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Financial Statement Reporting of Pending Litigation: Attorneys, Auditors, and Difference of Opinions

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ESSAYS

FINANCIAL STATEMENT REPORTING OF PENDING LITIGATION: ATTORNEYS, AUDITORS, AND DIFFERENCES OF OPINIONS

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What we've got here is a failure to communicate.[1]

I. INTRODUCTION

Pending litigation can be a significant source of potential liability for public companies. The lack of adequate disclosure of this potential liability has caused confusion for investors, lenders, and other financial statement users. Auditors are required to assess the appropriateness of financial statement disclosures regarding pending litigation. However, the auditor's ability to do so depends upon receiving information from the company's attorneys. Obtaining this information, however, is problematic because the accounting and auditing standards that guide auditors and the professional standards that guide attorneys have been at odds for the past thirty years. Recent scandals[2] have resulted in

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1. COOL HAND LUKE (Warner Brothers Pictures 1967).

2. Scandals in recent years began with Enron and soon included MCI-Worldcom, Tyco International, Adelphia, Rite Aid, and many others. *See* Scott Harshbarger &

legislation[3] and increased scrutiny of the disclosure of contingent liabilities from pending litigation, thus magnifying this conflict between auditors and attorneys.

Parts II and III of this Article discuss the U.S. accounting standards and auditing standards applicable to pending litigation. Part IV identifies the issues raised by communications between attorneys and auditors, including the attorney-client privilege, the work product doctrine, and the American Bar Association guidelines[4] on communications with a client's auditor. Part V describes three possible solutions offered by previous commentators to the conflict between attorneys and auditors and an assessment of the viability of these solutions. Finally, Part VI provides our conclusions and a recommendation for addressing this conflict.

II. U.S. ACCOUNTING STANDARDS REGARDING PENDING LITIGATION

Certified Public Accountants ("CPAs")[5] play a critical role in the U.S. financial markets. Investors and lenders rely heavily on the information provided in a company's financial statements in making investment, lending, and other decisions regarding business with a particular company. As independent auditors, CPAs express their opinion re-

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Goutam U. Jois, *Looking Back and Looking Forward: Sarbanes-Oxley and the Future of Corporate Governance*, 40 AKRON L. REV. 1 (2007); Gregory C. Leon, *Stigmata: The Stain of Sarbanes-Oxley on U.S. Capital Markets*, 9 DUQ. BUS. L.J. 125 (2007).

3. These scandals led to the passage of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

4. *See infra* notes 72-74 and accompanying text.

5. A Certified Public Accountant is a professional who has met the requirements of his state board of accountancy, which include completing a program of study in accounting at a college or university, passing the national Uniform CPA Exam, and obtaining a specific amount of professional work experience in public accounting. *See* AICPA Media Center—Frequently Asked Questions, Becoming a CPA, Question 2, http://www.aicpa.org/MediaCenter/FAQs.htm#cpa_answer2 (last visited Dec. 29, 2009). Certified Public Accountants may perform many different services for their clients, including tax return advice and preparation, bookkeeping, valuation services, management consulting and information system consulting, as well as auditing a client's financial statements. It is the audit function that is critical for purposes of this article. As an auditor, the independent certified public accountant issues an opinion that the public corporation's financial statements are or are not presented fairly in accordance with the Generally Accepted Accounting Principles (GAAP). *See* United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984).

garding the reliability and integrity of a publicly traded company's financial statements based upon their examination and testing of the company's books and records.[6] The U.S. Supreme Court has recognized the important role auditor's play, as discussed in the following statement:

> The independent public accountant performing this special function [the audit] owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.[7]

As one commentator describes it, the auditor's duty is "to the reader of the client's financial reports and is public in nature."[8]

To form their opinion as to the fairness of the company's financial statements, the auditors must determine which items are material to the financial condition of the company, and this determination is "a matter of professional judgment made in light of surrounding circumstances, and necessarily involves both quantitative and qualitative considerations."[9]

Since 1973, the financial accounting principles that govern the preparation of financial statements for public companies have been the Generally Accepted Accounting Principles ("GAAP"), issued by the Financial Accounting Standards Board ("FASB").[10] GAAP is "a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practice . . . and . . . provide a standard by which to measure financial presentations."[11] Thus, the FASB is the organization recognized as setting accounting and

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6. *See infra* notes 35-47 and accompanying text.

7. *Arthur Young & Co.*, 465 U.S. at 817-18.

8. John W. Allen, *Ethical and Liability Risks in Auditor Response Letters*, 77-JAN FLA. B.J. 10, 10 (2003).

9. Charles D. Lee, *When Professions Collide—Lawyers' Reponses to Auditors' Requests*, 61-FEB J. KAN. B.A. 27, 27 (1992).

10. Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, Accounting Series Release No. 150, 28 Fed. Reg. 2261 (Dec. 20, 1973).

11. THE MEANING OF "PRESENT FAIRLY IN CONFORMITY WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES," Statement on Auditing Standards No. 69, § 411.02 (Am. Inst. of Certified Pub. Accountants 1992).

reporting standards in the United States.[12]

With regard to pending litigation, the relevant accounting standard is Statement of Financial Accounting Standard ("SFAS") No. 5—Accounting for Contingencies,[13] which provides the criteria for determining whether a company must accrue or disclose loss contingencies.[14] Under these standards, a loss contingency is defined as "an existing condition, situation, or set of circumstances involving uncertainty. . ..to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur."[15] While SFAS No. 5 does not provide specific guidance related to the disclosure of potential losses from litigation against an enterprise as of a particular balance sheet date, the inclusion of an extensive example involving unresolved litigation within an interpretation[16] of SFAS No. 5 issued by the FASB indicates that pending litigation has been an important type of loss contingency for several decades.[17]

Under SFAS No. 5, a potential loss resulting from pending litigation is to be accrued when it is "probable that one or more future events will occur confirming the fact of the loss" and when "the amount of the loss can be reasonably estimated."[18] If an enterprise determines that one or both of those conditions have not been met, SFAS No. 5

12. Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Securities Act Release No. 8221, Exchange Act Release No. 47,743, Investment Company Act Release No. 26,028, 80 SEC Docket 183 (Apr. 25, 2003) (indicating that the FASB accounting standards are recognized as "generally accepted" for U.S. security laws). For a recent examination of a proposal for the U.S. to move to a new set of international accounting standards, see Lawrence A. Cunningham, *The SEC's Global Accounting Vision: A Realistic Appraisal of a Quixotic Quest*, 87 N.C. L. REV. 1 (2008).

13. ACCOUNTING FOR CONTINGENCIES, Statement of Fin. Accounting Standards No. 5 (Fin. Accounting Standards Bd. 1975) [hereinafter FAS No. 5].

14. *Id.* at ¶¶ 8-13.

15. *Id.* at ¶ 1.

16. REASONABLE ESTIMATION OF THE AMOUNT OF A LOSS, FASB Interpretation No. 14 (Fin. Accounting Standards Bd. 1976).

17. *Id.* at ¶¶ 4-6.

18. FAS No. 5, *supra* note 13, at ¶ 8. Commentators have described the process as a sequential decision-making process, first determining whether the amount is material, and if so, determining whether the occurrence of a future loss is "probable" or "reasonably possible," and, finally, determining whether the future loss is "remote." *See* Joseph Aharony & Amihud Dotan, *A Comparative Analysis of Auditor, Manager and Financial Analyst Interpretations of SFAS 5 Disclosure Guidelines*, 31 J. BUS. FIN. & ACCT. 475, 475-76 (2004).

requires the enterprise to disclose loss contingency when "there is at least a reasonable possibility that a loss . . . may have occurred."[19] This disclosure "shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made."[20] Neither accrual nor disclosure is required when the probability of the future event(s) occurring that would trigger the loss for the enterprise is considered to be remote, which SFAS No. 5 defines as being "slight".[21]

For decades, academics, regulators, and investors have expressed frustration with the lack of disclosure of information related to, and accruals for, pending litigation given the standards set forth in SFAS No. 5 and FIN 14.[22] For example, the author of a study of one of the most significant corporate lawsuits of the 1980s, Pennzoil's $14 billion lawsuit against Texaco,[23] found that Texaco, in its 1986 financial statements, failed to accrue any portion of the more than $9.1 billion judgment it was ordered to pay Pennzoil during that year.[24] Within days of filing its 1986 financial statements with the SEC in early 1987, however, Texaco filed for bankruptcy protection[25] and began negotiating with Pennzoil for a settlement through the proceedings of the bankruptcy court.[26]In its 1987 financial statements filed twelve months later, Texaco revealed that the bankruptcy was the result of the Pennzoil judgment and accrued the approximately $3 billion that it ultimately settled on paying Pennzoil in December 1987.[27] While Texaco was sure enough that it was going to be paying Pennzoil enough money to warrant filing

19. FAS No. 5, *supra* note 13, at ¶ 10.

20. *Id.*

21. *Id.* at ¶ 3. *See* Aharaony & Dotan, *supra* note 18, at 478 (describing differences in the interpretation of the terms "remote" and "probable" by financial analysts, auditors and managers). *See generally* Kenneth E. Harrison & Lawrence A. Tomassini, *Judging the Probability of a Contingent Loss: An Empirical Study*, 5 COMTEMP. ACCT. RES. 642 (1989) (describing differences in auditors' interpretation of the terms "reasonably possible" and "probable").

22. *See infra* notes 23-34 and accompanying text.

23. Texaco, Inc. v. Pennzoil Co., 729 S.W.2d 768 (Tex. App. 1987). For subsequent proceedings regarding the enforceability of the resulting judgment, see *Texaco, Inc. v. Pennzoil Co.*, 626 F. Supp. 250 (S.D.N.Y.), *modified*, 784 F.2d 1133 (2d Cir. 1986), *rev'd* 481 U.S. 1 (1987).

24. Edward B. Deakin, *Accounting for Contingencies: The* Pennzoil-Texaco *Case*, 3 ACCT. HORIZONS 21, 25 (1989).

25. *See In re* Texaco Inc., 73 B.R. 960 (Bankr. S.D.N.Y. 1987).

26. Deakin, *supra* note 24, at 26-27.

27. TEXACO, INC., 1987 ANNUAL REPORT 16 (1988).

bankruptcy in April 1987, it was apparently unable to supply even the low end of a range for what the potential amount of the settlement was going to be in its financial statements filed that same month.[28]

More recently, SEC Deputy Chief Accountant Scott Taub noted it is "somewhat surprising the number of instances where zero is considered the low end of a range with no number more likely than any other right up until a large settlement is announced."[29] Regarding financial statement disclosures, Taub said that "these situations are also often the ones for which no significant disclosure has been made in the financial statement before the settlement is announced."[30] Taub's comments are supported by an SEC empirical study which revealed that while 64% of SEC registrants sampled reported being sued, only 9.5% of them accrued any liability for pending litigation on their financial statements.[31] A footnote in the same SEC report indicates that "approximately 97% of the $23,761 billion of potential legal contingent losses disclosed for the entire sample relate to instances where no liability was reported as being recognized on the balance sheet."[32]

There are other examples of under-accruals for pending litigation that demonstrate that financial statement disclosure is not moving in a direction consistent with the kind of transparency that Taub and investors desire. For example, Wall Street estimated Merck's total Vioxx liability somewhere between $5 and $50 billion.[33] At the same time, however, while Merck's management estimated revenues of $22 billion, the company did not set aside any reserves for potential liability

28. Things haven't changed much since the late 1980s. *See* J. DAVID SPICELAND ET AL., INTERMEDIATE ACCOUNTING 632 (4th ed. 2007) (noting that "ExxonMobil, disclosed but did not accrue damages from a [$56,000,000] lawsuit it lost, even after the award was affirmed by trial court").

29. Scott A. Taub, Deputy Chief Accountant, U.S. Sec. and Exchange Comm'n, Speech by SEC Staff: Remarks at the University of Southern California Leventhal School of Accounting SEC and Financial Reporting Conference (May 27, 2004) (transcript available at http://www.sec.gov/news/speech/spch052704sat.htm).

30. *Id.*

31. OFFICE OF THE CHIEF ACCOUNTANT, OFFICE OF ECON. ANALYSIS, DIV. OF CORP. FIN., SEC. AND EXCHANGE COMM'N, REPORT AND RECOMMENDATIONS PURSUANT TO SECTION 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 69-70 (2005).

32. *Id.* at 72 n.175.

33. John Goff, *Coming Distractions*, CFO MAG., Apr. 1, 2006, at 4.

relating to the Vioxx litigation.[34]

These examples illustrate a clear problem: while the legal exposure of public companies has grown exponentially, the accrual of loss contingencies has remained as woefully limited as it was decades ago.

III. U.S. AUDITING STANDARDS FOR PENDING LITIGATION

As a public company's management prepares its financial statements, they work with internal and external counsel to appropriately categorize loss contingencies in accordance with GAAP.[35] Auditors are responsible for determining if their clients' categorizations and subsequent disclosures and accruals, or lack thereof, are in accordance with GAAP, given the evidence they gather in an audit performed in compliance with the standards of the Public Company Accounting Oversight Board ("PCAOB").[36] The auditor's goal is to provide an independent report on whether the company's financial statements present fairly the financial position of the company in conformance with

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34. *Id.* In its filings with the Securities and Exchange Commission, Merck described potential liabilities from the Vioxx litigation as follows.

> The Company believes that it has meritorious defenses to the Vioxx Lawsuits and will vigorously defend against them. In view of the inherent difficulty of predicting the outcome of litigation, particularly where there are many claimants and the claimants seek indeterminate damages, the Company is unable to predict the outcome of these matters, and at this time cannot reasonably estimate the possible loss or range of loss with respect to the Vioxx Lawsuits. The Company has not established any reserves for any potential liability relating the Vioxx Lawsuits or the Vioxx Investigations, including for those cases in which verdicts or judgments have been entered against the Company, and are now in post-verdict proceedings or on appeal. In each of those cases the Company believes it has strong points to raise on appeal and therefore that unfavorable outcomes in such cases are not probable. Unfavorable outcomes in the Vioxx Litigation (as defined below) could have a material adverse effect on the Company's financial position, liquidity and results of operations.

Merck & Co. Inc., Annual Report (Form 10-K), at 22 (Feb. 28, 2007).

35. *See* INQUIRY OF A CLIENT'S LAWYER CONCERNING LITIGATION, CLAIMS, AND ASSESSMENTS, Statement on Auditing Standards No. 12, § 337.02 (Am. Inst. of Certified Pub. Accountants 1976) ("Management is responsible for adopting policies and procedures to identify, evaluate, and account for litigation, claims, and assessments as a basis for the preparation of financial statements in conformity with generally accepted accounting principles.").

36. REFERENCES IN AUDITORS' REPORT TO THE STANDARDS OF THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS, Auditing Standard No. 1, at ¶ 3 (Pub. Co. Acct. Oversight Bd. 2004).

GAPP,[37] including disclosures and accruals for contingent liabilities.

Statement of Auditing Standards ("SAS") No. 12[38] provides the guidelines the auditor must follow in gathering such evidence from the client's attorneys.[39] Although it was issued in January 1976, SAS No. 12 remains the operative auditing standard today even after the enactment of the Sarbanes-Oxley Act and the creation of the PCAOB.[40]

Under SAS No. 12, as codified within the AICPA Professional Standards in AU Sec. 337,[41] the auditor must obtain evidence regarding the existence of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims and assessments; the period in which the underlying cause for legal action occurred; the degree of probability of an unfavorable outcome; and the amount or range of potential loss.[42] Because auditors do not have legal training and therefore do not possess the skills necessary to make legal judgments concerning this information, auditors should request that the client's management send a letter of inquiry to attorneys with whom management consulted concerning litigation, claims, and assessments.[43] The "letter of audit inquiry" from the auditors to the client's lawyer "is the primary means of obtaining corroborating evidence of the information furnished by management concerning litigation."[44]

The letter of audit inquiry should address specific matters like identification of the company, including subsidiaries; the date of the audit; a list prepared by management that describes and evaluates pending or threatened litigation, claims, and assessments with respect

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37. *See* Lee, *supra* note 9, at 27.

38. INQUIRY OF A CLIENT'S LAWYER CONCERNING LITIGATION, CLAIMS AND ASSESSMENTS, Statement on Auditing Standards No. 12, § 337 (Am. Inst. of Certified Pub. Accountants 1976) [hereinafter SAS No. 12].

39. Byron F. Egan, *Communicating with Auditors After the Sarbanes-Oxley Act*, 41-FALL TEX. J. BUS. L. 131, 196 (2005).

40. The PCAOB has adopted the generally accepted auditing standards as they existed on April 16, 2003 as the interim PCAOB standards until further guidance is issued. *See* PCAOB Rulemaking: Public Company Accounting Oversight Board; Order Approving Proposed Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*, Exchange Act Release No. 49,707 (May 14, 2004).

41. SAS No. 12, *supra* note 38.

42. *Id.* § 337.04.

43. RELATED PARTIES, Statement on Auditing Standards No. 45, § 334.06 (Am. Inst. of Certified Pub. Accountants 1983).

44. SAS No. 12, *supra* note 38, at § 337.08.

that the attorney has been engaged in and has devoted substantive attention to in the form of legal representation; and 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 attorney has been engaged and devoted attention in the form of legal representation.[45] The auditor should request that the attorney "describe and evaluate pending or threatened litigation, [including the] progress of the case to date. . .an evaluation of the likelihood of an unfavorable outcome and estimate, if one can be made, of the amount or range of the potential loss."[46] With regard to unasserted claims and assessments, the attorney should also be requested to disclose if his views "differ from those stated by management."[47]

IV. COMMUNICATIONS BETWEEN ATTORNEYS AND AUDITORS

Communications between attorneys and auditors are hindered by the legal and ethical standards that each group must adhere to in their representation of the client company. The auditors are guided by the auditing standards discussed above. Attorneys, on the other hand, are limited in what they may disclose due to the application of the attorney-client privilege and the work product doctrine. The discussion below addresses the attorney-client privilege and work product doctrine generally, followed by a discussion of the American Bar Association's guidance on communications with a client's auditors.

A. The Attorney-Client Privilege

The attorney-client privilege is the oldest privilege recognized by the law.[48] The confidentiality that it guarantees is considered a fundamental principle of the attorney-client relationship[49], encouraging the client to freely discuss relevant information with their attorney without fear of disclosure to allow the attorney to provide adequate legal

45. *Id.* § 337.09(a)-(c).
46. *Id.* § 337.09(d)(1)-(2).
47. *Id.* § 337.09(d)(3).
48. *See* Upjohn Co. v. United States, 449 U.S. 383, 389 (1981).
49. MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt. 2 (2002).

representation.[50] Corporations are generally entitled to the same protection under the attorney-client privilege as individuals.[51]

The attorney-client privilege protects confidential communications between a client and their attorney from disclosure in any civil or criminal proceeding.[52] The privilege, however, is not unlimited. For example, the privilege only applies where the communication is made in the context of the attorney providing legal advice; if the attorney is providing general business advice, the privilege does not apply.[53] Moreover, while the privilege applies to communications between the attorney and the client, it does not protect the facts underlying those communications.[54] Likewise, the privilege may be waived if the privileged communications are made available to a third party outside the attorney-client relationship.[55] As discussed in detail below, it is the potential for this waiver that is raised by the communications between the attorney and the auditor in response to the auditor's request for information.

B. The Work Product Doctrine

The work product doctrine protects an attorney's thought processes, legal analysis and trial preparation work from disclosure.[56] Like the attorney-client privilege, the facts regarding an issue are not protected by the work product doctrine.[57] Rather, what is protected is "the work performed, materials generated and considerations of the lawyers in connection with the investigation and any recommendations to the

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50. *Upjohn*, 449 U.S. at 389.

51. *Id.* at 389-90; MODEL RULES OF PROF'L CONDUCT R. 1.13 cmt. 2 (2002).

52. *Upjohn*, 449 U.S. at 389.

53. *See, e.g.*, Hardy v. N.Y. News, Inc., 114 F.R.D. 633 (S.D.N.Y. 1987) (communications concerning affirmative action programs made to attorney serving as director of employee relations not privileged).

54. Upjohn Co. v. United States, 449 U.S. 383, 395 (1981).

55. United States v. El Paso Co., 682 F.2d 530, 539-40 (5th Cir. 1982) (involving waiver based on disclosure of internal tax analysis to outside auditors); *In re* John Doe Corp., 675 F.2d 482, 488-89 (2d Cir. 1982) (involving waiver based on disclosure of internal report to outside auditors and underwriters); David M. Brodsky, *Updates on the Corporate Attorney-Client Privilege*, 8 SEDONA CONF. J. 89, 90 (2007). For a detailed discussion of the scope of the waiver of the attorney-client privilege, see Egan, *supra* note 39, at 182-87.

56. Hickman v. Taylor, 329 U.S. 495, 511 (1947).

57. Brodsky, *supra* note 55, at 91.

company."[58] The theory behind the doctrine is that attorneys should be allowed to prepare for trial without fear that their work will be required to be turned over to the other party through discovery requests.[59] The common law rule was codified in Federal Rule of Civil Procedure 26(b)(3), which provides as follows:

> [A] party may obtain discovery of documents and tangible things otherwise discoverable under subdivision (b)(1) of this rule and prepared in anticipation of litigation or for trial . . . 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 materials by other means. In ordering discovery of such materials when the required showing has been made, the court shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation.[60]

Under this language, the initial question is whether the materials sought were prepared in anticipation of litigation.[61] Courts have interpreted this phrase under either a "primary purpose" approach or a "because of" approach.[62] Under the "primary purpose" approach, a document is prepared in anticipation of litigation only if it is prepared principally or exclusively to assist in litigation.[63] Under the "because of" approach, a document is prepared in anticipation of litigation if it is created because of the prospect of litigation or because it analyzes the outcome of litigation.[64] Most courts now recognize the broader "because of" approach,[65] with the result that work product protection is

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58. *Id.*

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

60. FED. R. CIV. P. 26(b)(3).

61. Ricardo Colón, *Caution: Disclosures of Attorney Work Product to Independent Auditors May Waive the Privilege*, 52 LOY. L. REV. 115, 124-25 (2006) (citing *In re* Raytheon Sec. Litig., 218 F.R.D. 354, 357 (D. Mass. 2003)).

62. *Id.* at 125 (citing United States v. Adlman, 134 F.3d 1194, 1997 (2d Cir. 1998) (discussing the two interpretations of the term "in anticipation of litigation")).

63. *Adlman*, 134 F.3d at 1198, n.3.

64. *Id.* at 1202.

65. *See In re* Grand Jury Subpoena, 357 F.3d 900 (9th Cir. 2004); Maine v. U.S. Dep't of Interior, 298 F.3d 60 (1st Cir. 2002); *Adlman*, 134 F.3d 1194; Nat'l Union Fire Ins. Co. v. Murray Sheet Metal Co., 967 F.2d 980 (4th Cir. 1992); Simon v. G.D. Searle & Co., 816 F.2d 397 (8th Cir. 1987); *In re* Grand Jury Proceedings, 604 F.2d 798 (3d Cir. 1979).

extended to documents prepared by attorneys at the request of an independent auditor if the documents contain an estimate of the likelihood of success in litigation or discusses litigation strategies.[66]

Like the attorney-client privilege, the work product protection is subject to waiver, but on a more limited basis.[67] For example, merely disclosing information subject to the work product protection to a third party with a common interest will not result in a waiver.[68] Likewise, disclosure subject to a confidentiality agreement has been found to avoid waiver given that the agreement is evidence of an attempt to protect the information for disclosure to the opposing party.[69] However, widespread disclosure could lead to a waiver, as could disclosure to a government agency,[70] particularly where the agency is an adversarial party.[71]

C. ABA Guidance on Communications with a Client's Auditor

In responding to the auditor's letter of inquiry, the client's attorney must be careful not to disclose information that results in a waiver of the attorney-client privilege or information protected by the work product doctrine. In response to this concern, the American Bar Association provided guidance to attorneys by publishing its "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information" in 1975.[72]

Unlike the required adherence to accounting and auditing standards, the Statement of Policy is "desirable" but not mandatory.[73] Moreover, with the primary focus on the preservation of the attorney-client and work product doctrine privileges, the Statement of Policy does little to assist the auditor in their quest for disclosure. The Statement of Policy addresses this issue as follows:

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66. Colón, *supra* note 61, at 125-26 (citing *Adlman*, 134 F.3d at 1200).

67. *See* Egan, *supra* note 39, at 191.

68. United States v. Gulf Oil Corp., 760 F.2d 292, 296 (Temp. Emer. Ct. App. 1985).

69. Egan, *supra* note 39, at 191 (citing Blanchard v. EdgeMark Fin. Corp., 192 F.R.D. 233, 237 (N.D. Ill. 2000)).

70. *See Blanchard*, 192 F.R.D. at 237.

71. United States v. Jones, 696 F.2d 1069, 1072 (4th Cir. 1982). For a more detailed discussion of this theory of waiver, see Egan, *supra* note 39, at 191 n.260.

72. *ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information*, 31 BUS. LAW. 1709 (1976) [hereinafter *ABA Statement of Policy*].

73. *Id.* at 1710.

> It is also recognized that our legal, political and economic systems depend to an important extent on public confidence in published financial statements. To meet this need the accounting profession must adopt and adhere to standards and procedures that will command confidence in the auditing process. It is not, however, believed necessary, or sound public policy, to intrude upon the confidentiality of the lawyer-client relationship in order to command such confidence.[74]

The ABA concern regarding potential waiver of the attorney-client privilege and work product doctrine is substantiated by case law. Regarding the attorney-client privilege, federal courts have consistently held that disclosure to independent auditors of information subject to the attorney-client privilege destroys the confidentiality and therefore waives the privilege.[75] As both courts and commentators have recognized, however, the waiver of the attorney-client privilege does not automatically preclude protection under the work product doctrine.[76] Thus, the issue becomes whether disclosure to independent auditors effects a waiver of the work product doctrine as well.

As discussed above,[77] unlike the attorney-client privilege, merely disclosing information subject to the work product protection does not automatically waive the protection. Rather, the issue is whether the disclosure substantially increases the opportunity for potential adversaries to obtain the information.[78] Thus, courts have been required to address the question of whether the third party to whom the protected information is disclosed is or should be considered an adversary.[79] Disclosure of protected information to a third party who shares a common interest with the disclosing party does not result in a waiver.[80] The question then is whether the independent auditor, to whom the audit

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74. *Id.*

75. United States v. El Paso Co., 682 F.2d 530, 540 (5th Cir. 1982) (holding that company waived the attorney-client privilege as to documents disclosed to its independent auditors); *In re* Pfizer, Inc. Sec. Litig., No. 90 Civ. 1260 (SS), 1993 WL 561125, at *7 (S.D.N.Y. Dec. 22, 1993); Colón, *supra* note 61, at 122-23.

76. Colón, *supra* note 61, at 123 (citing Medinol, Ltd. v. Boston Scientific Corp., 214 F.R.D. 113, 114 (S.D.N.Y. 2002)).

77. *See supra* notes 67-71 and accompanying text.

78. In re *Pfizer*, 1993 WL 561125, at *6.

79. Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc., 229 F.R.D. 441, 446 (S.D.N.Y. 2004).

80. *Id.* at 446; *In re* Copper Mkt. Antitrust Litig., 200 F.R.D. 213, 221 n.6 (S.D.N.Y. 2001); In re *Pfizer*, 1993 WL 561125, at *6.

letter and its contents are disclosed, should be considered an "adversary."

In addressing this question, two approaches have emerged in the courts. The first approach is illustrated by *In re* Pfizer, Inc. Securities Litigation.[81] In that case, the court held that Pfizer and its auditor shared common interests in the information disclosed and that the auditor therefore is not reasonably viewed as a conduit to a potential adversary.[82] Several courts that considered the issue have adopted this analysis.[83] In the words of one court, "the fact that an independent auditor must remain independent from the company it audits does not establish that the auditor also has an adversarial relationship with the client as contemplated by the work product doctrine."[84]

The second approach is based on a 2002 case, Medinol, Ltd. v. Boston Scientific Corp.[85], which emphasized the "public watchdog role" of independent auditors.[86] This approach focuses on the required independent nature of auditors, observing that "in order for auditors to properly do their job, they *must* not share common interests with the company they audit."[87] It should be noted that, while the Medinol approach is still under consideration by the courts, many courts seem to find the reasoning of the Pfizer approach more persuasive.[88]

Other courts have found the role of the independent auditor to increase substantially the opportunities for potential adversaries to obtain the information in the audit letter based on the disclosure duties the

81. In re *Pfizer*, 1993 WL 561125.

82. *Id.* at *6.

83. *See* Gutter v. E.I. DuPont de Nemours & Co., No. 95 Civ. 2152, 1998 WL 2107926, at *5 (S.D. Fla. May 18, 1998); Gramm v. Horsehead Indus., Inc., No. 87 Civ. 5122, 1990 WL 142404, at *5 (S.D.N.Y. Jan. 25, 1990). See *Merrill Lynch & Co.*, 229 F.R.D. at 447-49, for a detailed discussion of the some of the policy reasons behind one court's decision that auditors should not be treated as adversaries to their audit clients.

84. Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc., 237 F.R.D. 176, 183 (N.D. Ill. 2006).

85. Medinol, Ltd. v. Boston Scientific Corp., 214 F.R.D. 113 (S.D.N.Y. 2002).

86. *Id.* at 116 (quoting United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984)).

87. *Medinol, Ltd.*, 214 F.R.D. at 116 (emphasis in original).

88. Vacco v. Harrah's Operating Co., Inc., No. 1:07-CV-0663, 2008 WL 4793719, at *6 (N.D.N.Y. Oct. 29, 2008); Am. S.S. Owners Mut. Prot. & Indemnification Ass'n, Inc. v. Alcoa S.S. Co., Inc., No. 04 Civ. 4309, 2006 WL 278131, at *2 (S.D.N.Y. Feb. 2, 2006).

auditor has to creditors, stockholders and the investing public.[89] Thus, to the extent the securities laws and/or relevant accounting standards mandate public disclosure, a court is likely to find that the materials will likely be disclosed to the company's adversaries and therefore are not subject to work product protection.[90]

The uncertainty about the likely application and potential waiver of the attorney-client privilege and, perhaps more importantly, information covered by the work product doctrine, creates an incentive for this limited disclosures to the auditor. However, the attorney's limited disclosure to the auditor creates potential concerns regarding the auditor's opinion. AU § 337.13 indicates that "a lawyer's refusal to furnish the information requested in an inquiry letter. . .would be a limitation on the scope of the audit sufficient to preclude an unqualified opinion."[91] Whether a lawyer refuses to furnish all of the information requested in an inquiry letter or does not provide enough evidence for the auditor to "support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, the auditor should consider the need to express a qualified or to disclaim an opinion because of a scope limitation. . *.if sufficient evidential matter does or did exist but was not available to the auditor*."[92] Thus, if the communication issues between auditor and lawyer are such that the audit client's lawyer has information that could comply with the auditor's request for information related to pending litigation against the client, but the lawyer does not provide that information to the auditor due to attorney-client privilege, then the auditor appears to be bound to qualify or disclaim its opinion given the current state of U.S. accounting and auditing standards.

Moreover, for public companies (and their attorneys and auditors) subject to U.S. securities law, Section 303(a) of the Sarbanes-Oxley Act

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89. *In re* Raytheon Sec. Litig., 218 F.R.D. 354, 360 (D. Mass. 2003); Diasonics Sec. Litig., No. C-83-4584-RFP (FW), 1986 WL 53402, at *1 (N.D. Cal. June 15, 1986) (holding that documents disclosed to an accounting firm acting as an auditor were either not entitled to work product protection or that such protection was waived as a result of the disclosure).

90. In re *Raytheon*, 218 F.R.D. at 360; *see also* United States v. Gulf Oil Corp., 760 F.2d 292 (Temp. Emer. Ct. App. 1985).

91. SAS No. 12, *supra* note 38, at § 337.13.

92. REPORTS ON AUDITED FINANCIAL STATEMENTS, Statement on Auditing Standards No. 98, § 508.31 (Am. Inst. of Certified Pub. Accountants 1989) (emphasis added).

specifically prohibits any officer or director of the company, or any other person acting under their direction, "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."[93] SEC Final Rule 34-47890 codifies Section 303 and notes that these activities "include, but are not limited to, directly or indirectly. . .(p)roviding an auditor with an inaccurate or misleading legal analysis."[94] Section 303 raises the stakes in this game between auditor and attorneys of the audit client that is also an SEC registrant. Where the attorney does not reply to the inquiry letter from an auditor in a manner which allows the auditor to determine if his client's financials are free of material misstatement, the attorney risks assessment of the post-Sarbanes-Oxley heightened penalties associated with violating federal securities law.[95]

V. POSSIBLE SOLUTIONS

As the above discussion demonstrates, the auditor's goals of transparency and adequate disclosure are at odds with the attorney's goal of confidentiality. For over thirty years there has been an inability to harmonize these differences.[96] With continued uncertainty in the financial markets creeping into financial statement reporting, this predicament is unacceptable. The auditor wants the attorney to evaluate claims and provide a number that the auditors can rely upon in evaluating the financial statement disclosures. Because of the attorney's obligations to adhere to the ABA's Statement of Policy, the auditor is often placed between the "rock" of evaluating a client's treatment of pending litigation as appropriate within the confines of GAAP without sufficient evidence from a client's attorneys to support such a claim and the "hard place" of qualifying or even disclaiming its opinion on a client's financials for reasons of scope limitation. Regardless of Sarbanes-Oxley and the demands of the U.S. investor, it is unlikely that

93. 15 U.S.C. § 7242(a) (2006).

94. Improper Influence on Conduct of Audits, Exchange Act Release No. 47,890, Investment Company Act Release No. 26,050, 80 SEC Docket 770 (May 20, 2003). For a more detailed discussion of the potential liabilities for making misleading statements to auditors, see Egan, *supra* note 39, at 144-54.

95. 17 C.F.R. § 240.13b2-2 (2009).

96. *See ABA Statement of Policy*, *supra* note 72.

the ABA is going to change its stance on letters of audit inquiry in the foreseeable future.[97]

Commentators have suggested three possible solutions to this dilemma. One approach calls for the "reeducation" of attorneys, auditors and the courts.[98] Regarding attorneys, this reeducation would include a revision of the ABA Statement of Policy "to make it less hostile to the process."[99] With regard to auditors, it would require an expansion of the audit inquiry letter to solicit more information that might be available in order to encourage disclosure of potential loss contingencies.[100] Finally, with respect to the courts, the reeducation is simply a suggestion that the court decisions over the past twenty years concerning this area be changed.[101] Given the more than thirty years that the ABA Statement of Policy has been in effect, any change will be slow and minimal. Moreover, any change will inevitably have a negative impact on the most sacred foundations of the legal profession—the attorney-client privilege and the work product doctrine. Thus, this reeducation process is unlikely to be a successful solution.

A second approach is based on an expansion of privilege to include the auditor and client in a manner similar to that enjoyed by attorneys.[102] While an auditor is subject to professional and ethical requirements to protect the confidentiality of client information,[103] and while some states have recognized various forms of accountant/auditor-client privilege,[104] the federal courts[105] have not.[106] Moreover, the PCAOB has publicly

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97. *See* James Johnson, *The Accountable Attorney: A Proposal to Revamp the ABA's 1976 Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information*, 14 TEX. WESLEYAN L. REV. 27, 33-34 (2007) (discussing the reform momentum generated by the requirements of the Sarbanes-Oxley Act and the legal profession's refusal to change its position as stated in the *ABA Statement of Policy*).

98. M. Eric Anderson, *Talkin' 'Bout My Litigation—How the Attorney Responsible to an Audit Inquiry Letter Discloses as Little as Possible*, 7 TRANSACTIONS: TENN. J. BUS. L. 143, 167 (2005).

99. *Id.*

100. *Id.*

101. *Id.*

102. Colón, *supra* note 61, at 143.

103. CODE OF PROFESSIONAL CONDUCT R. 301 (Am. Inst. of Certified Pub. Accountants 1992).

104. David M. Greenwald, *Corporate Governance—Transparency in Financial Reporting Without Waiving a Corporation's Privileges*, SL081 ALI-ABA 1261, 1264-65 (2006); Gideon Mark & Thomas C. Pearson, *Corporate Cooperation During Investigations and Audits*, 13 STAN. J. L. BUS. & FIN. 1, 20 (2007).

105. For a discussion of the attempt by Congress to create an attorney-client type

stated that it will not recognize such a privilege.[107] Given this hostility from the regulatory side, expansion of privilege to include auditors seems unlikely, particularly when the federal government continues to apply pressure to waive the attorney-client privilege and work product doctrine in criminal cases.[108]

A third approach calls for a report by an independent legal counsel in response to the auditor's request for information.[109] Under this approach, an independent attorney would review the litigation and claims threatened or asserted against the client and provide an opinion that the financial statement disclosure "presents fairly, in all material respects, the legal contingencies" of the company as of a specific date.[110] In theory, this approach would preserve the attorney-client privilege because information gathered from the client's various attorneys would never be disclosed to outside legal counsel.[111] Moreover, because of his legal training, the independent attorney is in a better position than the auditor to evaluate the merits of the claims asserted and the probable and potential losses the client might face.[112]

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privilege that applies to accountants and other tax practitioners in the context of non-criminal proceedings before the Internal Revenue Service and the federal courts, see Steven J. Arsenault & W. R. Koprowski, *Tax Practitioner Privilege: A Safety Net with Many Holes*, 63 PRACTICAL TAX STRATEGIES 12 (1999).

106. United States v. Arthur Young & Co., 465 U.S. 805, 817 (1984); Couch v. United States, 409 U.S. 322, 344 (1973). *See* Mark & Pearson, *supra* note 104, at 20; Thomas J. Molony, *Is the Supreme Court Ready to Recognize Another Privilege? An Examination of the Accountant-Client Privilege in the Aftermath of* Jaffee v. Redmond, 55 WASH. & LEE L. REV. 247 (1988).

107. Mark & Pearson, *supra* note 104, at 20; Rules on Investigations and Adjudications, PCAOB Release No. 2003-015, at app. 2, A2-33-34 (Sept. 29, 2003).

108. Many commentators have discussed in detail the policies of the U.S. Department of Justice and other regulatory agencies that attempt to induce corporations and other business entities to waive the attorney-client privilege and work product protection, particularly in the context of criminal investigations. For a detailed discussion of these efforts and the public criticism of these policies that followed, see Brodsky, *supra* note 55, at 94-98. *See generally* U.S. SENTENCING GUIDELINES MANUAL (2008).

109. Johnson, *supra* note 97, at 48-49.

110. *Id.* at 49. This language reflects the language generally used by CPAs in issuing their opinion as to the fairness of a company's financial statements. *See* REPORTS ON AUDITED FINANCIAL STATEMENTS, Statement on Auditing Standards No. 98, § 508.08 (Am. Inst. of Certified Pub. Accountants 1989).

111. Johnson, *supra* note 97, at 48.

112. *Id.* at 48-49.

One concern with this approach, however, is whether it would actually solve the problem. The attorney-client privilege only applies to communications to attorneys in the context of legal representation.[113] The independent attorney whose sole task is to review the claims against the client and issue an opinion on the fairness of management's disclosures of those claims is arguably not providing legal representation, but rather is serving as a de facto auditor. Thus, whether this solution would actually protect information subject to the attorney-client privilege and work product doctrine is questionable at best.

Even if this approach does successfully preserve the attorney-client privilege and work product protection, it still has its share of other problems. Inserting an independent attorney into the review process would be unwieldy, adding yet another layer of review to a process that is often subject to significant time constraints. In addition, hiring an independent attorney to serve as a de facto-auditor with regard to the client's litigation disclosures would add significant costs to the audit.[114]

VI. CONCLUSIONS AND RECOMMENDATIONS

Considering the problems with the various approaches discussed above,[115] none appears to offer an effective solution to the problem. The common denominator among these approaches is a focus on law-based solutions: reeducating attorneys, expanding the attorney-client privilege and work product protection to include auditors, and the use of independent legal counsel. It seems clear that it is unlikely that there will be any change in the legal profession's approach to this issue. We believe, therefore, that any solution must lie on the auditor's side of the equation.

Unlike other areas of the audit, such as inventory or accounts receivable, where the auditor is able to confirm the balances of such accounts and the accuracy of the financial statement disclosures of those balances, the situation regarding legal contingencies is very different. Because the attorney is unwilling or unable to sufficiently disclose information to the auditors concerning pending litigation, the auditor is required to express an opinion on the company's financial statements

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113. *See supra* notes 52-54 and accompanying text.

114. The independent attorney is also subject to the same liability issues under Sarbanes Oxley § 303(a) that the client's regular attorneys already face. *See supra* notes 93-95 and accompanying text. This potential liability will further increase the already high costs of the audit.

115. *See supra* notes 98-114 and accompanying text.

without knowing whether they possess the requisite information to justify such an opinion. In such cases, where the requisite information is unavailable or insufficient, accounting and auditing standards require the auditor to issue a qualifying or disclaiming opinion, depending on the materiality of the incomplete information. However, determining the materiality of the incomplete information is impossible without knowing the extent of the missing information. Consequently, a large number of audit opinions may be incorrectly expressing an opinion on the fair presentation of the financial statements concerning these contingent liabilities posed by pending litigation.

Our recommendation is that the auditor should consider limiting the scope of the audit to recognize the inherent limitation of the information available to the auditor concerning legal matters. While this approach does not resolve the communication conflict between the auditor and the attorney, it does signal to investors, lenders and others relying on the company's financial statements that the auditor is unable to render an opinion on these matters. In such cases, limiting the scope of the audit opinion is a far more transparent and honest approach than the current vague and uncertain nature of current disclosures.