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# “Pragmatic Practices for Protecting Privilege”

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### **I. Introduction: Need for focus on practical resources and suggested responses to problems involving the erosion of attorney-client privilege**

The continued vitality of the attorney-client privilege<sup>1</sup> is threatened by a number of governmental policies – foremost among them those of the U.S. Department of Justice. Because of these policies, companies that have been accused of wrongdoing or that are engaged in voluntary self-evaluation or self-reporting are often forced to waive their attorney-client privileges in order to be judged as “cooperating” with prosecutors or enforcement officials. Erosion of the attorney-client privilege has a negative and concrete impact: executives and directors who would like to consult with corporate counsel about the most sensitive issues are confused about whether the corporate attorney-client privilege will apply to their conversations with counsel and thus their communications with lawyers are “chilled”; lawyers investigating allegations of wrongdoing are worried about how their honest attempts to unearth and correct serious problems may be used against the company’s interests in the future; and line employees who lack the sophistication or means to protect themselves can be deprived of their Constitutional rights and left without the protections we would guarantee to any other person whose actions are under scrutiny as a result of a government investigation.

The practice of forcing waivers of the attorney-client privilege has the unintended consequence of negatively impacting aggressive self-policing by corporations, which we should encourage in order to promote a compliant and reliable economic marketplace. Policies and practices of the government that undercut the lawyer-client relationship in the corporate context have the effect of deflating responsible corporate compliance efforts and ethical leadership by making it more

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<sup>1</sup> Although the “attorney-client privilege” (maintaining the confidentiality of communications between an attorney and client) is distinct from the “work product doctrine” (precluding adversaries from discovering the work product of attorneys developed in anticipation of litigation), these protections are closely related. Except where specifically noted, for ease of exposition in this document the terms “attorney-client privilege” and “privilege” are used to refer collectively to both protections.

likely that industrious executives in fast-paced businesses will simply forego consultation with lawyers with whom no predictable presumption of confidential communications exists.

Much of the public discourse focuses primarily on documenting the existence of this erosion of the attorney-client privilege and arguing its merits, and not on how to address its ramifications (such as offering practical applications that corporate counsel and clients should consider adopting). So even as we continue to work to address abusive practices and protect corporate assertion of the privilege ACC wants to move , and with this document is delving into pragmatic practices that will work to address privilege erosion, seek to prevent wavier problems, and provide strategies for pushing back against inappropriate demands to divulge attorney client confidences. The best way to collect such ideas? Benchmark the folks in the trench who've already thought about this issue and have implemented responses. ACC asked Steve Cannon, our privilege counsel and the former CLO of a Fortune 200 company (now at Constantine Cannon PC) to reach out to the in-house counsel community to identify the key issues ACC members face and to catalogue the various approaches employed to address those issues.

Constantine Cannon interviewed a significant number of CLOs (as well as in-house compliance, litigation and governance counsel), at corporations of various sizes in a wide range of industries (including consumer goods, retail, manufacturing, high tech, financial services, insurance, pharmaceuticals, and telecommunications). They also interviewed a number of outside counsel to these corporations, as well as current and former government officials responsible for investigating and prosecuting allegations of corporate wrongdoing, in order to garner any additional thoughts they could share.

The resulting research shows that privilege erosion problems generally fall into one (or more) of the following categories: audit process, internal investigations, individual rights of employees, document retention policies, limited waiver issues, and prosecution agreements and corporate monitorships.

**Thus, this primer starts with an overview of privilege erosion issues for those would like to get more familiar with the topic before diving into suggested practices. This overview is followed by six sections corresponding to the above-listed categories. To bypass the overview and go directly to the research results and practical applications benchmarks, proceed to Section III, at page 10.**

**For more information on ACC's efforts to change privilege practices in the prosecutorial and regulatory community, or for additional research material on this topic, go to ACC's privilege homepages at <http://www.acc.com/advocacy/index.cfm>. Please note that some of ACC's online resources offered on our privilege homepages or in the subsequent pages are password-protected documents, available to ACC members only.**

**Questions, comments, or additional ideas for additions to this resource can be directed to ACC's General Counsel, Susan Hackett, at 202/203-4103, ext. 318 or [hackett@acc.com](mailto:hackett@acc.com).**

## II. General Overview: Erosion of privilege in the corporate criminal context

### A. Importance of the attorney-client privilege

Attorney-client confidentiality is the foundation of the relationship between a lawyer and client. The attorney-client privilege is an evidentiary/procedural right governed by a court when one party to an adversarial matter wishes to exclude from the other party's discovery requests or questioning that material which includes attorney-client communications or confidences. What can be excluded from an adversary's request as attorney-client privileged is actually quite narrow in scope: the privilege does not protect facts, or information that has been previously divulged to parties who aren't part of the confidential lawyer-client relationship.<sup>2</sup> Since it thus only protects the client's requests for legal advice and the actual advice or work product of the legal counselor responding to that request, there is rarely a reason to assume that withholding such information from an adversary will leave the adversary without the ability to discover the facts needed to make its case.

While lawyers are generally bound by rules of professional ethics<sup>3</sup> to preserve their clients' confidences, it is the attorney-client privilege that allows a *client* to assert its rights to the confidentiality of its conversations with counsel and the non-disclose-able nature of the work lawyers do for the client in anticipation of possible or pending litigation. The U.S. Supreme Court confirmed that corporations are entitled to the protections of the privilege as clients of lawyers they retain or employ in the landmark Supreme Court case of *Upjohn Co. v. United States*.<sup>4</sup> Likewise, the Supreme Court addressed the issue of related work product doctrine protections that can be asserted by the lawyer whose work in "in anticipation of litigation" against the corporate client contains attorney thought processes, defense strategies, and other indicators which would show the opposing side the client's legal strategy or what they think is relevant.<sup>5</sup>

The *Upjohn* decision is clear: privilege should be respected and promoted in the corporate context because it operates in the public's best interest by encouraging executives and managers in companies to seek out legal advice in order to ensure compliant conduct in their daily work. The Court reasoned that protecting client confidences also helps to facilitate timely reporting of problems so that they can be quickly addressed and remedied. The Supreme Court was clearly concerned that without predictable and enforceable confidentiality in lawyer-client communications, employees of a company would be unwilling to put corporate concerns ahead of their own personal interests in staying out of the spotlight when trouble might be brewing inside the company. The Court endorsed the concept of rewarding – not penalizing – employees

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<sup>2</sup> It also should be noted that some exceptions to the privilege exist, which make it impossible for a client to assert privilege rights against another party. The most important exception is what is called the crime-fraud exception. Under this well-recognized doctrine, a client cannot claim and a court cannot apply privilege protections regarding conversations or advice which result in the lawyer's services being used in furtherance of the commission of a crime or fraud.

<sup>3</sup> See, for example, ABA Model Rule of Professional Conduct 1.6, and its counterpart rule in every state's code of professional responsibility. (<http://www.acca.com/resource/index.php?key=6296>)

<sup>4</sup> See *Upjohn Co. v. U.S.*, 449 U.S. 383 (1981).

<sup>5</sup> *Hickman v. Taylor*, 329 U.S. 495 (1947).

for consulting a lawyer about a complex, sensitive, or troubling matter; to do so encourages well-informed and responsible corporate actions.

## **B. What has changed? What is causing concern?**

For hundreds of years, the courts have acted as guardians of clients' privilege rights, but increasingly, demands to waive the attorney-client privilege are being made outside the courthouse and without the oversight of an impartial judge. And so, the concern today is not that the courts are somehow incorrectly making decisions that improperly erode privilege protections: rather, the concern is that government agencies (such as the Department of Justice) are unilaterally making their own decisions about whether privilege rights and protections should or should not be afforded to those they plan to prosecute or, worse yet, against those against whom they have no case, but hope to enlist in collecting information that can be used against the real targets of their investigations. When prosecutors feel entitled to unilaterally force companies to waive their attorney-client privileges in order to receive fair treatment, courts are no longer the impartial arbiters of the privilege rights: rather, they simply are not present when privilege waiver demands are being made during pre-charging conversations between prosecutors and targets, and therefore they are no longer properly positioned to adjudicate privilege confidentiality disputes.

ACC surveys document an alarming increase in the number of instances in which privilege waiver demands are unilaterally made by prosecutors, enforcement officials, auditors and third-party plaintiffs.<sup>6</sup> Those demanding a waiver of the corporation's privileges regularly presume that they need to review everything and anything that may assist them in investigating potential misconduct or problems at the company, even if the information would be protected were a court of law overseeing the parties, and even if there is no showing that this most intrusive and extreme method of gathering information is necessary because other avenues of investigation or fact-finding are not available.

In the enforcement or prosecutorial context, privilege waiver demands are often made at the earliest stages of the charging process. According to their own policy statements, in order for the Department of Justice or the Securities and Exchange Commission to deem a potential "targeted" company as cooperative, they may in their own discretion require a waiver of the corporation's privilege rights, well before charges have been filed or even a determination of the relevant facts is complete. ACC surveys suggest that an increasing number of these "requests" are made at the first meeting between the targeted company and the prosecutors – before any facts are in or any investigations have been done: indeed, often before there is a confirmation that an allegation of wrongdoing has any merit at all.

When privilege waivers are demanded and secured unrelated to any pre-determined need for the specific information that constitutes the attorney-client communication, the only real beneficiaries are future third-party plaintiffs who can then demand access to privileged information that the company was forced to waive to the government. Some companies engage in a last-ditch effort to protect themselves against third party plaintiffs by executing a

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<sup>6</sup> ACC has developed and published two surveys that help document the actual practices and experiences of corporate lawyers and their clients regarding privilege waiver and the practical effect of government prosecutorial policies and practices. See <http://www.acca.com/Surveys/attyclient.pdf>, and <http://www.acca.com/Surveys/attyclient2.pdf>. The results of these surveys are discussed in detail in Appendix A, but it is worth noting here that the assertions regarding privilege waiver practices of the government are based upon the documentation of the actual experiences of hundreds of corporations through these surveys.

confidentiality agreement (otherwise known as a limited waiver) that they hope will have the effect of allowing them to put privileged documents provided in the context of an investigation “back into the box” of confidential material. DOJ and enforcement officials often suggest limited waiver agreements to reticent targets as an incentive to believe that the future distribution of privileged material that they wish to review can be controlled. While there is a split between the circuits regarding the enforceability of such confidentiality or limited waiver agreements when challenged by third party plaintiffs, the majority of courts have held that, once waived as to one party, the privilege is waived as to all future parties, as well, regardless of what the parties may agree amongst themselves to protect.<sup>7</sup>

### C. Privilege in the post-Sarbanes-Oxley environment

While nothing has technically changed in the laws governing the application of the privilege in the corporate context in recent years, past corporate accounting scandals have raised concerns about the need for corporations to operate in a more transparent and accountable fashion, and have put pressure on prosecutors and enforcement officials to find and punish both culpable organizations and individuals. But the fact that the number of opportunities for prosecutions has increased does not infer that the tools needed by a prosecutor in order to obtain a conviction have changed. Indeed, as noted by an array of former top DOJ officials from past administrations (both Democrat and Republican), privilege waivers are not necessary for the DOJ to do its job. These former attorneys general and senior enforcement officials state that they are disappointed that current leadership at DOJ suggest that privilege waivers are a necessary and appropriate tool to ensuring a successful prosecution.<sup>8</sup> They make a compelling case against these tactics, arguing that weakening the attorney-client privilege will be counterproductive to the ultimate goals of promoting corporate accountability, transparency, self-reporting, and preventive compliance. They join us in arguing that increased corporate transparency is not connected to the elimination of confidential legal counseling; indeed, without a right to engage in confidential counseling, corporate transparency will suffer.

According to the ACC surveys, privilege is essential to successfully counseling officers, directors, and employees on legal compliance issues that arise in the daily conduct of business. Though it is clear that corporate counsel’s client is the entity and not any one of the entity’s individual officers, directors or employees, in order to fulfill their fiduciary duties, corporate leaders must be able to include lawyers in every aspect of the business’ work so that they are present when managers are making decisions about how to proceed with even seemingly routine tasks. The success of corporate counsel’s efforts requires that they gain the trust of employees

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<sup>7</sup> For example, see the recent holding of the 10<sup>th</sup> Circuit Court of Appeals, in *In re: QWEST Communications International, Inc.*, (No. 06-1070, decided in June of 2006), in which the Court refused to provide relief to QWEST from demands made by third party plaintiffs for documents produced to the SEC at the government’s demand. Even though QWEST waived its privileges to satisfy the SEC requirements, it did so pursuant to the government’s promise that a limited waiver agreement would protect the company from third party requests of just this type. The Court held that much as they might like, the SEC and QWEST could not contract around privilege waiver doctrine. As a result, the SEC received the full benefit of the bargain it struck; QWEST was painted into a waiver corner by the SEC, and then denied the protections of the bargain that was their only comfort and upon which they had reasonably relied. ACC (joined by the U.S. Chamber of Commerce) filed an amicus brief in this case, available at: <http://www.acca.com/public/amicus/qwest.pdf>.

<sup>8</sup> See, Letter of Former DOJ officials to Attorney General Alberto Gonzales, September 5, 2006: available at <http://www.acca.com/public/attyclientpriv/agsept52006.pdf>. Another letter (2005) from a group of the same former DOJ leaders was addressed to the US Sentencing Commission: <http://www.acca.com/public/policy/attyclient/doj.pdf>.

and are able to encourage these employees in their role as agents of the entity to seek and follow legal advice in an increasingly fast-paced, competitive, complex and highly-regulated business environment. Corporate counsel know that many of the employees they counsel believe their jobs would be easier if they didn't have to take time out to consult a lawyer in the first place; if the confidentiality of corporate communications with the lawyer is attacked as well, a relationship that is hard enough to encourage is further chilled, and the lawyer's pro-active role as a gatekeeper in the company is nearly impossible to fulfill.

In sum, the attorney-client privilege is an important incentive encouraging those with relevant information or concerns about possible wrongdoing to report what they know, rather than simply sitting on (or affirmatively burying) troubling facts. Knowing that a sensitive conversation about a potential problem is confidential allows an employee or executive to feel more confident about sharing these issues with their company counsel, who can then advise them as to whether there is indeed a problem (rather than a misunderstanding) and how to react. If employees believe that the attorney-client privilege will not protect the confidentiality of these kinds of conversations (knowing that the privilege is not the employee's but the entity's to waive or protect), then these conversations will likely not occur. As the Supreme Court declared in the *Upjohn* case, "An uncertain privilege . . . is little better than no privilege at all."<sup>9</sup>

#### **D. Government prosecutorial practices are the leading cause of privilege erosion**

In recent years, particularly at the federal level, criminal law enforcement and regulatory authorities have adopted policies and employed practices and procedures promising that if corporations disclose documents and information that are protected by the corporate attorney-client privilege and work-product doctrine, they may receive credit for "cooperation."<sup>10</sup>

While this sounds like an option that a company can choose to exercise or not in its discretion, the reality is that corporations have no practical choice but to waive their attorney-client privilege when they are offered this "choice" because they are under investigation by the government. In federal criminal cases against companies, U.S. Attorneys cite the "authority" granted them to consider privilege waiver as a necessary component in assessing a targeted company's cooperation by both the Justice Department's internal policy guideline on charging corporations (the Thompson Memorandum<sup>11</sup>), as well as a (now- proposed-for-elimination)

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<sup>9</sup> *Upjohn*, supra note 2,449 U.S. at 393.

<sup>10</sup> Former leaders of the Department of Justice have testified that the aggressive practices occurring today were not the norm during their tenures, and are not only unnecessary to accomplishing the Department's goals, but deplorable and inappropriate. See, e.g., the testimony of former Attorney General Dick Thornburgh before the US Sentencing Commission at [http://www.uscc.gov/corp/11\\_15\\_05/Thornburgh.pdf](http://www.uscc.gov/corp/11_15_05/Thornburgh.pdf); and the submitted statement of a number of former senior DOJ officials, including former Attorneys General, Deputy Attorneys General and Solicitors General at <http://www.acca.com/public/policy/attyclient/doj.pdf>. These former DOJ officials sent an additional letter to the Senate Judiciary Committee in advance of that committee's September 12, 2006 hearing.

<sup>11</sup> Deputy Attorney General Larry Thompson issued a 2003 memorandum that addressed the principles of federal prosecution of business organizations. (Memorandum from Deputy Attorney General Larry Thompson to Heads of Department Components and U.S. Attorneys, "Principles of Federal Prosecution of Business Organizations" (Jan. 20, 2003) ([http://www.usdoj.gov/dag/cftf/corporate\\_guidelines.htm](http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm)). The Thompson Memorandum (which updates the "Holder Memorandum," originated by one of his predecessors, Deputy AG Eric Holder, who served during the Clinton Administration) lists nine factors that federal prosecutors should consider when charging companies. One of the factors is the corporation's "timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, the waiver of corporate attorney-client and work product

provision of the Federal Sentencing Guidelines<sup>12</sup>, both of which suggest that prosecutors can demand waiver of privilege if they feel that it is important to making their case. Companies that refuse to waive can be deemed uncooperative and thus may forfeit the ability to engage in settlement discussions, smaller (remunerative) fines or damages (as opposed to punitive penalties), or deferred or non-prosecution agreements. SEC enforcement officials who are targeting companies suspected of wrongdoing and who seek privilege waiver rely on the precedent set by the SEC in the so-called “Seaboard Report,” as well as their well-asserted need for lawyers to act as “gatekeepers” in their entity clients.<sup>13</sup> Furthermore, other enforcement officials at agencies such as the IRS, the DOL, the FTC, the EPA, the FEC and others are imitating the SEC’s strategies.<sup>14</sup>

Formerly, a company could evidence its cooperation with prosecutors by providing insight and access to both relevant information and to the company’s workplace and employees. The definition of a company’s “cooperation” did not entail production of legally privileged communications and attorneys’ litigation work product. Nor did it entail the need for the

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protections.” This provision in practice is interpreted to require that companies routinely identify and hand over damaging documents, disclose the results of internal investigations, furnish the text and results of interviews with company officers and employees, and agree to waive attorney-client and work product protections in order to be deemed cooperative; such demands are often made without regard to whether privilege waiver is in fact necessary to the government getting all the facts it needs to undertake its investigation or prosecution, and before any meaningful assessment or investigation into the allegations suggesting that the company or any of its employees were engaged in any wrongdoing or negligent failures.

<sup>12</sup> Amendments made to the US Sentencing Guidelines, which became effective in November of 2004, state that in order to qualify for a reduction in sentence for providing assistance to a government investigation, a corporation is required to waive confidentiality protections if “such waiver is necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization.” (U.S. Sentencing Guidelines Manual § 8C2.5 (2004) (available at [http://www.ussc.gov/2004guid/8c2\\_5.htm](http://www.ussc.gov/2004guid/8c2_5.htm)). The Coalition to Preserve the Attorney-Client Privilege, and a number of its members and other interested organizations such as the American Bar Association, petitioned the US Sentencing Commission to overturn their recent amendments and we are pleased to note that this year’s amendment cycle, currently before Congress for authorization purposes, include a proposal to remove the privilege waiver language from § 8C2.5. The Coalition’s testimony to the Sentencing Commission can be found at <http://www.acca.com/public/attyclntprvlg/coalitionussctestimony031506.pdf>, and the Sentencing Commission’s amendment proposals for 2006 can be found at 71 Federal Register 28063-28073, available at <http://www.ussc.gov/FEDREG/2006finalnot.pdf>.

<sup>13</sup> Federal regulators, and particularly the SEC, have begun to adopt policies and practices mirroring those of the Department of Justice, which while discussing “cooperation credit,” mention disclosures of protected confidential information. See, e.g., the Seaboard Report, [“Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions,” Exch. Act Rel. No. 44969 (Oct. 23, 2001)]; in the Seaboard Report, the SEC outlined some of the criteria that it considers when assessing the extent to which a company’s self-policing and cooperation efforts will influence its decision to bring an enforcement action against a company for federal securities law violations. The concern that waiver of the attorney-client privilege and work-product protections are now viewed as necessary elements evidencing a company’s cooperation is bolstered by public remarks made by former SEC enforcement chief Stephen Cutler, in his remarks made during a program discussing the changing role of lawyers in remedying corporate wrongdoing during a presentation at UCLA’s Law School in the Fall of 2004 (“The Themes of Sarbanes-Oxley as reflected in the Commission’s Enforcement Program,” (September 20, 2004) (transcript available at <http://www.sec.gov/news/speech/spch092004smc.htm>).

<sup>14</sup> See, e.g., “Statement of the Coalition to Protect the Attorney-Client Privilege,” Submission to the U.S. Senate Judiciary Committee (September 12, 2006): <http://www.acca.com/public/attyclientpriv/coalitionsenjudtestimony.pdf>.

company to become the unofficial deputy of the prosecutor in implicating employees who may or may not be culpable for underlying failures or criminal activities. Now, however, in order to convince the prosecutor or regulator that the company is cooperating with the investigation, and indeed to avoid being accused of engaging in obstructionist behavior, companies are told directly or indirectly to waive their privileges and help prosecutors cut targeted employees off from any ability to defend themselves from the government's accusations. Neither requirement is tenable or appropriate for the government to impose on a company; neither requirement serves the public's interest in assuring that culpable wrongdoers will be prosecuted and convicted, or that our system of justice will be better served. So why do government officials continue to argue that privilege waiver is an appropriate requirement to prove that a company is cooperating or is necessary to successfully prosecute a corporate wrongdoer?

The Justice Department does not seem to have an answer to this question. Worse yet, in October of 2005, in what is now referred to as the McCallum Memorandum (named for its author, Associate Attorney General Robert McCallum),<sup>15</sup> the DOJ instructed its field offices regarding the issue of waiver by requesting that each establish or review their own office's policies for privilege waiver requests and report them back to DOJ Main. Mr. McCallum specifically notes in this memo that it is fine if field office policies differ from office to office based on local needs and circumstances. Thus, DOJ does not seem interested in either justifying or reigning in abusive practices, but in encouraging each field office to make its own procedural decisions, ensuring further chaos for clients unsure about whether or how they can push back against inappropriate privilege waiver demands made in each of the 94 offices of the U.S. Attorneys across the country.

And so the DOJ continues to deny that there is a problem, even in the face of combined support from all of the nation's leading bars, business groups, and civil liberties organizations, two national surveys on the subject detailing abusive practices, extensive media criticism of DOJ waiver policies, a House Judiciary Committee hearing that decried prosecutorial practices (on March 7, 2006), a ruling by Judge Kaplan in KPMG that provisions in the Thompson Memorandum are clearly unconstitutional, a statement from the Conference of Chief Justices (made up of the chief justices of each state's court system) that DOJ waiver policies and practices are inappropriate and must be stopped<sup>16</sup>, and a Senate Judiciary Committee hearing at which there was bipartisan criticism of these government policies (on September 12, 2006). It seems that no one other than the DOJ thinks that the Thompson Memo sets good or appropriate policies or engenders appropriate prosecutorial practices regarding privilege waivers. (To be fair, there are some field offices of the DOJ where we have not noted the level of complaint regarding these practices – while these offices are few in number, there are in some important districts, and we do not wish to suggest that every prosecutor in every office of the US Attorneys is engaged in coercive and inappropriate behaviors.)

Thus, erosion of privilege continues. Accordingly, corporate counsel must address the ramifications of this ongoing erosion on a daily basis. While the ACC will continue to fight for reforms and wide-scale changes in the manner in which prosecutorial or enforcement actions are

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<sup>15</sup> A copy of the McCallum Memo can be found at <http://www.acca.com/public/attylntprvlg/mccallumwaivermemo.pdf>.

<sup>16</sup> Resolution of the Conference of Chief Justices, adopted on August 2, 2006, and reprinted at <http://cej.ncsc.dni.us/resol9StateCommitteesOnAttorneyClientPrivilege.html>.

pursued, in-house counsel must act (hopefully in concert with their outside lawyers) to individually protect their clients' interests: from relationships with auditors to the development of better document retention and labeling policies, there is much that can be done now to address privilege concerns and improve your client's chances of being able to assert its rights.

### **III. The Audit Context**

#### **A. Introduction**

In the last few years, corporate scandals and policymakers' reactions to those scandals changed the nature of the auditors' interactions with their corporate clients. Especially subsequent to passage of the Sarbanes-Oxley Act and the demise of Arthur Andersen following the Enron debacle, auditors are more aggressive; they know they are the marketplace's independent watchdog and their actions are under heightened scrutiny when vouching for companies' financial representations.

As a result, auditors increasingly demand more information from corporations, including documents otherwise entitled to attorney-client or work product protections. In turn, this creates a "Hobson's choice" for in-house counsel as they go through their regular outside auditing process: either resist the request for privileged documents and risk a negative or qualified audit opinion which could badly damage the company or, alternatively, turn over the privileged documents and risk waiving all confidentiality rights as to potential third party litigants in the future.

While some think that only public companies are affected by the outside auditor issue, think again: because these standards are now the regular practice and codified in the internal operations policies for the largest accounting companies, these standards will be applied equally to private company clients who need to provide certification of their books (whether for investors, insurers, in order to gain financing from a bank, or to work with public companies that want to verify the private company's integrity and solidity). So just because you work for a private company doesn't mean that you're in the clear.

The following "Background" section sketches this recent evolution of privilege issues in the audit context. The subsequent "Discussion Topics" section (page 17) presents a range of practices employed by companies to address their auditors' requests for otherwise privileged information.

#### **B. Background**

The Securities Exchange Commission ("SEC") has long required that public companies file a form 10K, which must include a financial statement certified by an independent auditor. In fulfilling its professional duties, an auditor must determine if the company's financial statements fairly represent its financial condition and adherence to generally accepted accounting principles.<sup>17</sup>

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<sup>17</sup> Douglas R. Richmond, "The Attorney-Client Privilege and Associated Concerns in the Post-Enron Era." 110 Penn St. L. Rev. 381.

Traditionally, attorneys and auditors dealt with privilege concerns by following the guidelines of the ABA/AICPA “Treaty” (see below); if you understood how to navigate the Treaty, you could generally give your auditors assurances that were sufficient for them to forego production of privileged source documents requested in a review. Those we interviewed about the audit process tell us that for all intents and purposes, the Treaty is dead. In the last few years, major corporate scandals as well as passage of Sarbanes-Oxley, adoption of new rules and regulations by the SEC, and creation of the Public Company Accounting Oversight Board (PCAOB) altered the overall relationship between auditors and corporate counsel. Pressure has grown for “transparency” in companies, which seems to translate in the audit context to auditor demands for all information they can possibly gather. Examples of what auditors now regularly request before certifying their reports include assessments of litigation reserves or accruals prepared by both outside and in-house counsel, tax opinions prepared by outside counsel, and results of internal investigations.<sup>18</sup>

If a company gives in to auditor demands, then it risks waiver of otherwise privileged information. As described below, disclosure of attorney-client communications to auditors generally waives privilege, and disclosure of attorney work product may waive those protections, as well.

### 1. The “Treaty” and audit letters

For many years, if an attorney followed the ABA/AICPA “Treaty” in responding to an audit inquiry, an expectation would arise that the response would not waive any privilege. The “Treaty” consists of two documents, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Request for Information and the AICPA Statement of Auditing Standards No. 12.<sup>19</sup> It was a compromise between the two groups reached in December 1975 and January 1976, dealing with an auditor’s respect for privilege and willingness to cooperate with attorneys in seeking information on issues otherwise privileged.

One common application of the “Treaty” has been in the context of “audit letters.”<sup>20</sup> According to the “Treaty,” in an audit letter the lawyer should “normally refrain from expressing judgments as to the outcome [of litigation] except in those relatively few cases where it appears to the lawyer that an unfavorable outcome is either ‘probable’ or ‘remote.’” The definitions for these exceptions were very narrow. An outcome 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.” An outcome is “remote” if “the prospects for the client not

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<sup>18</sup> Susan Hackett, “Whither Attorney-Client Privilege?” ACC Docket 23, no. 8 (September 2005): 132-143.

<sup>19</sup> Memorialized in AICPA “Statement on Auditing Standards Number 12” (“SAS 12”) and the ABA “Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information” (“ABA Statement”).

<sup>20</sup> One issue auditors address is whether a company’s legal reserves are adequate for pending claims against the company and whether there are any material claims known against the company that have not been asserted. To address this issue, an auditor typically requests from in-house counsel a written description of claims against the company and evaluation or quantification such claims. These written descriptions are called “audit letters” or “FASB 5 letters.” The auditor has an important interest in wanting to accurately assess a company’s liability that cuts against the corporation’s interest in maintaining this privileged information. Unfortunately, however, if the audit letter contains the substance of the evaluation of a claim, there is an argument that the company has waived attorney-client privilege and/or work product protection. See, e.g., John K. Villa, “Audit Letter Responses in the Wake of Sarbanes-Oxley,” ACC Docket 21, no. 9 (October 2003): 164-169, 165.

succeeding in its defense are judged to be extremely doubtful and the prospects of success by the claimant are judged to be slight.”<sup>21</sup> In sum, many audit letters under the “Treaty” guidelines did not provide any evaluations of the substance of claims because they are deemed to be too “remote” or not “probable,” and it was uncommon for there to be estimates about potential loss.<sup>22</sup>

Enactment of Sarbanes-Oxley Section 303 and adoption of SEC Rule 13b2-2, however, has changed the landscape dramatically.

## 2. Sarbanes Oxley Section 303 and SEC Rule 13b2-2

The Sarbanes-Oxley Act was enacted to raise the standards of transparency and accountability of public corporations to their shareholders.<sup>23</sup> Section 303, in particular, was intended to correct perceived abuses in public companies misleading their auditors.<sup>24</sup> While the language of this provision is rather innocuous on its face, Congress also gave the SEC the authority to promulgate rules and regulations under that section.

By issuing Rule 13b2-2 on May 20, 2003, the SEC made two subtle changes which resulted in substantially broadening the definition of prohibited conduct. First, while the statute outlawed actions that “*fraudulently* influence, coerce, manipulate or mislead...[an auditor],” the regulation outlaws actions that “coerce, manipulate or mislead or *fraudulently* influence ...[an auditor]” (emphasis supplied). By rearranging the verbs, the SEC very deftly takes the intent out of “coercing,” “manipulating” or “misleading,” so as to vastly expand the statute’s reach. The “*fraudulently*” now only attaches to the word “influence.” Moreover, while it can be argued that the words “coerce” and “manipulate” inherently suggest deception, the same is not true for “mislead.” One can mislead another without having any intention to do so. Importantly, this is not an overly-labored interpretation. In the official comments for this rule, the SEC explicitly stated that it intended “*fraudulently*” to only modify “influence.”<sup>25</sup>

Secondly, the statute prohibits an action if the conduct was done “for the purpose” of making a statement materially misleading. The new rule uses the higher standard, in effect “if the person *knew or should have known* that such an action, if successful, *could* result in rendering the issuer’s financial statements materially misleading” (emphasis supplied). Not only is the statute

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<sup>21</sup> ABA Statement at ¶ 5. Also, the ABA Statement says “it is appropriate for the lawyer to provide an estimate of the amount of range of 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.” It should be noted, however, that the AICPA component of the “Treaty” (SAS 12) does not define “probable” or “remote” quite as narrowly.

<sup>22</sup> Villa at 166.

<sup>23</sup> While the terms of the statute exclusively refer to public companies, its principles are being applied by the marketplace to both private companies and non-profits. Byron F. Egan, “Communicating with Auditors After the Sarbanes-Oxley Act,” *Tex. J. Bus. L.* 131 (Fall 2005): 131, 134-135.

<sup>24</sup> 17 C.F.R. § 240.13a-1, *et seq.*, “[i]t shall be unlawful...for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.”

<sup>25</sup> See Final Rule: Improper Influence on Conduct of Audits, S.E.C. Rel. No. 34-47890, May 20, 2003, at <http://www.sec.gov/rules/final/34-47890.htm>.

transformed from a specific intent provision to a negligence standard, but also the “could result” language makes this statute incredibly broad.<sup>26</sup>

As a result of this new Rule 13b2-2, in-house counsel must weigh very seriously the question of whether to decline to evaluate a claim or quantify its value. And if counsel does evaluate a claim, then he or she risks waiving attorney client privilege and/or work product protection.

### 3. Section 307 of Sarbanes-Oxley and internal investigations.

Another section of Sarbanes-Oxley relevant to the evolution of privilege issues in the audit context is Section 307 (and the SEC regulations implementing it).<sup>27</sup> Under Section 307, attorneys must 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.”<sup>28</sup> These rules apply to all attorneys “appearing and practicing” before the SEC, whether in-house or outside counsel.

As a result, a corporate attorney has an affirmative duty to run any evidence of misconduct up the proverbial corporate flagpole and to ensure satisfactorily that the company has taken appropriate (when warranted) remedial action.<sup>29</sup> This is similar to an auditor’s duty under Section 10A of the Exchange Act.<sup>30</sup> Such a process inevitably will give rise to internal investigations, which generate privileged attorney-client communications and attorney work product. This is yet another example of Sarbanes-Oxley leading auditors to require disclosure of privileged information, including whether legal counsel has found any material violations of the law in the underlying investigation.

### 4. The Public Company Accounting Oversight Board

One of the major goals of Sarbanes-Oxley was to make auditors more independent in general. As with many aspects of Sarbanes-Oxley, the goal is laudable, but in practice it can lead to some unintended consequences. As part of this overall goal, the PCAOB was formed, in order to inspect, investigate and discipline auditors in their audits of public companies.<sup>31</sup> Section 105

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<sup>26</sup> Villa at 168.

<sup>27</sup> See Implementation of Standards of Professional Conduct for Attorneys, S.E.C. Rel. No. 33-8185, January 29, 2003, at <http://www.sec.gov/rules/final/33-8185.htm>, now codified at 17 CFR Part 205. ACC has a full line of Sarbox 307 resources online at <http://www.acca.com/php/cms/index.php?id=316>.

<sup>28</sup> The “SOX § 307 Rules” constitute a new Part 205 to 17 CFR, Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission, 17 C.F.R. § 205.1-205.7 (2005).

<sup>29</sup> Id.

<sup>30</sup> Egan, 155.

<sup>31</sup> The Sarbanes Oxley Act, Sections 101-105, 15 U.S.C. §§ 7211-15. (information from Latham & Watkins article).

directs this body to “establish fair procedures for the investigation and disciplining of registered public accounting firms and associated persons of such firms.”<sup>32</sup>

The PCAOB has taken such an aggressive tact with the auditors that the auditors have in turn been forced to be far more aggressive in seeking privileged documents. SEC Deputy Chief Accountant, Scott Taub, recently explicitly suggested that auditors should seek out privileged information in relation to audits of litigation loss and tax contingency accruals under FAS 5.<sup>33</sup> He warned in the same speech that the PCAOB inspection teams will be closely scrutinizing the auditors’ work. On August 26, 2004, the PCAOB released some very harsh limited inspection reports on each of the four major accounting firms.<sup>34</sup> Among other things, the report criticized two firms for not having documentation for contingent liabilities, including analysis of counsel.<sup>35</sup>

Section 105 (b)(5) does provide a blanket evidentiary privilege for all information shared with the PCAOB or prepared in connection with their limited inspections and investigations of the company’s auditing firms. However, this provision does not help protect against the waiver problem that arises when a company’s auditors obtain privileged information. No one will be able to take discovery from the PCAOB, but both the company and its auditors may still be subject to discovery demands by the company’s third party adversaries.<sup>36</sup>

#### 5. Case law regarding waiver of privilege in the audit context<sup>37</sup>

(a) In general, disclosure of attorney-client communications to auditors will waive the privilege.<sup>38</sup>

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<sup>32</sup> See PCAOB Rulemaking: Public Company Accounting Oversight Board; Order Approving Proposed Rules Relating to Investigations and Adjudications, S.E.C. Rel. No. 34-49704, May 14, 2004, at <http://www.sec.gov/rules/pcaob/34-49704.htm>.

<sup>33</sup> “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.” SEC Deputy Chief Accountant Scott A. Taub, Remarks at the University of Southern California Leventhal School of Accounting SEC and Financial Reporting Conference (May 27, 2004). (transcript available at <http://www.sec.gov/news/speech/spch052704sat.htm>).

<sup>34</sup> Latham and Watkins LLP, “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.” (Corp. Couns. Consortium 2004; available online at <http://www.acca.com/public/article/attyclient/debate.pdf>).

<sup>35</sup> PCAOB, Report on 2003 Limited Inspection of Deloitte & Touche LLP (Aug. 26, 2004) at 19-20, available at [http://www.pcaobus.org/documents/Inspections/2004/Public\\_Reports/Deloitte\\_Touche.pdf](http://www.pcaobus.org/documents/Inspections/2004/Public_Reports/Deloitte_Touche.pdf); PCAOB, Report on 2003 Limited Inspection of KPMG LLP (Aug. 26, 2004) at 19, n.4, available at [http://www.pcaobus.org/documents/Inspections/2004/Public\\_Reports/KPMG.pdf](http://www.pcaobus.org/documents/Inspections/2004/Public_Reports/KPMG.pdf).

<sup>36</sup> Latham & Watkins, 14-15.

<sup>37</sup> Although this subsection focuses on U.S. law, there are interesting developments in other jurisdictions, as well. For example, in September 2006, the Canadian Supreme Court recognized the doctrine of limited waiver specifically for auditors in *Minister of Justice v. Blank*, 2003 FCT 462, rev’d 2004 FCA 287, appeal dismissed 2006 SCC 39.

<sup>38</sup> See, e.g., *Gutter v. E.I DuPont De Nemours and Co.*, 1998 WL 2017926, at 3 ( S.D. Fla. May 18, 1998), (“[d]isclosure to outside accountants waives the attorney-client privilege”)

Because attorney-client privilege exists solely to protect the confidentiality of communications between attorneys and their clients, almost any disclosure of such communications to an outsider constitutes waiver. This includes disclosure to auditors, although there are state laws in fifteen states that recognize an accountant-client privilege. Only seven of the fifteen, however, have expressly extended the privilege to independent auditors under theories that suggest that sharing information with an auditor who can be considered to carry common interests with the client does not constitute waiver.<sup>39</sup> Federal courts, as well as 35 other states, have never recognized any type of accountant-client privilege.

Earlier this year, the Association of Corporate Counsel advocated for an accountant-client privilege in its amicus brief for a writ of mandamus to the Texas Supreme Court in *In Re Stone & Webster, Inc., The Shaw Group Inc., and Ernst and Young LLP*.<sup>40</sup> In the case, a dispute between Shaw and AES led AES to request documents from Shaw's auditors, Ernst & Young. AES subpoenaed these documents, even though Shaw and the auditor were based in Louisiana, which has a law recognizing accountant-client privilege. The trial court judge ordered Ernst & Young to comply with the discovery request, notwithstanding the existence of the privilege. Although Shaw was not ultimately successful in its fight for judicial recognition of a privilege, it is likely this is a fight that will continue on in other jurisdictions.

(b) Disclosure to auditors *may* waive attorney work product protections.

The "common interest" concept derives from authorities holding that co-parties or allies may share work product without waiving any protection. In today's post-Enron environment, however, it may be increasingly hard to argue that independent auditors and their clients share a "common interest."

Compared to the uniformity regarding attorney-client privilege, courts are more divided on the effect of disclosure of work product to auditors. In general, however, disclosure to auditors *does not* waive the work product protection in relation to the client's litigation adversaries.<sup>41</sup> This is because the real rationale behind work product protection is to prevent disclosure to these litigation adversaries, unlike the attorney-client privilege, which exists to protect the confidentiality of the communication. Auditors are not seen as such adversaries, or conduits to the adversaries, and thus the protection still stands.<sup>42</sup>

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<sup>39</sup> The seven states that have expressly extended the privilege to independent auditors are Colorado, Georgia, Illinois, Kansas, Maryland, Michigan, and New Mexico. The other eight states recognizing some sort of accountant-client privilege are Arizona, Florida, Idaho, Indiana, Louisiana, Missouri, Pennsylvania and Tennessee.

<sup>40</sup> 2005 WL 1654875 (Tex.App.-Fort Worth Jul 12, 2005) (NO. 2-05-189-CV), mandamus denied (Mar 03, 2006), rehearing of motion for mandamus overruled (Apr 28, 2006). (<http://www.acca.com/public/amicus/txamicus.pdf>)

<sup>41</sup> See *Southern Scrap Material Co. v. Fleming*, 2003 WL 21474516, at 9 (E.D. La. June 18, 2003) (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.")

<sup>42</sup> Additionally, some courts have refused to compel third party discovery on evidentiary grounds, without reaching the question of waiver. Arguments are that legal analysis of loss contingencies are not relevant or that any probative value is outweighed by unfair prejudice and public interest concerns. See *Tronitech, Inc. v. NCR Corp.*, 108 F.R.D. 655, 655-656 (S.D. Ind. 1985) (attorney letter to auditors was not discoverable under Fed R. Civ. Proc. 26(b)(1))

For example, in *In re Pfizer Inc. Sec. Litig.*,<sup>43</sup> securities class action plaintiffs wanted to discover individual litigation case reserves that the company had set after consulting with counsel. The court found the reserves protected work product despite disclosure to the company's auditors. The auditors shared a common interest with the company, and could not reasonably be "viewed as a conduit to a potential adversary."

In contrast, in *Medinol, Ltd. v. Boston Scientific Corp.*,<sup>44</sup> Boston Scientific engaged counsel to perform an investigation and report the results to a Special Litigation Committee (SLC) of the Board. Minutes of the SLC meeting reflecting this investigation was provided to defendant's auditors, Ernst & Young. The court held that this disclosure waived the work product protection, ruling on its finding that Boston Scientific and Ernst & Young did not share "common interests" in litigations. *Medinol* found that the auditor client relationship did not fit neatly into that category, and therefore there was a waiver. Boston Scientific's disclosure to Ernst & Young did not serve the privacy interests that the work product doctrine was intended to protect.

Subsequently, in *Merrill Lynch & Co., Inc. v. Alleghany Energy, Inc.*,<sup>45</sup> the same court rejected the approach in *Medinol*, holding that disclosure to an outside auditor did not waive the work product protection. In that case, Alleghany tried to compel production of two internal investigation reports prepared by Merrill Lynch attorneys in response to a federal investigation into a particular transaction. Deloitte and Touche had used these two reports to evaluate the Merrill Lynch's internal control, accounting and auditing issues. Though the court stressed the need for auditors to be independent, it did not see the auditor-corporation relationship as an adversarial one by nature. Also, from a public policy standpoint, the court feared that a "blanket rule of waiver" would chill corporations from performing necessary internal controls and "sharing the fruits of such inquiry" with their auditors.

Thus, there is a chance that disclosure of attorney work product to an auditor waives any existing protections, and a near certainty that disclosure of otherwise privileged attorney-client communications to an auditor constitutes waiver in most jurisdictions. In sum, any time otherwise privileged material is disclosed to an outside auditor the company risks waiver.

### **C. Discussion topics: Practices to address evolving privilege issues in the audit context**

The combination of waiver jurisprudence and auditors' increasing demands for protected material puts companies in a difficult situation. As noted above, in the post-Enron era auditors

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because it was not legally relevant or reasonably calculated to lead to the discovery of admissible evidence). The minority view is that any evaluation of litigation risk and loss exposure in response to an audit inquiry is not work product at all because it was prepared for a business purpose, as opposed to "in anticipation of litigation or for trial." But most courts say that litigation analysis prepared for auditors is in fact work product, due to its being prepared "because of" actual or potential litigation.

<sup>43</sup> 1993 WL 561125 (S.D.N.Y. 1993).

<sup>44</sup> 214 F.R.D. 113 (S.D.N.Y. 2002).

<sup>45</sup> 229 F.R.D. 441 (S.D.N.Y. 2004).

are more risk averse and less sensitive to their clients' attorney-client and work product protections. For example, at least one major audit firm has a written FASB 109 policy requiring access to underlying documents even if they are privileged or subject to work product protections:

When a company has obtained a written opinion or analysis issued by a third-party with respect to a potentially material tax matter, we need to obtain the opinion or analysis notwithstanding potential concerns regarding attorney-client privilege. There is no substitute for having complete access to the opinion or analysis in lieu of reviewing in its entirety the actual written opinion or analysis. Furthermore, a company cannot avoid providing access to a third-party opinion or analysis by claiming that the company's accounting treatment is not based on the opinion or analysis. Nor can we perform additional analysis of our own in lieu of reviewing the adviser's written analysis or opinion. Anything less than complete access to written third-party tax advice may constitute a scope limitation. We should obtain written representation from company management that they have made us aware of and provided us access to all third-party opinions or analyses relating to tax positions taken by the company."<sup>46</sup>

Another development in the evolving audit environment is that auditors are increasingly likely to include privileged communications in their work papers, including even oral comments containing privileged information. Additionally, some companies are concerned that broad certifications or representations by their CLO could constitute waiver of protection for all underlying documents relied upon – an issue not yet addressed by the courts. Ultimately, the evolution of these and other related privilege issues in the audit context could call into question the extent to which the traditional assumption of a “common interest” between companies and their auditors remains valid. During this evolution, therefore, it is critical that every company carefully consider how to their relationship with their auditor.

In order to protect themselves, companies commonly include standard terms in their engagement letter with the auditor. One such term is an acknowledgement by the auditor of the confidentiality of the information received from the company during the audit and that such information will be used solely for the purposes of the engagement. Another standard term requires the auditor to give the company notice before responding to any request for this the company's information by a third party. Beyond these provisions in their engagement letters, however, companies employ a range of practices to deal with their auditors' requests for otherwise privileged information, including the following:

- Negotiate the terms of requesting/producing information in advance so there are clear “rules of the road” to address sensitive issues that arise during the course of an audit. By negotiating in advance, the company and its auditor can avoid addressing each information request on a case-by-case basis. This will save time, minimize conflict between the company and its auditor, promote consistent treatment of information from all sources, and dissuade auditors from seeking special treatment for any particular pieces of information. In certain cases, however, auditors may deem certain information so crucial to their work that they demand an exception to pre-negotiated “rules of the road.”
- Work with auditors to identify what information they really need and try to find a way to provide it without giving them access to privileged documents. When possible, this approach will give both the company and its auditors what they want. If counsel does not

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<sup>46</sup> PriceWaterhouseCooper, “Important Reminders When Auditing a Client's Accounting for Income Taxes.”

affirmatively work to understand the auditors specific needs and propose possible solutions, however, it is unlikely that auditors will stop asking for the privileged information. While this practice is not always feasible in the eyes of the auditor, sometimes initial resistance from the auditor can be overcome by the company escalating the issue to the audit firm's relationship partner or national office.

- Give auditors the same information given to the board's audit committee. This practice has the advantage of using information that already has been created and carefully reviewed. This information, however, may be subject to attorney-client or work product protections. If so, the company may be waiving those protections by giving it to the auditors.
- Allow auditors to review quarterly litigation summaries prepared for management. As with the previous practice, this approach has the advantage of using previously created and reviewed information, but the disadvantage of possibly waiving those protections. To the extent waiver is an issue, companies cannot prevent it simply by sharing the protected information orally or by letting auditors see documents without giving them copies to keep.
- Tell auditors to either accept the corporate lawyer's representations or hire their own outside lawyer to conduct an investigation, but either way there is no need for the business organization to turn over privileged documents. Obviously, this is a more aggressive approach to the auditor relationship. It is unlikely to engender good will with the auditor, but may be effective in protecting information that the company views to be particularly sensitive.
- Make clear that if privileged information given to the auditor is used in litigation against the business organization that business organization will make the auditor a third party defendant and seek indemnification. This is an even more aggressive practice, although it does provide the auditor with the privileged information requested. One likely result of this approach is that it will force the auditor to carefully consider whether the requested information is truly necessary.

## IV. Internal Investigations

### A. Overview

While necessary, internal investigations by business organizations are unsettling because what starts out as a good faith effort to get to the root of a corporate problem (so it can be remedied) can end up leading to civil or criminal liability of a corporation or its employees. Moreover, as a practical matter, the investigation process creates challenging issues for corporate counsel on numerous fronts, including: deciding whether to conduct an investigation in the first place, deciding who should conduct it, and interviewing corporate employees as part of the investigation. As noted in Section IV.C., however, the erosion of the attorney-client privilege has complicated the analysis relevant to addressing these issues.

### B. Background

#### 1. Determining whether to conduct an investigation

The decision whether or not to conduct an internal investigation typically is triggered by allegations of misconduct. There are many reasons to launch an investigation. First, an

investigation will help the company fully understand and eliminate behavior detrimental to corporate performance, consistent with the fiduciary duty directors owe the shareholders. Second, an investigation gives the corporation the ability to respond proactively to any potential litigation, by identifying the relevant information and controlling its flow. Third, an investigation may put the company in a position to negotiate more lenient treatment with government investigators or prosecutors.

On the other hand, there are many potential pitfalls associated with launching an investigation. One is that an investigation can draw the attention of government investigators even if no wrongdoing is uncovered. Another is that internal investigations could lead to putting privileged documents in the hands of third party adversaries that can provide a road map for establishing criminal or civil liability of a corporation or its employees.

A key issue for in-house counsel is to assess the allegation at issue. Often the allegation will be vague, with not enough information for the attorney to determine the likelihood of a serious problem or to determine what information is going to likely satisfy the investigator. In making the decision to investigate on their own or with outside counsel or another agent, in-house counsel should consider the complaint's source, its form, and its substance. With respect to the source of the allegation, did it come from within, from a government agency, from a competitor or from an anonymous source? Is there any evidence of bias or self-interest? With respect to form, was it an anonymous communication or a public news story? Is the allegation documented? With respect to the substance of the allegation, counsel has to make a judgment regarding the scope and potential seriousness of the allegation and the likelihood that the allegation has merit. Sometimes an initial investigation may be warranted to make a determination as to whether a more formal investigation should be conducted. If a formal investigation is conducted, however, all information received in the initial investigation should be passed along to the formal investigation team.<sup>47</sup>

In the end, decisions regarding whether or not to conduct an internal investigations often are based upon challenging judgment calls, but corporate counsel often has a great deal of latitude in making them.<sup>48</sup> It is worth noting, however, that this latitude is more limited where the corporation faces self-reporting obligations. Typically arising in the context of the financial services industry, securities issues, and stock exchange rules, self-reporting obligations may put additional pressure on corporate counsel to launch investigations even where the allegations otherwise wouldn't warrant such an approach.

## 2. Determining who should conduct an investigation

Once the decision is made to investigate, one of the first questions an in-house counsel has to face is who should conduct the investigation. A threshold question is whether a lawyer needs to be involved or if it can be handled by non-lawyers in the corporate compliance or human resources departments. Although privilege will not attach to any aspect of investigations conducted entirely by non-lawyers, depending upon the allegation being investigated this may not matter. Moreover, the sheer volume of investigations at many large corporations makes it impractical for lawyers to conduct more than a fraction of them. In those situations, in-house

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<sup>47</sup> William Michael, Jr., "Internal Investigations." (September 2004) at <http://www.acca.com/infopaks/intinvest.html>.

<sup>48</sup> Deborah J. Edwards, et al, "What to Do When the Whistle Blows," *ACC Docket* 22, no. 5 (May 2004).

counsel can develop screening procedures to identify the most sensitive cases that should be handled by a lawyer.

If a lawyer should be involved, the next question is whether to retain outside counsel to conduct the investigation. This may be appropriate for investigations of particularly serious allegations as well as when the targets of an investigation are high-level corporate executives. Although there can be substantial costs associated with retaining outside counsel to conduct investigations, the benefit is the perception that the results will be more arm's-length and objective than if conducted by in-house counsel.<sup>49</sup> In certain situations, this perception may make the difference in negotiating with government investigators and prosecutors. Another advantage of retaining outside counsel to conduct an investigation is that sometimes there can be a question regarding whether in-house counsel is performing a business or legal function.<sup>50</sup> Non-lawyers may also be hired or enlisted to conduct the investigation, including vendor-investigation firms, or personnel from the company's internal audit or compliance functions. These workers will be agents of the in-house counsel for purposes of privilege protection, but if the point was to get outside counsel to help preserve the privilege, that benefit is likely lost when taking this course.

### 3. Issuing *Miranda* or *Upjohn* warnings in employee interviews

A crucial part of any internal investigation is interviewing employees who potentially have knowledge relevant to the alleged improper conduct. If an attorney is conducting an interview, privilege may attach to the communications and related work product, but any such privilege belongs to the corporation, not the employee. This is where *Upjohn* warnings, sometimes referred to as "corporate *Miranda*" warnings, come into play. Such warnings are crucial both to preserve a corporation's privilege and to avoid the possibility of the interviewing attorney subsequently misleading the employee re who the lawyer's real client is (and thus being deemed to have established a relationship as the employee's counsel) and being disqualified from representing the corporation on that matter.

The basic message that counsel needs to communicate to an employee in an *Upjohn* warning before the interview starts is: (1) counsel represents the company, not the employee being interviewed;<sup>51</sup> (2) the information learned during the interview is privileged to the company, and it is the company's decision alone whether to disclose or waive the information to the government or other parties; (3) the information in the interview is to be kept confidential so that the company's privilege can be preserved.<sup>52</sup> Additional statements may be appropriate, based on whether the employee needs to be told that he or she is entitled to counsel, whether

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<sup>49</sup> Id.

<sup>50</sup> The leading case on this issue, *Diversified Industries v. Meredith*, 572 F.2d 596 (8<sup>th</sup> Cir. 1977), indicates that an investigator's status as an in-house attorney is prima facie evidence that privilege should attach. Even so, attorneys with additional business obligations are still subject to challenge.

<sup>51</sup> The new ethical rules for attorneys based on ABA Model Rules of Professional Conduct Rule 4.3 places an affirmative duty on attorneys to "make reasonable efforts to correct" a misunderstanding of the attorney role of someone who is not represented by counsel (i.e. an interviewed employee) if the attorney "knows or reasonably should know" of this misunderstanding.

<sup>52</sup> Some business organizations have confidentiality obligations in employment contracts or corporate code of conduct.

joint defense options are available, whether fee reimbursement will be offered and under what terms, and so on.<sup>53</sup>

A recent Fourth Circuit case demonstrates the importance of adequate *Upjohn* warnings and the potential consequences that can arise if an employee gets the mistaken belief that investigating counsel represents him or her, rather than the company. In *In Re Grand Jury Subpoena*,<sup>54</sup> outside counsel conducted an internal investigation for AOL Time Warner (AOL), and its dealings with PurchasePro. Having reason to believe some of its employees had engaged in illegal conduct, the company interviewed a number of employees to quickly decide if any wrongdoing occurred, and whether to disclose it to the government. Unfortunately, counsel's *Upjohn* warnings in some of these interviews were far from perfect. For example, in one interview counsel stated that they "could" represent the employee "as long as no conflict appeared."<sup>55</sup> In another interview an employee asked if he needed personal counsel, and the investigating attorney said he did not recommend it, but would tell the company not to be concerned if outside counsel was retained.<sup>56</sup>

When the SEC began a criminal investigation, AOL agreed to waive the attorney-client privilege and turn over memoranda generated by outside counsel containing summaries of the interviews. The employees moved to quash the subpoenas on the grounds that each attorney had *an individual relationship with in-house counsel*. The trial court refused to quash these subpoenas, and the Fourth Circuit affirmed. In its decision, the circuit court found: (1) no evidence that outside counsel told employees that they represented them, or that employees asked to be represented by them. (2) that the employees were each advised that the information could be disclosed at the discretion of the company. (3) no evidence that employees ever sought legal advice, nor that any such advice was rendered.<sup>57</sup>

This case demonstrates the need for interviewing counsel to be absolutely clear in warning the employees. Although the warnings at issue in *In Re Grand Jury Subpoena* ultimately were found to be sufficient, one lesson is that there are things lawyers should *not* tell an employee in an interview. First, the interviewing lawyer should be absolutely sure that the company's and employee's interests will never diverge before telling the employee that the in-house counsel "can," "could," or "might" represent them if the circumstances become right. That's a standard that will almost never be met. Consistent with this approach, lawyers should not give any legal advice other than that it might be advisable for the employee to secure their own counsel. Secondly, lawyers should not tell an employee that anything is "off the record." Sometimes matters tangential to the investigation can arise, but often the relevance of an employee's statements will become clear or appreciated long after conclusion of the interview. Before knowing what the employee has to say, a lawyer should never promise confidentiality. Finally,

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<sup>53</sup> See the treatment on issuing such warnings contained in ACC's "Responsive Measures for Government Investigations," available at <http://www.acca.com/protected/policy/compliance/respond.pdf>.

<sup>54</sup> 415 F.3d 333 (4<sup>th</sup> Cir 2005)

<sup>55</sup> *Id.* at 336.

<sup>56</sup> *Id.*

<sup>57</sup> *Id.* at 340.

an interviewing lawyer must not be anything but straightforward with employees. He or she can decline to answer an employee question, but should not say anything to mislead an employee.<sup>58</sup>

There are also two important limitations on the *Upjohn* Court's holding that privilege attaches to communication between the counsel and a company's lower level employees (rejecting a "control group" test that would limit the attorney-client privilege to "communications between counsel and upper-echelon ... management").<sup>59</sup> First, this holding is not binding on state courts. Only fourteen states have adopted some version of the *Upjohn* rule, while eight have adopted the more restrictive "control group" test, and the rest have not decided one way or the other.<sup>60</sup> Further, because this holding is grounded in the federal common law of attorney-client privilege, it also may not apply in diversity cases where the federal court is obligated to use state privilege law. Second, this holding may not apply to former employees and consultants. With respect to former employees, courts are split on whether the privilege should be upheld.<sup>61</sup>

As for consultants, for there to be privilege the consultant must "improve the comprehension of the communications between attorney and client"<sup>62</sup> and the communications must "be made in confidence for the purpose of obtaining legal advice from the lawyer."<sup>63</sup>

### C. Discussion Topics: Practices to address evolving privilege issues in the context of internal investigations

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<sup>58</sup> Douglas R. Richmond, "Organizational *Miranda* Warnings." *For the Defense* (September 2006): 71-72. With respect to misleading statements in employee interviews, the recent Computer Associates case raises a different issue -- an employee can be indicted for lying to his or her *own company's lawyers*. This issue arose in the context of a joint investigation between prosecutors in Brooklyn, New York and the SEC into accounting irregularities at the software firm. Three former executives plead guilty to obstruction of justice for lying to outside counsel the Computer Associates hired to investigate the charges against itself. Because outside counsel passed the information along to the government, the government claimed that the targeted employees indirectly misled the government. Later, the government unsealed the indictment and charged two other executives, Kumar and Richards, on the same grounds. Both moved to dismiss the obstruction counts because of an insufficient "nexus" between their statements to the company's attorneys and an official proceeding required under the obstruction statute. This past February, the district court denied the defendants' motions, calling it sufficient that Kumar and Richards "knew" their statements "would have the effect of obstructing and impeding Government investigations," and therefore a challenge would have to await a trial. The two plead guilty two months later. See Order Denying Motion to Dismiss Counts Six and Seven of the Superseding Indictment as to Sanjay Kumar, Stephen Richards, *U.S. v. Kumar*, No. 04-cr-846, slip op. (E.D.N.Y. Feb. 21, 2006).

<sup>59</sup> 449 U.S. 383 (1981) at 391. "While in the case of the individual client the provider of information and the person who acts on the lawyer's advice are one and the same, in the corporate context it will frequently be employees beyond the control group...who will possess the information needed by the corporation's lawyers."

<sup>60</sup> The fourteen states adopting some version of the *Upjohn* test are Alabama, Arkansas, California, Colorado, Florida, Kentucky, Louisiana, Mississippi, Nevada, Oregon, Texas, Utah and Vermont. The eight states adopting the control group standard are Alaska, Hawaii, Illinois, Maine, New Hampshire, North Dakota, Oklahoma, and South Dakota. See Thomas R. Mulroy, "The Internal Corporate Investigation." 1 DePaul Bus. & Com. L.J. 49, nt. 34 (2002).

<sup>61</sup> See, e.g., *In Re Allen*, 106 F.3d 582, 605 (4<sup>th</sup> Cir. 1997)(upholding the privilege for a former employee); *Clark Equip. Co. v. Lifts Parts Mfg. Co.*, 1985 WL 2917 (N.D. Ill. Oct. 1, 1985) (refusing to apply the privilege to a former employee).

<sup>62</sup> *United States v. Ackert*, 169 F.3d 136, 139-140 (2<sup>nd</sup> Cir. 1999).

<sup>63</sup> *United States v. Kovel*, 296 F.2d 918, 922 (2<sup>nd</sup> Cir. 1961).

To approach these issues regarding internal investigations in the face of the erosion of privilege, corporations have adopted a variety of practices, including the following:

- Conduct only bare bones internal investigations, or none at all if possible, to minimize creation of privileged material that may be subject to waiver. While perhaps a “cautious” approach in terms of preventing the possible waiver of privileged materials, such a policy may ultimately reduce ability of in-house counsel to provide important legal advice to corporate officers and directors. Specifically, practices such as less comprehensive investigations (or none at all), less candid assessments of issues raised in investigations, limited retention of investigation materials, and providing only oral advice to management all constrain the ability corporate lawyers to provide effective legal counsel.
- Use non-lawyers from corporate compliance or human resources departments as default investigators and use attorney on when necessary. This is a practical response to the combination of limited legal resources and large volume of investigations common at many large corporations. While many investigations can be handled effectively by non-lawyers outside the legal department, there needs to be a sound process in place to identify sensitive investigations that should to be conducted by a lawyer. The companies most comfortable with this approach use rigorous screening procedures before investigations are commenced, and schedule frequent communications between non-lawyers screening/conducting investigations and the legal department.
- Set up a “privilege database” with lawyers-only access. This can be a useful tool to segregate information that the corporation believes is protected, and especially helpful in avoiding inadvertent disclosure of these materials. Ultimately, however, even use of this database will not protect materials if a court disagrees with the decision to designate them privileged or if a prosecutor coerces the company to waive privilege.
- Conduct investigation on behalf of government regulators. Companies in highly-regulated industries often are coerced to deputize their in-house counsel to perform investigations designed by the regulators.<sup>64</sup> While this coerced “deputization” is always improper and often burdensome, it may avoid the need to waive privilege with respect to internal investigations that the company does not wish to share. Moreover, this conscription of in-house lawyers is less invasive than having government lawyers on the premises conducting exactly the same investigation in a scorched earth fashion, often terrorizing or de-moralizing employees.
- Balance the need to memorialize the *Upjohn* warning with desire to avoid employee from claming up. Counsel wants to elicit as much information as possible out of the interviewee, but the strongest or inartful applications of an *Upjohn* warning can undermine this effort. Ideas shared about best practices in delivering this warning include having a witness in the room when the lawyer gives the warning, putting the warning in writing, transcribing the communication of the warning, having the employee affirmatively state that he or she understands the warning, and requiring the employee to acknowledge the warning in writing. The best approach depends upon the circumstances and requires a case-by-case determination. The more you “formalize” the warning, the more likely it is that the

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<sup>64</sup> Note that a recently passed piece of legislation [The Regulatory Relief bill, passed in October of 2006 in Section 607, amending Section 18 of the Federal Deposit Insurance Act (12 U.S.C. 1828)] creates some welcome relief from this forced waiver situation for counsel to financial services industry clients. The act creates a statutory limited waiver for information that banks must produce to their regulators under federal law, thus protecting it from production demands made by third parties. Since no privilege existed under law for these clients, this institutionalization of a limited waiver is actually a welcome step forward.

employee may not wish to offer the information that counsel needs to conduct the investigation as their worry grows that this is more than a simple interview to get at the facts, but rather a sticky legal mess they're personally being caught up in.

- Include obligation to cooperate with internal investigations in all employment contracts or manuals with termination a possible penalty. This obligation does not eliminate individual employees' right to counsel, but requires them to cooperate in an investigation if they want to remain employed at the company. Of course, this policy does not provide much incentive to cooperate to the most culpable employees who realize that their employment at the company will terminate regardless of whether or not they cooperate. And it puts corporate counsel into the position of placing all employees between a rock and a hard place: of choosing between their livelihood and professional standing, or waiving their Constitutional rights that protect them from self-incrimination.
- Include confidentiality obligations in employment contracts or corporate code of conduct. Although similar to the preceding practice, this is relevant more for ex-employees and legal adversaries of the corporation. Specifically, parties approaching ex-employees of an adverse business organization may have an obligation to give warnings regarding the ex-employees' confidentiality obligations.

## V. Individual Rights of Employees

### A. Overview

As noted above, in addition to coercing corporations to waive privilege, current government policies also may infringe on the rights of individual employees. Specifically, government investigators and prosecutors are putting pressure on corporations in order to manipulate the corporation's relationship with employees. This can happen in the context of advancement of legal fees, joint defense agreements, sharing relevant information, and termination: the Thompson Memorandum of the DOJ, for instance, makes whether the corporation has cooperated in these fashions with employees relevant to the decision of the government as to whether the corporation is properly cooperating with the government, or is adjudged as obstructing justice. Interference of the government in this manner (by infringing on employees' individual rights), however, has not gone unnoticed by the courts. In particular, the bar is still waiting to determine the ramifications of Judge Kaplan's recent opinions in *U.S. v. Stein*, discussed more fully below, accusing federal prosecutors of misconduct in this area.

### B. Background

1. There are four major "bundles" of employee/individual rights affected by the Thompson Memorandum's policies.

The Thompson Memorandum, described in detail in Section II, instructs prosecutors in assessing a corporation's cooperation in an investigation to see whether it "appears to be protecting culpable employees and agents." The four issues implicated by this instruction are discussed immediately below.

#### (a) Advancement of legal fees

Many states permit business organizations to indemnify their directors, officers, and employees for legal fees incurred as a result of their employment. In turn, corporations frequently have

bylaws or informal policies to indemnify or advance legal fees to at least a subset of such individuals “to the fullest extent allowed under applicable law.” Such policies regarding the advancement of legal fees are a well-established corporate practice, not only because it is commonly considered the ‘right thing to do,’ but also because it is necessary to attract highly qualified executives. Individual legal fees in most litigation in the corporate context are large that denying employees indemnification is effectively denying them the assistance of counsel.

Prosecutors following current government policies, however, sometimes pressure business organization to refrain from supporting “culpable employees and agents . . . through the advancing of attorney’s fees.”<sup>65</sup> For those employees who cannot afford to hire their own defense counsel, such government policies may have the effect of depriving employees of counsel altogether, even though they have neither admitted nor been convicted of wrongdoing.

#### (b) Joint defense or information sharing agreements

Joint defense agreements have been recognized for at least a century as an exception to the general rule that disclosure to third parties will waive the attorney client privilege. Often in complex corporate cases there will be multiple codefendants and joint targets of government investigations, and both the corporation and its employees will be facing indictment. It *should be* in each targets’ best interests to share information and coordinate efforts to the greatest extent possible.

Much like with advancement of legal fees, however, when the government is investigating a company there sometimes is pressure for the corporation to refrain from entering into joint defense agreements with its employees. The resulting denial of joint defense options limits the ability of targeted employees to mount an effective legal defense, and again infringes on an individual’s right to make one’s own strategic decisions about his or her legal defense.<sup>66</sup> As Judge Kaplan in *Stein* said, “the government may not both prosecute a defendant and then seek to influence the manner in which he or she defends the case.”<sup>67</sup>

Refraining from entering into joint defense agreements with employees also has an adverse effect on the corporation’s ability to investigate alleged wrongdoing. When an organization obtains counsel to conduct an internal investigation, it has a legitimate interest in gathering as much information as possible. In some cases, for the sake of efficiency, it would want to share information with counsel of a targeted employee with whom it has a common interest pursuant to a joint defense agreement. In the absence of such an agreement, this is information the corporation may not have access to at all.<sup>68</sup>

#### (c) Information sharing in general

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<sup>65</sup> Thompson, pp. 7-8.

<sup>66</sup> See Wilmer Hale Cutler Pickering Hale and Dorr LLP Briefing Series, “Limits on Corporate Cooperation – A Judicial Criticism of the Thompson Memorandum,” pp. 4-5 (September 2006).

<sup>67</sup> See *Stein*, 435 F. Supp. 2d 330 (S.D.N.Y. June 26, 2006) at 357

<sup>68</sup> Task Force Report and Recommendation to the ABA House of Delegates on Employee Rights as Adopted (August 2006) at 10, available online at <http://www.acca.com/public/attyclientpriv/abahodreportemployee.pdf>.

Beyond the advancement of legal fees and joint defense contexts, government policies like the Thompson Memorandum go even further in disfavoring information sharing among parties, even if it is a corporation sharing its own records with counsel of targeted officers and employees. This has negative implications for both the corporation and the employee. As with the denial of joint defense options, this policy severely hampers the ability of the employee and the corporation to gather the necessary facts to prepare an adequate defense. And in the interests of fairness, shouldn't records provided to the government also be available to the defense, especially when such demands of the government are made before all the facts are in? Employees are often targeted by the government long before anyone is able to assess the predominant likelihood of an employee's guilt. But those interviewed tell us that the coercion to deny access to records even extends to corporate historical records and records related to the alleged wrongdoing.<sup>69</sup>

#### (d) Termination or sanctioning of employees

Prosecutors sometimes make it clear to a corporation that it is expected to discharge or sanction employees who assert their right against self-incrimination against the government. The mere assertion of this right should not be used against a targeted employee, but it has been by the government, to the detriment of the employee's Constitutional rights. In the context of a government investigation, an organization will have to demonstrate cooperation before anyone has been tried or charged. Sometimes it will happen even before all the facts of the case can come out. As with other aspects of the Thompson Memorandum, this policy contravenes the principle that one is innocent until proven guilty.<sup>70</sup> And it disrupts morale for corporate employees who remain at the company, sending a message that the company is not to be trusted and has no loyalty – even to employees whose criminality is still unclear.

For more on this issue, you may wish to read ACC's amicus brief in the case of two officers who were forced "under the bus" in an effort by the company to save itself from indictment under terms demanded by prosecutors, in *U.S. vs. Lake & Wittig*, available online at <http://www.acca.com/public/amicus/lakewittig.pdf>.

#### 2. *U.S. v. Jeffrey Stein*<sup>71</sup>: A Turning Point Against Coercive Government Practices?

Earlier this year, the Association of Corporate Counsel joined the Securities Industry Association, the Bond Market Association, and the National Chamber Litigation Center in *U.S. v. Jeffrey Stein*. Still ongoing, *Stein* is the largest tax fraud case in American history. Recent rulings in the case revolve around the coercive tactics of the U.S. Attorney's Office for the Southern District of New York (USAO) in its investigation of tax shelters allegedly created by KPMG and others. KPMG went to great lengths to ensure the USAO of its cooperativeness in the investigation, in hopes of avoiding a criminal indictment of the firm. No doubt, the fate of

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<sup>69</sup> Id. at 14.

<sup>70</sup> Id. at 15-16.

<sup>71</sup> 435 F. Supp. 2d 330 (S.D.N.Y. June 26, 2006) ("Stein I"); 440 F. Supp. 2d. 315 (LAK) (S.D.N.Y. July 25, 2006) ("Stein II").

former accounting giant Arthur Andersen, which did not cooperate with government demands, was on the minds of KPMG leaders.<sup>72</sup>

Like many organizations, it had been longstanding practice at KPMG to pay the legal fees of its employees. However, in communications with KPMG attorneys, the USAO was very persistent in asking whether KPMG intended to pay the attorney fees of the targeted present and former employees under investigation. The court found that the USAO “deliberately, and consistent with DOJ policy, reinforced the threat inherent in the Thompson Memorandum” that advancement of legal fees to “culpable” employees was a factor in determining a targeted company’s cooperation. KPMG in turn agreed it would put a cap on the amount of attorneys’ fees it would pay (\$400,000), and stipulated that the payments would be cut off if any employee was indicted. In essence, KPMG acceded to the government’s demands, and, proverbially speaking, “threw its employees under the bus.”<sup>73</sup>

In August 2005, KPMG entered into a deferred prosecution agreement with the government so it not be indicted. KPMG would admit wrongdoing, accept some restrictions on its business, pay a \$456 million fine, and continue to cooperate “fully and actively” in the investigation.<sup>74</sup> Once the individual defendants were indicted, KPMG cut off their legal fees. The former KPMG partners argued that the government’s interference with their advancement of attorneys’ fees was in violation of their Constitutional and other rights.

In what would be known as *Stein I*, issued June 26, 2006, Judge Lewis Kaplan noted KPMG’s longstanding policy of advancing legal fees and that the employees had “every reason to expect” KPMG would cover their costs, adding “KPMG refused to pay because the government held the proverbial gun to its head.” The Court held that the pressure exerted by Thompson Memorandum to induce a company to deny advancement of legal fees to employees was so coercive that it infringed the employees’ Fifth Amendment (due process) and 6th Amendment (right to counsel) rights.<sup>75</sup> In his written opinion, Judge Kaplan let loose his contempt for the government tactics:

Those who commit crimes – regardless of whether they wear white or blue collars - must be brought to justice. The government, however, has let its zeal get in the way of its judgment. It has violated the Constitution it is sworn to defend.<sup>76</sup>

Some have criticized the *Stein* case for not going far enough, by not outright dismissing the case against the KPMG executives upon a finding of Constitutional violation. What Judge Kaplan opted for instead was a judicial remedy of a hearing to decide whether KPMG would be required to pay attorneys’ fees. The argument is that denial of a right to attorneys fees in the early stages

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<sup>72</sup> Id.

<sup>73</sup> Id.

<sup>74</sup> Deferred prosecution agreements and non-prosecution agreements are discussed at greater length in Section VIII of this paper.

<sup>75</sup> *Stein I* at 367.

<sup>76</sup> Id. at 336.

of an investigation when they were government “targets,” “subjects,” or witnesses cannot be remedied after the fact.<sup>77</sup>

In *Stein II*, issued July 25, 2006, in the same court in the same case, nine of the defendants moved to suppress statements they had made to USAO prosecutors in the investigation. The court found that when the prosecutors requested these statements from the individuals and they refused, the prosecutors reported their uncooperative behavior to KPMG. The firm in turn advised the targeted employees and former employees that this stance could result in termination of legal fees, and in discharge for the current employees.<sup>78</sup>

The government contended that KPMG’s actions were private actions that could not be attributable to prosecutors. The court disagreed, finding that the firm’s actions were a direct result of the prosecutors’ coercive tactics. In the end, each of the nine defendants made the proffers after being informed of the KPMG response if they withheld their statements. Six of them could not produce any evidence that they had no alternative but to make the statements (one woman had evidence for one proffer, but not for a second). Two of the proffers, and “the fruits thereof,” were suppressed because the court found the government coercion was attributable to their decision to make the statements.<sup>79</sup>

In sum, the court in *Stein II* found that where that mechanism of pressure *actually* coerced employees to make statements to the prosecutors, those statements were obtained in violation of the Fifth Amendment right against self-incrimination. The fact that employees made their statements after KPMG let them know that advancement was contingent on cooperation was not enough. It had to be *because* of the pressure placed on them by KPMG.<sup>80</sup>

In commenting on one example of coercion, Judge Kaplan noted that the witness had “no practical choice but to cooperate .... [T]he government here coerced KPMG to apply pressure to Mr. Watson and other individual defendants in order to secure waivers of constitutional rights that the government itself could not obtain. That goes beyond the bounds of appropriate government action.”<sup>81</sup> Former Attorney General Ed Meese, commenting on this decision, put it this way: “When an individual’s constitutional rights are implicated, the government may not do indirectly...what it is forbidden to do directly.”<sup>82</sup> Though the Constitution would not allow prosecutors to threaten the targeted employees with loss of employment if they asserted their Fifth Amendment rights, in essence they did that indirectly through threats to KPMG.

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<sup>77</sup> Stephen W. Grafman and William F. Boyer, “Judge Kaplan’s Ruling is Right and Wrong.” *National Law Journal* (August 14, 2006) at <http://www.law.com/jsp/nlj/PubArticleNLJ.jsp?id=1155303321428>.

<sup>78</sup> *Stein II* at 323-324

<sup>79</sup> *Id.* at 338

<sup>80</sup> *Id.* at 333

<sup>81</sup> *Id.*

<sup>82</sup> Statement of Edwin Meese III Before the U.S. Senate Committee on the Judiciary Regarding the Thompson Memorandum’s Effect on the Right to Counsel in Corporate Investigations (September 12, 2006) at p. 4, citing *Rutan v. Republican Party of Ill.*, 497 U.S. 62, 77-78 (1990).

Because the *Stein* case is still ongoing, the full implications of this case cannot be known. While the government does not show any signs of backing down from its use of policies like the Thompson Memorandum, at least one commentator has questioned whether the government can continue its use and thereby risk the integrity of future prosecutions.<sup>83</sup> And there are conversations about whether Judge Kaplan's ruling will stand if challenged on appeal. As it stands as of this writing, corporate counsel need to expect the government to continue its coercive tactics.

### C. Discussion Topics: Practices to address evolving privilege issues in the context of employee rights

Given the unsettled state of employee rights issues in the immediate aftermath of Judge Kaplan's *Stein* decisions, many corporations are adopting a 'wait and see' attitude regarding how to approach these issues. Practices that corporations have adopted, however, include the following:

- Ensure there is a set policy in place regarding advancement of legal fees to employees. Some case law supports an argument that if a company is simply following its legal obligations, it has no choice but to advance legal fees. In *Bergonzi v. Rite Aid*,<sup>84</sup> for example, the Delaware Chancery Court found Rite Aid was obligated to pay legal fees to a former CFO up until the time of sentencing, despite the fact he had plead guilty to criminal fraud. Such policies should be applied uniformly, however, to dissuade the government from arguing that the policy is simply a tool on the company's books used to impede investigations. This is not to say that advancement of legal fees should always be made to employees under criminal investigation, but rather that any weighing of the merits on an individual basis should be done in a consistent manner and preferably in response to a clearly written policy.
- Clearly identify the terms of any fee advancement policy. Questions that can arise unless specifically addressed in a fee advancement policy include:
  - What group of employees is covered? Is the group (*e.g.*, "officers") clearly defined?
  - What relationship do those covered employees have with the business organization's counsel both before and after the issue of indemnity/advancement of legal fees arises? When, if ever, will a business organization share counsel with a covered employee?
  - At what point does the business organization provide covered employees their own counsel?
  - What is the scope of this outside counsel's legal representation?
  - Does the business organization have the right to refuse, revoke or limit indemnification? Under what circumstances?
  - Will there be a clawback provision? If so, what are its terms?
- Take special care with respect to directors and officers. Some business organizations' engagement letters for lawyers representing board members make clear that representation is limited to the director's conduct in their specified role at the indemnifying company. Another area of particular sensitivity arises when directors or officers are targeted individually is waiver of privilege.<sup>85</sup> A corporation may want to try to clarify that as a

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<sup>83</sup> Ellen D. Podgor, White Collar Crime Professor Blog (August 14, 2006) at [http://lawprofessors.typepad.com/whitecollarcrime\\_blog/2006/08/more\\_on\\_kpmg\\_st\\_1.html](http://lawprofessors.typepad.com/whitecollarcrime_blog/2006/08/more_on_kpmg_st_1.html).

<sup>84</sup> 2003 WL 22407303 (Del. Ch. Oct 20, 2003).

general rule a single board member or officer cannot waive a corporation's privilege. On the other hand, directors and officers may balk if such a rule applies even in the context of a legal defense (*e.g.*, "I relied on advice from the corporation's counsel"). Moreover, even under a joint defense agreement, concerns regarding waiver may arise if (i) an outside director who is the CEO of another company seeks advice regarding a privileged board issue from the general counsel of that other company, (ii) corporate counsel sends a privileged e-mail to the work e-mail address of an outside director who works at a company where the e-mail policy is that "nobody should have any expectation of privacy with regard to their e-mails," or (iii) corporate counsel sends a privileged e-mail to the home e-mail address of an outside director who shares that e-mail account with her or his spouse.

## VI. Document Retention and Labeling

### A. Overview

In the age of electronic discovery where cases can involve literally millions of documents, document retention policies are particularly important. Basic elements of such a policy include clearly instructing employees on basic retention procedures (*e.g.*, what documents need to be saved and where to save them), proper labeling of protected information (designations such as 'attorney-client privilege' and 'attorney work product' should not be under-used or over-used, and should be consistently used), a well-organized system to archive retained documents (*e.g.*, efficient search and retrieval functionality as well as easy identification of privileged documents), regularly scheduled destruction of documents (including ensuring that employees comply), and procedures to preserve documents relevant to litigation (*e.g.*, use of "do not destroy" or "litigation hold" memos). Although mundane, document retention policies can have a substantial impact on a company's legal fortunes.

### B. Background

#### 1. Severe Consequences for Destruction of Documents

Under the doctrine of spoliation, a company has an obligation to preserve documents potentially relevant to pending or threatened litigation. Litigants must take great care in identifying and preserving all such documents, or else face severe sanctions, including fines, attorney fees, default judgment, or even dismissal of the case.<sup>86</sup> Another possible sanction is the court giving a "spoliation" inference to the jury. This permits the jury to infer that missing documents might or would have been unfavorable to the party who did not produce the documents – even if the reality is that the missing documents are, in fact, neutral or favorable to that party.<sup>87</sup>

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<sup>85</sup> A recent Alabama case held that outside directors can claim attorney-client privilege against the company with personal counsel paid for by the company, even if corporate affairs are part of the discussion. *Ex parte Smith*, 2006 WL 1304943 (2006), Ala., No. 1050607, 5/12/06.

<sup>86</sup> See, *e.g.*, Deborah J. Edwards, et al, "What To Do When the Whistle Blows," *ACC Docket* 22, no. 5 (May 2004).

<sup>87</sup> See, *e.g.*, *Mosaid Technologies v. Samsung Electronics Co., Ltd.*, 348 F.Supp.2d 332 (D.N.J. 2004); *Coleman v. Morgan Stanley*, 2005 WL 674885 (Fla. Cir. Ct. Mar. 23, 2005).

In addition to the adverse consequences a failed document retention policy can have in litigation, the criminal sanctions also can be severe. For example, the catch-all obstruction of justice statute, 18 U.S.C. 1503, punishes by a fine and/or up to 10 years in prison anyone who “corruptly” endeavor to impede or obstruct the “due administration of justice.” Under this provision, the government only needs to prove intent to obstruct justice, not that justice was actually obstructed.<sup>88</sup>

Furthermore, the Sarbanes-Oxley Act created a very far-reaching document destruction offense, which does not even require an active government investigation. Sec. 802 imposes corporate responsibility for improper destruction of documents done “knowingly...with the intent to impede, obstruct or influence the investigation or proper administration of any matter within the jurisdiction...of the United States.”<sup>89</sup> Additionally, Sec. 1102, metes out sanctions for interfering with official proceedings: “[w]hoever corruptly alters, destroys, mutilates or conceals a record, document, or other object, or attempts to do so with the intent to impair the object’s integrity or availability for use in an official proceeding.”<sup>90</sup>

## 2. Inadvertent Waiver and Non-Waiver Agreements

Particularly in the digital age, inadvertent waiver of privileged documents is becoming increasingly common. Although a lawyer can ask for the return of an inadvertently produced document and courts are often sympathetic, with the growing prevalence of large-scale electronic discovery so-called “non-waiver agreements” are becoming increasingly popular. Under such agreements, the parties agree to massive productions of electronic documents with an agreement that the production of protected documents will not constitute waiver of privilege. The agreements also contain a set of defined procedures for litigants to retrieve the privileged materials, called “quick peek” or “clawback” procedures. Courts are split, however, regarding whether such non-waiver agreements are enforceable. Moreover, even if these agreements are enforceable between the signing parties themselves, they may not protect parties from waiver claims by non-parties.<sup>91</sup>

It is likely that the use of non-waiver agreements will increase due to changes in the Federal Rules of Civil Procedure expected to take place in December 2006. For example, proposed FRCP 26(b)(5) includes a mechanism for the return of inadvertently produced documents and proposed FRCP 26(f)(4) lets parties agree on a procedure for post-production privilege claims. Importantly, however, despite the text of the rule permitting such agreements, the comments are clear that the rule does not substantively impact whether the privilege will in fact be waived. That issue remains a matter for the courts to determine.<sup>92</sup>

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<sup>88</sup> 18 U.S.C. § 1503

<sup>89</sup> SOX §802(a) (18 USC 1519)

<sup>90</sup> SOX §1102, amending 18 USC § 1512

<sup>91</sup> O’Melveny & Myers, “Non-Waiver Agreements: Is the Privilege Actually Protected?” (Sept 27, 2006) at [www.omm.com/webdata/content/publications/client\\_alert\\_electronic\\_discovery\\_2006\\_09\\_27.htm](http://www.omm.com/webdata/content/publications/client_alert_electronic_discovery_2006_09_27.htm).

<sup>92</sup> See “Summary of the Report of the Judicial Conference Committee Rules of Practice and Procedure” (September 2005) at <http://www.uscourts.gov/rules/Reports/ST09-2005.pdf#page=114>.

### C. Discussion topics: Practices to have an effective document retention policy

Practices corporations have adopted regarding document retention policies and labeling include the following:

- Avoid improper designation of privilege. Although failure to designate privileged documents as “privileged” or “attorney work product” risks (under-use) disclosure of sensitive information and waiver of privilege, improperly designating non-privilege documents (over-use) also creates risks. Improper over-designation of privilege can give companies and employees a false (and dangerous) sense of security. First, employees become conditioned to be more candid about sensitive issues than they should be if they assume many documents are improperly designated. Business organizations also can lose credibility with prosecutors and judges if the privilege designation is overused. Finally, overuse of attorney work product designation is dangerous because plaintiffs can find the earliest work product designation regarding a given piece of litigation and look for a gap in time before the business organization issued a “do not destruct” memo. Any significant gap can be the basis of a spoliation claim. For this reason, some business organizations prevent their in-house lawyers from automatically stamping their e-mails “privileged.” In the end, however, there is no substitute for regular training and clear policies on this issue.
- Ensure clear labeling of properly designated privileged information. If a document is privileged, companies should make sure that fact is easy to spot in the course of a massive document review. Although the specific labeling procedure adopted is not crucial, uniformity within a company can be helpful. Such labeling is particularly important with respect to lawyers that also have a business role; labeling document as “privileged” can help identify when those lawyers are acting in their legal capacity.
- Establish comprehensive e-mail policies prohibiting certain topics from even being discussed over e-mail. Some who have reviewed this idea at work in one of the interviewed organizations have suggested that this is not a possible or reasonable expectation. But the company engaged in this practice argued that adoption of such policies can reduce the risk of “e-mail informality” resulting in the inadvertent waiver of privilege, and employee training can help to make what sounds like an unenforceable concept a very effective tool in eliminating a large percentage of problem emails. Apparently at least one aggressive prosecutor has threatened to base an obstruction of justice claim on the regular communication of such policies to employees, but such a threat appears misguided if the policy reflects merely reasonable prudence and is not designed or implemented for purposes of withholding non-privileged information.
- Anticipate requests for production of voicemail messages. Some business organizations are concerned that voicemails may be subject to discovery (and therefore should be retained) since they are saved at least temporarily on most systems. While this vigilance is admirable, it may be prudent to refrain from taking significant proactive steps to retain this information before the issue is better developed in the courts because a company could create an obligation to produce that it would not have but for taking such proactive steps.

## VII. Limited Waiver

### A. Overview

Given the “culture of waiver” detailed in Section II, it is common for private plaintiffs to seek the disclosure of privileged documents which a company previously was coerced to provide to government enforcers. While some have tried to solve this by entering into confidentiality agreements with the government, these agreements are not honored in most courts. Such an inequitable result – especially after the government strips the company of its ability to say *no* to the privilege demands – reinforces the message that the attorney-client privilege in the corporate context is unreliable.<sup>93</sup>

Although the concept of “limited waiver” is attractive to the extent it prevents further inequitable results for companies in this situation, it would not solve – and could exacerbate – the crucially important underlying problem of government enforcement policies eroding attorney-client and work product protections. While it is an admirable goal to fashion a remedy for companies that have been forced to waive their privileges against future litigants, to do so by establishing a limited waiver doctrine might have the impact of creating a presumption on the part of the government that it is indefensible for a company to reject a waiver request, given that the government can now offer protection against third party disclosures.

## **B. Background**

### 1. The majority of federal circuit courts do not recognize limited waiver.

With respect to attorney-client privilege, the Eighth Circuit first recognized the concept of limited waiver almost 30 years ago in *Diversified Industries, Inc. v. Meredith*.<sup>94</sup> This recognition was limited both literally and figuratively, however, as the Eighth Circuit’s entire discussion fell within a single paragraph and no other circuit subsequently has adopted limited waiver. In fact, the First, Second, Third, Fourth, Sixth, and D.C. Circuits all have explicitly rejected limited waiver in this context.

With respect to the work product doctrine, only the Fourth Circuit recognizes limited waiver, and even then only with respect to opinion work product. *In Re Martin Marietta Corp.*<sup>95</sup> While many of the other circuits have left open the possibility of applying the concept of limited waiver to work product in certain situations, none has adopted it explicitly, and the First, Fourth, and Eighth circuits have rejected it in the context of non-opinion work product.

Perhaps the best recent articulation of the current majority position regarding limited waiver is in *In Re Columbia/HCA*.<sup>96</sup> There the Sixth Circuit rejected limited waiver, holding that the attorney-client privilege was never intended to protect communications to the government. Despite a vigorous dissent, the majority observed that third-party disclosure waives the privilege and that the government is indeed a third party. Putting it succinctly, the majority characterized a decision between maintaining confidence or revealing privileged documents to combat prosecution as merely a “tactical litigation decision.” Similarly, the Third Circuit concluded that:

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<sup>93</sup> See *Upjohn*, 449 U.S. at 389-93, “[a]n uncertain privilege...is little better than no privilege at all.”

<sup>94</sup> 572 F.2d 596, 607 (8<sup>th</sup> Cir. 1977)

<sup>95</sup> 856 F.2d 619 (4<sup>th</sup> Cir. 1988)

<sup>96</sup> 293 F.3d 289 (6<sup>th</sup> Cir. 2002)

When a party discloses protected materials to a government agency investigating allegations against it, it uses those materials to forestall prosecution (if the charges are unfounded) or to obtain lenient treatment (in the case of well-founded allegations). These objectives, however rational, are foreign to the objectives underlying the work-product doctrine. Moreover, an exception for disclosures to government agencies is not necessary to further the doctrine's purposes; attorneys are still free to prepare their cases without fear of disclosure to an adversary as long as they and their clients refrain from making such disclosures themselves.<sup>97</sup>

Consistent with this position of the majority of federal circuit courts, “[i]t does not appear that any state has implemented, by statute or rule, a general government-investigation privilege, and this type of privilege does not appear in the Uniform Rules of Evidence (Uniform Rules).”<sup>98</sup> Accordingly, there is little current legal support for limited waiver.

## 2. Limited waiver may be adopted via proposed FRE 502.

In light of this legal landscape, the Advisory Committee on Evidence Rules of the Judicial Conference of the United States has recognized that “the courts generally reject the concept of a selective waiver is enforceable,” including when companies under investigation produce otherwise privileged materials to the government. In response, the Judicial Conference has published a proposed for comment an evidentiary rule recognizing limited waiver, proposed Federal Rule of Evidence 502. In current form, proposed FRE 502 states privilege is waived when a person or entity discloses protected information unless the disclosure is made “to a federal, state, or local governmental agency during an investigation by that agency, and is limited to persons involved in the investigation.”<sup>99</sup>

Although this limited waiver rule has been proposed, enactment is far from assured. There are eight steps before a proposed rule is enacted, and so far FRE 502 is on only the third. The Evidence Rules Advisory Committee met April 2006 and approved the limited waiver amendment to FRE 502, with recommendation to the Standing Committee on Rules of Practice and Procedure to approve its release for public comment. At its June 2006 meeting, the Standing Committee accepted the recommendations, and now FRE 502 is in the publication and comment stage (Steps 1 through 3). The deadline for comments on the rule is February 15, 2007, and public hearings are set to take place in January 2007 in New York and Phoenix. After the comment period it will be sent back to the Advisory Committee (Step 4) to be reassessed in light of the public comments, and if it survives it will go back to the Standing Committee (Step 5) for approval of the changes. Upon making changes, it would go to the Judicial Conference (Step 6), which has the power to amend the rule or to decline to send it on to the Supreme Court. If the rule reaches the Supreme Court (Step 7), it is nearly automatic that it will then go on to Congress (Step 8). Once in Congress, if neither chamber acts to derail the proposed rule it becomes law. [ACC filed its first set of comments with the Advisory Committee on June 20, 2006; it is available at <http://www.acca.com/public/attyclientpriv/502acc.pdf>.]

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<sup>97</sup> *Westinghouse Elec. Corp. v. Republic of the Phil.*, 951 F.2d 1414 (3d Cir. 1991)

<sup>98</sup> *In Re Qwest Comm. Int'l.*, 450 F.3d 1179, 1199, n.8 (10<sup>th</sup> Cir. 2006).

<sup>99</sup> Report on the Advisory Committee on Evidence Rules at <http://www.uscourts.gov/rules/Reports/EV05-2006.pdf>.

Although uncertain, this rulemaking could result in a limited waiver doctrine within a relatively brief period of time.<sup>100</sup> The ongoing development of common law is not irrelevant to this rulemaking process, however, as “[t]he accumulated experience of federal common law in the area of attorney-client privilege and work-product protection is but another source for the legislative and rule-making bodies to draw on to inform their deliberations concerning the need for and parameters of selective waiver or a new privilege.”<sup>101</sup>

### C. Discussion Topics

As discussed above, under current law companies cannot rely on a limited waiver doctrine, and therefore should expect that otherwise privileged documents produced to government officials – even under the auspices of a confidentiality agreement – may have to be turned over subsequently to private plaintiffs. Practice that companies have adopted in light of this legal reality include the following:

- Work with government officials to seek options other than even limited waiver. Government officials sometimes want information that the company can provide without producing privileged information. This is especially true when government investigators and prosecutors are truly in search of underlying facts and do not care about access to attorney work product or attorney-client communication per se. Unfortunately, there may not be an obvious dividing line between facts and protected materials. Moreover, once at loggerheads it can be hard to compromise with federal enforcers. Reports confirm that enforcers can put heavy and direct pressure on senior management, including to disregard the advice of their own counsel (management, not counsel, is the ultimate privilege decision-maker). Indeed, there even can be pressure to produce privileged documents before enforcers are willing to negotiate, and attempts at appeasement (e.g., producing facts only, agreeing to limited waiver of a subset of documents) may not satisfy enforcers. Experience with state enforcers, in contrast, typically has been less confrontational and ultimately more productive for everyone involved.
- Insist on a court order that turning over documents to the government under a confidentiality agreement does not constitute waiver with respect to third parties. Although not foolproof, a court order explicitly recognizing the limited nature of a company’s waiver likely will be dispositive in that court and may be accorded substantial weight in other courts. Of course, it is not always possible to get such a court order given time constraints, resistance of government officials, or refusal by the court to enter one. Even if a company does not succeed in getting a court order, however, insisting on one may give the company additional bargaining leverage (e.g., to further limit the scope documents being produced).
- Don’t ever explicitly waive privilege. In the face of often intense pressure, business organizations and their counsel need to think beyond the specific issue at hand. Even if coerced to turn over documents, companies should not explicitly agree to waive privilege or acknowledge that it has been. Government officials should not demand such an explicit admissions if they get the information they need. If there is no formal waiver, a company can preserve its arguments and live to fight another day.

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<sup>100</sup> See generally *Qwest* at 1201-02 (“[l]egislatures and rule-making bodies are endowed with tools to marshal evidence, facts, and experience from numerous and diverse sources that can support more dramatic and immediate creation of new rules or modifications of old rules [than common law]”).

<sup>101</sup> *Id.* at 1202.

## VIII. Prosecution Agreements and Corporate Monitorships

### A. Overview

Prosecution agreements are now the generally preferred way for the DOJ to resolve criminal investigations involving corporations. In a deferred prosecution agreement, the prosecutors charge the company with a crime, but agree to drop it if the obligations in the agreement are met. In a no prosecution deal, the government will agree not to press charges at all if the specified demands are met.

Although not universally required, the appointment of an independent monitor has become an accepted component of many prosecution agreements. The scope of the monitor's authority and the functions to be carried out by the monitor are not regulated by statute or dictated by DOJ policy; how monitors operate very dependent upon the nature and extent of the wrongdoing addressed by the prosecution agreement as well as the customs of the particular United States Attorney's office that is prosecuting the matter. It is safe to say, however, that by their nature all monitorships require a great deal of communication among the corporation, the monitor, the government and possibly the court. An important issue for corporate counsel today is the fact that sharing privileged communications with corporate monitors can waive privilege

### B. Background

#### 1. The Rise of Deferred Prosecution and Non-Prosecution Agreements

Deferred prosecution agreements and no prosecution deals are now the preferred way for government to handle corporate crime. According to the DOJ, since its corporate fraud task force was created four years ago, "a couple dozen" deferred prosecution agreements have been signed. According to one account, that is twice as many of such agreements as in the *ten years* before.<sup>102</sup> In the first *six months* of this year alone, the DOJ completed at least 12 deferred prosecution agreements or no prosecution deals, as opposed to the previous all-time high of eight that signed in 2005.<sup>103</sup>

There are certainly incentives for signing them. One, a company doesn't have to look past Arthur Andersen to see that criminal indictment can be the death knell of a company. Two, even if a corporation pays hundreds of millions of dollars in fines, the company's stock will typically go up, because the market prefers certainty. Overriding every other reason, however, is that corporations have no practical choice but to sign these agreements. Government prosecutors today have all the bargaining power, and they prefer prosecution agreements in part because they never get to trial and therefore their tactics will not be subject to judicial oversight.

But there can be consequences to signing DPAs – in essence, in most cases, a corporation will be signing away all of its rights and admitting to guilt (often characterized in a manner that is highly

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<sup>102</sup> Edward Iwata, "Debate heats up on Justice's deferred-prosecution deals." *USA Today* (May 31, 2006) at [http://www.usatoday.com/money/companies/regulation/2006-05-30-justice-usat\\_x.htm](http://www.usatoday.com/money/companies/regulation/2006-05-30-justice-usat_x.htm).

<sup>103</sup> Sue Reisinger, "Deal-making by DOJ is on the rise: Deferred-prosecution agreements way ahead of last year's pace." *Nat'l L.J.* 8 (2006).

distasteful and even inaccurate by prosecutors). Moreover, because a trial will not be involved, the conditions of settlement for a company will be set without judicial approval. Typically, privilege waiver will be required.

An illustrative example of the coercive power of a DPA can be seen in the KPMG tax shelter case, *U.S. v. Jeffrey Stein*.<sup>104</sup> There, KPMG went to great lengths to ensure its cooperativeness in a government investigation, in hopes of avoiding a criminal indictment of the firm. Eventually, the company entered into a deferred prosecution agreement with the government.<sup>105</sup> KPMG would have to admit wrongdoing, accept some restrictions on its business, pay a \$456 million fine, and continue to cooperate “fully and actively” in the investigation. As part of this “cooperation” to comply with the DPA, KPMG also was compelled to force their employees to offer proffers and threaten withdrawal of legal fees and/or termination for non-cooperation.<sup>106</sup> Finally, KPMG agreed to refrain “through its attorneys or agents, partners, or employees” from “mak[ing] any statement, in litigation of otherwise, contradicting the Statement of Facts or its representations in this Agreement.”

Such non-contradiction clauses can have pernicious consequences. If there is a contradictory statement, even an inadvertent one, and the company does not repair the breach by repudiating it, then the terms of the DPA are violated and the government remains free to prosecute. If the government does prosecute, the company’s admissions in the DPA should ensure a conviction.<sup>107</sup> There also is the possibility of judicial estoppel in related third party lawsuits in which any contradiction of previous statements is barred.<sup>108</sup> Although on *Stein* defendant moved to dismiss his indictment on the grounds that this non-contradiction clause constituted prosecutorial misconduct, Judge Kaplan rejected denied the motion.

As demonstrated in *Stein*, DPAs can be a powerful tool governments can use in punishing a company short of prosecution, but this comes at the expense of both employee and corporate rights. And another recent case still pending before the Supreme Court, revolves around the question of whether the government (unlike the corporation) has to live up to the terms of the agreement should they wish to go back and revisit them. Such a one-sided lack of certainty has sent waves of concern through the corporate community.<sup>109</sup>

## 2. The Corporate Monitorship and Privilege

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<sup>104</sup> The *Stein* case is discussed at greater length in the Section V on “Employee Rights.”

<sup>105</sup> The DPA can be found at <http://www.usdoj.gov/usao/nys/Press%20Releases/August%2005/KPMG%20dp%20AGMT.pdf>.

<sup>106</sup> As Judge Kaplan said in the case, “[t]he government has substantial influence and almost certainly, power over KPMG by virtue of the cooperation clauses in the [deferred prosecution agreement]. It may very well be in its interest to use that influence or power to cause KPMG to advance the defense costs.” *Stein I* at 380.

<sup>107</sup> Ben Vernia, “Here’s Your Story, And You’re Sticking To It: When Contradicting the Deal Can Mean Prosecution, Companies Must Step Carefully.” *Legal Times* 38 (2006).

<sup>108</sup> *Id.*

<sup>109</sup> See the amicus filing of ACC and the US Chamber of Commerce in *Stolt-Neilson v. US*, cert pending before the US Supreme Court: <http://www.acca.com/public/amicus/stoltnielsonbrief.pdf>.

There is potentially a large set of monitor-related communications and documents that are generated among the corporation, the monitor, the government, and sometimes the court. This may include communications and documents concerning: the nature of specific business reforms to be undertaken; advice from the monitor as to the sufficiency of the corporation's reform efforts; the design and operation of new compliance program components; the monitor's assessment of the corporation's compliance with its reform controls and with the prosecution agreement; reformed or new training program design and operation; revised document retention policies and compliance efforts; investigation of alleged conduct that potentially violates the terms of the prosecution agreement; handling of hotline and whistleblower complaints; pending or anticipated litigation involving the corporation; corporate activities related to mergers and acquisitions; and reports by the monitor, board or committee regarding the status of the corporation's efforts.

The possibility of disclosure of these communications and documents to third-parties creates a dilemma for corporations, similar in nature to the problem when corporations undertake an internal investigation. In the monitorship setting, the corporation's effort to fully comply with the prosecution agreement creates significant litigation risk should monitorship materials be subject to disclosure.

There are two independent bases, however, for shielding corporate monitoring documents and communications from disclosure to third-parties: the non-disclosure and confidentiality clause; and the "special officer" privilege covering attorney work-product and attorney-client communications. The doctrines underlying these protections are distinct, but prosecution agreements can be drafted to harmonize the requirements of both so that corporations can best attempt to protect a wide array monitoring materials. Importantly, planning for this needs to be done during the prosecution agreement's negotiation and drafting process.

#### (a) The Non-Disclosure and Confidentiality Provision

The non-disclosure and confidentiality provision protects a broad set of monitoring communications that would not exist but for the monitorship, not limited to attorney-client privileged documents and work product. The provision should require that parties not disclose non-public monitoring documents except by court order or as otherwise mandated by law. It should indicate that monitoring documents in the possession of the monitor will be returned at the conclusion of the monitorship. The provision should also require that all parties to the agreement maintain the confidentiality of all documents and communications.

Case law and practice suggest that companies involved in publicly disclosed investigations - or those likely to become so - enter into a deferred prosecution agreement to optimize the likelihood of successful enforcement of the provision. Because the deferred prosecution agreement is approved by the court, the provision can be made part of a protective order of the court. This is the approach that was utilized in *U.S. v. Computer Associates International, Inc.*<sup>110</sup> In that case, in addition to their deferred prosecution agreement, Computer Associates and the government filed a separate joint request for an order to appoint the selected monitor and to require that the corporation, the monitor and the government maintain the confidentiality of all monitoring-related documents. The joint request also asked for a protective order to shield monitoring-

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<sup>110</sup> Criminal Docket No. 04-837 (ILG) (E.D.N.Y.)

related documents from disclosure to third-parties. A copy of the protective order is included in Appendix 'A'.

There is support in case law for non-disclosure provisions in the area of consent decrees. In *U.S. v. Bleznak*,<sup>111</sup> the Second Circuit upheld a non-disclosure and confidentiality provision of the consent decree shielding telephone conversations that were explicitly required by the consent decree to be recorded and monitored by defendant's antitrust compliance officer. The Second Circuit essentially adopted the lower court's "but for" analysis of the recording, holding that there was strong policy arguments for protecting monitoring materials that would not have existed but for the consent decree's monitoring requirements.<sup>112</sup>

Two additional legal bases have been put forth to support the enforceability of monitoring document provisions in deferred prosecution agreements.<sup>113</sup> The first, put forth by the parties in their request for a protective order in *Computer Associates*, analogizes the protection of the monitor's communications to "the quasi-judicial immunity frequently accorded court-appointed bankruptcy examiners for the protection of testimony, documents and other information obtained by examiners through their court-ordered powers."<sup>114</sup> The second is also based upon analogy. It has been argued that because the monitor in a deferred prosecution agreement is performing a role that corresponds to that of the probation department in the progenitor to deferred prosecution agreements, the pre-trial diversion program, the communications should be accorded the same level of confidentiality as that granted to the probation department.<sup>115</sup>

#### (b) The "Special Officer" Privilege Covering Work Product and Attorney-Client Privileged Documents

The "special officer" privilege is a hybrid privilege created by some courts to protect monitorship "but for" documents. Much like non-disclosure and confidentiality provision, its protection is not limited to attorney-client privileged documents and work product. In fact, the basic requirements are the same here as for the non-disclosure and confidentiality provision, but there is a different underlying basis for each protection.

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<sup>111</sup> 153 F. 3d 16 (2<sup>nd</sup> Cir. 1998).

<sup>112</sup> Subsequently, in *McCoo v. Denny's*, 192 F.R.D. 675 (D. Kan. 2000), Denny's, operating under a consent decree that included the appointment of an independent monitor as well as a *Bleznak* nondisclosure provision, conducted an internal investigation. Documents relating to the investigation were disseminated to the monitor. In denying Denny's request to protect the documents from disclosure, based in part upon the non-disclosure provision, the court relied upon the *Bleznak* rationale in its determination to grant the request for production. The court held that the "Bleznak standard" only applied to documents that were required by the terms of the consent decree, and would not have been created but for the consent decree. Because the consent decree did not require Denny's to undertake the investigation – and because the investigation probably would have occurred without the consent decree, the court granted the plaintiff's request for production of the investigation documents.

<sup>113</sup> See D. Pitofsky "Monitor/Examiner's Role Under Deferred Prosecution Agreements", New York Law Journal, September 14, 2005.

<sup>114</sup> Computer Associates letter to J. Glasser

<sup>115</sup> *Supra*, note 3. (verify)

Two issues emerge when considering the use of this privilege to shield monitoring materials from disclosure. First is whether the corporation's communication with the monitor operates as a waiver of privilege. Second is the issue of whether monitoring communications are of the type that fall within the attorney-client privilege.

On the first issue, corporations can best avoid the waiver of privilege issue by having the monitor appointed by the court, and by having the monitor file only a summary status report to the government unless there are specific instances of improper conduct to report. There is case law to support the non-disclosure of otherwise privileged monitoring materials. In *In re LTV Securities*,<sup>116</sup> the court, acknowledging the deleterious effects of permitting disclosure of a corporation's remedial work under a consent decree, recognized a hybrid privilege that protected from disclosure work product and privileged documents of a "special officer" appointed pursuant to the decree.<sup>117</sup> In *Cobell v. Norton*,<sup>118</sup> the court granted the defendant's request for a protective order for privileged communications disclosed to a court-ordered monitor. Part of the court's reasoning relied on its interpretation of the monitor's status as an agent or officer of the court. Disclosure to the monitor, the court reasoned, was the equivalent of an in camera review. To best protect documents and communications between the corporation and the monitor under this approach, the prosecution agreement should mandate only summary reports to the court and the government unless there are specific instances of improper conduct to report.

There is a confusing array of case law as to whether the services of a monitor are the type of legal services or advice to which the attorney client privilege applies. Corporations can optimize the likelihood of the successful use of the "special officer" privilege by assuring that monitoring communications are framed as a necessary component to assist the monitor in rendering, at least in part, not only technical assessments but also legal services or advice. The safest course of action to successfully assert the attorney-client privilege is to include in the monitor's role functions that require some legal assessment of compliance and advice to the corporation as to its reform efforts.

### C. Discussion Topics

Integrating the strategies from these two approaches leads to the following set of recommendations for negotiating and drafting prosecution agreement provisions related to monitorship communications and documents:

1. To maintain the possibility of the attorney-client privilege, the monitor should be an attorney.
2. The prosecution agreement should anticipate court approval and a protective order covering monitoring communications and documents. This suggests a deferred prosecution agreement.
3. The prosecution agreement should clearly identify the monitor's duties to the court.

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<sup>116</sup> 89 F.R.D. 595 (N.D. Tex. 1981)

<sup>117</sup> Although the Second Circuit declined to address the privilege, the district court applied the privilege in holding that documents were not discoverable. *U.S. v. Brown*, 963 F. Supp. 235 (S.D.N.Y. 1997).

<sup>118</sup> 213 FRD 69 (D.D.C. 2003)

4. The prosecution agreement should include the non-disclosure and confidentiality provision and should reference the parties' joint request for a protective order covering monitoring communications and documents.
5. To the extent feasible, identify in the prosecution agreement those documents and communications that are a requirement of the agreement, and would not otherwise be created but for the agreement.
6. The prosecution agreement and proposed protective order should indicate that the monitor is court-ordered and approved.
7. The proposed order should contain a separate non-disclosure and confidentiality clause covering all monitoring documents and communications among the agreement parties.
8. To the extent feasible, the agreement should identify what tasks the corporation and the monitor must undertake as part of the agreement and to the extent appropriate state that these are specific requirements of the prosecution agreement that would not be otherwise undertaken.
9. Structure the monitor's reporting duties to report only in a summary fashion to the court and the government unless there are specific instances of improper conduct to report.
10. The monitor's duties should include some form of legal analysis including the rendering of an assessment of the adequacy of the corporation's compliance and recommending reform measures to help corporation comply with the agreement's requirements.

## APPENDIX A

### “In the Trenches: Waiver of the Privilege Has a Strong Negative Impact”

The Department of Justice maintains that there is no erosion of privilege and concerns regarding a “culture of waiver” are overblown, stating that its prosecutors very rarely seek waivers.<sup>119</sup> Confident that the DOJ’s contention is not supported by the facts but rather by their incorrect conjectures, ACC decided to collect empirical data on the prevalence of waiver requests made to ACC members, as well as other indicators of the current health of the attorney-client privilege. ACC particularly wished to address the contention of the Justice Department that waiver of the privilege is only one of the several criteria it examines under the Thompson Memorandum and is rarely determinative in the assessment of whether a company is cooperating with the government. ACC’s findings, based on actual experiences of corporations under investigation or being prosecuted by the government, suggest that this singular criterion – privilege waiver – is all-powerful in determining whether a company will qualify for the crucial designation of “cooperative.”

ACC and its coalition partners<sup>120</sup> on this issue have repeatedly challenged the Department of Justice to undertake a similar process by asking US Attorneys to respond to detailed information requests that include more nuanced questions than have been asked in the past, but so far, the only response we have received from the Department is that most US attorneys are required to get permission from a supervisor before they demand privilege waivers of corporate defendants, and only a small handful of such permissions have ever been recorded. We do not find it odd that prosecutors who may be violating internal policies requiring formal permissions to request waivers are not likely to report that they’ve asked for waivers without such permissions.

Further, we know that many prosecutors claim that “permission” requirements pertain to waiver “demands” and not to conversations with targeted companies when waivers are merely “requested.” Some prosecutors actually believe that when they say, “It’s your *choice*: you can waive or we’ll indict,” that they have actually provided the company with two viable options from which they can choose. Thus, they believe that their “requests” for privilege waivers do not constitute “demands.”

Other prosecutors cited in our surveys employ other “subtle” tactics such as tossing a copy of the Thompson Memo on the table with the privilege waiver section highlighted and making a statement such as “you’d like to qualify for the benefits of cooperation in this investigation, correct?” Perhaps prosecutors don’t deem such practices to qualify as “demands,” but the client

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<sup>119</sup> See, e.g., Mary Beth Buchanan, “Effective Cooperation by Business Organizations and the Impact of Privilege Waivers,” 39 Wake Forest L. Rev. 587, 598 (2004), citing to DOJ internal surveys conducted several years ago. No more recent review of department practices has been made available and many question whether this survey asked the best questions to elicit information that is responsive to this debate.

<sup>120</sup> The Coalition to Protect the Attorney-Client Privilege is made up of a diverse and broadly representative constituency of interests and memberships – from the U.S. Chamber of Commerce to the ACLU – all of whom are concerned by governmental policies and practices that erode the protections of the attorney-client privilege. In addition to the ACC, this coalition includes the following organizations: American Chemistry Council, American Civil Liberties Union, Business Civil Liberties, Inc., Business Roundtable, The Financial Services Roundtable, National Association of Criminal Defense Lawyers, National Association of Manufacturers, U.S. Chamber of Commerce.

receiving that communiqué gets the message loud and clear. Such loaded prosecutorial “requests” or presentations of “choices” are the functional equivalents of a demand to the corporation facing possible indictment and a shutdown of the entity. No choice but waiver exists for the company interested in protecting their stakeholders’ interests in continuing to engage in business and trying to get past the problems currently plaguing it.

ACC’s survey results from its members stems from original efforts to collect general information about privilege erosion in 2005, and a follow-up survey to delve deeper into additional related questions in 2006. In the first survey (2005), over 700 corporate lawyers offered answers and detailed perspectives about their privilege waiver experiences in the prosecutorial, enforcement, audit, and civil litigation context. Over half of our responses came from corporate counsel, many of them general counsel; the remainder came from outside counsel who specialize primarily in white collar criminal defense. We were struck by the strong response rate given the limited size of the pool we solicited to comment, and the unanimity of the message sent by respondents from different disciplines. The following are the results from this survey:<sup>121</sup>

- **Reliance on privilege:** In-house lawyers confirmed that their clients are aware of and rely on privilege when consulting them (93% affirmed this statement for senior-level employees; 68% for mid and lower-tier employees).
- **Absent privilege, clients will be less candid:** If the privilege does not offer protection, in-house lawyers believe there will be a “chill” in the flow or candor of information from clients (95%); indeed, in-house respondents stated that clients are far more sensitive as to whether the privilege and its protections apply when the issue is highly sensitive (236 of 363), and when the issue might impact the employee personally (189 of 363).
- **Privilege facilitates delivery of legal services:** 96% of in-house counsel respondents said that the privilege and work-product doctrines serve an important purpose in facilitating their work as company counsel.
- **Privilege enhances the likelihood that clients will proactively seek advice:** 94% of in-house counsel respondents believe that the existence of the attorney-client privilege enhances the likelihood that company employees will come forward to discuss sensitive/difficult issues regarding the company’s compliance with law.
- **Privilege improves the lawyer’s ability to guarantee effective compliance initiatives:** 97% of corporate counsel surveyed believe that the mere existence of the privilege improves the lawyer’s ability to monitor, enforce, and/or improve company compliance initiatives.

Presented with this data, the United States Sentencing Commission initiated a process to review its 2004 decision to include privilege waiver language in its organizational sentencing guidelines. Commissioners asked us to conduct further research in several areas of particular interest to their inquiry. The results of this second, follow-up survey were cited by the US Sentencing Commission as a primary determinant in their decision to propose amending the corporate sentencing guidelines in the 2005/6 amendment cycle to eliminate language they’d only inserted in 2004.

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<sup>121</sup> An executive summary of this survey and its results is online at <http://www.acca.com/Surveys/attyclient.pdf>.

In brief, this second survey<sup>122</sup>, found:

- **A Government Culture of Waiver Exists:** Almost 75% of both inside and outside counsel who responded to this question expressed agreement (almost 40% agreeing strongly) with a statement that a “‘culture of waiver’ has evolved in which governmental agencies believe it is reasonable and appropriate for them to expect a company under investigation to broadly waive attorney-client privilege or work product protections.” **(Only 1% of inside counsel and 2.5 % of outside counsel disagreed with the statement.)** It is important to note that these surveys were sent to a cross section of practitioners without any knowledge of whether their company clients had had exposure to government prosecutions or specifically to privilege waiver requests, and so the overwhelmingly negative evaluation of government practices is doubly troubling.
- **‘Government Expectation’<sup>123</sup> of Waiver of Attorney-Client Privilege Confirmed:** Of the respondents who confirmed that they or their clients had been subject to investigation in the last five years, approximately 30% of in-house respondents and 51% of outside respondents said that the government expected waiver in order to engage in bargaining or to be eligible to receive more favorable treatment.
- **Prosecutors Typically Request Privilege Waiver – It Is Rarely “Inferred” by Counsel:** Of those who had been investigated above, 55% of outside counsel responded that waiver of the attorney-client privilege was requested by enforcement officials either directly or indirectly. Twenty-seven percent of in-house counsel confirmed this to be true (60% of in-house counsel responded that they were not directly involved with waiver requests). Only 8% percent of outside counsel and 3% of in-house counsel said that they “inferred it was expected.” Clearly, prosecutors are regularly asking this question, even if they don’t believe that asking for waiver is the functional equivalent of demanding it, as our member constituents believe,
- **DOJ Policies Rank First, Sentencing Guidelines Second Among Reasons Given For Waiver Demands:** Outside counsel indicated that the Thompson/Holder/McCallum Memoranda are cited most frequently when a reason for waiver is provided by an enforcement official, and the Sentencing Guidelines are cited second. In-house counsel as a group placed the Guidelines third, behind “a quick and efficient resolution of the matter” (1) and DOJ policies (2).
- **Third Party Civil Suits Among Top Consequences of Government Investigations:** Fifteen percent of companies that experienced a governmental investigation within the past 5 years indicated that the investigation generated related third-party civil suits (such as private antitrust suits or derivative securities lawsuits). Of the eight response options that asked respondents to list the ultimate consequences of their clients’ investigations, related third-party civil suits rated third for in-house lawyers. The first and second most common outcomes for in-house counsel were that the government decided not to pursue the matter further (24%), or that the company engaged in a civil settlement with the government to avoid further prosecution (18%). For outside counsel, the most cited outcome was criminal charges against individual leaders/employees of the company

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<sup>122</sup> The second survey’s results are online at <http://www.acca.com/Surveys/attyclient2.pdf>.

<sup>123</sup> The survey defined ‘government expectation’ of waiver as a demand, suggestion, inquiry or other showing of expectation by the government that the company should waive the attorney-client privilege.

(18%), and a decision by the government not to prosecute (14%). “Related third party civil litigation” finished fifth (for outside counsel respondents) with 12%.

Faced with this evidence of privilege erosion and increasingly successful government waiver demands, the United States Sentencing Commission acted on April 5 of this year to repeal the privilege waiver language contained in the commentary to Chapter 8 – over the Justice Department’s objections. Thus, a critical leg of the stool on which the Thompson Memorandum rests has been kicked out; the DOJ has lost the one “independent” justification it regularly cited as an authority upon which it premises its right to demand privilege waivers. All that remains to justify DOJ’s waiver practices is their own internal policy guideline, which they suggest is not open to discussion or public scrutiny.