



608 Dealing with Accountants & Auditors

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Previously, he was a litigator with Willkie Farr & Gallagher in New York, where he focused on civil litigation involving accounting fraud claims and the representation of individuals and entities in SEC accounting fraud investigations.

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DEALING WITH ACCOUNTANTS & AUDITORS

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DEALING WITH ACCOUNTANTS & AUDITORS

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A grand compromise or treaty was reached in 1976 between the lawyers and the accountants that is reflected in the ABA Statement of Policy regarding Lawyers' Responses to Auditors' Requests for Information (the "*ABA Statement*").¹ The ABA Statement is intended to facilitate lawyers' provision of information to auditors regarding client loss contingencies in connection with the preparation and examination of client financial statements, while minimizing the risk of loss of attorney-client privilege in the process.

Auditors rely upon the letters provided by their clients' counsel regarding loss contingencies ("*Response Letters*") as they examine and report upon client financial statements. This gives the Response Letters a significant role in financial disclosure processes. Malpractice and other claims against attorneys can result from Response Letters and other statements to auditors regarding loss contingencies, particularly when a prediction is made regarding the likelihood of an unfavorable outcome or the amount or range of loss in the event of an unfavorable outcome.

The importance of the ABA Statement and the need for attorney diligence in preparing Response Letters and communicating with auditors were magnified when on July 30, 2002 President Bush signed the Sarbanes-Oxley Act of 2002 (H.R. 3763) ("*SOX*").² This is the

"tough new corporate fraud bill" trumpeted by the politicians and in the media as a response to the corporate scandals of 2001-2002 and as a means to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws. Among other things, SOX amends the Securities Exchange Act of 1934 (the "*1934 Act*") and the Securities Act of 1933 (the "*1933 Act*"). Although SOX does have some specific provisions, and generally establishes some important public policy changes, it is being implemented in large part through rules adopted and to be adopted by the Securities and Exchange Commission ("*SEC*") and the Public Company Accounting Oversight Board ("*PCAOB*"), which have impacted auditing standards and have increased scrutiny on auditors' procedures to verify company positions and representations. Further, while SOX is by its terms generally applicable only to public companies,³ its principles are being applied to privately held companies⁴ and nonprofit entities.⁵

³ SOX is generally applicable to all companies required to file reports with the SEC under the 1934 Act ("*reporting companies*") or that have a registration statement on file with the SEC under the 1933 Act, in each case regardless of size (collectively, "*public companies*" or "*issuers*"). Some of the SOX provisions apply only to companies listed on a national securities exchange ("*listed companies*"), such as the New York Stock Exchange ("*NYSE*") or the NASDAQ Stock Market ("*NASDAQ*") (the national securities exchanges and NASDAQ are referred to collectively as "*SROs*"), but not to companies traded on the NASD OTC Bulletin Board or quoted in the Pink Sheets or the Yellow Sheets. Small business issuers that file reports on Form 10-QSB and Form 10-KSB are subject to SOX generally in the same ways as larger companies although some specifics vary (references herein to Forms 10-Q and 10-K include Forms 10-QSB and 10-KSB).

SOX and the SEC's rules thereunder are applicable in many, but not all, respects to (i) investment companies registered under the Investment Company Act of 1940 (the "*1940 Act*") and (ii) public companies domiciled outside of the United States of America (the "*U.S.*") ("*foreign companies*").

Companies that file periodic reports with the SEC solely to comply with covenants under debt instruments, to facilitate sales of securities under Rule 144 or for other corporate purposes ("*voluntary filers*"), rather than pursuant to statutory or regulatory requirements to make such filings, are not issuers and generally are not required to comply with most of the corporate governance provisions of SOX. The SEC's rules and forms implementing SOX that require disclosure in periodic reports filed with the SEC apply to voluntary filers by virtue of the fact that voluntary filers are contractually required to file periodic reports in the form prescribed by the rules and regulations of the SEC. The SEC appears to be making a distinction in its rules between governance requirements under the Act (which tend to apply only to statutory "*issuers*") and disclosure requirements (which tend to apply to all companies filing reports under the 1934 Act).

While SOX is generally applicable only to public companies, there are three important exceptions: (i) SOX §§ 802 and 1102 make it a crime for any person to alter, destroy, mutilate or conceal a record or document so as to (x) impede, obstruct or influence an investigation or (y) impair the object's integrity or availability for use in an official proceeding; (ii) SOX § 1107 makes it a crime to knowingly, with the intent to retaliate, take any action harmful to a person for providing to a law enforcement officer truthful information relating to the commission of any federal offense; and (iii) SOX § 904 raises the criminal monetary penalties for violation of the reporting and disclosure requirements of the Employee Retirement Income Security Act of 1974 ("*ERISA*"). These three provisions are applicable to private and nonprofit entities as well as public companies.

⁴ Private companies that contemplate going public, seeking financing from investors whose exit strategy is a public offering or being acquired by a public company may find it advantageous or necessary to conduct their affairs as if they were subject to SOX. See Joseph Kubarek, *Sarbanes-Oxley Raises the Bar for Private Companies*, NACD-Directors Monthly (June 2004 at 19-20); Peter H. Ehrenberg and Anthony O.

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¹ 31 Bus. Law. 5 (April 1976), reprinted in ABA AUDITOR'S LETTER HANDBOOK (2003).

² A summary of SOX is attached as Exhibit A. See Byron F. Egan, *The Sarbanes-Oxley Act and Its Expanding Reach*, 40 Tex. J. of Bus. L. 305 (Winter 2005).

Following the enactment of SOX and the adoption of rules thereunder, the role of independent auditors in detecting financial statement fraud within public companies has received enhanced scrutiny. In turn, companies are expected both to implement controls for dealing with alleged fraud internally and to provide their auditors with detailed information on a wide range of corporate issues. Companies involve legal counsel, both in-house and outside, for a wide variety of tasks, from conducting investigations of alleged fraud to dealing with employee issues (including whistleblower complaints) and advising directors on their duties in connection with corporate transactions. Auditors are increasingly asking for information regarding these often privileged communications to supplement their reliance on management representations. Making such privileged information available to auditors, however, subjects companies to the risk of loss of attorney client and work product privileges, which can provide a road-map to success for adversaries in civil litigation.

SOX does not repudiate the ABA Statement. SOX does, however, reinforce the importance of providing meaningful information to auditors. Further SOX mandates that attorneys not mislead or improperly influence auditors in the performance of an audit as that could result in misleading financial statements.

While not denying the right of lawyers to rely on the ABA Statement in actions taken in conformity with the ABA Statement, SEC rulemaking and enforcement actions post-SOX attempt to place lawyers in the role of “gatekeepers” or “sentries of the marketplace” whose responsibilities include “ensuring that our markets are clean.”⁶ These SEC actions do, however, affect the role of the lawyer in dealing with clients, auditors and others.⁷

I.

PRESSURE ON AUDITORS TO DETECT CORPORATE FRAUD

GAAS. Generally acceptable auditing standards (“GAAS”) recognize that auditors have particular responsibilities with respect to the discovery of corporate fraud during an audit. The auditor has a responsibility to plan and to perform financial statement audits in order to obtain

“reasonable assurance” about whether the financial statements are free of material misstatement, whether caused by error or fraud.⁸

Accounting Standards Board Statement (“SAS”) No. 99 (“SAS 99”) establishes guidance to help auditors to fulfill that responsibility with respect to fraud. In the allocation of responsibilities between auditors and their clients, “it is management’s responsibility to design and implement programs and controls to prevent, deter, and detect fraud.” In connection with its audit of financial statements in accordance with GAAS, the auditor’s “interest” is in obtaining evidential matter regarding intentional acts that “result in a material misstatement of the financial statements.”⁹

Thus, the auditor, in exercising the required professional skepticism when planning and performing the audit, is to consider whether the presence of certain “risk factors” indicate the possible presence of fraud and, if risks of fraudulent, material misstatement are identified, consider the impact of this finding on the audit report and whether reportable conditions relating to the company’s internal controls exist and should be communicated to the company or its audit committee.¹⁰ An auditor’s obligations to gather evidential matter to satisfy itself regarding the presence of fraud includes making inquiries “about the existence or suspicion of fraud” to any appropriate personnel within the company, and SAS 99 suggests that the auditor “may wish to direct these inquiries” to the company’s in-house legal counsel.¹¹

⁸ SAS 1, *Codification of Auditing Standards and Procedures*; see AICPA Professional Standards, AU § 110.02, *Responsibilities and Functions of the Independent Auditor*.

⁹ Auditing Standards Board SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*. SAS No. 99 superseded SAS No. 82, also entitled, *Consideration of Fraud in a Financial Statement Audit*. SAS 82 provided that “[t]he auditor has a responsibility to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.” AICPA, Auditing Standards Board, Statement on Auditing Standards No. 82, *Consideration of Fraud in a Financial Statement Audit* (codified in AU § 316). This standard, however, expressly disavowed any per se obligation on auditors to uncover all instances of corporate fraud; indeed, SAS 82 recognized that a properly performed and executed audit may fail to detect fraud. As it explained: “An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected. Because of (a) the concealment aspects of fraudulent activity, including the fact that fraud often involves collusion or falsified documentation, and (b) the need to apply professional judgment in the identification and evaluation of fraud risk factors and other conditions, even a properly planned and performed audit may not detect a material misstatement resulting from fraud.” AU § 316.10.

¹⁰ SAS 99, ¶¶ 5, 12, 31, 80.

¹¹ SAS 99 at ¶¶ 24-25. Other guidance found in GAAS suggests that an auditor may wish to obtain evidential matter through company counsel. In regard to an auditor’s obligations regarding loss contingencies for litigation, claims and assessments pursuant to FAS 5, GAAS states that the “opinion of legal counsel on specific tax issues that he is asked to address and to which he has devoted substantive attention . . . can be useful to the auditor in forming his own opinion.” See AU § 9326.17 (warning further that “it is not appropriate for the auditor to rely solely on such legal opinion” in conducting the audit regarding these issues).

Pergola, *Why Private Companies Should Not Ignore the Sarbanes-Oxley Act*, Wall Street Lawyer (December 2002 at 12-13).

⁵ See BoardSource, *The Sarbanes-Oxley Act and Implications for Nonprofit Organizations* (2003); Richard Merli, *Sarbanes-Oxley Rules Seeping Into Not-for-Profit Hospitals*, KPMG Insider (Dec. 15, 2004), which can be found at http://www.kpmginsights.com/display_analysis_print_nobuttons.asp?content_id=512552.

⁶ Speech entitled “The Themes of Sarbanes-Oxley as Reflected in the Commission’s Enforcement Program” by Stephen M. Cutler, Director of SEC Division of Enforcement, at UCLA School of Law on September 20, 2004, which can be found at <http://www.sec.gov/news/speech/spch092004smc.htm>. Speeches by SEC members or staff are the expressions of the speakers themselves, and are not to be construed as representations of the Commission itself.

⁷ See Sections II. Misleading Statements to Auditors and III. Enhanced Attorney Responsibilities under SOX *infra*.

Section 10A. Section 10A of the 1934 Act,¹² which was added by the Private Securities

¹² 15 U.S.C. § 78j-1. The relevant portion of Section 10A of the 1934 Act was modeled after SAS 53, the predecessor to SAS 82, and provides as follows:

Sec. 10A. Audit requirements (Sec. 78j-1)

(a) *In general.* Each audit required pursuant to this title of the financial statements of an issuer by a registered public accounting firm shall include, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission—

(1) procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts;

(2) procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein; and

(3) an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year.

(b) *Required response to audit discoveries.*

(1) *Investigation and report to management.* If, in the course of conducting an audit pursuant to this title to which subsection (a) applies, the registered public accounting firm detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred, the firm shall, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission—

(A)(i) determine whether it is likely that an illegal act has occurred; and

(ii) if so, determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and damages; and

(B) as soon as practicable, inform the appropriate level of the management of the issuer and assure that the audit committee of the issuer, or the board of directors of the issuer in the absence of such a committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of such firm in the course of the audit, unless the illegal act is clearly inconsequential.

(2) *Response to failure to take remedial action.* If, after determining that the audit committee of the board of directors of the issuer, or the board of directors of the issuer in the absence of an audit committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of the firm in the course of the audit of such accountant, the registered public accounting firm concludes that—

(A) the illegal act has a material effect on the financial statements of the issuer;

(B) the senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act; and

(C) the failure to take remedial action is reasonably expected to warrant departure from a standard report of the auditor, when made, or warrant resignation from the audit engagement;

the registered public accounting firm shall, as soon as practicable, directly report its conclusions to the board of directors.

(3) *Notice to Commission; response to failure to notify.* An issuer whose board of directors receives a report under paragraph (2) shall inform the Commission by notice not later than 1 business day after the receipt of such report and shall furnish the registered public accounting firm making such report with a copy of the notice furnished to the Commission. If the registered public accounting firm fails to receive a copy of the notice before the expiration of the required 1-business-day period, the registered public accounting firm shall—

(A) resign from the engagement; or

(B) furnish to the Commission a copy of its report (or the documentation of any oral report given) not later than 1 business day following such failure to receive notice.

(4) *Report after resignation.* If a registered public accounting firm resigns from an engagement under paragraph (3)(A), the firm shall, not later than 1 business day following the failure by the issuer to notify the Commission under paragraph (3), furnish to the Commission a copy of the report of the firm (or the documentation of any oral report given).

(c) *Auditor liability limitation.* No registered public accounting firm shall be liable in a private action for any finding, conclusion, or statement expressed in a report made pursuant to paragraph (3) or (4) of subsection (b), including any rule promulgated pursuant thereto.

(d) *Civil penalties in cease-and-desist proceedings.* If the Commission finds, after notice and opportunity for hearing in a proceeding instituted pursuant to section 21C, that a registered public accounting firm has willfully violated paragraph (3) or (4) of subsection (b), the Commission may, in addition to entering an order under section 21C, impose a civil penalty against the registered public accounting firm and any other person that the Commission finds was a cause of such violation. The determination to impose a civil penalty and the amount of the penalty shall be governed by the standards set forth in section 21B.

(e) *Preservation of existing authority.* Except as provided in subsection (d), nothing in this section shall be held to limit or otherwise affect the authority of the Commission under this title.

(f) *Definitions.* As used in this section, the term “illegal act” means an act or omission that violates any law, or any rule or regulation having the force of law. As used in this section, the term “issuer” means an issuer (as defined in section 3), the securities of which are registered under section 12, or that is required to file reports pursuant to section 15(d), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.

Litigation Reform Act of 1995 (“PSLRA”),¹³ created additional reporting obligations for auditors with regard to fraud that had not existed prior to that time. Like GAAS, Section 10A requires auditors to employ procedures, in accordance with GAAS, designed to provide “reasonable assurance of detecting illegal acts” that would have a direct and material effect on the financial statements. In addition, however, Section 10A requires auditors to report evidence of fraud up the corporate ladder to management and to the audit committee under certain circumstances. Section 10A further requires that the auditor report not only up, but *out* to the SEC if – after investigation of evidence of an illegal act uncovered during an audit – the auditor determines that (1) the audit committee or board is adequately informed of the illegal act, (2) the illegal act has a material effect on the financial statements, (3) the illegal act has not been appropriately remediated, and (4) as a result, the auditor will be required to issue a qualified audit opinion or resign.¹⁴ The creation of the “illegal act” requirement of Section 10A exposed auditors to potential administrative proceedings based not only on alleged deficiencies in their audits or reviews of financial statements, but also on allegations that they have taken insufficient steps to satisfy these reporting requirements.

SEC Enforcement Actions. Under SEC Rule 102(e)(1)(ii), the SEC may sanction accountants for “improper professional conduct.”¹⁵ Administrative and enforcement actions

filed in recent years reflect enhanced scrutiny of the work of auditors who failed to catch fraud by their clients or to take sufficient steps to satisfy Section 10A.¹⁶ When he was Director of the

“We begin with the observation that in the amended Rule 102(e), the Commission has cured the defects identified in *Checkosky I* and *II*.”

¹⁶ See *In the Matter of Deloitte & Touche LLP, Steven H. Barry, CPA, and Karen T. Baker, CPA*, Admin. Proc. File No. 3-11911, Accounting and Auditing Enforcement Release No. 2238 (April 26, 2005), which can be found at <http://www.sec.gov/litigation/admin/34-51607.pdf> (action against Deloitte and personnel in connection with audit of the financial statements of Just for Feet, Inc. which (i) improperly recognized as income the value of advertising support from suppliers rather than as a reduction of merchandise cost which GAAP required and sometimes before all conditions precedent to its entitlement to the support had been satisfied and (ii) failed to provide adequate reserves for obsolete inventory; although Just for Feet was regarded as a high risk client which was run by an autocrat, interpreted accounting standards aggressively and had presented issues in prior audits, the SEC found Deloitte’s audit processes did not insist on proper vendor confirmations (some of which were found to be ambiguous or incomplete and some of which contained vendor misstatements); Deloitte was fined \$375,000 and the individuals were prohibited from practicing before the SEC); *In the Matter of Deloitte & Touche LLP*, Admin. Proc. File No. 3-11910, Accounting and Auditing Enforcement Release No. 2237 (April 26, 2005), which can be found at <http://www.sec.gov/litigation/admin/34-51606.pdf> (action against Deloitte for failure to detect a massive fraud in audits of Adelphia Communications Corporation although Adelphia was regarded a very high risk because of management dominated by Rigas family without compensating controls, management tendency to interpret accounting standards aggressively and frequent disputes with auditors, transactions with unaudited affiliated parties (some of which posed form over substance questions) and high capital requirements and debt levels (some obligations were classified as guarantees even though documents showed Adelphia was jointly and severally liable with related party borrowers and the financial condition of some borrowers made it probable under FAS 5 that Adelphia would have to pay the debt); Deloitte failed to detect Adelphia’s fraud, failed to tailor its audit approach to the risks in violation of GAAS, and issued an unqualified opinion on Adelphia’s financial statements while it knew or should have known that Adelphia: (a) failed to record all co-borrowing debt on its balance sheet or otherwise disclose that a portion had been excluded; (b) failed to disclose significant related party transactions by improperly netting related party payables and receivables; and (c) overstated its stockholders’ equity by \$375 million; in settling the SEC action, Deloitte (i) paid \$25 million into a disgorgement fund to be distributed to defrauded investors pursuant to a plan to be established pursuant to SOX §308(a) and court approval and (ii) undertook to establish specified policies and procedures to detect and report fraud pursuant to Section 10A); *In the Matter of KPMG LLP*, Admin. Proc. File No. 3-11905, Accounting and Auditing Enforcement Release No. 2234 (April 19, 2005), which can be found at <http://www.sec.gov/litigation/admin/34-51574.pdf> (action against KPMG regarding revenue recognition issues in accounting for leases in audits of financial statements of Xerox Corporation and failing to report Xerox’s failures to comply with GAAP under Section 10A; in settlement KPMG agreed to (i) avoid circumstances where a client may improperly influence the firm’s assignment of engagement partners; (ii) create additional lines of communication within the firm to allow KPMG professionals to raise issues, which they may believe have not been adequately addressed at the engagement team level, to a more senior level within the firm, and establish “Whistle-blower” channels of communication; (iii) ensure that KPMG has policies and procedures designed to provide reasonable assurance that workpapers prepared in connection with the audits of the financial statements of public companies include documentation of significant consultations with KPMG’s Department of Professional Practice, firm specialists or others within or without the firm; (iv) provide training to its audit professionals concerning evaluation of audit evidence in a situation involving period-ending material adjustments by management to a company’s original accounting system entries; and (v) disseminate to all audit professionals, and incorporate in its training for new audit professionals, requirements that auditors of public company clients at least annually reassess a client’s justification for client accounting practices which are not in accordance with GAAP and assess the materiality of such departures; *In the Matter of PricewaterhouseCoopers LLP*, Admin. Proc. File No. 3-11483, Accounting and Auditing Enforcement Release No. 2008 (May 11, 2004) (action against PwC in connection with audit of the Warnaco Group’s financial statements from 1998 for failure to correctly characterize the cause of an inventory overstatement

¹³ Section 10A is the part of the 1934 Act entitled “Audit Requirements” and predates SOX; Section 10A was added to the 1934 Act on December 22, 1995 as part of the PSLRA: Title III – Auditor Disclosure of Corporate Fraud. When Congress passed SOX, it tacked on the SOX requirements to the preexisting illegal act requirements from the PSLRA.

¹⁴ 15 U.S.C. § 78j-1. Section 10A requires (in plain English) that if an auditor becomes aware of anything indicating that an illegal act has or may have occurred at one of her public clients, her firm must: inform the appropriate level of management and the audit committee of the issue; conclude whether there has been an illegal act that has a material effect on the financials; conclude whether the company has taken timely and appropriate remedial action; and report the client to the SEC if the client fails to take timely and appropriate remedial action.

¹⁵ SEC Rule 102(e)(1)(iv) defines improper professional conduct as follows:

“(A) Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or

(B) Either of the following two types of negligent conduct:

(1) A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.

(2) Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.”

SEC Rule 102(e)(1)(iv) History: Section (iv) was added to the Rule in 1998 to address the D.C. Circuit’s concerns -- as expressed in *Checkosky I* [23 F. 3d 452 (D.C. Cir. 1994)] and *Checkosky II* [139 R. 3d 221 (D.C. Cir. 1998)] -- about the lack of clarity in the term “improper professional conduct”.

SEC Rule 102(e)(1)(ii) & (iv): *Marrie v. SEC*, slip op. at 10 (D.C. Cir. July 16, 2004)

SEC Division of Enforcement, Stephen Cutler called auditors “the sentries of the marketplace,” and said that the SEC was focusing on auditing firm responsibility for audits in the hope that “accounting firms will take an even greater role in ensuring that individual auditors are properly discharging their special and critical gatekeeping role.”¹⁷

PCAOB. Besides the SEC’s Enforcement Division, the auditors’ newest regulator has put the industry on notice of its expectations with respect to fraud. The PCAOB was established under SOX §101 to inspect, investigate and discipline auditors conducting public company audits.¹⁸ In an August 2, 2004 interview, PCAOB Chairman William McDonough stated his view as to the auditor’s *obligation* to detect client fraud:

We have a very clear view that it *is* their job [to detect fraud]. If we see fraud that wasn’t detected and should have been, we will be very big on the tough and not so [big] on the love. ... [A]uditors [need to] understand that, with relatively few

as resulting from internal control deficiencies as opposed to changed accounting rules, as misrepresented by Warnaco in a press release); *In the Matter of Grant Thornton LLP, et al.*, Admin. Proc. File No. 3-11377, Accounting and Auditing Enforcement Release No. 1945 (Jan. 20, 2004) (administrative proceeding against Grant Thornton for aiding and abetting fraud and violating Section 10A by failing to obtain sufficient audit evidence despite “red flags” that client failed to disclose material related party transactions); *In the Matter of Richard P. Scalzo, CPA*, Admin. Proc. File No. 3-11212, Accounting and Auditing Enforcement Release No. 1839 (Aug. 13, 2003) (auditor permanently barred from public practice based on audits of Tyco between 1997 and 2001 in which he became aware of facts that put him on notice regarding the integrity of Tyco’s management but failed to perform additional audit procedures or reevaluate his risk assessment); *In the Matter of Warren Martin, CPA*, Admin. Proc. File No. 3-11211, Accounting and Auditing Enforcement Release No. 1835 (Aug. 8, 2003) (auditor suspended from public practice for two years for undue reliance upon management representations regarding the interpretation of contracts, thereby ignoring “unambiguous contractual language” that affected revenue recognition and led to a \$66 million restatement); *In the Matter of Phillip G. Hirsch, CPA*, Admin. Proc. File No. 3-11133, Accounting and Auditing Enforcement Release No. 1788 (May 22, 2003) (suspending PwC auditor for one year in settlement of allegations that he did not ensure that sufficient audit procedures were conducted in light of PwC’s risk of fraud assessment and that he placed undue reliance on management representations despite awareness of evidence “from which he should have realized further audit work was required.”); *SEC v. KPMG*, Civil Action No. 02-cv-0671 (S.D.N.Y. January 29, 2003), Accounting and Auditing Enforcement Release No. 1709 (seeking civil injunction against KPMG and disgorgement of fees and civil penalties in connection with the firm’s audit of Xerox based on allegation that auditors had evidence of manipulation of financial results and failed to ask Xerox to justify departures from GAAP); *In Matter of Barbara Horvath, CPA*, Admin. Proc. File No. 3-10665, Accounting and Auditing Enforcement Release No. 1483 (Dec. 27, 2001) (a Deloitte & Touche auditor for placing reliance on management representations as her principal source of audit evidence for the company’s capitalization of expenses which, it turned out, were fraudulent).

¹⁷ Speech entitled “The Themes of Sarbanes-Oxley as Reflected in the Commission’s Enforcement Program” by Stephen M. Cutler, then Director of SEC Division of Enforcement, at UCLA School of Law on September 20, 2004, which can be found at <http://www.sec.gov/news/speech/spch092004smc.htm>. Speeches by SEC members or staff are the expressions of the speakers themselves, and are not to be construed as representations of the Commission itself.

¹⁸ SOX §§ 101-105, 15 U.S.C. §§ 7211-15. History: SOX §105 granted the PCAOB broad investigative and disciplinary authority over registered firms and those firms’ partners, principals, and employees. September 29, 2003 the PCAOB adopted Rules on Investigations and Adjudications in PCAOB Release No. 2003-015, which on May 14, 2004 the SEC approved SEC Exchange Act Release No. 34-49704.

exceptions, they should find it. To me, the relatively few exceptions are those cases where you would have some extremely dedicated, capable crooks. In most cases, though, the crooks either are not that smart or they don’t cover their tracks that well.¹⁹

Under SOX and the PCAOB’s implementing regulations, *any* violation of laws, rules or policies by individual auditors or firms detected during inspections of selected audit and review engagements is to be identified in a written report and may be handed over to the SEC or other regulatory authorities and become the subject of further investigation and disciplinary proceedings.²⁰ The PCAOB has stated that inspections will assess compliance at all levels – *i.e.*, actions, omissions, policies and behavior patterns “from the senior partners to the line accountants.”²¹ The inspections will allow the PCAOB, in its own words, to “apply pressure to improve a firm’s audit practices.”²²

All of these factors -- the evolution of the law regarding auditors’ obligations with respect to client fraud, the SEC’s enforcement actions in recent years, and the introduction of the PCAOB’s expectations into the equation -- indicate that auditors will continue to feel pressure to increase their role in monitoring and finding inappropriate corporate accounting behavior.

II. MISLEADING STATEMENTS TO AUDITORS

SOX §303 makes it unlawful, in contravention of rules adopted by the SEC, 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. On May 20, 2003, the SEC amended and expanded Rule 13b2-2²³ under the 1934 Act (which already prohibited the falsification of books, records and accounts, and false or misleading statements, or omissions to make certain statements, to accountants²⁴) by adding (x) a new subsection (b)(1)

¹⁹ *The Enforcer*, CFO.com (Aug. 2, 2004) (emphasis added).

²⁰ When the PCAOB believes that an act, practice or omission by a registered firm or individual auditor may violate SOX, PCAOB rules or other professional standards or any securities law or regulation pertaining to audit reports or to the duties of accountants, the PCAOB may open an investigation. *See* PCAOB R. 5101. Such an investigation can lead to disciplinary proceedings, exposing the offending auditor or firm to penalties ranging from compulsory training and mandated quality control procedures to heavy civil fines and temporary or permanent suspension from audit practice.

²¹ Steven Berger, *PCAOB—Beyond The First Year*, 2004 WL 69983842, Monday Business Briefing (July 15, 2004).

²² Public Company Accounting Oversight Board 2003 Annual Report, p. 4, *available at* http://www.pcaobus.org/documents/PCAOB_2003_AR.pdf.

²³ SEC Release No. 34-47890 (May 20, 2003).

²⁴ Both before and after the May 20, 2003 amendment to 1934 Act Rule 13b2-2, the SEC was bringing enforcement actions against individuals (including inside counsel) for their roles in the falsification of

accounting records and misleading statements to accountants, some of which predated the enactment of SOX. See, for example, the following actions:

In *U.S. vs. Sanjay Kumar, et al*, SEC Litigation Release No. 18891 (September 22, 2004), SEC Accounting and Auditing Enforcement Release No. 2106 (September 22, 2004); *SEC v. Computer Associates International, Inc.*, 04 Civ. 4088 (E.D.N.Y.) (Glasser, I.L.); *SEC v. Sanjay Kumar and Stephen Richards*, 04 Civ. 4104 (E.D.N.Y.) (Glasser, I.L.); *SEC v. Steven Woghin*, 04 Civ. 0487 (E.D.N.Y.) (Glasser, I.L.), securities fraud charges were brought by the Department of Justice and the SEC against Computer Associates International, Inc. ("CA") and three of the company's former top executives – Sanjay Kumar, former CEO and Chairman, Stephen Richards, former Head of Sales, and Steven Woghin, former General Counsel, alleging that from 1998 to 2000, CA routinely kept its books open to record revenue from contracts executed after the quarter ended in order to meet Wall Street quarterly earnings estimates and obstructed the SEC's investigation into the CA's accounting practices. In settlements with the SEC and the Justice Department, CA agreed pay \$225 million in restitution to shareholders and to make reforms to its corporate governance and financial accounting controls. General Counsel Woghin pled guilty and agreed in a partial settlement to a permanent injunction and officer and director bar with monetary sanctions to be decided at a later point. See U.S. Department of Justice Press Release dated September 22, 2004; SEC 1934 Act Release No. 50653 (November 10, 2004).

The SEC's complaints in the CA cases filed in the U.S. District Court for the Eastern District of New York allege, among other things:

- The defendants manipulated CA's quarter end cutoff to align CA's reported financial results with market expectations.
- CA prematurely recognized revenue from software contracts that CA, its customer, or both parties, had not yet executed, in violation of GAAP.
- CA executives, including defendants Kumar, Richards, and Woghin, held CA's books open for several days after the end of each quarter to improperly record in that quarter revenue from contracts that were not executed by customers or CA until several days or more after the expiration of the quarter. In a Superseding Indictment filed in the E.D.N.Y. in *U.S. vs. Sanjay Kumar and Stephen Richards* on June 30, 2005, the U.S. alleged that this practice was referred to within CA as the "35-day month" or the "three-day window." As a result of this improper practice, CA made material misrepresentations and omissions about its revenue and earnings in SEC filings and other public statements.
- Woghin (1) signed an SEC filing that contained materially false and misleading information regarding CA's revenues and earnings per share; (2) approved backdated contracts, including drafting a contract with misleading dates; and (3) allowed CA Legal Department to approve contracts obtained by the sales force while knowing, or recklessly disregarding the fact that, those contracts contained false and misleading signature dates and that CA would recognize revenue from those contracts in the incorrect fiscal quarter.
- Woghin encouraged several CA employees to make false and misleading statements to the SEC and/or CA's outside counsel.

In *the Matter of John E. Isselmann*, Release No. 50428 (September 23, 2004), which can be found at <http://www.sec.gov/litigation/admin/34-50428.htm> and in which a consent cease and desist order was entered against a general counsel who failed to advise the audit committee and auditors that he had received an opinion of local foreign counsel that the company could not eliminate benefits to its Asian employees where the benefits termination allowed the company to report a profit rather than a loss and resulted improper financial reporting in Form 10-Q Report.

In *the Matter of Jonathan B. Orlick, Esq.*, SEC 1934 Act Release 51081, Auditing and Auditing Enforcement Release No. 2177 (January 26 2005), which can be found at <http://www.sec.gov/litigation/admin/34-51081.htm> and in which the SEC announced settlement of an

enforcement action against Jonathan B. Orlick, the former Executive Vice President, General Counsel, Secretary and a director of Gemstar-TV Guide International, Inc., a media and technology company that publishes TV Guide and "develops, licenses, and markets an interactive program guide ("IPG") for televisions....." which it touted as the "value driver" of the company's stock. According to the SEC, during the period from June 1999 through September 2002 Gemstar overstated its total revenues by at least \$248 million to meet growth projections for IPG licensing and advertising, and the SEC alleged that Orlick knew that the company was improperly recognizing and reporting licensing revenue. It was also alleged that Orlick repeatedly signed false representation letters to the company's outside auditors regarding the status of negotiations with another company regarding a material licensing agreement. As part of the settlement, Orlick was enjoined from violating, or aiding and abetting violations, of securities laws, and was ordered to pay \$305,511 in disgorgement of a prior bonus, interest and a civil penalty. In addition, Orlick may not serve as an officer or director of a public company for a period of ten years, and has been suspended from appearing or practicing before the SEC. Orlick consented to the penalties but neither admitted or denied liability.

In *the Matter of James A. Fitzhenry*, 1934 Act Release No. 46870, Accounting And Auditing Enforcement Release No. 1670 (November 21, 2002), Administrative Proceeding File No. 3-10943, involved an SEC enforcement action against James A. Fitzhenry, Senior Vice President, General Counsel and Secretary for FLIR Systems, Inc. ("FLIR"). At year-end 1998, FLIR improperly recognized \$4.1 million in revenue from two purported sales to one of FLIR's independent sales representatives in Columbia, based upon non-binding letters of intent. As part of the 1998 year-end audit of FLIR's financial statements, FLIR's outside auditors, PricewaterhouseCoopers LLP ("PwC"), selected these sales for testing and sent an accounts receivable confirmation, which the sales representative refused to return. In February 1999, Fitzhenry attempted to obtain a binding and unconditional agreement from FLIR's independent sales representative to purchase the units stated in the non-binding letters of intent. The sales representative refused to provide an agreement of the type requested by Fitzhenry. From Fitzhenry's negotiations with FLIR's independent sales representative, he understood that the \$4.1 million in sales were conditional in nature because the sales representative had no obligation to purchase the units. On April 12, 1999 and April 20, 1999, Fitzhenry signed two management representation letters to PwC, in connection with FLIR's 1998 year-end audit. Among other things, both letters confirmed that: (1) risk of ownership for the units had passed to FLIR's independent sales representative; and (2) the independent sales representative had made a fixed commitment to purchase the goods. Fitzhenry never told PwC about his negotiations with the independent sales representative, nor did he tell PwC that he understood the transactions were "conditional" in nature. Consequently, Fitzhenry made material misrepresentations and omitted material information in the management representation letters. As a result of the conduct described above, the SEC found that Fitzhenry willfully violated pre-SOX Rule 13b2-2. In the settlement, Fitzhenry was denied the privilege of appearing or practicing before the SEC as an attorney for five years.

Securities and Exchange Commission v. Vincent Steckley, Complaint for Permanent Injunction and Other Legal and Equitable Relief, filed in U.S. District Court for Northern District of California, San Jose Division, on September 8, 2003, the SEC charged a vice president of sales of a public company with aiding and abetting his employer in improperly recognizing revenue in violation of Rules 10b-5 and pre-amendment 13b2-1 under the 1934 Act by arranging for an undisclosed side letter that made an otherwise unconditional order for the purchase of software provided to the issuer's legal and accounting departments subject to cancellation. The SEC's Complaint stated that under GAAP the side letter made the sale a contingent sale, which should not be recognized as revenue, and that the defendant concealed the side letter from the legal and accounting departments, thereby causing the improper revenue recognition.

See also *In the Matter of Google, Inc. and David C. Drummond*, SEC Release No. 8523 (January 13, 2005), which can be found at <http://www.sec.gov/litigation/admin/33-8523.htm> and in which the general counsel of Google consented to a cease and desist order as a result of giving erroneous advice to Google regarding disclosures required to be given to employees to whom employee stock options were granted; and *In the Matter of FFP Marketing Company, Inc., Warner Williams, and Craig Scott, CPA*, SEC Release No. 51198, (February 14, 2005), which can be found at <http://www.sec.gov/litigation/admin/34-51198.htm> and

that specifically prohibits officers and directors and “persons acting under [their] direction,”²⁵ from coercing, manipulating, misleading or fraudulently influencing (collectively referred to

in which a general counsel was sanctioned for signing a misleading Form 12b-25 stating why the Company could not file its Form 10-K Report within the prescribed time period (the Form 12b-25 failed to disclose that the auditors could not complete their audit because of an ongoing study into accounting irregularities that ultimately resulted in a significant write down of credit card receivables and a restatement of FFP’s financial statements).

²⁵

In adopting Release No. 34-47890 (May 20, 2003), the SEC commented:

“[N]ew rule 13b2-2(b)(1) covers the activities of not only officers and directors of the issuer who engage in an attempt to misstate financial statements but also “any other person acting under the direction thereof.” Activities by such “other persons” currently may constitute violations of the anti-fraud or other provisions of the securities laws or aiding or abetting or causing an issuer’s violations of the securities laws. Section 303(a) and the new rule provide the Commission with an additional means of addressing efforts by persons acting under the direction of an officer or director to improperly influence the audit process and the accuracy of the issuer’s financial statements.

As noted in the proposing release, we interpret Congress’ use of the term “direction” to encompass a broader category of behavior than “supervision.” In other words, someone may be “acting under the direction” of an officer or director even if they are not under the supervision or control of that officer or director. **Such persons might include not only the issuer’s employees but also, for example, customers, vendors or creditors who, under the direction of an officer or director, provide false or misleading confirmations or other false or misleading information to auditors, or who enter into “side agreements” that enable the issuer to mislead the auditor.** In appropriate circumstances, persons acting under the direction of officers and directors also may include not only lower level employees of the issuer but also other partners or employees of the accounting firm (such as consultants or forensic accounting specialists retained by counsel for the issuer) and **attorneys**, securities professionals, or other advisers who, for example, pressure an auditor to limit the scope of the audit, to issue an unqualified report on the financial statements when such a report would be unwarranted, to not object to an inappropriate accounting treatment, or not to withdraw an issued audit report on the issuer’s financial statements. * * *

“Some commenters were concerned that including customers, vendors and creditors in the discussion of those persons who, in appropriate circumstances, might be considered to be acting under the direction of an officer or director would have a chilling effect on communications between those persons and the auditors. Other commenters noted that this chilling effect would be enhanced by the Commission’s position in the proposing release that **negligently misleading** the auditor was sufficient conduct to trigger application of the rule. * * * We believe that third parties providing information or analyses to an auditor should exercise reasonable attention and care in those communications. A primary purpose for enactment of the Sarbanes-Oxley Act is the restoration of investor confidence in the integrity of financial reports, which will require the cooperation of all parties involved in the audit process. We do not intend to hold any party accountable for honest and reasonable mistakes or to sanction those who actively debate accounting or auditing issues. We do believe, however, that those third parties who, under the direction of an issuer’s officers or directors, mislead or otherwise improperly influence auditors when they know or should know that their conduct could result in investors being provided with misleading financial statements or a misleading audit report, should be subject to sanction by the Commission.” [emphasis added]

herein as “*improperly influencing*”) an auditor “engaged in the performance of an audit”²⁶ of the issuer’s financial statements when the officer, director or other person “knew or should have known”²⁷ that the action, if successful, could result in rendering the issuer’s financial statements filed with the SEC materially misleading and (y) a new subsection (b)(2) that provides examples of actions that improperly influence an auditor that could result in “rendering the issuer’s financial statements materially misleading.”

Types of conduct that the SEC suggests could constitute “improperly influencing” include, but are not limited to, directly or indirectly:

- Offering or paying bribes or other financial incentives, including offering future employment or contracts for non-audit services,
- **Providing an auditor with inaccurate or misleading legal analysis** [emphasis added],
- Threatening to cancel or canceling existing non-audit or audit engagements if the auditor objects to the issuer’s accounting,
- Seeking to have a partner removed from the audit engagement because the partner objects to the issuer’s accounting,

²⁶

Amended Rule 13b2-2’s applicability is not limited to the formal engagement period of the issuer’s current outside auditor. In adopting Release No. 34-47890 (May 20, 2003), the SEC commented that “the phrase ‘engaged in the performance of an audit’ should be given a broad reading and . . . encompass the professional engagement period and any other time the auditor is called upon to make decisions or judgments regarding the issuer’s financial statements, including during negotiations for retention of the auditor and subsequent to the professional engagement period when the auditor is considering whether to issue a consent on the use of prior years’ audit reports.”

²⁷

Amended Rule 13b2-2 can be violated without any specific intent to render the issuer’s financial statements materially misleading and without the prohibited action achieving its desired end or actually resulting in misleading financial statements. In adopting Release No. 34-47890 (May 20, 2003), the SEC commented that “the phrase ‘knew or should have known,’ . . . historically has indicated the existence of a negligence standard [which] is consistent with the Commission’s enforcement actions in this area and . . . particularly in the absence of any private right of action under the rule, best achieves the purpose of restoring investor confidence in the audit process.” Amended Rule 13b2-2 departs from the text of SOX §303 by using “knew or should have known,” a negligence standard, in place of the statutory “for the purpose of” language, which would require specific intent. Thus, the SEC will not be required to show that a person’s actions were intended to render the issuer’s financial statements materially misleading, but only that the person knew or was negligent in not knowing that his or her actions could achieve that result. The distinction is illustrated by an example in the adopting release:

For example, if an officer of an issuer coerces an auditor not to conduct certain audit procedures required by generally accepted auditing standards (“GAAS”) because the officer wants to conceal his embezzlement of funds from the issuer, then it is possible that his actions might not be found to be for the “purpose of rendering the financial statements misleading.” If that officer, however, knew or should have known that not performing the procedures could result in the auditor not detecting and seeking correction of material errors in the financial statements, then we believe the officer’s conduct should be subject to the rule.

- Blackmailing, and
- Making physical threats.

Rule 13b2-2 applies throughout the professional engagement and after the professional engagement has ended when the auditor is considering whether to consent to the use of, reissue, or withdraw prior audit reports. Conducting reviews of interim financial statements and issuing consents to use past audit reports are within the scope of Rule 13b2-2.

SOX §303(b) provides the SEC with sole civil enforcement authority with respect to SOX §303 and any rule or regulation issued under SOX §303, thereby precluding a private right of action. While there is no private right of action for violations of SOX § 303 and related SEC rules, persons providing misleading information to auditors could have liability therefor under common law causes of action such as negligent misrepresentation.²⁸

Internal investigations into allegations of wrong doing by corporate representatives are being conducted with increasing frequency by counsel retained by boards of directors or audit committees.²⁹ The results of an internal investigation conducted by counsel are frequently furnished to the company's auditors. As a result, counsel conducting such an investigation could have a duty under Rule 13b2-2 to conduct the investigation with sufficient thoroughness that the results do not mislead the auditors. When he was Director of the SEC Division of Enforcement, Stephen Cutler commented:

One area of particular focus for us is the role of lawyers in internal investigations of their clients or companies. We are concerned that, in some instances, lawyers

may have conducted investigations in such a manner as to help hide ongoing fraud, or may have taken actions to actively obstruct such investigations.³⁰

A violation of Rule 13b2-2 is an "illegal act" within the meaning of Section 10A(b) of the 1934 Act and, therefore, must be reported by auditors under that section. Attorneys also should be aware that evidence of a violation of Rule 13b2-2 may be reportable by them under SOX §307 if it amounts to "evidence of a material violation" as defined in the SOX §307 Rules.

There is no exemption or qualification in amended Rule 13b2-2 excluding foreign private issuers from its application.

III. ENHANCED ATTORNEY RESPONSIBILITIES UNDER SOX

SOX §307. SOX §307 mandates that the SEC shall adopt rules of professional responsibility for attorneys representing public companies before the SEC, including: (1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty to the chief legal officer or the equivalent ("CLO"), if the issuer has a CLO, or to both the CLO and the CEO, of the company; and (2) if corporate executives do not respond appropriately, requiring the attorney to report to the board of directors or an appropriate committee thereof.³¹ On January 23, 2003, the SEC complied with the SOX §307 mandate by adopting the rules implementing provisions of SOX §307 that prescribe minimum standards of professional conduct for attorneys appearing and practicing before the SEC in any way in the representation of issuers, which were published in SEC Release No. 33-8185 (January 29, 2003), titled "Implementation of Standards of Professional Conduct for Attorneys," and which can be found at <http://www.sec.gov/rules/final/33-8185.htm> (the "SOX §307 Release"). These rules adopted under SOX §307 (the "SOX §307 Rules") constitute a new Part 205 to 17 CFR, Standards of Professional Conduct for Attorneys Appearing and Practicing before the Commission, and became effective on August 5, 2003.

³⁰ Speech entitled "The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program" by Stephen M. Cutler, then Director of SEC Division of Enforcement, at UCLA School of Law on September 20, 2004, which can be found at <http://www.sec.gov/news/speech/spch092004smc.htm>.

³¹ SOX attempts to protect investors from a repeat of the scandals that led to its enactment by regulating "[t]he sentries of the marketplace: the auditors who sign off on companies' financial data; the lawyers who advise companies on disclosure standards and other securities law requirements; the research analysts who warn investors away from unsound companies; and the boards of directors responsible for oversight of company management." Speech entitled "The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program" by Stephen M. Cutler, Director of SEC Division of Enforcement, at UCLA School of Law on September 20, 2004, which can be found at <http://www.sec.gov/news/speech/spch092004smc.htm>. See also *In the Matter of John E. Isselmann*, Release No. 50428 (September 23, 2004), which can be found at <http://www.sec.gov/litigation/admin/34-50428.htm> and in which a consent cease and desist order was entered against a general counsel who failed to advise the audit committee and auditors that he had received an opinion of local foreign counsel that the company could not eliminate benefits to its Asian employees where the benefits termination allowed the company to report a profit rather than a loss and which resulted in improper financial reporting in the Form 10-Q Report.

²⁸ *Cf. Dean Foods Company v. Pappathanasi*, 18 Mass. L. Rep. 598, 2004 WL 3019442 (Mass. Super. Dec. 3, 2004), in which a \$9 million judgment was rendered by a trial court after a non-jury trial against a law firm for negligent misrepresentation as a result of the failure to disclose in a closing opinion for an acquisition certain information which it had regarding a government subpoena of documents regarding a customer's alleged tax fraud. The defendant law firm had opined, as counsel to the acquired company, to the acquiring company that "to the firm's knowledge, without investigation, except as disclosed in a schedule to the acquisition agreement: (a) there was no investigation of any kind pending or threatened against the Company and (b) the Company was not 'subject to any... continuing' governmental investigation." The law firm had assisted the acquired company in responding to the government's subpoena, had looked into whether the acquired company had aided the fraud, but guessed that the investigation had probably gone away with the customer making payments to the government. The law firm advised the acquired company that the matter did not require disclosure in a schedule to the acquisition agreement. Three months after the closing, the acquired company received a "target letter" from the government. Ultimately the acquired company pled guilty to aiding and abetting tax fraud, and paid a fine of \$7.2 million. The purchaser sued the acquired company's law firm which had rendered the opinion that no proceedings were pending or threatened against the acquired company. The court concluded that the law firm had enough notice that it could not rely on the acquired company's representations and had a duty to investigate, which it did not do adequately. The law firm ended up settling the case. See Donald W. Glazer and Arthur Norman Field, *No-litigation Opinions Can Be Risky Business: Looking at the Facts – and Beyond*, 14 Business Law Today No. 6 (July/August 2005) at 37.

²⁹ See William R. Baker III and Joel H. Trotter, *Corporate Internal Investigations after Sarbanes-Oxley*, in 2 THE PRACTITIONER'S GUIDE TO THE SARBANES-OXLEY ACT VII-4-1 (John J. Huber et al. eds., ABA 2004).

Generally, the SOX §307 Rules require that, in the event that an attorney has *credible evidence based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation of any U.S. law or fiduciary duty has occurred, is on going, or is about to occur*, the attorney has a duty to seek to remedy the problem by “reporting up the ladder” within the issuer. This standard, developed from the SEC’s attempt to make objective rather than subjective the test of when a lawyer must report a violation, has a lower threshold than a “more likely than not” standard. An attorney’s duty is not confined to matters as to which the attorney has formed a legal conclusion that there has been a material violation.

Relationship to State Disciplinary Rules. The SOX §307 Rules purport to set forth minimum standards of professional conduct for attorneys appearing and practicing before the SEC in the representation of an issuer. SOX §307 standards are intended to supplement applicable standards of any jurisdiction where an attorney is admitted or practices, and are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the application of SOX §307 Rules. Where the standards of a state or other U.S. jurisdiction where an attorney is admitted or practices conflict with SOX §307 Rules, SOX §307 Rules provide that they shall govern.

Attorneys Covered. The SOX §307 Rules apply to all attorneys, whether in-house counsel or outside counsel and those in foreign jurisdictions, “*appearing and practicing*” before the SEC. The term “appearing and practicing” before the SEC is defined to include, without limitation: (1) transacting any business with the SEC, including communication in any form with the SEC; (2) representing an issuer in an SEC administrative proceeding or in connection with any SEC investigation, inquiry, information request or subpoena; (3) providing advice in respect of the U.S. securities laws regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document;³² or (4) advising an issuer as to whether information or a statement, opinion, or other writing is required under the U.S. securities laws to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC; but does not include an attorney who (x) conducts these activities other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship;³³ or (y) is a non-appearing foreign attorney.³⁴ The SEC intends that the issue whether an attorney-

client relationship exists for purposes of the SOX § 307 Rules will be a federal question and, in general, will turn on the expectations and understandings between the attorney and the issuer. Thus, whether the provision of legal services under particular circumstances would or would not establish an attorney-client relationship under the state laws or ethics codes of the state where the attorney practices or is admitted may be relevant to, but will not be controlling on, the issue under the SOX §307 Rules.

Who is the Client? The SOX §307 Rules affirmatively state that an attorney representing an issuer represents the issuer as an entity, rather than the officers or others with whom the attorney interacts in the course of that representation. The attorney owes his or her professional and ethical duties to the issuer as an organization.³⁵ In the case of a large corporation with multiple subsidiaries, questions will arise as to whether the attorney represents the consolidated group or only a particular entity within, and the answers will vary depending on the unique facts of each situation.³⁶

What Evidence Triggers Reporting Duty? The SOX §307 reporting duties are triggered when an attorney has “*evidence of a material violation*,” which is defined to mean credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.³⁷ “*Material violation*” in turn is defined

³⁴ The SOX §307 Rules incorporate a concept of “non-appearing foreign attorney” to address the situation of attorneys who are admitted outside of the U.S., do not give advice as to U.S. securities laws and whose involvement with SEC matters is either peripheral or through U.S. counsel, and to relieve such attorneys of the responsibilities of the SOX §307 Rules.

³⁵ Tex. R. Disc. P. 1.12 provides that “[a] lawyer employed or retained by an organization represents the entity” rather than the individuals to whom the lawyer reports in the ordinary course of working relationships.

³⁶ Attorneys’ engagement letters sometimes are very specific as to the representation being solely of a specified entity and not any parent or subsidiary entities or related persons; sometimes the client will want the attorneys to agree that the client is all of the members of the consolidated group.

³⁷ The SOX §307 Release comments that the definition of “evidence of a material violation” is an objective standard, instead of a subjective standard which would require “actual belief” that a material violation has occurred, is ongoing, or is about to occur before the attorney would be obligated to make an initial report within the client issuer. In explaining how the definition’s objective standard should be interpreted, the SOX §307 Release states:

Evidence of a material violation must first be credible evidence. An attorney is obligated to report when, based upon that credible evidence, “it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.” This formulation, while intended to adopt an objective standard, also recognizes that there is a range of conduct in which an attorney may engage without being unreasonable. The “circumstances” are the circumstances at the time the attorney decides whether he or she is obligated to report the information. These circumstances may include, among others, the attorney’s professional skills, background and experience, the time constraints under which the attorney is acting, the attorney’s previous experience and familiarity with the client, and the availability of other lawyers with whom the lawyer may consult. Under the revised definition, an attorney is not required (or expected) to report “gossip, hearsay, [or]

³² Mere preparation of a document that may be included as an exhibit to a filing with the SEC does not constitute “appearing and practicing” before the SEC, unless the attorney has notice that the document will be filed with or submitted to the SEC and he or she provides advice on U.S. securities law in preparing the document. Thus, preparing an employment contract for an executive officer would not be, but drafting a description of the contract for a proxy statement would be, “appearing and practicing” before the SEC.

³³ This portion of the definition of “appearing and practicing” before the SEC has the effect of excluding from coverage attorneys at public broker-dealers and other issuers who are licensed to practice law and who may transact business with the SEC, but who are not in the legal department and do not provide legal services within the context of an attorney-client relationship.

to mean a material violation of an applicable U.S. federal or state securities law, a material “breach of fiduciary duty” arising under U.S. federal or state law, or a similar material violation of any U.S. federal or state law. The SOX §307 Release comments that the SOX §307 Rules do not contain a separate definition of “material” because “that term has a well-established meaning under the federal securities laws and the [SEC] intends for that meaning to apply under” the SOX §307 Rules.³⁸ The SOX §307 Release, however, does comment that material violations must arise under U.S. law (federal or state) and do not include violations of foreign laws. “*Breach of fiduciary duty*” under the SOX §307 Rules refers to any breach of fiduciary or similar duty to the issuer recognized under an applicable federal or state statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust and approval of unlawful transactions.³⁹

innuendo.” Nor is the rule’s reporting obligation triggered by “a combination of circumstances from which the attorney, in retrospect, should have drawn an inference,” as one commenter feared.

On the other hand, the rule’s definition of “evidence of a material violation” makes clear that the initial duty to report up-the-ladder is not triggered only when the attorney “knows” that a material violation has occurred or when the attorney “conclude[s] there has been a violation, and no reasonable fact finder could conclude otherwise.” That threshold for initial reporting within the issuer is too high. Under the Commission’s rule, evidence of a material violation must be reported in all circumstances in which it would be unreasonable for a prudent and competent attorney not to conclude that it is “reasonably likely” that a material violation has occurred, is ongoing, or is about to occur. To be “reasonably likely” a material violation must be more than a mere possibility, but it need not be “more likely than not.” If a material violation is reasonably likely, an attorney must report evidence of this violation. The term “reasonably likely” qualifies each of the three instances when a report must be made. Thus, a report is required when it is reasonably likely a violation has occurred, when it is reasonably likely a violation is ongoing or when reasonably likely a violation is about to occur.

³⁸ The SOX § 307 Release cites *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-336 (1988); and *TCS Indus. v. Northway, Inc.*, 426 U.S. 438 (1976) for the generally accepted definition of “material.” Materiality is defined in those cases as follows: “An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” *TSC Industries* at 449, expressly adopted in *Basic, Inc.* at 231-232.

³⁹ Both TBCA art. 2.31 and DGCL § 141(a) provide that the business and affairs of a corporation are to be managed under the direction of its board of directors. While the Texas and Delaware corporation statutes provide statutory guidance as to matters such as the issuance of securities, the payment of dividends, the conduct of meetings of directors and shareholders, and the ability of directors to rely on specified persons and information, the nature of a director’s “fiduciary” duty to the corporation and the shareholders has been largely defined by the courts through damage and injunctive actions. In Texas, “[t]hree broad duties stem from the fiduciary status of corporate directors; namely the duties of obedience, loyalty, and due care.” *Gearhart Industries, Inc. v. Smith International, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984). *Gearhart* describes those duties as follows: (i) the duty of obedience requires a director to avoid committing *ultra vires* acts, i.e., acts beyond the scope of the authority of the corporation as defined by its articles of incorporation or the laws of the state of incorporation, (ii) the duty of loyalty dictates that a director must act in good faith and must not allow his personal interests to prevail over the interests of the corporation,

Duty to Report Evidence of a Material Violation. If an attorney, appearing and practicing before the SEC “in the representation of an issuer,”⁴⁰ becomes aware of evidence of a material violation by the issuer or by any officer, director, employee or agent of the issuer, the SOX §307 Rules require the attorney to “report”⁴¹ the evidence to the issuer’s CLO (if the issuer has a CLO) or to both the issuer’s CLO and its CEO forthwith. By communicating such information to the issuer’s officers or directors, an attorney does not reveal client confidences or secrets or privileged or otherwise protected information related to the attorney’s representation of an issuer.

The CLO is then obligated to cause such inquiry⁴² into the evidence of a material violation as he or she “reasonably believes”⁴³ is appropriate to determine whether the material violation described in the report has occurred, is ongoing, or is about to occur. If the CLO determines no material violation has occurred, is ongoing, or is about to occur, he or she shall notify the reporting attorney and advise the reporting attorney of the basis for such determination. Unless the CLO reasonably believes that no material violation has occurred, is ongoing, or is about to occur, he or she shall take all reasonable steps to cause the issuer to adopt an “appropriate response,”⁴⁴ and shall advise the reporting attorney thereof. In lieu of causing

and (iii) the duty of due care requires that a director must handle his corporate duties with such care as an ordinarily prudent man would use under similar circumstances. In Delaware, the fiduciary duties include those of loyalty, care, candor and oversight. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); *In re Caremark International, Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996); *See In re Abbott Laboratories Derivative Shareholders Litigation*, 293 F.3d 378 (7th Cir. 2002). Both Texas and Delaware have adopted a judicial rule of review of business decisions, known as the “business judgment rule,” that is intended to protect disinterested directors from liability for decisions made by them when exercising their business judgment, but there are substantial differences in the Delaware and Texas judicial approaches to the business judgment rule. *See* Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation - Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. Rev. 249, 287-288 (Winter 2001). The extent to which traditional business judgment rule analyses will be applicable in respect of SOX requirements is unclear.

⁴⁰ The SOX §307 Rules define “in the representation of an issuer” to mean providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer.

⁴¹ The SOX §307 Rules define “report” to mean to make known to directly, either in person, by telephone, by e-mail, electronically, or in writing.

⁴² An attorney conducting an inquiry into reported evidence of a material violation would be deemed appearing and practicing before the SEC in the representation of the issuer. The attorney reporting the evidence to the CLO could be a person commissioned by the CLO to conduct the inquiry into the evidence. The inquiry is important not only for what it finds about the possible violation which initiated the inquiry, but also for any additional possible violations which it may uncover.

⁴³ The SOX §307 Rules provide that “reasonably believes” to mean that an attorney believes the matter in question and that the circumstances are such that the belief is not unreasonable, and that “reasonable” or “reasonably” denote, with respect to the actions of an attorney, conduct that would not be unreasonable for a prudent and competent attorney.

⁴⁴ “Appropriate response” is defined by the SOX §307 Rules as a response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes that: (1) no material violation has occurred, is ongoing, or is about to occur; (2) the issuer has, as necessary, adopted appropriate

such an inquiry a CLO may refer a report of evidence of a material violation to a qualified legal compliance committee ("QLCC") if the issuer has duly established a QLCC prior to the report of evidence of a material violation.

Unless an attorney who has made the report reasonably believes that the CLO or CEO has provided an appropriate response within a reasonable time, the attorney shall report the evidence of a material violation to: (i) the issuer's audit committee, (ii) another committee consisting solely of independent directors, or (iii) the board of directors.⁴⁵

If an attorney reasonably believes that it would be futile to report evidence of a material violation to the issuer's CLO and CEO, the attorney may bypass them and report the evidence to the board or an appropriate committee.

An attorney retained or directed by an issuer to investigate evidence of a reported material violation shall be deemed to be appearing and practicing before the SEC. Directing or retaining an attorney to investigate reported evidence of a material violation does not relieve an officer or director of the issuer to whom such evidence has been reported from a duty to respond to the reporting attorney.

remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or (3) the issuer, with the consent of the issuer's board of directors, an appropriate committee thereof or a QLCC, has retained or directed an attorney to review the reported evidence of a material violation and either (x) has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence or (y) has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation.

⁴⁵ See Patrick McGeehan, *Lawyers Take Suspicion On TV Azteca To Its Board*, New York Times, December 24, 2003, Section C, page 1:

"In one of the first applications of a new provision of the Sarbanes-Oxley Act, outside lawyers for Mexico's second-largest broadcaster have told its board – and, possibly, federal regulators – that they think that the company violated United States securities laws.

"The company, TV Azteca, has had a long-running dispute with lawyers in New York about the need for greater disclosure about transactions that could have yielded a profit of more than \$100 million to the company's billionaire chairman and controlling shareholder, Ricardo B. Salinas Pliego. When company executives refused to make the disclosures that the lawyers demanded, the lawyers cited the new provision of the act, which requires them to notify the company's board and permits them to contact regulators as well.

"... in a Dec. 12 letter to the boards of TV Azteca and its parent company, Azteca Holdings, [outside New York counsel citing SOX §307] told the boards that [the firm] was withdrawing as counsel to the company on a pending bond offering and that it might notify the Securities and Exchange Commission of its withdrawal and the reasons for it."

An attorney shall not have any obligation to report evidence of a material violation if (i) the attorney was retained or directed by the issuer's CLO to investigate such evidence of a material violation and reports the results of such investigation to the CLO and to the board or an appropriate committee or each of the attorney and the CLO reasonably believes that no material violation has occurred, is ongoing, or is about to occur, or (ii) the attorney was retained or directed by the CLO to assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation, and the CLO provides reasonable and timely reports on the progress and outcome of such proceeding to the issuer's board or appropriate committee.

An attorney shall not have any obligation to report evidence of a material violation if the attorney was retained or directed by a QLCC to either investigate such evidence of a material violation or to assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation.

An attorney who receives what he or she reasonably believes is an appropriate and timely response to a report he or she has made need do nothing more under the SOX §307 Rules with respect to his or her report.

An attorney who does not reasonably believe that the issuer has made an appropriate response within a reasonable time to the report or reports made shall explain the reason behind his or her belief to the CLO, the CEO, and the directors to whom the attorney reported the evidence of a material violation. An attorney formerly employed or retained by an issuer who has reported evidence of a material violation under the SOX §307 Rules and reasonably believes that he or she has been discharged for so doing may notify the issuer's board of directors or any committee thereof that he or she believes that he or she has been discharged for reporting evidence of a material violation. Discharging an attorney/employee for reporting under the SOX §307 Rules would violate the whistleblower protections afforded by SOX §806.

The SOX §307 Rules are specific as to how reports thereunder must be made and how the recipient of the report must investigate and respond to the report. The SOX §307 Rules do not restrict informal communication between the issuer representatives and the attorney to resolve the issue, but in the event that the SOX §307 Rules are triggered, the SOX §307 Rules should be promptly and literally complied with, even if it duplicates prior communications informally made to responsible issuer representatives.

Alternative Reporting Procedures For An Issuer That Has Established A QLCC. If an attorney, appearing and practicing before the SEC in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney may, as an alternative to the preceding reporting requirements, report such evidence directly to a QLCC, if the issuer has formed such a committee. An attorney who reports evidence of a material violation to a QLCC has satisfied his or her obligation to report such evidence and is not required to assess the issuer's response to the reported evidence of a material violation.

A CLO may refer a report of evidence of a material violation to a QLCC in lieu of causing an inquiry to be conducted, and shall inform the reporting attorney that the report has been referred to a QLCC. Thereafter, the QLCC shall be responsible for responding to the evidence of a material violation reported to it.

Issuer Confidences. The SOX §307 Rules provide that any report under or any response thereto (or any contemporaneous record of the report or the response) may be used by an attorney in connection with any investigation, proceeding, or litigation in which the attorney's compliance with the SOX §307 Rules is in issue. In the SOX §307 Release, the SEC states that it is making "clear that an attorney may use any records the attorney may have made in the course of fulfilling his or her reporting obligations under this part to defend himself or herself against charges of misconduct," and that the SOX §307 Rules are effectively equivalent to the ABA's present Model Rule 1.6(b)(3) and corresponding "self-defense" exceptions to client-confidentiality rules in every state.⁴⁶

The SOX §307 Rules further provide that an attorney appearing and practicing before the SEC in the representation of an issuer may reveal to the SEC, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably

⁴⁶ The Texas Disciplinary Rules of Professional Conduct provide as follows:

RULE 1.05. CONFIDENTIALITY OF INFORMATION

- (b) Except as permitted by paragraphs (c) and (d), or as required by paragraphs (e) and (f), a lawyer shall not knowingly:
 - (1) Reveal confidential information of a client or a former client . . .
- (c) A lawyer may reveal confidential information:
 - (5) To the extent reasonably necessary to enforce a claim or establish a defense on behalf of the lawyer in a controversy between the lawyer and the client.
 - (6) To establish a defense to a criminal charge, civil claim or disciplinary complaint against the lawyer or the lawyers associates based upon conduct involving the client or the representation of the client.
 - (7) When the lawyer has reason to believe it is necessary to do so in order to prevent the client from committing a criminal or fraudulent act.
 - (8) To the extent revelation reasonably appears necessary to rectify the consequences of a client's criminal or fraudulent act in the commission of which the lawyer's services had been used.
- (e) When a lawyer has confidential information clearly establishing that a client is likely to commit a criminal or fraudulent act that is likely to result in death or substantial bodily harm to a person, the lawyer shall reveal confidential information to the extent revelation reasonably appears necessary to prevent the client from committing the criminal or fraudulent act.

believes necessary: (i) to prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors; (ii) to prevent the issuer from committing or suborning perjury or committing any act that is likely to perpetrate a fraud upon the SEC; or (iii) to rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used. The SOX §307 Release comments that in permitting, but not requiring, an attorney to disclose, under specified circumstances, confidential information related to his appearing and practicing before the SEC in the representation of an issuer, the SOX §307 Rules correspond to the ABA's Model Rule 1.6 as proposed by the ABA's Kutak Commission in 1981-1982 and by the ABA's Commission of Evaluation of the Rules of Professional Conduct ("*Ethics 2000 Commission*") in 2000, and as adopted in the vast majority of states.⁴⁷

Responsibilities of Supervisory Attorneys. An attorney supervising or directing another attorney who is appearing and practicing before the SEC in the representation of an issuer is a "*supervisory attorney*" and is required to make reasonable efforts to ensure that a subordinate attorney that he or she supervises or directs conforms to the SOX §307 Rules. Supervising an attorney in the representation of an issuer in non-SEC related matters, or overall management of a law firm, would not result in an attorney being considered a "supervisory attorney" for SOX §307 purposes.

A supervisory attorney is responsible for complying with the reporting requirements when a subordinate attorney has reported to the supervisory attorney evidence of a material violation and may report evidence of a material violation from a subordinate attorney to the issuer's QLCC.

Responsibilities of a Subordinate Attorney. An attorney who appears and practices before the SEC in the representation of an issuer on a matter under the supervision or direction of another attorney (other than under the direct supervision or direction of the issuer's CLO) is a "*subordinate attorney*" and is obligated to comply with the SOX §307 Rules notwithstanding that the subordinate attorney acted at the direction of or under the supervision of another person.

A subordinate attorney complies with the SOX §307 Rules if the subordinate attorney reports to his or her supervising attorney evidence of a material violation of which the subordinate attorney has become aware in appearing and practicing before the SEC, but may "report up the ladder" if the subordinate attorney reasonably believes that the supervisory attorney to whom he or she has reported evidence of a material violation has failed to comply with the SOX §307 Rules.

Sanctions and Discipline. A violation of the SOX §307 Rules by any attorney appearing and practicing before the SEC in the representation of an issuer shall subject such attorney to the civil penalties and remedies for a violation of the federal securities laws available to the SEC, regardless of whether the attorney may also be subject to discipline for the same conduct in a jurisdiction where the attorney is admitted or practices.

⁴⁷ *Id.*

An attorney who complies in good faith with the provisions of the SOX §307 Rules is not subject to discipline or otherwise liable under inconsistent standards imposed by any state or other U.S. jurisdiction where the attorney is admitted or practices.

Issues of compliance with the SOX §307 Rules will likely arise when a corporate debacle emerges and the SEC staff investigates to find out who knew what and when, and asks where the lawyers were. In that context the staff will look at whether there was compliance with the SOX §307 Rules. Under such circumstances, lawyers would be more comfortable if they could point to strict compliance with the SOX §307 Rules rather than trusting to prosecutorial discretion to conclude that substantial compliance was good enough.

No SOX §307 Private Right of Action. The SOX §307 Rules provide that nothing therein is intended to, or does, create a private right of action against any attorney, law firm, or issuer based upon compliance or noncompliance with its provisions. Authority to enforce compliance with the SOX §307 Rules is vested exclusively in the SEC.

Enron Civil Liability Fallout. Compliance with the requirements of the SOX §307 Rules does not assure attorneys that they will not be subject to private claims based on other securities laws.⁴⁸ In her lengthy opinion dated December 19, 2002 on the motions to dismiss filed by Vinson & Elkins L.L.P. (“V&E”), Kirkland & Ellis (“K&E”), Arthur Andersen LLP and nine banks in the *Newby v. Enron* case, Judge Melinda Harmon granted the motions to dismiss of K&E and Deutsche Bank, but denied in whole or in part the motions of V&E, Arthur Andersen, J.P. Morgan Chase, Citigroup, Credit Suisse, CIBC, Merrill Lynch, Barclays, Lehman Brothers and Bank America. In exploring the circumstances under which law firms, accounting firms, and investment banks/integrated financial services institutions (lumped together by the Court as “secondary actors in securities markets”) can be liable for the acts of companies they serve under SEC Rule 10b-5 and the Texas Securities Act, the Court noted that it was influenced by revelations of corporate corruption in other courts, Congress, investigations by the SEC and New York Attorney General Eliot Spitzer, and the media.

While paying homage to the 1994 holding of the Supreme Court in *Central Bank of Denver*⁴⁹ that a private plaintiff may not bring an aiding and abetting claim under Rule 10b-5, the Court found that the Supreme Court had left open for it to determine when the conduct of a secondary actor makes it a primary violator subject to liability under Rule 10b-5. Rejecting the “bright line” test that a defendant must actually make a false or misleading statement to be liable, the Court adopted the SEC’s amicus position that a defendant can be liable if it “creates” a misleading document even though the defendant is not identified with it to the outside world,

with “reliance” being established under the “fraud on the market” theory.⁵⁰ “Scienter” remains a crucial element, with the plaintiff having to show intent to deceive or extreme recklessness to sustain a Rule 10b-5 claim.

The Court gave a broad reading to the liability provisions of the Texas Securities Act,⁵¹ commenting that “liability may be imposed against a defendant [who] constituted any link in the chain of the selling process” and that proof of reliance or scienter are not required. The Court found that the Texas Securities Act “applies if any act in the selling process of securities...occurs in Texas.”⁵²

With respect to attorney liabilities, the Court acknowledged that Texas law requires privity for malpractice liability, but found that claims for fraudulent or negligent misrepresentation can be made by those who the attorney had reason to know would rely on the information and who justifiably relied on it. The Court concluded that “professionals, including lawyers and accountants, when they take the affirmative step of speaking out, whether individually or as essentially an author or co-author in a statement or report, whether identified or not, about their client’s financial condition, do have a duty to third parties not in privity not to knowingly or with severe recklessness issue materially misleading statements on which they intend or have reason to expect that those third parties will rely.”

In denying V&E’s motion to dismiss, the Court recited V&E’s involvement in structuring the partnerships and special purpose entities (“SPEs”) that contributed to Enron’s demise and in working on its SEC filings and other public disclosures, and found that V&E “was necessarily privy to its client’s confidences and intimately involved in and familiar with the creation and structure of its numerous businesses, and thus, as a law firm highly sophisticated in commercial matters, had to know of the alleged ongoing illicit and fraudulent conduct.” The Court wrote that V&E “was not merely a drafter, but essentially a co-author of the documents it created for public consumption.” The Court commented “[r]elevant to Vinson & Elkins undertaking of the investigation of Enron in the fall of 2001, [Texas Rule of Professional Conduct] 1.06(a)(2) bars a lawyer from representing a client where that representation ‘reasonably appears to be or becomes limited by the lawyer’s or law firm’s own interests....’ [and under such circumstances] a client’s consent is not effective....”

However, the Court dismissed the lawsuit as to K&E, calling the charges against K&E “conclusory and general.” The Court said any documents K&E drafted were for private

⁴⁸ See Memorandum and Order Re Secondary Actors’ Motion to Dismiss filed December 20, 2002 in *In re Enron Corp. Securities, Derivative and ERISA Litigation*, 235 F.Supp. 2nd 549 (S.D. Tex. 2002), Civil Action No. H-03-3624, Consolidated Cases (also known as *Newby v. Enron* or the *Newby* case) (the opinion is 159 pages long in F.Supp. 2nd).

⁴⁹ *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), in which the U.S. Supreme Court held that SEC Rule 10b-5 prohibits only the making of a material misstatement or omission (or the commission of a manipulative act) and does not prohibit the giving of aid to another who then commits a primary Rule 10b-5 violation.

⁵⁰ The Court in *Newby* wrote: “Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability . . . are met.”

⁵¹ Tex. Sec. Act §33, Art. 581-33 Tex. Rev. Civ. Stat. (Vernon Supp. 2002).

⁵² *Brown v. Cole*, 155 Tex. 624, 291 S.W.2d 704, 708 (Tex. 1956); *Rio Grande Oil Co. v. State*, 539 S.W.2d 917, 922 (Tex. Civ. App.-Houston [1st Dist.] 1976, writ ref’d n.r.e.); *Texas Capital Securities, Inc. v. Sandefer*, 58 S.W.3d 760, 775 (Tex. App. – Houston [1st Dist.] 2001).

transactions, “and were not included in or drafted for any public disclosure or shareholder solicitation” and noted that K&E was not Enron’s counsel for its securities or SEC filings.

Attorney-Client/Work Product Privilege. The final SOX §307 Rules do not contain any provision to the effect that information reported by an attorney to the SEC does not constitute a waiver of any attorney-client or other privilege. The SOX §307 Release states that the SEC finds that allowing issuers to produce internal reports to the SEC, including those prepared in response to reports as a result of the SOX §307 Rules, without waiving an otherwise applicable attorney-client and other privilege, enhances the SEC’s investigatory and enforcement capabilities and, thus, is in the public interest. The SOX §307 Release further states that the SEC will continue to follow its policy of entering into confidentiality agreements where it determines that its receipt of information pursuant to those agreements will ultimately further the public interest, and will vigorously argue in defense of those confidentiality agreements where litigants argue that the disclosure of information pursuant to such agreements waives any privilege or protection.⁵³

Differences From Proposed Rules. On November 21, 2002, the SEC issued Release No. 33-8150, which can be found at <http://www.sec.gov/rules/proposed/33-8150.htm>, that proposed rules under SOX §307. After comment, the final SOX §307 Rules were issued on January 29, 2003 and differ in a number of respects from the initially proposed rules.

The final SOX §307 Rules continue to emphasize, as did the proposed rules, that a lawyer for the corporation owes allegiance to the corporation and not to the individual who was responsible for retaining the lawyer or the lawyer’s firm, but differ from the proposed rules in at least three important respects: First, in a reluctant retreat from the proposed “noisy withdrawal” rule, which many felt would have involved a breach of the attorney-client privilege, securities lawyers will **not** be required, if company executives and the board do not respond appropriately to a lawyer’s warning or expressed concern that a material securities violation has occurred or will occur, to resign representation, report to the SEC that their resignation is for “professional reasons,” and disaffirm any “tainted” documents filed with or submitted to the SEC.

Instead, the SEC extended for 60 days the comment period on the “noisy withdrawal” proposal, while proposing an alternative that still would require a lawyer to withdraw, but that would place instead upon the company the burden to report the lawyer’s withdrawal.⁵⁴ Under the proposed alternative, the company would publicly disclose on a Form 8-K within two business days after the lawyer’s withdrawal for professional considerations, or of having received a notice from its lawyer that the issuer did not appropriately respond to the lawyer’s report of a material violation, either or both of such events. If the company does not make the

required disclosure, the lawyer would then be permitted (but not required) to inform the SEC that he or she had withdrawn. In-house counsel would be required only to cease participating in the matter involving the violation and notify the company in writing that he or she believed the company had not appropriately responded to the lawyer’s report of a material violation.

Second, the SEC changed the text of the rule specifying when lawyers must report “up the ladder.” Under proposed rules, a lawyer had to report up the ladder if he had “*evidence of a material violation of securities law or breach of fiduciary duty or similar violation*” by a client. Under the final rules adopted, a lawyer must report “*credible evidence based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.*” While this standard developed from the SEC’s attempt to make objective rather than subjective the test of when a lawyer must report a violation, its tortured manner of expression, in terms of a double negative (“unreasonable ... not to conclude that it is reasonably likely...”), may simply increase the SEC’s burden of proving a lawyer has failed to comply. In response to questions at the open meeting, the SEC staff suggested that this standard has a lower threshold than a “more likely than not” standard.

Third, the final SOX §307 Rules clarify that they cover lawyers providing legal services who have an attorney-client relationship, and then only if the lawyer has notice that documents they are preparing or assisting in preparing will be filed with or submitted to the SEC.

Other highlights of the final SOX §307 Rules include (a) removal of the requirement that issuers and their lawyers document reports of violations and the related responses; (b) clarification of coordination with state-mandated reporting obligations: namely, that the final SOX §307 Rules control if they conflict with less rigorous reporting requirements under state law, but that more rigorous state-imposed up-the-ladder reporting obligations will control, as long as they are not inconsistent with these rules; and (c) affirmation that the final SOX §307 Rules are enforceable exclusively by the SEC and do not create any private right of action.

Finally, the proposed SOX §307 rules provided that an issuer does not waive any applicable privileges by sharing confidential information regarding misconduct by the issuer’s employees or officers with the SEC pursuant to a confidentiality agreement, but this was replaced in the final rule release with commentary that such is the SEC’s view of good public policy.

IV. ATTORNEY-CLIENT PRIVILEGE AND THE WORK PRODUCT DOCTRINE IN THE CORPORATE CONTEXT

Introduction. Our system of jurisprudence is designed to facilitate resolving lawsuits based on what the facts reveal, not by what lawyers conceal. So that the real facts may be made known to all parties, the parties are permitted discovery from their opponents before trial begins. Each party may be called upon by his adversary or the court to, in effect, lay his cards on the table so that the dispute may be resolved on the basis of what all the cards show, rather than on the relative skill of the players. This philosophy is intended to level the tables between

⁵³ In *Saito v. McKesson HBOC, Inc.*, 2002 WL 31458233 (Del. Ch. Oct. 25, 2002), the Delaware Chancery Court, while acknowledging inconsistent holdings from other jurisdictions, held that the attorney work product privilege had not been waived as to private litigants in respect of documents furnished to the SEC pursuant to a confidentiality agreement during an SEC investigation, but had been waived as to documents furnished to the SEC before a confidentiality agreement had been executed.

⁵⁴ See SEC Release No. 33-8186 (January 29, 2003), which can be found at <http://www.sec.gov/rules/proposed/33-8186.htm>.

institutional litigants, perceived to have greater resources, and the individuals against whom they are often aligned. Countervailing considerations in the interests of fairness have produced a few limited exceptions to this policy of openness.

Attorney-Client Privilege.

Overview. The attorney-client privilege is the oldest recognized privilege against discovery known to the common law. It traces its roots back to the reign of Elizabeth I in the 16th century⁵⁵ during the days when a lawyer's honor as a gentleman was paramount.⁵⁶ The policy behind recognition of the privilege was most simply expressed by the United States Supreme Court in *Upjohn Co. v. United States*,⁵⁷ where the Court characterized the purpose of the privilege as being "to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice."⁵⁸ A more eloquent justification is found in the comment to Rule 210 of the American Law Institute's *Model Code of Evidence*:

In a society as complicated in structure as ours and governed by laws as complex and detailed as those imposed upon us, expert legal advice is essential. To the furnishing of such advice the fullest freedom and honesty of communication of pertinent facts is a prerequisite. To induce clients to make such communications, the privilege to prevent their later disclosure is said by courts and commentators to be a necessity. The social good derived from the proper performance of the functions of lawyers acting for their clients is believed to outweigh the harm that may come from the suppression of the evidence in specific cases.⁵⁹

Unfortunately, one of the complex and detailed laws referred to in the aforementioned comment turns out to be the attorney-client privilege itself. There are numerous requirements for the privilege to be applicable, and judicial interpretations differ from jurisdiction to jurisdiction and even from judge to judge.⁶⁰

⁵⁵ See *Kelway v. Kelway*, 21 Eng. Rep. 47 (Ch. 1580).

⁵⁶ Because divulging confidences entrusted to him would do him dishonor, it was the attorney, not the client who could exercise the privilege. The privilege now is considered to belong to the client, and not the lawyer. See *Apex Mun. Fund v. N-Group Securities*, 841 F. Supp. 1423 (S.D. Tex. 1993).

⁵⁷ 449 U.S. 383 (1981).

⁵⁸ *Id.* at 389.

⁵⁹ A.L.I. MODEL CODE OF EVID., Rule 210, comment (quoted in *United States v. United Shoe Mach. Corp.*, 89 F. Supp. 349, 358 (D. Mass. 1950)).

⁶⁰ "So that lawyers and clients will know in advance what communications will and will not be protected, and can conform their conduct accordingly, courts have endeavored to draw the lines with some clarity. Of course, it is impossible to achieve absolute certainty. At the margins, the application of the privilege is not always clear, and indeed, treatises can and have been written on the privilege, its exceptions, its intricacies, and its areas of ambiguity. Further uncertainty results from the fact that the relevant case decisions (and, in some states, statutes) differ from jurisdiction to jurisdiction. With respect to federal proceedings, Congress

The attorney-client privilege protects communications of legal advice between attorneys and clients, including communications between corporate employees and a corporation's attorneys to promote the flow of information between clients and their attorneys. Although the attorney-client privilege does not require ongoing or threatened litigation, it covers only "communications" between the lawyer and his client for the purposes of legal assistance.

The core requirement of the attorney-client privilege is that the confidentiality of the privileged information be maintained. Therefore, the privilege is typically waived when the privilege holder discloses the protected information to a third party. A waiver of attorney-client privilege destroys the attorney-client privilege with respect to all future opposing parties and for the entire subject matter of the item disclosed.

Further, the attorney-client privilege does not protect all things that pass back and forth between attorneys and their clients under all circumstances. A number of the requirements and limitations of the attorney-client privilege are discussed in the subsections which follow.

Derivative Actions. There is an issue as to whether a shareholder or a partner may compel disclosure of matters protected by the attorney-client privilege on the theory that he is the "client" or at least a "representative of the client." The leading shareholder case on this issue is *Garner v. Wolfinbarger*.⁶¹ In that case, the Fifth Circuit concluded that a shareholder maintaining a derivative action may have access to matters protected by the attorney-client privilege if he can show "good cause." The court set forth the circumstances by which good cause is to be judged, which include such factors as, the number of shareholders involved, the percentage of ownership they represent, the nature of the claim being made and the allegations made against the corporate officers, and similar concerns.⁶² The *Garner* doctrine has been followed by some courts,⁶³ but has been rejected as unnecessary by other courts, especially in

has not codified the attorney-client privilege but has authorized ongoing common law development of this and other privileges. Pursuant to its authority under the Federal Rules of Evidence, the Supreme Court of the United States has consistently recognized and upheld the privilege. But the Supreme Court has resolved only a limited number of questions concerning the boundaries of the privilege, and on the remaining questions, different districts and circuits – and even different judges within a given federal district – may take different approaches." *Report of ABA's Task Force on the Attorney-Client Privilege*, 60 Bus. Lawyer 1029, 1033 (May 2005).

⁶¹ 430 F.2d 1093 (5th Cir. 1970), *cert. denied*, 401 U.S. 974 (1971).

⁶² *Id.* at 1103-04.

⁶³ *In re Fuqua Industries, Inc. Shareholders Litigation*, Civ. Act. No. 11974, Del. Ch. May 2, 2002 (in the context of a derivative claim arising out of the Fuqua directors' decision to except its principal shareholder from Delaware General Corporation Law § 203 (which restricts certain transactions with a 15% shareholder) and to authorize the repurchase of Fuqua shares allegedly for the purpose of enhancing the principal shareholder's control without paying a change in control premium and entrenching the directors, Chancellor Chandler wrote *Garner* requires "mutuality of interest between the parties" at the time of the disputed communication; "because the director is obligated to act in the best interests of the corporation and its shareholders, there is a mutuality of interest among the director, the corporation and the shareholders when such legal advice is sought . . . upon a showing of good cause, the attorney-client privilege does not attach to prevent a plaintiff-shareholder – for whose ultimate benefit that advice was sought – from discovering the contents of the communication . . . when the interests of the fiduciary

light of the other exceptions to the attorney-client privilege, most notably the crime/fraud exception.⁶⁴ Further, the Garner exception is only applicable to the attorney-client privilege and will not result in discovery if the item is also protected by the work product doctrine.⁶⁵ In the partnership context, the courts have consistently held that the attorney-client privilege may not be used to deny a partner the right to inspect partnership records.⁶⁶

diverge, however, there is no longer a mutuality of interest and a *Garner* analysis is not appropriate . . . that divergence must necessarily occur when the parties can reasonably anticipate litigation over a particular action"; "there is no *Garner* exception to the work product privilege"; *Deutsch v. Cogan*, 580 A.2d 100, 108 (Del. Ch. 1990) ("A fiduciary owes an obligation to his beneficiaries to go about his duties without obscuring reasons from the legitimate inquiries of the beneficiaries"); cf. *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 348 (1985).

⁶⁴ See, e.g., *Shirvani v. Capital Investing Corp.*, 112 F.R.D. 389, 390 (D. Conn. 1986).

⁶⁵ *Saito v. McKesson HBOC, Inc.*, 2002 Del. Ch. LEXIS 125 at 11 (Del. Ch. October 25, 2002); *In re Fuqua Indus. Shareholders Litig.*, 2002 Del. Ch. LEXIS 52 at 20 (Del. Ch. May 2, 2002).

⁶⁶ The courts that have considered the question whether a general partner may shield documents from its limited partner have consistently held that it cannot. See *Roberts v. Heim*, 123 F.R.D. 614, 625 (N.D. Cal. 1988) (limited partners of a partnership sued the partnership's general partners and its law firm to compel production of certain documents the defendants claimed were privileged; rejecting the defendant's argument that, for purposes of the attorney-client privilege, the law firm's clients were the general partners, the court held that the limited partners were clients of the law firm and were entitled to inspect all of the partnership's records, including the documents generated by and sent to the partnership's attorneys); *McCain v. Phoenix Resources, Inc.*, 230 Cal. Rptr. 25, 26-28 (Cal. Ct. App. 1986) (court concluded that "a limited partner has the right to inspect all documents and papers affecting the partnership, including those held by the partnership's attorney;" while recognizing that the attorney-client privilege could be asserted as to records relating to the "purely private or personal interest" of one of the partners, the court held the privilege would not bar disclosure of matters related to a partnership business "simply because such business was conducted through a law firm"); *Wortham & Van Liew v. Superior Court*, 233 Cal. Rptr. 725, 728 (Cal. Ct. App. 1987) (the court framed the issue as whether "the attorney for the partnership [could] withhold from a partner important information received from another partner concerning partnership transactions claiming the information is confidential under the attorney-client privilege," held that "[a]ll partners are entitled to access to a wide range of partnership information, whether or not that information is generated under the aegis of the partnership's attorney," and ordered the attorney to "divulge all partnership information to all partners"); *Abbott v. The Equity Group*, 1988 WL 86826 (E.D. La. 1988) ("We begin by stating that a member of a partnership is entitled to disclosure of communications to and from an attorney representing the partnership in connection with partnership matters. Because of the relationship existing between partners in the creation of a partnership, which we view as stronger than that existing between stockholder and corporation, we conclude that the bar preventing disclosure of attorney communications, as between partners, is not simply relaxed, but non-existent. Partners therefore need not establish "cause" to discover privileged communications of an attorney in matters in which the partnership, of which they are members, is the client"); *Adell v. Somers*, 428 N.W.2d 26 (Mich. App. 1988) (limited partner is "client" of partnership's law firm and has standing to assert malpractice claim against attorney); *Bronson v. Superior Court*, 29 Cal. Rptr. 2d 268 (Cal. Ct. App. 1994) (because of mere "potential presence of implied attorney-client duties," limited partner is entitled to production of documents concerning partnership business over privilege objection); but see *Continental Ins. Co. v. Rutledge & Co., Inc.*, 1999 WL 66528 (not reported in A.2nd) (Del. Ch. Jan. 26, 1999) (in dispute between general and limited partners over whether limited partners had right to withdraw from partnership pursuant to partnership agreement, limited partners sought to compel production by general partner of documents containing legal advice regarding the formation and internal affairs of the partnership; the Delaware Chancery Court found an absence of Delaware precedent and followed the Fifth Circuit's corporate derivative action holding in *Garner v. Wolfenbarger* that allowed

Legal Advice Purpose. At the heart of the attorney-client privilege is the notion that communications are privileged in order to facilitate the delivery of legal advice. The privilege necessarily has encompassed communications that actually constitute legal advice as well as communications made for the purpose of seeking, obtaining or facilitating the rendition of legal advice. But the privilege does not protect all communications to or from an attorney.⁶⁷ Accordingly, sending copies of documents to an attorney or including an attorney in a meeting will not automatically trigger the privilege.⁶⁸ It is only where the attorney is acting in his capacity as an attorney, that is, as a legal adviser, that the privilege is applicable.⁶⁹

In many circumstances, especially for in-house counsel, the determination of whether an attorney is acting in his capacity as a legal adviser, or in some other role, will be difficult.⁷⁰ The difficulty may be increased when the attorney (whether in-house or outside counsel) also serves as a director of the corporation, because business advice is not privileged.⁷¹

production upon a showing of "good cause" and the existence of a mutuality of interest between the parties; the required mutuality of interest was found lacking as to advice in connection with the formation of the partnership and after a dispute had arisen between the parties over the withdrawal issue that was the subject of the litigation).

⁶⁷ See *Thacker v. State*, 852 S.W.2d 77 (Tex. App. — Austin 1993, writ denied).

⁶⁸ See, e.g., *U.S. Postal Serv. v. Phelps Dodge Ref. Corp.*, 852 F. Supp. 156, 163-64 (E.D.N.Y. 1994) (stating that "[a] corporation cannot be permitted to insulate its files from discovery simply by sending a 'cc' to in-house counsel"); *International Tel. & Tel. Corp. v. United Tel. Co. of Fla.*, 60 F.R.D. 177, 185 (M.D. Fla. 1973) (finding that "the mere attendance of an attorney at a meeting, even where the meeting is held at the attorney's instance, does not render everything done or said at that meeting privileged").

⁶⁹ See *USA v. Ackert*, 169 F.3d 136 (2nd Cir. 1999) (attorney functioning as investment banker for Goldman Sachs & Co. provided information as to tax implications of a proposed transaction to tax counsel for Paramount; recognizing that attorney-client privilege applies only to communications between an attorney and his client, court held that the attorney at Goldman Sachs was not functioning as an attorney and that the attorney-client privilege was not applicable even though the communication did assist Paramount's attorney in representing his client); *Teltron, Inc. v. Alexander*, 132 F.R.D. 394 (E.D. Pa. 1990).

⁷⁰ See Todd Presnell, *A Higher Standard: Claiming Attorney-Client Privilege is Tougher for In-House Counsel*, 14 Business Law Today No. 5 (May/June 2005) at 19; Derek Lisk, *When Does the Texas Attorney-Client Privilege Protect Communications With In-House Counsel?*, 68 Tex. B.J. 368 (May 2005).

⁷¹ ABA Formal Opinion 98 410 (February 1998) holds that a lawyer may serve as a director of client-business entities provided the following precautions are taken:

The Committee acknowledges that lawyers will continue to be asked and many will accept engagements as directors of client business entities and that it is not unethical for them to do so. It nevertheless is essential that lawyer-directors and their clients continue to be sensitive to the issues discussed in this opinion.

Though a lawyer serving in the dual role of corporate counsel and director is not subject to discipline absent a violation of a specific Rule, the following suggestions . . . should help to avoid a disciplinary infraction. The lawyer-director should:

1. Reasonably assure that management and the board of directors understand (i) the different responsibilities of legal counsel and director; (ii) that when acting as legal counsel, the lawyer represents

No bright-line tests have been developed for determining whether the attorney is acting as a legal advisor.⁷² Most courts have stated that, for a communication to be privileged, the lawyer must be acting “primarily” or “predominantly” as a lawyer,⁷³ although business advice may be intermingled with the legal advice and still be privileged.⁷⁴ One court defined “primarily legal” as requiring a showing that the communication “would not have been made but for the corporation’s need for legal advice or services.”⁷⁵ Another court has stated that the “critical

only the corporate entity and not its individual officers and directors; and (iii) that at times conflicts of interest may arise under the rules governing lawyers’ conduct that may cause the lawyer to recuse herself as a director or to recommend engaging other independent counsel to represent the corporation in the matter, or to serve as co-counsel with the lawyer or her firm.

2. Reasonably assure that management and the board of directors understand that, depending upon the applicable law, the attorney-client evidentiary privilege may not extend to matters discussed at board meetings when the lawyer-director is not acting in her corporate counsel role and when other lawyers representing the corporation are not present in order to provide legal advice on the matters.

3. Recuse herself as a director from board and committee deliberations when the relationship of the corporation with the lawyer or her firm is under consideration, such as issues of engagement, performance, payment or discharge.

4. Maintain in practice the independent professional judgment required of a competent lawyer, recommending against a course of action that is illegal or likely to harm the corporation even when favored by management or other directors.

5. Perform diligently the duties of counsel once a decision is made by the board or management, even if, as a director, the lawyer disagrees with the decision, unless the representation would assist in fraudulent or criminal conduct, self-dealing or otherwise would violate the Model Rules.

6. Decline any representation as counsel when the lawyer’s interest as a director conflicts with her responsibilities of competent and diligent representation, for example, when the lawyer is so concerned over her personal liability as a director resulting from the course approved by management or the board that her representation of the corporation in the matter would be materially and adversely affected.

See Harris and Valihura, *Outside Counsel as Director: The Pros and Potential Pitfalls of Dual Service*, 53 The Business Lawyer 479, 483-89 (Feb. 1998).

⁷² In *In re Texas Farmers Insurance Exchange*, 1999 WL 74099 (Tex. Civ. App. - Texarkana Feb. 18, 1999), the Texarkana Court of Appeals held that communications between an insurance company and an attorney conducting for it a routine investigation of a fire of suspicious origin to determine whether a claim should be paid were not privileged because the attorney was not functioning as such at the time of the communications and the communications concerned bare facts, but that the privilege would apply to communications with the attorney concerning legal strategy, assessments and conclusions.

⁷³ See, e.g., *Sedco Int’l. S.A. v. Cory*, 683 F.2d 1201, 1205 (8th Cir.), cert. denied, 459 U.S. 1017 (1982) (“primarily”); *Arcuri v. Trump Taj Mahal Assocs.*, 154 F.R.D. 97, 102 (D.N.J. 1994) (“primarily”); *Zenith Radio Corp. v. Radio Corp. of Am.*, 121 F. Supp. 792, 794 (D. Del. 1954) (“predominantly”).

⁷⁴ See *Pittsburgh Corning Corp. v. Caldwell*, 861 S.W.2d 423 (Tex. App. — Houston [14th Dist.] 1993, no writ) (holding that the court was without authority to order privileged legal advice, opinions, or mental analysis in documents redacted and remainder produced).

⁷⁵ *Leonen v. Johns Manville*, 135 F.R.D. 94, 99 (D.N.J. 1990).

inquiry is whether, viewing the lawyer’s communication in its full content and context, it was made in order to render legal advice or services to the client.”⁷⁶ By contrast, another court has held that legal advice may not be privileged if it is only incidental to business advice.⁷⁷

Attorneys and clients recognize that statements made by an attorney to his client’s adversary in a negotiation are not privileged, but would expect that private communications between attorney and client in respect of the negotiation would be privileged. Many courts, however, have held that a lawyer conducting negotiations is not acting in a legal capacity and his communications and advice to his client, therefore, are not privileged.⁷⁸ Undoubtedly, the notion that a negotiating lawyer is not acting in a legal capacity is surprising and alarming to all lawyers, not just to corporate counsel. The courts that have so held generally base their decision on the idea that the negotiation involves business judgment, not legal judgment. Fortunately, some courts have been more painstaking in their analysis and have concluded that the negotiation did, in fact, involve a preponderance of legally significant issues, and therefore, was a privileged act.⁷⁹ This idea is often referred to as “predominant purpose” test.⁸⁰ Unfortunately, there are no bright line rules to identify the precise degree of legal advice necessary to satisfy the predominant purpose test.

Internal Investigations. Most courts agree in principle that an investigation conducted by counsel for the purpose of rendering legal advice is privileged.⁸¹ Generally speaking, though, the fact that a lawyer is involved in an investigation does not, standing alone, render the privilege applicable. However, determining whether an investigation is conducted for that purpose, or some other, can be difficult.

There are a number of cases involving the application of the attorney-client privilege⁸² to investigations conducted by counsel. In *Upjohn*, the privilege was held applicable when the

⁷⁶ *Spectrum Sys. v. Chemical Bank*, 581 N.E.2d 1055, 1061 (N.Y. 1991).

⁷⁷ *United States v. IBM*, 66 F.R.D. 206, 210 (S.D.N.Y. 1974).

⁷⁸ See, e.g., *United States v. Wilson*, 798 F.2d 509 (1st Cir. 1986); *Georgia-Pacific Corp. v. GAF Roofing Mfg. Corp.* 1996 WL 29392 (S.D.N.Y. 1996); *J.P. Foley & Co. v. Vanderbilt*, 65 F.R.D. 523 (S.D.N.Y. 1974).

⁷⁹ In *Note Funding Corp. v. Bobian Investment Co.*, No. 93 CIV. 7427 (DAB), 1995 WL 662402 (S.D.N.Y. Nov. 9, 1995), the court reasoned that “[i]f the attorney’s advice is sought, at least in part, because of his legal expertise and the advice rests “predominantly” on his assessment of the requirements imposed, or the opportunities offered, by applicable rules of law, he is performing the function of a lawyer.”

⁸⁰ See, e.g., *McCormick, Barstow, Shepheard, Wayte & Carruth v. Superior Court*, Cal. Court. App. 5th Dist. No. F029503 (1998) (internal memos prepared by law firm in anticipation of becoming a defendant in a malpractice case held not privileged).

⁸¹ *Report of ABA’s Task Force on the Attorney-Client Privilege*, 60 Bus. Lawyer 1029, 1036 (May 2005).

⁸² Other privileges, more appropriate to rely upon, are often implicated, but are not discussed here. These might include the work product doctrine and the party communication privilege. There is no general “privilege of self-critical analysis” applicable to compliance manuals, internal audit findings, outside accountants’ reports, management letters, and an outside accounting firm’s review of internal controls and

investigation was conducted by “counsel for Upjohn acting as such, at the direction of corporate superiors in order to secure legal advice from counsel.”⁸³ The Supreme Court quoted from the findings of the magistrate, who found:

“[Counsel] consulted with the Chairman of the Board and outside counsel and thereafter conducted a factual investigation to determine the nature and extent of the questionable payments *and to be in a position to give legal advice to the company with respect to the payments.*”⁸⁴

By contrast, the court in *Mission Nat'l Ins. Co. v. Lilly*⁸⁵ found the results of an investigation conducted by outside counsel not privileged. There, the outside lawyers were hired by an insurance company “as a matter of course to conduct its claims adjustment investigations in a geographic area including Minnesota for all claims exceeding \$25,000.”⁸⁶ Thus, the court concluded that the lawyers were simply performing the business function of claims investigation, as opposed to any legal function.⁸⁷

The touchstone of an investigation that constitutes an attorney-client privileged exercise seems to be the attorney’s role as legal adviser. Where the investigation truly can be shown to have been conducted for the purpose of collecting the data necessary to render legal advice, then communications made during the investigation will be deemed privileged.⁸⁸ On the other hand, when a lawyer is used merely in the hope that the investigation will be privileged, most courts will not so find.⁸⁹ The safest practice is to document the reason for conducting the investigation,

compliance. See *Dowling v. American Hawaii Cruises, Inc.*, 971 F.2d 423, 425-26 (9th Cir. 1992) (no protection for routine internal safety reviews prior to the accident); Note, *The Privilege of Self-Critical Analysis*, 96 HARV. L.R. 1083 (1983). But see *In re Crazy Eddie Securities Litigation*, 792 F. Supp. 197, 205-06 (E.D.N.Y. 1992) (accounting firm’s internal review of its audit, peer review report and letter of comments on internal quality controls protected). The Texas Legislature has recognized the value of critical self evaluation in certain areas when it adopted the Environmental, Health, and Safety Audit Privilege Act which appears at Tex. Rev. Civ. Stat. Ann. art. 4447cc (Vernon 1998); other states have similar statutes but the Environmental Protection Agency does not recognize the privilege. See Egan, *Miscellaneous Updates--“Ten Other Laws You Should Know About”*, State Bar of Texas Professional Development Legislative Update Institute (Sept. 1995).

⁸³ *Upjohn*, 449 U.S. at 394.

⁸⁴ *Id.* (emphasis original).

⁸⁵ 112 F.R.D. 160 (D. Minn. 1986).

⁸⁶ *Id.* at 162.

⁸⁷ See also *In re Texas Farmers Insurance Exchange*, 990 S.W.2d 337 (Tex. App. - Texarkana 1999, no pet.) (communications between insurance company and an attorney functioning as an investigator were not privileged because the attorney was not functioning as such at the time of the communications).

⁸⁸ See, e.g., *In re LTV Securities Lit.*, 89 F.R.D. 595 (N.D. Tex. 1981); *Spectrum Systems Int'l Corp. v. Chemical Bank*, 581 N.E.2d 1055 (N.Y. 1991).

⁸⁹ But see *Diversified Indus., Inc. v. Meredith*, 572 F.2d 596 (8th Cir.), *rev'd on reh'g en banc*, 572 F.2d 609 (8th Cir. 1978) (finding that use of an attorney is prima facie evidence of privilege).

and include in all written communications some prefatory notation regarding the purpose for the communication along with the requirement that it be kept confidential.⁹⁰

Generally Unprivileged Items. Consistent with the idea that the communication must be for the purpose of rendering or facilitating legal advice, various types of information relating to the attorney-client relationship or otherwise in the possession or knowledge of the attorney are not considered privileged. These include the identity of the client,⁹¹ fee arrangements,⁹² factual circumstances surrounding the communication,⁹³ and billing statements.⁹⁴

Waiver. The privileged nature of an attorney-client communication must be preserved by not voluntarily disclosing the privileged communication to third parties⁹⁵ or injecting it as an issue in litigation. The privilege belongs to the client, and only may be waived by the client or by the attorney as agent for the client.⁹⁶

Compelled disclosure does not constitute a waiver.⁹⁷ Governmental authorities are increasingly putting pressure on corporations to “voluntarily” provide privileged information to

⁹⁰ E.g. “This interview is conducted by counsel for XYZ, Inc. for the purpose of ascertaining facts needed in order to render legal advice to XYZ, Inc. This document is a confidential, attorney-client privileged communication; the contents of this document should not be disclosed other than to [insert names or titles].” In addition, inclusion of statements relevant to showing work product also might be helpful. E.g. “This document is prepared by counsel in anticipation of litigation for the purpose of facilitating the defense or prosecution of litigation.”

⁹¹ See *In re Grand Jury Subpoena Served upon Doe*, 781 F.2d 238 (2d Cir.) (en banc), *cert. denied sub nom.*, *Roe v. United States*, 475 U.S. 1108 (1986); *Humphreys, Hutcheson and Mosely v. Donovan*, 755 F.2d 1211 (6th Cir. 1985). But see *In re Grand Jury Proceedings (Jones)*, 517 F.2d 666 (5th Cir. 1975) (identity protected to the extent it constitutes last link to inculcate client).

⁹² See *In re Two Grand Jury Subpoenae Duces Tecum*, 793 F.2d 69 (2d Cir. 1986).

⁹³ See *Condon v. Petacque*, 90 F.R.D. 53 (N.D. Ill. 1981).

⁹⁴ See *Clarke v. American Commerce Nat'l Bank*, 974 F.2d 127 (9th Cir. 1992).

⁹⁵ See, e.g., *United States v. Stewart*, 287 F.Supp. 2d 461 (S.D.N.Y. 2003) (Martha Stewart lost the attorney-client privilege covering her e-mail to her lawyer by sharing it with her own daughter); *Stenovich v. Wachtell, Lipton, Rosen & Katz*, 756 NYS 2d 367 (N.Y. App. Div. 2003) (attorney-client privilege lost as to communications shared with corporation’s investment bankers); *United States v. El Paso Co.*, 682 F.2d 530, 540-41 (5th Cir. 1982), *cert. denied*, 466 U.S. 944 (1984) (disclosure to outside auditors of internal tax analysis in which attorneys participated constituted waiver of attorney-client privilege); *In re John Doe Corp.*, 675 F.2d 482, 488-89 (2nd Cir. 1982) (disclosure of internal report to outside auditors and underwriters constituted waiver of the attorney-client privilege).

⁹⁶ *Report of ABA’s Task Force on the Attorney-Client Privilege*, 60 Bus. Lawyer 1029, 1041 (May 2005).

⁹⁷ See Tex. R. Evid. 512. See also *In re Grand Jury Proceedings (Vargas)*, 723 F.2d 1461 (10th Cir. 1983) (production of documents in response to a court order is not necessarily a voluntary disclosure constituting waiver).

them in order to show the cooperation with their investigations and thereby receive less harsh treatment.⁹⁸

No Waiver Where Common Interest. Voluntary disclosure of a privileged communication to a person with a common interest does not constitute waiver.⁹⁹ Thus, communications between a lawyer for a parent corporation and an employee of a wholly-owned subsidiary usually are considered privileged.¹⁰⁰ Similarly, multiple clients represented by the same attorney may talk freely with their attorney without fear that the presence of more than one client will constitute a waiver as to third parties.¹⁰¹

⁹⁸ 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) (available at http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm) (identified nine factors that federal prosecutors should utilize in making their charging decisions regarding corporations or other business entities, including 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 protection); U.S. SENTENCING GUIDELINES MANUAL § 8C2.5 (2004) (emphasis added) (available at http://www.uscc.gov/2004guid/8c2_5.htm) (to qualify for a reduction in its sentence for providing assistance to the government investigation, a corporation may be 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"); Report of Investigation Pursuant to Section 21(a) of the 1934 Act and SEC Statement on the Relationship of Cooperation to Agency Enforcement Decisions, 1934 Act Rel. No. 44969 (Oct. 23, 2001) (available at <http://www.sec.gov/litigation/investreport/34-44969.htm>) (the "Seaboard Report") (in determining whether to initiate SEC enforcement proceedings, the SEC considers the seriousness of the conduct; whether the company had "cooperate[d] completely with appropriate regulatory and law enforcement bodies"; whether the company had conducted "a thorough review of the nature, extent, origins and consequences of the conduct and related behavior"; whether the company "promptly [made] available to [SEC] staff the result of its review and provide[d] sufficient documentation reflecting its response to the situation"; whether "the company identifi[ed] possible violative conduct with sufficient precision to facilitate prompt enforcement actions against those who violated the law"; whether "the company produce[d] a thorough and probing written report detailing the findings of its review"; and whether "the company voluntarily disclose[d] information [SEC] staff did not directly request and otherwise might not have uncovered." Report of ABA's Task Force on the Attorney-Client Privilege, 60 Bus. Lawyer 1029, 1043-52 (May 2005), discussing these recent governmental policies, practices and procedures, and the implications thereof to the attorney-client privilege and the public policies underlying it.

⁹⁹ See *USA v. Zolin*, 809 F.2d 1411, 1417 (9th Cir. 1987) (in tax fraud case involving L. Ron Hubbard, court found attorney-client privilege had not been waived by presence of members of Church of Scientology at meetings with attorney because the persons present had a common interest in sorting out the respective affairs of the Church and Mr. Hubbard, commenting that "[e]ven where the non-party who is privy to the attorney-client communications has never been sued on the matter of common interest and faces no immediate liability, it can still be found to have a common interest with the party seeking to protect the communications.").

¹⁰⁰ See *In re Grand Jury Subpoenas*, 89-3 and 89-4, 902 F.2d 244 (4th Cir. 1990); *Admiral Ins. Co. v. U.S. Dist. Ct.*, 881 F.2d 1486 (9th Cir. 1989); *Bowne of New York City, Inc. v. AmBase Corp.*, 150 F.R.D. 465 (S.D.N.Y. 1993).

¹⁰¹ See *In re Auclair*, 961 F.2d 65 (5th Cir. 1992).

Disclosure to lawyers or clients in a joint defense situation also does not create waiver.¹⁰² In the event the clients in the joint defense arrangement later become adverse to each other, their communications which were privileged as to third parties are not privileged in the controversy between them.¹⁰³ As a consequence, attorneys whose clients are entering into a joint defense

¹⁰² The courts have developed two doctrines of exceptions to the waiver of the privilege through voluntary disclosure. *Wilson P. Abraham Constr. Corp. v. Armco Steel Corp.*, 559 F.2d 250, 253 (5th Cir. 1977); *Ryals v. Canales*, 767 S.W.2d 226 (Tex. App. — Dallas 1989, no writ). The joint defendant rule, embodied in UNIF. R. EVID. 502(b)(5), protects communications relevant to a matter of common interest between two or more clients of the same lawyer from disclosure. UNIF. R. EVID. 502 (d)(5). This widely accepted doctrine applies strictly to clients of the same lawyer who are joint defendants in litigation. Several courts have expanded the joint defense doctrine in order to create another exception to the waiver of attorney-client privilege: the doctrine of common-interest. Under the common interest doctrine, privileged information can be disclosed to a separate entity that has a common legal interest with the privilege holder, whether or not the third party is a co-defendant.

Federal circuit courts and state courts diverge in their interpretation and application of the common interest and joint defendant doctrine. *U.S. v. Weissman*, 1996 WL 737042 *7 (S.D.N.Y. 1996). In the most expansive application of the common interest doctrine, courts exclude a waiver of the attorney-client privilege when there is a common interest between the disclosing party and the receiving party, and parties have a reasonable expectation of litigation concerning their common interest. See *Hewlett-Packard Co. v. Bausch & Lomb*, 115 F.R.D. 308, 309 (N.D.Cal. 1987). More restrictive courts require that the parties share an identical legal, as opposed to purely commercial, interest. See *Duplan Corp. v. Deering Milliken*, 397 F. Supp. 1146, 1172 (D.S.C. 1974). Finally, some courts persist in rejecting the common interest theory absent actual or pending litigation in which both parties are or will be joint defendants. See *Int'l Ins. v. Newmont Mining Corp.*, 800 F.Supp. 1195, 1196 (S.D.N.Y. 1992).

Although there is no uniform test for application of the common interest doctrine, courts have consistently examined three elements when applying the doctrine: (1) whether the confidentiality of the privileged information is preserved despite disclosure; (2) whether, at the time that the disclosures were made, the parties were joint defendants in litigation or reasonably anticipated litigation; and (3) whether the legal interests of the parties are identical or at least closely aligned at the time of disclosure. See, e.g. *U.S. v. Gulf Oil Corp.*, 760 F.2d 292, 296 (Temp. Emer. Ct. App. 1985).

The core requirement of the common interest doctrine is the existence of a shared legal interest. Courts will have less difficulty in finding an exception to a waiver when the parties actively pursue common legal goals. See *U.S. v. Schwimmer*, 892 F.2d 237, 244 (2nd Cir. 1989). An asset purchase agreement in which the buyer does not assume the litigation liability of the seller does not demonstrate an alignment of the parties' interests. A common business enterprise, such as the sale of assets, or a potential merger, will not suffice unless the parties' legal interests are at least parallel and non-adverse. *Jedwab v. MGM Grand Hotels*, 1986 WL 3426 * 2 (Del. Ch. 1986). Disclosures by a corporation and its counsel to the corporation's investment banking firm during merger discussions have resulted in a waiver of the attorney-client privilege because the common interest rule did not apply. See *Blanchard v. EdgeMark Financial Corp.*, 192 F.R.D. 233 (N.D. Ill. 2000). The court said the common-interest rule protects from disclosure those communications between one party and an attorney for another party "where a joint defense effort or strategy has been decided upon and undertaken by the parties and their respective counsel," noting that the common interest must be a legal one, not commercial or financial. Id at 236. The court concluded, however, that the common interest rule did not apply because the defendants did not demonstrate that the investment banking firm's legal interest in the threatened litigation was anything more than peripheral. Id at 237.

¹⁰³ See *Garner V. Wolfenbarger*, 430 F.2d 1093, 1103 (5th Cir. 1970) ("In many situations in which the same attorney acts for two or more parties having a common interest, neither party may exercise the privilege in

arrangement and sharing otherwise privileged information have an ethical duty to advise their clients of this risk of privilege loss.

Issue Injection. Another means of waiver is through offensive use, sometimes also called issue injection. The rule is simple, although sometimes difficult to implement. A client may not make an affirmative claim for relief, assert privilege as to an outcome determinative matter, and deny the adverse party its only means of discovering the information.¹⁰⁴ The key to this test is whether the privileged matter is outcome determinative. If so, the client is given the choice of disclosing the privileged information or abandoning his claim.¹⁰⁵

Clients may assert a defense based on their good faith belief that their actions were in conformity with applicable laws. Often the good faith can be shown only by showing that the action was in reliance on advice of counsel. Once the client opens the issue of the advice received by selectively revealing any of the advice it received, the client risks placing at issue, and waives the privilege as to, all steps it took to comply with the law at issue.¹⁰⁶ Such a waiver

a subsequent controversy with the other. This is true even where the attorney acts jointly for two or more persons having no formalized business arrangement between them.”).

¹⁰⁴ *Republic Ins. Co. v. Davis*, 856 S.W.2d 158 (Tex. 1993).

¹⁰⁵ *Cf. Texas Dept. of Pub. Safety Officers Ass’n v. Denton*, 897 S.W.2d 757 (Tex. 1995) (involving offensive use of fifth amendment privilege).

¹⁰⁶ *See Nguyen v. Excel Corp.*, 197 F.3d 200, 206-7 (5th Cir. 1999):

A corporate client has a privilege to refuse to disclose, and prevent its attorneys from disclosing, confidential communications between its representatives and its attorneys when the communications were made to obtain legal services. A client waives the attorney-client privilege, however, by failing to assert it when confidential information is sought in legal proceedings. Inquiry into the general nature of the legal services provided by counsel does not necessitate an assertion of the privilege because the general nature of services is not protected by the privilege. Further inquiry into the substance of the client’s and attorney’s discussions does implicate the privilege and an assertion is required to preserve the privilege. A client’s specific request to an attorney and pertinent information related thereto fall within the reaches of the privilege. Additionally, the research undertaken by an attorney to respond to a client’s request also falls within the reaches of the privilege.

Though Excel raised some privilege-based objections, it did not object to all questions designed to elicit information about privileged communications. The district court observed that Excel did not object to all questions designed to elicit information about confidential communications, and that Excel did not halt its executives’ responses to all such questions. * * * Excel waived the attorney-client privilege by its failure to assert the privilege.

As related, but alternative, grounds for affirming the district court’s order, Excel waived the attorney-client privilege by selectively disclosing confidential communications. When relayed to a third party that is not rendering legal services on the client’s behalf, a communication is no longer confidential, and thus it falls outside of the reaches of the privilege. Therefore, a client implicitly waives the attorney-client privilege by testifying about portions of the attorney-client communication.

But see In re Carbo Ceramics, Inc., 81 S.W.3d 369, 378-379 (Tex. App.—Houston [14th Dist.] 2002) (“Texas courts apply the offensive use doctrine when the advice of counsel defense is raised. [Citations omitted]. The offensive use doctrine applies when a party seeking affirmative relief attempts to claim a

can result in both the client and the attorney being compelled to submit to deposition and testimony at trial.¹⁰⁷

Scope of Waiver. Concerns about waiving privilege surround communications with accountants, underwriters and prospective merger partners regarding litigation loss contingencies. In each of those communications, there is a voluntary disclosure that is necessary for the corporation to accomplish its business. Yet, when documents or other communications are disclosed to persons outside the scope of the attorney-client privilege, waiver of the privilege occurs. The issue involves how far the waiver goes.

The scope of waiver is broad. It is generally considered to be permanent, that is, the privilege cannot be reclaimed in another circumstance or proceeding.¹⁰⁸ Furthermore, the waiver may extend not only to the document or communication specifically disclosed, or to which the privilege was waived, but to all communications on the “**subject matter.**”¹⁰⁹

privilege to shield evidence that would materially weaken or defeat that party’s claims. [Citation omitted]. ‘A plaintiff cannot use one hand to seek affirmative relief in court and with the other lower an iron curtain of silence against otherwise pertinent and proper questions which may have a bearing upon his right to maintain his action.’....Texas courts define affirmative relief narrowly for the purpose of determining whether offensive use commands the waiver of privilege.”).

¹⁰⁷ *See Excel, supra*, 197 F.3d at 208-210:

Excel next maintains that, even if it waived the privilege, its executives rather than its counsel should be deposed regarding matters no longer privileged. Excel encourages this court to adopt the inquiry of the Eighth Circuit [in *Shelton v. Am. Motors Corp.*, 805 F.2d 1323 (8th Cir. 1986)] and forbid a party from deposing opposing counsel unless (1) no other means exist to obtain the information, (2) the information sought is relevant and non-privileged, and (3) the information is crucial to the preparation of the case. Excel contends that appellees cannot establish any of the three criteria.

* * *

Because depositions of opposing counsel are disfavored generally and should be permitted in only limited circumstances, one would suspect that a request to depose opposing counsel generally would provide a district court with good cause to issue a protective order. The district court, however, did not abuse its discretion in authorizing the depositions of defense counsel, even assuming the applicability of the *Shelton* inquiry.

* * *

The second sentence of the magistrate judge’s order permits inquiry into counsels’ understanding of defendant’s perceptions, and the third sentence of the order permits inquiry into counsels’ opinions. These inquiries are impermissible. “An attorney’s thoughts [are] inviolate . . .” Even though an attorney’s mental impressions and opinions fall outside of the attorney-client privilege, they also “fall[] outside the arena of discovery [as their disclosure would] contravene[] the public policy underlying the orderly prosecution and defense of legal claims.”

¹⁰⁸ *See United States v. Suarez*, 820 F.2d 1158 (11th Cir. 1987).

¹⁰⁹ 8 J. WIGMORE, EVIDENCE § 2328, at 638 (McNaughton rev. ed. 1961). *See also United States v. Davis*, 636 F.2d 1028, 1043 n. 18 (5th Cir.), *cert. denied*, 454 U.S. 862 (1981); *Zielinski v. Clorox Co.*, 504 S.E.2d 683 (Ga. 1998) (the court held that attorney-client privilege was waived as to the subject matter of certain documents turned over to the district attorney’s office as part of an ongoing embezzlement investigation).

In *In re Grand Jury Proceedings*,¹¹⁰ the Court addressed the issue of whether a corporate officer inadvertently waived attorney-client privilege *to the entire subject matter of communications with their lawyer about a particular matter* when they disclosed *certain portions* of the attorney's advice to a government agent. In making their determination, the court allowed discovery of certain information, disallowed discovery of other information, and specifically instructed the lower court to conduct further proceedings in order to determine what other information came within the "subject matter" of the information disclosed:

[T]wo government investigators met with [a company's] owner and president. Shortly after the meeting began, the owner and president informed the agents that they had met with a Washington, D.C. attorney who specializes in Medicare law, and they told the investigators the attorney's name. They told the agents that they brought their twenty-four point marketing plan to the attorney and that they described the various elements of the plan to her in detail.

The owner and president told the investigators that their attorney was concerned that providing free Sharps needle disposal containers could constitute an illegal inducement or kickback. But, the president noted, the attorney had no problem with the laboratory billing Medicare for tests done by nursing home personnel or with providing nursing homes free glucose testers and lancets. When asked by the agents about the apparent inconsistency between the lawyer's advice regarding free Sharps disposal containers and free glucose testers, the president responded, "That's the advice I had of the attorney at the time."

The District Court held that the owner and president had waived the attorney-client privilege by voluntarily disclosing the substance of their attorney's advice to the government agents. The District Court also held that "the government's motion to compel is granted to the extent of the legal advice and documents relating to [the laboratory's] marketing plan."

Having concluded that the attorney-client privilege was waived as to specific elements of the marketing plan, we must now determine the scope of that waiver.

In support of the District Court's order, the Government argues that "[i]t is well established that voluntary disclosure of the content of a privileged communication constitutes a waiver of the privilege as to all other such communication on the same subject matter." The government relies on several cases to support its claim that in view of the waiver on specific items of the marketing plan, the laboratory

waived its privilege with respect to the rest of the plan. *See, e.g., United States v. Jones*, 696 F.2d 1069, 1072 (4th Cir.1982) ("Any voluntary disclosure by the client to a third party waives the privilege not only as to the specific communication disclosed, but often as to all other communications relating to the same subject matter."); *In re Sealed Case*, 676 F.2d 793, 818 (D.C.Cir.1982) ("When a party reveals part of a privileged communication in order to gain an advantage in litigation, it waives the privilege as to all other communications relating to the same subject matter...."); *Edwards v. Whitaker*, 868 F.Supp. 226, 229 (M.D.Tenn.1994) ("[V]oluntary disclosure of the content of a privileged attorney communication constitutes waiver of the privilege as to all other such communications on the same subject.").

[T]he government may ask questions that clearly pertain to the subject matter of the specific points on which a waiver did occur. *The District Court will have to decide whether the remaining points in the marketing plan are truly the same subject matter as those in the specific marketing plan points on which there was a waiver and approve or disallow questions on that basis.*¹¹¹

While *In re Grand Jury Proceedings* adopts the subject matter test, only one court has given much guidance in determining what is and what is not in the same subject matter when disclosure of some privileged communications has taken place. In a series of opinions arising from the case styled *U.S. v. Skeddle*,¹¹² a U.S. District Court in Ohio addressed the scope of a corporation's waiver to its claim of attorney-client privilege. The case arose in the context of a criminal charge of wire and mail fraud against former employees of Libbey Owens Ford Co. ("LOF") arising out of their allegedly improper self-dealing transactions with LOF. LOF's general counsel became suspicious of defendants' activities and began an internal investigation which led to LOF commencing civil litigation against the criminal defendants and others. In connection with the general counsel's trial testimony in the criminal case, LOF agreed to waive its attorney-client privilege as to communications between the general counsel and LOF management prior to his discovery of the allegedly fraudulent activities, but refused to waive the privilege as to communications related to its internal investigation and litigation against defendants.¹¹³ The general counsel then testified at the criminal trial of the former LOF employees regarding conversations he had with other LOF officials as to which LOF had expressly waived its attorney-client privilege. The defendants claimed that this testimony waived the corporation's attorney-client privilege as to the entire contents of the investigative file.¹¹⁴

¹¹¹ *Id.* [emphasis added]

¹¹² 989 F.Supp. 905, 989 F.Supp. 913, 989 F.Supp. 917 (N.D. Ohio 1997).

¹¹³ 989 F.Supp. at 908.

¹¹⁴ 989 F.Supp. at 919.

¹¹⁰ 78 F.3d 251 (6th Cir. 1996).

Exhibiting a judicial tendency to narrowly construe the subject matter as to which the privilege has been waived, the court noted that the general counsel's file covered three stages in respect of the case: (i) an "implementation" phase during which the legal department was communicating with management as the transactions at issue were being developed in the apparent ordinary course of business, (ii) an "investigatory phase" that began when LOF had significant reason to believe wrongdoing had occurred, and (iii) a "litigation" phase after LOF had decided to file suit to recover the value defendants had wrongfully obtained. The court then held that LOF could waive its privilege as to the implementation phase without any waiver as to the investigatory and litigation phases. The court noted that in the implementation phase, the legal department lawyers were working with defendants in the transaction in the ordinary course, perhaps acting in the dual role of lawyer and businessman, and were involved as the facts at issue were developing. In the investigatory and litigation phases, the legal department was endeavoring to assert the interests of LOF against defendants. In so holding, the court explained the subject matter test as follows:

As a general rule, waiver of the privilege with regard to some communications waives the privilege as to all other communications relating to the "same subject matter." *In re Grand Jury Proceedings*, 78 F.3d at 255-256; *United States v. Mendelsohn*, 896 F.2d 1183, 1189 (9th Cir. 1990). This rule seeks to avoid the unfairness that might result from selective disclosure while, at the same time, upholding the privilege and preserving the interests it protects from excessive exposure.

Despite the centrality of the term, "same subject matter," to this inquiry, courts have not defined its meaning and content precisely. Aside from a general instruction to construe "same subject matter" narrowly, . . . no guidance has been given about how a trial court is to determine what is and what is not within the same subject matter when disclosure of some privileged communications has taken place.

Among the factors which appear to be pertinent in determining whether disclosed and undisclosed communications relate to the same subject matter are: 1) the general nature of the lawyer's assignment; 2) the extent to which the lawyer's activities in fulfilling that assignment are undifferentiated and unitary or are distinct and severable; 3) the extent to which the disclosed and undisclosed communications share, or do not share, a common nexus with a distinct activity; 4) the circumstances in and purposes for which disclosure originally was made; 5) the circumstances in and purposes for which further disclosure is sought; 6) the risks to the interests protected by the privilege if further disclosure were to occur; and 7) the prejudice which might result if disclosure were not to occur. By applying these factors, and such other factors as may appear appropriate, a court may be able to comply with the mandate that it construe "same subject matter" narrowly while accommodating fundamental fairness.¹¹⁵

The *Skedde* court then applied these factors to the specifics of the general counsel's testimony. While the general counsel did testify regarding telephone conversations and meetings with certain corporate officers and other facts acquired during the general counsel's investigation into the scheme, the court concluded that the subject of the general counsel's limited testimony could not be found to cover the entire investigative file of the corporation, finding that the testimony referred to only a small portion of the general counsel's activities for the corporation, activities consisting of distinct and severable activities, all self-contained and unitary in focus.¹¹⁶ The court further stated that the testimony did not have a common nexus with every other attorney-client communication in the corporation's investigative file, and that to use the limited, factual disclosures as a bootstrap to discover the entire investigative file would run counter to the principles underlying the narrow waiver of the attorney-client privilege.¹¹⁷

The *Skedde* court even found that the disclosure of documents which made references to discussions that were otherwise privileged did not waive privilege as to those discussions, finding that the referenced discussions related to a subject distinct from the subject of the documents disclosed.¹¹⁸ The court noted the jeopardy in which privileged documents would be placed if partial disclosure waived privilege as to the entire matter, stating:

"If . . . disclosure of the notes exposed every otherwise privileged communication as to the matters referenced . . . , the privilege would be withdrawn from dozens, if not hundreds of communications as to which all participants had expected confidentiality. Interests protected by the privilege would be placed in great jeopardy if the subject matter of the . . . notes were deemed to be every topic mentioned in those notes."¹¹⁹

One document addressed in this opinion is of particular relevance. A letter from the corporation's outside counsel to an attorney for liability insurers of corporate directors and officers, which set forth the corporation's basis for an insurance claim arising from the defendants' alleged misconduct, was disclosed at trial.¹²⁰ While the letter itself was found not privileged, the court found privileged the communications which underlay the conclusions of the letter because allowing such disclosure would undermine substantially, if not completely, the

¹¹⁶ *Id.* at 920.

¹¹⁷ *Id.*

¹¹⁸ 989 F. Supp. at 911. A close examination of this series of opinions illustrate the court's effort to find the undisclosed statements privileged. For example, relating to one particular document, the court found that the subject matter of the document was the author's understanding of the significance of certain events rather than being the subject matter of the events themselves. See *In re Carbo Ceramics, Inc.*, 81 S.W.3d 369, 378-379 (Tex. App.—Houston [14th Dist.] 2002) in which the court focused on particular documents as to which the privilege was waived and rejected claims that all other documents on a privilege log lost their privilege as a result of a waiver as to other documents.

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹¹⁵ 989 F.Supp. at 908-9.

purpose of the attorney-client privilege.¹²¹ The court stated that, “requiring such disclosure would permit discovery of underlying privileged communications whenever an attorney states an opinion based on such communications. Such broad waiver runs counter to the protection generally afforded to attorney-client relationship.”¹²²

In light of the potential danger of a broad scale waiver of attorney-client privilege under the subject matter test, counsel should be particularly attentive to opportunities to stress the confidential nature of attorney-client communications with the officers and representatives of their clients. When disclosing information that may be privileged, counsel may endeavor to limit the scope of any waiver by stating in writing that no waiver of the attorney-client privilege is intended thereby.

In one unreported case, a corporation avoided waiving the attorney-client privilege in certain documents, and as to all other documents covering the same subject matter, by specifically not waiving the attorney-client privilege in the process of disclosing the documents:

Ernst & Young next claims that ShareAmerica’s “disclosure of communications with and among attorneys from K & L regarding the SEC’s inquiry and the planned public offering constitutes a waiver of the attorney-client and work product privileges with respect to those documents *and all other documents covering the same subject matter.*” (Defendant’s brief dated 5/30/97 at p. 13.) ShareAmerica, however, has submitted an affidavit from Attorney Daniel Shepro that shows the document production and testimony occurred without a waiver of ShareAmerica’s privileges . . . The motion to compel is denied.

ShareAmerica, Inc. v. Ernst & Young, (1998 WL 90731 (Conn. Super. Not Reported in A.2d) [emphasis added].

Exceptions to the Privilege. The Texas Rules of Evidence recognize the following five exceptions to the attorney-client privilege:

(1) *Furtherance of Crime or Fraud.* If the services of the lawyer were sought or obtained to enable or aid anyone to commit or further continuing or future criminal or fraudulent activity, as contrasted with advice regarding prior wrong doing.¹²³

(2) *Claimants Through Same Deceased Client.* As to a communication relevant to an issue between parties who claim through the same deceased client,

regardless of whether the claims are by testate or intestate succession or by *inter vivos* transactions;

(3) *Breach of Duty by a Lawyer or Client.* As to a communication relevant to an issue of breach of duty by a lawyer to the client or by a client to the lawyer;

(4) *Document Attested by a Lawyer.* As to a communication relevant to an issue concerning an attested document to which the lawyer is an attesting witness; or

(5) *Joint Clients.* As to a communication relevant to a matter of common interest between or among two or more clients if the communication was made by any of them to a lawyer retained or consulted in common, when offered in an action between or among any of the clients.¹²⁴

In contrast to other aspects of the attorney-client privilege, the exceptions are relatively straightforward and have yielded remarkably little litigation. Of the five, the crime/fraud exception has resulted in the most controversy in terms of its applicability. The U.S. Supreme Court has explained that the “privilege takes flight if the relation is abused. A client who consults an attorney for advice that will serve him in the commission of a fraud will have no help from the law. He must let the truth be told.”¹²⁵

Some plaintiffs have tried to pierce the attorney-client privilege by simply asserting a fraud cause of action and then arguing that the crime/fraud exception applies to all legal advice the adverse party received. This tactic has been rejected, with courts holding that the plaintiff must first prove a prima facie case of fraud and then show that the attorney-client communication was in furtherance of the fraud in order to commit the fraud.¹²⁶ Key to the application of the crime/fraud exception is the timing of the communication. In order for the exception to apply, it is usually necessary for the communication to have been made in contemplation of the fraud¹²⁷ and either before or during the commission of the fraud.¹²⁸ Recently, several courts have applied the exception in situations where the attorney’s advice was alleged to have assisted in covering up the fraud.¹²⁹

¹²⁴ TEX. R. EVID. 503(d).

¹²⁵ *Clark v. United States*, 289 U.S. 1, 15 (1933).

¹²⁶ *Cigna Corp. v. Spears*, 838 S.W.2d 561 (Tex. App. — San Antonio 1992, no writ).

¹²⁷ *Arkla, Inc. v. Harris*, 846 S.W.2d 623, 630 (Tex. App. — Houston [14th Dist.] 1993, orig. proceeding).

¹²⁸ *Freeman v. Bianchi*, 820 S.W.2d 853, 861-62 (Tex. App. — Houston [1st Dist.] 1991), *approved sub nom.*, *Granada Corp. v. First Ct. of Appeals*, 844 S.W.2d 223, 225 (Tex. 1992).

¹²⁹ *See, e.g., American Tobacco Co. v. Florida*, 697 So.2d 1249 (Fla. App. 4th Dist. 1997); *In re A. H. Robbins Co., Inc.*, 107 F.R.D. 2 (D. Kan. 1985).

¹²¹ *Id.* at 911-912.

¹²² *Id.* at 912.

¹²³ *In re Subpoena*, ____ F.3d ____ (5th Cir. 7/26/05) (crime-fraud exception does not extend to all communications made in the course of the attorney-client relationship, but rather is limited to those communications and documents in furtherance of the contemplated or ongoing criminal or fraudulent conduct and does not apply to advice regarding prior wrongful acts).

Work Product Doctrine. The work product privilege¹³⁰ is a common law doctrine now codified in the federal and state rules of civil procedure that protects the privacy of an attorney's trial preparations, and may protect an attorney's work product from discovery by opposing counsel where the attorney-client privilege is not available. Generally, the work product privilege only protects from unwarranted disclosure materials prepared by an attorney, or under an attorney's direction, "in anticipation of litigation or for trial."¹³¹ Therefore, in absence of any anticipated or pending litigation, documents prepared for the purposes of a specific business transaction are not protected by the work product doctrine.

The work product doctrine was first recognized by the U. S. Supreme Court in *Hickman v. Taylor*¹³² wherein, finding no existing privilege that applied, the Court created a new common law privilege for what it termed the "work product of the lawyer," consisting of interviews, memoranda, briefs and other materials prepared "with an eye toward litigation."¹³³ The Court justified the privilege as follows:

Proper preparation of a client's case demands that [the attorney] assemble information, sift what he considers to be the relevant from the irrelevant facts, prepare his legal theories and plan his strategy without undue and needless interference. That is the historical and the necessary way in which lawyers act within the framework of our system of jurisprudence to promote justice and to protect their clients' interests.¹³⁴

The Court indicated that the privilege could be overcome as to factual information otherwise unavailable to the opposing party, but not as to the attorney's "mental impressions."¹³⁵

The *Hickman* work product doctrine was codified in Rule 26(b)(3) of the Federal Rules of Civil Procedure in 1970, which extends protection to the work of a party's representatives, "including an attorney, consultant, surety, indemnitor, insurer, or agent" in anticipation of litigation or for trial. The rule maintains the distinction between ordinary work product, which is discoverable upon a showing of "substantial need" and "undue hardship," and an attorney's "mental impressions, conclusions, opinions, or legal theories," which are discoverable, if at all, only upon a much higher showing.¹³⁶ This latter category has come to be known as "opinion" or

"core" work product.¹³⁷ Rule 26(b)(3) has been adopted verbatim by 34 states, and in substantial part by 10 others.¹³⁸ The work product doctrine has been more specifically and comprehensively incorporated into Texas Rules of Civil Procedure,¹³⁹ which defined "*work product*"¹⁴⁰ consistently with the Federal Rules of Civil Procedure.

for the materials; and 2) the party cannot acquire a substantial equivalent of the materials by other means without undue hardship. Even when such a showing of need and unavailability is made, the rule specifically protects the mental impressions, conclusions, opinions and legal theories of the party's attorney. This is referred to as *opinion* work product (as opposed to trial preparations that are merely historical or fact based). Opinion work product is subject to disclosure according to a more stringent standard. A court will protect opinion work product unless the requesting party can show that it is *directed to the pivotal issue* in the current litigation and the need for the information is compelling. *Saito v. McKesson HBOC, Inc.*, 2002 Del. Ch. LEXIS 125 at 3 (Del. Ch. October 25, 2002).

¹³⁷ See *In re Murphy*, 560 F.2d 326, 329 n. 1 (8th Cir. 1977); Jeff A. Anderson et al., Special Project, *The Work Product Doctrine*, 68 Cornell L.Rev. 760, 817-20 (1983).

¹³⁸ See Elizabeth Thornburg, *Rethinking Work Product*, 77 Va.L.Rev. 1515, 1520-21 (1991).

¹³⁹ See Tex. R. Civ. P. 192.5 (1999). The party communication privilege, previously codified separately in the Texas Rule of Civil Procedure 166b(3)(d), has been incorporated into the work product rule as Rule 192.5(a)(2). The Texas Supreme Court has previously held under old Tex. R. Civ. P. 166(3)(d) that the party communications privilege is case specific (i.e. to be privileged, the communication must "occur during or in anticipation of the particular suit in which the privilege is asserted") in *Republic Insurance Co. v. Davis*, 856 S.W.2d 158, 164-65 (Tex. 1993), but this result was based on specific wording of the old rule that is different in new Rule 192.5(a)(2) and should not be the result under the wording of the new rule, which is not case specific. In *Owens-Corning Fiberglas v. Caldwell*, 818 S.W.2d 749, 751-52 (Tex. 1991), the Texas Supreme Court rejected the argument that the work product privilege applies only in the particular case in which it was generated, writing "we hold that the work product privilege in Texas is of continuing duration."

¹⁴⁰ Tex. R. Civ. P. 192.5(a) (1999) provides:

192.5 Work Product.

(a) *Work product defined.* Work product comprises:

- (1) material prepared or mental impressions developed in anticipation of litigation or for trial by or for a party or a party's representatives, including the party's attorneys, consultants, sureties, indemnitors, insurers, or agents; or
- (2) a communication made in anticipation of litigation or for trial between a party and the party's representatives or among a party's representatives.

(b) *Protection of work product.*

- (1) *Protection of core work product -- attorney mental processes.* Core work product -- the work product of an attorney or an attorney's representative that contains the attorney's or the attorney's representative's mental impressions, opinions, conclusions, or legal theories -- is not discoverable.
- (2) *Protection of other work product.* Any other work product is discoverable only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of the party's case and that the party is unable without undue hardship to obtain the substantial equivalent of the material by other means.

¹³⁰ Some courts prefer to use the term "doctrine" rather than "privilege" because of the more limited protection given to work product in certain situations. See *Westinghouse Elec. Corp. v. Republic of The Philippines*, 951 F.2d 1414, 1417 n. 1 (3rd Cir. 1991).

¹³¹ See Fed. R. Civ. P. 26(b)(3); Tex. R. Civ. P. 192.5.

¹³² 329 U.S. 495 (1947).

¹³³ *Hickman*, 329 U.S. at 511.

¹³⁴ *Id.*

¹³⁵ *Id.* at 512.

¹³⁶ The work product doctrine, however, is not an impenetrable barrier, it is a qualified immunity: "It allows a party to seek materials prepared in anticipation of litigation only when the party: 1) has a substantial need

Like the attorney-client privilege, the work product privilege is subject to waiver, but the scope of a work product waiver is more limited. Work product protection can be destroyed or waived only by an action that substantially increases the possibility that an adversary in litigation will gain access to the work product documents.¹⁴¹ For example, waiver will not result from disclosing work product information to a non-adversarial party with a common interest.¹⁴² Disclosure under a confidentiality agreement militates against a finding of waiver, for it is evidence the party took steps to insure that its work product did not land in the hands of its adversaries.¹⁴³ Widespread disclosure, however, might prompt a court to find waiver from substantially increasing the probability that privileged information will fall into the hands of an adversary.¹⁴⁴ Disclosing work product documents to a government body, particularly where the government is an adversary, can result in privilege waiver.¹⁴⁵

¹⁴¹ In most jurisdictions, a waiver of the work-product protection can occur where the protected communications are disclosed in a manner which “substantially increases the opportunity for potential adversaries to obtain the information.” See *Behnia v. Shapiro*, 176 F.R.D. 277, 279 (N.D.Ill. 1997); see also 8 WRIGHT, MILLER & MARCUS, FEDERAL PRACTICE AND PROCEDURE: CIVIL, § 2024, at 369 (1994). The question is whether the particular disclosure was of such a nature as to enable an adversary to gain access to the information. See *Behnia*, 176 F.R.D. at 279-80; *U.S. v. Amer. Tel. & Tel.*, 642 F.2d 1285, 1299 (D.C.Cir. 1980); *United States v. Gulf Oil Corp.*, 760 F.2d 292, 295 (Temp. Emer. Ct. App. 1985); *In re Grand Jury Subpoenas*, 561 F. Supp. 1247, 1257 (E.D.N.Y. 1982). In a minority of jurisdictions, the waiver of work product protection depends on whether the parties share a common legal interest. In such jurisdictions, the courts will apply the same analysis as for the waiver of attorney-client privilege. See *In re Grand Jury Subpoenas 89-3 v. U.S.*, 902 F.2d 244, 248 (4th Cir. 1990).

¹⁴² *Gulf Oil*, 760 F.2d at 295; *In re Grand Jury*, 561 F. Supp. at 1257.

¹⁴³ *Blanchard v. EdgeMark Financial Corp.*, 192 F.R.D., 233, 237 (N.D.Ill. 2000).

¹⁴⁴ *Id.*

¹⁴⁵ See *Westinghouse Elec. Corp. v. Republic of The Philippines*, 951 F.2d 1414, 1423-31 (3rd Cir. 1991); *In re Subpoenas Duces Tecum*, 738 F.2d 1367, 1369-75 (D.C. Cir. 1984); *United States v. Jones*, 696 F.2d 1069, 1072 (4th Cir. 1982); but see *Diversified Industries, Inc. v. Meredith*, 572 F.2d 596, 611 (8th Cir. 1977) (voluntary disclosure to a government agency waives the privilege only for the purpose of litigation against that government agency) and *Teachers Ins. and Annuity Ass'n v. Shamrock Broadcasting Co.*, 521 F.Supp. 638, 644-45 (S.D.N.Y. 1981) (disclosure waives the privilege only for the purpose of litigation against the agency if the disclosing party expressly reserves the privilege; otherwise, complete waiver occurs). The forum in which the waiver issue is adjudicated can be outcome determinative. *Contrast McKesson Corporation v. Green*, S04G1228, S04G1229 (Georgia March 7, 2005), which can be found at <http://www.loislaw.com>, in which the Supreme Court of Georgia held that the voluntary production of a 180-page internal investigation report by PricewaterhouseCoopers and Skadden, Arps to the SEC and the U.S. Attorney's Office resulted in a waiver of the work product privilege as they were actual or potential adversaries and the confidentiality agreement allowed the SEC to give the documents to others if it deemed such to be “in furtherance of the [SEC's] discharge of its duties and responsibilities” *with Saito v. McKesson HBOC, Inc.*, 2002 WL 31458233 (Del. Ch. Oct. 25, 2002), in which the Delaware Chancery Court adopted a “selective waiver” doctrine that allowed disclosures to the SEC pursuant to a confidentiality agreement without waiver of the work product protection, *vis a vis* private litigants, reasoning as follows:

As with any privilege, the protection of work product may be waived when it no longer serves its useful purpose. The purpose behind the protection of work product is “to promote the adversary system by safeguarding the fruits of an attorney's trial

preparations from the discovery attempts of the opponent.” * * * Thus, the focus of the doctrine is upon preventing discovery of the work product from an “*opposing party in litigation*,” not necessarily from the rest of the world generally.” * * * There is no waiver of privileged information to third parties if a disclosing party had a reasonable expectancy of privacy when it made an earlier disclosure. * * * Disclosures to, a third party do not waive attorney work product when the disclosing party and its recipient share some common interest. * * * The common interest question here boils down to whether the SEC acts as a friend or foe when it begins investigating a company for potential violations of the Securities Act. I think the more reasonable conclusion is that the SEC was a foe in this instance.

* * *

The Delaware Supreme Court has already determined that it is sometimes unfair to allow for *partial* waivers of work product. No Delaware court, however, has decided whether to allow *selective* waivers of work product. Selective waiver is the type of waiver at issue in this case, as McKesson HBOC has selectively disclosed its work product to the SEC and now asserts its work product privilege as to these same documents when requested by plaintiff Saito.

* * *

When attorneys secure a confidentiality agreement before sharing their work product with the SEC, as McKesson HBOC's attorneys did, those attorneys can reasonably assume that the SEC would not reveal those confidential disclosures to other adversaries.

Although it can be argued that McKesson HBOC should not have had an expectation of privacy because some other courts have decided, that such disclosures waive work product privilege, the courts of Delaware have not considered the issue. In fact, plaintiff, defendant, and the SEC alike fight this battle in this Court using weaponry borrowed almost exclusively from foreign jurisdictional battlefields because Delaware's terrain is barren. The vigorousness of this clashing of swords suggests that the matter is far from settled even on foreign soil.

The resulting decisions cover the entire spectrum—from protection of work product in the absence of a confidentiality agreement to no protection of work product even when a disclosure was secured by a confidentiality agreement. The Eighth Circuit first established the selective waiver doctrine and protected work product disclosures made to the SEC during a private, nonpublic investigation, even without a confidentiality agreement in place. The D.C. Circuit has since found that work product privilege could only be preserved if a confidentiality agreement is in place before the disclosure. The Second, Third, Fourth, and Sixth Circuits have found that waiver of the privilege as to one opponent waives the privilege as to all when there is no confidentiality agreement in place. Of these, some indicated that a confidentiality agreement may have changed the outcome of their decision. Only two cases cited to this Court found that the privilege was waived even when the disclosure was subject to a confidentiality agreement. Therefore, in light of conflicting but non-binding precedent, McKesson HBOC acted reasonably in expecting that its disclosures to the SEC under a confidentiality agreement would not reach the hands of its other adversaries.

* * *

Legal Fee Audits. Insurers routinely audit bills from outside defense counsel to measure compliance with billing guidelines and reduce costs. Disclosure of itemized billings to outside auditors may waive the attorney-client privilege for the documents disclosed.¹⁴⁶ Under the subject matter standard discussed above under “Scope of Waiver,” the waiver might (but should not) be extended beyond the bills themselves to the items referred to therein.

Issues have been raised in ethics opinions in a number of states regarding the propriety of an attorney’s submission of legal bills for outside audit review. The typical conclusion is that law firms may submit their bills directly to an audit company after an informed consent is obtained from the client.¹⁴⁷

Mergers and Acquisitions. One of the more troublesome problems related to the disclosure of confidential information in the context of negotiating a business combination is how to disclose information to facilitate a meaningful evaluation of litigation-related confidential information without waiving any work-product protections, attorney-client privileges, and similar protections and privileges. The issue can arise either prior to or after closing of a proposed transaction. In an attempt to allow the seller to furnish to the buyer confidential information without waiving the seller’s work product, attorney-client privilege and similar protections by demonstrating that the buyer and seller have or should be presumed to have common legal and commercial interests, or are or may become joint defendants in litigation, Section 12.6 of the ABA Model Asset Purchase Agreement with Commentary (2001) provides:

12.6 ATTORNEY-CLIENT PRIVILEGE.

The Disclosing Party is not waiving, and will not be deemed to have waived or diminished, any of its attorney work product protections, attorney-client privileges, or similar protections and privileges as a result of disclosing its Confidential Information (including Confidential Information related to pending

Thus, because I find that it is in the best interests of the shareholders to encourage corporate compliance, and because the law enforcement agencies are designed by our legislature as the first line of defense for such shareholders, I adopt a selective waiver rule for disclosures made to law enforcement agencies pursuant to a confidentiality agreement. Confidential disclosure of work product during law enforcement agency investigations relinquishes the work product privilege only as to that agency, not as to the client’s other adversaries. The selective waiver rule encourages cooperation with law enforcement agencies without any negative cost to society or to private plaintiffs.

¹⁴⁶ See *United States of America v. Massachusetts Institute of Technology*, 129 F.3rd 687 (1st Cir. 1997).

¹⁴⁷ K. Hansen and L. Marema, *Confidentiality Issue Sparks Controversy*, Bests Review ‘77 (Feb. 1999); see Professional Ethics Committee for the State Bar of Texas Opinion No. 552 (August 2004) in which the Professional Ethics Committee opines that a lawyer’s fee statement or invoice is confidential information which the lawyer must protect under Rule 1.05 of the Texas Disciplinary Rules of Professional Conduct and that a lawyer who has been retained by an insurance company to defend its insured cannot disclose the lawyer’s fee statement to the insurance company’s third party auditor absent consent of the client after consultation (consent in advance through a policy provision is not sufficient consent since it is by definition not made after consultation with the client).

or threatened litigation) to the Receiving Party, regardless of whether the Disclosing Party has asserted, or is or may be entitled to assert, such privileges and protections. The parties (a) share a common legal and commercial interest in all of the Disclosing Party’s Confidential Information that is subject to such privileges and protections, (b) are or may become joint defendants in Proceedings to which the Disclosing Party’s Confidential Information covered by such protections and privileges relates, (c) intend that such privileges and protections remain intact should either party become subject to any actual or threatened Proceeding to which the Disclosing Party’s Confidential Information covered by such protections and privileges relates, and (d) intend that after the Closing the Receiving Party shall have the right to assert such protections and privileges. No Receiving Party shall admit, claim or contend, in Proceedings involving either party or otherwise, that any Disclosing Party waived any of its attorney work product protections, attorney-client privileges, or similar protections and privileges with respect to any information, documents or other material not disclosed to a Receiving Party due to the Disclosing Party disclosing its Confidential Information (including Confidential Information related to pending or threatened litigation) to the Receiving Party.

There may be instances when the receiving party is an actual or potentially adverse party in litigation with the disclosing party (e.g., when litigation is the driving force behind an acquisition). In those cases, the language of Section 12.6 is intended to bolster a claim by the disclosing party that the recipient is later precluded from using disclosure as a basis for asserting that the privilege was waived.

Whether work product protections and attorney-client privileges will be deemed to be waived as a result of disclosures in connection with a consummated or unconsummated asset purchase depends on the law applied by the forum jurisdiction and the forum jurisdiction’s approach to the joint defendant and common interest doctrines. In most jurisdictions, work product protection will be waived only if the party discloses the protected documents in a manner which substantially increases the opportunities for its potential adversaries to obtain the information. By contrast, the attorney-client privilege will be waived as a result of voluntary disclosure to any third party, unless the forum jurisdiction applies a form of the joint defense or common interest doctrines.

Although the consummation of a transaction is not determinative of the existence of a waiver, the interests of the parties may become closely aligned as a result of the closing. As a result, there is a higher probability that information will remain protected in a transaction that closes, and in which the buyer assumes liability for the seller’s litigation, than in a transaction that does not close and in which the buyer does not assume liability for the seller’s litigation.¹⁴⁸

¹⁴⁸ See Hundley, “White Knights, Pre-Nuptial Confidences, and the Morning After: The Effect of Transaction-Related Disclosures on the Attorney-Client and Related Privileges,” 5 DEPAUL BUS. L.J. 59 (Fall/Winter, 1992/1993); cf. *Cheeves v. Southern Clays*, 128 F.R.D. 128, 130 (M.D. Ga. 1989) (“Courts have found a community of interest where one party owes a duty to defend another, or where both consult the same attorney”).

Generally, (i) in a statutory merger the surviving corporation can assert the attorney-client privilege, (ii) in a stock-for-stock deal the privilege goes with the corporation, although in some cases the buyer and seller may share the privilege, and (iii) in the case of an asset sale most cases hold no privilege passes because the corporate holder of the privilege has not been sold.¹⁴⁹ In an asset sale, including a sale of a division, the parties could provide contractually for the buyer to have the benefit of the privilege, as Section 12.6 does, and, by analogy to joint defense and common interest cases, the privilege agreement should be upheld. Further, by analogy to those cases and the principle that the privilege attaches to communications between an attorney and prospective client prior to engagement, parties should be able to provide that due diligence information provided is protected by the attorney-client privilege.¹⁵⁰

Courts may also maintain the attorney-client privilege when the interests of both parties are aligned through specific contractual relationships.¹⁵¹ Therefore, the parties may find some comfort in provisions that align their legal interests and burdens, such as provisions pursuant to which buyer assumes the litigation liability of seller, indemnification provisions or assistance provisions which may facilitate a court's application of the common interest doctrine. If appropriate, the parties also should consider signing a "common interest agreement" or a "joint defense plan" that evidences their common legal interests and stipulates a common plan for litigation.

V. ATTORNEY LETTERS TO AUDITORS

SFAS 5. In March 1975 the Financial Standards Board ("FASB") issued its Statement of Financial Accounting Standards No. 5 ("SFAS 5")¹⁵² entitled "Accounting for Contingencies" which sets forth the standards for issuers to accrue for or disclose loss contingencies. Under SFAS 5 if both a loss is "probable" and the amount can be reasonably estimated, the contingency has to be accrued in the financial statements of the company. On the other hand, if it is reasonably possible (but not probable) that a loss has occurred or will occur, then there has to be disclosure in the footnotes to the financial statements and an estimate of that loss or range of losses has to be provided, if one can be provided. Under SFAS 5 "probable" means "the future event or events are likely to occur," "reasonably possible" means that "the chance of the future event or events occurring is more than remote and less than likely," and "remote" means that "the chance of the future event or events occurring is slight."¹⁵³

¹⁴⁹ *Id.*; *In re Cap Rock Electric Cooperative, Inc.*, 35 S.W.3d 222 (Tx. App. Texarkana 2000).

¹⁵⁰ *Id.*

¹⁵¹ *See In Re Regents of Univ. of Cal.*, 101 F.3d 1386, 1390 (Fed. Cir. 1996) (holding that parties to an exclusive license agreement have a substantially identical legal interest).

¹⁵² SFAS 5 can be found at <http://www.fasb.org/pdf/fas5.pdf>; SEC staff interpretations on the subject are contained in Codification of Staff Accounting Bulletins, at topic Y, which can be found at <http://www.sec.gov/inters/account/sabcodet5.htm#5y>.

¹⁵³ In the ABA Statement of Policy the respective definitions are slightly different.

SAS 12. In January 1976, the American Institute of Certified Public Accountants (the "AICPA") issued its Statement on Auditing Standards No. 12 ("SAS 12"), entitled Inquiry of a Client's Lawyer concerning Litigation, Claims, and Assessments,¹⁵⁴ which purports to provide "guidance on the procedures an independent auditor should consider for identifying litigation, claims, and assessments and for satisfying himself as to the financial accounting and reporting for such matters when he is performing an examination in accordance with generally accepted auditing standards."¹⁵⁵ SAS 12 sets forth the auditing process to be followed by auditors in gathering information to confirm that the client has made the appropriate determinations required by SFAS 5, and remains operative today even after the enactment of SOX and the establishment of the PCAOB.¹⁵⁶ SAS 12 is really the auditing standard implementing the process under SFAS 5 and it provides guidelines for the types of inquiries that the client will make of the lawyer.

Pursuant to SAS 12, the auditor must obtain evidence regarding the following factors:

- (1) The existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments;
- (2) The period in which the underlying cause for legal action occurred;
- (3) The degree of probability of an unfavorable outcome; and
- (4) The amount or range of potential loss.¹⁵⁷

The auditor is instructed to seek such evidence from management;¹⁵⁸ however, because auditors are not equipped to make legal judgments regarding such matters, SAS 12 instructs the auditor to "request the client's management to send a letter of inquiry to those lawyers with whom they consulted concerning litigation, claims, and assessments"¹⁵⁹ (an "Inquiry Letter"). The Inquiry Letter that lawyers receive is from the client, not from the auditors, although it probably was

¹⁵⁴ *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, Statement on Auditing Standards No. 12 (American Inst. of Certified Pub. Accounts 1976), reprinted in ABA AUDITOR'S LETTER HANDBOOK (2003). SAS 12 can be found at <http://www.fasb.org/pdf/fas12.pdf> and has been adopted as an interim audit standard by the PCAOB.

¹⁵⁵ SAS 12 ¶ 1 at 57.

¹⁵⁶ The PCAOB has adopted the generally accepted auditing standards that existed on April 16, 2003 as the interim PCAOB standards. SEC Release No. 34-49707 (May 14, 2004, which can be found at <http://www.sec.gov/rules/pcaob/34-49707.htm>).

¹⁵⁷ *Id.* ¶ 4 at 58.

¹⁵⁸ *Id.* ¶ 5 at 58-59.

¹⁵⁹ *Id.* ¶ 6 at 59.

drafted by the auditors.¹⁶⁰ The Inquiry Letter might also cover the additional category of contractually assumed obligations, but such inquiries are rarely made.

The matters to be addressed in an Inquiry Letter to counsel include the following:

- (a) Identification of the company, including subsidiaries, and the date of the examination;
- (b) A list prepared by management (or a request by management that the lawyer prepare a list) that describes and evaluates pending or threatened litigation, claims, and assessments with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of the company in the form of legal consultation or representation; and
- (c) A list prepared by management that describes and evaluates unasserted claims and assessments that management considers to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome, with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of the company in the form of legal consultation or representation.¹⁶¹

With respect to the information requested in paragraph (b) above, the lawyer is requested to furnish, among other things, a description of the matter, the action the company plans to take, “an evaluation of the likelihood of an unfavorable outcome, and an estimate, if one can be made, of the potential loss.”¹⁶² With respect to paragraph (c), the lawyer is requested to disclose if his views “differ from those stated by management.”¹⁶³

ABA Statement. Issued contemporaneously and in tandem with SAS 12, the ABA Statement attempts to balance the attorney’s need to avoid inadvertent waivers of the attorney-client privilege in responding to the auditors’ letter with the auditors’ need for complete and accurate information in audited financial statements, and addresses the privilege waiver concern as follows:

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

¹⁶⁰ In some cases a foreign auditor may send the Inquiry Letter directly to the lawyer.

¹⁶¹ *Id.* ¶ 9(a)-(c) at 60-61.

¹⁶² *Id.* ¶ 9(d)(1), (2) at 61.

¹⁶³ *Id.* ¶ 9(e) at 61. With respect to unasserted claims, the client must arrive at a judgment that the claim is probable of assertion, that it would be material, and then identify it in the Inquiry Letter or the lawyer cannot respond because if the does respond, without it being identified in the letter, the lawyer is violating a confidence or secret of the client, which could be an ethical problem for the lawyer.

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

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

The Statement of Policy has been prepared in the expectation that judicial development of the law in the foregoing areas will be such that useful communication between the lawyers and the auditors in the manner envisaged in the Statement will not prove prejudicial to clients engaged in or threatened with adversary proceedings. If developments occur contrary to this expectation, appropriate review and revision of the Statement of Policy may be necessary.¹⁶⁴

The ABA First Report of the Committee on Audit Inquiry Responses Regarding Initial Implementation of the Statement of Policy¹⁶⁵ sets forth an illustrative Inquiry Letter prepared in the name of the client pursuant to SAS 12.¹⁶⁶

¹⁶⁴ *Id.* at 12-13.

¹⁶⁵ 31 Bus. Law. 33 (April 1976) reprinted in the ABA AUDITOR’S LETTER HANDBOOK (2003).

¹⁶⁶ **Illustrative Form of Letter of Audit Inquiry:**

[Name and Address of Law Firm]

Dear Sirs:

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

Pending or Threatened Litigation (excluding Unasserted Claims)

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

This Inquiry Letter is the client's authorization for the lawyer to prepare the lawyer's Response Letter, which is necessary for the attorney to reveal confidential client information to the auditors under Rule 1.05 of the Texas Disciplinary Rules of Professional Conduct. If the Inquiry Letter is not in proper form, the attorney may discuss the situation with the client and request that the client submit another Inquiry Letter.

[If one or more unasserted possible claims or assessments are to be listed in the inquiry letter, include the following paragraph. If not, the following paragraph (and caption heading) should be omitted for the reason that the lawyer should be apprised *only* that management has advised the auditor that management has disclosed to the auditor all unasserted possible claims that the lawyer has advised are probable of assertion and must be disclosed (as specified in FAS 5).]

Unasserted Claims or Assessments

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

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

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

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

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

Very truly yours,

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Attorney Response Letters under the ABA Statement¹⁶⁷ differentiate between unasserted claims and pending litigation.¹⁶⁸ As to unasserted claims, the attorneys usually only confirm that

¹⁶⁷ Annex A to the ABA Statement sets forth the following illustrative form of letter to auditors for use by an outside practitioner or law firm:

[Name and Address of Accounting Firm]

Re: [Name of Client] [and Subsidiaries]

Dear Sirs:

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

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

* * *

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

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

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

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

[Insert information as appropriate]

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

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

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy and pursuant to the Company's request, this will confirm as correct the Company's understanding as set forth in its audit inquiry letter to us that whenever, in the course of performing legal services for the Company with respect to a matter

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they are aware of their professional responsibility not to knowingly participate in any violation by the client of the disclosure requirements of the securities laws and have consulted with the client regarding the client's disclosure obligations in language like the following:

Consistent with the last sentence of the paragraph 6 of the ABA Statement of Policy, and pursuant to the company's request, this will confirm as correct the Company's understanding as set forth in the audit inquiry letter to us, that whenever in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for a financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, we as a matter of professional responsibility to the Company will so advise the Company and will consult with the Company concerning questions of such disclosure and the applicable requirements of Statement of Auditing Standards No. 5.

The use of "whenever" in a Response Letter is very carefully worded and very carefully chosen by the ABA Committee that developed the Response Letter so that it is not saying we have done this in the past, or that we did this during the last year – it only says whenever necessary will we do it.

If the client does not identify an unasserted claim that the attorney recognizes should be disclosed to the auditors, the attorney would under the preceding paragraph be expected to discuss the issue with the client. If the client declined to authorize the attorney to disclose in the Response Letter, the attorney would have to consider his duties under Rule 12b2-2 and the SOX §307 Rules and might have to decline to issue a Response Letter or resign. Ultimately the financial statements, and the information provided to the auditors in connection with the audit

recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, we, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement.]

Very truly yours,

¹⁶⁸ The Preamble to the ABA Statement provides in part:

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

thereof, are the responsibility of the client and the attorney's duty is to advise the client, although the lawyer has a duty not to mislead the auditors.¹⁶⁹

As to pending litigation, the attorneys typically include an identification of the case or other proceeding, a brief description of the nature of the litigation or matter, the position asserted or to be asserted by the client, and the current procedural status of the matter. In the evaluation of overtly threatened or pending litigation, paragraph 5 of the ABA Statement states that lawyers should provide an opinion predicting the outcome of overtly threatened or pending litigation only in those relatively few clear cases that the likelihood of an unfavorable outcome is either "probable" or "remote."¹⁷⁰ The definitions of those terms in paragraph 5 of the ABA statement

¹⁶⁹ Paragraph 6 of the ABA Statement provides:

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

¹⁷⁰ Paragraph 5 of the ABA Statement provides in part:

In view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either "probable" or "remote;" for purposes of any such judgment it is appropriate to use the following meanings:

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

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

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

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

are narrow definitions, so that, unless the likelihood of an unfavorable outcome of the matters described is either probable or remote, the language that would typically be used in response would be to say with respect to each of the foregoing matters “because we have not concluded that the likelihood of an unfavorable outcome is either probable or remote, as those terms are defined in the ABA statement, we express no opinion as to the likely outcome of such matters.” This is not casual language: “We express no opinion” is not the same as “we have not formed an opinion” or “we cannot form an opinion” or “we decline to express an opinion,” each of which could later be viewed as having predicted that at some point in the future, an opinion would be forthcoming, or might indicate that an opinion has not been formed when in fact there may have been conversations between the lawyer and the client.

Discoverability of Audit Response Letters. The Response Letter approach in the ABA Statement is intended to reduce the likelihood of any waiver of privilege as to unasserted claims.¹⁷¹ The ABA Statement is structured such that ordinarily a Response Letter states little more about loss contingencies than what is in the public record, which may explain a paucity of reported cases in which a Response Letter has been held to have resulted in a privilege waiver.¹⁷²

provide an estimate of the amount or 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.

In the commentary on Paragraph 5, the ABA Statement on page 14 states:

[S]tatements that litigation is being defended vigorously and that the client has meritorious defenses do not, and do not purport to, make a statement about the probability of outcome in any measurable sense.

¹⁷¹ In December 1988, the Southern District of New York issued a sealed opinion ordering Drexel’s lawyer to disclose audit-inquiry responses. Unfortunately, because the decision was unpublished there is no way of knowing the court’s rationale.

The ABA, however, reacted to the Drexel case. In December 1989, the Subcommittee on Audit Inquiry Responses issued a report on the matter. Writing the report “[b]ecause of a recent court case and other judicial decisions involving lawyer’s responses to auditor’s requests for information, the Subcommittee chose not to amend the *Statement of Policy*, but “[i]n order to preserve explicitly the evidentiary privileges” suggested that in the audit-inquiry letter clients state the following: “[W]e do not intend that either our request to you to provide information to our auditor or your response to our auditor should be construed in any way to constitute a waiver of the attorney-client privilege or the attorney work-product privilege.”

To the extent that language is not in the audit-inquiry letter, the Subcommittee suggested insertion of similar language in the audit-inquiry response, “The Company . . . has advised us that . . . [it] does not intend to waive the attorney-client privilege [and] our response to you should not be construed in any way to constitute a waiver of the protection of the attorney work-product privilege. . . .” Two months later, the AICPA, working in conjunction with the ABA Subcommittee, issued its Auditing Interpretations of AU Section 337 (*Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments*) to acknowledge such language would not result in a limitation on the scope of an audit. Michael J. Sharp and Abraham M. Stanger, *Audit-Inquiry Responses in the Arena of Discovery: Protected by the Work-Product Doctrine*, 56 Bus. Lawyer 183, 206 (Nov. 2000).

¹⁷² See Douglas R. Richmond and William Freivogel, “The Attorney-Client Privilege and Work Product in the Post Enron Era, 2004 ABA Annual Meeting Program Materials, at 11.

As to pending litigation, any waiver as to the letter itself would likely not be harmful because the lawyer ordinarily would not be making an assessment of the case which could be construed as an admission against interest. Since a letter regarding pending litigation would be at a time when the work product privilege would be applicable to the litigation work product and work product waiver ordinarily is limited to the specific documents disclosed,¹⁷³ a Response Letter to auditors describing the case should not result in the attorney having to turn over the firm’s litigation file to the other side.

There is, however, no consensus among the courts that have addressed the discoverability of Response Letters. Litigants who have been confronted with a discovery request seeking a Response Letter, and who have resisted discovery, have argued attorney-client privilege, work product exclusion, or relevance as bases for refusing to produce the audit response letter.¹⁷⁴ A recent California opinion reviewed the conflicting decisions from other jurisdictions and held that a Response Letter was protected by the work product doctrine,¹⁷⁵ reasoning as follows:

¹⁷³ But cf. *U.S. v. Skeddle*, 989 F.Supp. 917, 921 (N.D. Ohio 1997).

¹⁷⁴ In *Tronitech, Inc. v. NCR Corporation*, 108 FRD 655, 3 Fed.R.Ser.3rd 1265 (S.D. Ind. 1985), the Court held (i) the audit response letter was not relevant because it was clearly inadmissible at trial and contained only opinions which could not conceivably lead to admissible evidence, and (ii) while acknowledging that work product protection applies only to materials prepared in anticipation of litigation or for trial, held that an audit letter “is not prepared in the ordinary course of business but rather arises only in the event of litigation,” and therefore constituted work product that was not discoverable. *United States v. Arthur Young & Co.*, 1984 U.S. Dist. LEXIS 22991, at *11 (N.D. Okla. Oct. 5, 1984) (“If some theory of relevance can be advanced concerning the documents under review, the Court would conclude its probative value is substantially outweighed by the danger of unfair prejudice and public interest concerns.”); *In re Genentech, Inc. v. Securities Litig.*, Case No. C-99-4038 (N.D. Cal. 1999) (unpublished) (noting that attorney’s opinions are not relevant or at issue in the lawsuit); *Comerica Bank of Calif. v. Lloyd Raymond Free*, Case No. 88-20880 (N.D. Cal. 1999) (unpublished) (noting “tangential relevance” of information and finding public policy in favor of protecting attorney’s work-product to be more important); *Teberg v. Am. Pacific Int’l, Inc.*, Case No. C 196448 (Los Angeles Superior Ct., April 29, 1982) (unpublished) (relevance of documents was outweighed by the public policy of promoting candid and full disclosure by counsel to auditor and by the right of privacy).

Other courts, when confronted with disputes regarding discovery of lawyer’s responses to auditor’s requests, found the letters to be discoverable. See *United States v. Gulf Oil Corp.*, 760 F.2d 292 (Temp. Emer. Ct. App. 1985), in which the court dismissed a claim that the audit letters constituted work product, holding “that these documents do not constitute attorney work product because they were created primarily for the business purpose of compiling financial statements which would satisfy the requirements of the federal securities laws,” and *Independent PetroChemical Corp. v. Aetna Casualty & Surety Co.*, 117 FRD 292 (D. D.C. 1987), in which the court further held that any attorney-client privilege associated with the audit response letter was waived when the letter was furnished to the auditor and that the work product exclusion was not applicable. *United States v. El Paso Corp.*, 682 F.2d 530, 543-44 (5th Cir. 1982) (lawyer’s analysis and memoranda “written ultimately to comply with SEC regulations” were prepared “with an eye on [the company’s] business needs, not on its legal ones” and did not “contemplate litigation in the sense required to bring it within the work product doctrine”).

¹⁷⁵ *Laguna Beach County Water District v. Superior Court of Orange County*, 22 Cal. Rptr. 3rd 387 (December 15, 2004). Similar reasoning was followed in *Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*, 2004 U.S. Dist. LEXIS 21543 (SDNY October 26, 2004), in which internal investigation reports did not result in a loss of work product protection because they were turned over to independent auditors:

Generally speaking, “the work product privilege should not be deemed waived unless disclosure is inconsistent with maintaining secrecy from possible adversaries.” *Stix Prods. v. United Merchants & Mfrs.*, 47 F.R.D. 334, 338 (S.D.N.Y. 1969). “The work product privilege is not automatically waived by any disclosure to third persons. Rather, the courts generally find a waiver of the work product privilege only if the disclosure ‘substantially increases the opportunity for potential adversaries to obtain the information.’” *In re Pfizer Inc. Sec. Litig.*, 1993 U.S. Dist. LEXIS 18215, No. 90 Civ. 1260, 1993 WL 561125, at *6 (S.D.N.Y. Dec. 23, 1993) (quoting *In re Grand Jury*, 561 F. Supp. 1247, 1257 (E.D.N.Y. 1982)) (internal citation omitted). Implicit in this analysis is the question of whether the third party itself can or should be considered an adversary. Accordingly, courts have generally held that where the disclosing party and the third party share a common interest, there is no waiver of the work product privilege. E.g., *id.* (“Disclosure of work product to a party sharing common interests is not inconsistent with the policy of privacy protection underlying the doctrine.”); *see also In re Copper Mkt. Antitrust Litig.*, 200 F.R.D. 213, 221 n.6 (S.D.N.Y. 2001) (same).

This much is settled. However, courts are split in their treatment of disclosures to a corporation’s accountants or auditors. More precisely, courts differ in their conceptualization of two critical points that are often implicitly intertwined in their analysis: whether the “adversary” contemplated by the work product privilege is necessarily a litigation adversary and whether a corporation’s auditor is such an adversary, to whom disclosure will waive the privilege. While admittedly there are good arguments on both sides, in this case, I answer both questions in the negative and conclude that Merrill Lynch’s disclosure of the reports to Deloitte & Touche did not constitute a waiver of the applicable work product protection.

In a frequently cited case, *In re Pfizer, Inc. Sec. Litig.*, Judge Buchwald held that Pfizer’s disclosure of documents to its independent auditor, KPMG Peat Marwick (“Peat Marwick”), did not waive its work product privilege. 1993 U.S. Dist. LEXIS 18215, 1993 WL 561125, at *6. Judge Buchwald’s decision was based on her observation that “Pfizer and Peat Marwick obviously shared common interests in the information, and Peat Marwick is not reasonably viewed as a conduit to a potential adversary.” *Id.* Other courts have adopted precisely this analysis. E.g., *Gutter v. E.I. DuPont de Nemours & Co.*, 1998 U.S. Dist. LEXIS 23207, No. 95 Civ. 2152, 1998 WL 2017926, at *5 (S.D. Fla. May 18, 1998) (holding that disclosure to outside accountants did not waive the work product privilege “since the accountants are not considered a conduit to a potential adversary”); *Gramm v. Horsehead Indus., Inc.*, 1990 U.S. Dist. LEXIS 773, No. 87 Civ. 5122, 1990 WL 142404, at *5 (S.D.N.Y. Jan. 25, 1990) (same). Still others have applied this approach, but scrutinized the precise role of the accountants. E.g., *Samuels v. Mitchell*, 155 F.R.D. 195, 201 (N.D. Cal. 1994) (deciding that disclosure did not constitute a waiver of the work product privilege because the accounting firm was acting as a consultant, not a “public accountant,” at the relevant time).

Judge Hellerstein articulated another view in *Medinol, Ltd. v. Boston Scientific Corp.*, where, in finding a waiver of the work product privilege, he emphasized the “public watchdog” role of independent auditors. 214 F.R.D. 113, 116 (S.D.N.Y. 2002) (quoting *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18, 79 L. Ed. 2d 826, 104 S. Ct. 1495 (1984)). Judge Hellerstein observed that it “has become crystal clear in the face of the many accounting scandals that have arisen as of late, in order for auditors to properly do their job, they *must* not share common interests with the company they audit.” *Id.* 214 F.R.D. at 116 (emphasis in original). While this is a valid policy consideration, the fact is that the determination in *Medinol* was based on a finding that the auditor’s interests were not aligned with that of the corporation and that the disclosure

Neither party cited nor did we find any California law dealing with the specific question of whether work product loses its protection if it is disclosed to an auditor in an audit response letter. The few cases from federal courts have come down on both sides of this issue. For example, in *Tronitech, Inc. v. NCR Corp.* (S.D.Ind. 1985) 108 F.R.D. 655, the court held an audit response letter was protected by the work product rule (Fed. Rules Civ.Proc., rule 26(b)(3)) because it was “comprised solely of an attorney’s

of the documents at issue -- the Special Litigation Committee’s minutes -- did not serve a pertinent litigation interest.

* * *

As these cases make clear, the Court’s inquiry must not end with the mere fact of a disclosure to the independent auditors. * * *

Instead, the critical inquiry -- to me -- must be whether Deloitte & Touche should be conceived of as an adversary or a conduit to a potential adversary. As Judge Hellerstein and other courts have observed, an independent auditor could be conceived of as an adversary because of its important public function to independently ensure the accuracy of a company’s financial reports. Clearly, outside auditors must maintain an independent role in this regard. Indeed, a good portion of the reforms embodied in the *Sarbanes-Oxley Act of 2002* (“Sarbanes Oxley”), 15 U.S.C. § 7201 *et seq.*, are aimed at strengthening the independence of auditors and eliminating conflicts of interest (S.E.C. Release No. Jan 28, 2003). * * *

Thus, any tension between an auditor and a corporation that arises from an auditor’s need to scrutinize and investigate a corporation’s records and book-keeping practices simply is not the equivalent of an adversarial relationship contemplated by the work product doctrine. Nor should it be. A business and its auditor can and should be aligned insofar as they both seek to prevent, detect, and root out corporate fraud. Indeed, this is precisely the type of limited alliance that courts should encourage. * * *

There was no further disclosure of the protected material in this case, nor could there have been, as Deloitte & Touche was under an ethical and professional obligation to maintain materials received from its client confidential, unless disclosure was required by law or accounting standards. Gueli Letter, Ex. B P7. The relevant standards at the time in question did not contemplate disclosure of documents or their specific contents to a third party. Instead, if an auditor learned of a “reportable condition,” i.e., an internal control deficiency that “could adversely affect the organization’s ability to record, process, summarize, and report financial data,” AICPA SAS 60.02, the auditor was obligated to report this information to corporate management, the audit committee, and/or the board of directors, AICPA SAS 60.02, .09, .10, AICPA SAS 61. The applicable standard specifically provides that an auditor’s report on a reportable condition should state that it is to be used only by personnel within the corporation, unless the auditor is required to furnish the report to government authorities. AICPA SAS 60.10. The only public revelation could have been, in the worst case scenario, a general statement by Deloitte & Touche regarding its inability to accurately evaluate Merrill Lynch’s financial statements due to internal control deficiencies. In sum, the nature of the disclosure in this case and the obligations of Deloitte & Touche under the applicable accounting standards simply do not make out a waiver.

opinion.” (*Id.* at p. 656.) Further, “[a]n audit letter is not prepared in the ordinary course of business but rather arises only in the event of litigation. It is prepared because of the litigation, and it is comprised of the sum total of the attorney’s conclusions and legal theories concerning that litigation.” (*Ibid.*)

The cases finding against the protection are distinguishable. First, as interpreted in some circuits, the federal work product doctrine is more limited than California’s, with its protection extending only to documents “prepared in anticipation of litigation or for trial” (Fed. Rules Civ.Proc., rule 26(b)(3); see, e.g., *JumpSport, Inc. v. Jumpking, Inc.* (N.D.Cal. 2003) 213 F.R.D. 329, 330-331; *Dawson v. New York Life Ins. Co.* (N.D.Ill. 1995) 901 F.Supp. 1362, 1368.) In California, however, “[t]he protection afforded by the [attorney work product doctrine] is not limited to writings created by a lawyer in anticipation of a lawsuit. It applies as well to writings prepared by an attorney while acting in a nonlitigation capacity. [Citation.]” (*County of Los Angeles v. Superior Court* (2000) 82 Cal.App.4th 819, 833.) Thus, *United States v. Gulf Oil Corp.* (Temp. Emer. Ct.App. 1985) 760 F.2d 292 is inapt because the decision not to afford work product protection to audit inquiry responses was based on the finding that the “documents were not created to assist ... in the litigation” (*Id.* at pp. 296-297.)

Moreover, in *In re Hillsborough Holdings Corp.* (Banks. M.D.Fla. 1991) 132 B.R. 478, the court did not rely on the work product doctrine. The decision to require production of audit inquiry responses was based on the finding that the documents were not protected by the accountant-client privilege. (*Id.* at pp. 480-481.)

Thus, based on the contents of the letters, which contain the attorney’s thoughts, impressions, and opinions, plus the purpose of the work product doctrine, and the rule that waiver occurs only when work product is disclosed to a third party “‘who has no interest in maintaining the confidentiality ... of a significant part of the work product’” (*OXY Resources California v. Superior Court, supra*, 115 Cal.App.4th at p. 891), we conclude Gokoo’s audit response letters to Diehl remained protected work product. Based on our determination on this ground, we have no need to and do not decide the effect of the attorney-client privilege on these two documents.

Even though the lawyer’s letter to the auditor may not be protected by the attorney-client privilege, any waiver should be limited to the contents of the letter and should not require the contents of the attorney’s entire file on the matter covered by the letter.¹⁷⁶

Auditors often ask for information about loss contingencies beyond Response Letters, and courts often hold that disclosure of attorney-client communications to auditors waives the attorney-client privilege, just as almost any disclosure to an outsider breaches the confidence and waives the attorney-client privilege.¹⁷⁷ Thus, unless the controversy arises in one of the fifteen

states that, by statute, recognize an accountant-client privilege¹⁷⁸ or the accountant is helping the attorney to advise the client (a role that an auditor typically does not undertake given independence constraints), disclosure to the outside accountant likely waives the attorney-client privilege.¹⁷⁹ With respect to whether work product protection survives disclosure to auditors, the opinions are divided, but the majority view seems to be that work product includes any material prepared “because of” actual or potential litigation (thus encompassing analysis of litigation exposure prepared in response to an Inquiry Letter) and survives disclosure to the auditors.¹⁸⁰

Litig., 1993 WL 561125, at *6 (S.D.N.Y. Dec. 23, 1993) (“Disclosure of documents to an outside accountant destroys the confidentiality seal required of communications protected by the attorney-client privilege, notwithstanding that the federal securities laws require an independent audit”).

¹⁷⁸ The fifteen states that recognize the accountant-client privilege are listed below:

Arizona, ARIZ. REV. STAT. § 32-749; Colorado, COLO. REV. STAT. § 13-90-107; Florida, FLA. STAT. ANN. § 90.5055; Georgia, GA. CODE ANN. § 43-3-32; Idaho, IDAHO CODE § 9-203A AND IDAHO ST. REV. Rule 515; Illinois, 225 ILL. COMP. STAT. 450/27; Indiana, IND. CODE § 34-46-2-18; Kansas, KS. STAT. ANN. § 1-401; Louisiana, LA. CODE EVID. ANN. art. 515; Maryland, MD. CODE ANN., CTS. & JUD. PROC. § 9-110; Michigan, MICH. COMP. LAWS § 339.732; Missouri, MO. REV. STAT. § 326.322; New Mexico, N.M. STAT. ANN. § 38-6-6; Pennsylvania, PA. STAT. ANN. tit. 63 § 9.11; and Tennessee, TENN. CODE ANN. § 62-1-116.

Other states have statutes requiring accountants and auditors to maintain the confidentiality of client materials, but not purporting to establish any evidentiary privilege from discovery. See Alabama, ALA. CODE § 34-1-21; California, 16 CAL. CODE REGS. tit. 16, § 54; Connecticut, CONN. GEN. STAT. ANN. § 20-281j; Iowa, IOWA CODE ANN. § 542.17; Kentucky, KY. REV. STAT. ANN. § 325.440; Massachusetts, MASS. GEN. LAWS ANN. ch. 112 § 87E; Minnesota, MINN. STAT. ANN. § 326A.12; Mississippi, MISS. CODE ANN. § 73-33-16; Montana, MONT. CODE ANN. § 37-50-402; New Jersey, N.J. STAT. ANN. § 45:2B-65; North Dakota, N.D. CENT. CODE § 43-02.2-16; Oregon, OR. REV. STAT. § 673.385; Rhode Island, R.I. GEN. LAWS § 5-3-1-23; Vermont, VT. CODE R. § 81; Washington, WASH. REV. CODE ANN. § 18.04.405.

¹⁷⁹ See *Ferko Nat’l Assoc. for Stock Car Auto Racing*, 218 F.R.D. 125, 135 (E.D. Tex. 2003), citing *United States v. Kovel*, 296 F.2d 918, 921-22 (2d Cir. 1961), which extended the attorney client privilege to attorney-accountant communications for the purpose of assisting the lawyer to advise the client.

¹⁸⁰ See *United States v. Adlman*, 134 F.3d 1194, 1202 (2d Cir. 1998) (observing, in *dicta*, that the work-product doctrine would protect an audit-inquiry response and approving the rule adopted by the Third, Fourth, Seventh, Eighth, and D.C. Circuits that a document is work product if “in light of the nature of the document and the factual situation in the particular case, the document can fairly be said to have been prepared or obtained because of the prospect of litigation”) (emphasis in original); *In re Honeywell Int’l, Inc. Securities Litig.*, 2003 WL 22722961, at *6 (S.D.N.Y. Nov. 18, 2003) (rejecting plaintiff’s argument that the “preeminent business purpose” of an audit rendered the work product doctrine inapplicable and finding that defendant’s “assertion of work product protection for ... audit letters and litigation reports prepared by its internal and external counsel, as well as PWC documents memorializing ... opinion work product, is proper.”); *Southern Scrap Material Co. v. Fleming*, 2003 WL 21474516, at *9 (E.D. La. June 18, 2003) (“The audit letters ... were prepared by outside counsel at the request of [party’s] general counsel with an eye toward litigation then ongoing. [Thus] ... they are attorney work product of the opinion/mental impression/litigation strategy genre.”); *In re Raytheon Securities Litig.*, 218 F.R.D. at 358 (citing cases in the Third, Fourth, Seventh, Eighth and D.C. Circuits that have adopted the “because of” definition of work product); *Vanguard Sav. and Loan Assoc. v. Barton Banks*, 1995 U.S. Dist. LEXIS 13712, at *11-12 (E.D. Pa. 1995) (lawyer letters regarding litigation, prepared to assist client in reporting loss contingencies for a regulatory examination, were work product and protected even though created “primarily” for a business purpose); *Tronitech, Inc.*, 108 F.R.D. at 657 (“an audit letter is not prepared in the ordinary course of

¹⁷⁶ See *United States v. Upjohn Company*, 600 F.2d 1223, 1227 n.12 (6th Cir. 1979), *rev’d on other grounds*, 449 U.S. 383 (1981) (“The corporation’s voluntary disclosure to the SEC amounts to a waiver of the privilege only with respect to the facts actually disclosed.”).

¹⁷⁷ 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”); *In re Pfizer Inc. Securities*

The forum in which the discoverability issues are litigated, as well as particular circumstances of the case, will determine whether the protection otherwise applicable will survive disclosure to auditors.¹⁸¹ Companies, therefore, have no guarantee that courts will protect the work product generated from internal investigations from waiver as to adversaries if these materials are disclosed to auditors, and could complain: “[a]n uncertain privilege, or one which purports to be certain but results in widely varying applications by the courts, is little better than no privilege at all.”¹⁸²

VI. SELECTED RESPONSE LETTER ISSUES

Is the ABA Statement Superseded by SOX §303? Concern has been expressed as to whether compliance with the ABA Statement will protect the lawyer in view of SOX §303(a) and Rule 13b2-2. The ABA Statement has not been superseded by SOX §303 and Rule 13b2-2. In a situation where no estimate of outcome is given in the audit response because the likelihood of an unfavorable outcome is considered neither “remote” or “probable,” but the lawyer has in fact developed the view that the likelihood of an unfavorable outcome is significant (but short of “probable”), could the response be said to be misleading on the basis that it fails to state a material fact? The lawyer’s communication would be within the framework of the ABA Statement that established clear standards for what will and will not be included in the Response Letters.

A Response Letter conforming to the ABA Statement delivered to accountants who were parties to the professional treaty memorialized in the ABA Statement can hardly be misled by such a response because they know the basis on which it was prepared and what it means. If, however, the Response Letter does not conform to the ABA Statement or the attorney has oral communication with the auditors, the attorney would have the risk of negligent advice which would be sanctionable under Rule 13b2-2 under the 1934 Act.

Further, the attorney has a duty to consult with the client regarding material loss contingencies not disclosed in the Response Letter which the attorney believes the client should disclose or consider disclosing. If the client does not respond appropriately, the lawyer would

business but rather arises only in the event of litigation. It is prepared because of the litigation ... [and] should be protected by the work product privilege”).

¹⁸¹ Compare *Medinol, Ltd. v. Boston Scientific Group*, 214 F.R.D. 113, 115 (S.D.N.Y. 2002) (minutes of the Special Litigation Committee meeting reflecting counsel’s investigation were provided to the auditors in connection with their audit of loss contingency reserves and the court held that the disclosure waived the work product protection) to *Gramm v. Horsehead Indus., Inc.*, 1990 U.S. Dist. LEXIS 773, at *19 (S.D.N.Y. Jan. 25, 1990) (finding no waiver upon disclosure to auditors because “disclosure to another person who has an interest in the information but who is not reasonably viewed as a conduit to a potential adversary will not be deemed a waiver of protection of the rule”); *Tronitech*, 108 F.R.D. at 657 (no waiver upon disclosure of work product to auditors since “audit letters are produced under assurances of strictest confidentiality”); see *Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*, 2004 U.S. Dist. LEXIS 21543 (SDNY 2004) and cases discussed therein.

¹⁸² *Upjohn*, 449 U.S. at 392.

have to comply with the lawyers reporting up the ladder obligation under the SOX §307 Rules. An attorney could also have exposure under the securities laws.¹⁸³

The Company Dilemma. The ABA Ad Hoc Committee on Audit Responses continues to report that the ABA Statement is in full force and effect as far as law firms and corporate law departments are concerned. For the most part, attorneys are adhering to the ABA Statement in responding to Inquiry Letters. SOX §303 and SEC Rule 13b2-2, however, must be considered by attorneys when communicating with accountants and may have significantly raised the stakes in such communications, particularly when large, complex cases are pending or threatened against a company and their outcome could be of material significance.¹⁸⁴

The ABA Statement cautions that the lawyer “should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either ‘probable’ or ‘remote’.” However, what if the auditor asserts that the attorney must provide an evaluation by reason of SOX §303? The attorney representing the company faces the following unattractive choices. If the attorney provides an evaluation, it may be asserted that it is a waiver of the attorney-client privilege or work product protection that might under normal circumstances insulate the information from third party discovery.¹⁸⁵ Moreover, if the privilege or protection is waived, it is potentially waived for all purposes and as to all third parties.¹⁸⁶ Although it is far from clear that a waiver would be found, this potential could be a very high price to pay with respect to the pending case or claim.

On the other hand, if the attorney decides or is instructed by the company to “stick to the ABA Statement,” that decision could expose the attorney to enforcement action under SEC Rule 13b2-2, which implements SOX §303, if the case or claim ultimately results in a material exposure relative to the assets of the company. In this regard, the SEC has already indicated that one type of conduct that could result in rendering an issuer’s financial statements materially misleading would be providing an auditor with an inaccurate or misleading response or legal analysis, and the SEC has also indicated that responsibility for a misleading response or analysis falls on the attorney providing information to the auditor.¹⁸⁷ Thus, if the case or claim results in a material adverse judgment or settlement, the attorney (particularly in the case of an in-house attorney acting under the direction of, or based on information supplied by, the company general counsel or its chief financial officer or their designee(s)) could be asserted to have been responsible, as may be those supplying the information or direction, for “misleading” the auditor. This is not a very attractive situation and one which could also result in significant personal exposure to the responsible parties.

¹⁸³ See “Enron Civil Liability Fallout” under “III. Enhanced Attorney Responsibilities under SOX,” *supra*.

¹⁸⁴ See “II. Misleading Statements to Auditors,” *supra*.

¹⁸⁵ See “IV. Attorney-Client Privilege and the Work Product Doctrine in the Corporate Context,” *supra*.

¹⁸⁶ *Id.*

¹⁸⁷ See “II. Misleading Statements to Auditors,” *supra*.

As a practical matter the dilemma described above is most likely to arise relative to large, complex cases or claims of potential material significance, particularly in circumstances in which it may be too early to form a solid conclusion as to whether the matter is in the “probable” or “remote” category for purposes of the ABA Statement. What is clear in such situations is the need for close and continuous consultation between outside lawyers representing the company and the general counsel, chief financial officer or their designee(s). There is unquestionably a need to develop a “good faith” consensus on responses to any auditor request for information and to maintain consistency throughout the process of interaction with the auditor, while not undermining the independence of the attorney’s professional judgment. This process may also include requests for estimates of loss, requests beyond the ABA Statement, updates, informal discussions and information as to specific cases. These issues are discussed in greater detail in the material which follows.

Thus, while the ABA Statement remains in full force and effect, the risks associated with responses in connection with potentially material cases or claims which have not matured to the point of being able to be categorized as either “probable” or “remote” must be considered in view of SOX §303 and SEC Rule 13b2-2. It may be hoped that the policy importance of protecting the attorney-client and work product privileges will be recognized in appropriate situations, but the likelihood is that barring further legislative or regulatory clarification, the contours of such risks of waiver as well as of enforcement attitudes will be defined over some time and on a case-by-case basis.

Law Firm Policies. Many law firms have adopted policies and procedures for processing Inquiry Letters and issuing Response Letters which typically are based on the ABA Statement.¹⁸⁸ Law firms typically have adopted policies for circulating information to its attorneys that the client’s Inquiry Letter has been received and soliciting information needed to complete the Response Letter. Some firms designate a particular individual or committee to respond to questions or to review all or particular kinds of Response Letters. Before undertaking to respond to an Inquiry Letter or work on a Response Letter, attorneys should become familiar with the ABA Statement and the firm’s policies and procedures.

Estimates of Loss. With respect to opinions as to outcome and estimates of potential loss, each lawyer should carefully read and consider Paragraph 5 of the ABA Statement. There the lawyer is cautioned that the lawyer “should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either ‘probable’ or ‘remote’,” using such terms in accordance with their meanings set forth in Paragraph 5 and the related Commentary. It should be noted that a lawyer is not in a position to express an opinion that the likelihood of an unfavorable outcome is “remote” unless in the lawyer’s “unqualified judgment, taking into account all relevant facts which may affect the outcome,...the client may confidently expect to prevail on a motion for summary judgment on all issues due to the clarity of the facts and the law.” Likewise, the lawyer should not attempt to estimate, in dollar terms, the potential amount of loss or range of loss in the event of an unfavorable outcome unless the lawyer believes that the probability of inaccuracy of the estimate is slight. In practical terms, in a situation involving an unliquidated claim or

demand, attorneys should rarely if ever make a loss estimate. Unless the likelihood of an unfavorable outcome is probable or remote, within the meaning of the ABA Statement, a typical response to an inquiry concerning outcome and the amount or range of potential loss is the following:

Because we have not formed a conclusion as to whether an unfavorable outcome is either probable or remote (as those terms are defined in the ABA Statement), we express no opinion with respect to the likelihood of an unfavorable outcome or the amount or range of potential loss if the outcome should be unfavorable.

The language used when declining to state an opinion as to outcome can be important and should track the wording and structure of the ABA Statement. To state “we are unable to express an opinion” may be inadvisable because it does not track the structure of the ABA Statement, and could be misleading if the attorney in fact has formed an opinion. Similarly, keying the non-expressing of an opinion as to outcome to the case being in the early stages of litigation should be avoided, as arguably it could be construed to create a duty to update which is contrary to other wording in the Response Letter. Language that is keyed to the language of the ABA Statement, such as “because we have not formed a conclusion as to whether an unfavorable outcome is either probable or remote (as those terms are defined in the ABA Statement), we express no opinion as to the likelihood of an unfavorable outcome” should be good practice.

Requests Beyond Scope of ABA Statement. Ordinarily, the Response Letter should include only information as to loss contingencies as permitted by the ABA Statement and, if requested, information as to fees and disbursements owed by the client. As a result of the pressures on auditors to be more thorough in their audit procedures and documentation,¹⁸⁹ some

¹⁸⁹ SEC Deputy Chief Accountant Scott A. Taub summarized the SEC’s concerns that the audit process adequately address accruals for and disclosures of loss contingencies, including obtaining appropriate information from counsel, in the following remarks delivered at the University of Southern California Leventhal School of Accounting SEC and Financial Reporting Conference (May 27, 2004), which can be found at <http://www.sec.gov/news/speech/spch052704sat.htm>.

... I am well aware that loss contingencies are one of the most difficult areas there is to audit. Representations from management and from attorneys sometimes seem to be all that there is to support an accrual or the lack of one. The difficulty in auditing these types of accruals, however, should cause the auditor to spend more time on them, not less. Auditors should seek to review the company’s own analyses of the issues, including the support for the conclusions as to whether an accrual is necessary, and what the possible range of loss is. If the only procedures that can be performed are face-to-face discussions with company personnel and with outside counsel, those discussions should be held, and experienced auditors should be part of them. 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. Audit documentation should follow the same high standards that apply to other areas of the audit, as well. This, of course, includes the documentation of the audit of the tax contingency accounts. A note or short memo that indicates that qualified personnel from the audit firm held discussion of all relevant risks with company personnel is not sufficient. I would expect that the PCAOB inspection teams will be looking at the audit work done in these sensitive areas as they begin their first year of a full inspection schedule.

¹⁸⁸ Attached as Exhibit B is a common form of law firm Response Letter.

Request Letters ask for information about other matters, such as security agreements, the filing of financing statements, outstanding stock, legislative developments, compliance with environmental laws, securities laws or ERISA, violations of laws or codes of conduct, or fiduciary duties or changes in business practices. One form of non-standard Inquiry Letter asks the law firm to confirm in the Response Letter that any possible illegal acts of the company that the law firm knows of have been reported to the company's audit committee and auditors. Since attorneys cannot be assured that auditors will conform to the Inquiry Letter format contemplated by the ABA Statement or to the form of Inquiry Letter issued for the same client in prior years, attorneys will need to consider each Inquiry Letter individually for particular issues of non-conformity with the ABA Statement. These non-standard Inquiry Letters typically do not reflect sensitivity to the importance of avoiding waiver of the attorney-client privilege.¹⁹⁰

On August 26, 2004 in a limited inspection report on one of the largest accounting firms (which can be found at http://www.pcaobus.org/Inspections/Public_Reports/2003/Deloitte_and_Touche.pdf) the PCAOB criticized the firm for instances of inadequate support regarding the treatment of contingent liabilities under FAS 5, including:

... With respect to a potential contingent liability, the engagement team obtained a memo from the issuer that documented the company's conclusions regarding the loss contingency, and the engagement team documented in a memo to the work papers its conclusion that no accrual for this liability was required as of a particular date. The memo documented that the contingent liability could arise from two default provisions in an existing agreement – currently known defaults by the company or future potential defaults based on operating decisions the company was contemplating. The memo and the disclosures in the financial statements indicated that management's conclusion that an accrual was not required was based on the advice of legal counsel. The work papers maintained by the U.S. engagement team, however, did not include a copy of a letter to the issuer from its counsel containing legal advice on which the issuer had based its conclusions. Nor did the work papers make any specific reference to such a letter being maintained elsewhere. The work papers also did not provide a clear assessment as to the basis, as between the competing alternative bases, for the conclusion that accrual of the potential contingent liability was not required.

¹⁹⁰ In a Report to the ABA House of Delegates by an ABA Task Force on Attorney-Client Privilege, which is published at 60 Bus. Lawyer 1029 (May 2005) and available at <http://www.abanet.org/buslaw/attorneyclient/>, it was noted:

The AICPA interpretations of SAS No. 12 (AU Section 337.09) also recognize the importance of the attorney-client privilege by limiting the need to examine documents in the company's possession that are subject to the privilege. Recently, however, with increasing frequency, auditors have requested from companies privileged communications or attorneys' litigation work product. The Task Force has been made aware of several types of material that auditors are requesting that companies provide for audits. Examples of the requested material include (1) tax opinions prepared for companies by outside counsel that underlie tax positions and tax accruals; (2) assessments prepared by both in-house and outside counsel that relate to litigation accruals and set forth counsel's reasoning underlying such accruals; (3) reports and papers produced as a result of internal investigations regardless of whether such investigations are ongoing or are likely to have an impact upon an audit; and (4) materials related to compliance with legal and regulatory requirements, e.g., requests to see board and committee members' annual self-assessments.

See "Discoverability of Audit Response Letters" in Section V, *supra*.

Attorneys often decline to supply information in a Response Letter beyond what is contemplated by the ABA Statement, and generically comment that such other information is not being provided.¹⁹¹ Some commentators suggest that, in addition, it is appropriate to specifically reference the requested information not being furnished and state that it is not being provided because the request is beyond the scope of the ABA Statement in order that there be no ambiguity that the non-conforming request is being denied.¹⁹² Attorneys should understand, however, that the auditors' requests for the additional information may be based upon a real need for corroborative information to complete their audit procedures and that there are circumstances in which the auditors' inability to obtain the requested additional information could lead the auditors to qualify opinions on clients' financial statements, which could be worse for the clients than the consequences of giving the auditors the information they require. For example, in circumstances in which the auditor believes that it needs the attorney's response about illegal acts in order to satisfy the auditor's Section 10A obligations, there may need to be communications from a reliable source sufficient to satisfy the auditor's requirements.

Some Inquiry Letters include a request beyond the scope of the ABA Statement in the form of a general inquiry regarding unasserted claims. Since under the ABA Statement a request for comment about unasserted claims is appropriate only if the client has determined that it is probable that a claim will be asserted, that there is a reasonable possibility that the outcome (assuming the claim is asserted) will be unfavorable, and that the resulting liability would be material, some lawyers specifically note in their Response Letter the general inquiry and the inappropriateness under the ABA Statement of responding to it. Others rely on the general incorporation by reference of the ABA Statement into the Response Letter as sufficient explanation as to why there is no response to a non-standard general inquiry regarding unasserted claims.

Requests for Updates or Informal Discussions. The constraints on what may be said in Response Letters under the ABA Statement sometimes lead to requests for informal discussions in which supplemental information is elicited from the lawyer. The ABA Statement does not envision informal sessions with auditors or otherwise provide any parameters for what may be communicated to auditors in such a context different from those applicable to a formal response. While many law firms discourage or even forbid such discussions because of the risks of miscommunication or misunderstanding¹⁹³ or inadvertent waiver of privilege, auditors may insist

¹⁹¹ The second paragraph of a typical Response Letter provides:

This response is limited by, and is in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December, 1975) and the accompanying Commentary (collectively, the "ABA Statement of Policy"). We are not responding to any request, nor are we commenting on any statement, contained in the Request Letter which we believe to be inconsistent with the intent of the ABA Statement of Policy. No inference should be drawn from our failure to respond to or comment on any such request or statement.

¹⁹² See Ad Hoc Committee on Audit Responses: Report on Listserv Activity (Inception to August 3, 2004), ABA Section of Business Law Ad Hoc Committee on Audit Responses.

¹⁹³ See the discussion of SEC Rule 13b2-2, *supra*, and *In the Matter of Google, Inc. and David C. Drummond*, SEC Release No. 8523 (January 13, 2005), which can be found at <http://www.sec.gov/litigation/admin/33-8523.htm> and in which the general counsel of Google consented to a cease and desist order as a result of

that they require such discussions or written representations as a prerequisite to expressing an unqualified opinion on the client's financial statements. When and if an attorney enters into such a discussion, he can expect that his oral statements will be summarized in auditors' notes and workpapers, which the attorney will not have an opportunity to review or correct.

Auditors often ask for updated Response Letters. Providing an updated Response Letter requires that the firm's internal search process be repeated, and is often discouraged for cost and timing reasons.

Auditors sometimes request updates via telephone. Attorneys often respond that responses to auditor requests for information should be in accordance with the ABA Statement, which does not contemplate oral updates. Further, an update requires reinitiation of the firm search process, which takes time and costs the client money. Nonetheless, if the auditors conclude that they need an update as a prerequisite for an unqualified opinion on the financial statements, the client may ask the attorneys to perform the appropriate procedures to provide an updated Response Letter.

Information as to Specific Cases. On occasion an auditor will advise the client that the typical "we express no opinion" as to outcome or amount or range of loss is unsatisfactory and will advise the client that the significance of the case requires further guidance from the lawyer or the auditor will have to qualify the auditor's opinion as to the financial statements. In such a case the attorney is permitted by the ABA Statement to provide additional information. Since predictions as to the outcome of litigation are fraught with peril for both the client and the lawyer, the client's disclosure position does not justify a deviation from the principles of the Statement as to predictions as to outcome or loss exposure.

VII. CONCLUSION

SOX and the SEC's rules thereunder are already having a significant impact on how issuers, both public and private, are governed and manage their disclosure processes. They are also having profound effects on the accountants, attorneys and others who deal with issuers, and are influencing how accountants and attorneys deal with Inquiry Letters and Response Letters.

giving erroneous advice to Google regarding disclosures required to be given to employees to whom employee stock options were granted.

EXHIBIT A

SUMMARY OF SOX

To What Companies Does SOX Apply. SOX is generally applicable to all companies required to file reports with the SEC under the 1934 Act ("*reporting companies*") or that have a registration statement on file with the SEC under the 1933 Act, in each case regardless of size (collectively, "*public companies*" or "*issuers*"). Some of the SOX provisions apply only to companies listed on a national securities exchange¹⁹⁴ ("*listed companies*"), such as the New York Stock Exchange ("*NYSE*") or the NASDAQ Stock Market ("*NASDAQ*")¹⁹⁵ (the national securities exchanges and NASDAQ are referred to collectively as "*SROs*"), but not to companies traded on the NASD OTC Bulletin Board or quoted in the Pink Sheets or the Yellow Sheets.¹⁹⁶ Small business issuers¹⁹⁷ that file reports on Form 10-QSB and Form 10-KSB are subject to SOX generally in the same ways as larger companies although some specifics vary (references herein to Forms 10-Q and 10-K include Forms 10-QSB and 10-KSB).

¹⁹⁴ A "national securities exchange" is an exchange registered as such under 1934 Act §6. There are currently nine national securities exchanges registered under 1934 Act §6(a): American Stock Exchange (AMEX), Boston Stock Exchange, Chicago Board Options Exchange (CBOE), Chicago Stock Exchange, Cincinnati Stock Exchange, International Stock Exchange, New York Stock Exchange (NYSE), Philadelphia Stock Exchange and Pacific Stock Exchange.

¹⁹⁵ A "national securities association" is an association of brokers and dealers registered as such under 1934 Act §15A. The National Association of Securities Dealers ("*NASD*") is the only national securities association registered with the SEC under 1934 Act §15A(a). The NASD partially owns and operates The NASDAQ Stock Market ("*NASDAQ*"), which has filed an application with the SEC to register as a national securities exchange.

¹⁹⁶ The OTC Bulletin Board, the Pink Sheets and the Yellow Sheets are quotation systems that do not provide issuers with the ability to list their securities. Each is a quotation medium that collects and distributes market maker quotes to subscribers. These interdealer quotations systems do not maintain or impose listing standards, nor do they have a listing agreement or arrangement with the issuers whose securities are quoted through them. Although market makers may be required to review and maintain specified information about the issuer and to furnish that information to the interdealer quotation system, the issuers whose securities are quoted on the systems do not have any filing or reporting requirements to the system. See SEC Release No. 33-8820 (April 9, 2003).

¹⁹⁷ "Small business issuer" is defined in 1934 Act Rule 0-10(a) as an issuer (other than an investment company) that had total assets of \$5 million or less on the last day of its most recent fiscal year, except that for the purposes of determining eligibility to use Forms 10-KSB and 10-QSB that term is defined in 1934 Act Rule as a United States ("*U.S.*") or Canadian issuer with neither annual revenues nor "*public float*" (aggregate market value of its outstanding voting and non-voting common equity held by non-affiliates) of \$25,000,000 or more. Some of the rules adopted under SOX apply more quickly to larger companies that are defined as "*accelerated filers*" under 1934 Act Rule 12b-2 (generally issuers with a public common equity float of \$75 million or more as of the last business day of the issuer's most recently completed second fiscal quarter that have been reporting companies for at least 12 months).

SOX and the SEC's rules thereunder are applicable in many, but not all, respects to (i) investment companies registered under the Investment Company Act of 1940 (the "1940 Act") and (ii) public companies domiciled outside of the U.S. ("*foreign companies*").¹⁹⁸

Companies that file periodic reports with the SEC solely to comply with covenants under debt instruments, to facilitate sales of securities under Rule 144 or for other corporate purposes ("*voluntary filers*"), rather than pursuant to statutory or regulatory requirements to make such filings, are not issuers and generally are not required to comply with most of the corporate governance provisions of SOX.¹⁹⁹ The SEC's rules and forms implementing SOX that require disclosure in periodic reports filed with the SEC apply to voluntary filers by virtue of the fact that voluntary filers are contractually required to file periodic reports in the form prescribed by the rules and regulations of the SEC. The SEC appears to be making a distinction in its rules between governance requirements under the Act (which tend to apply only to statutory "issuers") and disclosure requirements (which tend to apply to all companies filing reports under the 1934 Act).

While SOX is generally applicable only to public companies, there are three important exceptions: (i) SOX §§ 802 and 1102 make it a crime for any person to alter, destroy, mutilate or conceal a record or document so as to (x) impede, obstruct or influence an influence an investigation or (y) impair the object's integrity or availability for use in an official proceeding; (ii) SOX § 1107 makes it a crime to knowingly, with the intent to retaliate, take any action harmful to a person for providing to a law enforcement officer truthful information relating to the commission of any federal offense; and (iii) SOX § 904 raises the criminal monetary penalties for violation of the reporting and disclosure requirements of the Employee Retirement Income Security Act of 1974 ("*ERISA*"). These three provisions are applicable to private and nonprofit entities as well as public companies.

¹⁹⁸ Many of the SEC rules promulgated under SOX's directives provide limited relief from some SOX provisions for the "*foreign private issuer*," which is defined in 1933 Act Rule 405 and 1934 Act Rule 3b-4(c) as a private corporation or other organization incorporated outside of the U.S., as long as:

- More than 50% of the issuer's outstanding voting securities are not directly or indirectly held of record by U.S. residents;
- The majority of the executive officers or directors are not U.S. citizens or residents;
- More than 50% of the issuer's assets are not located in the U.S.; and;
- The issuer's business is not administered principally in the U.S.

¹⁹⁹ *Question 1*, SEC's Division of Corporation Finance: Sarbanes-Oxley Act of 2002 – Frequently Asked Questions, posted November 8, 2002 (revised November 14, 2002) at www.sec.gov/divisions/corpfina/faqs/soxact2002.htm.

Private companies that contemplate going public, seeking financing from investors whose exit strategy is a public offering or being acquired by a public company may find it advantageous or necessary to conduct their affairs as if they were subject to SOX.²⁰⁰

Accounting Firm Regulation. SOX creates a five-member board appointed by the SEC and called the Public Company Accounting Oversight Board (the "*PCAOB*") to oversee the accounting firms that serve public companies and to establish accounting standards and rules. SOX does not address the accounting for stock options, but the PCAOB would have the power to do so. The PCAOB is a private non-profit corporation to be funded by assessing public companies based on their market capitalization. It has the authority to subpoena documents from public companies. The PCAOB is required to notify the SEC of any pending PCAOB investigations involving potential violations of the securities laws. Additionally, SOX provides that the PCAOB should coordinate its efforts with the SEC's enforcement division as necessary to protect ongoing SEC investigations.

Restrictions on Providing Non-Audit Services to Audit Clients. SOX and the SEC rules thereunder restrict the services accounting firms may offer to clients. Among the services that audit firms may not provide for their audit clients are (1) bookkeeping or other services related to the accounting records or financial statements of the audit client; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; (8) legal services; and (9) expert services unrelated to the audit. Accounting firms may generally provide tax services to their audit clients, but may not represent them in tax litigation.

Enhanced Audit Committee Requirements/Responsibilities. SOX provides, and the SEC has adopted rules such that, audit committees of listed companies (i) must have direct responsibility for the appointment, compensation and oversight (including the resolution of disagreements between management and the auditors regarding financial reporting) of the auditors, (ii) must be composed solely of independent directors, which means that each member may not, other than as compensation for service on the board of directors or any of its committees (x) accept any consulting, advisory or other compensation from the issuer, directly or indirectly, or (y) be an officer or other affiliate of the issuer, and (iii) are responsible for establishing procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters, and the confidential, anonymous submission by employees of the issuer ("*whistleblowers*") of concerns regarding any questionable accounting or auditing matters. Whistleblowers are protected against discharge or discrimination by an issuer.

Issuers are required to disclose (i) the members of the audit committee and (ii) whether the audit committee has an "*audit committee financial expert*" and, if so, his or her name.

²⁰⁰ See Joseph Kubarek, *Sarbanes-Oxley Raises the Bar for Private Companies*, NACD-Directors Monthly (June 2004 at 19-20); Peter H. Ehrenberg and Anthony O. Pergola, *Why Private Companies Should Not Ignore the Sarbanes-Oxley Act*, Wall Street Lawyer (December 2002 at 12-13).

SOX requires that auditors report to audit committees regarding (a) all critical accounting policies and practices to be used and (b) all alternative treatments of financial information within generally accepted accounting principles for financial reporting in the U.S. ("GAAP") that have been discussed with management.

SOX requires audit committee preapproval of all auditing services and non-audit services provided by an issuer's auditor. The audit committee may delegate the preapproval responsibility to a subcommittee of one or more independent directors.

CEO/CFO Certifications. SOX contains *two* different provisions that require the chief executive officer ("CEO") and chief financial officer ("CFO") of each reporting company to sign and certify company SEC periodic reports, with possible criminal and civil penalties for false statements. The result is that CEOs and CFOs must each sign two separate certifications in their companies' periodic reports, one certificate being required by rules adopted by the SEC under an amendment to the 1934 Act (the "*SOX §302 Certification*") and the other being required by an amendment to the Federal criminal code (the "*SOX §906 Certification*"). Chairpersons of boards of directors who are not executive officers are not required to certify the reports.

Improperly Influencing Auditors. Pursuant to SOX, the SEC has adopted a rule that specifically prohibits officers and directors and "persons acting under [their] direction" (which would include attorneys), from coercing, manipulating, misleading or fraudulently influencing an auditor "engaged in the performance of an audit" of the issuer's financial statements when the officer, director or other person "knew or should have known" that the action, if successful, could result in rendering the issuer's financial statements filed with the SEC materially misleading.

Enhanced Attorney Responsibilities. The SEC has adopted under SOX rules of professional responsibility for attorneys representing public companies before the SEC, including: (1) requiring an attorney to report evidence of a material violation of any U.S. law or fiduciary duty to the chief legal officer ("*CLO*") or the CEO of the company; and (2) if corporate executives do not respond appropriately, requiring the attorney to report to an appropriate committee of independent directors or to the board of directors.

CEO/CFO Reimbursement to Issuer. SOX provides that, if an issuer is required to restate its financial statements owing to noncompliance with securities laws, the CEO and CFO must reimburse the issuer for (1) any bonus or incentive or equity based compensation received in the 12 months prior to the restatement and (2) any profits realized from the sale of issuer securities within the preceding 12 months.

Insider Trading Freeze During Plan Blackout. Company executives and directors are restricted from trading stock during periods when employees cannot trade retirement fund-held company stock ("*blackout periods*"). These insiders are prohibited from engaging in transactions in any equity security of the issuer during any blackout period when at least half of the issuer's individual account plan participants are not permitted to purchase, sell or otherwise transfer their interests in that security.

Insider Loans. SOX prohibits issuers from making loans to their directors or executive officers. There are exceptions for existing loans, for credit card companies to extend credit on credit cards issued by them, for securities firms to maintain margin account balances and for certain regulated loans by banks.

Disclosure Enhancements. Public companies will be required to publicly disclose in "plain English" additional information concerning material changes in their financial condition or operations on a "real time" basis. SEC rulemaking will define the specific requirements of the enhanced reporting.

SOX instructs the SEC to require by rule: (1) Form 10-K and 10-Q disclosure of all material off-balance sheet transactions and relationships with unconsolidated entities that may have a material effect upon the financial status of an issuer; and (2) presentation of pro forma financial information in a manner that is not misleading, and which is reconcilable with the financial condition of the issuer under generally accepted accounting principles ("GAAP"). The SEC has adopted rules changes under SOX designed to address reporting companies' use of "non-GAAP financial measures" in various situations, including (i) Regulation G which applies whenever a reporting company publicly discloses or releases material information that includes a non-GAAP financial measure and (ii) amendments to Item 10 of Regulation S-K to include a statement concerning the use of non-GAAP financial measures in filings with the SEC.

Effective August 23, 2004, the SEC has adopted amendments to Form 8-K, which require disclosure of additional items for all public companies.²⁰¹ In addition to the new disclosure items, many of the old disclosure items were reworked. New Item 2.02 incorporates the substantive disclosures previously required by Item 12, "Results of Operations and Financial Condition." Item 2.02 requires issuers to furnish to the SEC all releases or announcements disclosing material non-public financial information about completed annual or quarterly periods.²⁰²

SOX amends §16(a) of the 1934 Act to require officers, directors and 10% shareholders to file with the SEC Forms 4 reporting (i) a change in ownership of equity securities or (ii) the purchase or sale of a security based swap agreement involving an equity security "*before the end of the second business day following the business day on which the subject transaction has been executed...*" and the SEC has amended Regulation S-T to require insiders to file Forms 3, 4 and 5 (§16(a) reports) with the SEC on EDGAR. The rules also require an issuer that maintains a corporate website to post on its website all Forms 3, 4 and 5 filed with respect to its equity securities by the end of the business day after filing.

SOX also requires the SEC to regularly and systematically review corporate filings. Each issuer must be reviewed at least every three years. Material restatements, the level of market

²⁰¹ See Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release No. 33-8400, (May 16, 2004), available at <http://www.sec.gov/rules/final/33-8400.htm>.

²⁰² See *infra* "Form 8-K Filing of Earnings Release" in Section V.

capitalization and price volatility are factors specified for the SEC to consider in scheduling reviews.

Internal Controls. As directed by SOX, the SEC has prescribed rules mandating inclusion of an internal control report and assessment in Form 10-K annual reports. The internal control report is required to (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. SOX further requires the public accounting firm that issues the audit report to attest to, and report on, the assessment made by corporate management on internal controls.

Codes of Ethics. The SEC has adopted rules that require reporting companies to disclose on Form 10-K:

- Whether the issuer has adopted a code of ethics that applies to the issuer's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions; and
- If the issuer has not adopted such a code of ethics, the reasons it has not done so.

Record Retention. SOX and SEC rules thereunder prohibit (1) destroying, altering, concealing or falsifying records with the intent to obstruct or influence an investigation in a matter in Federal jurisdiction or in bankruptcy and (2) auditor failure to maintain for a seven-year period all audit or review work papers pertaining to an issuer.

Criminal and Civil Sanctions. SOX mandates maximum sentences of 20 years for such crimes as mail and wire fraud, and maximum sentences of up to 25 years for securities fraud. Civil penalties are also increased. SOX restricts the discharge of such obligations in bankruptcy.

SOX, as a response to the abuses which led to its enactment, will also influence courts in dealing with common law fiduciary duty claims.²⁰³

Further Information. For further information regarding SOX, see "*The Sarbanes Oxley Act and Its Extraterritorial Reach*" by Byron F. Egan (October 3, 2003) which can be found at <http://www.jw.com/site/jsp/publicationinfo.jsp?id=247>.

²⁰³ See Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Impacts of the Enron Debacle*, 57 Bus. Lawyer 1371 (Aug. 2002).

EXHIBIT B

FORM OF LAW FIRM RESPONSE LETTER

Re: _____ (the "*Company*", such term to refer also to the subsidiaries or other related entities, if any, listed in Annex A hereto)

Gentlemen:

By letter dated _____ (the "*Inquiry Letter*"), _____, requested that we furnish you certain information in connection with your examination of the accounts of the Company as of _____ (the "*Examination Date*") and for the year then ended. Accordingly, subject to the qualifications and limitations set forth below, we advise you that as of _____, which is the date our internal review procedure for purposes of preparing this letter was commenced (the "*Review Date*"), we were not engaged on behalf of the Company in giving substantive legal attention to, or representing the Company in connection with, any Loss Contingency, except as set forth in Annex B hereto. As used herein, "Loss Contingency" means (i) any overtly threatened or pending litigation (as defined in the ABA Statement of Policy referred to below) which we have recognized as involving a potential loss to the Company of _____ or more, (ii) any contractually assumed obligation, if any, which the Company has, in the Inquiry Letter, specifically identified and requested that we comment on herein and (iii) any unasserted possible claim or assessment, if any, which the Company has, in the Inquiry Letter, specifically identified and requested that we comment on herein.

This response is limited by, and is in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December, 1975) and the accompanying Commentary (collectively, the "*ABA Statement of Policy*"). We are not responding to any request, nor are we commenting on any statement, contained in the Inquiry Letter which we believe to be inconsistent with the intent of the ABA Statement of Policy. No inference should be drawn from our failure to respond to or comment on any such request or statement.

The information set forth in this response is current as of the Review Date, except as otherwise noted, and we disclaim any undertaking or obligation to advise you of any changes which thereafter may have been or may be brought to our attention.

In connection with the preparation of this response, we have made no examination of the records or files of the Company, nor have we reviewed any of the transactions or contractual arrangements of the Company or interviewed any of the officers or employees of the Company, or made any other investigation of the Company whatsoever. On the contrary, our procedures in the preparation of this response have been limited to an endeavor to determine from lawyers presently in our Firm who, on behalf of the Firm, have performed services for the Company since _____ whether such services involved substantive attention in the form of legal consultation or legal representation (as distinguished from general legal advice) concerning any Loss Contingency of the nature described in clause (i) of the definition of such term in the first

paragraph of this letter existing as of the dates referred to in the second sentence of such first paragraph.

Consistent with the last sentence of paragraph 6 of the ABA Statement of Policy and pursuant to the Company's request, this will confirm as correct the Company's understanding as set forth in the Company's inquiry letter to us that whenever, in the course of performing legal services for the Company on specific matters which we have recognized as involving an unasserted possible claim or assessment that may call for financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment we, as a matter of professional responsibility to the Company, will endeavor to so advise the Company and, if requested to do so, will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. You are further advised, however, that we have not been engaged by the Company for the specific purpose of providing advice and consultation concerning questions of financial disclosure. Accordingly, and in view of the limited extent to which we have represented the Company and our limited knowledge of the Company's affairs and the requirements for financial statement disclosures applicable to the Company, it is unlikely that we would form any professional conclusions concerning such disclosures. Furthermore, while we will so consult with the Company, we will not ordinarily make an independent investigation of facts furnished to us by the Company. Also, in the course of such consultation we will not ordinarily reach and express a professional conclusion that the Company must disclose a discrete matter or that the ultimate decision which the Company may make is either correct or incorrect. We are not commenting on the accuracy or completeness of any specification, or lack of specification, made by the Company in the Inquiry Letter in respect of unasserted possible claims or assessments or any advice, or lack of advice, we may have given the Company with respect to any such claims or assessments.

It is our understanding that the Company, by making the request set forth in the Inquiry Letter, does not intend to waive the attorney-client privilege with respect to any information which the Company has furnished to us. Moreover, please be advised that this response should not be construed in any way to constitute a waiver of the attorney-work product privilege with respect to any of our files involving the Company.

Please refer to Annexes A and B hereto for certain other information relating to this response letter.

This letter is solely for your information and assistance in connection with your audit of the financial condition of the Company as of the Examination Date and is not to be quoted or otherwise referred to in any financial statement of the Company or related documents nor is it to be filed with or furnished to any governmental agency or any other person without the prior written consent of this Firm.

Very truly yours,

[Law Firm Name]

By _____

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ANNEX A

MISCELLANEOUS MATTERS

1. List of Subsidiaries or Other Related Entities

List all subsidiaries or other related entities, if any, named in the Inquiry Letter. Make certain that each subsidiary or other related entity named in the Inquiry Letter was similarly named in the related Firm information request form. If no subsidiaries or other related entities are named in the Inquiry Letter, insert the word NONE.

[LIST SUBSIDIARIES HERE]

2. Scope of Engagement

Insert one of the following paragraphs or an appropriate variation thereof:

While we represent the Company on a regular basis, we are not undertaking to comment on whether the Company is involved in legal matters for which we have no responsibility or on matters in respect of which we may have rendered general legal advice to the Company.

While we represent the Company (or certain of the subsidiaries or other entities included within the meaning of "*Company*" herein) on a regular basis, the Company, as you are aware, engages other counsel from time to time with respect to various legal matters. We are not undertaking to comment on whether the Company is involved in legal matters for which we have no responsibility or on matters in respect of which we may have rendered general legal advice to the Company.

We do not represent the Company generally and our representation of the Company is limited to matters for which we are specifically engaged as its counsel. We are not undertaking to comment on whether the Company is involved in legal matters for which we have no responsibility.

3. Other Matters

- (a) If requested by the Inquiry Letter, insert one of the following paragraphs or an appropriate variation thereof:

Our records reflect that as of _____, there was _____ and _____, respectively, owing to us by the Company for services and disbursements previously billed. It is not our practice to quote unbilled expenses and estimated fees.

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ANNEX B

DESCRIPTION OF LOSS CONTINGENCIES

Our records reflect that as of _____, there was no amount owing to us by the Company for services and disbursements previously billed. It is not our practice to quote unbilled expenses and estimated fees.

Our records reflect that as of _____, there was _____ owing to us by the Company for services and disbursements previously billed and that as of the date hereof no amount is owed to us by the Company for services and disbursements previously billed. It is not our practice to quote unbilled expenses and estimated fees.

Our records reflect that as of _____ no amount was owing to us by the Company for services and disbursements previously billed and that as of the date hereof _____ is owed to us by the Company for services and disbursements previously billed. It is not our practice to quote unbilled expenses and estimated fees.

(b) Insert the following paragraph if appropriate:

_____, an attorney in this Firm, is a Director of the Company. This letter does not purport to encompass information which may have been communicated to such attorney by reason of his serving as a Director.

(c) Insert paragraphs containing other information, if any, which the attorney in charge deems necessary or appropriate. If no paragraphs are being inserted in response to this Item 3, insert the word NONE.

1. Contractually Assumed Obligations

Describe each Loss Contingency of this type being commented on. Remember that no such Loss Contingency is to be commented on unless it is specifically identified in the Inquiry Letter. See "CAUTION" at the end of this Fill-in Information Sheet.

If no Loss Contingency of this type is specifically identified in the Inquiry Letter, insert the following:

NONE. No contractually assumed obligation was specifically identified in the Inquiry Letter for comment in this response. Accordingly, we are not commenting on any contractually assumed obligations or any representations of the Company in the Inquiry Letter with respect thereto.

2. Unasserted Possible Claims and Assessments

Describe each Loss Contingency of this type being commented on. Remember that no such Loss Contingency is to be commented on unless it is specifically identified in the Inquiry Letter. See "CAUTION" at the end of this Fill-in Information Sheet.

If no Loss Contingency of this type is specifically identified in the Inquiry Letter, insert the following:

NONE. No unasserted claim or assessment was specifically identified in the Inquiry Letter for comment in this response. Accordingly, we are not commenting on any unasserted possible claims or assessments or any representations of the Company in the Inquiry Letter with respect thereto.

3. Overtly Threatened or Pending Litigation

Describe each Loss Contingency of this type being commented on. See "CAUTION" at the end of this Fill-in Information Sheet. If there is no Loss Contingency of this type to be described, insert the word NONE.

(a) Because we have not formed a conclusion as to whether an unfavorable outcome is either probable or remote (as defined in the ABA Statement of Policy), we express no opinion as to the likelihood of an unfavorable outcome or the amount or range of any possible loss to the Company.

CAUTION: BE SURE TO REMOVE THIS INFORMATION BEFORE FINALIZING THE LETTER!!!

The definition of “Loss Contingency” is contained in the first paragraph of the response letter. For this purpose, the attorney preparing the response letter should understand that the ABA Statement of Policy defines “overtly threatened litigation” to mean “that a potential claimant has manifested to the client an awareness of and present intention to assert a possible claim or assessment unless the likelihood of litigation (or of settlement when litigation would normally be avoided) is considered remote”.

Each Inquiry Letter which we receive from a client attempts, in one way or another, to get us to evaluate, with respect to each Loss Contingency described in our response letter, the likelihood of an unfavorable outcome and to estimate the amount or range of potential loss. Because applicable accounting rules (Statement of Financial Accounting Standards No. 5) use the terms “probable”, “reasonably possible” and “remote” in describing the process of quantifying the likelihood of an unfavorable outcome, such terms, when used in a response letter, will generally be accorded specific meanings. Therefore, none of these terms should be utilized unless the attorney preparing the response letter intends to convey the specific meaning contemplated by the accounting rules.

The ABA Statement of Policy contains several statements to the effect that, given the uncertainties associated with defending or prosecuting a Loss Contingency, clients (and their auditors) generally should not expect attorneys to render, and attorneys generally will not be in a position to give, any meaningful estimate of the likelihood of an unfavorable outcome or the amount or range of damages. Consider, in this regard, the following excerpts from the ABA Statement of Policy:

“In view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either ‘probable’ or ‘remote’; for purposes of any such judgment it is appropriate to use the following meanings:

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

[T]he amount or range of potential loss will normally be as inherently impossible to ascertain, with any degree of certainty, as the outcome of the litigation. Therefore, it is appropriate for the lawyer to provide

an estimate of the amount or range 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.... In most cases, the lawyer will not be able to provide any such estimate to the auditor.”

Essentially, a response letter can properly contain an unqualified evaluation of probable outcome only in instances where we believe the client would win or lose on summary judgment. If we cannot say that the client would prevail on a summary judgment motion filed by it, then we cannot say that a favorable outcome is probable or that an unfavorable outcome is remote. Moreover, if we cannot say that the client would lose a summary judgment motion filed against it, then we cannot say that a favorable outcome is remote or that an unfavorable outcome is probable.

For the foregoing reasons, Loss Contingency descriptions typically conclude with or otherwise contain a sentence reading substantially as follows:

“Because we have not formed a conclusion as to whether an unfavorable outcome is either probable or remote (as defined in the ABA Statement of Policy), we express no opinion as to the likelihood of an unfavorable outcome or the amount or range of any possible loss to the Company”.

Any response letter containing a Loss Contingency description which does not include a sentence similar to the foregoing must be signed or otherwise approved by [a member of the Firm Response Letter Committee].

The Commentary forming a part of the ABA Statement of Policy observes that:

“statements that litigation is being defended vigorously and that a client has meritorious defenses do not, and do not purport to, make a statement about the probability of outcome in any measurable sense.”

The information which we provide to auditors regarding Loss Contingencies can have a significant effect on, and is therefore very important to, the client. Depending on the nature of the information, the auditors may, for example, either “qualify” their audit report or insist that the client establish a loss reserve. Should such a situation arise, all Firm attorneys are expected to demonstrate a sincere willingness to cooperate in any way possible so that the needs and wishes of our clients are satisfied. In most situations, it is possible to expand on the description of a Loss Contingency in a way which satisfies the concerns of the auditors but which nonetheless does not result in the rendering of an opinion as to probable outcome or amount of loss.