

## 4 Tips For Protecting Privilege When Working With Auditors

By John Carney, Patrick Campbell and Christina Gotsis

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On Dec. 21, 2018, the U.S. Securities and Exchange Commission charged national audit firm Crowe LLP and two of its partners for alleged significant failures in their 2013 audit of Corporate Resource Services Inc., which went bankrupt in 2015 after the discovery of approximately \$100 million in unpaid federal payroll tax liabilities.[1] The SEC alleged that Crowe's audit team identified pervasive fraud risks yet failed, among other things, to "[o]btain sufficient appropriate audit evidence to respond to these fraud risks, support recognition of revenue, and otherwise support the audit opinion." [2] Crowe agreed to pay a penalty of \$1.5 million, be censured and retain an independent compliance consultant to review its audit policies and procedures.[3] The partners agreed to pay penalties and be suspended from appearing and practicing before the SEC as accountants (with the ability to reapply).[4]

The SEC's action against Crowe and its partners illustrates the significant pressure on independent auditors to gather enough evidence to defend their audits of public company financial statements and internal controls. As a result, auditors increasingly are asking companies for attorney-client privileged information and work product, such as internal investigation reports, to support their audit findings and to better scrutinize management representations.

While a company must provide all information required by the auditor to render an accurate opinion, disclosing privileged material risks waiving the privilege vis-à-vis third parties in subsequent litigation. Internal investigation reports and other privileged material can be appealing to regulators and private litigants, as oftentimes these materials identify weaknesses in corporate internal controls or include other information that adversaries can use to their advantage. If a company discloses privileged materials to its independent auditors, adversaries may argue that the company waived privilege and seek disclosure of the documents in litigation. Such arguments likely would succeed with respect to the attorney-client privilege and, if made in the right jurisdiction, may succeed concerning the work product doctrine as well.

Thus, there is a dangerous tension between the independent auditor's need for information to support its audit findings and the company's need to protect its privileged information from third-party adversaries in subsequent litigation. This article explores the root causes of this tension and proposes solutions for managing it.

### Pressure Facing Independent Auditors

Efforts to reform the accounting profession reached unprecedented levels after the Enron-



John Carney



Patrick Campbell



Christina Gotsis

era corporate auditing failures. Congress passed the Sarbanes-Oxley Act of 2002, which ushered in a new era for the auditing profession, including the creation of the Public Company Accounting Oversight Board. The PCAOB overhauled auditing standards to which independent auditors must adhere and, for the first time, subjected the accounting industry to substantive federal oversight.[5]

In this new environment, independent auditors who fail to obtain sufficient evidence to support their audit opinions or adequately scrutinize company representations risk substantial liability, especially from the SEC. Since the early 2000s, the SEC has brought numerous cases against accounting firms based on allegations that their independent audits should have but failed to identify fraud at the client.

In a September 2016 speech, then-SEC Director of Enforcement Andrew Ceresney called independent auditors “critical gatekeepers in the area of issuer reporting and disclosure” and stated that “auditors need to exercise appropriate professional skepticism, gather sufficient appropriate audit evidence, adequately document work, and, particularly when there are red flags, require more sufficient evidential matter than representations from management.”[6] Ceresney concluded that “[w]hile good faith errors in judgment will not result in liability, those who fail to follow audit standards and perform unreasonable audits can expect scrutiny through our enforcement efforts.”[7] The SEC’s action against Crowe shows that the agency remains focused on independent auditors.

Aside from the SEC, the U.S. Department of Justice has brought civil claims against independent auditors under the False Claims Act for knowingly deviating from applicable auditing standards and failing to detect materially false and misleading financial statements and client fraud. Auditors may also face significant private lawsuits from corporate stakeholders, such as shareholders and creditors, who use audited financial statements and potentially from foreseeable users, such as lender banks.

### **Risk of Waiving Privilege By Disclosure to Independent Auditors**

In most jurisdictions, a company waives the attorney-client privilege if it provides privileged information to its independent auditors. According to a leading case, *United States v. El Paso*, disclosure of privileged information to independent auditors destroys any confidentiality with respect to that information, and “with the destruction of confidentiality goes as well the right to claim the attorney-client privilege.”[8] The attorney-client privilege is waived even if the auditor agrees to keep any privileged materials it obtains confidential.[9]

But courts have treated waiver of work product protection differently. The minority view, as stated by a leading case, *Medinol Ltd. v. Boston Scientific Corp.*, finds that a company waives any work product protection associated with materials it discloses to its independent auditor because the auditor acts as a “public watchdog” with interests that are not necessarily aligned with those of the company.[10]

However, the majority view, led by *Merrill Lynch & Co. v. Allegheny Energy Inc.*, holds that the work product doctrine is not waived by disclosure to independent auditors.[11] The court in *Merrill Lynch* reasoned that the work product privilege is waived “only if the disclosure substantially increases the opportunity for potential adversaries to obtain the information.”[12] While acknowledging the important function of an independent auditor to

ensure the accuracy of financial statements, the court found that “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.”[13]

The court reasoned that a company and its auditor may have aligned interests in attempting to discover and eradicate corporate fraud.[14] The court further found that construing auditors as adversaries and applying a blanket waiver rule could discourage companies from conducting critical self-analyses and sharing the fruits of their critiques with their auditors.[15]

In 2010, in the only federal appellate decision on this subject, the U.S. Court of Appeals for the D.C. Circuit agreed with Merrill Lynch. In *United States v. Deloitte LLP*, the government sought to obtain certain work product that the client gave Deloitte for the auditor to assess the adequacy of the client’s contingency reserves.[16] The government contended that the client waived the work product doctrine because Deloitte was a potential adversary, on the basis that auditors can issue opinions that adversely affect their clients. The court rejected the government’s view, reasoning that while significant, the auditor’s power to issue an opinion “does not make it the sort of litigation adversary contemplated by the waiver standard.”[17] The court also rejected the government’s contention that Deloitte was a conduit to its client’s adversaries because, due to an auditor’s obligation to maintain confidentiality, the client had a reasonable expectation of confidentiality concerning the information it provided to its auditor.[18]

### **Practical Suggestions for Communicating With Independent Auditors**

The pressure on independent auditors to ensure that their audits are sufficient to detect corporate fraud will persist. A judicial consensus on whether disclosure to independent auditors waives the work product doctrine does not appear to be forthcoming. Thus, companies must consider the risk of privilege waiver when disclosing materials to independent auditors. The following recommendations can assist companies and their counsel to ensure that independent auditors obtain the information that they need and at the same time protect the company’s interest in maintaining the privilege:

- The company’s engagement letter with its independent auditor should include robust confidentiality provisions, including that any information the company provides to the auditor is confidential and may be subject to the attorney-client privilege and/or work product doctrine. The letter also should limit use of client information to the audit and prohibit the auditor from disclosing client information to any third party. In the event the auditor is served with a subpoena for production of client information, the engagement letter should require the auditor to immediately provide the company with notice of the subpoena and an opportunity to review any materials that may include the company’s privileged information prior to production.
- The engagement letter also should include disclosure guidelines. Company counsel should discuss the issues associated with disclosing privileged information with the company’s auditors and reach an understanding on this matter before the audit begins. The engagement letter also should include the auditor’s agreement to abide by the

1976 “treaty” between the American Institute of Certified Public Accountants and the American Bar Association, which sought to strike a balance between an auditor’s need to confirm management’s assertions and the company’s need to preserve privilege.[19] The “treaty” contains numerous limitations on counsel’s obligations in responding to audit request letters, including requiring lawyers to report only pending or “overtly threatened” claims and not unasserted claims.[20] For claims they need to report, counsel need not express their opinions on potential outcomes, except where an unfavorable outcome is either “probable” or “remote.”[21]

- Companies and their counsel should carefully review the scope of an auditor’s request for information and minimize disclosure of privileged information if possible. At the least, companies should avoid disclosing any attorney-client privileged information, as disclosure will waive the attorney-client privilege in most jurisdictions. Companies should try to satisfy an independent auditor’s need for information by factual, oral presentations (though companies should consider that auditor’s notes of oral presentations could be discoverable by third-party litigants if a court determines that disclosure waived the work product doctrine).
- If the auditor insists on written materials from the company, the documentation provided should be factual and not contain speculation or attorney opinion. New materials, like summary memoranda, should not be created just for disclosure to auditors, as such materials may not be afforded work product protection. Instead, companies and their counsel should always prepare materials with an eye to possible disclosure. Moreover, to increase the likelihood of a court finding a common interest, the company’s audit committee should make any disclosure to independent auditors.

## Conclusion

The tension between the independent auditor’s need for information and the company’s need to protect the privilege is not insurmountable. Handled constructively and with due regard to the pressure faced by auditors and the company’s risk of waiving privilege, auditors should be able to obtain the information they need without putting the company’s privilege in jeopardy.

*Update: This article has been updated with additional author information.*

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*[John J. Carney](#) is a partner and co-leader of the national white collar, investigations and securities enforcement and litigation team at [BakerHostetler](#).*

*[Patrick T. Campbell](#) is a partner at BakerHostetler.*

*Christina O. Gotsis is a law clerk at BakerHostetler. She is currently pending admission to the New York State bar.*

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[1] Press release, Sec. and Exch. Comm'n, SEC Charges Audit Firm and Suspends Accountants for Deficient Audits (Dec. 21, 2018).

[2] Id.

[3] Id.

[4] Id.

[5] Pub. Co. Accounting Oversight Board, Rule 3100 (2003).

[6] Andrew Ceresney, Director, Div. of Enf't, Sec. and Exch. Comm'n, Keynote Address at the American Law Institute Conference on Accountants' Liability 2016: Confronting Enforcement and Litigation Risks (Sept. 22, 2016).

[7] Id.

[8] 682 F.2d 530, 540 (5th Cir. 1982).

[9] [United States v. Textron](#), 507 F. Supp. 2d 138, 152 (D.R.I. 2007), aff'd in part, rev'd in part, 553 F.3d 87 (1st Cir. 2009), reh'g granted, vacating judgment, 560 F.3d 513 (1st Cir. 2009), vacated en banc on other grounds, 2009 WL 2476475, No. 07-2631 (1st Cir. Aug, 13, 2009).

[10] 214 F.R.D 113, 116 (S.D.N.Y. 2002). See also [First Horizon Nat'l Corp. v. Houston Casualty Co.](#), No. 2:15-cv-2235, 2016 WL 5867268, at \*10 (W.D. Tenn. Oct. 5, 2016) (finding disclosure of privileged communications to outside auditor waives work product protection).

[11] E.g., [Vacco v. Harrah's Operating Co.](#), No. 1:07 CV 663, 2008 WL 4793719, at \*6 (N.D.N.Y. Oct. 29, 2008) (finding that Medinol has been nearly uniformly rejected).

[12] [Merrill Lynch & Co. v. Allegheny Energy Inc.](#), 229 F.R.D. 441, 445-46 (S.D.N.Y. 2004).

[13] Id. at 448.

[14] Id.

[15] Id. at 449.

[16] 610 F.3d 129, 133 (D.C. Cir. 2010).

[17] Id. at 140.

[18] Id. For a more recent case finding that disclosure to outside auditors does not waive work product protection, see [In re Weatherford Int'l Sec. Litig.](#), No. 11 Civ.1646, 2013 WL 12185082, at \*5 (S.D.N.Y. Nov. 19, 2013).

[19] Am. Inst. of Certified Pub. Accountants, Statement on Auditing Standards No. 12, Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments (1976).

[20] Am. Bar Ass'n, Audit Responses Committee, Audit Responses What You Need to Know in 2017 (2017).

[21] Id.