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Trends in Work Product Waivers: Disclosures to Auditors

With the U.S. Department of Justice's (DOJ) issuance of the so-called McNulty Memorandum on Dec. 12, 2006, setting limits on federal prosecutors' requests during investigations that companies waive attorney-client and work product protections, the debate over the sanctity of these protections should shift now to a far more frequent occurrence for corporations—the effects of normal and important disclosures companies routinely make to their independent auditor.

When a company shares its counsel's work product with its outside auditor in connection with an audit—for example, interpretation of a stock plan, assessment of a legal claim, or review of an environmental exposure—must it fear that work product protection will be waived as to all third parties? Courts are split on the answer,[1] most notably in the U.S. District Court for the Southern District of New York, highlighted by contrasting decisions by Judge Alvin Hellerstein in *Medinol, Ltd. v. Boston Scientific Group*, 214 FRD 113, 115 (SDNY 2002) (waiver), and Judge Harold Baer in *Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 229 FRD 441 (SDNY 2004) (no waiver).

With no hard-and-fast rule, the oft-repeated aphorism that "[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,"[2] certainly rings true. Companies have therefore expected that disclosure of protected information to auditors waives the protections as to third parties. But the current trend supports the view of *Merrill Lynch*. In fact, in October 2006, the court which has been most aligned with the *Medinol* view, the U.S. District Court for the Northern District of California, recently changed course and backed the reasoning and result of *Merrill Lynch*. See *In re JDS Uniphase Corp. Sec. Litig.*, No. C-02-1486, 2006 U.S. Dist. LEXIS 76169, at *12 (N.D. Cal. Oct. 5, 2006).

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This is an important development which should not go unnoticed by companies as they debate exactly how their counsel's work product should be shared with their auditors, and the ramifications of such disclosure.

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The 'Medinol' Decision

In *Medinol*, a company engaged counsel to perform an investigation into the termination of several employees and report the results of the investigation to a Special Litigation Committee (SLC) of the Board. Minutes of the SLC meeting reflecting counsel's investigation were provided to the company's outside auditor. The court held that the disclosure waived work product protection because, although the SLC meetings were held "with an eye to litigation, the disclosures to the independent auditor had no such purpose." The company and its auditor "did not share 'common interests' in litigation," and therefore disclosing the materials did not "serve the privacy interests that the work product doctrine was intended to protect." The court was persuaded by the "independent" role of the auditor, as described by the Supreme Court in *Arthur Young & Co.*, 465 US 805, 817-818 (1984): "By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client."

The *Medinol* court defined the "common interest" concept as a tool by which coparties or allies may share work product without waiving the protection as to a common adversary. Since the *Medinol* court found that the auditor-client relationship does not fit this bill, it found a waiver.

A parallel analysis can be found in decisions by the U.S. District Court for the Northern District of California. In particular, in *In re Diasonics Securities Litigation*, No. C-83-4584-RFP, 1986 WL 53402, at *1 (N.D. Cal. June 15, 1986), the court held that documents disclosed to the company's auditor, including "documents relating to issues raised in this litigation," were not work product because they "were generated for the business purpose of creating financial statements…and not to assist in the litigation." The court assumed that another set of documents regarding an "acquisition" at issue were in fact work product, but held that the documents were not shared "with a common interest under a guarantee of confidentiality." The public audit function, the court held, "is at odds with such a guarantee" for the same reasons later voiced by Judge Hellerstein. The court thus held that work product protections were waived by the disclosure.

The 'Merrill Lynch' Decision

In *Merrill Lynch*, the court held that the plaintiff's disclosure to its auditor of internal investigative reports did not waive work product protection. The court reconciled what *Medinol* and *Diasonics* viewed as an apparent tension between independence and common goals by explaining that, despite the tension created by the auditor's need to "scrutinize" a company's books and records, "[a] business and its auditor can and should be aligned insofar as they both seek to prevent, detect, and root out

corporate fraud." The court concluded that "this is precisely the type of limited alliance that courts should encourage." Taking aim at *Medinol*, the court held that denying work product protection when a company decides to share information with its auditor "could very well discourage corporations from conducting a critical self-analysis and sharing the fruits of such an inquiry with the appropriate actors."

Judge Baer determined that *Medinol* was inconsistent with the Second Circuit's standard for extending work product protection under FedRCivP 26(b)(3). In *United States v. Adlman*, 134 F3d 1194, 1202 (2d Cir. 1998), the Second Circuit held 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). The Second Circuit thus observed that the work product doctrine would protect an attorney's audit response letter, for example (which is the majority view among courts). Thus, the Second Circuit's test looks past the parochial meaning of "in anticipation of litigation" in Rule 26(b)(3) and seeks to afford work product protection to all materials which a party expects will remain confidential as to its adversaries, upholding the purpose of the Rule.[3] Thus, Judge Baer held that *Medinol* failed to uphold the purpose behind Rule 26(b)(3)'s protection as discussed in *Adlman*—namely, that the fruits of attorney work product should be enjoyed by the client and withheld from the client's litigation adversary. Auditors are decidedly not mere conduits to their clients' adversaries.[4]

Trend: Common Interest View

Several courts to consider this issue recently have rejected the *Medinol* view.[5] In fact, in the Southern District of New York, the "common interest" theory has been applied in two recent cases to uphold work product protection of materials disclosed to outside auditors and actuaries. In *International Design Concepts, Inc. v. Saks Inc.*, No. Civ. 4754, 2006 U.S. Dist. LEXIS 36695, at *6-9 (SDNY 2006), Judge P. Kevin Castel denied discovery of an internal investigative report prepared by a company's outside counsel and disclosed to the company's independent auditor. Guided by *Merrill Lynch*, Judge Castel stated that the court should find "waiver of the work product privilege only if the disclosure substantially increases the opportunity for potential adversaries to obtain the information," and disclosure to auditors does not meet this test. The court held that, while withholding the report from the auditor might prevent it from rendering an opinion on the company's financial statements and thereby deny "[c]reditors, employees, investors and all who read the financial statements" the benefit of that opinion, this alone would not "be a sufficient reason to find that the work product protection remains intact." There was no waiver, however, because the report "was created in reliance upon the attorney work product protection and was communicated to the client's auditor under a strict pledge of confidentiality for a valid purpose that serves the interest of the client." See also *American Steamship Owners Mutual Protection and Indemnity Ass'n v. Alcoa Steamship Co.*, No. 04 Civ. 4309, 2006 WL 278131, at *10 (SDNY Feb. 2, 2006) (upholding work product protection for two opinion letters which plaintiff had provided to its actuary, rejecting the reasoning of *Medinol* and the argument that, because the actuary could have turned the opinion letters over to the New York Insurance Department, their disclosure to the actuary by plaintiff's counsel waived work product protection).

Most recently, on Oct. 5, 2006, the Northern District of California—the only other court to apply reasoning in a published decision comparable to that in *Medinol*—rejoined the debate.[6] In *JDS Uniphase*, 2006 U.S. Dist. LEXIS 76169 at *12, the court examined corporate minutes withheld from production to plaintiffs as attorney work product, which plaintiffs argued was waived when the minutes were disclosed to the company's outside auditors.

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Applying the familiar test of whether the disclosure substantially increases the risk that adversaries will obtain the information, the court turned to *Medinol* and *Merrill Lynch* as representing the split of authorities analyzing disclosures to outside auditors. "While there are good arguments on both sides of the issue," the court stated, it was more persuaded by the *Merrill Lynch* view that the relationship between an auditor and its client was not so adversarial that disclosure to an auditor destroys work product protection. Like the Southern District of New York, therefore, the Northern District of California's most recent precedent takes the position that a company and its outside auditor share common interests and enough of an expectation of confidentiality that the disclosure of work product-protected information to the auditor does not effect a waiver.

Conclusion

In recent years, legal events and changes in business climate have altered perceptions regarding the role of independent auditors as "gatekeepers" of the financial markets. When companies share information with their auditors—including materials traditionally protected by the work product doctrine—they should not fear that they will be punished by awarding these materials to litigation adversaries. Decisions which fail to protect these materials ignore that the true "common interest" of auditors and their clients is in ensuring full and accurate financial disclosures to the public, under the strict scrutiny of regulators and watchful eyes of many others. Moreover, as *Merrill Lynch* recognizes, such disclosure does not sacrifice auditors' independence. Such decisions also produce tensions potentially inimical to effective audits and to the attorney-client relationship itself.

Fortunately, with the *JDS* decision —coming from the court previously offering the lone support (in any published opinion) for the *Medinol* court's view that there are no such common interests—these decisions may be losing the support of other courts. If so, companies may have greater comfort that the work product of their counsel, when shared with their outside auditors, will remain confidential, and the purpose of the work product doctrine will be satisfied. As the court stated in *Merrill Lynch*, "the aim should be for corporations to share information with their auditors to facilitate a meaningful review and, ultimately, the availability of more accurate information for the investing public."

1. The attorney-client privilege, by contrast, is generally waived by disclosure to third parties, including outside auditors.
2. *Upjohn Co. v. United States*, 449 US 383, 392 (1981).
3. Some courts never reach the issue of work product or waiver, holding that audit response letters are not relevant evidence.
4. See, e.g., *Laguna Beach County Water District v. Superior Court*, 124 Cal. App. 4th 1453, 1461 (2004) (attorney's providing audit response letter does not contravene purpose of the work product doctrine).
5. See, e.g., *Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc.*, 237 FRD 176, 183 (N.D. Ill. 2006) (disclosing documents to outside auditors does not effect a waiver).
6. In an unpublished decision, *Chinn v. Endocare, Inc.*, No. Civ.A. 20262, 2003 WL 21517869, at *1 (Del. Ch. July 1, 2003), the Delaware Chancery Court found that a company's disclosure of an internal investigation report to its auditors resulted in a waiver of "whatever privilege might otherwise have attached to" it, because the auditors were under no obligation to refrain from disclosing the documents to the public. As a point of fact, however, CPAs are bound by AICPA Code of Professional Conduct Rule 301, which prohibits disclosure of client confidential information without "the specific consent of the client," unless narrow exceptions apply.

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