COMMUNICATING WITH AUDITORS AFTER THE SARBANES-OXLEY ACT

(INCLUDING ATTORNEY LETTERS TO AUDITORS RE LOSS CONTINGENCIES, ATTORNEY DUTIES UNDER SOX §§ 303 AND 307, AND OPTIONS BACKDATING)

By

BYRON F. EGAN
Jackson Walker L.L.P.
901 Main Street, Suite 6000
Dallas, Texas 75202-3797
began@jw.com

ASSOCIATION OF CORPORATE COUNSEL (ACC)
HOUSTON CHAPTER ◆ OCTOBER MEETING

HOUSTON, TX • OCTOBER 10, 2006

Copyright© 2006 by Byron F. Egan. All rights reserved.

TABLE OF CONTENTS

I. PRESSURE ON AUDITORS TO DETECT CORPORATE FRAUD 5
GAAS 5
Accountant Duties Under 1934 Act Section 10A 7
SEC Enforcement Actions 9
PCAOB 11
PCAOB Issues Audit Practice Alert Regarding Timing and Accounting for Stock Option Grants 12
Vocabulary 13
Discounted 14
In-the-Money 14
Spring-loading 14
spring-dating 14
Bullet-dodging 14
GAAP Accounting for Options 14
APB 25 14
FAS 123(R) 15
Background 15
Backdating 16
When Was Option Granted 16
Consequences 18
Spring-Loading 28
Matters for Auditor Consideration Under the Alert 29
New Executive Compensation Rules 33

II. MISLEADING STATEMENTS TO AUDITORS 35
SOX §303 Requirements 35
Enforcement 37
False Confirmations 44
Internal Investigations 45
Relationship of SOX §303 Requirements to 1934 Act §10A 46
Foreign Private Issuers 46

III. ENHANCED ATTORNEY RESPONSIBILITIES UNDER SOX 46
SOX §307 46
Relationship to State Disciplinary Rules 47
Attorneys Covered 47
Who is the Client? 48
What Evidence Triggers Reporting Duty? 49
Duty to Report Evidence of a Material Violation 50
Alternative Reporting Procedures For An Issuer That Has Established A QLCC 53
Issuer Confidences 53
Responsibilities of Supervisory Attorneys 55
Responsibilities of a Subordinate Attorney 55
Sanctions and Discipline 55
No SOX §307 Private Right of Action 56

Enron Civil Liability Fallout 56
Attorney-Client/Work Product Privilege 57
Differences From Proposed Rules 58

IV. ATTORNEY-CLIENT PRIVILEGE AND THE WORK PRODUCT DOCTRINE IN THE CORPORATE CONTEXT 59
Introduction 59
Attorney-Client Privilege 59
Overview 60
Derivative Actions 61
Legal Advice Purpose 63
Internal Investigations 66
Generally Unprivileged Items 69
Waiver 69
No Waiver Where Common Interest 71
Issue Injection 72
Scope of Waiver 74
Exceptions to the Privilege 79
Work Product Doctrine 80
Legal Fee Audits 85
Mergers and Acquisitions 85

V. ATTORNEY LETTERS TO AUDITORS 88
SFAS 5 88
SAS 12 88
ABA Statement 90
Discoverability of Audit Response Letters 97

VI. SELECTED RESPONSE LETTER ISSUES 103
Is the ABA Statement Superseded by SOX §303? 103
The Company Dilemma 104
Law Firm Policies 105
Estimates of Loss 106
Requests Beyond Scope of ABA Statement 106
Requests for Updates or Informal Discussions 109
Information as to Specific Cases 109
Inside Counsel Special Issues 110
Triangle 112
Gain Contingencies 112

VII. LIMITATION OF LIABILITY PROVISIONS IN AUDITOR ENGAGEMENT LETTERS 114

VIII. CONCLUSION 117

EXHIBIT A – FORM OF OUTSIDE LAW FIRM RESPONSE LETTER

COMMUNICATIONS WITH AUDITORS AFTER THE SARBANES-OXLEY ACT (INCLUDING ATTORNEY LETTERS TO AUDITORS RE LOSS CONTINGENCIES, ATTORNEY DUTIES UNDER SOX §§ 303 AND 307, AND OPTIONS BACKDATING)

By

Byron F. Egan, Dallas, TX*

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

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

---

* Copyright© 2006 by Byron F. Egan. All rights reserved.

Byron F. Egan is a partner of Jackson Walker L.L.P. in Dallas, Texas. Mr. Egan is a former Chairman of the Texas Business Law Foundation and is also former Chairman of the Business Law Section of the State Bar of Texas and of that Section's Corporation Law Committee. Mr. Egan is Vice-Chair of the ABA Business Law Section's Negotiated Acquisitions Committee and former Co-Chair of its Asset Acquisition Agreement Task Force, which published the ABA Model Asset Purchase Agreement with Commentary (2001). He is also a member of the American Law Institute.

The author wishes to acknowledge the contributions of the following in preparing this paper: Michael L. Laussade, Gordon M. Shapiro and Jeffrey M. Sone of Jackson Walker L.L.P. in Dallas, Texas, Sabrina A. McTopy of Jackson Walker L.L.P. in Houston, Texas, and Steve R. Jacobs of Jackson Walker L.L.P. in San Antonio, Texas; Harold F. Degenhardt of Fulbright & Jaworski L.L.P. in Dallas; Cullen M. Godfrey, the General Counsel of The Texas A & M University System in College Station, Texas, James D. Goldsmith of KPMG LLP in New York, New York; and Charles R. Lotter, the former Executive Vice President, Secretary & General Counsel of, and now a consultant to, J.C. Penney Corp., Inc. in Plano, Texas.

[1] *See Statement of Policy Adopted by American Bar Association Regarding Responsibilities and Liabilities of Lawyers in Advising with Respect to the Compliance by Clients with Laws Administered by the Securities and Exchange Commission*, 31 BUS. LAW. 543 (Apr. 1976).

The importance of the ABA Statement and the need for attorney diligence in preparing Response Letters and communicating with auditors were magnified when on July 30, 2002 President Bush signed the Sarbanes-Oxley Act of 2002 (H.R. 3763) (*"SOX"*).[2] This is the "tough new corporate fraud bill" trumpeted by the politicians and in the media as a response to the corporate scandals of 2001-2002 and as a means to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws. Among other things, SOX amends the Securities Exchange Act of 1934 (the *"1934 Act"*) and the Securities Act of 1933 (the *"1933 Act"*). Although SOX does have some specific provisions, and generally establishes some important public policy changes, it is being implemented in large part through rules adopted and to be adopted by the Securities and Exchange Commission (*"SEC"*) and the Public Company Accounting Oversight Board (*"PCAOB"*), which have impacted auditing standards and have increased scrutiny on auditors' independence and procedures to verify company financial statement positions and representations. Further, while SOX is by its terms generally applicable only to public companies,[3] its principles are being applied by the marketplace to privately held companies[4] and nonprofit entities.[5]

---

[2] *See* Byron F. Egan, *The Sarbanes-Oxley Act and Its Expanding Reach*, 40 Tex. J. of Bus. L. 305 (Winter 2005).

[3] SOX is generally applicable to all companies required to file reports with the SEC under the 1934 Act (*"reporting companies"*) or that have a registration statement on file with the SEC under the 1933 Act, in each case regardless of size (collectively, *"public companies"* or *"issuers"*). Some of the SOX provisions apply only to companies listed on a national securities exchange (*"listed companies"*), such as the New York Stock Exchange (*"NYSE"*) or the NASDAQ Stock Market (*"NASDAQ"*) (the national securities exchanges and NASDAQ are referred to collectively as *"SROs"*), but not to companies traded on the NASD OTC Bulletin Board or quoted in the Pink Sheets or the Yellow Sheets. *See* Standards Relating to Listed Company Audit Committees, 1933 Act Release No. 33-8220 (April 9, 2003), *available at* http://www.sec.gov/rules/final/33-8220.htm.

Small business issuers that file reports on Form 10-QSB and Form 10-KSB are subject to SOX generally in the same ways as larger companies although some specifics vary (references herein to Forms 10-Q and 10-K include Forms 10-QSB and 10-KSB). "*Small business issuer*" is defined in 1934 Act Rule 0-10(a) as an issuer (other than an investment company) that had total assets of $5 million or less on the last day of its most recent fiscal year, except that for the purposes of determining eligibility to use Forms 10-KSB and 10-QSB that term is defined in 1934 Act Rule as a United States ("*U.S.*") or Canadian issuer with neither annual revenues nor "*public float*" (aggregate market value of its outstanding voting and non-voting common equity held by non-affiliates) of $25,000,000 or more. SEC Registration and Reporting General, 17 C.F.R. § 240.12b-2 (2005). Some of the rules adopted under SOX apply more quickly to larger companies that are defined as "*accelerated filers"* under 1934 Act Rule 12b-2 (generally issuers with a public common equity float of $75 million or more as of the last business day of the issuer's most recently completed second fiscal quarter that have been reporting companies for at least 12 months). *Id*.

SOX and the SEC's rules thereunder are applicable in many, but not all, respects to (i) investment companies registered under the Investment Company Act of 1940 (the *"1940 Act"*) and (ii) public companies domiciled outside of the United States of America (the *"U.S."*) (*"foreign companies"*). Many of the SEC rules promulgated under SOX's directives provide limited relief from some SOX provisions for the "*foreign private issuer*," which is defined in 1933 Act Rule 405 and 1934 Act Rule 3b-4(c) as a private corporation or other organization incorporated outside of the U.S., as long as: (i) more than 50% of the issuer's outstanding voting securities are <u>not</u> directly or indirectly held of record by U.S. residents; (ii) the majority of the executive officers or directors are <u>not</u> U.S. citizens or residents; (iii) more than 50% of the

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

---

issuer's assets are not located in the U.S.; and (iv) the issuer's business is not administered principally in the U.S.

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

While SOX is generally applicable only to public companies, there are three important exceptions: (i) SOX §§ 802 and 1102 make it a crime for any person to alter, destroy, mutilate or conceal a record or document so as to (x) impede, obstruct or influence an investigation or (y) impair the object's integrity or availability for use in an official proceeding, 18 U.S.C. § 1519 (Supp. 2002); 18 U.S.C. § 1512 (2000 & Supp. 2002); (ii) SOX § 1107 makes it a crime to knowingly, with the intent to retaliate, take any action harmful to a person for providing to a law enforcement officer truthful information relating to the commission of any federal offense, 18 U.S.C. § 1513 (2000 & Supp. 2002); and (iii) SOX § 904 raises the criminal monetary penalties for violation of the reporting and disclosure requirements of the Employee Retirement Income Security Act of 1974 (*"ERISA"*). 29 U.S.C. § 1131 (Supp. 2002). These three provisions are applicable to private and nonprofit entities as well as public companies.

[4] Private companies that contemplate going public, seeking financing from investors whose exit strategy is a public offering or being acquired by a public company may find it advantageous or necessary to conduct their affairs as if they were subject to SOX. *See* Mark Peters, Jin-Kyu Koh and Jeffrey Belisle, *Private Companies Toe the SOX* Line, Mergers & Acquisitions (Oct. 2005 at 34-36); Joseph Kubarek, *Sarbanes-Oxley Raises the Bar for Private Companies*, NACD-Directors Monthly (June 2004 at 19-20); Peter H. Ehrenberg and Anthony O. Pergola, *Why Private Companies Should Not Ignore the Sarbanes-Oxley Act*, 6 No. 7 WALLSTREETLAWYER.COM: SEC. ELEC. AGE 12, 12–13 (2002).

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

Further, providing such information to auditors subjects the provider to the requirements of Section 303 of SOX (*"SOX §303"*) and expanded Rule 13b2-2[6] under the 1934 Act adopted pursuant to SOX §303 (collectively, the *"SOX §303 Requirements"*). The SOX §303 Requirements specifically prohibit officers and directors, and "persons acting under [their] direction," from coercing, manipulating, misleading or fraudulently influencing (collectively referred to herein as *"improperly influencing"*) an auditor "engaged in the performance of an audit" of the issuer's financial statements when the officer, director or other person "knew or should have known" that the action, if successful, could result in rendering the issuer's financial statements filed with the SEC materially misleading. Since attorneys representing a corporation are usually engaged by, and are acting at the direction of, its directors or officers, the attorneys are subject to the SOX §303 Requirements.[7]

The SOX §303 Requirements should influence an attorney in communicating with accountants, and reinforce the importance of providing meaningful information to auditors and clients. The SOX §303 Requirements, however, should not be viewed as repudiating or supplanting the ABA Statement. A lawyer who prepares a Response Letter in accordance with the ABA Statement should not be considered to have misled or otherwise improperly influenced an auditor as the letter typically states that it was prepared in accordance with the ABA Statement and is prepared in response to a request letter that also should conform to the ABA Statement.

While not denying the right of lawyers to rely on the ABA Statement in actions taken in conformity with the ABA Statement, SEC rulemaking and enforcement actions post-SOX attempt to place lawyers in the role of "gatekeepers" or "sentries of the marketplace" whose responsibilities include "ensuring that our markets are clean."[8] These SEC actions do, however, affect the role of the lawyer in dealing with clients, auditors and others.[9]

---

6 Improper Influence on Conduct of Audits, 1934 Act Release No. 34-47890, 80 S.E.C. Docket 770 (May 20, 2003), *available at* http://www.sec.gov/rules/final/34-47890.htm.

7 *Cf.* Implementation of Standards of Professional Conduct for Attorneys, 1933 Act Release No. 33-8185, 79 S.E.C. Docket 1351 (Jan. 29, 2003), *available at* http://www.sec.gov/rules/final/33-8185.htm, explaining adoption of rules pursuant to SOX § 307 that generally provide that, in the event that an attorney has "credible evidence based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation [of any U.S. law or fiduciary duty] has occurred, is ongoing, or is about to occur," the attorney has a duty to seek to remedy the problem by "reporting up the ladder" within the issuer to the issuer's chief legal officer, or to both the chief legal officer and the chief executive officer, or if those executives do not respond appropriately, to the issuer's board of directors or an appropriate committee thereof. *See infra* part III. Enhanced Attorney Responsibilities Under SOX.

8 Stephen M. Cutler, Director, SEC Div. of Enforcement, The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program, Speech at the UCLA School of Law (Sept. 20, 2004) (in which the point was made that SOX attempts to protect investors from a repeat of the scandals that led to its enactment by regulating "[t]he sentries of the marketplace: the auditors who sign off on companies' financial data; the lawyers who advise companies on disclosure standards and other securities law requirements; the research analysts who warn investors away from unsound companies; and the boards of directors responsible for oversight of company management") *available at*

I.
PRESSURE ON AUDITORS TO DETECT CORPORATE FRAUD

GAAS. Generally acceptable auditing standards (*"GAAS"*) recognize that auditors have particular responsibilities with respect to the discovery of corporate fraud during an audit. The auditor has a responsibility to plan and to perform financial statement audits in order to obtain "reasonable assurance" about whether the financial statements are free of material misstatement, whether caused by error or fraud.[10]

Accounting Standards Board Statement (*"SAS"*) No. 99 (*"SAS 99"*) establishes guidance to help auditors to fulfill that responsibility with respect to fraud.[11] In the allocation of responsibilities between auditors and their clients, "it is management's responsibility to design and implement programs and controls to prevent, deter, and detect fraud."[12] In connection with its audit of financial statements in accordance with GAAS, the auditor's "interest" is in obtaining

---

http://www.sec.gov/news/speech/spch092004smc.htm. Speeches by SEC members or staff are the expressions of the speakers themselves, and are not to be construed as representations of the Commission itself.

9 *See infra* parts II. Misleading Statements to Auditors and III. Enhanced Attorney Responsibilities Under SOX.

10 CODIFICATION OF AUDITING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 1 (Am. Inst. of Certified Pub. Accountants); *see also* RESPONSIBILITIES AND FUNCTIONS OF THE INDEPENDENT AUDITOR, Statement on Auditing Standards No. 1, § 110.02 (Am. Inst. of Certified Pub. Accountants), *available at* http://www.aicpa.org/download/members/div/auditstd/AU-00110.PDF, and Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters, 71 Federal Register No. 27 6847, 6849 (February 9, 2006), *available at* http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/06-1189.pdf, wherein five federal agencies supervising financial institutions stated that they "believe that including an indemnification or limitation of liability provision for the client's knowing misrepresentations, willful misconduct, or fraudulent behavior in an Audit engagement letter may not be viewed as consistent with the auditor's duty and obligation to comply with auditing standards."

11 CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT, Statement on Auditing Standards No. 99, § 316 (Am. Inst. of Certified Pub. Accountants), *available at* http://www.aicpa.org/download/members/div/auditstd/AU-00316.PDF.

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

evidential matter regarding intentional acts that "result in a material misstatement of the financial statements."[13]

Thus, the auditor, in exercising the required professional skepticism when planning and performing the audit, is to consider whether the presence of certain "risk factors" indicate the possible presence of fraud and, if risks of fraudulent, material misstatement are identified, consider the impact of this finding on the audit report and whether reportable conditions relating to the company's internal controls exist and should be communicated to the company or its audit committee.[14] An auditor's obligations to gather evidential matter to satisfy itself regarding the presence of fraud includes making inquiries "about the existence or suspicion of fraud" to any appropriate personnel within the company, and SAS 99 suggests that the auditor "may wish to direct these inquiries" to the company's inside legal counsel.[15]

---

[13] CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT, Statement on Auditing Standards No. 99, § 316 (Am. Inst. of Certified Pub. Accountants), *available at* http://www.aicpa.org/download/members/div/auditstd/AU-00316.PDF.

[14] *Id*. at §§ 316.05, 316.12, 316.31, 316.80.

[15] *Id*. at §§ 316.24–25. Other guidance found in GAAS suggests that an auditor may wish to obtain evidential matter through company counsel. In regard to an auditor's obligations regarding loss contingencies for litigation, claims and assessments pursuant to FAS 5, GAAS states that the "opinion of legal counsel on specific tax issues that he is asked to address and to which he has devoted substantive attention . . . can be useful to the auditor in forming his own opinion." *See* EVIDENTIAL MATTER: AUDITING INTERPRETATIONS OF SECTION 326, Statement on Auditing Standards No. 31, § 9326.19 (Am. Inst. of Certified Pub. Accountants) (warning further that "it is not appropriate for the auditor to rely solely on such legal opinion" in conducting the audit regarding these issues).

Accountant Duties Under 1934 Act Section 10A. Section 10A of the 1934 Act,[16]

---

[16] 15 U.S.C. § 78j-1. The relevant portion of Section 10A of the 1934 Act was modeled after SAS 53, the predecessor to SAS 82, and provides as follows:

> **Sec. 10A. Audit requirements (Sec. 78j–1)**
>
> (a) *In general*. Each audit required pursuant to this title of the financial statements of an issuer by a registered public accounting firm shall include, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission—
>
> (1) procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts;
>
> (2) procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein; and
>
> (3) an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year.
>
> (b) *Required response to audit discoveries*.
>
> (1) *Investigation and report to management*. If, in the course of conducting an audit pursuant to this title to which subsection (a) applies, the registered public accounting firm detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred, the firm shall, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission—
>
> (A)(i) determine whether it is likely that an illegal act has occurred; and
>
> (ii) if so, determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and damages; and
>
> (B) as soon as practicable, inform the appropriate level of the management of the issuer and assure that the audit committee of the issuer, or the board of directors of the issuer in the absence of such a committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of such firm in the course of the audit, unless the illegal act is clearly inconsequential.
>
> (2) *Response to failure to take remedial action*. If, after determining that the audit committee of the board of directors of the issuer, or the board of directors of the issuer in the absence of an audit committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of the firm in the course of the audit of such accountant, the registered public accounting firm concludes that—
>
> (A) the illegal act has a material effect on the financial statements of the issuer;
>
> (B) the senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act; and

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

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

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

(A) resign from the engagement; or

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

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

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

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

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

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

which was added by the Private Securities Litigation Reform Act of 1995 (*"PSLRA"*),[17] created additional reporting obligations for auditors with regard to fraud that had not existed prior to that time. Like GAAS, Section 10A requires auditors to employ procedures, in accordance with GAAS, designed to provide "reasonable assurance of detecting illegal acts" that would have a direct and material effect on the financial statements. In addition, however, Section 10A requires auditors to report evidence of fraud up the corporate ladder to management and to the audit committee under certain circumstances. Section 10A further requires that the auditor report not only up, but *out* to the SEC if – after investigation of evidence of an illegal act uncovered during an audit – the auditor determines that (1) the audit committee or board is adequately informed of the illegal act, (2) the illegal act has a material effect on the financial statements, (3) the illegal act has not been appropriately remediated, and (4) as a result, the auditor will be required to issue a qualified audit opinion or resign.[18] The creation of the "illegal act" requirement of Section 10A exposed auditors to potential administrative proceedings based not only on alleged deficiencies in their audits or reviews of financial statements, but also on allegations that they have taken insufficient steps to satisfy these reporting requirements.

SEC Enforcement Actions. Under SEC Rule 102(e)(1)(ii), the SEC may sanction accountants for "improper professional conduct."[19] Administrative and enforcement actions

---

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

[18] 15 U.S.C. § 78j-1. Section 10A requires (in plain English) that if an auditor becomes aware of anything indicating that an illegal act has or may have occurred at one of her public clients, her firm must: inform the appropriate level of management and the audit committee of the issue; conclude whether there has been an illegal act that has a material effect on the financials; conclude whether the company has taken timely and appropriate remedial action; and report the client to the SEC if the client fails to take timely and appropriate remedial action.

[19] SEC Rule 102(e)(1)(iv) defines improper professional conduct as follows:

> "(A) Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or
>
> (B) Either of the following two types of negligent conduct:
>
> (1) A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.
>
> (2) Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission."

Securities and Exchange Commission Rules, 17 C.F.R. § 201.102 (2005). SEC Rule 102(e)(1)(iv) History: Section (iv) was added to the Rule in 1998 to address the D.C. Circuit's concerns – as expressed in Checkosky v. S.E.C., 23 F.3d 452 (D.C. Cir. 1994) (hereinafter *Checkosky* I) and Checkosky v. S.E.C., 139 F.3d 221 (D.C. Cir. 1998) (hereinafter *Checkosky* II) – about the lack of clarity in the term "improper professional conduct." Marrie v. S.E.C., 374 F.3d 1196, 1198 (D.C. Cir. 2004) ("we begin with the

filed in recent years reflect enhanced scrutiny of the work of auditors who failed to catch fraud by their clients or to take sufficient steps to satisfy Section 10A.[20] When he was Director of the

---

observation that in the amended Rule 102(e), the Commission has cured the defects identified in Checkosky I and II").

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

SEC Division of Enforcement, Stephen Cutler called auditors "the sentries of the marketplace," and said that the SEC was focusing on auditing firm responsibility for audits in the hope that "accounting firms will take an even greater role in ensuring that individual auditors are properly discharging their special and critical gatekeeping role.[21]

PCAOB. Besides the SEC's Enforcement Division, the auditors' newest regulator has put the industry on notice of its expectations with respect to fraud. The PCAOB was established under SOX §101 to inspect, investigate and discipline auditors conducting public company audits.[22] In an August 2, 2004 interview, PCAOB Chairman William McDonough stated his view as to the auditor's *obligation* to detect client fraud:

---

financial statements from 1998 for failure to correctly characterize the cause of an inventory overstatement as resulting from internal control deficiencies as opposed to changed accounting rules, as misrepresented by Warnaco in a press release); *In the Matter of Grant Thornton LLP, et al.*, Admin. Proc. File No. 3-11377, Accounting and Auditing Enforcement Release No. 1945 (Jan. 20, 2004) (administrative proceeding against Grant Thornton for aiding and abetting fraud and violating Section 10A by failing to obtain sufficient audit evidence despite "red flags" that client failed to disclose material related party transactions; *In the Matter of Richard P. Scalzo, CPA*, Admin. Proc. File No. 3-11212, Accounting and Auditing Enforcement Release No. 1839 (Aug. 13, 2003) (auditor permanently barred from public practice based on audits of Tyco between 1997 and 2001 in which he became aware of facts that put him on notice regarding the integrity of Tyco's management but failed to perform additional audit procedures or reevaluate his risk assessment); *In the Matter of Warren Martin, CPA*, Admin. Proc. File No. 3-11211, Accounting and Auditing Enforcement Release No. 1835 (Aug. 8, 2003) (auditor suspended from public practice for two years for undue reliance upon management representations regarding the interpretation of contracts, thereby ignoring "unambiguous contractual language" that affected revenue recognition and led to a $66 million restatement); *In the Matter of Phillip G. Hirsch, CPA*, Admin. Proc. File No. 3-11133, Accounting and Auditing Enforcement Release No. 1788 (May 22, 2003) (suspending PwC auditor for one year in settlement of allegations that he did not ensure that sufficient audit procedures were conducted in light of PwC's risk of fraud assessment and that he placed undue reliance on management representations despite awareness of evidence "from which he should have realized further audit work was required."); *SEC v. KPMG*, Civil Action No. 02-cv-0671 (S.D.N.Y. January 29, 2003), Accounting and Auditing Enforcement Release No. 1709 (seeking civil injunction against KPMG and disgorgement of fees and civil penalties in connection with the firm's audit of Xerox based on allegation that auditors had evidence of manipulation of financial results and failed to ask Xerox to justify departures from GAAP); *In Matter of Barbara Horvath, CPA*, Admin. Proc. File No. 3-10665, Accounting and Auditing Enforcement Release No. 1483 (Dec. 27, 2001) (a Deloitte & Touche auditor for placing reliance on management representations as her principal source of audit evidence for the company's capitalization of expenses which, it turned out, were fraudulent).

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

[22] SOX §§ 101-105, 15 U.S.C. §§ 7211-15. History: SOX §105 granted the PCAOB broad investigative and disciplinary authority over registered firms and those firms' partners, principals, and employees. September 29, 2003 the PCAOB adopted Rules on Investigations and Adjudications in PCAOB Release No. 2003-015, which on May 14, 2004 the SEC approved 1934 Act Release No. 34-49704. In *Free Enterprise Fund v. Public Company Accounting Oversight Board*, D.D.C., No. 06 Civ. 00217 (September 1, 2006), the constitutionality of the PCAOB was challenged on grounds that PCAOB's existence violates

> 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.[23]

Under SOX and the PCAOB's implementing regulations, *any* violation of laws, rules or policies by individual auditors or firms detected during inspections of selected audit and review engagements is to be identified in a written report and may be handed over to the SEC or other regulatory authorities and become the subject of further investigation and disciplinary proceedings.[24] The PCAOB has stated that inspections will assess compliance at all levels – *i.e.*, actions, omissions, policies and behavior patterns "from the senior partners to the line accountants."[25] The inspections will allow the PCAOB, in its own words, to "apply pressure to improve a firm's audit practices."[26]

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

PCAOB Issues Audit Practice Alert Regarding Timing and Accounting for Stock Option Grants. On July 28, 2006, the PCAOB issued its staff Practice Alert No. 1, entitled "Matters Relating to Timing and Accounting for Options Grants,"[27] that was prompted by recent reports and disclosures about issuer practices related to the granting of stock options, including

---

the appointments clause, the general separation of powers principle and the non-delegation doctrine of the U.S. Constitution. The SEC and U.S. Department of Justice have filed briefs supporting the constitutionality of the PCAOB. *See* 38 BNA Sec. Reg. & Law Rept. No. 37 at 1573 (September 18, 2006).

[23] *The Enforcer*, CFO.com (Aug. 2, 2004) (emphasis added).

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

[25] Steven Berger, *PCAOB—Beyond The First Year*, MONDAY BUSINESS BRIEFING (July 15, 2004), *available at* 2004 WL 69983842.

[26] PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, ANNUAL REPORT, FISCAL YEAR 2003, at 4 (2004), *available at* http://www.pcaobus.org/About_the_PCAOB/Annual_Reports/2003.pdf.

[27] http://www.pcaobus.org/News_and_Events/News/2006/07-28.aspx

the "backdating" of such grants, which indicate that some issuers' actual practices in granting options might have been inconsistent with the manner in which these transactions were initially recorded and disclosed.[28] The Alert noted that some issuers have announced restatements of previously issued financial statements as a result of these practices and that some of these practices could result in legal and other contingencies that may require recognition of additional expense or disclosure in financial statements.

As of September 21, 2006, more than 115 companies were undergoing some form of investigation involving their stock option grants, and more are likely to come under scrutiny.[29] Further, among nearly 150 late filers of quarterly results in the second quarter, roughly 50 companies disclosed delays resulting from stock option grant reviews.[30]

The Alert advises auditors that these stock option grant practices may have implications for audits of financial statements or of internal control over financial reporting and discusses factors that may be relevant in assessing the risks related to these matters. As a result of this Alert, together with SEC investigations, media, analyst and shareholder activist inquiries, and litigation surrounding option grant practices of other issuers, auditors are making more detailed and far reaching requests for documentation and representations from their clients about stock option grants than in prior years. Further, the significantly expanded executive compensation and related person disclosures that will be required for all proxy and information statements filed on or after December 15, 2006 by the amendments to SEC Regulation S-K items 402 and 404 adopted by the SEC on July 26, 2006 (the *"2006 Executive Compensation Rules"*)[31] will require specific information regarding option granting practices.

Vocabulary.

"*At-the-money*" options are stock options granted with an exercise price equal to the fair market value (usually the closing price) of the issuer's stock on the grant date.

"*Backdating*" involves setting the grant date of an employee stock option that precedes the actual date of the corporate action required to effect the grant in order to provide a lower exercise price, and hence a higher value, to the recipient.

---

28 *See* David I. Walker, "Some Observations on the Stock Options Backdating Scandal of 2006," Boston University School of Law Working Paper Series, Law and Economics Working Paper No. 06-31, available at http://www.bu.edu/law/faculty/scholarship/workingpapers/2006.html, in which the author suggests that the options backdating phenomena in the companies he surveyed is less about accounting fraud and executive greed than about a broad based effort to compensate rank-and-file employees as well as officers.

29 *See* Options Scorecard, Wall Street Journal Online (September 21, 2006), available at http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html.

30 *See* "Is Your Target an Option Timer?", Securities Mosaic (September 25, 2006).

31 1933 Act Release No. 33-8732A (August 29, 2006) "Executive Compensation and Related Person Disclosure," *available at* http://www.sec.gov/rules/final/2006/33-8732a.pdf (the *"2006 Executive Compensation Release"*).

"*Bullet-dodging*" is the converse of spring loading and involves granting of stock options after the issuer's release of negative information that can reasonably be expected to have a negative impact on the market value of the stock.

"*Discounted*" or "*In-the-Money*" options are stock options granted with an exercise price less than the fair market value of the stock at the time of grant (usually the closing price of the issuer's stock on the grant date).

"*Grant date*" or "*measurement date*" under APB 25 is the first date on which both of the following are known: (1) the number of options that an individual employee is entitled to receive and (2) the option or purchase price. Under APB 25, even if documents related to an award of options are dated "as of" an earlier date, the measurement date does not occur until the date the terms of the award and its recipient are actually determined.

"*Spring-loading*" or "*spring-dating*" involves granting stock options in advance of the issuer's release of material information that can reasonably be expected to have a positive effect on the market price of the stock.

GAAP Accounting for Options. The Alert notes that under generally accepted accounting principles for financial reporting in the U.S. (*"GAAP"*), the recorded value of a stock option depends, in part, on the market price of the underlying stock on the date that the option is granted and the exercise price specified in the option. Where discounted options were granted, the issuer would ordinarily record initially the amount of the discount as compensation cost in the period of grant. If proper recording of the compensation cost was not made, the errors may cause the issuer's financial statements, including related disclosures, to be materially misstated. Periods subsequent to the grant of an option may also be affected by improper accounting for a grant because option cost is generally expensed over the period during which the issuer receives the related services, most commonly its vesting period.

The specific accounting treatment for an option will be determined by whichever of the following is applicable:

APB 25. Under Accounting Principles Board (*"APB"*) Opinion No. 25, *Accounting for Stock Issued to Employees* (*"APB 25"* or *"Opinion 25"*), which defined the method many companies used to account for stock options until recently, there was no compensation expense recorded if the option was issued with an exercise price not less than the fair market price (usually the closing price) of the stock on the date of grant (the *"measurement date"*) entitling the employee to purchase a fixed number of shares for a fixed price for a fixed period of time and vesting based on continued service over a specified period of time. If on the measurement date the fair market value of the stock exceeded the option exercise price, then the issuer would have to record the amount of the discount as compensation expense in the period of grant.[32]

---

[32] In a letter dated September 19, 2006 from the SEC Chief Accountant to the Chairman of Center for Public Company Audit Firms, American Institute of Certified Public Accountants (the *"SEC Options Guidance"*), the importance of the measurement date was emphasized:

FAS 123(R). An option granted today is accounted for under Financial Accounting Statement No. 123(R), titled "Accounting for Stock Based Compensation" (*"FAS 123(R)"*),[33] which requires a charge to earnings of the fair value of the option (often determined under the Black-Scholes method) over the vesting period. An option exercise price which is lower than the fair market value on the date of grant will increase the value of the option and hence the charge to earnings.

Background. In 2005 Dr. Erik Lie of the University of Iowa published a paper[34] that showed that before 2003 a number of public companies had an uncanny ability to choose grant dates coinciding with the lowest stock prices around the time of the grant.[35] Media analyses suggested that "the odds of this happening by chance were extraordinarily remote – around one in 300 billion."[36] Suspecting that such patterns were not the result of chance but of some manipulation, the SEC and other federal and state law enforcement groups began to investigate. The scandal has mushroomed to the point that on September 6, 2006 the SEC was investigating over 100 companies concerning possible fraudulent reporting of stock option grants involving a variety of companies ranging from Fortune 500 companies to smaller cap issuers and spanning multiple industry sectors, with a large number from the technology sector.[37] More companies have announced internal investigations into their option granting practices, often with announcements that the filing of SEC reports is being delayed pending completion of the investigation.

> The accounting under Opinion 25 relies heavily on the determination of the *measurement date*, which is defined as "the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any." Under Opinion 25, the final amount of compensation cost of an option is measured as the difference between the exercise price and the market price of the underlying stock at the measurement date. As such, for the purpose of determining compensation cost pursuant to Opinion 25, it is important to determine whether a company's stock option granting practices resulted in the award of stock options with an exercise price that was lower than the market price of the underlying stock at the date on which the terms and recipients of those stock options were determined with finality.

[33] Financial Accounting Standards Board (*"FASB"*) Statement of Financial Accounting Standards (*"SFAS"*) No. 123 R (revised 2004), *Share-Based Payment*, applies to issuer reporting periods beginning after June 15, 2005 (December 15, 2005 for small business issuers).

[34] Erik Lie, *On the timing of CEO stock option awards*, 51 MGMT. SCI. 801,802 (2005).

[35] "Testimony Concerning Options Backdating" by Christopher Cox, Chairman, U.S. Securities and Exchange Commission, before the U.S. Senate Committee on Banking, Housing and Urban Affairs on September 6, 2006, which can be found at http://www.sec.gov/news/testimony/2006/ts090606cc.htm.

[36] Charles Forelle and James Bandler, *The Perfect Payday – Some CEO's reap millions by landing stock options when they are most valuable. Luck – or something else?*, Wall St. J., March 18, 2006, at A1.

[37] "Testimony Concerning Executive Compensation and Options Backdating Practices" by Linda Thomsen, Director, Division of Enforcement, U.S. Securities and Exchange Commission, before the U.S. Senate Committee on Finance on September 6, 2006, which can be found at http://www.sec.gov/news/testimony/2006/ts090606lt.htm.

The incidence of backdating may have substantially decreased after the implementation of the shortened filing deadline for reports of option grants specified by SOX § 403, which resulted in the SEC requiring the reporting of an option grant on Form 4 within two days of the date of grant.[38]

***Backdating*.**

When Was Option Granted. An option is "granted" under an employee stock option plan, and a "measurement date" under APB 25 occurs, when the person authorized by the plan to make the grant (typically the compensation or stock options committee of the board of directors) takes the requisite corporate action to effect the grant in accordance with the terms of the plan. A committee can act either at a meeting at which a quorum is present or by unanimous written consent. A written consent is effective on the later of the date specified in the consent or the date on which all directors have signed the consent to the action.[39] The "unanimous" requirement may make the written consent problematic when one of the persons who must sign the consent has a disabling self interest that would prohibit voting because he or she is to receive an option.[40]

The SEC Chief Accountant recognized that corporate formalities do not always keep up with what the issuer's governing authority intended and thought it was accomplishing. In a letter dated September 19, 2006 from the SEC Chief Accountant to the Chairman of Center for Public Company Audit Firms, American Institute of Certified Public Accountants (the *"SEC Options Guidance"*), the SEC Chief Accountant recognized:

---

38 *See* Byron F. Egan, *Effect of Sarbanes-Oxley on M&A Transactions* – Accelerated §16(a) Reporting, at 74-80, *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=527.

39 DGCL § 141(f) and TBCA art. 9.10A both authorize boards of directors and committees thereof to act by unanimous written consent.

40 In *Solstice Capital II, Ltd. P'ship v. Ritz*, 2004 WL 765939 (not reported in A.2d) (Del. Ch. April 6, 2004), Delaware Chancellor Chandler held that a written consent to the removal of an officer was invalid because it was not signed by all of the directors even though it was signed by all of the disinterested directors, and explained:

> Action by written consent requires unanimity of the entire board, not just the unanimity of the disinterested directors. There is no exception to this rule, even if a director has an interest in the transaction at issue. This comports with the notion that directors should participate actively and engage in discussion before voting at meetings. The policy underlying board action by written consent is that "meetings should be required except where the decision is so clear that the vote is unanimous and in writing." Unless there is unanimous written consent, the only way to remove Puchek as the CEO is at a special meeting of the board.

Action on a compensation issue was found not to be in good faith where it was taken by unanimous written consent without any deliberation or advice from any expert in *Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins*, No. CIV.A.20228-NC, 2004 WL 1949290 (Del. Ch. Aug. 24, 2004).

> [T]here may also be situations where an at-the-money grant was actually decided with finality, but there were unimportant delays in the completion of administrative procedures to document the grant that did not involve misrepresentation of the option granting actions. In those situations, if compensation cost would not have otherwise been recorded pursuant to Opinion 25, short delays in completing the administrative procedures to finalize the grant would not result in an accounting consequence.[41]

---

[41] In the SEC Options Guidance, the SEC Chief Accountant elaborated as follows:

> Typically, a company's corporate governance provisions, stock option plans, and applicable laws specify the actions required in order to effect the grant of a stock option (collectively referred to as "required granting actions"). Absent provisions of the option or company practices that indicate the terms of the award could change at a later date, the date when these actions are completed in full has generally been regarded as the measurement date.
>
> However, we understand that some companies have accounted for their option grants using a measurement date that is other than the date at which all required granting actions have been completed. Two such examples that we have become aware of are as follows.
>
> > a) Companies may have been awarding stock options by obtaining oral authorization from the board of directors (or compensation committee thereof) and subsequently completing the documents evidencing the award at a later date, or
> >
> > b) Companies may have delegated the authority to award options to a member or committee of management. That member or committee of management determined option awards to be made to subordinates within specific parameters previously communicated by the board of directors (or compensation committee thereof) and obtained any appropriate approvals at a later date.
>
> The delay in completion of all required granting actions suggests that options terms may not have been final until the completion of those actions. Nonetheless, some companies that utilized the practices described above have asserted that the measurement date occurred before the required granting actions were completed because all option terms and recipients were final and known at an earlier date, and the completion of required granting actions represented only an administrative delay, rather than a period during which any of the terms of the award remained under consideration or subject to change.
>
> The staff believes that a conclusion that a measurement date occurred before the completion of required granting actions must be considered carefully, as the fact that the applicable corporate governance provisions, terms of the stock option plans, or applicable laws require certain procedures to be completed in order to effect a stock option grant suggests that option terms may not have been final (or "known") until those procedures were completed. * * *
>
> In many cases, when options were awarded before (or in the absence of) completion of required granting actions, the terms cannot be considered to have been determined with finality until (and unless) such actions were completed. Indeed, as evidenced by some of the option granting practices and patterns of conduct that the staff has become aware of, awarding options in a manner that did not comply with the required granting actions does

Consequences. Backdating of options can be a valid corporate action that does not violate any fiduciary duties if the action is taken by an informed board or committee,[42] but it may

suggest that the terms and recipients of the options may have been subject to change. For example, in the event that the company's stock price declined prior to finalizing the required granting actions, the company may have retracted awards (e.g., failed to follow through with the initially determined awards) or lowered the exercise price of options. This type of practice indicates that, for all awards (including those awards for which the terms were not changed), the terms and recipients were not determined with finality (and therefore were not "known") prior to the completion of all required granting actions. Similarly, any evidence indicating that the preparation of documentation was done in a manner calculated to disguise the true nature of the option granting actions would preclude a company from concluding that a measurement date occurred prior to the completion of all required granting actions. **If a company operated as if the terms of its awards were not final prior to the completion of all required granting actions (such as by retracting awards or changing their terms), the staff believes the company should conclude that the measurement date for all of its awards (including those awards that were not changed) would be delayed until the completion of all required granting actions.**

On the other hand, in certain instances where a company's facts, circumstances, and pattern of conduct evidence that the terms and recipients of a stock option award were determined with finality on an earlier date prior to the completion of all required granting actions, it may be appropriate to conclude that a measurement date under Opinion 25 occurred prior to the completion of these actions. This would only be the case, however, when a company's facts, circumstances, and pattern of conduct make clear that the company considered the terms and recipients of the awards to be *fixed and unchangeable* at the earlier date. The practices described in the preceding paragraph would, of course, preclude a company from concluding that a measurement date occurred prior to the completion of all required granting actions.

In evaluating whether a company's facts and circumstances do support a conclusion that the terms of stock option awards were fixed ("known") prior to the completion of all required granting actions, it is important that all information be considered. * * *

Any analysis will be heavily dependent upon the particular facts and circumstances of each company, and evidence of fraudulent or manipulative conduct would affect the analysis. * * *

[42] On July 6, 2006, SEC Commissioner Paul S. Atkins in his "Remarks Before the International Corporate Governance Network 11th Annual Conference," *available at* http://www.sec.gov/news/speech/2006/spch070606psa.htm, commented, "Backdating of options sounds bad, but the mere fact that options were backdated does not mean that the securities laws were violated. Purposefully backdated options that are properly accounted for and do not run afoul of the company's public disclosure are legal. Similarly, there is no securities law issue if backdating results from an administrative, paperwork delay. A board, for example, might approve an options grant over the telephone, but the board members' signatures may take a few days to trickle in. One could argue that the grant date is the date on which the last director signed, but this argument does not necessarily reflect standard corporate practice or the logistical practicalities of getting many geographically dispersed and busy, part-time people to sign a document. It also ignores that these actions reflect a true meeting of the minds of the directors, memorialized by executing a unanimous written consent."

Speeches by SEC members or staff are the expressions of the speakers themselves, and are not to be construed as representations of the Commission itself.

still not comply with the requirements of the option plan which was approved by the shareholders if it results in the granting of in-the-money options.[43] Most option plans specify

---

[43] In the SEC Options Guidance, the SEC Chief Accountant addressed the accounting consequences where an issuer's consistent practice may not have complied with the terms of the applicable plan and suggested that more flexibility may be appropriate with respect to grants to rank and file employees:

> We understand that, in certain circumstances, the validity of past option grants has been called into question, even though both the company and the affected employees have and continue to comply with the terms of such options. For example, an option plan may preclude grants that are in-the-money at the grant date, or may contain a cap on the number of options that may be issued. Notwithstanding these restrictions, options that may not have complied with the terms of the plan were awarded to employees. This could arise due to some of the practices described in this letter.
>
> Questions have arisen as to whether an option can be accounted for as a fixed option with a measurement date on the date that the terms and recipient of the award were determined if uncertainty exists as to the validity of the grant. Specifically, the following questions have arisen:
>
>> a) If, for example, a shareholder-approved option plan only permits at-the-money grants, some have questioned whether the compensation committee may have lacked the authority under the entity's corporate governance procedures to authorize an in-the-money grant. If that were the case, under the plan, only the shareholders had the ability to approve such a grant and shareholder approval was not obtained. * * *
>>
>> b) Some have questioned whether the non-compliance of options with the company's option plan may create uncertainty as to whether the company will ultimately have the ability to settle the award in stock or instead may be required to settle the award in cash. Absent an ability to settle the award in stock, it is possible that the option would be accounted for as a cash-settled stock appreciation right pursuant to FASB Interpretation No. 28, "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans."
>
> We understand that, in many of these cases, (a) the company has, as applicable, been honoring the awards and settling in stock, (b) the company intends to honor outstanding unexercised awards and has a reasonable basis to conclude that the most likely outcome is that the awards will be honored, and (c) the company intends to settle the outstanding unexercised awards in stock and has a reasonable basis to conclude that it will be able to do so (even if such settlement is not entirely within the company's control). In those circumstances, the staff believes that the substantive arrangement that is mutually understood by both the company and its employees represents the underlying economic substance of the past option grants, and should serve as the basis for the company's accounting. Accordingly, assuming all other conditions for the establishment of a measurement date have been satisfied, the staff believes it would be appropriate to account for the awards as fixed options with a measurement date on the date that the terms and recipients were determined with finality. While legal opinions regarding the validity of the option grant and the company's ability to honor the award would be helpful, the staff does not believe that a company would necessarily be required to obtain a legal opinion in order to reach these accounting conclusions.
>
> When a company either does not intend to or does not have a reasonable basis to conclude that it will be able to honor the award or settle it in stock, further analysis of the

facts and circumstances would be necessary to determine the appropriate accounting for the options. The staff understands that significant uncertainty as to a company's ability to honor options arises more often for grants that were made to senior officers of the company (particularly officers who were involved in the option granting process), and less often for grants made to rank-and-file employees. Accordingly, the staff believes that the need for a legal analysis may be greater when questions exist as to the validity of grants made to senior officers who participated in the option granting process.

Similar flexibility was expressed in the SEC Options Guidance where there was uncertainty as to individual award recipients:

> We understand that some companies may have approved option awards before the number of options to be granted to each individual employee was finalized. For example, the compensation committee may have approved an award by authorizing an aggregate number of options to be granted prior to the preparation of a final list of individual employee recipients. In these cases, the allocation of options to individual employees was completed by management after the award approval date, or the unallocated options were reserved for grants to future employees. Pursuant to paragraph 10(b) of Opinion 25, no measurement date can occur until "the number of shares that an individual employee is entitled to receive" is known.
>
> In certain circumstances, the approved award may contain sufficient specificity to determine the number of options to be allocated to individual employees, notwithstanding the absence of a detailed employee list. If management's role was limited to ensuring that an allocation was made in accordance with definitive instructions (e.g., the approved award specified the number of options to be granted based on an individual's level within the organization), the measurement date could appropriately be the date the award was approved. However, if management was provided with discretion in determining the number of options to be allocated to each individual employee, a measurement date could not occur for such options prior to the date on which the allocation to the individual employees was finalized. If the allocation of a portion of the award is specified at the award approval date with the allocation of the remainder left to the discretion of management, the measurement date could appropriately be the date the award was approved only for those options whose allocation was specified.
>
> The staff also has become aware that some companies may have changed the list of recipients or the number of options allocated to each recipient subsequent to the preparation of the initial list at the award approval date. When changes to a list are made subsequent to the preparation of the list that was prepared on the award approval date, based on an evaluation of the facts and circumstances, the staff believes companies should conclude that either (a) the list that was prepared on the award approval date did not constitute a grant, in which case the measurement date for the entire award would be delayed until a final list has been determined or (b) the list that was prepared on the award approval date constituted a grant, in which case any subsequent changes to the list would be evaluated to determine whether a modification (such as a repricing) or cancellation has occurred. When a company determines that a repricing occurred, variable accounting should be applied to the option from the date of modification to the date the award is exercised, is forfeited, or expires unexercised.

The SEC Options Guidance provided some flexibility where (i) the legal documents evidencing past grants may not exist in the issuer's records, (ii) contemporaneous documentation of the date on which a telephonic or in-person meeting of the compensation committee was held may not have been prepared, (iii) written

how the option exercise price is to be determined (typically at the closing price of the stock on the date of grant). Failure to comply with the plan or GAAP can result in a number of collateral consequences, including the following:

- Financial Statement Impact. A backdating that results in options being issued at a discount could result in the understatement of compensation expenses with the attendant consequences described in the Alert[44] and could require the issuer to restate[45] its financial statements.[46]

---

documentation includes only "as of" dates, and not the dates the documentation was actually prepared and approved, or (iv) the issuer may have reason to believe that the documentation in its records is not accurate:

> The appropriate accounting in circumstances where records cannot be located or may be inaccurate will depend on the particular facts and circumstances. We understand that, in some cases, the lack of documentation or existence of contradictory documentation may lead a company to conclude either that the terms of options cannot reasonably be considered fixed, resulting in the application of variable accounting, or that awards do not substantively exist until the board of directors affirms which awards will be honored. However, the staff does not believe that the lack of complete documentation being available several years after the activities occurred should necessarily result in a "default" to variable accounting or to treating the awards as if they had never been granted. Rather, a company must use *all available relevant information* to form a reasonable conclusion as to the most likely option granting actions that occurred and the dates on which such actions occurred in determining what to account for. The existence of a pattern of past option grants with an exercise price equal to or near the lowest price of the entity's stock during the time period surrounding those grants could indicate that the terms of those grants were determined with hindsight. Further, in some cases, the absence of documentation, in combination with other relevant factors, may provide evidence of fraudulent conduct.

[44] *See infra* part I. Pressure on Auditors to Detect Corporate Fraud – Grants – Matters for Auditor Consideration Under the Alert.

[45] *See* David Reilly, *No More 'Stealth Restating' – SEC Forces Companies to Highlight Earnings Changes, Not Just Tack Them on to Their Newest Filings*, WALL ST. J., Sept. 21, 2006 at C1:

> At issue is guidance from the regulator that companies shouldn't try to sweep under the carpet errors in their financial results. In recent years, scores of companies have changed previously reported figures via what critics call "stealth restatements," commonly including the new, different figures in subsequent securities filings. The SEC's stand: Such changes constitute information that is material to investors and thus needs to be formally disclosed in a restatement filing clearly labeled as such. As a result, some companies are announcing restatements to earnings reports they made months ago.
>
> In 2004, as part of changes brought about by the Sarbanes-Oxley corporate-overhaul legislation, the SEC said companies should file a special form announcing a restatement with the agency. But some companies mistakenly believed that they wouldn't have to do so if they were submitting a new earnings filing in the days after concluding that a restatement of old results was necessary. Instead, they would just include the restated results in the new filing.

- Misleading SEC Filings. The resulting financial statement misreporting could result in the issuer's periodic reports being in violation of the 1934 Act and any 1933 Act registration statement which incorporates them by reference being in violation of the 1933 Act and could require amendment of any SEC filings containing materially misstated financial statements.[47] Further, the compensation disclosures in proxy statements filed with the SEC could likewise be incorrect.

> John White, director of the corporate-finance division, added that his staff has "focused" on restatement-related disclosures to make clear that companies can't avoid such announcements by simply including a restatement in a filing of current results. The loophole some companies may have tried to exploit didn't actually exist, he explained.
>
> Restatements are admissions by companies that a prior financial filing can't be relied upon, which explains why many executives prefer not to draw attention to them. "It's embarrassing," said Eric Keller, chief executive of Movaris Inc., a company that develops financial-reporting systems. "It's akin to a product recall."

See also Peter Grant, James Bandler and Charles Forelle, *Cablevision Gave Backdated Grant To Dead Official*, WALL ST. J., Sept. 22, 2006 at A1:

> Cablevision Systems Corp. awarded options to a vice chairman after his 1999 death but backdated them, making it appear the grant was awarded when he still was alive, according to a company filing and people familiar with the matter. The country's fifth-largest cable operator in terms of subscribers also improperly awarded a compensation consultant options but accounted for them as if he were an employee, according to a Securities and Exchange Commission filing, citing the results of a six-week investigation by an outside law firm. The findings of the probe were released yesterday as the . . . company restated its financial results and said two of its directors had stepped down from posts on the board's audit and compensation committees as part of an escalating investigation into its improper granting of stock options.
>
> * * *
>
> John Coffee, a professor of law at Columbia University, noted that options are intended to create an incentive for executives to boost their company's stock price. "Trying to incentivize a corpse suggests they were not complying with the spirit of shareholder-approved stock-option plans," he said.

[46] The SEC Options Guidance suggests that an issuer may have to restate its financial statements where options backdating has occurred in prior periods:

> Companies that determine their prior accounting to be in error and that those errors are material should restate their financial statements to reflect the correction of those errors. Evaluation of materiality requires a consideration of all relevant facts and circumstances. Qualitative factors (for example, if the error is intentional) may cause misstatements of quantitatively small amounts to be material. When disclosures of these issues are made, it is important that the registrant discuss not only the accounting restatements, but also the circumstances that gave rise to the errors.

[47] The SEC Options Guidance suggests that an issuer may have to amend its prior SEC filings that contained financial statements that had to be restated due to options backdating:

- SOX §§ 302 and 906 Certifications. The CEO and CFO of a public company are required to certify in each periodic report filed with the SEC that, to the best of their knowledge: (1) the financial statements and other information in the report fairly present, in all material respects, the financial condition and results of operation of the issuer, (2) the disclosure controls and procedures are designed to provide reasonable assurance regarding the reliability of the financial statements in accordance with GAAP, and (3) they have disclosed to the company's auditors and audit committee any internal control deficiencies.[48] Options backdating and other manipulations, if committed with the knowledge of the certifying officer, could subject the officer to SEC enforcement action or criminal prosecution for false certification.

- Federal Income Tax Consequences. Under the Internal Revenue Code of 1986, as amended (the *"IRC"*), a finding that an option was backdated can cause the tax treatment of the option grant and exercise to be different for both the issuer and the employee, with the result that the issuer may be subject to tax liabilities and liabilities to the option grantee under federal securities laws and a variety of common law causes of action.

    - IRC § 162(m). In-the-money options may not be treated as "performance based" compensation within the meaning of IRC § 162(m). Thus, for the issuer, any deduction of compensation related to the backdated option would be subject to the $1 million IRC § 162(m) limitation and would be disallowed if paid to the chief executive officer or one of the four other highest paid executive officers.[49]

    - Incentive Stock Options. If an Incentive Stock Option (*"ISO"*) is backdated so that it was in-the-money on the real date of grant, the option would no longer qualify for preferential ISO treatment and would be reclassified as a nonqualified stock option.[50] The difference between the exercise price and

---

Generally, previously filed reports containing financial statements determined to be materially misstated require amendment. The staff understands that errors related to the issues addressed in this letter may affect several years of filings, and that companies may believe that amending all of the affected filings is unnecessary. Companies that propose to correct material errors without amending all previously filed reports should contact the staff of the Division of Corporation Finance. No amendment of previously filed reports is necessary to correct prior financial statements for immaterial errors. Such corrections, if necessary, may be made the next time the registrant files the prior financial statements.

48 *See* Byron F. Egan, *Effect of Sarbanes-Oxley on M&A Transactions* - CEO/CFO Certifications, at 31, *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=527.

49 "Testimony on Backdating of Stock Options and Other Executive Compensation Issues" by Mark Everson, Commissioner of Internal Revenue, before the U.S. Senate Committee on Finance on September 6, 2006.

50 Under IRC § 421 an optionee does not recognize income upon the receipt or exercise of an ISO and, upon sale of stock acquired upon the exercise thereof, the entire spread between the exercise price and the sale price is taxed as a capital gain. This favorable tax treatment is available only if the option exercise price is at or above the fair market value of the underlying stock on the date of grant and the option and the plan under which it was granted meet the other requirements of IRC § 421 on the date of grant, including issuer

the sales price would be additional wages to the executive and should be included on the employee's Form W-2 in the year of exercise. The executive would lose the deferral and rate benefits associates with ISO qualification, but the corporation may be eligible for an additional wage deduction if IRC § 162(m) limitations are not triggered.[51]

- IRC § 409A. Under IRC § 409A, the grantee of a backdated option may now be responsible for the payment of tax on income previously deferred until the exercise of the options.[52] In addition, there can be substantial additional taxes under IRC § 409A. This provision applies to options granted after 2004 and options granted before 2005 that were not earned and vested as of December 31, 2004. During the transition period with the rules relating to IRC § 409A, options that were in the money on the grant date can be amended to avoid violating IRC § 409A either by (1) increasing the exercise price to equal the fair market value on the original grant date and eliminate any other deferral feature, or (2) amending the options to provide for a fixed exercise date after which the option will be worthless. Alternatively, the grant of backdated options could be rescinded if the options have not been exercised.[53]

- Internal Investigations. An early step in an issuer's investigating and determining how to deal with suggestions that it may have backdated stock option grants is an internal investigation conducted by the issuer's audit committee, or another committee of independent directors appointed by the issuer's board of directors, often with the assistance of independent counsel and forensic accountants.[54]

- Stock Exchange Delisting. Issuer listing agreements with the stock exchanges generally require that listed companies (1) timely file their SEC periodic reports and (2) obtain shareholder approval of new or amended plans

---

shareholder approval of the plan pursuant to which the ISO was granted. If the option does not qualify as an ISO, under IRC § 83 the optionee would recognize income on the date of grant if it then has a readily ascertainable fair market value and, if not, ordinarily would recognize ordinary income when the option is exercised equal to the spread between the exercise price and the fair market value of the stock on the date of exercise.

51 "Testimony on Backdating of Stock Options and Other Executive Compensation Issues" by Mark Everson, Commissioner of Internal Revenue, before the U.S. Senate Committee on Finance on September 6, 2006.

52 *Id.*

53 *Id.*

54 *See infra* part II. Misleading Statements to Auditors – Internal Investigations and part IV. Attorney-Client Privilege and the Work Product Doctrine in the Corporate Context – Attorney-Client Privilege – Internal Investigations.

under which issuer stock may be issued. The delays in filing SEC reports because of backdated option related internal investigations or restatements would result in listing agreement violations. Likewise, the grant of backdated options could be deemed a defacto amendment of the option plan without shareholder approval in violation of listing agreement covenants.

- Lenders. Loan agreements with banks and other institutional lenders require the timely filing of SEC reports. The failure to make such filings can result in covenant defaults which can justify accelerating the debt, which in turn would require the issuer to classify the debt as a current liability in its financial statements. Lenders are increasingly extracting payments or other consideration in exchange for waivers of covenant defaults.[55]

- Civil and Criminal Actions by SEC, Department of Justice and Others. Some SEC and criminal actions[56] have been initiated to date and, with over 115 investigations pending as of September 21, 2006, more such actions are to be expected.[57] Anyone in the chain of action in granting a backdated option is subject to scrutiny,[58] including outside directors on compensation

---

55 *See* Peter Lattman and Karen Richardson, *Hedge Funds Play Hardball With Firms Filing Late Financials*, WALL ST. J., Aug. 29, 2006, at A1.

56 *See* SEC v. Symbol Technologies, Inc., et al, Accounting and Auditing Release No. 2029 (June 3, 2004), *available at* http://www.sec.gov/litigation/litreleases/lr18734.htm (SEC complaint alleged defendants fraudulently used a variety of non-GAAP revenue recognition principles to create false impression that Symbol had met or exceeded its financial projections; Symbol's former general counsel and senior vice president, Leo Goldner consented to a final judgment referenced at Accounting and Auditing Release No. 2391 (March 2, 2006), *available at* http://www.sec.gov/litigation/litreleases/lr19585.htm, permanently enjoining him from violating the 1933 Act, the 1934 Act and rules thereunder, and civil forfeiture of $2 million in connection with his guilty plea in a parallel criminal case, based on allegations that Goldner chose "a more advantageous exercise date" from a 30-day look back period to calculate the cost of exercising the executive option plans instead of the stated terms of Symbol's option plans and without the approval of the board or public disclosure, and also used improper "look-back" practices to benefit himself and directly instructed his staff to backdate SEC forms, including Forms 4, registration statements and proxy statements); SEC v. Gregory L. Reyes, et al, Litigation Release No. 19768 (July 20, 2006), *available at* http://www.sec.gov/litigation/litreleases/2006/lr19768.htm (SEC and DOJ civil and criminal complaints alleged former chief executive officer, chief financial officer and vice president of human resources of Brocade Communications Systems, Inc. caused Brocade to issue in the money backdated stock options to both new and current employees between 2002 and 2004, thus concealing millions of compensation expenses from investors); SEC v. Jacob "Kobi" Alexander, et al, Accounting and Auditing Release No. 2472 (August 9, 2006), *available at* http://www.sec.gov/litigation/litreleases/2006/lr19796.htm, in which the former chief executive officer, chief financial officer and general counsel of Comverse Technology, Inc. were charged in civil and criminal actions with a decade long fraudulent scheme to grant options backdated to coincide with historically low closing prices of Comverse common stock and to use a slush fund of backdated options to be granted first to fictitious employees and later to new key hires.

57 *See* Options Scorecard, Wall Street Journal Online (September 21, 2006), available at http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html.

58 Eric Dash, *Who Signed Off on Those Options?*, N.Y. Times, August 27, 2006.

committees[59] and general counsel.[60] Plaintiffs' lawyers have filed numerous derivative and class action lawsuits.[61]

- Business Combinations. Most agreements for the sale of a business via merger, stock sale or asset sale require the seller to make representations regarding the financial statements[62] of the business, the absence of any material adverse change in the business or condition (financial or other) of the issuer (*"MAC"*),[63] and its compliance with applicable laws,[64] and condition the closing of the transaction on the correctness of the representations[65] and the absence of any MAC. The negotiation and documentation of such a transaction will require seller to make disclosures regarding its option backdating exposure,[66] which in turn might result in the

---

[59] SEC Commissioner Roel C. Campos, How to be an Effective Board Member, speech at the HACR Program on Corporate Responsibility, Boston, MA (Aug. 15, 2006), *available at* http://www.sec.gov/news/speech/2006/spch081506rcc.htm, in which he said, "[I]f the facts permit – and I want to emphasize that all our Enforcement cases are very fact-specific – it wouldn't surprise me to see charges brought against outside directors."

[60] Petra Pasternak, In-House Counsel Vulnerable to Options Backdating Inquiries, The Recorder (August 14, 2006), 2006 Texas Lawyer Online, *available at* http://www.texaslawyer.com. *See* SEC Seen Likely to Look at Role Of Lawyers in Stock Option Investigations, 38 BNA Sec. Reg. & Law Rept. No. 26 at 1118 (June 26, 2006) ("SEC has greatly stepped up the number of enforcement actions its brings against lawyers, accountants, and other 'gatekeepers' since the implosion of Enron. * * * [T]he SEC expects attorneys to understand wrongdoing is when a company has used a side letter to conceal a specific term of a deal from its auditors . . . [I]n ongoing investigations regarding the backdating of stock options, . . . the SEC will be interested in knowing 'what lawyers knew and said about the fact that some companies were dating the options as of a date different from the grant date'").

[61] Julie Creswell, *One Route Seems Closed, So Lawyers Try Different Lawsuit in Stock-Option Scandal*, The N.Y. Times, September 5, 2006 (author counts 57 derivative actions and 15 class actions to September 5, 2006 based on options backdating).

[62] ABA Model Asset Purchase Agreement with Commentary (2001) § 3.4.

[63] *Id*. at § 3.15.

[64] *Id*. at § 3.17.

[65] *Id*. at § 7.1.

[66] On July 25, 2006, Hewlett-Packard Company (*"HP"*) filed a Form 8-K Report with the SEC announcing that it had entered into an Agreement and Plan of Merger dated August 25, 2006 with Mercury Interactive Corporation (*"Mercury"*). Mercury had made various public statements regarding ongoing investigations into its option granting practices. To make exception for these investigations and a related restatement of its financial statements, the HP/Mercury merger agreement definition of the term "Company Material Adverse Effect" in § 1.1 contained a broad carve-out for Mercury's option situation, including accounting and tax aspects, which read as follows:

> "(ix) (A) actions, claims, audits, arbitrations, mediations, investigations, proceedings or other Legal Proceedings (in each case whether threatened, pending or otherwise), (B) penalties, sanctions, fines, injunctive relief, remediation or any other civil or criminal

waiver of any attorney-client privilege that might otherwise protect the confidentiality of the information.[67]

- D&O Insurance. Options backdating investigations and litigation are causing affected issuers, officers and directors to hire counsel (often separate counsel because of differing exposures and defenses), and to focus on indemnification and advancement of expenses of defense from the issuer pursuant to applicable indemnification contracts and provisions in the issuer certificate of incorporation and bylaws and applicable state laws.[68] They will also be

---

sanction (in each case whether threatened, pending, deferred or otherwise, and whether financial or otherwise), or (C) facts, circumstances, changes, effects, outcomes, results, occurrences and eventualities (whether or not known, contemplated or foreseeable, and whether financial or otherwise), in each case with respect to (A) through (C), resulting from, relating to or arising out of: (1) the Company's restatement of its historical consolidated financial statements for the fiscal years ended December 31, 2002, 2003 and 2004 (the *"Restatement"*), the matters referred to in Item 9A, Note 3 or Note 19, or the Company's pending restatement of the unaudited financial statements contained in its quarterly report on Form 10-Q for the quarter ended March 31, 2005; (2) the Company's failure to file in a timely manner its Annual Report on Form 10-K for the fiscal year ended December 31, 2005, the Quarter Reports on Form 10-Q for the quarters ended March 31, June 30, and September 30, 2006; or (3) the Company's historical stock-based compensation practices, including with respect to the grant of stock options and the purchase of Company stock by employees; the recording of, accounting for and disclosure relating to the stock option grants and the purchase of Company stock purchases by employees, remedies determined by the Company's Special Committee or Special Litigation Committee of the Company Board or the Company Board relating to the Company's investigation of such stock-based compensation or in connection with the Restatement, and the Company's tax practices with respect to such compensation practices, including the grant of stock options and the purchase of Company stock by employees."

The HP/Mercury merger agreement representations and warranties were typical and did not make any other special provision. Mercury's disclosure schedule, which is not publicly available, likely listed exceptions to Mercury's representations and warranties to deal with its options issues.

On July 31, 2006, Sandisk Corp. (*"SDC"*) filed a Form 8-K Report with the SEC announcing that it had entered into an Agreement and Plan of Merger dated as of July 31, 2006 pursuant to which it would acquire msystems Ltd. (*"msystems"*). On July 13, 2006, msystems had announced that its board of directors had determined that the actual measurement dates of certain past stock option grants differed from the previously recorded measurement dates. The SDC/msystems merger agreement included in the definition of "Material Adverse Change" in § 8.7 the following reference to an options issue: "with respect to the Company, the matters described in Section 8.7(f) of the Company Disclosure Letter (the 'Options Matters')." The representations and warranties of msystems were typical and were all qualified by reference to matters disclosed in the Company Disclosure Letter, which would have contained any qualifications relating to the "Options Matters."

67 § 12.6 of the ABA Model Asset Purchase Agreement with Commentary (2001) is a provision for an asset purchase agreement to the effect the parties do not intend to waive any attorney-client or work product privilege and the related Comment discusses the effect of such a provision in different circumstances.

68 *See*, e.g. Texas Business Corporation Act art. 2.02-1, Texas Business Organizations Code §§ 8.001 et seq., and Delaware General Corporation Law § 145.

reviewing the issuer's director and officer insurance policies (*"D&O Policies"*).[69] D&O Policies are typically written on a "claims made" basis which requires prompt notice within the policy period of any claim which the insurer will be asked to pay or defend. The applicable definitions of covered "claims," "wrongful acts"[70] and "losses" will vary. D&O Policies typically contain representations regarding the correctness of the issuer's financial statements and SEC filings, which could be breached by the very options backdating that results in the claim for which insurance protection is sought.[71] Many D&O Policies also contain a personal-profit exclusion which precludes coverage when "an insured has in fact gained any personal profit, remuneration or advantage to which the insured was not legally entitled," and which could be applicable to claims related to options backdating.[72] Some more recent D&O Policies are including specific exclusions for claims arising out of the issuance or use of stock options, which would preclude claims related to options backdating.[73] Whether any of the possible D&O Policy coverage defenses or exclusions would be applicable is a very policy provision and fact specific analysis whose result will vary from issuer to issuer.

Spring-Loading. Some issuers have granted options immediately before the release of information that the issuer believed would be favorable to its share price, which may create legal or reputational risks and raise concerns about the issuer's control environment. There is a debate

---

69 Liam Pleven, *Options Timing Raises Concerns Among Insurers – Probes Could Shake Up Coverage For Company Officials' Liability; Bracing for a Slew of Claims*, WALL ST. J., June 20, 2006, at C1.

70 Latham & Watkins Litigation Department Client Alert, No. 519 (June 27, 2006), *available at* http://www.lw.com/resource/Publications/ClientAlerts/clientAlert.asp?pid=1592:

> [T]he term "Wrongful Act" is frequently defined to include any actual or alleged error, misstatement or action or failure to act in connection with the company's regular activities.
>
> In recent years, however, some insurers have been changing their policy definition of "Wrongful Act" to include only *negligent* acts or omissions. If the policy is so limited, the carrier may deny coverage on the ground that the option dating was an intentional act and therefore any claim against the director or officer based on it falls outside the policy's coverage. *See, e.g., Oak Park Calabasas Condominium Assn. v. State Farm Fire and Cas. Co.*, 137 Cal. App. 4th 557 (Cal. App. 2 Dist. 2006) (holding that language of D&O liability insurance coverage grant applied only to negligent acts and omissions).

71 Daniel K. Winters, *Obtaining Insurance Coverage for Stock-Option Backdating Investigations and Suits*, 22 No. 5 Andrews Corp. Off. & Directors Liab. Litig. Rep. 3 (September 7, 2006).

72 *Id*.

73 Latham & Watkins Litigation Department Client Alert, No. 519 (June 27, 2006), *available at* http://www.lw.com/resource/Publications/ClientAlerts/clientAlert.asp?pid=1592.

about the propriety of spring-loading,[74] with SEC Commissioner Paul S. Atkins arguing that a board of directors can exercise informed business judgment to grant options ahead of what is expected to be favorably received and noting that a board is almost always in possession of some material non-public information.[75] Former SEC Chief Accountant Lynn E. Turner has argued that spring-loading inevitably results in financial statements not conforming to GAAP because the options were issued at less than fair market value because the market price at grant did not reflect the undisclosed information, which would make the issuer's representations to its auditors false and its SEC disclosures misleading.[76] The SEC staff, however, suggested that neither bullet-dodging nor spring-loading would require any adjustment in the "market price of a share of the same class that trades freely in an established market" for the purposes of measuring compensation costs.[77]

Matters for Auditor Consideration Under the Alert. The Alert cautioned that auditors planning or performing an audit should be alert to the risk that the issuer may not have properly accounted for stock option grants and, as a result, may have materially misstated its financial statements or may have deficiencies in its internal controls. For audits currently underway or to be performed in the future, the auditor should acquire sufficient information to allow the auditor to assess the nature and potential magnitude of these risks, and use professional judgment in making these assessments and in determining whether to apply additional procedures in response. In making these judgments, the PCAOB Alert said that auditors should be mindful of the following:

> *Applicable Financial Accounting Standards*. If an auditor determines that it is necessary to consider the accounting for option grants and related disclosures in financial statements of a prior period, the Alert states that the auditor should determine the GAAP in effect in those periods and to consider the specific risks associated with these principles.

- *Accounting for Discounted Options*. For periods in which an issuer used the provisions of APB 25 to determine compensation cost related to stock options, the issuer may have been required to record additional compensation cost equal to the difference in the exercise price and the market price at the measurement date (as defined in APB 25). In periods in which the issuer has recorded option compensation cost using the fair value method under FAS

---

74 Kara Scannell, Charles Forelle and James Bandler, *Can Companies Issue Options, Then Good News? – SEC Is Divided on Practice Known as 'Spring Loading;' Critics See 'Insider Trading'*, Wall St. J., July 8-9, 2006, at A1.

75 SEC Commissioner Paul S. Atkins, Remarks Before the International Corporate Governance Network 11th Annual Conference (July 6, 2006), *available at* http://www.sec.gov/news/speech/2006/spch070606psa.htm, at 5-7.

76 Prepared Statement of Lynn E. Turner, then SEC Chief Accountant, before U.S. Senate Committee on Banking, Housing, and Urban Afairs Hearing on: Stock Options Backdating on September 6, 2002.

77 SEC Options Guidance at p. 9.

No. 123 R, the impact on the calculated fair value of options of using an incorrect date as the grant date would depend on the nature and magnitude of changes in conditions that affect option valuation between the incorrect date used and the actual grant date. In all cases, the compensation cost of options should be recognized over the period benefited by the services of the option holder.

- *Accounting for Variable Plans*. For periods in which an issuer used the provisions of APB 25 to determine compensation cost related to stock options, an option with terms allowing a modification of the exercise price, or whose exercise price was modified subsequent to the grant date, may require variable plan accounting. Variable option accounting requires that compensation cost be recorded from period to period based on the variation in current market prices. In periods in which the issuer records option compensation cost under FAS No. 123 R, the right to a lower exercise price may constitute an additional component of value of the option that should be considered at the grant date. In all cases, the cost of options should be recognized over the period benefited by the services of the option holder.

- *Accounting for Contingencies*. If the consequences of the issuer's practices for stock option grants or its accounting for, and disclosure of, option grants result in legal or other contingencies, the application of SFAS No. 5, *Accounting for Contingencies*, may require that the issuer record additional cost or make additional disclosures in financial statements.

- *Accounting for Tax Effects*. The grant of discounted stock options may affect the issuer's ability to deduct expenses related to these options for income tax purposes, thereby affecting the issuer's cash flows and the accuracy of the related accounting for the tax effects of options.

Consideration of Materiality. In evaluating materiality, the Alert cautioned auditors to remember that both quantitative and qualitative considerations must be assessed.[78] The Alert cautioned that quantitatively small misstatements may be material when they relate to unlawful acts or to actions by an issuer that could lead to a material contingent liability and that, in all cases, auditors should evaluate the adequacy of related issuer disclosures.

Possible Illegal Acts. Auditors who become aware that an illegal act may have occurred must comply with the applicable auditing requirements[79] and § 10A of the 1934 Act, which requires a registered public accounting firm to take certain actions if it "detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may

[78] See paragraph .11 of AU § 312, *Audit Risk and Materiality in Conducting an Audit*, and SEC Staff Accounting Bulletin: No. 99 – *Materiality*.

[79] *See* AU § 317, *Illegal Acts*.

have occurred….”[80] If it is likely that an illegal act has occurred, the registered public accounting firm must “determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and damages.” The registered public accounting firm must also inform the appropriate level of management and assure that the audit committee is adequately informed “unless the illegal act is clearly inconsequential.” The auditor may, depending on the circumstances, also need to take additional steps required under Section 10A if the issuer does not take timely and appropriate remedial actions with respect to the illegal act.

Effects of Options-related Matters on Planned or Ongoing Audits. In planning and performing an audit of financial statements and internal controls, the Alert cautioned the auditor to assess the nature and potential magnitude of risks associated with the granting of stock options and perform procedures to appropriately address those risks. The following factors are relevant to accomplishing these objectives --

- Assessment of the potential magnitude of risks of misstatement of financial statements and deficiencies in internal controls related to option granting practices. This assessment should include consideration of possible indicators of risk related to option grants, including, where appropriate:
    - The status and results of any investigations relating to the timing of options grants conducted by the issuer or by regulatory or legal authorities.
    - The results of direct inquiries of members of the issuer’s management and its board of directors that should have knowledge of matters related to the granting and accounting for stock options.
    - Public information related to the timing of options grants by the issuer.
    - The terms and conditions of plans or policies under which options are granted; in particular, terms that allow exercise prices that are not equal to the market price on the date of grant or that delegate authority for option grants to management. In these situations, auditors should also consider whether issuers have other policies that adequately control the related risks.
    - Patterns of transactions or conditions that may indicate higher levels of inherent risk in the period under audit. Such patterns or conditions may include levels of option grants that are very high in relation to shares outstanding, situations in which option-based compensation is a large component of executive compensation, highly variable grant

80 *See supra* part I. Pressure on Auditors to Detect Corporate Fraud – Accountant Duties Under 1934 Act Section 10A.

dates, patterns of significant increases in stock prices following option grants, or high levels of stock-price volatility.

- In planning and performing audits, auditors should appropriately address the assessed level of risk, if any, related to option granting practices. Specifically:

  - In addition to the general planning considerations for financial statement audits, the auditor was advised to consider:

    - The implications of any identified or indicated fraudulent or illegal acts related to option grants to assessed risks of fraud; the potential for illegal acts; or the assessment of an issuer's internal controls.

    - The scope of procedures applied to assess the potential for fraud and illegal acts.

  - The nature, timing, and extent of audit procedures applied to elements of the financial statements affected by the issuance of options, including:

    - The need for specific management representations related to these matters[81] and **the nature of matters included in inquiries of lawyers**.[82]

    - Where applicable, the result of tests of internal controls over the granting, recording, and reporting of option grants.

    - The need, based on the auditor's risk assessment, for additional specific auditing procedures related to the granting of stock options.

For integrated audits[83] the Alert advised the auditor to consider the implications of identified or potential accounting and legal risks related to options in planning, performing and reporting on audits of internal controls. In addition, the results of the audit of internal controls should be considered in connection with the related financial statement audit.

Auditor Involvement in Registration Statements. In cases where an auditor is requested to consent to the inclusion of a report (including a report on internal controls) in a registration statement under the 1933 Act, the Alert reminds the auditor to perform certain procedures prior to issuing such a consent with respect to events subsequent to the

---

81 *See* AU § 333, *Management Representations*.

82 *See* AU § 337, *Inquiry of a Client's Lawyer*.

83 See PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* (*"AS No. 2"*).

date of the audit opinion up to the effective date of the registration statement (or as close thereto as is reasonable and practical under the circumstances), including inquiry of responsible officials and employees of the issuer and obtaining written representations from them about whether events have occurred subsequent to the date of the auditor's report that have a material effect on the financial statements or that should be disclosed in order to keep the financial statements from being misleading with particular consideration to inquiries and representations specifically related to the granting and recording of option grants.[84] In the case of a predecessor auditor that has been requested to consent to the inclusion of a report on prior-period financial statements in a registration statement, the predecessor auditor should obtain written representations from the successor auditor regarding whether the successor auditor's audit and procedures with respect to subsequent events revealed any matters that might have a material effect on the financial statements reported on by the predecessor auditor or that would require disclosure in the notes to those financial statements. If the successor auditor becomes aware of information that leads him or her to believe that financial statements reported on by the predecessor auditor may require revision, the successor auditor was instructed to follow specified procedures.[85] If either the successor or predecessor auditor discovers subsequent events that require adjustment or disclosure in the financial statements or becomes aware of facts that may have existed at the date of his or her report and might have affected the report had he or she been aware of them, the auditor is admonished to refer to existing guidance.[86]

Effects of Option-related Matters on Previously Issued Opinions. If an auditor becomes aware of information that relates to financial statements previously reported on by the auditor, but which was not known to him or her at the date of the report, and which is of such a nature and from such a source that he or she would have investigated it had it come to his or her attention during the course of the audit, the auditor may be required to take specified actions.[87]

New Executive Compensation Rules. The 2006 Executive Compensation Rules require that proxy statements filed with the SEC after December 15, 2006 contain a new narrative disclosure section called "Compensation, Discussion and Analysis" (*"CD&A"*), which is intended to address a number of key compensation question, including information about the time and pricing of option grants. The 2006 Executive Compensation Rules require disclosure of company programs, plans and practices relating to the granting of options, including in particular the timing of option grants in coordination with the release of material non-public information and the selection of exercise prices that differ from the underlying stock's price on the grant date, including:

---

84 *See* AU § 711, *Filings Under Federal Securities Statutes.*

85 *See* ¶s .21 and .22 of AU § 315.

86 *See* AU § 711.

87 *See* AU § 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report.*

- Tabular presentations of option grants including:
    - The grant date fair value;
    - The FAS 123R grant date;
    - The closing market price on the grant date if it is greater than the exercise price of the award; and
    - The date the compensation committee or full board of directors took action to grant the award if that date is different than the grant date.

    Further, if the exercise price of an option grant is not the grant date closing market price per share, the rules will require a description of the methodology for determining the exercise price.
- The CD&A must contain narrative disclosure about option grants to executives. Companies are required to analyze and discuss, as appropriate, material information such as the reasons a company selects particular grant dates for awards or the methods a company uses to select the terms of awards, such as the exercise prices of stock options.
- With regard to the timing of stock options in particular, companies are called upon to answer questions such as:
    - Does a company have any program, plan or practice to time option grants to its executives in coordination with the release of material non-public information?
    - How does any program, plan or practice to time option grants to executives fit in the context of the company's program, plan or practice, if any, with regard to option grants to employees more generally?
    - What was the role of the compensation committee in approving and administering such a program, plan or practice? How did the board or compensation committee take such information into account when determining whether and in what amount to make those grants? Did the compensation committee delegate any aspect of the actual administration of a program, plan or practice to any other persons?
    - What was the role of executive officers in the company's program, plan or practice of option timing?
    - Does the company set the grant date of its stock option grants to new executives in coordination with the release of material non-public information?

- Does a company plan to time, or has it timed, its release of material non-public information for the purpose of affecting the value of executive compensation?

Disclosure is also be required where a company has not previously disclosed a program, plan or practice of timing option grants to executives, but has adopted such a program, plan or practice or has made one or more decisions since the beginning of the past fiscal year to time option grants.

- Similar disclosure standards apply if a company has a program, plan or practice of awarding options and setting the exercise price based on the stock's price on a date other than the actual grant date or if the company determines the exercise price of option grants by using formulas based on average prices (or lowest prices) of the company's stock in a period preceding, surrounding or following the grant date.

II.
MISLEADING STATEMENTS TO AUDITORS

SOX §303 Requirements. SOX §303 makes it unlawful, in contravention of rules adopted by the SEC, for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading. On May 20, 2003, the SEC amended and expanded Rule 13b2-2[88] under the 1934 Act (which already prohibited the falsification of books, records and accounts, and false or misleading statements, or omissions to make certain statements, to accountants) by adding (x) a new subsection (b)(1) that specifically prohibits officers and directors and "persons acting under [their] direction,"[89] from coercing, manipulating, misleading or fraudulently influencing

---

88 Improper Influence on Conduct of Audits, 1934 Act Release No. 34-47890, 80 S.E.C. Docket 770 (May 20, 2003), *available at* http://www.sec.gov/rules/final/34-47890.htm.

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

> "[N]ew rule 13b2-2(b)(1) covers the activities of not only officers and directors of the issuer who engage in an attempt to misstate financial statements but also "any other person acting under the direction thereof." Activities by such "other persons" currently may constitute violations of the anti-fraud or other provisions of the securities laws or aiding or abetting or causing an issuer's violations of the securities laws. Section 303(a) and the new rule provide the Commission with an additional means of addressing efforts by persons acting under the direction of an officer or director to improperly influence the audit process and the accuracy of the issuer's financial statements.
>
> As noted in the proposing release, we interpret Congress' use of the term "direction" to encompass a broader category of behavior than "supervision." In other words, someone may be "acting under the direction" of an officer or director even if they are not under the supervision or control of that officer or director. **Such persons might include not only the issuer's employees but also, for example, customers, vendors or creditors who, under the direction of an officer or director, provide false or misleading**

(collectively referred to herein as "*improperly influencing*") an auditor "engaged in the performance of an audit"[90] of the issuer's financial statements when the officer, director or other person "knew or should have known"[91] that the action, if successful, could result in rendering the

---

> **confirmations or other false or misleading information to auditors, or who enter into "side agreements" that enable the issuer to mislead the auditor.** In appropriate circumstances, persons acting under the direction of officers and directors also may include not only lower level employees of the issuer but also other partners or employees of the accounting firm (such as consultants or forensic accounting specialists retained by counsel for the issuer) and **attorneys**, securities professionals, or other advisers who, for example, pressure an auditor to limit the scope of the audit, to issue an unqualified report on the financial statements when such a report would be unwarranted, to not object to an inappropriate accounting treatment, or not to withdraw an issued audit report on the issuer's financial statements. * * *
>
> "Some commenters were concerned that including customers, vendors and creditors in the discussion of those persons who, in appropriate circumstances, might be considered to be acting under the direction of an officer or director would have a chilling effect on communications between those persons and the auditors. Other commenters noted that this chilling effect would be enhanced by the Commission's position in the proposing release that **negligently misleading** the auditor was sufficient conduct to trigger application of the rule. * * * We believe that third parties providing information or analyses to an auditor should exercise reasonable attention and care in those communications. A primary purpose for enactment of the Sarbanes-Oxley Act is the restoration of investor confidence in the integrity of financial reports, which will require the cooperation of all parties involved in the audit process. We do not intend to hold any party accountable for honest and reasonable mistakes or to sanction those who actively debate accounting or auditing issues. We do believe, however, that those third parties who, under the direction of an issuer's officers or directors, mislead or otherwise improperly influence auditors when they know or should know that their conduct could result in investors being provided with misleading financial statements or a misleading audit report, should be subject to sanction by the Commission." [emphasis added]

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

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

issuer's financial statements filed with the SEC materially misleading and (y) a new subsection (b)(2) that provides examples of actions that improperly influence an auditor that could result in "rendering the issuer's financial statements materially misleading."

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

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

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

Enforcement. SOX §303(b) provides the SEC with sole civil enforcement authority with respect to SOX §303 and any rule or regulation issued under SOX §303, thereby precluding a private right of action. While there is no private right of action for violations of SOX §303 and related SEC rules, persons providing misleading information to auditors could have liability therefor under common law causes of action such as negligent misrepresentation.[92]

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

[92] *Cf. Dean Foods Company v. Pappathanasi*, 18 Mass. L. Rep. 598, 2004 WL 3019442 (Mass. Super. Dec. 3, 2004), in which a $9 million judgment was rendered by a trial court after a non-jury trial against a law firm for negligent misrepresentation as a result of the failure to disclose in a closing opinion for an acquisition certain information which it had regarding a government subpoena of documents regarding a customer's alleged tax fraud. The defendant law firm had opined to the acquiring company, as counsel to the acquired company, to the acquiring company that "to the firm's knowledge, without investigation,

Both before and after the May 20, 2003 amendment to 1934 Act Rule 13b2-2, the SEC was bringing enforcement actions against individuals (including inside counsel) for their roles in the falsification of accounting records and misleading statements to accountants, some of which predated the enactment of SOX. See, for example, the following actions:

Rite Aid. In *U.S. v. Martin L. Grass, Franklin C. Brown and Franklyn M. Bergonzi*, 1:CR-02-146-01 (M.D.Pa.), *SEC v. Frank M. Bergonzi, Martin L. Grass and Franklin C. Brown*, 1:CV02-1084 (M.D.Pa.) the Department of Justice and the SEC brought criminal and civil charges respectively against three senior executives of Rite Aid Corporation.[93] The executives (the chief executive officer, chief financial officer and the vice chairman/chief legal officer) were accused of utilizing various schemes to inflate Rite Aid's revenues and net income every quarter over a two year period, thereby increasing their performance based bonuses and other compensation, and, in furtherance of those schemes, directing Rite Aid's accounting staff to enter false or misleading accounting entries which were subsequently included in Rite Aid's public filings, registration statements and other documents related to offerings of securities. Among the violations alleged in the SEC's complaint were (i) deducting from amounts owed vendors inflated and unsupported allowances for damaged and outdated products that were not authorized by agreements, (ii) classifying vendor rebates that were contingent on future sales as reductions to accounts payable, (iii) prematurely recognizing income from a litigation settlement before the settlement agreement was signed, (iv) failing to disclose the CEO's personal interest in three properties which the company leased as store locations, (v) falsifying board committee minutes, (vi) making misrepresentations to lenders, and (vii) signing management representation

---

except as disclosed in a schedule to the acquisition agreement: (a) there was no investigation of any kind pending or threatened against the Company and (b) the Company was not 'subject to any… continuing' governmental investigation." The law firm had assisted the acquired company in responding to the government's subpoena, had looked into whether the acquired company had aided the fraud, but guessed that the investigation had probably gone away with the customer making payments to the government. The law firm advised the acquired company that the matter did not require disclosure in a schedule to the acquisition agreement. Three months after the closing, the acquired company received a "target letter" from the government. Ultimately the acquired company pled guilty to aiding and abetting tax fraud, and paid a fine of $7.2 million. The purchaser sued the acquired company's law firm which had rendered the opinion that no proceedings were pending or threatened against the acquired company. The court concluded that the law firm had enough notice that it could not rely on the acquired company's representations and had a duty to investigate, which it did not do adequately. The law firm ended up settling the case. *See* Donald W. Glazer and Arthur Norman Field, *No-litigation Opinions Can Be Risky Business: Looking at the Facts – and Beyond*, 14 Business Law Today No. 6 (July/August 2005) at 37. An attorney could also have liability exposure under other provisions of federal or state securities laws. *Cf.* Memorandum and Order Re Secondary Actors' Motion to Dismiss filed December 20, 2002 in *In re Enron Corp. Securities, Derivative and ERISA Litigation,* 235 F.Supp. 2nd 549 (S.D. Tex. 2002), Civil Action No. H-03-3624, Consolidated Cases (also known as *Newby v. Enron* or the *Newby* case) (the opinion is 159 pages long in F.Supp. 2nd).

[93] *See* Securities and Exchange Commission v. Frank M. Bergonzi, Martin L. Grass, and Franklin C. Brown, Litigation Release 17577 (June 21, 2002), which can be found at http://www.sec.gov/litigation/litreleases/lr17577.htm; press release "SEC Announces Fraud Charges Against Former Rite Aid Senior Management," dated June 21, 2002, which can be found at http://www.sec.gov/news/press/2002-92.htm.

letters to auditors that contained false statements.[94] Unraveling these schemes resulted in Rite Aid to restating cumulative pretax income by $2.3 billion and cumulative net income by $1.6 billion.[95]

All three officers either pled guilty or were found guilty of criminal charges brought against them and received prison sentences ranging from 28 months to 10 years.[96] The SEC's civil actions against the officers were stayed during the pendency of the criminal actions and were settled subsequent to the criminal convictions with monetary penalties and injunctive relief. Rite Aid Corporation itself settled SEC charges by agreeing to a cease and desist order.

Computer Associates. In *U.S. vs. Sanjay Kumar, et al*, SEC Litigation Release No. 18891 (September 22, 2004), SEC Accounting and Auditing Enforcement Release No. 2106 (September 22, 2004); *SEC v. Computer Associates International, Inc.*, 04 Civ. 4088 (E.D.N.Y.) (Glasser, I.L.); *SEC v. Sanjay Kumar and Stephen Richards*, 04 Civ. 4104 (E.D.N.Y.) (Glasser, I.L.); *SEC v. Steven Woghin*, 04 Civ. 0487 (E.D.N.Y.) (Glasser, I.L.), securities fraud charges were brought by the Department of Justice and the SEC against Computer Associates International, Inc. (*"CA"*) and three of the company's former top executives – Sanjay Kumar, former CEO and Chairman, Stephen Richards, former Head of Sales, and Steven Woghin, former General Counsel, alleging that from 1998 to 2000, CA routinely kept its books open to record revenue from contracts executed after the quarter ended in order to meet Wall Street quarterly earnings estimates and obstructed the SEC's investigation into the CA's accounting practices.[97] In settlements with the SEC and the Justice Department, CA agreed pay $225 million in restitution to shareholders and to make reforms to its corporate governance and financial accounting controls.[98] General Counsel Woghin pled guilty and agreed in a partial

---

[94] *See* Complaint, Securities and Exchange Commission v. Frank M. Bergonzi, Martin L. Grass, and Franklin C. Brown (June 20, 2002), which can be found at http://www.sec.gov/litigation/complaints/complr17577.htm.

[95] S.E.C. v. Frank M. Bergonzi, Martin L. Grass, and Franklin C. Brown, Accounting and Auditing Enforcement Act Release No. 1,581, 77 S.E.C. Docket 3003 (June 21, 2002), *available at* http://www.sec.gov/litigation/litreleases/lr17577.htm.

[96] *See* S.E.C. v. Frank M. Bergonzi, Martin L. Grass, and Franklin C. Brown, Accounting and Auditing Enforcement Act Release No. 2,023, 82 S.E.C. Docket 3327 (May 26, 2004), *available at* http://www.sec.gov/litigation/litreleases/lr18727.htm; S.E.C. v. Frank M. Bergonzi, Martin L. Grass, and Franklin C. Brown, Accounting and Auditing Enforcement Act Release No. 2,024, 82 S.E.C. Docket 3327 (May 27, 2004), *available at* http://www.sec.gov/litigation/litreleases/lr18728.htm; S.E.C. v. Frank M. Bergonzi, Martin L. Grass, and Franklin C. Brown, Accounting and Auditing Enforcement Act Release No. 2,328, (Sept. 30, 2005), *available at* http://www.sec.gov/litigation/litreleases/lr19409.htm.

[97] *See* Press Release, U.S. Department of Justice, Enforcement Proccedings: In the Matter of Steven Woghin (Nov. 12, 2004), *available at* http://www.sec.gov/news/digest/dig111204.txt.

[98] S.E.C. v. Computer Associates International, Inc., Accounting and Auditing Enforcement Act Release No. 2106, 83 S.E.C. Docket 2462 (Sept. 22, 2004), *available at* http://www.sec.gov/litigation/litreleases/lr18891.htm.

settlement to a permanent injunction and officer and director bar with monetary sanctions to be decided at a later point.[99]

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

- The defendants manipulated CA's quarter end cutoff to align CA's reported financial results with market expectations.

- CA prematurely recognized revenue from software contracts that CA, its customer, or both parties, had not yet executed, in violation of GAAP.

- CA executives, including defendants Kumar, Richards, and Woghin, held CA's books open for several days after the end of each quarter to improperly record in that quarter revenue from contracts that were not executed by customers or CA until several days or more after the expiration of the quarter. In a Superseding Indictment filed in the E.D.N.Y. in *U.S. vs. Sanjay Kumar and Stephen Richards* on June 30, 2005, the U.S. alleged that this practice was referred to within CA as the "35-day month" or the "three-day window." As a result of this improper practice, CA made material misrepresentations and omissions about its revenue and earnings in SEC filings and other public statements.

- Woghin (1) signed an SEC filing that contained materially false and misleading information regarding CA's revenues and earnings per share; (2) approved backdated contracts, including drafting a contract with misleading dates; and (3) allowed CA Legal Department to approve contracts obtained by the sales force while knowing, or recklessly disregarding the fact that, those contracts contained false and misleading signature dates and that CA would recognize revenue from those contracts in the incorrect fiscal quarter.

- Woghin encouraged several CA employees to make false and misleading statements to the SEC and/or CA's outside counsel.[100]

Isselmann. *In the Matter of John E. Isselmann*,[101] resulted in a consent cease and desist order being entered against John E. Isselmann, the General Counsel of Electro Scientific Industries, Inc. (*"ESI"*), whose "failure to fulfill his gatekeeper role was a cause of the Company reporting materially fake financial results for" a quarter. His failure was to timely advise ESI's Audit Committee and auditors that he had received an opinion of local foreign counsel that ESI

---

99 *See* Press Release, U.S. Department of Justice, Enforcement Proccedings: In the Matter of Steven Woghin (Nov. 12, 2004), *available at* http://www.sec.gov/news/digest/dig111204.txt.

100 S.E.C. v. Computer Assoc. Int'l, Inc., Accounting and Auditing Enforcement Act Release No. 2106, 83 S.E.C. Docket 2462 (Sept. 22, 2004), *available at* http://www.sec.gov/litigation/litreleases/lr18891.htm.

101 *In re* John E. Isselmann, Jr., Accounting and Auditing Enforcement Act Release No. 50,428, 83 S.E.C. Docket 2413 (Sept. 23, 2004), *available at* http://www.sec.gov/litigation/admin/34-50428.htm.

could not eliminate benefits to its Asian employees where the benefits termination allowed ESI to report a profit rather than a loss and resulted improper financial reporting in its Form 10-Q Report.

The facts were that ESI's Chief Financial Officer (*"CFO"*) and Controller, without involving or consulting Isselmann, elected to terminate a retirement plan for ESI's employees in Asia and reverse an accrual for pension benefits. During an Audit Committee meeting two weeks before the close of the quarter, the CFO advised "that the Japanese benefits were not legally required and that the decision had been approved by legal counsel," and "Isselmann identified ESI's legal counsel in Japan, causing an Audit Committee member to believe that outside counsel had reviewed the decision." Isselmann's fault at this stage was not speaking up since he knew that he, as General Counsel, had not "sought any outside legal review of the issue." Three days after the end of the quarter Isselmann sought legal advice of counsel in Japan. When the Japanese opinion was received four days later, it indicated that the pension benefits could not be eliminated unilaterally. Isselmann tried to raise the point at meetings with ESI's Audit Committee, Disclosure Committee and auditors prior to filing ESI's Form 10-Q, but he was cut off by the CFO, who signed the Form 10-Q Report. Five months after the foregoing events occurred, the CFO had been promoted to CEO, and the new CFO told Isselmann for the first time exactly what had occurred with regard to the earlier accrual reversal. Isselmann immediately advised ESI's Audit Committee and outside counsel, but the SEC concluded that his actions were too little-too late. While there is no allegation that Isselmann in any way participated in the scheme to falsify ESI's numbers, the SEC found that Isselmann's failure to timely disclose the Japanese legal opinion to the Audit Committee, the Board of Directors and outside auditors "allowed the CFO and Controller to hide an ongoing fraud." For their part the CFO and Controller were indicted on 17 counts of financial fraud and falsifying records.

Orlick/Gemstar-TV Guide. *In re Jonathan B. Orlick, Esq*,[102] the SEC announced settlement of an enforcement action against Jonathan B. Orlick, the former Executive Vice President, General Counsel, Secretary and a director of Gemstar-TV Guide International, Inc., a media and technology company that publishes TV Guide and "develops, licenses, and markets an interactive program guide (*"IPG"*) for televisions.....," which it touted as the "value driver" of the company's stock. According to the SEC, during the period from June 1999 through September 2002 Gemstar overstated its total revenues by at least $248 million to meet growth projections for IPG licensing and advertising, and the SEC alleged that Orlick knew that the company was improperly recognizing and reporting licensing revenue. It was also alleged that Orlick repeatedly signed false representation letters to the company's outside auditors regarding the status of negotiations with another company regarding a material licensing agreement. As part of the settlement, Orlick was enjoined from violating, or aiding and abetting violations, of securities laws, and was ordered to pay $305,511 in disgorgement of a prior bonus, interest and a civil penalty. In addition, Orlick may not serve as an officer or director of a public company for a period of ten years, and has been suspended from appearing or practicing before the SEC. Orlick consented to the penalties, but neither admitted or denied liability.

---

[102] *In re* Jonathan B. Orlick, Esq., Auditing and Auditing Enforcement Release No. 51,081, 84 S.E.C. Docket 2560 (Jan. 26, 2005), *available at* http://www.sec.gov/litigation/admin/34-51081.htm.

Fitzhenry. *In re James A. Fitzhenry*,[103] involved an SEC enforcement action against James A. Fitzhenry, Senior Vice President, General Counsel and Secretary for FLIR Systems, Inc. (*"FLIR"*). At year-end 1998, FLIR improperly recognized $4.1 million in revenue from two purported sales to one of FLIR's independent sales representatives in Columbia, based upon non-binding letters of intent. As part of the 1998 year-end audit of FLIR's financial statements, FLIR's outside auditors, PricewaterhouseCoopers LLP (*"PwC"*), selected these sales for testing and sent an accounts receivable confirmation, which the sales representative refused to return. In February 1999, Fitzhenry attempted to obtain a binding and unconditional agreement from FLIR's independent sales representative to purchase the units stated in the non-binding letters of intent. The sales representative refused to provide an agreement of the type requested by Fitzhenry. From Fitzhenry's negotiations with FLIR's independent sales representative, he understood that the $4.1 million in sales were conditional in nature because the sales representative had no obligation to purchase the units. On April 12, 1999 and April 20, 1999, Fitzhenry signed two management representation letters to PwC, in connection with FLIR's 1998 year-end audit. Among other things, both letters confirmed that: (1) risk of ownership for the units had passed to FLIR's independent sales representative; and (2) the independent sales representative had made a fixed commitment to purchase the goods. Fitzhenry never told PwC about his negotiations with the independent sales representative, nor did he tell PwC that he understood the transactions were "conditional" in nature. Consequently, Fitzhenry made material misrepresentations and omitted material information in the management representation letters. As a result of the conduct described above, the SEC found that Fitzhenry willfully violated pre-SOX Rule 13b2-2. In the settlement, Fitzhenry was denied the privilege of appearing or practicing before the SEC as an attorney for five years.

Steckler. In *Securities and Exchange Commission v. Vincent Steckler*, the SEC charged a vice president of sales of a subsidiary of a public company with aiding and abetting a supplier of his employer in improperly recognizing revenue in violation of Rules 10b-5 and 13b2-1 under the 1934 Act by arranging for an undisclosed side letter that made an otherwise unconditional order by his employer for the purchase of software provided to the supplier's legal and accounting departments subject to cancellation.[104] The SEC's Complaint stated that under GAAP the side letter made the sale a contingent sale, which should not be recognized as revenue, and that the defendant concealed the side letter from the supplier's legal and accounting departments, thereby causing the improper revenue recognition by the supplier.[105]

---

103 *In re* James A. Fitzhenry, Accounting And Auditing Enforcement Release No. 46870 (Nov. 21, 2002), *available at* http://www.sec.gov/litigation/admin/34-46870.htm.

104 *See* S.E.C. v. Vincent Steckler, Accounting and Auditing Enforcement Act Release No. 1,850, 81 S.E.C. Docket 151 (Sept. 8, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18327.htm; Complaint, S.E.C. v. Vincent Steckler, (Sept. 8, 2003), *available at* http://www.sec.gov/litigation/complaints/comp18327.htm.

105 *See* Complaint, S.E.C. v. Vincent Steckler, (Sept. 8, 2003), *available at* http://www.sec.gov/litigation/complaints/comp18327.htm.

Google. *In the Matter of Google, Inc. and David C. Drummond*,[106] the general counsel of Google consented to a cease and desist order as a result of giving erroneous advice to Google regarding the availability of an exemption from 1933 Act registration for the grant of employee stock options. In 2003, Google was a privately held company whose financial statements were confidential. Google believed that disclosing these financial statements would be "strategically disadvantageous," and that making the financial statements widely available among Google employees could result in loss of information confidentiality that was essential at that stage in its business. At this time, Google was considering issuing stock options to its employees without registering the securities, but Rule 701 under the 1933 Act provided an exemption for the issuance of only $5 million in options over a 12-month period without providing detailed financial statements and other disclosures to the option recipients. When contemplating the first of these options grants in 2003, the general counsel consulted with outside counsel and his legal department colleagues at Google, and concluded that the $5 million threshold of the Rule 701 exemption would not likely be exceeded. Even if it were, he believed that exemptions under SEC Regulation D and 1933 Act § 4(2) might apply to allow Google to issue the options without registering the securities or transmitting detailed financial information to the option recipients, and "even if it were later determined that his analysis of the applicability of other registration exemptions was incorrect, Google could make an offer of rescission to the option holders." Ultimately, Google issued approximately $49 million worth of stock options during 2003 and an additional $33 million worth during the first four months of 2004, prior to the filing of its registration statement for an initial public offering (*"IPO"*), without the general counsel explaining to Google's board of directors that Rule 701 had not been complied with and the risks of reliance on another exemption from registration. The SEC ultimately concluded that there was no exemption from registration as all of the optionees did not have the requisite sophistication or receive the requisite information about Google. In August 2004 before its IPO, Google did offer rescission to the option holders, an offer that went unanswered due to the anticipated success of the IPO (the option exercise prices were less than $4 and the IPO price was expected to be over $100). By bringing this case, the Commission sent a reminder that a "technical violation" is a violation even if no economic harm occurs (i.e., there is no "good deal defense" to SEC enforcement actions).

FFP. In *In re FFP Marketing Company, Inc., Warner Williams, and Craig Scott, CPA*,[107] a general counsel was sanctioned for signing a misleading Form 12b-25 stating why the company could not file its Form 10-K Report within the prescribed time period. The Form 12b-25 failed to disclose that the auditors could not complete their audit because of an ongoing study into accounting irregularities that ultimately resulted in a significant write down of credit card receivables and a restatement of FFP's financial statements.

---

[106] *In re* Google, Inc. and David C. Drummond, Securities Act Release No. 8523, 84 S.E.C. Docket 2293 (Jan. 13, 2005), *available at* http://www.sec.gov/litigation/admin/33-8523.htm.

[107] *In re* FFP Mktg. Co., Accounting and Auditing Enforcement Act Release No. 51,198, 84 S.E.C. Docket 2981 (Feb. 14, 2005), *available at* http://www.sec.gov/litigation/admin/34-51198.htm.

Biopure Corporation. In *SEC v. Biopure Corporation*,[108] Biopure Corporation and its general counsel consented to final judgments in a previously-filed action[109] that (i) permanently enjoins Biopure from violating antifraud provisions of the federal securities laws and requires the company to retain an independent consultant to review Biopure's disclosure, compliance and other policies and procedures and (ii) permanently enjoins the general counsel from aiding and abetting violations of the reporting provisions of the federal securities laws and orders her to pay a $40,000 civil penalty. The SEC's Complaint alleged that Biopure received negative information from the FDA regarding its efforts to obtain FDA approval of its synthetic blood product, but failed to disclose the information, or falsely described it as positive developments. Biopure's chief executive officer and its regulatory affairs head were separately charged.

False Confirmations. On November 2, 2005, the SEC charged seven individuals with providing false confirmations to the outside auditors of U.S. Foodservice, Inc., a subsidiary of Royal Ahold.[110] Each defendant was an employee of a supplier to a subsidiary of Royal Ahold and was also the subject of criminal conspiracy charges filed by the U.S. Attorney's Office for the Southern District of New York. Similar charges previously had been filed against nine others, and on June 7, 2006 civil charges were filed and settled against the owner/operator of several suppliers which had provided false confirmations to the subsidiary's auditors,[111] bringing the total number of third-party defendants in the matter to 17. Royal Ahold itself settled a related SEC proceeding in October 2004.

Industry practice was for such vendors to provide the Ahold subsidiary and other wholesale food distributors with sales rebates, referred to as "promotional allowances." The Government alleged that, between 2000 and 2003, the Ahold subsidiary's executives inflated the allowances paid by the vendors, and owed at year-end, by millions of dollars in the subsidiary's financial statements. The executives also allegedly "induced" the Ahold subsidiary's vendors to provide false confirmations of these amounts to Royal Ahold's auditors. The implication was that, had the vendors not gone along with the scheme, the subsidiary's officers would have steered business elsewhere.

This fact pattern is similar to prior cases in which the SEC has charged third parties who provided false confirmations to another company's auditors with aiding and abetting securities

---

108 SEC Litigation Release No. 19825 (September 12, 2006), *available at* http://www.sec.gov/litigation/litreleases/2006/lr19825.htm.

109 Securities and Exchange Commission v. Biopure Corporation, Thomas Moore, Howard Richman and Jane Kober, (United States District Court for the District of Massachusetts, Civil Action No. 05-11853-WGY), Litigation Release No. 19376 (September 14, 2005), *available at* http://www.sec.gov/litigation/litreleases/lr19376.htm.

110 SEC Litigation Release No. 19454 (Nov. 2, 2005), *available at* http://www.sec.gov/litigation/litreleases/lr19454.htm.

111 SEC Litigation Release No. 19721 (June 7, 2006), *available at* http://www.sec.gov/litigation/litreleases/2006/lr19721.htm.

fraud.[112] What is significant in the Royal Ahold proceedings, however, is the number of third-party defendants who were charged. The majority of the defendants in the Royal Ahold proceedings were not employees of SEC registrants, but instead were owners or employees of private food distributors that did business with the Ahold subsidiary. The proceedings demonstrate that the SEC is prepared to bring charges against persons or entities not otherwise subject to SEC oversight, if their conduct interferes with the ability of a public company's auditors to conduct a fair examination of the company's financial statements.[113]

The SEC did not rely on amended Rule 13b2-2 in the Royal Ahold proceedings as most of the conduct predated the effective date of the revised rule. In the future, however, the SEC may bring cases under Rule 13b2-2 against third parties for providing "misleading" confirmations to another company's auditors, even if they did not conspire with issuer officials or know that their confirmations were inaccurate. Should this occur, questions likely will arise as to whether the party furnishing the confirmation was acting "under the direction" of an officer or director of the issuer, as required to establish a Rule 13b2-2 violation, simply because he or she provided a confirmation at the request of an issuer officer.

Internal Investigations. Internal investigations into allegations of wrongdoing by corporate representatives are being conducted with increasing frequency by counsel retained by boards of directors or audit committees.[114] The results of an internal investigation conducted by counsel are frequently furnished to the company's auditors. As a result, counsel conducting such an investigation in some circumstances could have a duty under Rule 13b2-2 to conduct the investigation with sufficient thoroughness that the results do not mislead the auditors. When he was Director of the SEC Division of Enforcement, Stephen Cutler commented:

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

---

[112] *See In the Matter of Kemps LLC, f/k/a Marigold Foods, LLC, James Green and Christopher Thorpe*, Admin. Proc. File No. 3-11656, Accounting and Auditing Enforcement Release No. 2101 (September 14, 2004), which can be found at http://www.sec.gov/litigation/admin/33-8485.pdf; *In the Matter of John K. Adams*, Admin. Proc. File No. 3-11655, Accounting and Auditing Enforcement Release No. 2098 (September 14, 2004), which can be found at http://www.sec.gov/litigation/admin/33-8484.pdf; *In the Matter of Digital Exchange Systems, Inc., Rosario Coniglio and Steven Schmidt*, Admin. Proc. File No. 3-11654, Accounting and Auditing Enforcement Release No. 2099 (September 14, 2004), which can be found at http://www.sec.gov/litigation/admin/33-8483.pdf.

[113] *See SEC v. Scientific-Atlanta, Inc.*, 06 Civ. 4823 (PKC) (S.D.N.Y. June 22, 2006) (vendor that supplied set-top boxes for use in Adelphia Communications' cable business sued for aiding and abetting Adelphia's reporting, books and records, and internal controls violations by entering into marketing support arrangements pursuant to which Scientific-Atlanta made marketing-support payments to Adelphia that were offset by price increases on equipment it sold to Adelphia, which enabled Adelphia to reduce its ordinary marketing expense and book the offsetting additional equipment costs as capital expenditures); Brian A. Ochs, "*Has the Securities and Exchange Commission Expanded Corporate Liability?*", 38 BNA Sec. Reg. & L. Rept. 37 at 1549 (September 18, 2006).

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

may have conducted investigations in such a manner as to help hide ongoing fraud, or may have taken actions to actively obstruct such investigations.[115]

The DOJ is taking the position that lying to issuer counsel conducting an internal investigation is equivalent to lying to a prosecutor, law enforcement officer or regulator about a crime, and exposes the liar to federal obstruction of justice charges.[116] The DOJ has indicted under 18 U.S.C. § 1512(c) added by SOX Title XI[117] two former officers of Computer Associates International Inc. in respect of allegedly false statements made to issuer counsel during an internal investigation at that company.[118] Charges under 18 U.S.C. § 1512(c) added by SOX Title XI were also brought against an employee of El Paso Corp. based on statements made to outside counsel during an internal investigation.[119]

Relationship of SOX §303 Requirements to 1934 Act §10A. A violation of Rule 13b2-2 is an "illegal act" within the meaning of Section 10A(b) of the 1934 Act and, therefore, must be reported by auditors under that section. Attorneys also should be aware that evidence of a violation of Rule 13b2-2 may be reportable by them under SOX §307 if it amounts to "evidence of a material violation" as defined in the SOX §307 Rules.

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

III.
ENHANCED ATTORNEY RESPONSIBILITIES UNDER SOX

SOX §307. SOX §307 mandates that the SEC shall adopt rules of professional responsibility for attorneys representing public companies before the SEC, including: (1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty to the chief legal officer or the equivalent (*"CLO"*), if the issuer has a CLO, or to both the CLO and the CEO, of the company; and (2) if corporate executives do not respond appropriately, requiring the attorney to report to the board of directors or an appropriate committee thereof.[120] On January 23, 2003, the SEC complied with the SOX §307 mandate by

---

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

[116] Timothy P. Harkness and Darren LaVerne, *Private lies may lead to prosecution – DOJ views false statements to private attorney investigators as a form of obstruction of justice*, NAT'L L.J., July 24, 2006, at S1.

[117] *See* Byron F. Egan, *Effect of Sarbanes-Oxley on M&A Transactions* – part XII. Corporate Fraud Accountability (SOX Title XI), at 99, *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=527.

[118] *U.S v. Kumar*, No. 04-cr-846, slip op. (E.D.N.Y. Feb. 21, 2006).

[119] *See U.S. v. Singleton*, No. 4:04-cr-514-1 (S.D. Texas filed Nov. 17, 2004).

[120] SOX attempts to protect investors from a repeat of the scandals that led to its enactment by regulating "[t]he sentries of the marketplace: the auditors who sign off on companies' financial data; the lawyers who

adopting the rules implementing provisions of SOX §307 that prescribe minimum standards of professional conduct for attorneys appearing and practicing before the SEC in any way in the representation of issuers, which were published in 1933 Act Release No. 33-8185 (January 29, 2003), titled "Implementation of Standards of Professional Conduct for Attorneys," and which can be found at http://www.sec.gov/rules/final/33-8185.htm (the *"SOX §307 Release"*). These rules adopted under SOX §307 (the *"SOX §307 Rules"*) constitute a new Part 205 to 17 CFR, Standards of Professional Conduct for Attorneys Appearing and Practicing before the Commission, and became effective on August 5, 2003.

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

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

Attorneys Covered. The SOX §307 Rules apply to all attorneys, whether inside counsel or outside counsel and those in foreign jurisdictions, "*appearing and practicing*" before the SEC. The term "appearing and practicing" before the SEC is defined to include, without limitation: (1) transacting any business with the SEC, including communication in any form with the SEC; (2) representing an issuer in an SEC administrative proceeding or in connection with any SEC investigation, inquiry, information request or subpoena; (3) providing advice in respect of the

---

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

U.S. securities laws regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document;[121] or (4) advising an issuer as to whether information or a statement, opinion, or other writing is required under the U.S. securities laws to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC; but does not include an attorney who (x) conducts these activities other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship;[122] or (y) is a non-appearing foreign attorney.[123] The SEC intends that the issue whether an attorney-client relationship exists for purposes of the SOX § 307 Rules will be a federal question and, in general, will turn on the expectations and understandings between the attorney and the issuer. Thus, whether the provision of legal services under particular circumstances would or would not establish an attorney-client relationship under the state laws or ethics codes of the state where the attorney practices or is admitted may be relevant to, but will not be controlling on, the issue under the SOX §307 Rules.

Who is the Client? The SOX §307 Rules affirmatively state that an attorney representing an issuer represents the issuer as an entity, rather than the officers or others with whom the attorney interacts in the course of that representation. State ethics rules likewise provide that the attorney owes his or her professional and ethical duties to the issuer as an organization.[124] In the case of a large corporation with multiple subsidiaries, questions will arise as to whether the attorney represents the consolidated group or only a particular entity within, and the answers will vary depending on the unique facts of each situation.[125] While the state

---

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

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

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

124 TEX. DISCIPLINARY R. PROF'L CONDUCT 1.12 (providing that "[a] lawyer employed or retained by an organization represents the entity" rather than the individuals to whom the lawyer reports in the ordinary course of working relationships. *See also* MODEL RULES OF PROF'L CONDUCT R. 1.13(a) ("[a] lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents").

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

ethics rules apply to both public and private companies, the SOX §307 Rules apply only to attorneys in the representation of public companies.[126]

What Evidence Triggers Reporting Duty? The SOX §307 reporting duties are triggered when an attorney has "*evidence of a material violation*," which is defined to mean credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.[127] "*Material violation*" in turn is defined to mean a material violation of an applicable U.S. federal or state securities law, a material "breach of fiduciary duty" arising under U.S. federal or state law, or a similar material violation of any U.S. federal or state law. The SOX §307 Release comments that the SOX §307 Rules do not contain a separate definition of "material" because "that term has a well-established meaning under the federal securities laws and the [SEC] intends for that same meaning to apply" under

---

[126] 17 C.F.R. § 205.3 (2005).

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

> Evidence of a material violation must first be credible evidence. An attorney is obligated to report when, based upon that credible evidence, "it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur." This formulation, while intended to adopt an objective standard, also recognizes that there is a range of conduct in which an attorney may engage without being unreasonable. The "circumstances" are the circumstances at the time the attorney decides whether he or she is obligated to report the information. These circumstances may include, among others, the attorney's professional skills, background and experience, the time constraints under which the attorney is acting, the attorney's previous experience and familiarity with the client, and the availability of other lawyers with whom the lawyer may consult. Under the revised definition, an attorney is not required (or expected) to report "gossip, hearsay, [or] innuendo." Nor is the rule's reporting obligation triggered by "a combination of circumstances from which the attorney, in retrospect, should have drawn an inference," as one commenter feared.
>
> On the other hand, the rule's definition of 'evidence of a material violation" makes clear that the initial duty to report up-the-ladder is not triggered only when the attorney "knows" that a material violation has occurred or when the attorney "conclude[s] there has been a violation, and no reasonable fact finder could conclude otherwise." That threshold for initial reporting within the issuer is too high. Under the Commission's rule, evidence of a material violation must be reported in all circumstances in which it would be unreasonable for a prudent and competent attorney not to conclude that it is "reasonably likely" that a material violation has occurred, is ongoing, or is about to occur. To be "reasonably likely" a material violation must be more than a mere possibility, but it need not be "more likely than not." If a material violation is reasonably likely, an attorney must report evidence of this violation. The term "reasonably likely" qualifies each of the three instances when a report must be made. Thus, a report is required when it is reasonably likely a violation has occurred, when it is reasonably likely a violation is ongoing or when reasonably likely a violation is about to occur.

the SOX §307 Rules.[128] The SOX §307 Release, however, does comment that material violations must arise under U.S. law (federal or state) and do not include violations of foreign laws. "*Breach of fiduciary duty*" under the SOX §307 Rules refers to any breach of fiduciary or similar duty to the issuer recognized under an applicable federal or state statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust and approval of unlawful transactions.[129]

Duty to Report Evidence of a Material Violation. If an attorney, appearing and practicing before the SEC "in the representation of an issuer,"[130] becomes aware of evidence of a material violation by the issuer or by any officer, director, employee or agent of the issuer, the

---

[128] The SOX § 307 Release cites *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-236 (1988); and *TSC Indus. v. Northway, Inc.*, 426 U.S. 438 (1976) for the generally accepted definition of "material." Materiality is defined in those cases as follows: "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Indus.,* 426 U.S. at 449 (expressly adopted in *Basic, Inc.* at 231-32). *See* 15 U.S.C. § 7245 (Supp. 2002).

[129] Both TBCA art. 2.31 and DGCL § 141(a) provide that the business and affairs of a corporation are to be managed under the direction of its board of directors. While the Texas and Delaware corporation statutes provide statutory guidance as to matters such as the issuance of securities, the payment of dividends, the conduct of meetings of directors and shareholders, and the ability of directors to rely on specified persons and information, the nature of a director's "fiduciary" duty to the corporation and the shareholders has been largely defined by the courts through damage and injunctive actions. In Texas, "[t]hree broad duties stem from the fiduciary status of corporate directors; namely the duties of obedience, loyalty, and due care." *Gearhart Industries, Inc. v. Smith International, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984). *Gearhart* describes those duties as follows: (i) the duty of obedience requires a director to avoid committing *ultra vires* acts, i.e., acts beyond the scope of the authority of the corporation as defined by its articles of incorporation or the laws of the state of incorporation, (ii) the duty of loyalty dictates that a director must act in good faith and must not allow his personal interests to prevail over the interests of the corporation, and (iii) the duty of due care requires that a director must handle his corporate duties with such care as an ordinarily prudent man would use under similar circumstances. In Delaware, the fiduciary duties include those of loyalty, care, candor and oversight. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); *In re Caremark International, Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996); S*ee In re Abbott Laboratories Derivative Shareholders Litigation*, 293 F.3d 378 (7th Cir. 2002). Both Texas and Delaware have adopted a judicial rule of review of business decisions, known as the "business judgment rule," that is intended to protect disinterested directors from liability for decisions made by them when exercising their business judgment, but there are substantial differences in the Delaware and Texas judicial approaches to the business judgment rule. *See* Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation - Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. Rev. 249, 287-288 (Winter 2001). The extent to which traditional business judgment rule analyses will be applicable in respect of SOX requirements is unclear.

[130] The SOX §307 Rules define "*in the representation of an issuer*" to mean providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer.

SOX §307 Rules require the attorney to "*report*"[131] the evidence to the issuer's CLO (if the issuer has a CLO) or to both the issuer's CLO and its CEO forthwith. By communicating such information to the issuer's officers or directors, an attorney does not reveal client confidences or secrets or privileged or otherwise protected information related to the attorney's representation of an issuer.

The CLO is then obligated to cause such inquiry[132] into the evidence of a material violation as he or she "*reasonably believes*"[133] is appropriate to determine whether the material violation described in the report has occurred, is ongoing, or is about to occur. If the CLO determines no material violation has occurred, is ongoing, or is about to occur, he or she shall notify the reporting attorney and advise the reporting attorney of the basis for such determination. Unless the CLO reasonably believes that no material violation has occurred, is ongoing, or is about to occur, he or she shall take all reasonable steps to cause the issuer to adopt an "*appropriate response*,"[134] and shall advise the reporting attorney thereof. In lieu of causing such an inquiry a CLO may refer a report of evidence of a material violation to a qualified legal compliance committee (*"QLCC"*) if the issuer has duly established a QLCC prior to the report of evidence of a material violation.

Unless an attorney who has made the report reasonably believes that the CLO or CEO has provided an appropriate response within a reasonable time, the attorney shall report the

---

[131] The SOX §307 Rules define "*report*" to mean to make known to directly, either in person, by telephone, by e-mail, electronically, or in writing.

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

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

[134] "*Appropriate response*" is defined by the SOX §307 Rules as a response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes that: (1) no material violation has occurred, is ongoing, or is about to occur; (2) the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or (3) the issuer, with the consent of the issuer's board of directors, an appropriate committee thereof or a QLCC, has retained or directed an attorney to review the reported evidence of a material violation and either (x) has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence or (y) has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation.

evidence of a material violation to: (i) the issuer's audit committee, (ii) another committee consisting solely of independent directors, or (iii) the board of directors.[135]

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

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

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

An attorney shall not have any obligation to report evidence of a material violation if the attorney was retained or directed by a QLCC to either investigate such evidence of a material violation or to assert, consistent with his or her professional obligations, a colorable defense on

---

[135] *See* Patrick McGeehan, *Lawyers Take Suspicions On TV Azteca To Its Board*," New York Times, December 24, 2003, Section C, page 1:

> "In one of the first applications of a new provision of the Sarbanes-Oxley Act, outside lawyers for Mexico's second-largest broadcaster have told its board – and, possibly, federal regulators – that they think that the company violated United States securities laws.
>
> "The company, TV Azteca, has had a long-running dispute with lawyers in New York about the need for greater disclosure about transactions that could have yielded a profit of more than $100 million to the company's billionaire chairman and controlling shareholder, Ricardo B. Salinas Pliego. When company executives refused to make the disclosures that the lawyers demanded, the lawyers cited the new provision of the act, which requires them to notify the company's board and permits them to contact regulators as well.
>
> "… in a Dec. 12 letter to the boards of TV Azteca and its parent company, Azteca Holdings, [outside New York counsel citing SOX §307] told the boards that [the firm] was withdrawing as counsel to the company on a pending bond offering and that it might notify the Securities and Exchange Commission of its withdrawal and the reasons for it."

behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation.

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

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

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

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

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

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

ABA's present Model Rule 1.6(b)(3) and corresponding "self-defense" exceptions to client-confidentiality rules in every state.[136]

The SOX §307 Rules further provide that an attorney appearing and practicing before the SEC in the representation of an issuer may reveal to the SEC, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary: (i) to prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors; (ii) to prevent the issuer from committing or suborning perjury or committing any act that is likely to perpetrate a fraud upon the SEC; or (iii) to rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used. The SOX §307 Release comments that in permitting, but not requiring, an attorney to disclose, under specified circumstances, confidential information related to his appearing and practicing before the SEC in the representation of an issuer, the SOX §307 Rules correspond to the ABA's Model Rule 1.6 as proposed by the ABA's Kutak Commission in 1981-1982 and by the ABA's Commission of

---

[136] The Texas Disciplinary Rules of Professional Conduct provide as follows:

> RULE 1.05. CONFIDENTIALITY OF INFORMATION
>
> (b) Except as permitted by paragraphs (c) and (d), or as required by paragraphs (e) and (f), a lawyer shall not knowingly:
>
> > (1) Reveal confidential information of a client or a former client . . .
>
> (c) A lawyer may reveal confidential information:
>
> > (5) To the extent reasonably necessary to enforce a claim or establish a defense on behalf of the lawyer in a controversy between the lawyer and the client.
> >
> > (6) To establish a defense to a criminal charge, civil claim or disciplinary complaint against the lawyer or the lawyers associates based upon conduct involving the client or the representation of the client.
> >
> > (7) When the lawyer has reason to believe it is necessary to do so in order to prevent the client from committing a criminal or fraudulent act.
> >
> > (8) To the extent revelation reasonably appears necessary to rectify the consequences of a client's criminal or fraudulent act in the commission of which the lawyer's services had been used.
>
> (e) When a lawyer has confidential information clearly establishing that a client is likely to commit a criminal or fraudulent act that is likely to result in death or substantial bodily harm to a person, the lawyer shall reveal confidential information to the extent revelation reasonably appears necessary to prevent the client from committing the criminal or fraudulent act.

Evaluation of the Rules of Professional Conduct ("*Ethics 2000 Commission*") in 2000, and as adopted in the vast majority of states.[137]

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

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

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

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

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

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

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

[137] *Id*.

to strict compliance with the SOX §307 Rules rather than trusting to prosecutorial discretion to conclude that substantial compliance was good enough.

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

Enron Civil Liability Fallout. Compliance with the requirements of the SOX §307 Rules does not assure attorneys that they will not be subject to private claims based on other securities laws.[138] In her lengthy opinion dated December 19, 2002 on the motions to dismiss filed by Vinson & Elkins L.L.P. ("*V&E*"), Kirkland & Ellis ("*K&E*"), Arthur Andersen LLP and nine banks in the *Newby v. Enron* case, Judge Melinda Harmon granted the motions to dismiss of K&E and Deutsche Bank, but denied in whole or in part the motions of V&E, Arthur Andersen, J.P. Morgan Chase, Citigroup, Credit Suisse, CIBC, Merrill Lynch, Barclays, Lehman Brothers and Bank America. In exploring the circumstances under which law firms, accounting firms, and investment banks/integrated financial services institutions (lumped together by the Court as "*secondary actors in securities markets*") can be liable for the acts of companies they serve under SEC Rule 10b-5 and the Texas Securities Act, the Court noted that it was influenced by revelations of corporate corruption in other courts, Congress, investigations by the SEC and New York Attorney General Eliot Spitzer, and the media.

While paying homage to the 1994 holding of the Supreme Court in *Central Bank of Denver*[139] that a private plaintiff may not bring an aiding and abetting claim under Rule 10b-5, the Court found that the Supreme Court had left open for it to determine when the conduct of a secondary actor makes it a primary violator subject to liability under Rule 10b-5. Rejecting the "bright line" test that a defendant must actually make a false or misleading statement to be liable, the Court adopted the SEC's amicus position that a defendant can be liable if it "creates" a misleading document even though the defendant is not identified with it to the outside world, with "reliance" being established under the "fraud on the market" theory.[140] "Scienter" remains a crucial element, with the plaintiff having to show intent to deceive or extreme recklessness to sustain a Rule 10b-5 claim.

---

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

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

140 The Court in *Newby* wrote: "Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability . . . are met." 235 F. Supp. 2d 549, 582 (S.D. Tex. 2002).

The Court gave a broad reading to the liability provisions of the Texas Securities Act,[141] commenting that "liability may be imposed against a defendant [who] constituted any link in the chain of the selling process" and that proof of reliance or scienter are not required. The Court found that the Texas Securities Act "applies if any act in the selling process of securities…occurs in Texas."[142]

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

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

However, the Court dismissed the lawsuit as to K&E, calling the charges against K&E "conclusory and general." The Court said any documents K&E drafted were for private transactions, "and were not included in or drafted for any public disclosure or shareholder solicitation" and noted that K&E was not Enron's counsel for its securities or SEC filings.

<u>Attorney-Client/Work Product Privilege</u>. The SOX §307 Rules do not contain any provision to the effect that information reported by an attorney to the SEC does not constitute a waiver of any attorney-client or other privilege. The SOX §307 Release states that the SEC finds that allowing issuers to produce internal reports to the SEC, including those prepared in response to reports as a result of the SOX §307 Rules, without waiving an otherwise applicable attorney-client and other privilege, enhances the SEC's investigatory and enforcement capabilities and,

---

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

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

thus, is in the public interest. The SOX §307 Release further states that the SEC will continue to follow its policy of entering into confidentiality agreements where it determines that its receipt of information pursuant to those agreements will ultimately further the public interest, and will vigorously argue in defense of those confidentiality agreements where litigants argue that the disclosure of information pursuant to such agreements waives any privilege or protection.[143]

Differences From Proposed Rules. On November 21, 2002, the SEC issued 1933 Act Release No. 33-8150, which can be found at http://www.sec.gov/rules/proposed/33-8150.htm, that proposed rules under SOX §307. After comment, the final SOX §307 Rules were issued on January 29, 2003 and differ in a number of respects from the initially proposed rules.

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

Instead, the SEC extended for 60 days the comment period on the "noisy withdrawal" proposal, while proposing an alternative that still would require a lawyer to withdraw, but that would place instead upon the company the burden to report the lawyer's withdrawal.[144] Under the proposed alternative, the company would publicly disclose on a Form 8-K within two business days after the lawyer's withdrawal for professional considerations, or of having received a notice from its lawyer that the issuer did not appropriately respond to the lawyer's report of a material violation, either or both of such events. If the company does not make the required disclosure, the lawyer would then be permitted (but not required) to inform the SEC that he or she had withdrawn. Inside counsel would be required only to cease participating in the matter involving the violation and notify the company in writing that he or she believed the company had not appropriately responded to the lawyer's report of a material violation.

Second, the SEC changed the text of the rule specifying when lawyers must report "up the ladder." Under proposed rules, a lawyer had to report up the ladder if he had *"evidence of a material violation of securities law or breach of fiduciary duty or similar violation"* by a client. Under the final rules adopted, a lawyer must report *"credible evidence based upon which it*

---

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

[144] *See* 1933 Act Release No. 33-8186 (January 29, 2003), which can be found at http://www.sec.gov/rules/proposed/33-8186.htm.

would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur." While this standard developed from the SEC's attempt to make objective rather than subjective the test of when a lawyer must report a violation, its tortured manner of expression, in terms of a double negative ("unreasonable … not to conclude that it is reasonably likely…"), may simply increase the SEC's burden of proving a lawyer has failed to comply. In response to questions at the open meeting, the SEC staff suggested that this standard has a lower threshold than a "more likely than not" standard.

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

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

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

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

Introduction. Our system of jurisprudence is designed to facilitate resolving lawsuits based on what the facts reveal, not by what lawyers conceal. So that the real facts may be made known to all parties, the parties are permitted discovery from their opponents before trial begins. Each party may be called upon by his adversary or the court to, in effect, lay his cards on the table so that the dispute may be resolved on the basis of what all the cards show, rather than on the relative skill of the players. This philosophy is intended to level the tables between institutional litigants, perceived to have greater resources, and the individuals against whom they are often aligned. Countervailing considerations in the interests of fairness have produced a few limited exceptions to this policy of openness.

Attorney-Client Privilege.

Overview. The attorney-client privilege is the oldest recognized privilege against discovery known to the common law. It traces its roots back to the reign of Elizabeth I in the 16th century[145] during the days when a lawyer's honor as a gentleman was paramount.[146] The policy behind recognition of the privilege was most simply expressed by the United States Supreme Court in *Upjohn Co. v. United States*,[147] where the Court characterized the purpose of the privilege as being "to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice."[148] A more eloquent justification is found in the comment to Rule 210 of the American Law Institute's *Model Code of Evidence*:

> In a society as complicated in structure as ours and governed by laws as complex and detailed as those imposed upon us, expert legal advice is essential. To the furnishing of such advice the fullest freedom and honesty of communication of pertinent facts is a prerequisite. To induce clients to make such communications, the privilege to prevent their later disclosure is said by courts and commentators to be a necessity. The social good derived from the proper performance of the functions of lawyers acting for their clients is believed to outweigh the harm that may come from the suppression of the evidence in specific cases.[149]

Unfortunately, one of the complex and detailed laws referred to in the aforementioned comment turns out to be the attorney-client privilege itself. There are numerous requirements for the privilege to be applicable, and judicial interpretations differ from jurisdiction to jurisdiction and even from judge to judge.[150]

---

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

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

147 449 U.S. 383 (1981).

148 *Id.* at 389.

149 A.L.I. MODEL CODE OF EVID. R. 210, cmt (*quoted in* United States v. United Shoe Mach. Corp., 89 F. Supp. 357, 358 (D. Mass. 1950)).

150 "So that lawyers and clients will know in advance what communications will and will not be protected, and can conform their conduct accordingly, courts have endeavored to draw the lines with some clarity. Of course, it is impossible to achieve absolute certainty. At the margins, the application of the privilege is not always clear, and indeed, treatises can and have been written on the privilege, its exceptions, its intricacies, and its areas of ambiguity. Further uncertainty results from the fact that the relevant case decisions (and, in some states, statutes) differ from jurisdiction to jurisdiction. With respect to federal proceedings, Congress has not codified the attorney-client privilege but has authorized ongoing common law development of this and other privileges. Pursuant to its authority under the Federal Rules of Evidence, the Supreme Court of the United States has consistently recognized and upheld the privilege. But the Supreme Court has resolved only a limited number of questions concerning the boundaries of the privilege, and on the remaining questions, different districts and circuits – and even different judges within a given federal

The attorney-client privilege protects communications of legal advice made (and kept) between attorneys and clients, including communications between corporate employees and a corporation's attorneys to promote the flow of information between clients and their attorneys.[151] Although the attorney-client privilege does not require ongoing or threatened litigation, it covers only "communications" between the lawyer and his client for the purposes of legal assistance.[152]

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

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

Derivative Actions. There is an issue as to whether a shareholder or a partner may compel disclosure of matters protected by the attorney-client privilege on the theory that he is the "client" or at least a "representative of the client." The leading shareholder case on this issue is *Garner v. Wolfinbarger*.[153] In that case, the Fifth Circuit concluded that a shareholder maintaining a derivative action may have access to matters protected by the attorney-client privileged if he can show "good cause." The court set forth the circumstances by which good cause is to be judged, which include such factors as, the number of shareholders involved, the percentage of ownership they represent, the nature of the claim being made and the allegations made against the corporate officers, and similar concerns.[154] The *Garner* doctrine has been followed by some courts,[155] but has been rejected as unnecessary by other courts, especially in

---

district – may take different approaches." *Report of ABA's Task Force on the Attorney-Client Privilege*, 60 Bus. Lawyer 1029, 1033 (May 2005).

151 *Upjohn*, 449 U.S. at 389–391.

152 *Id.*

153 430 F.2d 1093 (5th Cir. 1970), *cert. denied*, 401 U.S. 974 (1971).

154 *Id.* at 1103-04.

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

light of the other exceptions to the attorney-client privilege, most notably the crime/fraud exception.[156] Further, the Garner exception is only applicable to the attorney-client privilege and will not result in discovery if the item is also protected by the work product doctrine.[157] In the partnership context, the courts have consistently held that the attorney-client privilege may not be used to deny a partner the right to inspect partnership records.[158]

---

divergence must necessarily occur when the parties can reasonably anticipate litigation over a particular action"; "there is no *Garner* exception to the work product privilege"); *Deutsch v. Cogan*, 580 A.2d 100, 108 (Del. Ch. 1990) ("A fiduciary owes an obligation to his beneficiaries to go about his duties without obscuring reasons from the legitimate inquiries of the beneficiaries"); *cf. Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 348 (1985).

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

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

158 The courts that have considered the question whether a general partner may shield documents from its limited partner have consistently held that it cannot. *See Roberts v. Heim*, 123 F.R.D. 614, 625 (N.D. Cal. 1988) (limited partners of a partnership sued the partnership's general partners and its law firm to compel production of certain documents the defendants claimed were privileged; rejecting the defendant's argument that, for purposes of the attorney-client privilege, the law firm's clients were the general partners, the court held that the limited partners were clients of the law firm and were entitled to inspect all of the partnership's records, including the documents generated by and sent to the partnership's attorneys); *McCain v. Phoenix Resources, Inc.*, 230 Cal. Rptr. 25, 26-28 (Cal. Ct. App. 1986) (court concluded that "a limited partner has the right to inspect all documents and papers affecting the partnership, including those held by the partnership's attorney;" while recognizing that the attorney-client privilege could be asserted as to records relating to the "purely private or personal interest" of one of the partners, the court held the privilege would not bar disclosure of matters related to a partnership business "simply because such business was conducted through a law firm"); *Wortham & Van Liew v. Superior Court*, 233 Cal. Rptr. 725, 728 (Cal. Ct. App. 1987) (the court framed the issue as whether "the attorney for the partnership [could] withhold from a partner important information received from another partner concerning partnership transactions claiming the information is confidential under the attorney-client privilege," held that "[a]ll partners are entitled to access to a wide range of partnership information, whether or not that information is generated under the aegis of the partnership's attorney," and ordered the attorney to "divulge all partnership information to all partners"); *Abbott v. The Equity Group*, 1988 WL 86826 (E.D. La. 1988) ("We begin by stating that a member of a partnership is entitled to disclosure of communications to and from an attorney representing the partnership in connection with partnership matters. Because of the relationship existing between partners in the creation of a partnership, which we view as stronger than that existing between stockholder and corporation, we conclude that the bar preventing disclosure of attorney communications, as between partners, is not simply relaxed, but non-existent. Partners therefore need not establish "cause" to discover privileged communications of an attorney in matters in which the partnership, of which they are members, is the client"); *Adell v. Somers*, 428 N.W.2d 26, 29 (Mich. App. 1988) (limited partner is "client" of partnership's law firm and has standing to assert malpractice claim against attorney); *Bronson v. Superior Court*, 29 Cal. Rptr. 2d 268, 280 (Cal. Ct. App. 1994) (because of mere "potential presence of implied attorney-client duties," limited partner is entitled to production of documents concerning partnership business over privilege objection); *but see Continental Ins. Co. v. Rutledge & Co., Inc.*, 1999 WL 66528 (not reported in A.2nd) (Del. Ch. Jan. 26, 1999) (in dispute between general and limited partners over whether limited partners had right to withdraw from partnership pursuant to partnership agreement, limited partners sought to compel production by general partner of documents containing legal advice regarding the formation and internal affairs of the partnership; the Delaware Chancery Court found an absence of Delaware precedent and followed the Fifth Circuit's corporate derivative action holding in

Legal Advice Purpose. At the heart of the attorney-client privilege is the notion that communications are privileged in order to facilitate the delivery of legal advice. The privilege necessarily has encompassed communications that actually constitute legal advice as well as communications made for the purpose of seeking, obtaining or facilitating the rendition of legal advice. But the privilege does not protect all communications to or from an attorney,[159] and does not prevent disclosure of the underlying facts.[160] Accordingly, sending copies of documents to an attorney or including an attorney in a meeting will not automatically trigger the privilege.[161] It is only where the attorney is acting in his capacity as an attorney, that is, as a legal adviser, that the privilege is applicable.[162]

In many circumstances, especially for inside counsel, the determination of whether an attorney is acting in his capacity as a legal adviser, or in some other role, will be difficult.[163] The difficulty may be increased when the attorney (whether inside or outside counsel) also serves as an officer[164] or director[165] of the corporation, because business advice is not privileged.

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

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

160 *Upjohn v. United States*, 449 U.S. 383, 396 (1981) (client cannot "refuse to disclose any relevant fact within his knowledge merely because he incorporated a statement of such fact into his communication to his attorney"); *In re Six Grand Jury Witnesses*, 979 F.2d 939, 944 (2d Cir. 1992) (communications between attorney and client regarding internal investigation into alleged fraud against government held privileged, but factual information contained in written communications between them, including results of investigation, were not privileged from discovery).

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

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

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

164 *See Desert Orchid Partners LLC v. Transaction System Architects, Inc.*, 2006 WL 1401683 (D. Nebraska May 17, 2006) (redacted portion of audit committee minutes held privileged based on attorney's affidavit that the redacted portion related to matters on which the audit committee "sought legal advice, which he gave regarding the proper course of action to take about . . . audit committee activities" even though he was

No bright-line tests have been developed for determining whether the attorney is acting as a legal advisor.[166] Most courts have stated that, for a communication to be privileged, the

---

secretary and unredacted portions of the minutes related to unprivileged discussions of business transactions).

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

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

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

1. Reasonably assure that management and the board of directors understand (i) the different responsibilities of legal counsel and director; (ii) that when acting as legal counsel, the lawyer represents only the corporate entity and not its individual officers and directors; and (iii) that at times conflicts of interest may arise under the rules governing lawyers' conduct that may cause the lawyer to recuse herself as a director or to recommend engaging other independent counsel to represent the corporation in the matter, or to serve as co-counsel with the lawyer or her firm.

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

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

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

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

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

ABA Comm. On Ethics and Prof'l Responsibility, Formal Op. 98-410 (1998). *See* Micalyn S. Harris and Karen L. Valihura, *Outside Counsel as Director: The Pros and Potential Pitfalls of Dual Service*, 53 BUS. LAW. 479, 483–89 (Feb. 1998).

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

lawyer must be acting "primarily" or "predominantly" as a lawyer,[167] although business advice may be intermingled with the legal advice and still be privileged.[168] One court defined "primarily legal" as requiring a showing that the communication "would not have been made but for the corporation's need for legal advice or services."[169] Another court has stated that the "critical inquiry is whether, viewing the lawyer's communication in its full content and context, it was made in order to render legal advice or services to the client."[170] By contrast, another court has held that legal advice may not be privileged if it is only incidental to business advice.[171]

Attorneys and clients recognize that statements made by an attorney to his client's adversary in a negotiation are not privileged, but would expect that private communications between attorney and client in respect of the negotiation would be privileged. Many courts, however, have held that a lawyer conducting negotiations is not acting in a legal capacity and his communications and advice to his client, therefore, are not privileged.[172] Undoubtedly, the notion that a negotiating lawyer is not acting in a legal capacity is surprising and alarming to all lawyers, not just to corporate counsel. The courts that have so held generally base their decision on the idea that the negotiation involves business judgment, not legal judgment. Fortunately, some courts have been more painstaking in their analysis and have concluded that the negotiation did, in fact, involve a preponderance of legally significant issues, and therefore, was a privileged act.[173] This idea is often referred to as "predominant purpose" test.[174] Unfortunately, there are

---

communications and the communications concerned bare facts, but that the privilege would apply to communications with the attorney concerning legal strategy, assessments and conclusions.

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

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

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

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

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

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

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

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

no bright line rules to identify the precise degree of legal advice necessary to satisfy the predominant purpose test.

Internal Investigations. Most courts agree in principle that an investigation conducted by counsel for the purpose of rendering legal advice is privileged.[175] Generally speaking, though, the fact that a lawyer is involved in an investigation does not, standing alone, render the privilege applicable.[176] However, determining whether an investigation is conducted for that purpose, or some other, can be difficult.

There are a number of cases involving the application of the attorney-client privilege[177] to investigations conducted by counsel. In *Upjohn*, the privilege was held applicable when the investigation was conducted by "counsel for Upjohn acting as such, at the direction of corporate superiors in order to secure legal advice from counsel."[178] The Supreme Court quoted from the findings of the magistrate, who found:

> "[Counsel] consulted with the Chairman of the Board and outside counsel and thereafter conducted a factual investigation to determine the nature and extent of the questionable payments *and to be in a position to give legal advice to the company with respect to the payments*."[179]

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

176 *See Seibu Corp. v. KPMG LLP*, 2002 U.S. Dist. LEXIS 906 at *9-10 (N.D. Tex. 2002) (the "critical inquiry is whether … any particular communication in connection with [the] investigation facilitated the rendition of legal advice to the client"); *Wells Fargo Bank v. Superior Court*, 22 Cal. 4th 201, 210 (2000) ("[A] client may be examined at deposition or at trial as to facts of the case, whether or not he has communicated them to his attorney").

177 Other privileges, more appropriate to rely upon, are often implicated, but are not discussed here. These might include the work product doctrine and the party communication privilege. There is no general "privilege of self-critical analysis" applicable to compliance manuals, internal audit findings, outside accountants' reports, management letters, and an outside accounting firm's review of internal controls and compliance. *See Dowling v. American Hawaii Cruises, Inc.*, 971 F.2d 423, 425-26 (9th Cir. 1992) (no protection for routine internal safety reviews prior to the accident); Note, *The Privilege of Self-Critical Analysis*, 96 HARV. L.R. 1083 (1983). *But see In re Crazy Eddie Securities Litigation*, 792 F. Supp. 197, 205-06 (E.D.N.Y. 1992) (accounting firm's internal review of its audit, peer review report and letter of comments on internal quality controls protected). The Texas Legislature has recognized the value of critical self evaluation in certain areas when it adopted the Environmental, Health, and Safety Audit Privilege Act which appears at Tex. Rev. Civ. Stat. Ann. art. 4447cc (Vernon 1998); other states have similar statutes but the Environmental Protection Agency does not recognize the privilege. *See* Egan, *Miscellaneous Updates--"Ten Other Laws You Should Know About",* State Bar of Texas Professional Development Legislative Update Institute (Sept. 1995).

178 *Upjohn Co. v. United States*, 449 U.S. 383, 394 (1981).

179 *Id.* (emphasis in original).

By contrast, the court in *Mission Nat'l Ins. Co. v. Lilly*[180] found the results of an investigation conducted by outside counsel not privileged. There, the outside lawyers were hired by an insurance company "as a matter of course to conduct its claims adjustment investigations in a geographic area including Minnesota for all claims exceeding $25,000."[181] Thus, the court concluded that the lawyers were simply performing the business function of claims investigation, as opposed to any legal function.[182]

The touchstone of an investigation that constitutes an attorney-client privileged exercise seems to be the attorney's role as legal adviser. Where the investigation truly can be shown to have been conducted for the purpose of collecting the data necessary to render legal advice, then communications made during the investigation will be deemed privileged.[183] On the other hand, when a lawyer is used merely in the hope that the investigation will be privileged, most courts will not so find.[184] The safest practice is to document the reason for conducting the investigation, and include in all written communications some prefatory notation regarding the purpose for the communication along with the requirement that it be kept confidential.[185]

While an internal investigation conducted by counsel may be privileged, there are pressures by auditors to give them access to privileged materials developed during the investigation.[186] The materials sought by the auditors may include privileged materials such as the investigating counsel's notes of interviews, legal assessments and advice to the client, as well as factual information such as documents received and transcripts of interviews which may not

---

[180] 112 F.R.D. 160 (D. Minn. 1986).

[181] *Id.* at 162.

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

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

[184] *But see Diversified Indus., Inc. v. Meredith*, 572 F.2d 596 (8th Cir. 1977), *rev'd on reh'g en banc*, 572 F.2d 609 (8th Cir. 1978) (finding that use of an attorney is prima facie evidence of privilege).

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

[186] Report to the ABA House of Delegates, ABA Task Force on the Attorney-Client Privilege (June 14, 2006).

be protected.[187] The auditors pressure may be attributed in part due to their obligations under 1934 Act § 10A[188] and the potential relevance to the issuer's internal controls.[189]

The U.S. Department of Justice (*"DOJ"*), the SEC and other federal and state governmental agencies are increasingly asking issuers under investigation to produce privileged materials, including materials developed in connection with internal investigations conducted by counsel, in order to show cooperation with the government in an effort to discourage prosecutorial or enforcement actions. This practice is supported by then Deputy Attorney General Larry Thompson's January 20, 2003 memorandum (the *"Thompson Memorandum"*) to the DOJ addressing the "Principles of Federal Prosecution of Business Organizations."[190] The Thompson Memorandum identified nine factors that federal prosecutors should utilize in making their charging decisions regarding corporations or other business entities, including the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary the waiver of corporate attorney-client and work product protection.

As a practical matter, corporations rarely can resist prosecutorial requests for disclosure, because of the harsh consequences of having to defend against criminal charges, and because, in cases where criminal charges are brought and sustained, corporations depend on the leniency in sentencing that results from providing assistance satisfactory to the prosecution, which was reinforced by the November 1, 2004 amendments to the Commentary for Chapter 8, Section 8C2.5 of the Guidelines, to qualify for a reduction in its sentence for providing assistance to the government investigation, a corporation would be required to waive confidentiality protections if "such waiver is necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization.[191]

---

187 *Id*. at V.

188 *See supra* part I. Pressure on Auditors to Detect Corporate Fraud – GAAS – Accountant Duties Under 1934 Act Section 10A.

189 Report to the ABA House of Delegates, ABA Task Force on the Attorney-Client Privilege (June 14, 2006) at 10.

190 Memorandum from Deputy Attorney General Larry Thompson to Heads of Department Components and U.S. Attorneys, Principles of Federal Prosecution of Business Organizations (Jan. 20, 2003) (available at http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm). The Thompson Memorandum expanded and revised previous policies of the DOJ that were established in a memorandum drafted by former Deputy Attorney General Eric Holder. Memorandum from Deputy Attorney General Eric Holder to Head of Department Components and U.S. Attorneys, Bringing Criminal Charges Against Corporations (June 16, 1999), reprinted in Justice Department Guidance on Prosecution of Corporations, in 66 CRIM. L. REP. (BNA) 189 (1999) (available at http://www.usdoj.gov/criminal/fraud/policy/Chargingcorps.html).

191 U.S. SENTENCING GUIDELINES MANUAL § 8C2.5 (2004) (emphasis added) (available at http://www.ussc.gov/2004guid/8c2_5.htm); Report to the ABA House of Delegates, ABA Task Force on the Attorney-Client Privilege (June 14, 2006) at 15.

The SEC and other regulators have adopted policies and practices mirroring those of the Thompson Memorandum, which while discussing "cooperation credit," mention disclosures of protected confidential information.[192]

Turning over privileged materials from an internal investigation may result in a waiver of the privilege,[193] at least for the materials furnished.[194]

Generally Unprivileged Items. Consistent with the idea that the communication must be for the purpose of rendering or facilitating legal advice, various types of information relating to the attorney-client relationship or otherwise in the possession or knowledge of the attorney are not considered privileged. These include the identity of the client,[195] fee arrangements,[196] factual circumstances surrounding the communication,[197] and billing statements.[198]

Waiver. The privileged nature of an attorney-client communication must be preserved by not voluntarily disclosing the privileged communication to third parties[199] or injecting it as an

---

192 *Id.* at 16-17; Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exch. Act Rel. No. 44969 (Oct. 23, 2001).

193 *In re Qwest Communications International Inc. Securities Litigation*, 450 F.3d 1179 (10th Cir. 2006) (Qwest Communications International Inc.'s voluntary disclosure of sensitive documents to the DOJ and SEC waived the attorney-client privilege and work product protection as to third parties who seek the documents in civil litigation against the company; surveying case law from other circuits and weighing policy arguments, the court found no basis for embracing the concept of "selective waiver" in this case and that the company's confidentiality agreements with the agencies did little to prevent further dissemination of the privileged materials). *See infra* Waiver.

194 *See infra* Scope of Waiver and part V. Attorney Letters to Auditors – Discoverability of Audit Response Letters.

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

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

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

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

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

issue in litigation.[200] The privilege belongs to the client, and only may be waived by the client or by the attorney as agent for the client.[201]

Compelled disclosure does not constitute a waiver.[202] Governmental authorities are increasingly putting pressure on corporations to "voluntarily" provide privileged information to them in order to show the cooperation with their investigations and thereby receive less harsh treatment.[203]

---

200 *See McIntyre v. Main St. & Main Inc.*, 2000 U.S. Dist. LEXIS 19617 at 9 (N.D. Cal. 2000) ("Plaintiffs are correct that defendant cannot rely on the investigation by outside counsel as part of its defense, while at the same time shielding the investigation from discovery. Any use of the investigation in its defense would waive the privilege."); *Wellpoint Health Networks v. Superior Court*, 59 Cal. App. 4th 110 (1997) (employer was not entitled to engage an attorney to conduct an investigation, cite the investigation as a defense, and then selectively produce only those portions of the investigation file that it deemed not to be privileged).

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

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

203 Memorandum from Deputy Attorney General Larry Thompson to Heads of Department Components and U.S. Attorneys, *Principles of Federal Prosecution of Business Organizations* (Jan. 20, 2003) (*available at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm) (identified nine factors that federal prosecutors should utilize in making their charging decisions regarding corporations or other business entities, including the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, *including, if necessary, the waiver of corporate attorney-client and work product protection*); U.S. SENTENCING GUIDELINES MANUAL § 8C2.5 (2004) (emphasis added) (*available at* http://www.ussc.gov/2004guid/8c2_5.htm) (to qualify for a reduction in its sentence for providing assistance to the government investigation, a corporation may be required to waive confidentiality protections if "such waiver is necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization"); Report of Investigation Pursuant to Section 21(a) of the 1934 Act and SEC Statement on the Relationship of Cooperation to Agency Enforcement Decisions, 1934 Act Rel. No. 44969 (Oct. 23, 2001) (available at http://www.sec.gov/litigation/investreport/34-44969.htm) (the "*Seabord Report*") (in determining whether to initiate SEC enforcement proceedings, the SEC considers the seriousness of the conduct; whether the company had "cooperate[d] completely with appropriate regulatory and law enforcement bodies"; whether the company had conducted "a thorough review of the nature, extent, origins and consequences of the conduct and related behavior"; whether the company "promptly [made] available to [SEC] staff the result of its review and provide[d] sufficient documentation reflecting its response to the situation"; whether "the company identif[ied] possible violative conduct with sufficient precision to facilitate prompt enforcement actions against those who violated the law"; whether "the company produce[d] a thorough and probing written report detailing the findings of its review"; and whether "the company voluntarily disclose[d] information [SEC] staff did not directly request and otherwise might not have uncovered." *Report of ABA's Task Force on the Attorney-Client Privilege*, 60 Bus. Lawyer 1029, 1043-52 (May 2005) (discussing these recent governmental policies, practices and procedures, and the implications thereof to the attorney-client privilege and the public policies underlying it). *See* William W. Horton, "*A Transactional Lawyer's Perspective on the Attorney-Client Privilege: A Jeremiad for Upjohn*," 61 Bus. Law. 95 (Nov. 2005) (officers and employees of corporations need confidence that attorney-client privilege will protect the confidence of their communications with their counsel (both inside and outside) so that they will provide counsel with the candid information needed to keep the corporation out of trouble) and Molly McDonough, *Justice Memo Stirs Up Another Storm – NY*

No Waiver Where Common Interest. Voluntary disclosure of a privileged communication to a person with a common interest does not constitute waiver.[204] Thus, communications between a lawyer for a parent corporation and an employee of a wholly-owned subsidiary usually are considered privileged.[205] Similarly, multiple clients represented by the same attorney may talk freely with their attorney without fear that the presence of more than one client will constitute a waiver as to third parties.[206]

Disclosure to lawyers or clients in a joint defense situation also does not create waiver.[207] In the event the clients in the joint defense arrangement later become adverse to each other, their

---

Judge Asks Whether Prosecutors Pressed Firm to Cut Off Legal Fees, ABA Journal eReport (April 28, 2006), available at http://www.abanet.org/journal/ereport/a28thomson.html.

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

205 *See In re Grand Jury Subpoenas, 89-3 and 89-4*, *John Doe* 89-129, 902 F.2d 244 (4th Cir. 1990); *Admiral Ins. Co. v. U.S. Dist. Court*, 881 F.2d 1486 (9th Cir. 1989); *Bowne of New York City, Inc. v. AmBase Corp.*, 150 F.R.D. 465 (S.D.N.Y. 1993).

206 *See In re Grand Jury Proceedings (Auclair)*, 961 F.2d 65 (5th Cir. 1992).

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

Federal circuit courts and state courts diverge in their interpretation and application of the common interest and joint defendant doctrine. *United States v. Weissman*, No. S1 94 CR. 760 CSH, 1996 WL 737042, at *7 (S.D.N.Y. Dec. 26, 1996). In the most expansive application of the common interest doctrine, courts exclude a waiver of the attorney-client privilege when there is a common interest between the disclosing party and the receiving party, and parties have a reasonable expectation of litigation concerning their common interest. *See Hewlett-Packard Co. v. Bausch & Lomb*, 115 F.R.D. 308, 309 (N.D.Cal. 1987). More restrictive courts require that the parties share an identical legal, as opposed to purely commercial, interest. *See Duplan Corp. v. Deering Milliken*, 397 F. Supp. 1146, 1172 (D.S.C. 1974). Finally, some courts persist in rejecting the common interest theory absent actual or pending litigation in which both parties are or will be joint defendants. See *Int'l Ins. v. Newmont Mining Corp.*, 800 F.Supp. 1195, 1196 (S.D.N.Y. 1992).

Although there is no uniform test for application of the common interest doctrine, courts have consistently examined three elements when applying the doctrine: (1) whether the confidentiality of the privileged information is preserved despite disclosure; (2) whether, at the time that the disclosures were made, the

communications which were privileged as to third parties are not privileged in the controversy between them.[208] As a consequence, attorneys whose clients are entering into a joint defense arrangement and sharing otherwise privileged information have an ethical duty to advise their clients of this risk of privilege loss.

Issue Injection. Another means of waiver is through offensive use, sometimes also called issue injection. The rule is simple, although sometimes difficult to implement. A client may not make an affirmative claim for relief, assert privilege as to an outcome determinative matter, and deny the adverse party its only means of discovering the information.[209] The key to this test is whether the privileged matter is outcome determinative. If so, the client is given the choice of disclosing the privileged information or abandoning his claim.[210]

Clients may assert a defense based on their good faith belief that their actions were in conformity with applicable laws. Often the good faith can be shown only by showing that the action was in reliance on advice of counsel. Once the client opens the issue of the advice received by selectively revealing any of the advice it received, the client risks placing at issue, and waives the privilege as to, all steps it took to comply with the law at issue.[211] Such a waiver

---

parties were joint defendants in litigation or reasonably anticipated litigation; and (3) whether the legal interests of the parties are identical or at least closely aligned at the time of disclosure. *See, e.g. U.S. v. Gulf Oil Corp.*, 760 F.2d 292, 296 (Temp. Emer. Ct. App. 1985).

The core requirement of the common interest doctrine is the existence of a shared legal interest. Courts will have less difficulty in finding an exception to a waiver when the parties actively pursue common legal goals. *See U.S. v. Schwimmer*, 892 F.2d 237, 244 (2nd Cir. 1989). An asset purchase agreement in which the buyer does not assume the litigation liability of the seller does not demonstrate an alignment of the parties' interests. A common business enterprise, such as the sale of assets, or a potential merger, will not suffice unless the parties' legal interests are at least parallel and non-adverse. *Jedwab v. MGM Grand Hotels, Inc.*, No. 8077, 1986 WL 3426, at * 2 (Del. Ch. Mar. 20, 1986). Disclosures by a corporation and its counsel to the corporation's investment banking firm during merger discussions have resulted in a waiver of the attorney-client privilege because the common interest rule did not apply. *See Blanchard v. EdgeMark Financial Corp.*, 192 F.R.D. 233 (N.D. Ill. 2000). The court said the common-interest rule protects from disclosure those communications between one party and an attorney for another party "where a joint defense effort or strategy has been decided upon and undertaken by the parties and their respective counsel," noting that the common interest must be a legal one, not commercial or financial. *Id*. at 237. The court concluded, however, that the common interest rule did not apply because the defendants did not demonstrate that the investment banking firm's legal interest in the threatened litigation was anything more than peripheral. *Id*. at 237.

[208] *See Garner v. Wolfinbarger*, 430 F.2d 1093, 1103 (5th Cir. 1970) ("In many situations in which the same attorney acts for two or more parties having a common interest, neither party may exercise the privilege in a subsequent controversy with the other. This is true even where the attorney acts jointly for two or more persons having no formalized business arrangement between them.").

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

[210] *Cf. Texas Dept. of Pub. Safety Officers Ass'n v. Denton*, 897 S.W.2d 757, 760 (Tex. 1995) (involving offensive use of Fifth Amendment privilege).

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

can result in both the client and the attorney being compelled to submit to deposition and testimony at trial.[212]

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

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

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

But see In re Carbo Ceramics, Inc., 81 S.W.3d. 369, 378-379 (Tex. App.—Houston [14th Dist.] 2002, no pet.) ("Texas courts apply the offensive use doctrine when the advice of counsel defense is raised. [Citations omitted]. The offensive use doctrine applies when a party seeking affirmative relief attempts to claim a privilege to shield evidence that would materially weaken or defeat that party's claims. [Citation omitted]. 'A plaintiff cannot use one hand to seek affirmative relief in court and with the other lower an iron curtain of silence against otherwise pertinent and proper questions which may have a bearing upon his right to maintain his action.'….Texas courts define affirmative relief narrowly for the purpose of determining whether offensive use commands the waiver of privilege.").

212 *See Excel*, *supra*, 197 F.3rd at 208-210:

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

* * *

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

* * *

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

The scope of waiver is broad. It is generally considered to be permanent, that is, the privilege cannot be reclaimed in another circumstance or proceeding.[213] Furthermore, the waiver may extend not only to the document or communication specifically disclosed, or to which the privilege was waived, but to all communications on the "**subject matter**."[214]

In *In re Grand Jury Proceedings*,[215] the Court addressed the issue of whether a corporate officer inadvertently waived attorney-client privilege *to the entire **subject matter** of communications with their lawyer about a particular matter* when they disclosed *certain portions* of the attorney's advice to a government agent. In making their determination, the court allowed discovery of certain information, disallowed discovery of other information, and specifically instructed the lower court to conduct further proceedings in order to determine what other information came within the "subject matter" of the information disclosed:

> [T]wo government investigators met with [a company's] owner and president. Shortly after the meeting began, the owner and president informed the agents that they had met with a Washington, D.C. attorney who specializes in Medicare law, and they told the investigators the attorney's name. They told the agents that they brought their twenty-four point marketing plan to the attorney and that they described the various elements of the plan to her in detail.
>
> * * *
>
> The owner and president told the investigators that their attorney was concerned that providing free Sharps needle disposal containers could constitute an illegal inducement or kickback. But, the president noted, the attorney had no problem

---

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

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

214 8 J. WIGMORE, EVIDENCE § 2328, at 638 (McNaughton rev. ed. 1961). *See also United States v. Davis*, 636 F.2d 1028, 1043 n. 18 (5th Cir.), *cert. denied*, 454 U.S. 862 (1981); *Zielinski v. Clorox Co.*, 504 S.E.2d 683 (Ga. 1998) (the court held that attorney-client privilege was waived as to the subject matter of certain documents turned over to the district attorney's office as part of an ongoing embezzlement investigation).

215 78 F.3d 251 (6th Cir. 1996).

with the laboratory billing Medicare for tests done by nursing home personnel or with providing nursing homes free glucose testers and lancets. When asked by the agents about the apparent inconsistency between the lawyer's advice regarding free Sharps disposal containers and free glucose testers, the president responded, "That's the advice I had of the attorney at the time."

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

* * *

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

* * *

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

* * *

[T]he government may ask questions that clearly pertain to the subject matter of the specific points on which a waiver did occur. *The District Court will have to decide whether the remaining points in the marketing plan are truly the same subject matter as those in the specific marketing plan points on which there was a waiver and approve or disallow questions on that basis.*[216]

---

216 *Id.* [emphasis added]

While *In re Grand Jury Proceedings* adopts the subject matter test, only one court has given much guidance in determining what is and what is not in the same subject matter when disclosure of some privileged communications has taken place. In a series of opinions arising from the case styled *U.S. v. Skeddle*,[217] a U.S. District Court in Ohio addressed the scope of a corporation's waiver to its claim of attorney-client privilege. The case arose in the context of a criminal charge of wire and mail fraud against former employees of Libbey Owens Ford Co. ("LOF") arising out of their allegedly improper self-dealing transactions with LOF. LOF's general counsel became suspicious of defendants' activities and began an internal investigation which led to LOF commencing civil litigation against the criminal defendants and others. In connection with the general counsel's trial testimony in the criminal case, LOF agreed to waive its attorney-client privilege as to communications between the general counsel and LOF management prior to his discovery of the allegedly fraudulent activities, but refused to waive the privilege as to communications related to its internal investigation and litigation against defendants.[218] The general counsel then testified at the criminal trial of the former LOF employees regarding conversations he had with other LOF officials as to which LOF had expressly waived its attorney-client privilege. The defendants claimed that this testimony waived the corporation's attorney-client privilege as to the entire contents of the investigative file.[219]

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

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

---

217 989 F.Supp. 905, 989 F.Supp. 913, 989 F.Supp. 917 (N.D. Ohio 1997).

218 989 F.Supp. at 908.

219 989 F.Supp. at 919.

same time, upholding the privilege and preserving the interests it protects form excessive exposure.

> Despite the centrality of the term, "same subject matter," to this inquiry, courts have not defined its meaning and content precisely. Aside from a general instruction to construe "same subject matter" narrowly, . . . no guidance has been given about how a trial court is to determine what is and what is not within the same subject matter when disclosure of some privileged communications has taken place.
>
> Among the factors which appear to be pertinent in determining whether disclosed and undisclosed communications relate to the same subject matter are: 1) the general nature of the lawyer's assignment; 2) the extent to which the lawyer's activities in fulfilling that assignment are undifferentiated and unitary or are distinct and severable; 3) the extent to which the disclosed and undisclosed communications share, or do not share, a common nexus with a distinct activity; 4) the circumstances in and purposes for which disclosure originally was made; 5) the circumstances in and purposes for which further disclosure is sought; 6) the risks to the interests protected by the privilege if further disclosure were to occur; and 7) the prejudice which might result if disclosure were not to occur. By applying these factors, and such other factors as may appear appropriate, a court may be able to comply with the mandate that it construe "same subject matter" narrowly while accommodating fundamental fairness.[220]

The *Skeddle* court then applied these factors to the specifics of the general counsel's testimony. While the general counsel did testify regarding telephone conversations and meetings with certain corporate officers and other facts acquired during the general counsel's investigation into the scheme, the court concluded that the subject of the general counsel's limited testimony could not be found to cover the entire investigative file of the corporation, finding that the testimony referred to only a small portion of the general counsel's activities for the corporation, activities consisting of distinct and severable activities, all self-contained and unitary in focus.[221] The court further stated that the testimony did not have a common nexus with every other attorney-client communication in the corporation's investigative file, and that to use the limited, factual disclosures as a bootstrap to discover the entire investigative file would run counter to the principles underlying the narrow waiver of the attorney-client privilege.[222]

The *Skeddle* court even found that the disclosure of documents which made references to discussions that were otherwise privileged did not waive privilege as to those discussions, finding that the referenced discussions related to a subject distinct from the subject of the

---

[220] 989 F.Supp. at 908-9.

[221] *Id.* at 920.

[222] *Id.*

documents disclosed.[223] The court noted the jeopardy in which privileged documents would be placed if partial disclosure waived privilege as to the entire matter, stating:

> "If . . . disclosure of the notes exposed every otherwise privileged communication as to the matters referenced . . . , the privilege would be withdrawn from dozens, if not hundreds of communications as to which all participants had expected confidentiality. Interests protected by the privilege would be placed in great jeopardy if the subject matter of the . . . notes were deemed to be every topic mentioned in those notes."[224]

One document addressed in this opinion is of particular relevance. A letter from the corporation's outside counsel to an attorney for liability insurers of corporate directors and officers, which set forth the corporation's basis for an insurance claim arising from the defendants' alleged misconduct, was disclosed at trial.[225] While the letter itself was found not privileged, the court found privileged the communications which underlay the conclusions of the letter because allowing such disclosure would undermine substantially, if not completely, the purpose of the attorney-client privilege.[226] The court stated that, "requiring such disclosure would permit discovery of underlying privileged communications whenever an attorney states an opinion based on such communications. Such broad waiver runs counter to the protection generally afforded to attorney-client relationship."[227]

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

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

---

[223] 989 F. Supp. at 911. A close examination of this series of opinions illustrate the court's effort to find the undisclosed statements privileged. For example, relating to one particular document, the court found that the subject matter of the document was the author's understanding of the significance of certain events rather than being the subject matter of the events themselves. *See In re Carbo Ceramics, Inc.,* 81 S.W 3rd. 369, 378-379 (Tex. App.—Houston [14th Dist.] 2002) in which the court focused on particular documents as to which the privilege was waived and rejected claims that all other documents on a privilege log lost their privilege as a result of a waiver as to other documents.

[224] *Id.*

[225] *Id.*

[226] *Id*. at 911-912.

[227] *Id*. at 912.

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

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

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

> (1) *Furtherance of Crime or Fraud.* If the services of the lawyer were sought or obtained to enable or aid anyone to commit or further continuing or future criminal or fraudulent activity, as contrasted with advice regarding prior wrong doing.[228]
>
> (2) *Claimants Through Same Deceased Client*. As to a communication relevant to an issue between parties who claim through the same deceased client, regardless of whether the claims are by testate or intestate succession or by *inter vivos* transactions;
>
> (3) *Breach of Duty by a Lawyer or Client*. As to a communication relevant to an issue of breach of duty by a lawyer to the client or by a client to the lawyer;
>
> (4) *Document Attested by a Lawyer*. As to a communication relevant to an issue concerning an attested document to which the lawyer is an attesting witness; or
>
> (5) *Joint Clients*. As to a communication relevant to a matter of common interest between or among two or more clients if the communication was made by any of them to a lawyer retained or consulted in common, when offered in an action between or among any of the clients.[229]

In contrast to other aspects of the attorney-client privilege, the exceptions are relatively straightforward and have yielded remarkably little litigation. Of the five, the crime/fraud exception has resulted in the most controversy in terms of its applicability. The U.S. Supreme Court has explained that the "privilege takes flight if the relation is abused. A client who

---

[228] *In re Grand Jury Subpoena*, 419 F.3d 329 (5th Cir. 2005) (crime-fraud exception does not extend to all communications made in the course of the attorney-client relationship, but rather is limited to those communications and documents in furtherance of the contemplated or ongoing criminal or fraudulent conduct and does not apply to advice regarding prior wrongful acts).

[229] TEX. R. EVID. 503(d).

consults an attorney for advice that will serve him in the commission of a fraud will have no help from the law. He must let the truth be told."[230]

Some plaintiffs have tried to pierce the attorney-client privilege by simply asserting a fraud cause of action and then arguing that the crime/fraud exception applies to all legal advice the adverse party received. This tactic has been rejected, with courts holding that the plaintiff must first prove a prima facie case of fraud and then show that the attorney-client communication was in furtherance of the fraud in order to commit the fraud.[231] Key to the application of the crime/fraud exception is the timing of the communication. In order for the exception to apply, it is usually necessary for the communication to have been made in contemplation of the fraud[232] and either before or during the commission of the fraud.[233] Recently, several courts have applied the exception in situations where the attorney's advice was alleged to have assisted in covering up the fraud.[234]

Work Product Doctrine. The work product privilege[235] is a common law doctrine now codified in the federal and state rules of civil procedure that protects the privacy of an attorney's trial preparations, and may protect an attorney's work product from discovery by opposing counsel where the attorney-client privilege is not available. Generally, the work product privilege only protects from unwarranted disclosure materials prepared by an attorney, or under an attorney's direction, "in anticipation of litigation or for trial."[236] Therefore, in absence of any

---

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

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

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

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

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

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

236 *See* Fed. R. Civ. P. 26(b)(3); Tex. R. Civ. P. 192.5(a)(1).

anticipated or pending litigation,[237] documents prepared for the purposes of a specific business transaction are not protected by the work product doctrine.[238]

The work product doctrine was first recognized by the U. S. Supreme Court in *Hickman v. Taylor*[239] wherein, finding no existing privilege that applied, the Court created a new common law privilege for what it termed the "work product of the lawyer," consisting of interviews, memoranda, briefs and other materials prepared "with an eye toward litigation."[240] The Court justified the privilege as follows:

> Proper preparation of a client's case demands that [the attorney] assemble information, sift what he considers to be the relevant from the irrelevant facts, prepare his legal theories and plan his strategy without undue and needless interference. That is the historical and the necessary way in which lawyers act within the framework of our system of jurisprudence to promote justice and to protect their clients' interests.[241]

The Court indicated that the privilege could be overcome as to factual information otherwise unavailable to the opposing party, but not as to the attorney's "mental impressions."[242]

The *Hickman* work product doctrine was codified in Rule 26(b)(3) of the Federal Rules of Civil Procedure in 1970, which extends protection to the work of a party's representatives, "including an attorney, consultant, surety, indemnitor, insurer, or agent" in anticipation of litigation or for trial. The rule maintains the distinction between ordinary work product, which is discoverable upon a showing of "substantial need" and "undue hardship," and an attorney's "mental impressions, conclusions, opinions, or legal theories," which are discoverable, if at all, only upon a much higher showing.[243] This latter category has come to be known as "opinion" or

---

237 *See McCoo v. Denny's, Inc.*, 192 F.R.D. 675, 683 (D. Kan. 2000) ("[t]he inchoate possibility, or even likely chance, of litigation does not give rise to the privilege"); *Garrett v. Metropolitan Life Ins. Co.*, No. 95 Civ. 2406, 1996 WL 325725 at *3 (S.D.N.Y. June 12, 1996) (investigations by regulatory agencies may present "more than a mere possibility of future litigation, and provide reasonable grounds for anticipating litigation").

238 Internal investigation to satisfy auditors or lenders did not have required relationship to litigation, although litigation was looming. *In re Royal Ahold N.V. Securities & ERISA Litigation*, 230 F.R.D. 433 (D. Md. 2006).

239 329 U.S. 495 (1947).

240 *Hickman*, 329 U.S. at 511.

241 *Id.*

242 *Id.* at 512.

243 The work product doctrine, however, is not an impenetrable barrier, it is a qualified immunity: "It allows a party to seek materials prepared in anticipation of litigation only when the party: 1) has a substantial need for the materials; and 2) the party cannot acquire a substantial equivalent of the materials by other means without undue hardship. Even when such a showing of need and unavailability is made, the rule specifically protects the mental impressions, conclusions, opinions and legal theories of the party's

"core" work product.[244] Rule 26(b)(3) has been adopted verbatim by 34 states, and in substantial part by 10 others.[245] The work product doctrine has been more specifically and comprehensively incorporated into Texas Rules of Civil Procedure,[246] which defined *"work product"*[247] consistently with the Federal Rules of Civil Procedure.

Like the attorney-client privilege, the work product privilege is subject to waiver, but the scope of a work product waiver is more limited. Work product protection can be destroyed or

---

attorney. This is referred to as *opinion* work product (as opposed to trial preparations that are merely historical or fact based). Opinion work product is subject to disclosure according to a more stringent standard. A court will protect opinion work product unless the requesting party can show that it is *directed to the pivotal issue* in the current litigation and the need for the information is compelling." *Saito v. McKesson HBOC, Inc.*, No. 18553, 2002 Del. Ch. LEXIS 125 at *9 (Del. Ch. Oct. 25, 2002).

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

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

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

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

192.5 Work Product.

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

(1) material prepared or mental impressions developed in anticipation of litigation or for trial by or for a party or a party's representatives, including the party's attorneys, consultants, sureties, indemnitors, insurers, or agents; or

(2) a communication made in anticipation of litigation or for trial between a party and the party's representatives or among a party's representatives.

(b) *Protection of work product.*

(1) *Protection of core work product -- attorney mental processes.* Core work product -- the work product of an attorney or an attorney's representative that contains the attorney's or the attorney's representative's mental impressions, opinions, conclusions, or legal theories -- is not discoverable.

(2) *Protection of other work product.* Any other work product is discoverable only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of the party's case and that the party is unable without undue hardship to obtain the substantial equivalent of the material by other means.

waived only by an action that substantially increases the possibility that an adversary in litigation will gain access to the work product documents.[248] For example, waiver will not result from disclosing work product information to a non-adversarial party with a common interest.[249] Disclosure under a confidentiality agreement militates against a finding of waiver, for it is evidence the party took steps to insure that its work product did not land in the hands of its adversaries.[250] Widespread disclosure, however, might prompt a court to find waiver from substantially increasing the probability that privileged information will fall into the hands of an adversary.[251] Disclosing work product documents to a government body, particularly where the government is an adversary, can result in privilege waiver.[252]

---

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

[249] *Gulf Oil*, 760 F.2d at 296; *In re Grand Jury Subpoenas*, 561 F. Supp. at 1257.

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

[251] *Id.*

[252] *See Westinghouse Elec. Corp. v. Republic of The Philippines*, 951 F.2d 1414, 1423-31 (3rd Cir. 1991); *In re Subpoenas Duces Tecum*, 738 F.2d 1367, 1369-75 (D.C. Cir. 1984); *United States v. Jones*, 696 F.2d 1069, 1072 (4th Cir. 1982); *but see Diversified Industries, Inc. v. Meredith*, 572 F.2d 596, 611 (8th Cir. 1977) (voluntary disclosure to a government agency waives the privilege only for the purpose of litigation against that government agency) and *Teachers Ins. and Annuity Ass'n v. Shamrock Broadcasting Co.*, 521 F.Supp. 638, 644-45 (S.D.N.Y. 1981) (disclosure waives the privilege only for the purpose of litigation against the agency if the disclosing party expressly reserves the privilege; otherwise, complete waiver occurs). The forum in which the waiver issue is adjudicated can be outcome determinative. Contrast *McKesson Corp. v. Green*, 610 S.E.2d 54 (Ga. 2005) (available at http://www.loislaw.com) (in which the Supreme Court of Georgia held that the voluntary production of a 180-page internal investigation report by PricewaterhouseCoopers and Skadden, Arps to the SEC and the U.S. Attorney's Office resulted in a waiver of the work product privilege as they were actual or potential adversaries and the confidentiality agreement allowed the SEC to give the documents to others if it deemed such to be "in furtherance of the [SEC's] discharge of its duties and responsibilities"), *with Saito v. McKesson HBOC, Inc.*, No. 18553, 2002 Del. Ch. LEXIS 125, at *10-39 (Del. Ch. Oct. 25, 2002), in which the Delaware Chancery Court adopted a "selective waiver" doctrine that allowed disclosures to the SEC pursuant to a confidentiality agreement without waiver of the work product protection, *vis a vis* private litigants, reasoning as follows:

> As with any privilege, the protection of work product may be waived when it no longer serves its useful purpose. The purpose behind the protection of work product is "to promote the adversary system by safeguarding the fruits of an attorney's trial preparations from the discovery attempts of the opponent." * * * Thus, the focus of the doctrine is upon preventing discovery of the work product from an "*opposing party in*

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

* * *

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

* * *

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

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

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

* * *

Thus, because I find that it is in the best interests of the shareholders to encourage corporate compliance, and because the law enforcement agencies are designed

Legal Fee Audits. Insurers routinely audit bills from outside defense counsel to measure compliance with billing guidelines and reduce costs. Disclosure of itemized billings to outside auditors may waive the attorney-client privilege for the documents disclosed.[253] Under the subject matter standard discussed above under "Scope of Waiver," the waiver might (but should not) be extended beyond the bills themselves to the items referred to therein.

Issues have been raised in ethics opinions in a number of states regarding the propriety of an attorney's submission of legal bills for outside audit review. The typical conclusion is that law firms may submit their bills directly to an audit company after an informed consent is obtained from the client.[254]

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

> 12.6 ATTORNEY-CLIENT PRIVILEGE.
>
> The Disclosing Party is not waiving, and will not be deemed to have waived or diminished, any of its attorney work product protections, attorney-client privileges, or similar protections and privileges as a result of disclosing its Confidential Information (including Confidential Information related to pending or threatened litigation) to the Receiving Party, regardless of whether the

---

> by our legislature as the first line of defense for such shareholders, I adopt a selective waiver rule for disclosures made to law enforcement agencies pursuant to a confidentiality agreement. Confidential disclosure of work product during law enforcement agency investigations relinquishes the work product privilege only as to that agency, not as to the client's other adversaries. The selective waiver rule encourages cooperation with law enforcement agencies without any negative cost to society or to private plaintiffs.

253 *See United States v. Mass. Inst. of Tech.*, 129 F.3d 681 (1st Cir. 1997).

254 K. Hansen and L. Marema, *Confidentiality Issue Sparks Controversy*, Bests Review '77 (Feb. 1999). *See* Tex. Comm. on Prof'l Ethics, Formal Op. 552 (2004) (in which the Professional Ethics Committee opines that a lawyer's fee statement or invoice is confidential information which the lawyer must protect under Rule 1.05 of the Texas Disciplinary Rules of Professional Conduct and that a lawyer who has been retained by an insurance company to defend its insured cannot disclose the lawyer's fee statement to the insurance company's third party auditor absent consent of the client after consultation (consent in advance through a policy provision is not sufficient consent since it is by definition not made after consultation with the client)).

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

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

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

Although the consummation of a transaction is not determinative of the existence of a waiver, the interests of the parties may become closely aligned as a result of the closing. As a result, there is a higher probability that information will remain protected in a transaction that closes, and in which the buyer assumes liability for the seller's litigation, than in a transaction that does not close and in which the buyer does not assume liability for the seller's litigation.[255] Generally, (i) in a statutory merger the surviving corporation can assert the attorney-client

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

privilege, (ii) in a stock-for-stock deal the privilege goes with the corporation, although in some cases the buyer and seller may share the privilege, and (iii) in the case of an asset sale some cases hold no privilege passes because the corporate holder of the privilege has not been sold[256] while others hold that a transfer of all of sellers right, title and interest in the assets of a business effectively transfers the right to assert or waive the privilege.[257] In an asset sale, including a sale of a division, the parties could provide contractually for the buyer to have the benefit of the privilege, as Section 12.6 does, and, by analogy to joint defense and common interest cases, the privilege agreement should be upheld.[258] Further, by analogy to those cases and the principle that the privilege attaches to communications between an attorney and prospective client prior to engagement, parties should be able to provide that due diligence information provided is protected by the attorney-client privilege.[259]

Courts may also maintain the attorney-client privilege when the interests of both parties are aligned through specific contractual relationships.[260] Therefore, the parties may find some comfort in provisions that align their legal interests and burdens, such as provisions pursuant to which buyer assumes the litigation liability of seller, indemnification provisions or assistance provisions which may facilitate a court's application of the common interest doctrine. If appropriate, the parties also should consider signing a "common interest agreement" or a "joint defense plan" that evidences their common legal interests and stipulates a common plan for litigation.

---

[256] *Cheeves v. Southern Clays*, 128 F.R.D. 128, 130 (M.D. Ga. 1989); *In re Cap Rock Elec. Coop., Inc.*, 35 S.W.3d 222 (Tex. App.—Texarkana 2000, no pet.).

[257] *Coffin v. Bowater Incorporated*, Civ. No. 03-227-P-C, 2005 U.S. Dist. LEXIS 9395 (D. Maine May 13, 2005); *Soverain Software LLC v. Gap, Inc.*, 340 F. Supp. 2d 760 (E.D. Tex. 2004); *see* Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 61 Bus. Law. 1007-1009 (2006).

[258] *See* Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 60 Bus. Law. 843, 861-63 (2005) (discussing *Venture Law Group v. Superior Court*, 12 Cal. Rptr. 3d 656 (Cal. Ct. App. 2004) which held that the surviving corporation in a merger is the holder of the attorney-client privileges of both constituent corporations post merger and an attorney for the non-surviving corporation has a duty to exercise the privilege unless instructed not to do so by the surviving corporation).

[259] *Cap Rock*, 35 S.W.3d at 222; *cf. Cheeves v. Southern Clays*, 128 F.R.D. 128, 130 (M.D. Ga. 1989) ("Courts have found a community of interest where one party owes a duty to defend another, or where both consult the same attorney").

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

V.
ATTORNEY LETTERS TO AUDITORS

SFAS 5. In March 1975 the Financial Standards Board (*"FASB"*) issued its Statement of Financial Accounting Standards No. 5 (*"SFAS 5"*)[261] entitled "Accounting for Contingencies" which sets forth the standards for issuers to accrue for or disclose loss contingencies. Under SFAS 5 if both a loss is "*probable*" and the amount can be reasonably estimated, the contingency has to be accrued in the financial statements of the company. On the other hand, if it is reasonably possible (but not probable) that a loss has occurred or will occur, then there has to be disclosure in the footnotes to the financial statements and an estimate of that loss or range of losses has to be provided, if one can be provided. Under SFAS 5 "*probable*" means "the future event or events are likely to occur," "*reasonably possible*" means that "the chance of the future event or events occurring is more than remote and less than likely," and "*remote*" means that "the chance of the future event or events occurring is slight."[262]

SAS 12. In January 1976, the American Institute of Certified Public Accountants (the *"AICPA"*) issued its Statement on Auditing Standards No. 12 (*"SAS 12"*), entitled Inquiry of a Client's Lawyer concerning Litigation, Claims, and Assessments,[263] which purports to provide "guidance on the procedures an independent auditor should consider for identifying litigation, claims, and assessments and for satisfying himself as to the financial accounting and reporting for such matters when he is performing an examination in accordance with generally accepted auditing standards."[264] SAS 12 sets forth the auditing process to be followed by auditors in gathering information to confirm that the client has made the appropriate determinations required by SFAS 5, and remains operative today even after the enactment of SOX and the establishment of the PCAOB.[265] SAS 12 is really the auditing standard implementing the process under SFAS 5 and it provides guidelines for the types of inquiries that the client will make of the lawyer.

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

---

261 ACCOUNTING FOR CONTINGENCIES, Fin. Accounting Standards No. 5 (Fin. Accounting Standard Bd. 1975 [hereinafter "SFAS 5"], *available at* http://www.sec.gov/interps/account/sabcodet5.htm.

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

263 *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, Statement on Auditing Standards No. 12 (American Inst. of Certified Pub. Accounts 1976), *available at* http://www.aicpa.org/download/members/div/auditstd/AU-00337.PDF, *reprinted in* ABA AUDITOR'S LETTER HANDBOOK (2003). SAS 12 has been adopted as an interim audit standard by the PCAOB.

264 SAS 12 ¶ 1 at 57.

265 The PCAOB has adopted the generally accepted auditing standards that existed on April 16, 2003 as the interim PCAOB standards. PCAOB Rulemaking: Public Company Accounting Oversight Board, 1934 Act Release No. 34-49707, 82 S.E.C. Docket 3079 (May 14, 2004), *available* at http://www.sec.gov/rules/pcaob/34-49707.htm.

(1) The existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments;

(2) The period in which the underlying cause for legal action occurred;

(3) The degree of probability of an unfavorable outcome; and

(4) The amount or range of potential loss.[266]

The auditor is instructed to seek such evidence from management.[267] However, because auditors are not equipped to make legal judgments regarding such matters, SAS 12 instructs the auditor to "request the client's management to send a letter of inquiry to those lawyers with whom they consulted concerning litigation, claims, and assessments"[268] (an *"Inquiry Letter"*). The Inquiry Letter that lawyers receive is from the client, not from the auditors, although it probably was drafted by the auditors.[269] The Inquiry Letter might also cover the additional category of contractually assumed obligations, but such inquiries are rarely made.

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

(a) Identification of the company, including subsidiaries, and the date of the examination;

(b) A list prepared by management (or a request by management that the lawyer prepare a list) that describes and evaluates pending or threatened litigation, claims, and assessments with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of the company in the form of legal consultation or representation; and

(c) A list prepared by management that describes and evaluates unasserted claims and assessments that management considers to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome, with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of the company in the form of legal consultation or representation.[270]

---

[266] *Id.* ¶ 4 at 58.

[267] *Id.* ¶ 5 at 58-59.

[268] *Id.* ¶ 6 at 59.

[269] In some cases a foreign auditor may send the Inquiry Letter directly to the lawyer.

[270] *Id.* ¶ 9(a)-(c) at 60-61.

With respect to the information requested in paragraph (b) above, the lawyer is requested to furnish, among other things, a description of the matter, the action the company plans to take, "an evaluation of the likelihood of an unfavorable outcome, and an estimate, if one can be made, of the potential loss."[271] With respect to paragraph (c), the lawyer is requested to disclose if his views "differ from those stated by management."[272]

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

> To the extent that the lawyer's knowledge of unasserted possible claims is obtained by means of confidential communications from the client, any disclosure thereof might constitute a waiver as fully as if the communication related to pending claims.
>
> A further difficulty arises with respect to requests for evaluation of either pending or unasserted possible claims. It might be argued that any evaluation of a claim, to the extent based upon a confidential communication with the client, waives any privilege with respect to that claim.
>
> Another danger inherent in a lawyer's placing a value on a claim, or estimating the likely result, is that such a statement might be treated as an admission or might be otherwise prejudicial to the client.
>
> The Statement of Policy has been prepared in the expectation that judicial development of the law in the foregoing areas will be such that useful communication between the lawyers and the auditors in the manner envisaged in the Statement will not prove prejudicial to clients engaged in or threatened with adversary proceedings. If developments occur contrary to this expectation, appropriate review and revision of the Statement of Policy may be necessary.[273]

The ABA First Report of the Committee on Audit Inquiry Responses Regarding Initial Implementation of the Statement of Policy[274] sets forth an illustrative Inquiry Letter prepared in the name of the client pursuant to SAS 12.[275]

---

271 *Id.* ¶ 9(d)(1), (2) at 61.

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

273 *Id.* at 12-13.

274 31 Bus. Law. 1709 (April 1976) reprinted in the ABA AUDITOR'S LETTER HANDBOOK (2003).

[275] **Illustrative Form of Letter of Audit Inquiry:**

[Name and Address of Law Firm]

Dear Sirs:

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

Pending or Threatened Litigation (excluding Unasserted Claims)

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

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

Unasserted Claims or Assessments

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

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

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

This Inquiry Letter is the client's authorization for the lawyer to prepare the lawyer's Response Letter, which is necessary for the attorney to reveal confidential client information to the auditors under Rule 1.05 of the Texas Disciplinary Rules of Professional Conduct and Rule 1.6 of the ABA Model Rules of Professional Conduct. If the Inquiry Letter is not in proper form, the attorney may discuss the situation with the client and request that the client submit another Inquiry Letter.

Attorney Response Letters under the ABA Statement may come from either an outside practitioner or law firm[276] or from inside counsel.[277] In each case, the Response letters

---

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

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

Very truly yours,

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

[Name and Address of Accounting Firm]

Re: [Name of Client] [and Subsidiaries]

Dear Sirs:

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

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

While this firm represents the Company on a regular basis, our engagement has been limited to specific matters as to which we were consulted by the Company.

[or]

We call your attention to the fact that this firm has during the past year represented the Company only in connection with certain [Federal income tax matters] [litigation] [real estate transactions] [describe other specific matters, as appropriate] and has not been engaged for any other purpose.

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

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

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

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

[Insert information as appropriate]

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

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

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December l975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy and pursuant to the Company's request, this will confirm as correct the Company's understanding as set forth in its audit inquiry letter to us that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, we, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement.]

Very truly yours,

____

* *NOTE*: See Paragraph 3 of the ABA Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.

[277] Annex A to the ABA Statement also sets forth the following illustrative form of letter for use by inside general counsel:

[Name and Address of Accounting Firm]

Re: [Name of Company] [and Subsidiaries]

Dear Sirs:

As General Counsel* of [*insert name of client*] [(the "Company"] [together with its subsidiaries, the "Company")], I advise you as follows in connection with your examination of the accounts of the Company as at [*insert fiscal year end*].

I call your attention to the fact that as General Counsel* for the Company I have general supervision of the Company's legal affairs. [*If the general legal supervisory responsibilities of the person signing the letter are limited, set forth here a clear description of those legal matters over which such person exercises general supervision, indicating exceptions to such supervision and situations where primary reliance upon be placed on other sources*.] In such capacity, I have reviewed litigation and claims threatened or asserted involving the Company and have consulted with outside legal counsel with respect thereto where I have deemed appropriate.

Subject to the foregoing and to the last paragraph of this letter, I advise you that since [*insert date of beginning of fiscal period under audit*] neither I, nor any of the lawyers over whom I exercise general legal supervision, have given substantive attention to, or represented the Company in connection with, [material]** loss contingencies coming within the scope of clause (a) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:

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

[If information concerning specified unasserted possible claims or assessments and/or contractually assumed obligations is to be supplied:]

With respect to matters which have been specifically identified as contemplated by clauses (b) or (c) of Paragraph 5 of the ABA Statement of Policy, I advise you, subject to the last paragraph of this letter, as follows:

[Insert information as appropriate]

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

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy, this will confirm as correct the Company's understanding that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, I have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, I, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of

differentiate between unasserted claims and pending litigation.[278] As to unasserted claims, the attorneys usually only confirm that they are aware of their professional responsibility not to knowingly participate in any violation by the client of the disclosure requirements of the securities laws and have consulted with the client regarding the client's disclosure obligations in language like the following:

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

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

> Financial Accounting Standards No. 5 [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement].
>
> Very truly yours,
>
> ________
>
> * It may be appropriate in some cases for the response to be given by inside counsel other than inside general counsel in which event this letter should be appropriately modified.
>
> ** *NOTE*: See Paragraph 3 of the ABA Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.

[278] The Preamble to the ABA Statement provides in part:

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

If the client does not identify an unasserted claim that the attorney recognizes should be disclosed to the auditors, the attorney would under the preceding paragraph be expected to discuss the issue with the client. If the client declined to authorize the attorney to disclosure in the Response Letter, the attorney would have to consider his duties under Rule 12b2-2 and the SOX §307 Rules and might have to decline to issue a Response Letter or resign. Ultimately the financial statements, and the information provided to the auditors in connection with the audit thereof, are the responsibility of the client and the attorney's duty is to advise the client, although the lawyer has a duty not to mislead the auditors.[279]

As to pending litigation, the attorneys typically include an identification of the case or other proceeding, a brief description of the nature of the litigation or matter, the position asserted or to be asserted by the client, and the current procedural status of the matter. In the evaluation of overtly threatened or pending litigation, paragraph 5 of the ABA Statement states that lawyers should provide an opinion predicting the outcome of overtly threatened or pending litigation only in those relatively few clear cases that the likelihood of an unfavorable outcome is either "*probable*" or "*remote*."[280] The definitions of those terms in paragraph 5 of the ABA statement

---

[279] Paragraph 6 of the ABA Statement provides:

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

Id. at 10 (internal citations omitted).

[280] Paragraph 5 of the ABA Statement provides in part:

> In view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either "probable" or "remote;" for purposes of any such judgment it is appropriate to use the following meanings:
>
> > (i) *probable* - an unfavorable outcome for the client is probable if the prospects of the claimant not succeeding are judged to be extremely doubtful and the prospects for success by the client in its defense are judged to be slight.
> >
> > (ii) *remote* - an unfavorable outcome is remote if the prospects for the client not succeeding in its defense are judged to be extremely doubtful and the prospects of success by the claimant are judged to be slight.

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

Discoverability of Audit Response Letters. The Response Letter approach in the ABA Statement is intended to reduce the likelihood of any waiver of privilege as to unasserted claims.[281] The ABA Statement is structured such that ordinarily a Response Letter states little

---

> If, in the opinion of the lawyer, considerations within the province of his professional judgment bear on a particular loss contingency to the degree necessary to make an informed judgment, he may in appropriate circumstances communicate to the auditor his view that an unfavorable outcome is "probable" or "remote," applying the above meanings. No inference should be drawn, from the absence of such a judgment, that the client will not prevail.
>
> The lawyer also may be asked to estimate, in dollar terms, the potential amount of loss or range of loss in the event that an unfavorable outcome is not viewed to be "remote." In such a case, the amount of range of potential loss will normally be as inherently impossible to ascertain, with any degree of certainty, as the outcome of the litigation. Therefore, it is appropriate for the lawyer to provide an estimate of the amount or range of potential loss (if the outcome should be unfavorable) only if he believes that the probability of inaccuracy of the estimate of the amount or range of potential loss is slight.

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

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

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

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

To the extent that language is not in the audit-inquiry letter, the Subcommittee suggested insertion of similar language in the audit-inquiry response, "The Company … has advised us that … [it] does not intend to waive the attorney-client privilege [and] our response to you should not be construed in any way to constitute a waiver of the protection of the attorney work-product privilege. . . ." Two months later, the AICPA, working in conjunction with the ABA Subcommittee, issued its Auditing Interpretations of AU

more about loss contingencies than what is in the public record, which may explain a paucity of reported cases in which a Response Letter has been held to have resulted in a privilege waiver.[282] As to pending litigation, any waiver as to the letter itself would likely not be harmful because the lawyer ordinarily would not be making an assessment of the case which could be construed as an admission against interest. Since a letter regarding pending litigation would be at a time when the work product privilege would be applicable to the litigation work product and work product waiver ordinarily is limited to the specific documents disclosed,[283] a Response Letter to auditors describing the case should not result in the attorney having to turn over the firm's litigation file to the other side.

There is, however, no consensus among the courts that have addressed the discoverability of Response Letters. Litigants who have been confronted with a discovery request seeking a Response Letter, and who have resisted discovery, have argued attorney-client privilege, work product exclusion, or relevance as bases for refusing to produce the audit response letter.[284] A

Section 337 (*Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*) to acknowledge such language would not result in a limitation on the scope of an audit. Michael J. Sharp and Abraham M. Stanger, *Audit-Inquiry Responses in the Arena of Discovery: Protected by the Work-Product Doctrine*, 56 Bus. Lawyer 183, 206 (Nov. 2000).

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

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

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

Other courts, when confronted with disputes regarding discovery of lawyer's responses to auditor's requests, found the letters to be discoverable. *See United States v. Gulf Oil Corp*, 760 F.2d 292 (Temp. Emer. Ct. App. 1985) (dismissing a claim that the audit letters constituted work product by holding "that these documents do not constitute attorney work product because they were created primarily for the business purpose of compiling financial statements which would satisfy the requirements of the federal securities laws"). *See also Indep. PetroChemical Corp. v. Aetna Cas. & Sur. Co.*, 117 FRD 292 (D. D.C. 1987) (holding that any attorney-client privilege associated with the audit response letter was waived when the letter was furnished to the auditor and that the work product exclusion was not applicable); *United States v. El Paso Corp.*, 682 F.2d 530, 543-44 (5th Cir. 1982) (noting that lawyer's analysis and memoranda "written ultimately to comply with SEC regulations" were prepared "with an eye on [the company's] business needs, not on its legal

recent California opinion reviewed the conflicting decisions from other jurisdictions and held that a Response Letter was protected by the work product doctrine,[285] reasoning as follows:

> Neither party cited nor did we find any California law dealing with the specific question of whether work product loses its protection if it is disclosed to an auditor in an audit response letter. The few cases from federal courts have come down on both sides of this issue. For example, in *Tronitech, Inc. v. NCR Corp.* (S.D.Ind. 1985) 108 F.R.D. 655, the court held an audit response letter was protected by the work product rule (Fed. Rules Civ.Proc., rule 26(b)(3)) because it was "comprised solely of an attorney's opinion." (*Id.* at p. 656.) Further, "[a]n audit letter is not prepared in the ordinary course of business but rather arises only in the event of litigation. It is prepared because of the litigation, and it is comprised of the sum total of the attorney's conclusions and legal theories concerning that litigation." (*Ibid.*)
>
> The cases finding against the protection are distinguishable. First, as interpreted in some circuits, the federal work product doctrine is more limited than California's, with its protection extending only to documents "prepared in anticipation of litigation or for trial ...." (Fed. Rules Civ.Proc., rule 26(b)(3); see, e.g., *JumpSport, Inc. v. Jumpking, Inc.* (N.D.Cal. 2003) 213 F.R.D. 329, 330-331; *Dawson v. New York Life Ins. Co.* (N.D.Ill. 1995) 901 F.Supp. 1362, 1368.) In California, however, "[t]he protection afforded by the [attorney work product doctrine] is not limited to writings created by a lawyer in anticipation of a lawsuit. It applies as well to writings prepared by an attorney while acting in a nonlitigation capacity. [Citation.]" (*County of Los Angeles v. Superior Court* (2000) 82 Cal.App.4th 819, 833.) Thus, *United States v. Gulf Oil Corp.* (Temp. Emer. Ct.App. 1985) 760 F.2d 292 is inapt because the decision not to afford work product protection to audit inquiry responses was based on the finding that the "documents were not created to assist ... in the litigation ...." (*Id.* at pp. 296-297.)
>
> Moreover, in *In re Hillsborough Holdings Corp.* (Banks. M.D.Fla. 1991) 132 B.R. 478, the court did not rely on the work product doctrine. The decision to require production of audit inquiry responses was based on the finding that the documents were not protected by the accountant-client privilege. (*Id.* at pp. 480-481.)
>
> Thus, based on the contents of the letters, which contain the attorney's thoughts, impressions, and opinions, plus the purpose of the work product doctrine, and the rule that waiver occurs only when work product is disclosed to a third party "'who has no interest in maintaining the confidentiality ... of a significant part of the work product'" (*OXY Resources California v. Superior Court*, *supra*, 115 Cal.App.4th at p. 891), we conclude Gokoo's audit response letters to Diehl remained protected work product.

---

ones" and did not "contemplate litigation in the sense required to bring it within the work product doctrine").

[285] *Laguna Beach County Water District v. Superior Court of Orange County*, 22 Cal. Rptr. 3rd 387 (December 15, 2004).

Based on our determination on this ground, we have no need to and do not decide the effect of the attorney-client privilege on these two documents.[286]

---

[286] Similar reasoning was followed in *Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*, 229 F.R.D. 441 (S.D.N.Y. 2004), in which internal investigation reports did not result in a loss of work product protection because they were turned over to independent auditors:

> Generally speaking, "the work product privilege should not be deemed waived unless disclosure is inconsistent with maintaining secrecy from possible adversaries." *Stix Prods. v. United Merchants & Mfrs.*, 47 F.R.D. 334, 338 (S.D.N.Y. 1969). "The work product privilege is not automatically waived by any disclosure to third persons. Rather, the courts generally find a waiver of the work product privilege only if the disclosure 'substantially increases the opportunity for potential adversaries to obtain the information.'" *In re Pfizer Inc. Sec. Litig.*, 1993 U.S. Dist. LEXIS 18215, No. 90 Civ. 1260, 1993 WL 561125, at *6 (S.D.N.Y. Dec. 23, 1993) (quoting *In re Grand Jury*, 561 F. Supp. 1247, 1257 (E.D.N.Y. 1982)) (internal citation omitted). Implicit in this analysis is the question of whether the third party itself can or should be considered an adversary. Accordingly, courts have generally held that where the disclosing party and the third party share a common interest, there is no waiver of the work product privilege. E.g., id. ("Disclosure of work product to a party sharing common interests is not inconsistent with the policy of privacy protection underlying the doctrine."); *see also In re Copper Mkt. Antitrust Litig.*, 200 F.R.D. 213, 221 n.6 (S.D.N.Y. 2001) (same).
>
> This much is settled. However, courts are split in their treatment of disclosures to a corporation's accountants or auditors. More precisely, courts differ in their conceptualization of two critical points that are often implicitly intertwined in their analysis: whether the "adversary" contemplated by the work product privilege is necessarily a litigation adversary and whether a corporation's auditor is such an adversary, to whom disclosure will waive the privilege. While admittedly there are good arguments on both sides, in this case, I answer both questions in the negative and conclude that Merrill Lynch's disclosure of the reports to Deloitte & Touche did not constitute a waiver of the applicable work product protection.
>
> In a frequently cited case, In re Pfizer, Inc. Sec. Litig., Judge Buchwald held that Pfizer's disclosure of documents to its independent auditor, KPMG Peat Marwick ("Peat Marwick"), did not waive its work product privilege. 1993 U.S. Dist. LEXIS 18215, 1993 WL 561125, at *6. Judge Buchwald's decision was based on her observation that "Pfizer and Peat Marwick obviously shared common interests in the information, and Peat Marwick is not reasonably viewed as a conduit to a potential adversary." Id. Other courts have adopted precisely this analysis. E.g., *Gutter v. E.I. Dupont de Nemours & Co.*, 1998 U.S. Dist. LEXIS 23207, No. 95 Civ. 2152, 1998 WL 2017926,at *5 (S.D. Fla. May 18, 1998) (holding that disclosure to outside accountants did not waive the work product privilege "since the accountants are not considered a conduit to a potential adversary"); *Gramm v. Horsehead Indus., Inc.*, 1990 U.S. Dist. LEXIS 773, No. 87 Civ. 5122, 1990 WL 142404, at *5 (S.D.N.Y. Jan. 25, 1990) (same). Still others have applied this approach, but scrutinized the precise role of the accountants. E.g., *Samuels v. Mitchell*, 155 F.R.D. 195, 201 (N.D. Cal. 1994) (deciding that disclosure did not constitute a waiver of the work product privilege because the accounting firm was acting as a consultant, not a "public accountant," at the relevant time).
>
> Judge Hellerstein articulated another view in Medinol, Ltd. v. Boston Scientific Corp., where, in finding a waiver of the work product privilege, he emphasized the "public watchdog" role of independent auditors. 214 F.R.D. 113, 116 (S.D.N.Y. 2002)

(quoting *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18, 79 L. Ed. 2d 826, 104 S. Ct. 1495 (1984)). Judge Hellerstein observed that it "has become crystal clear in the face of the many accounting scandals that have arisen as of late, in order for auditors to properly do their job, they *must* not share common interests with the company they audit." *Id.* 214 F.R.D. at 116 (emphasis in original). While this is a valid policy consideration, the fact is that the determination in Medinol was based on a finding that the auditor's interests were not aligned with that of the corporation and that the disclosure of the documents at issue -- the Special Litigation Committee's minutes -- did not serve a pertinent litigation interest.

* * *

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

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

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

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

Even though the lawyer's letter to the auditor may not be protected by the attorney-client privilege, any waiver should be limited to the contents of the letter and should not require the contents of the attorney's entire file on the matter covered by the letter.[287]

Auditors often ask for information about loss contingencies beyond Response Letters, and courts often hold that disclosure of attorney-client communications to auditors waives the attorney-client privilege, just as almost any disclosure to an outsider breaches the confidence and waives the attorney-client privilege.[288] Thus, unless the controversy arises in one of the fifteen states that, by statute, recognize an accountant-client privilege[289] or the accountant is helping the attorney to advise the client (a role that an auditor typically does not undertake given independence constraints), disclosure to the outside accountant likely waives the attorney-client privilege.[290] With respect to whether work product protection survives disclosure to auditors, the opinions are divided, but the majority view seems to be that work product includes any material prepared "because of" actual or potential litigation (thus encompassing analysis of litigation exposure prepared in response to an Inquiry Letter) and survives disclosure to the auditors.[291]

---

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

288 *See, e.g., Gutter v. E.I. Dupont De Nemours and Co.*, 1998 WL 2017926, at *3 (S.D. Fla. May 18, 1998) ("[d]isclosure to outside accountants waives the attorney-client privilege"); *In re Pfizer Inc. Securities Litig.*, 1993 WL 561125, at *6 (S.D.N.Y. Dec. 23, 1993) ("Disclosure of documents to an outside accountant destroys the confidentiality seal required of communications protected by the attorney-client privilege, notwithstanding that the federal securities laws require an independent audit").

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

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

Other states have statutes requiring accountants and auditors to maintain the confidentiality of client materials, but not purporting to establish any evidentiary privilege from discovery. *See* Alabama, ALA. CODE § 34-1-21; California, 16 CAL. CODE REGS. tit. 16, § 54 ; Connecticut, CONN. GEN. STAT. ANN. § 20-281j; Iowa, IOWA CODE ANN. § 542.17; Kentucky, KY. REV. STAT. ANN. § 325.440; Massachusetts, MASS. GEN. LAWS ANN. ch. 112 § 87E; Minnesota, MINN. STAT. ANN. § 326A.12; Mississippi, MISS. CODE. ANN. § 73-33-16; Montana, MONT. CODE. ANN. § 37-50-402; New Jersey, N.J. STAT. ANN. § 45:2B-65; North Dakota, N.D. CENT. CODE § 43-02.2-16; Oregon, OR. REV. STAT. § 673.385; Rhode Island, R.I. GEN. LAWS § 5-3.1-23; Vermont, VT. CODE R. § 81; Washington, WASH. REV. CODE ANN. § 18.04.405.

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

291 *See United States v. Adlman*, 134 F.3d 1194, 1202 (2d Cir. 1998) (observing, in *dicta*, that the work-product doctrine would protect an audit-inquiry response and approving the rule adopted by the Third,

The forum in which the discoverability issues are litigated, as well as particular circumstances of the case, will determine whether the protection otherwise applicable will survive disclosure to auditors.[292] Companies, therefore, have no guarantee that courts will protect the work product generated from internal investigations from waiver as to adversaries if these materials are disclosed to auditors, and could complain: "[a]n uncertain privilege, or one which purports to be certain but results in widely varying applications by the courts, is little better than no privilege at all."[293]

VI.
SELECTED RESPONSE LETTER ISSUES

Is the ABA Statement Superseded by SOX §303? Concern has been expressed as to whether compliance with the ABA Statement will protect the lawyer in view of the SOX §303 Requirements. The ABA Statement has not been superseded by the SOX §303 Requirements. In a situation where no estimate of outcome is given in the audit response because the likelihood of a unfavorable outcome is considered neither "remote" or "probable," but the lawyer has in fact developed the view that the likelihood of an unfavorable outcome is significant (but short of

---

Fourth, Seventh, Eighth, and D.C. Circuits that a document is work product if "in light of the nature of the document and the factual situation in the particular case, the document can fairly be said to have been prepared or obtained *because of* the prospect of litigation") (emphasis in original); *In re Honeywell Int'l, Inc. Securities Litig.*, 2003 WL 22722961, at *6 (S.D.N.Y. Nov. 18, 2003) (rejecting plaintiff's argument that the "preeminent business purpose" of an audit rendered the work product doctrine inapplicable and finding that defendant's "assertion of work product protection for …audit letters and litigation reports prepared by its internal and external counsel, as well as PWC documents memorializing … opinion work product, is proper."); *Southern Scrap Material Co. v. Fleming*, 2003 WL 21474516, at *9 (E.D. La. June 18, 2003) ("The audit letters … were prepared by outside counsel at the request of [party's] general counsel with an eye toward litigation then ongoing. [Thus] … they are attorney work product of the opinion/mental impression/litigation strategy genre."); *In re Raytheon Securities Litig.*, 218 F.R.D. at 358 (citing cases in the Third, Fourth, Seventh, Eighth and D.C. Circuits that have adopted the "because of" definition of work product); *Vanguard Sav. and Loan Assoc. v. Barton Banks*, 1995 U.S. Dist. LEXIS 13712, at *11-12 (E.D. Pa. 1995) (holding that lawyer letters regarding litigation, prepared to assist client in reporting loss contingencies for a regulatory examination, were work product and protected even though created "primarily" for a business purpose); *Tronitech, Inc. v. NCR Corp.*, 108 F.R.D. 655, 657 (S.D. Ind. 1985) ("an audit letter is not prepared in the ordinary course of business but rather arises only in the event of litigation. It is prepared because of the litigation … [and] should be protected by the work product privilege").

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

[293] *United States v. Upjohn Co.*, 449 U.S. 383, 391 (1981).

"probable"), could the response be said to be misleading on the basis that it fails to state a material fact? The lawyer's communication would be within the framework of the ABA Statement that established clear standards for what will and will not be included in the Response Letters.

A Response Letter conforming to the ABA Statement delivered to accountants who were parties to the professional treaty memorialized in the ABA Statement should not be misleading to the accountants to whom it is addressed since (i) they know the basis on which it was prepared and (ii) the Response Letter states the framework under which it was prepared. If, however, the Response Letter does not conform to the ABA Statement or the attorney has oral communication with the auditors, the attorney would not be responding within the framework of the ABA Statement and would have the risk of negligent advice which would be sanctionable under Rule 13b2-2 under the 1934 Act.

Further, the attorney has a duty to consult with the client regarding unasserted material loss contingencies not disclosed in the Response Letter which the attorney believes the client should disclose or consider disclosing. If the client does not respond appropriately, the lawyer would have to comply with the lawyer's reporting up the ladder obligation under the rules under SOX §307 described below or consider whether to resign or decline to deliver a Response Letter. An attorney could also have exposure under common law or applicable securities laws for an improper Response Letter.[294]

The Company Dilemma. The ABA Statement cautions that the lawyer "should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either 'probable' or 'remote'." However, what if the auditor asserts that the attorney must provide an evaluation by reason of SOX §303? The attorney representing the company faces the following unattractive choices. If the attorney provides an evaluation, it may be asserted that it is a waiver of the attorney-client privilege or work product protection that might under normal circumstances insulate the information from third party discovery.[295] Moreover, if the privilege or protection is waived, it is potentially waived for all purposes and as to all third parties.[296] Although it is far from clear that a waiver would be found, this potential could be a very high price to pay with respect to the pending case or claim.

Further, if the attorney decides or is instructed by the company to provide information beyond that specified in the ABA Statement, the nonconforming communication could expose

---

294 *Cf. In re Enron Corp. Sec., Derivative and ERISA Litig.*, 235 F. Supp. 2d 549, 563 (S.D. Tex. 2002) (containing Memorandum and Order Re Secondary Actors' Motion to Dismiss filed December 20, 2002). The opinion (also known as *Newby v. Enron* or the *Newby* case) is 159 pages long in F. Supp. 2d. *Cf. Dean Foods Co. v. Pappathanasi*, 18 Mass. L. Rep. 598, 2004 WL 3019442 (Mass. Super. Dec. 3, 2004); Donald W. Glazer and Arthur Norman Field, *No-litigation Opinions Can Be Risky Business: Looking at the Facts – and Beyond*, 14 BUS. L. TODAY No. 6, July/August 2005, at 37.

295 *See supra* part IV. Attorney-Client Privilege and the Work Product Doctrine in the Corporate Context.

296 *Id.*

the attorney to enforcement action under the SOX §303 Requirements if the case or claim ultimately results in a material exposure relative to the assets of the company which was not foreseen at the time of the attorney communication. In this regard, the SEC has already indicated that one type of conduct that could result in rendering an issuer's financial statements materially misleading would be providing an auditor with an inaccurate or misleading response or legal analysis, and the SEC has also indicated that responsibility for a misleading response or analysis falls on the attorney providing information to the auditor.[297] Thus, if the case or claim results in a material adverse judgment or settlement, the attorney (particularly in the case of an inside attorney acting under the direction of, or based on information supplied by, the company general counsel or its chief financial officer or their designee(s)) could be asserted to have been responsible, as may be those supplying the information or direction, for "misleading" the auditor. This is not a very attractive situation and one which could also result in significant personal exposure to the responsible parties.

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

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

Law Firm Policies. Many law firms have adopted policies and procedures for processing Inquiry Letters and issuing Response Letters which typically are based on the ABA Statement.[298] Law firms typically have adopted policies for circulating information to its attorneys that the client's Inquiry Letter has been received and soliciting information needed to complete the Response Letter. Some firms designate a particular individual or committee to

---

297 *See supra* part II. Misleading Statements to Auditors.

298 Attached as Exhibit A is a common form of law firm Response Letter.

respond to questions or to review all or particular kinds of Response Letters. Before undertaking to respond to an Inquiry Letter or work on a Response Letter, attorneys should become familiar with the ABA Statement and the firm's policies and procedures.

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

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

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

Requests Beyond Scope of ABA Statement. Ordinarily, the Response Letter should include only information as to loss contingencies as permitted by the ABA Statement and, if requested, information as to fees and disbursements owed by the client. As a result of the pressures on auditors to be more thorough in their audit procedures and documentation,[299] some

---

[299] SEC Deputy Chief Accountant Scott A. Taub summarized the SEC's concerns that the audit process adequately address accruals for and disclosures of loss contingencies, including obtaining appropriate

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

---

information from counsel, in the following remarks delivered at the University of Southern California Leventhal School of Accounting SEC and Financial Reporting Conference (May 27, 2004), which can be found at http://www.sec.gov/news/speech/spch052704sat.htm.

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

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

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

conformity with the ABA Statement. These non-standard Inquiry Letters typically do not reflect sensitivity to the importance of avoiding waiver of the attorney-client privilege.[300]

Attorneys often decline to supply information in a Response Letter beyond what is contemplated by the ABA Statement, and generically comment that such other information is not being provided.[301] Some commentators suggest that, in addition, it is appropriate to specifically reference the requested information not being furnished and state that it is not being provided because the request is beyond the scope of the ABA Statement in order that there be no ambiguity that the non-conforming request is being denied.[302] Attorneys should understand, however, that the auditors' requests for the additional information may be based upon a real need for corroborative information to complete their audit procedures and that there are circumstances in which the auditors' inability to obtain the requested additional information could lead the auditors to qualify opinions on clients' financial statements, which could be worse for the clients than the consequences of giving the auditors the information they require. For example, in circumstances in which the auditor believes that it needs the attorney's response about illegal acts in order to satisfy the auditor's Section 10A obligations, there may need to be communications from a reliable source sufficient to satisfy the auditor's requirements.

---

300 In a Report to the ABA House of Delegates by an ABA Task Force on Attorney-Client Privilege, it was noted:

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

Report of the American Bar Association's Task Force on the Attorney-Client Privilege, 60 BUS. LAW. 1029, 1053 (May 2005), *available at* http://www.abanet.org/buslaw/attorneyclient/. *See supra* Part V: Discoverability of Audit Response Letters.

301 The second paragraph of a typical Response Letter provides:

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

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

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

Requests for Updates or Informal Discussions. The constraints on what may be said in Response Letters under the ABA Statement sometimes lead to requests for informal discussions in which supplemental information is elicited from the lawyer. The ABA Statement does not envision informal sessions with auditors or otherwise provide any parameters for what may be communicated to auditors in such a context different from those applicable to a formal response. While many law firms discourage or even forbid such discussions because of the risks of miscommunication or misunderstanding[303] or inadvertent waiver of privilege, auditors may insist that they require such discussions or written representations as a prerequisite to expressing an unqualified opinion on the client's financial statements. When and if an attorney enters into such a discussion, he can expect that his oral statements will be summarized in auditors' notes and workpapers, which the attorney will not have an opportunity to review or correct.

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

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

Information as to Specific Cases. On occasion an auditor will advise the client that the typical "we express no opinion" as to outcome or amount or range of loss is unsatisfactory and will advise the client that the significance of the case requires further guidance from the lawyer or the auditor will have to qualify the auditor's opinion as to the financial statements. In such a case the attorney is permitted by the ABA Statement to provide additional information. Since

---

303 *See* the discussion of SEC Rule 13b2-2, *supra*, and *In the Matter of Google, Inc. and David C. Drummond*, SEC Release No. 8523 (January 13, 2005), which can be found at http://www.sec.gov/litigation/admin/33-8523.htm and in which the general counsel of Google consented to a cease and desist order as a result of giving erroneous advice to Google regarding disclosures required to be given to employees to whom employee stock options were granted.

predictions as to the outcome of litigation are fraught with peril for both the client and the lawyer, the client's disclosure position does not justify a deviation from the principles of the Statement as to predictions as to outcome or loss exposure.

Inside Counsel Special Issues. The ABA Statement applies to both inside and outside counsel, and includes a form of response letter for an inside general counsel[304] that is similar to

---

[304] Annex A to the ABA Statement also sets forth the following illustrative form of letter for use by inside general counsel:

> [Name and Address of Accounting Firm]
>
> Re: [Name of Company] [and Subsidiaries]
>
> Dear Sirs:
>
> As General Counsel* of [*insert name of client*] [(the "Company"] [together with its subsidiaries, the "Company")], I advise you as follows in connection with your examination of the accounts of the Company as at [*insert fiscal year end*].
>
> I call your attention to the fact that as General Counsel* for the Company I have general supervision of the Company's legal affairs. [*If the general legal supervisory responsibilities of the person signing the letter are limited, set forth here a clear description of those legal matters over which such person exercises general supervision, indicating exceptions to such supervision and situations where primary reliance upon be placed on other sources*.] In such capacity, I have reviewed litigation and claims threatened or asserted involving the Company and have consulted with outside legal counsel with respect thereto where I have deemed appropriate.
>
> Subject to the foregoing and to the last paragraph of this letter, I advise you that since [*insert date of beginning of fiscal period under audit*] neither I, nor any of the lawyers over whom I exercise general legal supervision, have given substantive attention to, or represented the Company in connection with, [material]** loss contingencies coming within the scope of clause (a) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:
>
> [Describe litigation and claims which fit the foregoing criteria.]
>
> [If information concerning specified unasserted possible claims or assessments and/or contractually assumed obligations is to be supplied:]
>
> With respect to matters which have been specifically identified as contemplated by clauses (b) or (c) of Paragraph 5 of the ABA Statement of Policy, I advise you, subject to the last paragraph of this letter, as follows:
>
> [Insert information as appropriate]
>
> The information set forth herein is [as of the date of this letter] [as of [*insert date*], the date on which we commenced out internal review procedures for purposes of preparing this response], except as otherwise noted, and I disclaim any undertaking to advise you of changes which thereafter may be brought to my attention or to the attention of the lawyers over whom I exercise general legal supervision.
>
> This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the

the form for outside counsel,[305] although the inside counsel form differs in its description of the attorney's capacity and does not refer to an Inquiry Letter since the attorney is employed by the company. Some inside counsel use adaptions of this Treaty form of Response Letter, while others who were formerly with law firms use essentially the same form of Response Letter as when they were in private practice. Others will coordinate the receipt of Response Letters from outside counsel and deliver them to the auditors with a letter to the effect that they are not aware of any pending or threatened or pending litigation not referenced in the outside counsel Response Letters. In some cases, inside counsel will deal with pending and threatened litigation in a representation letter structured much like a typical Response Letter, while in other instances the representation letter looks more like a typical management representation letter to auditors.

Whatever the form of the inside attorney written communication to the auditors, the auditors are increasingly pressing for inside counsel to provide much more detail as to the expected outcome of the cases and seeking to tie those evaluations to the loss reserves, if any, established by management for the cases. Often inside counsel, irrespective of how they respond to the auditors in writing, will meet with the auditors to discuss pending and threatened litigation and there will be candid discussions regarding the loss reserves established by management, the risks seen in particular cases and inside counsel's views as to the likely outcome of the case. Those communications are not protected by the ABA Statement, and expose the inside attorney

---

generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy, this will confirm as correct the Company's understanding that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, I have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, I, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5 [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement].

Very truly yours,

---

* It may be appropriate in some cases for the response to be given by inside counsel other than inside general counsel in which event this letter should be appropriately modified.

** *NOTE*: See Paragraph 3 of the ABA Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.

[305] See the form of outside counsel Response Letter attached as Exhibit A.

to charges under SOX § 303 if the information given ultimately proves incorrect and misleads the auditors.[306]

Triangle. The preparation of client financial statements involves at least three directions of communication: (1) client with auditor, (2) attorney with client, and (3) attorney with auditor. The most significant side of this triangle is the communication between the client and its auditors, for the financial statements are those of the client and report on its financial position and results of operations, and the auditor, which is performing specified processes in order to issue an opinion or report thereon. The Response Letter is the most typical attorney communication with the auditors and the formalized way that the ABA Statement contemplates attorneys are to provide information to the auditors as they pursue their processes in respect of the client financial statements. The Response Letter with respect to the sensitive subject of unasserted claims typically contains an attorney undertaking to communicate with the client that includes the following:

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

Communications by attorneys with their clients need to be made with sensitivity to client disclosure obligations under applicable securities laws and to attorney professional responsibilities under applicable state ethics rules and SOX §307 Rules.

Gain Contingencies. Both the foregoing discussion and the ABA Statement focus on loss contingencies, but companies may also seek to recover damages or other relief from third parties as a plaintiff. Some Inquiry Letters may request information regarding "contingencies", rather than "loss contingencies", or may frame the inquiry relating to overtly threatened or pending litigation in the form of a request such as: "Please furnish our auditors with a description of all pending or threatened litigation that you are handling on our behalf" and ask for "an evaluation of the likelihood of an unfavorable outcome", suggesting that the disclosable items are not limited to "loss" contingencies arising from pending or threatened litigation against the company.[307] Attorneys generally read "contingencies" in such letters in the context of the ABA

---

[306] See *supra* part II. Misleading Statements to Auditors.

[307] FAS 5 provides at Paragraph 17b. "Adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization." Footnote disclosure thus may be required of material gain contingencies. Accruals are not made for gain contingencies.

Statement, which clearly deals with "loss" contingencies, and deliver a standard Response Letter based on the Treaty.[308] In such a case, it may be desirable for the attorney to consider whether the company's assertion of claims is likely to lead to the assertion of counter- or cross-claims that either need to be disclosed as overtly threatened claims or considered as unasserted claims likely of assertion, although the attorney should not have a duty to address the possibility of counter- or cross-claims in a Response Letter in the absence of facts which would support the reference under a traditional unasserted claims analysis.

Other attorneys interpret "contingencies" to include not only claims against the client, but also claims by the client, and then proceed to respond in accordance with Treaty guidelines.[309] The August 1976 Second Report of the Committee on Audit Inquiry Responses Regarding Internal Implementation of the Statement of Policy[310] recognized that it would be appropriate for counsel to respond to inquiries regarding gain contingencies as follows:

> Historically, the auditor's concern, in his inquiry directed to the lawyer, has been limited to contingent liabilities. With the advent of FAS 5, this focus has been upon litigation. claims and assessments with present loss contingencies. In this connection, the Financial Accounting Standards Board continued in effect the provisions of Accounting Research Bulletin No. 50 regarding contingent assets: paragraph 17 of FAS 5 provides that:
>
> > a) Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization.
> >
> > b) Adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization.
>
> Given the orientation of the auditing and accounting professions to disclosure considerations as they relate to loss contingencies, the ABA Statement of Policy deals only with the subject of loss contingencies (i.e., litigation, claims and assessments where the client's involvement is as a defendant or prospective

---

308 Where counsel is not addressing a request that would encompass gains contingencies, some Response Letters express such limitations in language such as the following: "our response deals only with the subject of loss contingencies (i.e., litigation, claims, and assessments where the Company's involvement is as a defendant or prospective defendant) and not with matters in which we represent the Company as claimant or as plaintiff in which no litigation has been asserted against the Company or other matters (except billing information where requested in the Company's Inquiry letter)". Such a response also does not address uncollectible receivables or other forms of asset impairment beyond the type of loss contingencies identified in the Treaty.

309 James J. Fuld, *Lawyers' Responses to Auditors-Some Practical Aspects*, 44 Bus. Law, 159, 162 (Nov. 1988).

310 *Second Report of the Committee on Audit Inquiry Responses Regarding Internal Implementation of the Statement of Policy*, 32 Bus. Law, 43, 51 (Nov. 1976).

defendant). However, footnote 2 to SAS No. 12 does refer to the auditor's procedures with respect to gain contingencies; and, consistent therewith, some auditors have concluded that logic compels a better balanced presentation of contingencies, whether they are loss contingencies or gain contingencies, and have therefore solicited information, in the audit inquiry letter, with respect to matters in which the lawyer is acting in behalf of the client where the client is either plaintiff or defendant.

When the audit letter solicits such additional information, it is not improper for the lawyer to respond, but his response should be within the limits established by the ABA Statement of Policy. In this connection, it should be noted that there may be gain contingencies of such a material nature that they should be the subject of disclosure in financial statements and, in some instances, the auditor may conclude it appropriate or necessary to make the audit opinion "subject to" the uncertainty presented by such gain contingency.

VII.
LIMITATION OF LIABILITY PROVISIONS IN AUDITOR ENGAGEMENT LETTERS

Faced with the experience of liabilities to third parties resulting from the fraudulent or willful misconduct of their audit clients, or their failure to detect client frauds, auditors are increasingly in their engagement letters seeking to shift responsibility for client misconduct to the client.[311] Auditor engagement letters typically describe the objectives of the audit, provide that the information provided to the auditors is the responsibility of management, and set forth the fee arrangements.[312] Increasingly auditors are seeking to allocate risks to clients through engagement letter provisions that the client agrees (i) not to hold the auditor liable for damages except those resulting from the auditor's fraud or willful misconduct (i.e., release the auditor from liability for its own negligence in the conduct of the audit); (ii) the auditor will not be responsible for incidental or consequential damages; (iii) no claim will be asserted against the auditor after a fixed period of time (e.g., two years); (iv) the auditor will be liable only for losses that occur during the period covered by the audit; (v) the client will not assign or transfer any claim against the auditor, including assignments in business combinations or reorganizations; (vi) the client will protect the auditor from third party claims arising from the auditor's failure to

---

[311] *See* David Reilly, "Generally Accepted Accounting Principle? Auditor Pacts With Companies That Prevent Suits, Limit Awards Draw Scrutiny as Disclosure Grows," Wall Street Journal March 6, 2006 at C-1, which notes that public companies are beginning to disclose such engagement letter provisions in their proxy materials; *see also* "Survey Results: Auditor Inspection Reports and Engagement Letters," The Corporate Counsel.net (January-February 2006), which reports that a survey of 30 companies showed (i) 63.33% of the companies reported that their most recent auditor engagement letter included a cap on the auditor's liability (i.e., no liability except for willful misconduct and gross negligence); and (ii) 70% reported that their most recent auditor engagement letter included a provision that waives a jury trial.

[312] Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters, 71 Federal Register No. 27 at 6847, 6849 (February 9, 2006), *available at* http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/06-1189.pdf.

discover negligent conduct by management; and (vii) the auditor's liability is limited to the amount of fees paid.[313]

In an Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters (the *"Advisory"*),[314] the five federal agencies supervising financial institutions[315] expressed the view that limiting an auditor's liability for an audit may make the auditor less diligent in the audit process and thus make the audit less reliable, which raises safety and soundness concerns. The Advisory excludes (x) limitations on liability for punitive damages and (y) arbitration and other alternative dispute resolution provisions that apply equally to all parties, provide neutral decision makers and appropriate hearing procedures.[316] The Advisory warns directors, audit committees and management that "certain insurance policies (such as error and omission policies and director and officer liability policies) might not cover losses arising from claims that are precluded by limitation of liability provisions."[317]

While the Advisory by its terms applies only to financial institutions (whether public or private), its principles apply to other entities. The SEC has stated that when an auditor and its client enter into an agreement which purports to provide the auditor limitation of liability for its negligent acts, the auditor is not independent:

> "When an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or commission, one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement is removed or greatly weakened. Such condition must frequently induce a departure from the standards of objectivity and impartiality which the concept of independence implies. In such difficult matters, for example, as the determination of the scope of audit necessary, existence of such an agreement may easily lead to the use of less extensive or thorough procedures than would otherwise be followed. In other cases it may result in a failure to appraise with professional acumen the information disclosed by the

---

313 *Id*. at 6854-55.

314 *Id*. at 6847.

315 The Office of Thrift Supervision, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration and Office of the Comptroller of the Currency. *Id*.

316 *Id*. at 6853-6854.

317 *Id*. at 6853.

examination. Consequently, the accountant cannot be recognized as independent for the purpose of certifying the financial statements of the corporation."[318]

The PCAOB and the American Institute of Certified Public Accountants ("AICPA") are reviewing the impact of auditor engagement letter provisions that would reduce auditor liability exposure.[319] Currently, Ethics Ruling Number 94 under Rule 101 of AICPA's Code of Professional Conduct, which is included in the PCAOB's interim independence standards,[320] states that the auditor's independence is not impaired if the engagement letter includes "a clause that provides that the client would release, indemnify, defend, and hold the member . . . harmless from any liability and costs resulting from knowing misrepresentations by management.[321] Since auditors must comply with the SEC's auditor independence requirements set forth above (as well as those of the PCAOB) in a public company audit, AICPA Ethics Ruling Number 94 has no practical effect with respect to audits of public companies. Additionally, Ethics Ruling Number 95 under Rule 101 of the AICPA Code of Professional Conduct, which is also included in the

---

318 SEC Financial Reporting Policies Section 602.02.f.i—Indemnification by Client, 3 Fed. Sec. L. (CCH) ¶ 38,335, at 38,603–17 (2003); *see also* SEC Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence Frequently Asked Questions—Question 4 (issued December 13, 2004):

> Q: Has there been any change in the Commission's long standing view (Financial Reporting Policies—Section 600—602.02.f.i. "Indemnification by Client") that when an accountant enters into an indemnity agreement with the registrant, his or her independence would come into question?
>
> A: No. When an accountant and his or her client, directly or through an affiliate, enter into an agreement of indemnity which seeks to provide the accountant immunity from liability for his or her own negligent acts, whether of omission or commission, the accountant is not independent. Further, including in engagement letters a clause that a registrant would release, indemnify or hold harmless from any liability and costs resulting from knowing misrepresentations by management would also impair the firm's independence.

319 *See* Agenda for PCAOB Standing Advisory Group Meeting on February 9, 2006 under "Emerging Issue – The Effects on Independence of Indemnification, Limitation of Liability, and Other Litigation-Related Clauses in Audit Engagement Letters," *available at* http://www.pcaobus.org/News_and_Events/Events/2006/02-09.aspx, and related Standing Advisory Group white paper dated February 9, 2006 and entitled "Emerging Issue--The Effects on Independence of Indemnification, Limitation of Liability, and Other Litigation-Related Clauses in Audit Engagement Letters", available at http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2006/02-09/Indemnification.pdf; AICPA Proposed Interpretation 101-16 (September 15, 2005), *available at* http://www.aicpa.org/download/ethics/2--5_0915_ed_Indemn.pdf, which sets forth the AICPA's position on the types of clauses discussed above.

320 The PCAOB adopted as its interim independence standards (see PCAOB Rule 3600T) the AICPA Code of Professional Conduct Rules 101 and 191, and related interpretations and rulings, as they existed on April 16, 2003, to the extent not superseded or amended by the PCAOB.

321 AICPA Code of Professional Conduct, et sec. 191, *Ethics Rulings on Independence, Integrity, and Objectivity*, "Ethics Ruling No. 94, Indemnification Clause in Engagement Letters."

PCAOB's interim independence standards, currently states that independence would not be impaired if the auditor and the audit client agreed to alternative dispute resolution ("ADR") to resolve disputes relating to past services.[322] The AICPA is proposing to amend its independence standards to parallel the position of the Advisory so that generally limitation of auditor liability provisions in engagement letters would prejudice independence, but punitive damage limitation, ADR and the unsuccessful party to a lawsuit or ADR pays the costs of the successful party provisions would not impair auditor independence.[323]

VIII.
CONCLUSION

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

---

322 AICPA Code of Professional Conduct, et sec. 191, *Ethics Rulings on Independence, Integrity, and Objectivity*, "Ethics Ruling No. 95, Agreement With Attest Client to Use ADR Techniques."

323 AICPA Proposed Interpretation 101-16 (September 15, 2005) (available at http://www.aicpa.org/download/ethics/2--5_0915_ed_Indemn.pdf), which sets forth the AICPA's proposed position on the types of clauses discussed above.

EXHIBIT A

FORM OF OUTSIDE LAW FIRM RESPONSE LETTER

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

Gentlemen:

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

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

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

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

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

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

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

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

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

Very truly yours,

[Law Firm Name]

By_______________________________

ANNEX A

MISCELLANEOUS MATTERS

1. List of Subsidiaries or Other Related Entities

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

[LIST SUBSIDIARIES HERE]

2. Scope of Engagement

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

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

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

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

3. Other Matters

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

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

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

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

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

(b) Insert the following paragraph if appropriate:

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

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

ANNEX B

DESCRIPTION OF LOSS CONTINGENCIES

1. Contractually Assumed Obligations

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

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

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

2. Unasserted Possible Claims and Assessments

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

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

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

3. Overtly Threatened or Pending Litigation

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

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

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

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

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

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

> **"In view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either 'probable' or 'remote'; for purposes of any such judgment it is appropriate to use the following meanings:**
>
> **(i) probable--an unfavorable outcome for the client is probable if the prospects of the claimant not succeeding are judged to be extremely doubtful and the prospects for success by the client in its defense are judged to be slight.**
>
> **(ii) remote--an unfavorable outcome is remote if the prospects for the client not succeeding in its defense are judged to be extremely doubtful and the prospects of success by the claimant are judged to be slight....**
>
> **[T]he amount or range of potential loss will normally be as inherently impossible to ascertain, with any degree of certainty, as the outcome of the litigation. Therefore, it is appropriate for the lawyer to provide**

an estimate of the amount or range of potential loss (if the outcome should be unfavorable) only if he believes that the probability of inaccuracy of the estimate of the amount or range of potential loss is slight.... In most cases, the lawyer will not be able to provide any such estimate to the auditor."

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

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

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

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

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

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

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