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Responding to Auditors Without Waiving Attorney Work-Product Protection

ALAN I. RAYLESBERG AND
LAWRENCE E. BUTERMAN

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In order to comply with various provisions of the federal securities laws, a public company must have its financial statements audited by an independent accounting firm. In connection with the preparation of an auditor's opinion as to whether those financial statements have been prepared in accordance with generally accepted accounting principles, auditors will evaluate, *inter alia*, the adequacy and reasonableness of a company's reserve accounts and contingent liabilities -- an evaluation that often requires an assessment of the company's litigation exposure.

As part of an auditor's fundamental role to provide an opinion regarding a company's financial statements, an auditor cannot simply accept a company's or its outside counsel's determinations regarding litigation risks. In the wake of corporate scandals such as Enron and WorldCom (which implicated auditors) and the enactment of Sarbanes-Oxley, auditors have, if anything, been requesting more detailed information from outside counsel regarding significant pending or potential litigation that the company is facing.^[FOOTNOTE 1] When faced with these requests from their auditors, companies and their counsel find themselves in a difficult situation. On the one hand, if the company and its outside counsel do not provide information necessary to satisfy the auditor, the company runs the unacceptable risk that the auditor will refuse to render an opinion concerning the financial statements. On the other hand, broad disclosure of information concerning litigation, including the company's assessments of its litigation risks, creates its own set of problems -- as the company may end up waiving otherwise applicable privileges, thereby providing plaintiffs with information potentially damaging to the company.

The question of whether privilege is waived when information relating to litigation assessments is disclosed to outside auditors is one without a clear answer under existing case law. As an initial matter, such information may be protected from disclosure by both the attorney-client

privilege and the work-product doctrine. However, to the extent that the information is subject to the attorney-client privilege, that privilege usually is deemed waived when such materials are shared with a third party for purposes unrelated to the rendition of legal advice. *See, e.g., U.S. v. Kovel*, 296 F.2d 918, 922 (2d Cir. 1961). In contrast, work-product protection is not necessarily waived simply because disclosure has been made to a third party.

The courts are split as to whether disclosing work-product material to a company's auditors constitutes a waiver of work-product protection. In general, courts find waiver of work-product protection to have occurred only when the disclosure to a third party "substantially increases the opportunity for potential adversaries to obtain the information." *In re Pfizer, Inc. Securities Litigation*, No. 90 Civ. 1260, 1993 WL 561125, at *6 (S.D.N.Y. Dec. 23, 1993); *see also United States v. MIT*, 129 F.3d 681, 687 (1st Cir. 1997) (stating that "work product protection is provided against 'adversaries,' so only disclosing material in a way inconsistent with keeping it from an adversary waives work product protection"). Thus, in analyzing whether disclosure of otherwise protected information to auditors has resulted in a waiver, courts have considered whether such disclosure is of the type that "substantially increases the opportunity for potential adversaries to obtain" the information or is otherwise inconsistent with keeping it from an adversary. On that question, courts have come out both ways.

For example, in *Medinol, Ltd. v. Boston Scientific Corp.*, 214 F.R.D. 113 (S.D.N.Y. 2002), Southern District of New York Judge Alvin Hellerstein held that Boston Scientific had waived work-product protection over board meeting minutes that reflected the substance of an investiga-



ALAN I. RAYLESBERG



LAWRENCE E. BUTERMAN

Alan I. Raylesberg is a partner in and co-head of the commercial litigation group at Chadbourne & Parke LLP. Lawrence E. Buterman is a counsel in that group. They are reachable at 212-408-5100 or araylesberg@chadbourne.com and lbuterman@chadbourne.com

tion performed by outside counsel when Boston Scientific disclosed those meeting minutes to its outside auditors for purposes of analyzing litigation reserves. That decision was based on the finding that Boston Scientific and its independent auditors were adversarial to one another because "as has become crystal clear in the face of the many accounting scandals that have arisen of late, in order for auditors to properly do their job, they *must* not share a common interest with the companies they audit." *Id.* at 116 (emphasis in original). Because Hellerstein viewed auditors as adversarial to the company, he concluded that disclosure, by definition, made it more likely that the information could be obtained by potential adversaries. This result has been reached by at least one other district court. See *In re Raytheon Sec. Litig.*, 218 F.R.D. 354 (D. Mass. 2003).

In contrast, in *Merrill Lynch & Co. Inc. v. Allegheny Energy, Inc.*, 229 F.R.D. 441 (S.D.N.Y. 2004), Southern District of New York Judge Harold Baer determined that Merrill Lynch's auditors were neither adversaries nor conduits to a potential adversary and, accordingly, disclosure to those auditors of reports that were the result of an investigation undertaken by Merrill Lynch's counsel did not result in a waiver of the work-product privilege that had attached to those reports. Indeed, Baer took the position that "[a] business and its auditor can and should be aligned insofar as they both seek to prevent, detect, and root out corporate fraud." *Id.* at 448.

While the majority of cases seems to follow Baer's rationale, see, e.g., *In re JDS Uniphase Corp. Sec. Litig.*, No. C-02-1486, 2006 WL 2850049 (N.D. Cal. Oct. 5, 2006); *International Design Concepts, Inc. v. Saks Incorporated*, No. 05 Civ. 4754, 2006 WL 1564684 (S.D.N.Y. June 6, 2006); *American Steamship Owners Mut. Prot. and Indem. Ass'n v. Alcoa Steamship Co., Inc.*, No. 04 Civ. 4309, 2006 WL 278131 (S.D.N.Y. Feb. 2, 2006); *Lawrence E. Jaffe Pension Plan v. Household Intern., Inc.*, 237 F.R.D. 176 (N.D. Ill. 2006), at this point there is no consensus as to whether disclosure to auditors will waive work-product protection.

Notwithstanding the lack of clarity in the law, there are practical steps that can be taken to minimize the risk that sensitive information concerning litigation strategy will be required to be turned over to plaintiffs as a result of a response to an audit inquiry.

First, company counsel should work with the auditor to ascertain precisely what material the auditor needs, and engage in a "give and take." Given the nature of the audit process, it may be possible to satisfy an audit inquiry with a response focused on the facts of the litigation rather than counsel's particularized assessment of those facts. Because neither the attorney-client privilege nor the work-product doctrine protect facts from disclosure, potential damage may be limited by only disclosing facts.

Second, if an auditor does require more than the "facts" underlying a litigation, counsel should consider making an oral presentation to the

auditors rather than providing the auditor with written materials. While the contents of such a meeting between counsel and the auditors might be required to be disclosed, a face-to-face environment should make it easier to limit the information that needs to be provided.

Third, if the auditor requires written information concerning inside or outside counsel's evaluation of a litigation, counsel should be hesitant to create any documents for that purpose. The creation of documents for a meeting with auditors arguably means that those documents were not created "in anticipation of litigation," and, therefore, are not subject to work-product protection in the first place. Thus, rather than creating documents for the purpose, if written materials need to be provided to the auditor, it may be better to supply pre-existing documents, especially if the documents are part of the "litigation record" in the case or otherwise of the type that would not cause problems if it ultimately ended up in the plaintiff's possession.

Fourth, counsel should seek to get the auditor's agreement that the information in question is being provided to the auditor under a strict pledge of confidentiality, for the limited purpose of the engagement. By doing so, counsel increases the likelihood that a court may find that disclosure to the auditor has not substantially increased the opportunity for potential adversaries to obtain the information.

Finally, despite any and all precautions taken, there can be no guarantees that the work-product protection will be maintained once information is presented to the auditor. Accordingly, counsel should do his or her utmost to supply information in a form that will satisfy the auditor while at the same time best protect the company's interests in the event that any applicable work-product protection is ultimately deemed to have been waived.

;;;FOOTNOTES;;;

FN1 On June 5, 2008, the Financial Accounting Standards Board ("FASB") issued an Exposure Draft of a Proposed Statement of Financial Accounting Standards relating to the Disclosure of Certain Loss Contingencies. See File Reference No. 1600-100. The Proposed Statement, if adopted, would amend FASB Statements No. 5 and 141(R) to require expanded disclosures in financial statements of pending or anticipated litigation. In turn, one can expect that, if adopted, the Proposed Statement will result in auditors demanding even more detailed information regarding litigation exposures in order to opine on a company's financial statements.

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