

The Role of Company Lawyers Who Deal With Auditors

BY LAZAR EMANUEL

This article is the third and last in a series discussing the recommendations of the City Bar Task Force on the Lawyer's Role in Corporate Governance. The recommendations are contained in a 190-page Report (plus several Exhibits) which is available online at www.abcny.org. The Report covers the relationship between lawyers - both in-house and outside - and public companies.

In this article, I will discuss two questions considered by the Task Force: 1) should communications between corporate lawyers and auditors be privileged? and 2) should the procedures utilized by lawyers in conducting due diligence with respect to financial disclosures, including in public offerings, be changed or modified?

Question 1. The attorney-auditor privilege. The Task Force considered "whether to recommend that a privilege be recognized with respect to communications between a company's lawyers and its auditors."

The relationship between lawyer and auditor has become exceedingly tense and guarded over these years of corporate management crises. The tension between the two professions is the inevitable consequence of the basic difference in their roles. In *U.S. v. Arthur Young & Co.*, 465 U.S. 805 (1984), the Supreme Court reversed a decision of the Court of Appeals for the Second Circuit. On appeal from the district court, the Court of Appeals had drawn an analogy between auditor and lawyer and "fashioned" a work product immunity doctrine for tax-accrual work papers prepared by independent auditors "in the course of complying with the federal securities laws."

In the *Young* case, the IRS had issued an administrative summons to Young requiring it to make available to the IRS all its files relating to its client Amerada, including its tax accrual work papers. When Amerada instructed Young not to comply with the summons, the IRS commenced an enforcement action against Young. Amerada intervened, but the district court held that Young's tax accrual work papers were relevant to the IRS investigation and refused to recognize an accountant-client privilege that would protect Young's work papers.

Writing for the Court, Chief Justice Burger distinguished between company auditors and company lawyers:

....as this Court stated in *Couch v. United States*, 409 U.S. 322, 335 (1973), "no confidential accountant client privilege exists under federal law, and no state-created privilege had been recognized in federal cases." In light of *Couch*, the Court of Appeals' effort to foster candid communication between accountant and client by creating a self-styled work-product privilege was misplaced, and conflicts with what we see as the clear intent of Congress.

Nor do we find persuasive the argument that a work-product immunity for accountants' tax accrual work papers is a fitting analogue to the attorney work-product doctrine established in *Hickman v. Taylor*, 329 U.S. 495 (1947). The Hickman work-product doctrine was founded upon the private attorney's role as the client's confidential adviser and advocate, a loyal representative whose duty it is to present the client's case in the most favorable possible light. An independent certified public accountant performs a different role. By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. ...To insulate from disclosure a certified public accountants' interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations.

City Bar Task Force Rejects Auditor-Attorney Privilege

The *Young* case was relied upon by the City Bar Task Force to support its decision not to recommend the recognition of an attorney-auditor privilege. It cited as its reason, "Treating communications with an auditor as privileged is inconsistent with the nature of the auditor's public certification of a company's financials and the relevance, in the event of later litigation or regulatory scrutiny, of all facts and procedures on which the certificate was based."

I would suggest to the Task Force that another persuasive reason to reject the auditor-attorney privilege is the corrosive impact the privilege would have upon the attorney-client privilege. If the client company suspected that the wall between lawyer and auditor had been eroded, it might turn less often and with increased reluctance to the attorney for guidance in financial disclosures.

In rejecting the auditor-attorney privilege, the City Bar Task Force nevertheless encouraged "open, less guarded and less adversarial communication" between auditor and lawyer.

It suggested that, "A limited privilege covering attorney- auditor communications could facilitate such communications and enable better evaluation of issues that might affect a corporation's financial position." It did not explain how a limited privilege might be structured, but it did suggest a distinction between "facts" contained in a communication with company lawyers and the other elements of a communication. "The privilege applying to attorney-client communications does not render facts privileged."

When a lawyer knows facts "material to a company's financial condition," he must disclose them to the auditor.

Thus the Audit Committee and the General Counsel should ensure that the auditors are being provided with all the facts recognized as material that are in the possession of inside and outside counsel. The material facts known to counsel can be shared with the auditors either by counsel - recognizing that such counsel-to-auditor communications are not privileged - or by the company.

Participation by Lawyers in Due Diligence

The City Bar Task Force construed a lawyer's obligation with respect to due diligence in the broadest sense of the term. "Due diligence" means more than the processes and procedures applied by underwriters to ensure compliance with the requirements of the Securities Act.

The term also includes "work done to evaluate the accuracy and completeness of non-financial sections of disclosure documents and to test the representations and warranties made in corporate acquisitions, privately placed securities offerings and other transactions." In this broad sense, it applies whenever a lawyer is asked to review the accuracy or truthfulness of any document submitted to his client by a third party in connection with a pending transaction.

The Task Force asked whether due diligence as now practiced

....meets the reasonable expectations of, and is properly understood by, independent directors and corporate executives who necessarily rely in part on lawyers' participation in (1) the preparation and review of, and sometimes their sub-certifications or alternate assurances regarding, the company's public disclosure documents, and (2) the testing of representations and warranties in corporate transactions.

In its discussion of this question, the Task Force acknowledged that it felt a "sense of unease" that due diligence was not receiving adequate attention from issuers, underwriters, lawyers and the SEC. Its sense of unease was supported by anecdotal evidence, the experience of some of its own members, and interviews with other lawyers.

Although the Task Force believed that due diligence in behalf of issuers and underwriters is "often performed in a highly competent and professional manner," it also sensed a lack of consistency and "especially difficult challenges" in the case of accelerated public stock offers. It asked whether more effective and thorough due diligence might not have led to the "earlier discovery of the accounting and other misstatements and outright corporate frauds" that have plagued the market in recent years. The inquiry is made especially pertinent by the sheer frequency and size "of these unhappy events."

Inside and outside counsel are required to conduct effective ongoing review of corporate disclosure documents, and audit committees and independent directors are expected to oversee the practices of counsel as a part of sound corporate governance. Directors and officers who are conscientious in their due diligence will avoid allegations of bad faith or complicity. In some cases, especially before Enron and WorldCom, directors and officers were content to rely on indemnification and insurance to protect them against personal liability and failed to look adequately into the due diligence of company counsel. In some cases, perhaps, the lawyers, relying on the lack of inquiry into the scope of their investigation, "have not taken care to disclose the scope of their work or have done less work or less careful work than they might otherwise have done."

The Task Force recognized that many due diligence tasks are dull, unglamorous and often unappreciated, but cautioned corporate lawyers to avoid "skimping" on these tasks. It urged law firms to review the adequacy of their due diligence training programs and to assign qualified lawyers to lead the due diligence teams. Lawyers need to advise directors and management of the scope of their work in connection with public disclosure documents and material corporate transactions, as well as the duty to make themselves "meaningfully available" for due diligence interviews.

The SEC has encouraged shelf registration by companies that go to the public securities market often. [Shelf registration refers to a new issue which is prepared up to two years in advance, so that it can be

offered quickly as soon as funds are needed or market conditions are favorable.] This has "truncated" the time for traditional due diligence. The SEC had anticipated that due diligence in these cases would be performed "on a continuous basis" by the company's underwriter and its lawyers. Some frequent issuers have adopted the techniques of continuous due diligence, but "opinions vary on the effectiveness of these programs." Lawyers, issuers and underwriters should consider how continuous due diligence can be made more effective.

Lazar Emanuel is the Publisher of NYPRR.

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