Directors' and Officers' Liability:

Sharing Work Product with Outside Auditors

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DECEMBER 10, 2009

The enhanced role of independent auditors mandated by the Sarbanes-Oxley Act in evaluating a public company's financial statements and internal controls may produce a dilemma for corporate management and its counsel: either share attorney-client privileged and work product materials with the auditor to enable it to evaluate potential internal control, accounting or audit issues, or withhold such confidential information and risk having to file periodic reports late (after filing Form 12b-25 explaining the reason for filing late), or receive from the auditor a qualified audit report on financial statements and internal control over financial reporting. In this reckoning of interests, the potential regulatory, business and litigation consequences of refusing an independent auditor's request to see attorney analyses underlying loss contingency disclosures often lead management to share attorney work product with the auditor.

Judicial decisions determining whether and to what extent a company's disclosure of confidential information to a third party waives privilege or work product immunity seek to balance the public interests served by privilege and the competing interest in access to evidence. This column summarizes recent case law addressing the implications of disclosure of work product protected materials to outside auditors, and recommends best practices to increase the likelihood such disclosures do not constitute waiver of the immunity.

Overview

By statute in New York, attorney-client privilege attaches to any "confidential communication made between the attorney or his or her employee and the client in

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the course of professional employment."[1] Although attorney-client privilege generally is waived by disclosure to any third party (such as an outside accountant) because disclosure destroys the confidentiality underlying the privilege, there are limited circumstances in which attorney-client privileged communications may be shared with accountants without waiver.[2] When the accountant is retained to provide forensic accounting services to assist the lawyer's provision of legal services, or is retained to function in effect as a translator or interpreter of tax and accounting issues to facilitate the lawyer's provision of legal services, privilege extends to the accountant's communication as a representative of counsel.[3]

Because a reviewing court will undertake a factual analysis of the nature of the accountant's role, the better practice for preserving protection is to have the lawyers retain and directly supervise the accountants, who also should report their findings directly to the lawyers. If the accountant is not serving as the lawyer's interpreter, but as outside auditor of the company's financial statements, disclosure of privileged communications to the auditor results in waiver of the attorney-client privilege.[4]

The work product doctrine has important differences from privilege, and requires separate analysis to determine the effect of sharing information with an auditor. Work product provides qualified immunity from discovery to materials prepared "in anticipation of litigation." Work product protection extends to (i) a document or tangible thing, (ii) prepared in anticipation of litigation, and (iii) prepared by or for a party, or by or for its representative. As to the crucial second element, in the U.S. Court of Appeals for the Second Circuit the appropriate inquiry is whether "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," as opposed to a primarily business or other purpose.

In *United States v. Adlman*,[5] the Second Circuit took care to extend work product protection to materials prepared "because of" litigation, rather than only those prepared "primarily to assist in litigation," emphasizing that the broader formulation is necessary to protect materials that are primarily "prepared to assist in a business decision," yet also contain core work product in the form of legal analysis of actual or potential litigation. Otherwise, a company would face "untenable choice[s]" between making business decisions that depend on thorough

legal analysis, and alternatively "skimp[ing] on candor and completeness to avoid prejudicing its litigation prospects."

Adlman offered three hypotheticals to illustrate potential circumstances under which work product protection could attach even though materials were created for a dual litigation-business purpose. One of those hypotheticals posited a company's independent auditor requesting a memorandum prepared by the company's attorneys estimating the likelihood of success in litigation and an accompanying analysis of the company's legal strategies and options to assist it in estimating what should be reserved for litigation losses in connection with preparation of financial statements.

The court stated that a legal analysis of this type, which plainly has a mixed litigation and business purpose, is entitled to work product protection. Contrasting other potential circumstances, the court continued that "it should be emphasized that the 'because of' formulation that we adopt here withholds protection from documents that are prepared in the ordinary course of business or that would have been created in essentially similar form irrespective of the litigation."

In *United States v. Textron Inc.*,[6] the U.S. Court of Appeals for the First Circuit sitting in banc recently rejected the "because of" litigation test in favor of a far narrower "prepared for" use in litigation test. The controversial *Textron* decision warrants substantial attention, but practitioners at a minimum should heed the admonition contained in *Textron's* dissent: "Nearly every major business decision by a public company has a legal dimension that will require [litigation] analysis. Corporate attorneys preparing such analyses should now be aware that their work product is not protected in this circuit."

Work product comprehends two categories: fact work product and opinion work product. Fact work product embraces factual material, including witness interview transcriptions. It can include material prepared by accountants, such as financial analyses prepared by an accountant to assist counsel in determining a client's potential liability, or an accountant's assessment of a client's audit procedures and controls to determine if and how any irregularities occurred.[7] Opinion work product contains the mental impressions, conclusions, opinions or legal theories of an attorney or other representative.

Unlike the attorney-client privilege, work product protection is qualified, not absolute. If the asserting party can demonstrate that the work product doctrine applies, the protection can be overcome where the party seeking discovery demonstrates a substantial need for the materials, and its inability, without undue hardship, to obtain the substantial equivalent of the materials by other means, as where an interviewed witness has died.[8] Opinion work product receives nearly absolute protection.

A critical distinction between the attorney-client privilege and work product is that voluntary disclosure of work product to third parties with no common legal interest does not automatically waive work product protection. Because the purpose of work product immunity is to promote the adversary system by protecting the fruits of an attorney's trial preparations from discovery by an opponent, work product may be shared with a third party without triggering waiver as long as the disclosure does not substantially increase the possibility that an adversarial party could obtain the information. Stated differently, work product immunity remains intact after disclosure to a third party unless the disclosure is inconsistent with maintaining secrecy from possible adversaries.

The adversity contemplated by the work product waiver doctrine is that between litigation opponents or adversaries, typically the relationship between a plaintiff and defendant. Most decisions addressing the effect of sharing work product with outside auditors pivot on the application of this principle.

Disclosure to Auditors

Because the work product waiver doctrine asks whether a particular disclosure of legal strategy and opinion substantially increases the likelihood of litigation adversaries obtaining the information, the immunity is not necessarily waived when disclosed to an auditor or other non-adversarial third party, provided that the protected communications originate and are maintained in confidence. Two central inquiries determine whether third-party disclosures are likely to be maintained in confidence: the nature of the relationship and whether giving the third party access makes it more likely that work product may get into the hands of an adversarial party.

Public companies must file an annual report with the Securities and Exchange Commission, including financial statements which must be audited in accordance with Generally Accepted Auditing Standards. When an independent auditor is asked to certify a company's financial statements, including loss contingencies, the U.S. Supreme Court has noted some tension properly inheres in the auditor-client relationship. In *United States v. Arthur Young*,[9] the Court stated that the auditor "owes ultimate allegiance to the corporation's creditors and stockholders, as well as the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."

Sufficient audit documentation obviously is essential to a quality audit. In 2002, the Sarbanes-Oxley Act created the Public Company Accounting Oversight Board (PCAOB) to oversee public company auditors. The PCAOB has taken the position that auditors evaluating loss contingencies should ask the company and its counsel for privileged and work product information relevant to conclusions regarding loss contingencies, citing a failure to obtain such information as an audit documentation deficiency.[10] Moreover, post-Sarbanes the auditor's role encompasses not only an audit of financials, but also an audit of the effectiveness of the company's internal control over financial reporting.

An integrated audit of internal control over financial reporting and the financial statements can prompt auditor requests for a variety of attorney work product, including lawyer analyses of the merits of pending litigation against the company, case reserves and reports or minutes summarizing the conclusions of an internal investigation conducted under the supervision of a special litigation committee.

The majority of courts to consider the issue have held that disclosure of work product protected materials to outside auditors does not constitute waiver of the immunity as to litigation adversaries. Courts have long recognized a distinction between the concepts of "independence" and "adversity" when analyzing the work product doctrine in the context of an audit or investigation of a corporation's accounting practices. The rationale of the majority view is that the independence of an auditor from a company it audits simply does not create an adversarial relationship with the client as contemplated by the work product doctrine, and does not represent a conduit to litigation adversaries.

In *Merrill Lynch v. Allegheny Energy Inc.*,[11] Judge Harold Baer concluded that work product protection is not waived unless the third party to whom disclosure is made has a "tangible adversarial relationship" with the company, which ordinarily is not present between an independent auditor and its client. The company had complied with its auditor's request for copies of internal investigation reports regarding executive theft to assist the auditor's assessment of the company's internal controls, both to inform its audit work and to notify the company if there was a deficiency.

Any "tension between an auditor and a corporation that arises from an auditor's need to scrutinize and investigate a corporation's records and book-keeping practices," the court concluded, "simply is not the equivalent of an adversarial relationship contemplated by the work-product doctrine."[12] Rather, a "business and its auditor can and should be aligned insofar as they both seek to prevent, detect, and root out corporate fraud. Indeed, this is precisely the type of limited alliance that courts should encourage."

Recognition of the core common interest of a company and its auditor in ensuring the accuracy of the company's financials also promotes the public policy of encouraging critical self-policing by corporations. As *Merrill Lynch* stated, "to construe a company's auditor as an adversary and find a blanket rule of waiver of the applicable work product privilege under these circumstances could very well discourage corporations from conducting a critical self-analysis and sharing the fruits of such an inquiry with the appropriate actors."

In determining whether disclosure to an outside auditor was inconsistent with avoiding disclosure to an adversary, courts have emphasized the confidential nature of the relationship between a company and its outside auditors. This confidential relationship should give the company a reasonable basis to believe that work product information will remain confidential, particularly with respect to litigation adversaries.

Significantly, the *Merrill Lynch* investigation reports were shared pursuant to an agreement with the auditor recognizing that (i) they were prepared by counsel and were privileged and constituted attorney work product; (ii) the auditor would keep the materials confidential; and (iii) the auditor would make no further disclosure unless legally compelled to do so. Company management and its counsel should

insist that the auditor agree in writing to these stipulations before sharing work product.

Similarly, in *Int'l Design Concepts v. Saks Inc.*,[13] Judge Kevin Castel expressed concern that sharing information about litigation reserves and litigation threats with auditors would become difficult if auditors were viewed as litigation adversaries. The court noted that the auditors in *Saks* required this information in order to "assess whether the financial statements of the company should receive a qualified or unqualified opinion." Accordingly, the court held that "allowing the outside auditor, retained by the client, to know the content of the attorney's confidential threat assessment does not…destroy the protection."

A minority view holds that disclosure of attorney work product to an independent auditor retained by the company waives the immunity as to all third parties. Support for the minority view is scant, and waning. *Medinol, Ltd. v. Boston Scientific Corp.*,[14] in which the court characterized the "public watchdog" function of an auditor as sufficiently antagonistic to preclude waiver-free sharing, best expresses the minority view. In *Medinol*, the court in the Southern District of New York required the production to plaintiffs of minutes and supporting materials of a special litigation committee that previously were disclosed to the company's outside auditor during its audit of the company's litigation exposures.

According to *Medinol*, the outside auditor's work supports the auditor's independent opinion about the company's financial reports, "not the audited company's litigation interests." Thus, the auditor's interests were "not necessarily aligned" with the interests of the company. *Medinol* thus concluded that "the sharing by Boston Scientific's lawyers of selected aspects of their work product, although perhaps not substantially increasing the risk that such work product would reach potential adversaries, did not serve any litigation interest, either its own or that of [the outside auditor], or any other policy underlying the work product doctrine."

As a federal court observed this year, "*Medinol* has been roundly criticized for its holding and analysis."[15] *Medinol* seems incompatible with Second Circuit teaching in *Adlman*, which posited that if an independent auditor receives a legal memorandum estimating the likelihood of success in litigation and an accompanying analysis of the company's legal strategies and options in order to

assist the auditor in estimating what should be reserved for litigation losses, work product protection would remain intact.[16]

A final word on the mechanics of waiver. In 1975 the American Bar Association, Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information cautioned that "giving accountants access to privileged statements made to attorneys may…have the effect of waiving the privilege on other communications with respect to the same subject matter."[17] In federal court, Federal Rule of Evidence 502 governs the scope of any waiver of both the attorney-client privilege and work product immunity arising from disclosure "made in a federal proceeding." Under Rule 502(a), such disclosure does not waive protections for material concerning the same subject matter beyond what was disclosed unless disclosure was intentional and the additional, non-disclosed materials "ought in fairness be considered together" with the communications deliberately disclosed.

Since disclosures to an auditor typically would not be made in a federal proceeding, there is no assurance Rule 502 would apply, making pre-enactment principles relevant. The scope of a waiver once it has occurred differs depending on whether privilege or work product is at stake. While the voluntary disclosure of attorney-client communications may to some extent result in a subject matter waiver—i.e., a waiver of the privilege with respect to communications concerning the subject of the waived communications—the same is not true for work product. Although Rule 502 lacks any explicit language distinguishing between privilege and work product, both before and after enactment of the Rule courts have consistently held that subject matter waiver does not apply to work product material unless the asserting party has made affirmative and selective use of work product, and in any event waiver applies only to fact work product and does not extend to opinion work product.[18]

Endnotes:

1. N.Y. CPLR §4503(a)(1).

2. *In re Pfizer Inc. Sec. Litig.*, 1993 WL 561125, at *7 (SDNY 1993) ("Pfizer cannot assert attorney-client privilege for any documents that were provided to its independent auditor. Disclosure of documents to an outside accountant destroys

the confidentiality seal required of communications protected by the attorney-client privilege").

3. *United States v. Ackert*, 169 F.3d 136, 139 (2d Cir. 1999).

4. *Westernbank Puerto Rico v. Kachkar*, 2009 WL 530131 (D.P.R. 2009).

5. *United States v. Adlman*, 134 F.3d 1194, 1202 (2d Cir. 1998).

6. 577 F.3d 21 (1st Cir. 2009) (in banc).

7. *Westernbank Puerto Rico v. Kachkar*, 2009 WL 530131, at *5 (D.P.R. 2009).

8. Fed. R. Civ. P. 26(b)(3)(A).

9. 465 U.S. 805, 818 (1984).

10. PCAOB Report on 2003 Limited Inspection of Deloitte & Touche LLP at 21 (Aug. 26, 2004).

11. 229 F.R.D. 441, 448 (SDNY 2004).

12. Id; see also *Lawrence E. Jaffe Pension Plan v. Household Int'l Inc.*, 237 F.R.D. 176, 183 (N.D. Ill. 2006) ("[T]he fact that an independent auditor must remain independent from the company it audits does not establish that the auditor also has an adversarial relationship with the client as contemplated by the work product doctrine.").

13. 2006 WL 1564684, at *7-8 (SDNY 2006).

14. 214 F.R.D. 113 (SDNY 2002).

15. *Westernbank Puerto Rico v. Kachkar*, 2009 WL 530131 (D. P.R. 2009).

16. *Am. S.S. Owners Mut. Protection and Indem. Ass'n Inc. v. Alcoa S.S. Co. Inc.*, 2006 WL 278131 (SDNY 2006).

17. American Bar Association, Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information commentary to ¶1 (1975), reprinted at 31 Bus. Law 1709 (1976).

18. See, e.g., *Chick-fil-A v. ExxonMobil Corp.*, 2009 WL 3763032, (S.D. Fla. 2009); *Shinnecock Indian Nation v. Kempthorne*, 2009 WL 2873174, at *14-15 (EDNY 2009).

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