

# UPDATES ON THE CORPORATE ATTORNEY-CLIENT PRIVILEGE

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*David M. Brodsky\**  
*Latham & Watkins, LLP*  
*New York, NY*

## I. BACKGROUND

It has long been thought that the attorney-client privilege is one of the most sacrosanct and important evidentiary privileges available to lawyers and their clients. Because it encourages the free and open discussion between counsel and their clients, so as to allow full consideration of all legal issues that affect individuals and corporate entities alike. In recent years, however, some aspects of the attorney-client privilege have come under attack and increased scrutiny. Because one of the principal elements of the privilege is the ability of a client, corporate or individual, to refuse to reveal the nature of advice rendered by counsel, and the concomitant requirement that such counsel also refuse to reveal information communicated in order to seek advice or the advice so rendered, the privilege has long been viewed as hindering the ascertainment of the truth. But, in times past, this hindrance was thought necessary to encourage the full flowering of confidential communications between clients and their counsel.

This is no longer the case, especially in the case of the corporate attorney-client privilege. In recent years, there has been a concerted effort by federal, state, and local regulatory authorities to upend the traditional presumption that privileged information will remain confidential, with the result that a “culture of waiver” has set in, where virtually all corporations are being requested – or are expected – to waive or not assert the corporate attorney-client privilege to obtain the advantages associated with corporate cooperation with governmental investigations. In addition, because of inconsistent rulings in court proceedings regarding so-called “selective waiver,” disclosure by a corporation to an investigator or even to its external auditor are many times deemed to be general waivers as to all third parties, including counsel for adverse parties. The result is a substantial diminution of the protections of the corporate attorney-client privilege, and concomitant damage to the expectations of confidentiality which formerly accompanied consultations of corporate clients with their internal or external counsel.

This article will first analyze the corporate attorney-client privilege and work product doctrine (the “protections”) and the role of such protections in our society. Then, the article will deal with some of the significant developments adversely affecting the protections, and how some of the developments can be ameliorated so as to preserve the important principles underlying the corporate attorney-client privilege.

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\* Mr. Brodsky is a member of Latham & Watkins LLP and co-chair of the firm's Global Securities Litigation and Professional Liability Practice Group. He is a member of the New York State Bar Association Task Force on the Attorney-Client Privilege and liaison to the American Bar Association Task Force on the Attorney-Client Privilege from the Consortium of Corporate Counsel.

## II. BRIEF SURVEY OF THE PROTECTIONS

### A. The Attorney-Client Privilege

The privilege is an evidentiary rule and protects confidential disclosures of information between lawyers and their clients so as to encourage full and frequent communications. Since the privilege generally thwarts full disclosure, attempts are frequently made to limit its scope through various exceptions. Therefore, it is vital to observe the requisites of the privilege so as to maximize the protections it provides. First, there must be a client, whether an individual or a corporation.<sup>1</sup> When a corporation is the client, corporate counsel must always distinguish between the individual acting as the corporation, and that same individual acting for herself. Careful advice must be given to such individuals to make certain that it is clear that corporate counsel represents only the corporate entity.

Second, there must be a lawyer who is rendering advice to the corporation and from whom or to whom confidential communications may flow. In this regard, whether counsel is inside or outside the corporation is irrelevant; what is relevant is the role that the attorney is playing. In the case of inside counsel, often there is a blurring between the attorney's role *qua* attorney, and such person's role *qua* business advisor. The latter role is not one where communications can be protected from disclosure. Obtaining legal, not business, advice as difficult as that may be to determine, must be the reason why corporate counsel was retained, and will be the basis for judging whether corporate counsel's communications will remain confidential.<sup>2</sup>

Third, it is the communications between attorney and client that are protected from disclosure, not the underlying facts that the attorney may uncover by reason of her work. Thus, corporate documents that convey factual information, upon which the corporate counsel then based her advice to the Company, are not protected from disclosure, although the advice would be.<sup>3</sup>

Fourth, the communication must be confidential in order to be protected. Presence of an unprotected third party in an otherwise confidential setting would constitute a waiver of the privilege's protection, as would communication to a third party of otherwise confidential information of a client.<sup>4</sup> Other persons assisting corporate counsel may also engage in communications that are protected from disclosure if it is clear that their communications are made for the purpose of obtaining legal advice from the lawyer.

Fifth, communication to and from similarly-situated individuals or corporate clients, or their or its counsel, may be protected by reason of the joint defense or common interest doctrine. The parties, in the first instance, must have entered into an agreement to cooperate among each other before such privilege will be extended.<sup>5</sup>

### B. The Work Product Doctrine

Protecting the confidentiality of work product likewise furthers vital public interests. “[T]he work product privilege [exists] . . . to promote the adversary system by safeguarding the fruits of an

1 *See Upjohn Co. v. U.S.*, 449 U.S. 383 (1981) (holding that privilege and work product protections may be asserted by corporations with respect to internal investigations); *Strougo v. BEA Assocs.*, 199 F.R.D. 515 (S.D.N.Y. 2001) (“The attorney-client privilege applies not only to individuals, but also to corporate entities.”).

2 Courts have ruled that the communication by a client must be “made for the purpose of obtaining legal advice and directed to an attorney who has been consulted for that purpose.” *Rosi v. Blue Cross & Blue Shields of Greater New York*, 73 N.Y.2d 588, 593 (N.Y. 1989) (internal quotations and citations omitted). And if the communication is from a lawyer to the client it must be “for the purpose of facilitating the rendition of legal advice or services, in the course of a professional relationship.” *Id.*

3 *In re Grand Jury Subpoena Duces Tecum*, 731 F.2d 1032 (2d Cir. 1983) (“it is important to bear in mind that the attorney-client privilege protects communications rather than information; the privilege does not impede disclosure of information except to the extent that that disclosure would reveal confidential communications”); *ECDC Environment v. N.Y. Marine and General Ins. Co.*, No. 96 Civ. 6033, 1998 WL 614478 (S.D.N.Y. June 4, 1998) (finding that the documents were not subject to attorney-client privilege protection because they “merely convey factual information to plaintiff without any legal analysis or legal advice”).

4 3 Weinstein's Federal Evidence Section 503.09 [1] (“Any disclosure of a lawyer-client communication to a third party for purposes inconsistent with maintaining confidentiality waives the attorney-client privilege as to that disclosure.”).

5 *The Erosion of the Attorney-Client Privilege and the Work Product Doctrine in Federal Criminal Investigations*, Report of American College of Trial Lawyers, March 2002, at 15-16 (quoting *White-Collar Prosecutors Probe Joint Defense Agreements*, 1 The DOJ Alert 3, July 1991) (“DOJ Alert”); see also Report of the Am. Bar Ass'n Task Force on Attorney-Client Privilege (May 18, 2005), available at [www.abanet.org/buslaw/attorneyclient/materials/hod/report.pdf](http://www.abanet.org/buslaw/attorneyclient/materials/hod/report.pdf) (“ABA Task Force Report”). The Department of Justice and other law enforcement agencies have periodically attacked Joint Defense Agreement (JDAs) because prosecutors see that JDAs, “even unintentionally, [provide] an opportunity to get together and shape testimony.” Prosecutors are cautioned, however, not to have a “knee-jerk reaction” against Joint Defense Agreements, unless there is a “specific reason to believe the agreement [is] being used for improper purposes.” See DOJ Alert.

attorney's trial preparations from the discovery attempts of the opponent"<sup>6</sup> and "by affording an attorney 'a certain degree of privacy' so as to discourage 'unfairness' and 'sharp practices.'"<sup>7</sup> As one Supreme Court Justice wrote in a concurring opinion to the seminal decision supporting the doctrine, "[d]iscovery was hardly intended to enable a learned profession to perform its functions . . . on wits borrowed from the adversary."<sup>8</sup>

Protection of work product is codified in Federal Rule of Civil Procedure 26(b)(3), 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. Work product is not discoverable by an opposing party absent a showing of "substantial need for the materials in the preparation of the party's case and [inability] without undue hardship to obtain the substantial equivalent of the materials by other means." But even when an opposing party makes this showing, courts must protect against disclosure of the "mental impressions, conclusions, opinions or legal theories of an attorney or other representative of a party."<sup>9</sup> It is *only when it would not be unfair* for an adversary to obtain that work product – *i.e.*, when the adversary meets its burden to show that it "has substantial need of the materials in the preparation of the party's case and is unable without undue hardship to obtain the substantial equivalent of the materials by other means"<sup>10</sup> – that the policy to protect work product will not apply.

Not just individuals but also companies expect that the work product of their counsel will be protected, and legitimately so. Increasingly, companies and (when the circumstances warrant) their audit committees or other independent committees use counsel to investigate evidence of alleged corporate or employee wrongdoing by interviewing company employees, identifying relevant documents, analyzing the facts and law and formulating conclusions and recommendations. Internal investigations, conducted by and at the direction of legal counsel, are a critical tool by which companies and their boards learn about violations of law, breaches of duty and other misconduct that may expose the company to liability and damages. Internal investigations are an essential predicate to enabling companies to take remedial action and to formulate defenses, where appropriate. Companies are therefore entitled to and afforded work product protection from adversaries, so long as the investigations are not merely being conducted in the ordinary course of business. One commentator has noted that the "general rationale for finding work product protection is that litigation is virtually assured if the investigation confirms the allegations. Since the corporation would be required to report the results to shareholders and government agencies, the possibility of a suit following is considered inevitable."<sup>11</sup>

Work product protection does not mean that, where internal investigations are conducted by counsel, all facts related to the issue under investigation are inherently protected against disclosure to auditors or third parties. The *facts*, including underlying documents, regarding an issue are properly discoverable, and routinely produced, in litigation. By contrast, what is protected from disclosure is the work performed, materials generated and considerations of the lawyers in connection with the investigation and any recommendations to the company. This is the heart of what is protected by the work product doctrine. The distinction among the facts, the law and the strengths and weaknesses of the company's position is an important one that is well-accepted in the law.<sup>12</sup>

6 *In re Raytheon Securities Litig.*, 218 F.R.D. 354, 359 (D. Mass. 2003) (quoting *United States v. Amer. Tel. & Tel. Co.*, 642 F.3d 1286, 1299 (D.C. Cir. 1980)).

7 Joint Drafting Committee of the American College of Trial Lawyers, *The Erosion of the Attorney-Client Privilege and Work Product Doctrine in Federal Criminal Investigations* (March 2002), at 6, quoting *Hickman v. Taylor*, 329 U.S. 495, 510-11 (1946).

8 *Hickman v. Taylor*, 329 U.S. 495, 516 (1946) (Jackson, J., concurring).

9 Fed. R. Civ. P. 26(b)(3).

10 Fed. R. Civ. P. 26(b)(3).

11 John William Gergacz, *Attorney-Corporate Client Privilege* Section 7.37 (West 2000), at 7-53 (reporting that "[m]ost of the cases hold that intracorporate investigations of possible corporate illegal activity are performed with sufficient anticipation of litigation to give rise to work product protection"). The author also reports that it is not only the inevitability of litigation, but also "the importance of not discouraging corporate self-investigation, [which] provides the underlying basis for the finding of work product protection." *Id.* at 7-54.

12 See *Sporck v. Peil*, 759 F.2d 312, 315 (3rd Cir. 1985) (lawyer's choice of documents with which to prepare deponent is work product even if the underlying documents themselves are not, "[b]ecause identification of documents as a group will reveal defense counsel's selection process, and thus his mental impressions...."); see also *In re Grand Jury Subpoenas Dated October 22, 1991 and November 1, 1991*, 959 F.2d 1158, 1166-67 (2d Cir. 1992) (noting that work product exception is only found when there is "real, rather than speculative concern that the thought process of [the client's] counsel... would be exposed;"); and allowing production of all telephone records from a specified period) (internal citations and quotations omitted); *In re Grand Jury Subpoenas Dated March 19, 2002 and August 2, 2002*, 318 F.3d 379, 386-87 (2d Cir. 2003) (finding that lower court was correct in allowing discovery of disputed materials because producing party had failed to disclose any strategy ex parte to the district court judge, making it impossible for judge to determine whether the responsive subset of documents reflected lawyers' selection or was simply the product of document retention policies); *Shelton v. American Motors Corp.*, 805 F.2d 1323, 1326 (8th Cir. 1987) ("We hold that where, as here, the deponent is opposing counsel and has engaged in a selective process of compiling documents from among voluminous files in preparation for litigation, the mere acknowledgment of the existence of those documents would reveal counsel's mental impressions, which are work product.").

### III. THE PUBLIC INTEREST IN PRESERVING THE ATTORNEY-CLIENT PRIVILEGE AND WORK PRODUCT PROTECTION

It was formerly beyond serious discussion that the attorney-client privilege and work product doctrine as applied in the corporate context are “vital protections that serve society’s interests and protect clients’ Constitutional rights to counsel.”<sup>13</sup> A legal system that fails to assure business entities the benefits of the attorney-client privilege and work product protection denies those entities the effective assistance of counsel when potentially illegal corporate behavior is discovered within the organization. As the Supreme Court has stated, impairment of these privileges and protections would “not only make it difficult for corporate attorneys to formulate sound advice when their client is faced with a specific legal problem but also threaten to limit the valuable efforts of corporate counsel to ensure their client’s compliance with the law.”<sup>14</sup>

The strongest criticism of the attorney-client privilege – and, indeed, of any evidentiary privilege – had always been that, in court proceedings, potentially valuable evidence may be suppressed and the “truth” harder to find. “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.”<sup>15</sup> The Supreme Court long ago clarified that this social good extends to corporations as well as to individuals.<sup>16</sup>

Nonetheless, the upsurge of investigations into alleged corporate criminality has reignited the debate over the value of the privilege and the ability to have confidential communications between attorneys and clients. The risk of waiver by companies has increased in proportion to the volume of requests for disclosure of privileged materials. But it is precisely those confidential communications between corporate attorneys and the employees of the corporate client that are imperiled when the attorney-client privilege or work product doctrine is undermined. “Without reliable privilege protections, executives and other employees will be discouraged from asking difficult questions or seeking guidance regarding the most sensitive situations. Without meaningful privilege protections, lawyers are more likely to be excluded from operating in a preventive (rather than reactive) manner.”<sup>17</sup>

And it is not only corporate employees who will curtail – and have curtailed – the extent of their confidential communications with counsel to seek legal advice on business programs and strategies. It is our experience that company legal counsel (internal and outside) are curtailing their own activities, such as taking extensive notes at business meetings, for fear that if the subject of the business meetings were ever implicated in a governmental inquiry (where the company might not even be the “target”), such counsel’s notes would be turned over when the company waived the privilege and the counsel would be converted into a potential adverse witness against the company as client. Even outside counsel retained to conduct internal investigations have to be sensitive to procedures that might result in their becoming involuntary adverse witnesses. Those pressures create a potential conflict of interest between attorney and client that the privilege otherwise helps to prevent.

Protecting the confidentiality of work product likewise furthers vital public interests.<sup>18</sup> Work product protection supports a fair adversary system by “by affording an attorney ‘a certain degree of privacy’ so as to discourage ‘unfairness’ and ‘sharp practices.’”<sup>19</sup> The work-product doctrine is simply a recognition that a lawyer’s work on behalf of a client preparing a response to litigation or a potential claim – even when not subject to the attorney-client privilege – must also be protected, lest all lawyers be discouraged from conducting those preparations effectively, the clients be punished and their

13 See “The Decline of the Attorney-Client Privilege in the Corporate Context,” Survey Results, Presented to the United States Congress and the United States Sentencing Commission, March 2006.

14 *Upjohn Co. v. U.S.*, 449 U.S. 383, 392 (1981). This point was made forcefully in *Comments of the ABA’s Section of Antitrust Law On The Proposed Amendments To The Sentencing Guidelines For Organizations*, at 5-7, available at [http://www.abanet.org/antitrust/comments/2004/sentencing\\_guidelines0704.pdf](http://www.abanet.org/antitrust/comments/2004/sentencing_guidelines0704.pdf).

15 *United States v. United Shoe Mach. Corp.*, 89 F. Supp. 357, 358 (D. Mass. 1950); see *Trammel v. United States*, 445 U.S. 40, 50 (1980) (the privilege “promotes a public goal transcending the normally predominant principle of utilizing all rational means for ascertaining the truth”).

16 *Upjohn*, 449 U.S. at 389-90.

17 See “The Decline of the Attorney-Client Privilege in the Corporate Context,” Survey Results.

18 “[T]he work product privilege [exists] . . . to promote the adversary system by safeguarding the fruits of an attorney’s trial preparations from the discovery attempts of the opponent,” *In re Raytheon Securities Litig.*, 218 F.R.D. 354, 359 (D. Mass. 2003) (quoting *United States v. Amer. Tel. & Tel. Co.*, 642 F.3d 1286, 1299 (D.C. Cir. 1980)).

19 Joint Drafting Committee of the American College of Trial Lawyers, *The Erosion of the Attorney-Client Privilege and Work Product Doctrine in Federal Criminal Investigations* (March 2002), at 6, quoting *Hickman v. Taylor*, 329 U.S. 495, 510-11 (1946).

adversaries be unfairly rewarded. Those corporate clients (including their authorized representatives) who fear that the work product generated by their counsel in determining an appropriate response will be disclosed to their adversaries and promptly used against them will, not surprisingly, be reluctant to seek legal assistance at all much less provide information that will assist the attorney in providing such assistance.

#### IV. THE POLICIES OF THE UNITED STATES DEPARTMENT OF JUSTICE

Since the mid-1990s and continuing to date, the principal law enforcement and regulatory authorities in the United States have developed policies and guidelines that are designed to induce corporations and other business entities to waive, or not assert, applicable attorney-client and work-product privileges and protections.<sup>20</sup> First, in 1998, after several years of informal policies at various United States Attorney's Offices, principally the Southern District of New York, the Department of Justice formally adopted what came to be known as the "Holder Memorandum," after Eric Holder, then Deputy Attorney General of the United States. The Holder Memorandum, although advisory, set forth standards by which a corporation would be judged to be cooperative in a criminal investigation. One factor was whether the Corporation waived or did not assert privileges protecting the confidentiality of communication.

Then, in 2002, then Deputy-Attorney General, Larry Thompson, promulgated a revision of the Holder Memorandum, this time making mandatory the use of the factors in judging whether a corporation was sufficiently cooperative, including whether applicable principles were waived or not asserted. In 2004, following the general trend of policy reflected in the Thompson Memorandum, the United States Sentencing Commission adopted an amendment that a corporation's waiver of the attorney-client privilege and work product protections would be a prerequisite for obtaining a reduction by a corporation in its culpability score.

The adoption of these policies by the Department of Justice and other regulatory entities pushed aside historic policies protecting privilege and work-product in favor of policies promoting cooperation with governmental agencies and maximizing the effectiveness and efficiency of governmental investigations.<sup>21</sup> Companies formerly expected that the work product of their counsel prepared as a result of an internal investigation, and advice given as a result of such investigation, would be protected have come to learn that, upon the initiation of a governmental inquiry, whether formal or informal, whether the company is a target or not, such expectations of confidentiality were illusory. Internal investigations, conducted by and at the direction of legal counsel, that are a critical tool by which companies and their boards learn about violations of law, breaches of duty and other misconduct that may expose the company to liability and damages, and an essential predicate to enabling companies to take remedial action and to formulate defenses, where appropriate, no longer have clear and predictable protections of confidentiality in the current environment, viewed as a "culture of waiver."<sup>22</sup> At the height of the investigative storm, protected information is routinely expected to be made available to government authorities, sometimes, at the authorities' request, on a day-to-day basis during the internal investigations. Under such governmental policies, companies perceived they did not realistically have the option to preserve the confidentiality upon which an effective attorney-client relationship is so heavily dependent and otherwise protected by the privilege and doctrine, or they would run the considerable risk of being deemed "uncooperative" by the governmental authority – a characterization that is tantamount to a virtual corporate death sentence<sup>23</sup> or, at least, extraordinarily financially punitive.

20 See United States Attorneys' Criminal Resource Manual, Art. 162, Section VI.B; United States Sentencing Guidelines Manual Section 8C2.5(g)(2001); the SEC's Seaboard Report, available at <http://www.sec.gov/litigation/investreport/34-44969.htm>; see also the EPA Voluntary Disclosure Program, the HHS Provider Self-Disclosure Protocol, and the Department of Justice Antitrust Corporate Leniency Policy.

21 Committee Note to Proposed Amendments to the Federal Rules of Evidence (Rule 502), at 8; see also *In re Columbia/HCA Healthcare Corp. Billing Practices Litigation*, 293 F.3d 289, 314 (6th Cir. 2002) (Boggs, J., dissenting) ("the public interest in easing government investigations counsels against holding the attorney-work-product privilege waived when the holder of the privilege discloses privileged information to the government...a limited disclosure pursuant to a government agency's investigatory request ought not waive the privileges as to all other parties...").

22 See text at fn. 26.

23 As in the case of Arthur Andersen.

There are a variety of reasons why such authorities adopted such policies and, for a fuller discussion of them, we refer to the Report of the ABA's Task Force on the Attorney-Client Privilege,<sup>24</sup> and to the report by the Joint Drafting Committee of the American College of Trial Lawyers, *The Erosion of the Attorney-Client Privilege and Work Product Doctrine in Federal Criminal Investigations* (March 2002).<sup>25</sup> Regardless of the reasons proffered, the result at the Department of Justice, the Securities and Exchange Commission, the Commodity Futures Trading Commission, and other regulatory and self-regulatory agencies, as well as many state attorneys general offices and state regulatory agencies, has been a marked increase in the compelled, requested, suggested, or (pragmatically inevitable) "voluntary" waivers of the privilege and the work-product doctrine, in order to further enhance the likelihood that the company will avoid significant prosecution or regulatory action. The surge in such waivers has been well documented; a recent survey administered jointly by the Association of Corporate Counsel,<sup>26</sup> an organization representing nearly 19,000 public companies, and the National Association of Criminal Defense Lawyers<sup>27</sup> found that

- Nearly 75% of both inside and outside counsel state that, in their experience, government agencies expect a company under investigation to waive legal privileges (1 percent of in-house counsel and 2.5% of outside counsel disagreed with the statement);
- Of the respondents who confirmed that they or their clients had been subject to investigation in the past five years, approximately 30% of in-house counsel and 51% of outside counsel said that the government expected waiver in order to engage in bargaining or be eligible for more lenient treatment; and
- Of those who had been investigated, 55% of outside counsel said the privilege waiver was requested either directly or indirectly; 27% of in-house counsel confirmed that experience.

Of the over 675 responses to the survey, almost half of the general counsels responding on behalf of public and private companies have experienced some kind of privilege erosion, caused by the government's policies. Of these companies, by far the most were not from global companies with high visibility, but rather from a wide variety of differently-sized businesses. After more than a decade of increased pressure, explicit and implicit, on companies to waive the attorney-client privilege and work-product protections, there has emerged a "culture of waiver" in which government agencies expect a company under investigation to waive legal privileges, and many companies do so, most without even being asked any longer but knowing there is no practical alternative to doing so.

Recently, in response to rising criticism of the effects of these policies, some changes to these policies have begun to occur. First, in October 2004, the ABA established a Task Force on the Attorney-Client Privilege to examine the protections, "the circumstances in which competing objectives are currently being asserted by governmental agencies and others to override the privilege," and manners for achieving balance.<sup>28</sup> Following this, the Task Force held public hearings around the country, taking testimony from interested persons with familiarity with governmental policies and their effects, and preparing analyses of the relevant issues affecting the privilege.<sup>29</sup>

Then, in 2005 and early 2006, after hearings were held at which representatives of the American Bar Association, the Association of Corporate Counsel, and the U.S. Chamber of Commerce voiced objections to policies adopted in earlier years, the U.S. Sentencing Commission

<sup>24</sup> 60 Bus.Law. 1029 (May 2005); also available at <http://www.abanet.org/buslaw/attorneyclient/home.shtml>. The "Recommendation" approved by the ABA House of Delegates and outlined in footnote 4, *supra*, and not the related "Report" cited herein, constitutes official ABA policy.

<sup>25</sup> Available at <http://www.aatl.com>.

<sup>26</sup> "The Decline of the Attorney-Client Privilege in the Corporate Context." Survey Results, Presented to the United States Congress and the United States Sentencing Commission, March 2006, [http://www.nacdl.org/public.nsf/whitecollar/wcnews024/\\$FILE/A-C\\_PrivSurvey.pdf](http://www.nacdl.org/public.nsf/whitecollar/wcnews024/$FILE/A-C_PrivSurvey.pdf), and <http://www.acca.com/public/attyclntprvlg/coalitionsstestimony031506.pdf> ("Survey Results").

<sup>27</sup> The ABA and several other organizations provided active participation and access to their members in the survey process.

<sup>28</sup> See ABA Presidential Task Force on the Attorney-Client Privilege: Mission Statement, available at <http://www.abanet.org/buslaw/attorneyclient/home.shtml> (last visited August 29, 2006).

<sup>29</sup> See materials collected at <http://www.abanet.org/poladv/acprivilege.htm>

voted unanimously to reverse the 2004 amendment to the commentary for Section 8C2.5 of the Organization Sentencing Guidelines that had encouraged prosecutors to require companies and other organizations to waive their attorney-client privilege and work product protections as a condition for receiving credit for cooperation at sentencing. The Commission stated that such a deletion was made because it “could be misinterpreted to encourage waivers” by corporations.<sup>30</sup> The changes proposed were not modified by Congress and became effective on November 1, 2006.

The trend in criticism continued when, in August 2006, following the action by the U.S. Sentencing Commission, the ABA unanimously passed resolutions at its annual meeting, supporting the preservation of the attorney-client privilege and work product doctrine and opposing government policies and procedures that “have the effect of eroding the constitutional and other legal rights” of employees, past or present, if that employee decides to exercise his or her Fifth Amendment right against self-incrimination.” Arguments made in support of such resolutions included discussion of using impermissible factors to determine whether a corporation was cooperative with a governmental investigation, including whether the organization: (1) provides counsel to an employee; (2) participates in a joint defense and information sharing agreement with an employee or others with whom the organization has a common interest; (3) shares its own records or historical information about the conduct under investigation with an employee or other party involved in the investigation; or (4) declines to fire or otherwise sanction an employee who exercised his or her Fifth Amendment rights in response to government requests for information.

In the midst of this discussion, Federal District Judge Lewis Kaplan began to hold hearings in the KPMG Tax Shelter indictment, resulting in two well-publicized decisions regarding the over-breadth of the Thompson memorandum in its application and illegitimate use by the Department of Justice.<sup>31</sup>

At the same time, three former Attorneys General, three former Deputy AGs and four former Solicitors General urged that the DOJ revise its policies, specifically, the Thompson Memorandum, to state affirmatively that waiver of the attorney-client privilege and work product doctrine should not be factors in determining whether a corporation is being cooperative. The former DOJ officials call the “Thompson Memorandum” “seriously flawed” and argue that it “undermines, rather than enhances, compliance with the law.”<sup>32</sup>

## V. RESPONSE TO THE CRITICISM

In response to this intense criticism, there were two notable developments: first, Senator Arlen Specter (R-Pa.), then-chairman of the U.S. Senate Judiciary Committee, introduced legislation, entitled “Attorney-Client Privilege Protection Act of 2006,” to prevent the Department of Justice from demanding a waiver of the corporate attorney-client privilege;<sup>33</sup> and second, the Deputy Attorney General, Paul McNulty, issued a revision of the Thompson Memorandum.<sup>34</sup>

<sup>30</sup> <http://www.uscc.gov/2006guid/Finalamend2006.pdf>

<sup>31</sup> *In U.S. v. Stein*, 435 F.Supp.2d 330 (S.D.N.Y. 2006). Judge Kaplan dealt extensively with the issue of whether the Thompson Memorandum had had the effect, intended or otherwise, of forcing a large firm to withhold advancing of attorneys’ fees to former partners and employees, who were subjects and targets of a Grand Jury investigation, in order to earn for itself the label of having fully cooperated with the Government’s investigation, and thus be spared prosecution. The Court held that the government violated the Fifth and Sixth Amendment rights of the individual defendants by causing the firm—under threat of indictment and destruction of the firm—to depart from its uniform prior practice of paying the legal expenses of its personnel in all cases in which they were named in consequence of their activities on behalf of the firm. It found that the firm would have paid those expenses—whether legally obliged to do so or not—but for the government’s improper conduct.

In a later opinion in the same case, *U.S. v. Stein*, --- F.Supp.2d ---, 2006 WL 2060430, SDNY, 2006, July 25, 2006 the Court suppressed statements made by certain employees during the investigation, as having been coerced by the government in violation of their Fifth Amendment privilege against self-incrimination. The Court found that the government was responsible for the pressure put on the employees, by having threatened their employer’s existence, thus causing the firm to exert “substantial pressure on its employees to waive their constitutional rights.” The Court explicitly linked the firm’s pressure on their employees to the effects of the Thompson Memorandum: “In the words of its chief legal officer, [the firm] did everything it could to be able to say at the right time and with the right audience, we’re in full compliance with the Thompson Memorandum.”

<sup>32</sup> <http://online.wsj.com/article/SB115768279330257255.html>

<sup>33</sup> On January 4, 2007, Senator Specter re-introduced the legislation in the new 110th Congress and the “Attorney-Client Privilege Protection Act of 2007” was referred to the Senate Judiciary Committee for consideration. <http://thomas.loc.gov/cgi-bin/bdquery/z?d110:s:00186>

<sup>34</sup> See Principles of Federal Prosecution of Business Organizations, U.S. Deputy Attorney General Paul J. McNulty (December 12, 2006) (“McNulty Memorandum”), available at [http://www.usdoj.gov/dag/speech/2006/mcnulty\\_memo.pdf](http://www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf).

### A. The Specter Legislation

The proposed bill has the support of a diverse group, including the American Bar Association, National Association of Criminal Defense Attorneys, United States Chamber of Commerce, the American Civil Liberties Union, and the Association of Corporate Counsel. The bill would bar prosecutors from forcing companies to waive their attorney-client privilege over internal documents in order to avoid criminal charges, a key part of the Thompson Memo. In general, the proposed Act provides that an agent or attorney of the United States shall not

“demand, request, or condition treatment on the disclosure by an organization, or person affiliated with that organization, of any communication protected by the attorney-client privilege or any attorney work product...”

and

“condition a civil or criminal charging decision relating to an organization ...on, or use as a factor in determining whether an organization...is cooperating with the Government” any of the following:

- any valid assertion of the attorney-client privilege or privilege for attorney work product;
- the provision of counsel to an employee of that organization;
- the entry into a joint defense agreement with an employee of that organization, or
- failure to terminate any employee because of that employee’s decision to exercise his constitutional rights.

In addition, the bill would foreclose the Government from considering any of the foregoing actions when evaluating whether a corporation should be entitled to “cooperation credit.

The bill is responsive to the three specific issues raised by numerous witnesses before the U.S. Sentencing Commission Hearings, referred to above, namely agents of the Government should not demand or encourage an organization to refuse to indemnify an employee for her legal expenses, should not demand that the organization refuse to provide information to employees, and should not request or demand that an organization sanction an employee for invoking his Fifth Amendment privilege against self-incrimination. After having been introduced, the bill was sent to the Senate Judiciary Committee for further consideration.<sup>35</sup>

### B. The McNulty Memorandum

The “McNulty Memorandum” reaffirms many of the factors to be considered by federal prosecutors when conducting corporate investigations, considering whether to indict corporations and considering corporate plea agreements.<sup>36</sup> Of particular significance to any corporation, however, are the restrictions the new policy places on federal prosecutors with respect to: (1) requesting the disclosure of materials protected by the attorney-client privilege or work product doctrine, and considering whether the corporation makes such disclosure in deciding whether to indict the corporation; and (2) considering the corporation’s advancement of legal fees to its employees and other agents in deciding whether to indict the corporation.

<sup>35</sup> Senator Patrick Leahy, D-Vt., the new chair of the Judiciary Committee, has not yet announced his position with respect to the Specter bill. In a written statement following the release of the McNulty Memorandum, Senator Leahy made it clear that he welcomed the new prosecutorial standards and was “pleased that the Justice Department has heeded bipartisan criticism ... and moved away from its most excessive practices in corporate fraud investigations.” However, he also stated that he remained “concerned that, depending on how the new policies are implemented, prosecutors may still be able to inappropriately consider a corporation’s waiver of this important privilege” and that he would “continue to monitor the implementation of this new policy...” <http://www.acc.com/public/attvclientpriv/mcnultymemosenleahystatement.pdf>

<sup>36</sup> For a complete analysis of the McNulty Memorandum, see Shapiro and Malioneck, “The ‘Value of Cooperation’ - The Potential Impact of the McNulty Memorandum on DOJ Investigations,” <http://www.law.com/jsp/nylj/PubArticleNY.jsp?hubtype=outsideCounsel&id=1167127307792>

The new policy makes clear that most attorney-client communications “should only be sought in rare circumstances.”<sup>37</sup> It also establishes an approval process by which prosecutors seeking to request the disclosure of attorney-client protected information must establish a “legitimate need” for the information and obtain the approval of a supervisor, including in many cases the Deputy Attorney General himself. Importantly, if the corporation decides not to disclose protected information, other than purely factual information, “prosecutors will not view [the decision] negatively in making a charging decision.” Prosecutors may, however, give cooperation credit to corporations that decide to waive attorney-client protections.

In addition, the guidelines outlined by the McNulty Memorandum “now generally prohibit prosecutors from considering whether a corporation is advancing attorneys’ fees to employees or agents under investigation or indictment,” when making a charging decision. Only “in extremely rare cases,” when “the totality of the circumstances show” that fee advancement is being used “to impede a government investigation” may prosecutors consider this factor.<sup>38</sup>

The new policy also makes distinctions between different types of privileged materials (i.e., “Category I”, consisting mainly of factual work product materials and “Category II”, consisting of “attorney-client communications or non-factual attorney work product” materials) and establishes a separate approval standard and process for each type. The Memorandum also states that prosecutors cannot deny cooperation credit if a company refuses to waive but allows the government to grant credit to those companies that do waive, a provision that some commentators have labeled a “Catch-22.”<sup>39</sup>

Notwithstanding the changes from the Thompson Memorandum, the McNulty Memorandum still reserves for the Department of Justice the right to consider whether the organization was justified in not waiving the attorney-client privilege and attorney work-product, and makes it explicit that, while “waiver...is not a prerequisite to a finding that a company has cooperated...the disclosure of privileged information may be critical in enabling the government to evaluate the accuracy and completeness of the company’s voluntary disclosure.”<sup>40</sup> As one commentator has noted, “an examination of [the factors set forth in the McNulty memorandum] makes it clear that it would be easy for a prosecutor to determine that there is a legitimate need [for a waiver] in virtually any and every case.”<sup>41</sup>

## VI. THE ROLE OF AUDITORS

At the same time as companies were facing issues affecting their ability to rely on the attorney-client privilege because of governmental policies, they also began to deal with a different kind of pressure from their external auditors. Over the past decade, legal events and changes in business climate have altered perceptions regarding the role of independent auditors as “gatekeepers” of the financial markets. The pressures on independent auditors to require unfettered access to information possessed by their public company clients have increased through the fallout from corporate scandals, including legislation and increased regulation. With each increase in the pressures faced by auditors to demand information from their clients, the same clients have faced corresponding pressures to disclose privileged information to auditors in performance of their duties under generally acceptable auditing standards and under applicable laws.

We have been at similar crossroads before. In 1975, the legal and accounting professions reached an accord, often referred to as the “Treaty,” that was intended to balance seemingly competing interests: a client’s desire to maintain the protections of the attorney-client privilege and work product doctrine, on the one hand, and the auditor’s need for detailed corporate information related to the financial statements, on the other hand. The Treaty recognizes that maintaining the protections is

37 See McNulty Memorandum, *supra* n.33, at p. 10; see also Prepared Remarks of Deputy Attorney General Paul J. McNulty at the Lawyers for Civil Justice Membership Conference Regarding the Department’s Charging Guidelines in Corporate Fraud Prosecutions (Dec. 12, 2006), available at [http://www.usdoj.gov/speech/2006/dag\\_speech\\_061212.htm](http://www.usdoj.gov/speech/2006/dag_speech_061212.htm).

38 *Id.*

39 ABA Journal E-Report, “Thompson Memo Changes Not Enough, ABA Says,” December 15, 2006

40 See McNulty Memorandum, *supra* n.33, at p. 8.

41 N. Richard Janis, “The McNulty Memorandum: Much Ado About Nothing,” Washington Lawyer, February 2007, at 38.

entirely consistent with the function of auditors and their ability to obtain the information that they need to conduct proper audits.<sup>42</sup>

The mechanics by which the Treaty struck this balance involved limiting the range of acceptable disclosures that lawyers may make to auditors with the client's informed consent, and thus defining the scope of what the auditors may request from lawyers regarding confidential attorney information.<sup>43</sup> In 1977, the AICPA reaffirmed this protection and limitation regarding auditor access to privileged information and work product maintained by the client.<sup>44</sup>

More than just documenting these mechanics, however, the Treaty was an acknowledgement that there were common interests among companies, counsel and auditors.

*The public interest in protecting the confidentiality of lawyer-client communications is fundamental.* The American legal, political and economic systems depend heavily upon voluntary compliance with the law and upon ready access to a respected body of professionals able to interpret and advise on the law. The expanding complexity of our laws and governmental regulations increases the need for prompt, specific and unhampered lawyer-client communication. The benefits of such communication and early consultation underlie the strict statutory and ethical obligations of the lawyer to preserve the confidences and secrets of the client, as well as the long-recognized testimonial privilege for lawyer-client communication.<sup>45</sup>

Thus, while auditors require access to certain attorney-client information, they have also long recognized the importance of the privileges by cooperating in this "Treaty" designed to uphold the public interest in protecting these privileges.

While auditors historically have planned and performed their audits to obtain reasonable assurance that a company's financial statements are not materially misstated due to error or corporate fraud – and auditors continue to do so – recent developments in federal law and policy have strongly encouraged auditors to intensify their vigilance. The corporate scandals of 2001 and 2002 sparked legislative action by Congress, rule-making and enforcement initiatives by the SEC, standard-setting by the PCAOB, and initiatives by other oversight bodies, all of which have heightened the scrutiny over auditors' procedures to verify company positions and impacted generally accepted auditing standards ("GAAS") and how auditors apply GAAS.<sup>46</sup>

42 American Bar Association, "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information" (1975), available at <http://www.abanet.org/buslaw/catalog/5070426i/secure.html>.

Thoughtful law review articles discuss the tensions that led to the Treaty, including incidents of auditors asking lawyers open-ended questions seeking general information about the client's potential illegal acts and liability exposures. See Erbstoesser and Matson, *Lawyers' Letters to Auditors*, Ch. 8, Drafting Legal Opinion Letters, at 366, nn. 1 & 2 (2d ed. 1992); Deer, *Lawyers' Responses to Auditors' Requests for Information*, 28 Bus. Law. 947 (1973). The ABA Statement of Policy and SAS 12 ended these types of broad requests by clarifying that GAAS did not require them.

The Treaty involves three pieces of professional literature. The obligation of lawyers to limit their responses to auditor inquiries is set forth in the ABA Statement of Policy. The obligation of clients to accrue for and/or disclose loss contingencies properly is set forth in FAS 5, which is part of generally accepted accounting practices ("GAAP"). See Financial Accounting Standards Board, Statement of Accounting Standards No. 5: Accounting for Contingencies (March 1975). The obligation of auditors to inquire concerning litigation, claims and assessments is governed by GAAS and, specifically, SAS 12, adopted by Auditing Standards Executive Committee of the American Institute of Certified Public Accountants ("AICPA") in the wake of the ABA Statement of Policy. See AICPA, Auditing Standards Board, Statement on Auditing Standards No. 12: Inquiry of a Client's Lawyer Concerning Litigation, Claims and Assessments (Jan. 1976) (codified in AICPA Professional Standards, AU Section 337). The ABA Statement of Policy is an exhibit to SAS 12.

43 Pursuant to the Treaty, a lawyer may provide information to a client's auditors on matters to which the lawyer has devoted substantive attention regarding overtly threatened or pending litigation and, with the client's further specific consent, regarding unasserted possible claims or assessments or contractually-assumed obligations, and may provide specific confirmations regarding the lawyer's role for the client. Only in rare circumstances may the lawyer express to the auditors any professional judgment regarding the potential outcome of the matters. The lawyer may only provide information and evaluation of unasserted possible claims specifically identified by the client if the client has determined that it is "probable" the claims will be asserted, that there is a "reasonable possibility" that the outcome will be unfavorable and that the resulting liability will be material to the client's financial condition. ABA Statement of Policy, para. 5.

44 See AICPA Professional Standards, AU Section 9337 (4), Documents Subject to Lawyer-Client Privilege (March 1977). The interpretive release poses the question: "[SAS 12 states:] 'Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.' Would this include a review of documents at the client's location considered by the lawyer and the client to be subject to the lawyer-client privilege?" and answers as follows: "No. Although ordinarily an auditor would consider the inability to review information that could have a significant bearing on his audit as a scope restriction, in recognition of the public interest in protecting the confidentiality of lawyer-client communications, [SAS 12] is not intended to require an auditor to examine documents that the client identifies as subject to the lawyer-client privilege." (Emphasis added)

45 ABA Statement of Policy, Preamble (emphasis added).

46 Former SEC Enforcement Director Stephen M. Cutler referred to auditors in 2004 as one of the three principal "gatekeepers" in our capital markets, or "sentries of the marketplace." See Stephen M. Cutler, Director of the Division of Enforcement at the SEC, Remarks at the UCLA School of Law, Los Angeles, CA (September 20, 2004), "The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program" (transcript available at <http://www.sec.gov/news/speech/spch092004smc.htm>).

In January 2002, then-SEC Chairman Harvey Pitt, discussing what he called the “Enron situation,” directed strong rhetoric towards auditors:

[T]here is a need for reform of the regulation of our accounting profession. We cannot afford a system, like the present one, that facilitates failure rather than success. Accounting firms have important public responsibilities. We have had too many financial and accounting failures. ... [T]he potential loss of confidence in our accounting firms and the audit process is a burden our capital markets cannot and should not bear.<sup>47</sup>

In 2004, Scott Taub, then-Deputy Chief Accountant and now Chief Accountant for the SEC, suggested that auditors should seek out privileged information in auditing reserves or accruals for litigation losses and tax contingencies under FAS 5:

The difficulty in auditing [loss contingency accruals under FAS 5], however, should cause the auditor to spend more time on them, not less. *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.*<sup>48</sup>

In a report to Congress, mandated by Section 704 of the Sarbanes-Oxley Act, the SEC reported that, of 515 enforcement actions in total for the five years prior to 2003, 18 actions were filed against audit firms and 89 against individual auditors.<sup>49</sup> In the vast majority of these actions, auditors were sanctioned, in the SEC's words, for “failing to gain sufficient evidence to support the issuer's accounting, failing to exercise the appropriate level of skepticism in responding to red flags, and failing to maintain independence.”<sup>50</sup> The 704 Report concludes that “audit failures most often arise from auditors accepting management representations without verification, truncating analytical and substantive procedures, and failing to gain sufficient evidence to support the numbers in the financial statements.”<sup>51</sup>

The PCAOB has signaled an intention to be tough-minded in enforcing its mandate scrutinize auditors. In an August 2, 2004 interview, William McDonough, then Chairman of the PCAOB, stated his view on whether it is the auditor's *obligation* to detect client fraud.<sup>52</sup> He said:

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 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.<sup>53</sup>

Under the Sarbanes-Oxley Act 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 will be identified in a written report and may be handed over to the

47 SEC Chairman Harvey L. Pitt, Public Statement by SEC Chairman: Regulation of the Accounting Profession (Jan. 17, 2002) (transcript available at <http://www.sec.gov/news/speech/spch535.htm>).

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

49 SEC, Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002 (Jan. 24, 2003), available at <http://www.sec.gov/news/studies/sox704report.pdf>.

50 *Id.* at 3.

51 *Id.* at 40.

52 GAAS expressly recognizes that a properly performed and executed audit may fail to detect fraud. SAS 99, *Consideration of Fraud in a Financial Statement Audit*, explains how fraud is less likely to be detected when it involves concealment and collusion: “[A]bsolute assurance [that financial statements are free of material misstatement caused by fraud] is not attainable and thus even a properly planned and performed audit may not detect a material misstatement resulting from fraud. A material misstatement may not be detected because of the nature of audit evidence or because the characteristics of fraud as discussed above may cause the auditor to rely unknowingly on audit evidence that appears to be valid, but is, in fact, false and fraudulent.” AU Section 316.12.

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

SEC or other regulatory authorities and become the subject of further investigation and disciplinary proceedings.<sup>54</sup>

In 2004, in its first limited inspection reports on each of the four major accounting firms,<sup>55</sup> the Board criticized two firms for audits that lacked adequate audit evidence, including the analysis of counsel regarding contingent liabilities under FAS 5.<sup>56</sup> The PCAOB, acting as the new standard setter for public company audits, issued standards on audit documentation and on audits of internal controls over financial reporting, both of which seem to encourage more rigorous audit inquiries into areas involving legal compliance and advice of counsel.<sup>57</sup> These developments suggest that auditors will be making requests not simply for relevant factual information to back up management's representations, but also for *privileged* information in order to perform financial statement audits and reviews.<sup>58</sup>

The combination of these factors has had a direct impact on the relationship between corporations and their auditors and, in turn, on the attorney-client relationship and related protections and has caused many in both communities to regard reliance on the protections as illusory. It was in partial response to these pressures that the previously-mentioned ABA Task Force was established, and the auditor-client relationship was a principal part of the Task Force's work. In August 2006, the Task Force adopted a "Report and Recommendation to ABA House of Delegates on Audit Issues," stating that "it is both appropriate and necessary for the ABA to adopt a new resolution that directly addresses erosion of the privilege and the work product doctrine in the context of audits of financial statements."<sup>59</sup> The Task Force Report identified several examples of erosion of the protections in the audit context, as reported by corporations and their internal and external counsel, including the following:

- auditor requests for a much broader range of documents in the possession of the audited company;
- auditor requests for documents covered by the protections, even where there may be other sources of the relevant information or other ways of satisfying audit needs;
- departures from the Treaty and an increase in non-standard requests;
- expansive treatment of documents in the files of an audited company as constituting audit documentation, and thus necessary to obtain as part of the audit; and
- efforts to review protected materials unrelated to the audit of the financial statements in order to provide the internal controls certification required under the Sarbanes Oxley Act Section 404.<sup>60</sup>

In light of the comments emanating from the SEC and the criticisms levied in the PCAOB's first limited inspection reports, auditors may conclude that it would be imprudent in this climate *not* to demand access to privileged information of the sort described above. However, where auditors' demands for otherwise-protected information lead to disclosure by the company, there is a general fear that a full waiver of the protections will result. This fear is warranted. The lack of any

54 When the PCAOB believes that an act, practice or omission by a registered firm or individual auditor may violate the Sarbanes-Oxley Act, 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.

55 Each of the four 2003 Limited Inspection Reports issued by the PCAOB are available at <http://www.pcaobus.org/Inspections>.

56 PCAOB, Report on 2003 Limited Inspection of Deloitte & Touche LLP (Aug. 26, 2004) at 19-20, available at [http://www.pcaobus.org/documents/Inspections/2004/Public\\_Reports/Deloitte\\_Touche.pdf](http://www.pcaobus.org/documents/Inspections/2004/Public_Reports/Deloitte_Touche.pdf); KPMG Report, *supra* note 110, at 23 n.4.

57 Auditing Standard No. 2: An Audit of Internal Control over Financial Reporting Conducted In Conjunction with an Audit of Financial Statements (PCAOB, June 2004); Auditing Standard No. 3: Audit Documentation (PCAOB, August 2004).

58 It is difficult to gauge the precise degree to which the PCAOB believes company auditors should obtain attorney-client or work product protected documentation in the course of their audits. The Board's publicly available resources only rarely reference such situations. See, e.g., PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, REPORT ON 2004 INSPECTION OF PRICEWATERHOUSECOOPERS LLP 11 (Nov. 17, 2005) available at [http://www.pcaobus.org/inspections/public\\_reports/2005/pricewaterhousecoopers.pdf](http://www.pcaobus.org/inspections/public_reports/2005/pricewaterhousecoopers.pdf).

59 See ABA Presidential Task Force on the Attorney-Client Privilege: Report and Recommendation to ABA House of Delegates on Audit Issues (June 14, 2006), available at [http://www.abanet.org/buslaw/attorneyclient/materials/hod/0806\\_report.pdf](http://www.abanet.org/buslaw/attorneyclient/materials/hod/0806_report.pdf).

60 See *id.* at p. 6.

clear rule in federal and state jurisdictions precluding waiver is paramount to a lack of comfort that the protections will remain intact. While most courts support the argument that disclosure of work product to auditors should not waive the protection as to adversaries, the decisions are not uniform and some courts would hold that disclosure constitutes a waiver. 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. This uncertainty undermines the purpose of the privileges.<sup>61</sup>

Current public sentiment and public policy regarding corporate wrongdoing favor the bending of a company's interest in maintaining the attorney-client privilege and the protections of the work product doctrine to the demands of independent auditors. Significant case law referred to above suggests that yielding protected materials to auditors may result in a waiver. Yet, a balance can be struck between the two competing interests, as also suggested by the case law. One method of resolving the tensions between the two interests is to acknowledge the common interest between auditor and client as well as upholding the expectation that the auditors will maintain the information in confidence.

Other ways in which the issues between clients and their auditors can be dealt with have been suggested by the ABA Task Force on the Attorney-Client Privilege, including identifying the specific ways in which auditors may examine evidential matter without intruding on the area of counsel's privileged advice.<sup>62</sup>

First, with respect to tax advice and opinions, the Task Force pointed out that, under existing AICPA Standards of Field Work, "[i]f the client's support for the tax accrual of matters affecting it, including tax contingencies, is based upon an opinion issued by an outside advisor with respect to a potentially material matter, the auditor *should* obtain access to the opinion, notwithstanding potential concerns regarding attorney-client or other forms of privilege."<sup>63</sup> Before the opinion should be sought, the company must base its support for its tax position upon the opinion of counsel. It is only when the company seeks to justify its tax position on counsel's opinion that the standard calls for the auditor to have access to the opinion. Thus, in the area of tax advice and opinions from counsel, auditor's requests should be limited to those circumstances in which the opinion or advice is asserted by the company as the basis for its tax position. In most circumstances, however, it should be possible for the company to produce materials satisfying audit requirements that disclose the factual and legal bases for the tax position taken by the company without the need for inquiry by the auditor into the advice or opinion of counsel.<sup>64</sup>

Applying the same analysis to other situations, the Task Force was of the view that, with respect to litigation reserves, if the client seeks to support its litigation reserve by reference to the opinion or assessment of counsel, auditors should have access to that opinion. Otherwise, the auditor should refrain from so seeking the privileged material. Of course, the underlying information relevant to determining the proper amount of the reserve is not the subject of the protections in the first instance and therefore should not be withheld from its auditor. Furthermore, an auditor may, if necessary, seek confirmation from the client that the client's position on the litigation reserve is not inconsistent with the advice of its counsel.

1. Similarly, environmental contingencies, including those involving the future obligation to retire assets covered by FAS No. 143 and Interpretation No. 47, involve

61 For example, compare *Medinal, Ltd. v. Boston Scientific Group*, 214 F.R.D. 113, 115 (S.D.N.Y. 2002) (the defendant engaged counsel to perform an investigation and to report the results of the investigation to a Special Litigation Committee ("SLC") of the Board and to the defendant's auditors in connection with their audit of loss contingency reserves. Held: because of the "independent" role of the auditor, the auditor and client did not share "common interests," thus, the disclosure waived the work product protection) with *Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 229 F.R.D. 441 (S.D.N.Y. 2004) (plaintiff's disclosure to its auditors of internal investigative reports did not waive attorney work product protection, notwithstanding the independence of outside auditors, because "[a] business and its auditor can and should be aligned insofar as they both seek to prevent, detect, and root out corporate fraud"; the attorney-client privilege and work product confidentiality help to further legal compliance, thus preventing corporate fraud, much as independent auditing does; hence, the interests of the company's attorneys and its auditors were aligned).

62 See *supra* note 8, at 7-11.

63 Emphasis added.

64 Tax advice and tax opinions inherently involve legal analysis and determinations intended to be covered by the protections. These protections are essential to permit taxpayers to receive effective tax advice and to have the benefits of an adversarial system in controversies with the government. Moreover, tax matters are uniquely within the expertise of accounting firms, thus reducing their need to obtain protected analyses of counsel.

considerations similar to those with respect to tax matters. Questions relating to the proper accounting for environmental contingencies can involve legal determinations, such as whether environmental laws require remediation or taking an asset out of service and the expected timing of such actions. Counsel's assessment of these matters should only be sought by the auditor if the client justifies its position on the contingency by use of counsel's advice.

Finally, the PCAOB should formally acknowledge that the ABA Statement of Policy – the “Treaty” – has worked well for 30 years as a practical approach to preserving the protections in the context of communications directly between lawyers and auditors of companies, and should be reaffirmed. The PCAOB could also issue interpretive guidance, with approval by the SEC, advising that an auditor is generally expected to obtain adequate evidence to support its conclusions without demanding information protected by the attorney-client privilege or work product doctrine. An auditor should only require such information if it determines that there are no other sources from which it can fulfill its professional obligations.<sup>65</sup>

By issuing such guidance, the PCAOB and the SEC would acknowledge and support the compelling public interest served by protecting the confidentiality of attorney-client communications and work product, as did the AICPA in issuing its guidance that auditors need not seek access to a client's privileged information under SAS 12, beyond the Treaty, in order to audit litigation contingency reserves.

Finally, the PCAOB should promulgate guidance that an auditor does not violate independence standards by entering into a written agreement with a client providing for the confidential treatment of client information provided to the auditor, subject to the auditor's professional obligation to cooperate with the PCAOB and other oversight bodies.

By issuing such guidance, the PCAOB would further assist companies that must make their case in court for non-waiver by allowing auditors to enter into confidentiality agreements with clients. Confidentiality agreements have been crucial in the handful of decisions finding non-waiver despite disclosure of work product to government investigators.<sup>66</sup>

## VII. PROPOSED CHANGES TO THE FEDERAL RULES OF EVIDENCE

In early 2006, at the request of the Chairman of the House Committee on the Judiciary, the Judicial Conference Advisory Committee on Evidence Rules (the “Advisory Committee”) drafted a proposed rule of evidence, rule 502, entitled “Attorney-Client Privilege and Work Product; Waiver by Disclosure,” governing issues such as inadvertent disclosure, selective waiver, subject matter waiver, and the binding effect of confidentiality orders.

One particular section of the proposed rule – section 502(b)(3) – dealt with the so-called “selective waiver” doctrine by which a company first produces protected materials to a governmental authority, and later seeks to protect production to a third party in litigation.<sup>67</sup> Courts are routinely asked to opine on the question of whether that company can still invoke the confidentiality protections of the privilege and, usually but not always, rule that a company cannot

<sup>65</sup> This approach is consistent with the AICPA's 1977 guidance regarding SAS 12, discussed above.

<sup>66</sup> See, e.g., *Saino v. McKesson HBOC, Inc.*, 2002 WL 31657622, at \*6, 11 (Del. Ch. Ct. Nov. 13, 2002) (“[P]ublic policy seems to mandate that courts continue to protect the confidentially disclosed work product in order to encourage corporations to comply with law enforcement agencies.”); *Maruzen Co., Ltd. v. HSBC USA, Inc.*, 2002 WL 1628782, at \*2 (S.D.N.Y. June 23, 2002) (denying motion to compel because defendants had confidentiality agreements with U.S. Attorney's Office to whom documents were disclosed (citing *In re Steinhardt Partners, L.P.*, 9 F.3d 230, 236 (2nd Cir. 1993))).

<sup>67</sup> In a related development, on October 16, 2006, President Bush signed the so-called Regulatory Relief Bill, which contains a subsection designed to preserve the attorney/client privilege for disclosures “by any person of any information to any Federal banking agency, State bank supervisor, or foreign banking authority.” The specific provision dealing with nonwaiver of privileges provides that “The submission by any person of any information to any Federal banking agency, State bank supervisor, or foreign banking authority for any purpose in the course of any supervisory or regulatory process of such agency, supervisor, or authority shall not be construed as waiving, destroying, or otherwise affecting any privilege such person may claim with respect to such information under Federal or State law as to any person or entity other than such agency, supervisor, or authority.”

selectively waive as to the government and successfully maintain the privilege as to third parties.<sup>68</sup> It is as a result of such inconsistent court rulings that the “selective waiver” portion of the Rule was proposed to create a measure of certainty by providing that disclosure of protected material to a local, state, or federal investigating authority would not constitute a general waiver of either the attorney-client privilege or work-product protection,<sup>69</sup> and it would “further[] the important policy of cooperation with governmental agencies, and maximize[] the effectiveness and efficiency of governmental investigations.”<sup>70</sup>

However, concerns were raised that adopting the rule in the current “culture of waiver” environment may permanently prevent companies from ever being able, practically, assert a privilege again in governmental investigations, as well as whether a federally-enacted selective waiver rule would be effective in all instances in the courts of the various United States.<sup>71</sup> During the remainder of 2006 and early 2007, the Advisory Committee held additional hearings, including on January 29, 2007, at which all witness except one opposed the selective waiver portion of the proposed rule. In April 2007, a final Committee version of Rule 502 was adopted, in which provisions dealing with selective waiver were separately broken out and placed into a separate statute for Congress to consider, with the Committee taking no position on the merits of selective waiver. As separately redrafted, the provision states that “In a federal [or state] proceeding, the disclosure of a communication or information protected by the attorney client privilege or as work product – when made for any purpose to a federal office or agency in the course of any regulatory, investigative, or enforcement process – does not waive the privilege or work-product protection in favor of any person or entity other than a [the] federal office or agency.”<sup>72</sup>

Following review and presumably approval by the Standing Rules Committee on Rules of Practice and Procedure, the proposed Rule will be considered by the appropriate Congressional Committees, where it is possible that the selective waiver provision of Rule 502 will be given further consideration.

## VIII. CONCLUSION

As should be clear from the foregoing, the attorney-client privilege and work product doctrine, long the bedrock of the system by which we administer the system of justice in this country, have been put under severe strain, through a combination of governmental policies designed to root out corporate criminality, and the expected function of independent auditors, upon whose work, integrity, and independence, much of the financial disclosure system in the United States relies. Many initiatives have been undertaken to preserve the most important aspects of the protections, but whether any of them can be is unsettled at this time.

68 Compare (as to the same materials produced to the SEC by McKesson HBOC), *Saito v. McKesson HBOC, Inc.*, 2002 Del. Ch. LEXIS 139 [2002 WL 31657622 at p. \*11 (Del. Ch. Ct. Nov. 13, 2002) (“[P]ublic policy seems to mandate that courts continue to protect the confidentially disclosed work product in order to encourage corporations to comply with law enforcement agencies.”), with *McKesson HBOC, Inc. v. Superior Court*, 115 Cal. App. 4th 1229, 1241 (Cal. Ct. App. 2004) (“Given the Legislature’s expressed desire to control evidentiary privileges and protections, adoption of the selective waiver theory should come from that body. We agree with the trial court that under California law, McKesson waived the work product protection for the audit committee report and the interview memoranda.”); see also *In re McKesson HBOC Securities Litig.*, 2005 U.S. Dist. LEXIS 7098, upholding the selective waiver doctrine on behalf of McKesson HBOC.

69 See Committee Note, at 6-7 (*infra*, fn 20).

70 *Id.*

71 Compare Broun, “Memo on the Impact of the Draft Rule 502 on Waiver of Privilege in a State Action,” Capra and Broun, Memorandum to Advisory Committee on Evidence Rules, April 24-25, 2006, at 17-23, with Comment Letter, Corporations Committee of the Business Law Section of the State Bar of California, at 2.

72 See <http://www.josephnycc.com/blog/> and <http://wolfs2cents.wordpress.com/2007/04/14/advisory-committee-on-evidence-rules-completes-meetings-on-proposed-rule-502/>