undue reliance on management representations, failure to maintain an appropriate attitude of skepticism, failure to obtain sufficient evidential material to discover that the client investment fund’s financial statements improperly stated that all of its shares were unrestricted); \textit{In the Matter of Richard P. Scalzo, CPA}, Admin. Proc. File No. 3-11212, Accounting and Auditing Enforcement Release No. 1839 (Aug. 13, 2003) (corporate fraud) (auditor permanently barred from public practice based on audits of Tyco between 1997 and 2001 in which he
public statements by the Director of the Division of Enforcement, Stephen Cutler, called attention to the role of auditors, among others, being “the sentries of the marketplace,” the change in the Enforcement Division’s approach regarding “deficient audits” by focusing now on firm responsibility for those audits and the hope of the Enforcement Division that “accounting firms will take an even greater role in ensuring that individual auditors are properly discharging their special and critical gatekeeping role.” All of these factors reflect the expectation that scrutiny on auditors will continue to increase as expectations for their increased role in monitoring and finding inappropriate corporate accounting behavior continue to grow.

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

We have a very clear view that it is their job [to detect fraud]. If we see fraud that wasn’t detected and should have been, we will be very big on the tough

became aware of facts that put him on notice regarding the integrity of Tyco’s management but failed to perform additional audit procedures or reevaluate his risk assessment; In the Matter of Warren Martin, CPA, Admin. Proc. File No. 3-11211, Accounting and Auditing Enforcement Release No. 1835 (Aug. 8, 2003) (auditor suspended from public practice for two years for undue reliance upon management representations regarding the interpretation of contracts, thereby ignoring “unambiguous contractual language” that affected revenue recognition and led to a $66 million restatement); In the Matter of Michael J. Marrie, CPA and Brian L. Berry, CPA, Admin. Proc. File No. 3-9966, Accounting and Auditing Enforcement Release No. 1823 (July 29, 2003) (corporate fraud) (suspending two auditors from public practice for failing to act with sufficient skepticism and obtain enough audit evidence with respect to confirmation of accounts receivable, sales returns and allowances, and a $12 million write-off); In the Matter of Phillip G. Hirsch, CPA, Admin. Proc. File No. 3-11133, Accounting and Auditing Enforcement Release No. 1788 (May 22, 2003) (corporate fraud) (suspending PwC auditor for one year in settlement of allegations that he did not ensure that sufficient audit procedures were conducted in light of PwC’s risk of fraud assessment and that he placed undue reliance on management representations despite awareness of evidence “from which he should have realized further audit work was required.”); SEC v. KPMG, Civil Action No. 02-cv-0671 (S.D.N.Y. January 29, 2003), Accounting and Auditing Enforcement Release No. 1709 (possible corporate fraud) (civil injunction against KPMG seeking disgorgement of fees and civil penalties in connection with the firm’s audit of Xerox based on allegation that auditors had evidence of manipulation of financial results and failed to ask Xerox to justify departures from GAAP).


63 GAAS expressly recognizes that a properly performed and executed audit may fail to detect fraud. SAS 82, Consideration of Fraud in a Financial Statement Audit, explains how fraud is less likely to be detected when it involves concealment and collusion: “An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected. Because of (a) the concealment aspects of fraudulent activity, including the fact that fraud often involves collusion or falsified documentation, and (b) the need to apply professional judgment in the identification and evaluation of fraud risk factors and other conditions, even a properly planned and performed audit may not detect a material misstatement resulting from fraud.” AU § 316.10.
and not so [big] on the love. … [A]uditors [need to] understand that, with relatively few exceptions, they should find it. To me, the relatively few exceptions are those cases where you would have some extremely dedicated, capable crooks. In most cases, though, the crooks either are not that smart or they don’t cover their tracks that well.64

Under the Sarbanes-Oxley Act and the PCAOB’s implementing regulations, any violation of laws, rules or policies by individual auditors or firms detected during inspections of selected audit and review engagements will be identified in a written report and may be handed over to the SEC or other regulatory authorities and become the subject of further investigation and disciplinary proceedings.65 The PCAOB has stated that inspections will assess compliance at all levels — i.e., actions, omissions, policies and behavior patterns “from the senior partners to the line accountants.”66 The inspections will allow the PCAOB, in its own words, to “apply pressure to improve a firm’s audit practices.”67

The recent wave of scrutiny on auditors’ detection of fraud has also extended to the companies themselves. It has always been the obligation of a company, of course, to cooperate fully with its independent auditors. Recent legislation and regulatory developments have focused additional pressure on companies to do so – again, in the interest of strengthening the functionality of audits. Reaffirming the company’s obligation to cooperate fully with its auditors, the SEC promulgated Regulation 13b2-2, “Representations and conduct in connection with the preparation of required reports and documents,” effective June 27, 2003.68 The Regulation prohibits officers and directors of public companies from making a “materially false or misleading statement [or a material omission] to an accountant in connection with” an audit or other filing with the SEC. It further provides that officers and directors may not “directly or indirectly take any action to coerce, manipulate, mislead, or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements.”

By both design and effect, these regulatory developments — Section 10A, SEC enforcement and PCAOB inspections and rule-making — have led in recent years to a framework for enhanced government oversight of audited financial statement disclosure and auditors. These exemplify the strong public interest in preserving and strengthening the audit function. They

65 When the PCAOB believes that an act, practice or omission by a registered firm or individual auditor may violate the Sarbanes-Oxley Act, PCAOB rules or other professional standards or any securities law or regulation pertaining to audit reports or to the duties of accountants, the PCAOB may open an investigation. See PCAOB R. 5101. Such an investigation can lead to disciplinary proceedings, exposing the offending auditor or firm to penalties ranging from compulsory training and mandated quality control procedures to heavy civil fines and temporary or permanent suspension from audit practice.
68 17 C.F.R. § 240.13b2-2.
69 Id. at § 240.13b2-2(a) & (b).
also may reflect why auditors are perceived by their corporate clients to be seeking more privileged and work product protected materials than what appears to have been the case in years past.
APPENDIX B

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

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

The attorney-client privilege is “the oldest of the privileges for confidential communications known to the common law.”\(^70\) The purpose of the privilege is to “encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice.”\(^71\)

The strongest criticism of the attorney-client privilege – and, indeed, of any evidentiary privilege – is that, in court proceedings, potentially valuable evidence may be suppressed and the “truth” harder to find. This debate has been raised countless times, and no doubt it is being raised again now as the risk of waiver by companies increases in proportion with the volume of auditor requests for disclosure of the company’s confidential information. But in our society, the debate has been settled consistently; as one court has described: “The social good derived from the proper performance of the functions of lawyers acting for their clients is believed to outweigh the harm that may come from the suppression of the evidence in specific cases.”\(^72\) As the Supreme Court has held, this social good appropriately extends to corporations as well as to individuals.\(^73\)

Protecting the confidentiality of work product likewise furthers vital public interests. “[T]he work product privilege [exists] … to promote the adversary system by safeguarding the fruits of an attorney’s trial preparations from the discovery attempts of the opponent.”\(^74\) Work product protection encourages parties and their counsel to prepare for litigation and trial without concern that their work will be discoverable by the opposition. Work product protection supports a fair adversary system by “by affording an attorney ‘a certain degree of privacy’ so as to discourage ‘unfairness’ and ‘sharp practices.’”\(^75\) As one Supreme Court Justice wrote in a concurring opinion to the seminal decision supporting the doctrine, “[d]iscovery was hardly intended to enable a learned profession to perform its functions . . . on


\(^{71}\) Id.


\(^{73}\) Upjohn, 449 U.S. at 389-90.


wits borrowed from the adversary."\(^7\) The work-product doctrine is simply a recognition that a lawyer’s work on behalf of a client preparing a response to litigation or a potential claim – even when not subject to the attorney-client privilege – must also be protected, lest all lawyers be discouraged from conducting those preparations effectively, the clients be punished and their adversaries be unfairly rewarded. Those who fear that the work product generated by their counsel in determining an appropriate response will be disclosed to their adversaries and promptly used against them will, not surprisingly, be reluctant to seek legal assistance at all.

Protection of work product is codified in Federal Rule of Civil Procedure 26(b)(3), which extends protection to the work of a party’s representatives, “including an attorney, consultant, surety, indemnitor, insurer, or agent” in anticipation of litigation or for trial. Work product is not discoverable by an opposing party absent a showing of “substantial need for the materials in the preparation of the party’s case and [inability] without undue hardship to obtain the substantial equivalent of the materials by other means.” But even when an opposing party makes this showing, courts must protect against disclosure of the “mental impressions, conclusions, opinions or legal theories of an attorney or other representative of a party.”\(^7\) As Rule 26(b)(3) codifies, disclosure of the diligent work performed by an attorney to his client’s litigation opponent would undermine the adversarial underpinnings of our legal system itself. And it is because of this underlying rationale that work product protection may not – unlike the attorney-client privilege – be waived by mere disclosure to a third party, “but rather only if a disclosure runs counter to the principles embodied by the adversary system.”\(^7\) Protecting work product from adversaries is the policy goal of the doctrine; it is grounded on sheer fairness. It is only when it would not be unfair for an adversary to obtain that work product – i.e., when the adversary meets its burden to show that it “has substantial need of the materials in the preparation of the party’s case and that the party is unable without undue hardship to obtain the substantial equivalent of the materials by other means”\(^7\) – that the policy to protect work product will not apply.

Companies expect that the work product of their counsel prepared as a result of an internal investigation will be protected, and legitimately so. Increasingly, companies and, on occasion when the circumstances call for it, their audit committees or other independent committees, are using counsel to investigate evidence of alleged corporate or employee wrongdoing by interviewing company employees, identifying relevant documents, analyzing the facts and law and formulating conclusions and recommendations. Internal investigations, conducted by and at the direction of legal counsel, are a critical tool by which companies and their boards learn about violations of law, breaches of duty and other misconduct that may expose the company to liability and damages. Internal investigations are an essential predicate to enabling companies to take remedial action, and to formulate defenses, where appropriate. They are, therefore, entitled to and afforded work product protection from adversaries, so long as the investigations are not merely being conducted in the ordinary course of business. As one commentator has noted: “The general rationale for finding work product protection is that

\(^7\) \text{Hickman v. Taylor, 329 U.S. 495, 516 (1946) (Jackson, J., concurring).}

\(^7\) Fed. R. Civ. P. 26(b)(3).


\(^7\) Fed. R. Civ. P. 26(b)(3).
litigation is virtually assured if the investigation confirms the allegations. Since the corporation would be required to report the results to shareholders and government agencies, the possibility of a suit following is considered inevitable.”

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

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

81 See Sporck v. Peil, 759 F.2d 312, 315 (3rd Cir. 1985) (lawyer’s choice of documents with which to prepare deponent is work product even if the underlying documents themselves are not, “[b]ecause identification of documents as a group will reveal defense counsel's selection process, and thus his mental impressions…”); see also In re Grand Jury Subpoenas Dated October 22, 1991 and November 1, 1991, 959 F.2d 1158, 1166-67 (2d Cir. 1992) (noting that work product exception is only found when there is “real, rather than speculative concern that the thought process of [the client’s] counsel… would be exposed,” and allowing production of all telephone records from a specified period) (internal citations and quotations omitted); In re Grand Jury Subpoenas Dated March 19, 2002 and August 2, 2002, 318 F.3d 379, 386-87 (2d Cir. 2003) (finding that lower court was correct in allowing discovery of disputed materials because producing party had failed to disclose any strategy ex parte to the district court judge, making it impossible for judge to determine whether the responsive subset of documents reflected lawyers’ selection or was simply the product of document retention policies); Shelton v. American Motors Corp., 805 F.2d 1323, 1326 (8th Cir. 1987) (“We hold that where, as here, the deponent is opposing counsel and has engaged in a selective process of compiling documents from among voluminous files in preparation for litigation, the mere acknowledgment of the existence of those documents would reveal counsel’s mental impressions, which are work product.”).
APPENDIX C
SURVEY OF CASE LAW REGARDING WAIVER OF ATTORNEY-CLIENT PRIVILEGE AND WORK-PRODUCT PROTECTION BASED UPON DISCLOSURE TO AUDITORS

Attorney-Client Privilege

Courts generally hold that disclosure of attorney-client communications to auditors waives the attorney-client privilege.\(^2\) Courts reason that because the purpose of the privilege is to protect the confidentiality of the communications, almost any disclosure to an outsider breaches the confidence and waives the privilege. Thus, unless an accountant is helping the attorney to advise the client (a role that an auditor could rarely, if ever, undertake given independence constraints), disclosure to the outside accountant waives the privilege.\(^3\)

The only jurisdictions in which disclosure may not result in a waiver are states that, by statute, recognize an accountant-client privilege. Only fifteen states have any such statute and, of those, only seven have expressly extended the privilege to independent auditors by statute or judicial ruling.\(^4\) In every other jurisdiction, including all federal courts, the common law rule applies that communications between outside auditors and clients are not privileged.\(^5\)

Work Product Doctrine

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\(^3\) See Ferko Nat’l Assoc. for Stock Car Auto Racing, 218 F.R.D. 125, 135 (E.D. Tex. 2003), citing United States v. Kovel, 296 F.2d 918, 921-22 (2d Cir. 1961), which extended the attorney client privilege to attorney-accountant communications for the purpose of assisting the lawyer to advise the client.


\(^5\) See Couch v. United States, 409 U.S. 322, 335 (1973) (“no confidential accountant-client privilege exists under federal law, and no state-created privilege has been recognized in federal cases”).
With respect to whether work product protection survives disclosure to auditors, courts have divided at several analytical points. Some courts never reach the question of waiver, but nonetheless refuse to compel third-party discovery on the grounds that attorney analyses of loss contingencies are neither evidence nor relevant – or, to the extent that these analyses have any probative value, that value is outweighed by unfair prejudice and public interest concerns.\(^ {86} \)

In another line of authority, courts have held that any evaluation of litigation risk and loss exposure prepared in response to an audit inquiry does not constitute work product at all because the work was prepared primarily for a business purpose (i.e., auditing financial statements), rather than “in anticipation of litigation or for trial.”\(^ {87} \) This line of authority, however, is older, has attracted no recent followers and reflects a minority view.

The majority view, followed in several recent cases, is that work product includes any material prepared “because of” actual or potential litigation, thus encompassing analysis of litigation exposure prepared in response to an audit inquiry.\(^ {88} \) These authorities reject the earlier,\(^ {88} \)

\(^ {86} \) In the following cases, courts rejected attempts by client adversaries to discover documents created by counsel and provided to auditors, including audit-inquiry responses concerning assessment of pending and potential litigation. See Tronitech, Inc. v. NCR Corp., 108 F.R.D. 655, 655-56 (S.D. Ind. 1985) (attorney letter to auditors was not discoverable under Fed. R. Civ. Proc. 26(b)(1) because it was not legally relevant or reasonably calculated to lead to the discovery of admissible evidence); United States v. Arthur Young & Co., 1984 U.S. Dist. LEXIS 22991, at *11 (N.D. Okla. Oct. 5, 1984) (“If some theory of relevance can be advanced concerning the documents under review, the Court would conclude its probative value is substantially outweighed by the danger of unfair prejudice and public interest concerns.”); In re Genentech, Inc. v. Securities Litig., Case No. C-99-4038 (N.D. Cal. 1999) (unpublished) (noting that attorney’s opinions are not relevant or at issue in the lawsuit); Comerica Bank of Calif. v. Lloyd Raymond Free, Case No. 88-20880 (N.D. Cal. 1999) (unpublished) (noting “tangential relevance” of information and finding public policy in favor of protecting attorney’s work-product to be more important); Teberg v. Am. Pacific Int’l, Inc., Case No. C 196448 (Los Angeles Superior Ct., April 29, 1982) (unpublished) (relevance of documents was outweighed by the public policy of promoting candid and full disclosure by counsel to auditor and by the right of privacy).

\(^ {87} \) See Fed. R. Civ. P. 26(b)(3); United States v. Gulf Oil Corp., 760 F.2d 292, 296-97 (Temp. Emerg. CA 1985) (attorney letters in response to audit inquiries, although containing the mental impressions of defendant’s attorney regarding litigation exposure, did not qualify for work product protection because they were not created in anticipation of litigation, but rather “created, at [the auditor’s] request, in order to allow [the auditor] to prepare financial reports which would satisfy the requirements of the federal securities laws”); United States v. El Paso Corp., 682 F.2d 530, 543-44 (5th Cir. 1982) (lawyer’s analysis and memoranda “written ultimately to comply with SEC regulations” were prepared “with an eye on [the company’s] business needs, not on its legal ones” and did not “contemplate litigation in the sense required to bring it within the work product doctrine”); Independent Petrochemical Corp. v. Aetna Cas. & Sur. Co., 117 F.R.D. 292, 298 (D.D.C. 1987) (work product protection did not apply to lawyer’s letters to an auditor because the letters were not prepared to assist the company in litigation but rather to assist the auditor “in the performance of regular accounting work”).

\(^ {88} \) The following courts rejected the narrow construction of “work product” and found that litigation analysis prepared for auditors is work product. See United States v. Adlman, 134 F.3d 1194, 1202 (2d Cir. 1998) (observing, in dicta, that the work-product doctrine would protect an audit-inquiry response and approving the rule adopted by the Third, Fourth, Seventh, Eighth, and D.C. Circuits that a document is work product if “in light of the nature of the document and the factual situation in the particular case, the document can fairly be said to have been prepared or obtained because of the prospect of litigation”) (emphasis in original); In re Honeywell Int’l, Inc. Securities Litig., 2003 WL 22722961, at *6 (S.D.N.Y. Nov. 18, 2003) (rejecting plaintiff’s argument that the “preeminent business purpose” of an audit rendered the work product doctrine inapplicable and finding that defendant’s “assertion of work product protection for …
parochial construction of “work product” and find the “because of” construction to be more faithful to the language of Rule 26(b)(3) and to the purpose of the work product doctrine.89

Where courts find that attorney letters to auditors are, indeed, work product, they also generally conclude that disclosure to auditors does not waive the protection vis à vis the client’s litigation adversaries.90 These courts acknowledge that, unlike the attorney-client privilege, which protects the confidentiality of the communication, work-product protection is “intended only to prevent disclosure to the opposing counsel and his client” – so, it is not necessarily waived by disclosure to other third-parties.91 As one federal court explained:

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

90 See Southern Scrap, 2003 WL 21474516, at *9 (finding no waiver because disclosure of legal analysis to auditors was not like “one of those cases where a party deliberately disclosed work product in order to obtain a tactical advantage or where a party made testimonial use of work product and then attempted to invoke the work product doctrine to avoid cross-examination”); Gutter, 1998 WL 2017926, at *5 (“[t]ransmittal of documents to a company’s outside auditors does not waive the work product privilege because such a disclosure ‘cannot be said to have posed a substantial danger at the time that the document would be disclosed to plaintiffs’”); Vanguard Sav. and Loan Assoc. v. Barton Banks, 1995 U.S. Dist. LEXIS 13712, at *11-12 (E.D. Pa. 1995) (lawyer letters regarding litigation, prepared to assist client in reporting loss contingencies for a regulatory examination, were work product and protected even though created “primarily” for a business purpose); Tronitech, Inc., 108 F.R.D. at 657 (“an audit letter is not prepared in the ordinary course of business but rather arises only in the event of litigation. It is prepared because of the litigation … [and] should be protected by the work product privilege”).

The work product privilege does not exist to protect a confidential relationship, but rather to promote the adversary system by safeguarding the fruits of an attorney’s trial preparations from the discovery attempts of the opponent. The purpose of the work product privilege is to protect information against opposing parties, rather than against all others, in order to encourage effective trial preparation.92

Under this analysis – which is consistent with the Supreme Court’s decision establishing the doctrine in Hickman v. Taylor – waiver of work product protection only occurs if a disclosure substantially increases the opportunity for potential adversaries to obtain the information. Thus, most courts find that disclosure to auditors does not waive the protection because disclosure is made on an assurance of confidentiality and auditors are not considered to be conduits to potential adversaries.93

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

While Boston Scientific held meetings of its Special Litigation Committee with an eye to litigation, the disclosures to the independent auditor had no such purpose. Boston Scientific and its outside auditor Ernst & Young did not share ‘common interests’ in litigation, and disclosures to Ernst & Young as independent auditors did not therefore serve the privacy interests that the work product doctrine was intended to protect.94

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

By certifying the public reports that collectively depict a corporation’s financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation’s creditors and stockholders, as well as to the investing public. This ‘public watchdog’ function demands that

92 In re Raytheon, 218 F.R.D. at 359.
93 See cases cited in note 86, supra.
94 214 F.R.D. at 116-17 (emphasis added).
the accountant maintain total independence from the client at all times and
requires complete fidelity to the public trust.\textsuperscript{95}

The “common interest” concept on which \textit{Medinol} relied is derived from
authorities holding that co-parties or allies, such as co-defendants, may share work product
without waiving the protection as to a common adversary.\textsuperscript{96} Since the auditor-client relationship
does not fit neatly into this analytical box, the \textit{Medinol} court found a waiver. The “common
interest” analysis in \textit{Medinol} also has been invoked by other federal courts in considering the
issue of waiver following a disclosure to auditors.\textsuperscript{97}

To summarize the case law, while most authorities support the argument that
disclosure of work product to auditors should not waive the protection as to adversaries, the case
law is not uniform and some courts would hold that disclosure constitutes a waiver. Companies,
therefore, have no guarantee that courts will protect the work product generated from internal
investigations from waiver as to adversaries if these materials are disclosed to auditors. This
uncertainty undermines the purpose of the privileges: As the United States Supreme Court said,
“[a]n uncertain privilege, or one which purports to be certain but results in widely varying
applications by the courts, is little better than no privilege at all.”\textsuperscript{98}

\textsuperscript{95} Id. at 116 (quoting \textit{Arthur Young & Co.}, 465 U.S. at 817-818).


\textsuperscript{97} Although the Massachusetts District Court in \textit{In re Raytheon}, citing \textit{Medinol}, noted that “the existence of
common interests” was relevant to whether disclosure to auditors created a waiver, the court also found that
“there is no evidence that materials disclosed to an independent auditor are likely to be turned over to the
company’s adversaries except to the extent that the securities laws and/or accounting standards mandate
public disclosure,” and concluded that the record was inconclusive on the ultimate waiver issue. 218
F.R.D. at 360-61. \textit{But see In re Pfizer}, 1993 WL 561125, at *6 (finding that a company’s legal counsel and
outside auditors share “common interests” in information generated by counsel for purposes of an audit
and, accordingly, there was no waiver of work product).

\textsuperscript{98} \textit{Upjohn}, 449 U.S. at 392.