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The Accountable Attorney: A Proposal to Revamp the Aba's 1976 Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information

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COMMENTS

THE ACCOUNTABLE ATTORNEY: A PROPOSAL TO REVAMP THE ABA'S 1976 *STATEMENT OF POLICY REGARDING LAWYERS' RESPONSES TO AUDITORS' REQUESTS FOR INFORMATION*

I. INTRODUCTION 28
A. *Surprise, Surprise* 30
1. An Early Misjudgment: Texaco Loses Its Case Against Pennzoil 30
2. Two Decades Later: A Wave of Financial Reporting Scandals 30
3. Shortcomings Continue Today: The Process is Broken 32
B. *Do the Right Thing* 33
1. Sarbanes-Oxley Brings Reforms 33
2. The ABA Resists Enhanced Disclosures to Auditors 33
3. The SEC Pushes for Greater Transparency 34
II. THE NEED AND THE RULES 35
A. *Investors Rely on Published Financial Disclosures* 35
B. *The ABA's 1976 Statement of Policy Discourages Legal Risk Disclosures* 36
III. THE BROKEN PROCESS: DISCONNECT BETWEEN THE AICPA'S OBJECTIVES AND THE ABA'S POLICY 37
A. *The AICPA's Objectives and Requests for Attorney Input* 37
B. *Attorney Responses in Accordance with the ABA's SOP Fall Short* 38
IV. BARRIERS TO REFORM 41
A. *Concerns about Waiving Attorney-Client Privilege* 41
1. Courts Often Compel Attorneys to Disclose Their Audit Letters 41
2. Both the "Primary Purpose" and the "Because of Litigation" Approaches to Courts' Analyses Expose Lawyer Letters to Disclosure 44
B. *Some Attorneys Use Disclosures about Legal Risks for Tactical Advantage in Litigation* 45
C. *A Hobson's Choice: The Conflict Between Satisfying the Client and Complying with Sarbanes-Oxley* 47

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V. THE BREAKTHROUGH NEEDED: A REPORT BY AN INDEPENDENT LEGAL COUNSEL 48
VI. CONCLUSION 49

The American Bar Association's (ABA) long-standing compromise[1] with the American Institute of Certified Public Accountants (AICPA) regarding the role of lawyers in audits of public companies needs an overhaul. The current process is dysfunctional: accountants attempt to opine on a company's disclosures about litigation and to assess loss exposure without any foundation in the legal issues involved. During this process, those accountants turn to their clients' attorneys for help. But lawyers, concerned about preserving confidentiality and privilege, routinely respond to the accountants' requests with verbiage honed to say nothing at all.

This Comment argues that the time has come to divorce CPAs from the task of evaluating legal risks in the course of their audits. Instead, an Independent Legal Counsel should report on the company's disclosure of legal matters. The benefits of this approach are: (1) to eliminate ineffective and unproductive handoffs under the current audit processes; (2) to avoid troubling attorney-client privilege risks during the background discussions of the legal contingencies; and (3) to improve public confidence in the legal disclosures made in financial statements.

I. INTRODUCTION

In a variation of a tired old joke, an investor asks a CEO, an accountant, and a lawyer, "How much is zero minus one?"

"Sorry, I don't do negatives," quips the CEO, who turns to his accountant and asks, "What's your solution?"

The accountant responds, "I could build a spreadsheet, but I'll need someone to tell me which numbers to plug in."

The lawyer quietly stands up, walks over to the window, pulls down the shades, and whispers to the CEO, "How much do you want it to be?"[2]

Although lawyer jokes often are told in good fun, their increasing prevalence and sometimes sharp sarcasm point to a general public negativism toward the profession.[3] But when it comes to the legal profession's responsibility to bolster public confidence in the credibility of corporate financial reporting, lawyer image is no laughing matter. Some commentators take the position that only a company's

1. *See* ABA, *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information*, 31 BUS. LAW. 1709 (1976) [hereinafter *SOP*].
2. *See, e.g.*, KEVIN MCGUINESS, THE BEST LAWYER JOKES EVER 12–13 (2002).
3. *See* MARC GALANTER, LOWERING THE BAR: LAWYER JOKES AND LEGAL CULTURE 16 (2005) (listing types of negative perceptions of attorneys that recur in lawyer jokes).

management and its auditors have a duty to the public. This Comment argues instead that the time has come for the legal profession to take a more active role. By refusing to acquiesce to stereotypes of the devious lawyer, attorneys can greatly boost the image of the legal profession while at the same time improving disclosures of risks by public companies. In the process, confidence in the securities markets will be enhanced.

Part I of this Comment will introduce dramatic examples of failure by the current system to effectively disclose legal risks facing public companies. In case after case, public companies disclose that they are subject to litigation in the normal course of business and simply report that their management and auditors do not expect the pending matters to have any material effect on the company. Then, with alarming frequency, events turn negative and force companies to record enormous reserves shortly after the publication of their financial statements, or in some cases, force them into bankruptcy. The wiping out of shareholders and pensioners who had invested their life savings in reliance on published disclosures has potentially tragic effects.

Part II will chronicle the professional standards that apply to communications between accountants and lawyers during the audit process, including a compromise struck between the ABA and the AICPA in 1976 to address and purportedly to solve the issue. The resulting guidance published in the ABA's *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* has survived more than 30 years of annual reporting cycles but has done little to improve the quality of public reporting.

Part III will evaluate the processes used to audit financial statement disclosures of legal proceedings by public companies. In a routine that makes Keystone Cops look productive, auditors with no ability to analyze legal risks attempt to establish an opinion about the disclosures provided to them by management. With false hopes of obtaining help with their hopeless task, the auditors correspond with the various legal firms engaged by the client company. In response, the company's lawyers return verbose letters artfully crafted to say nothing at all.

Part IV will tackle the barriers to reform, including misperceptions about the proper segregation of duties between the management of a company, its auditors, and its legal counsel. This section of the Comment also will survey the most important barrier to overhauling the system: concerns over attorney-client privilege and confidentiality.

Finally, Part V will propose a breakthrough solution: establish a new function designated as the Independent Legal Counsel to remove the independent accountant from the middle of the process. Building further on reforms incorporated within the Sarbanes-Oxley Act of 2002, this Comment proposes that an Independent Legal Counsel be required annually to evaluate management's disclosure of legal risks

and to report on its accuracy. Because attorneys are versed in the applicable law, they are better able than accountants to evaluate potential losses from litigation. Also, by keeping the background discussions of legal risks within the circle of legal professionals, potential waivers of attorney-client privilege would be avoided.

A. *Surprise, Surprise*

1. An Early Misjudgment: Texaco Loses Its Case Against Pennzoil

On November 19, 1985, a Texas jury awarded the largest verdict in the history of corporate litigation—an $11 billion judgment against Texaco, Inc. for its tortious interference in an attempted acquisition of Getty Oil by Pennzoil.[4] In its immediately preceding public report to shareholders, Texaco had disclosed the existence of a lawsuit by Pennzoil.[5] However, Texaco emphasized that "Pennzoil's earlier attempt in the Delaware action to block Texaco's acquisition of Getty was rejected by the Court."[6] It concluded that "while it is impossible to ascertain the ultimate legal and financial liability . . . the aggregate amount of such liability is not anticipated to be materially important in relation to the consolidated financial position of the Company and its subsidiaries."[7] In a letter dated February 28, 1985, Texaco's auditors—Arthur Andersen & Co. of later Enron infamy[8]—issued a clean opinion on Texaco's disclosures.[9] Less than nine months later, a jury spoke[10] and sent Texaco plunging into bankruptcy.[11]

2. Two Decades Later: A Wave of Financial Reporting Scandals

The recent spate of public reporting scandals, including Enron, WorldCom, Global Crossing, Adelphia Communications, and HealthSouth, painfully brought public and Congressional focus back into the

4. *See generally* Texaco, Inc. v. Pennzoil, Co., 729 S.W.2d 768 (Tex. App.—Houston [1st Dist.] 1987, writ ref'd n.r.e.) (upholding compensatory damages of $7.5 billion but reducing punitive damages from $3 billion to $1 billion), *and* Pennzoil Co. v. Texaco, Inc., 481 U.S. 1, 18 (1987) (denying federal court injunction to block Texas trial court's award of $11 billion). *See also* Thomas C. Hayes, *Texaco Told To Pay $10.5 Billion*, N.Y. TIMES, Nov. 20, 1985, at D1; Thomas C. Hayes, *Texaco Must Pay $11 Billion Award, Texas Court Rules*, N.Y. TIMES, Dec. 11, 1985, at A1.

5. Texaco Inc., 1984 Annual Report, at Note 16 (1985).

6. *Id.*

7. *Id.*

8. *See generally* Cathy Booth Thomas, *Called to Account: Guilty of Obstruction, Arthur Andersen Becomes the First Courtroom Casualty of the Enron Collapse*, TIME, June 24, 2002, at 52, *available at* http://www.time.com/time/magazine/article/0,9171,1101020624-263006,00.html.

9. *See* Texaco, *supra* note 5, at Auditor's Report.

10. *See Pennzoil Co.*, 729 S.W.2d at 784. *See also* Hayes, *supra* note 4, at D1 (allowing a trial court's award of $11 billion).

11. *See* Steve Coll, *Texaco Inc. Files for Bankruptcy*, WASH. POST, Apr. 13, 1987, at A1.

arena of public reporting.[12] Those frauds implicated not only the financial misdeeds of the reporting companies but also the complicity of their banks and advisors.[13] The scandalous wave included settlements by Citigroup and Merrill Lynch with the Securities and Exchange Commission (SEC) and led to passage of the Sarbanes-Oxley Act to tighten oversight of financial reporting.[14]

Failure to properly disclose legal risks is not limited to the well-publicized mega-scandals. For example, few people would recognize Dr. Gary Michelson's defense of his medical patents.[15] In that case, Medtronic—a publicly-traded marketer of medical devices—sued Dr. Michelson for breach of patent-licensing agreements.[16] Dr. Michelson—the inventor of the medical devices marketed by Medtronic—countersued for payment of royalties.[17] At a trial ending in September 2004, a jury delivered its verdict in favor of Dr. Michelson.[18] The jury found that Medtronic wrongly infringed on Dr. Michelson's patents and underpaid royalties otherwise owed to him.[19] The jurors awarded Dr. Michelson compensatory damages of more than $100 million[20] plus an additional $400 million in punitive damages against Medtronic.[21] Despite knowledge of its use of Dr. Michelson's patents and the related bitter controversy, Medtronic merely acknowledged in its 2003 annual report that a dispute had existed since 2001 and that "[t]he case is in discovery, the court has under consideration certain motions for partial summary judgment, and trial is scheduled for January 2004."[22] No hint of any potential loss, much less a loss exceeding $500 million, was in any way foreshadowed.

In another case, Kinetic Concepts sued Hillenbrand Industries—a publicly-traded provider of healthcare products[23]—for antitrust violations in connection with the marketing of hospital beds.[24] Following a

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12. *See* Eugene H. Flegm, *On Solving the Problem, Not Being It*, 75 CPA J. 12 (2005), *available at* http://www.nysscpa.org/cpajournal/2005/205/perspectives/p12.htm.

13. *See id.*

14. Katy Byron, *Ken Lay's Conviction Tossed Out by Judge*, CNNMONEY.COM, http://money.cnn.com/2006/10/17/news/newsmakers/ken_lay/index.htm (last visited Aug. 31, 2007).

15. *See generally* Medtronic Sofamor Danek, Inc. v. Michelson, No. 01-2373, 2004 U.S. Dist. LEXIS 26385 (W.D. Tenn. 2004) (providing background information to the claim).

16. *Id.* at *9–13.

17. *See id.*

18. Jury Verdict Form at 2, Medtronic Sofamor Danek, Inc. v. Michelson, No. 01-2373 (W.D. Tenn. Sept. 28, 2004).

19. *Id.*

20. *Id.* at 27–28, 31–32, 34–36.

21. Jury Verdict Form–Punitive Damages, Medtronic Sofamor Danek, Inc. v. Michelson, No. 01-2373 (W.D. Tenn. Oct. 12, 2004).

22. Medtronic, Inc., Annual Report (Form 10-K), at 26 (July 14, 2003).

23. Hillenbrand Indus., Inc., Annual Report (Form 10-K), at 3 (Feb. 19, 2002).

24. Kinetic Concepts, Inc. v. Hillenbrand Indus., Inc., 262 F. Supp. 2d 722, 722 (W.D. Tex. 2003).

unanimous jury verdict in favor of Kinetic Concepts, Hillenbrand agreed to settle the lawsuit by paying $250 million to Kinetic.[25] In an opinion accepting the terms of the settlement, the presiding judge chided both sides for their "propensity to sue each other" and for "this latest in a long running series of lawsuits" between the parties.[26] The judge observed that "[o]f course, the one being sued thinks the other is filing frivolous claims."[27] Consistent with its previous disregard for any risk from the lawsuit, Hillenbrand only briefly described Kinetic's complaint in its annual report to shareholders by stating, "[t]he Company believes it has meritorious defenses to the claims against it and is aggressively defending itself against all allegations. Accordingly, it has not recorded any loss provision relative to damages sought by [Kinetic Concepts]."[28] One year earlier, in its year-2000 annual report, Hillenbrand disclosed that Kinetic had alleged "violation of various antitrust laws, including illegal bundling of products, predatory pricing, refusal to deal and attempting to monopolize the hospital bed industry."[29] But Hillenbrand strongly disclaimed any culpability by reporting, "The Company believes that [Kinetic Concepts'] claims are *without merit*."[30] This sort of denial in the face of claims against a publicly-held company cries out for a new approach.

3. Shortcomings Continue Today: The Process is Broken

Despite the increased public scrutiny and regulatory reform, inadequacies in financial statement disclosures persist. For example, in August 2004, Citigroup announced a $7.9 billion expense to cover its involvement in securities litigation, including its role in the Enron and WorldCom fiascos.[31] Only a few months earlier, in its immediately preceding annual report to shareholders dated February 26, 2004, Citigroup had assured its investors that it would resist attempts to make it pay for those third-party frauds and would "defend itself vigorously in these cases" because it "believes that it has substantial defenses to the claims asserted."[32] Six months after that public commitment, Citigroup acknowledged liability and accepted the charge of almost $8 billion.[33]

Litigation losses recognized by other banks involved in the Enron scandal followed a similar pattern. On June 14, 2005, JPMorgan Chase & Co. announced that it would pay $2.2 billion to plaintiffs in

25. *Id.* at 724–25.
26. *Id.* at 722.
27. *Id.*
28. Hillenbrand Indus., Inc., Annual Report (Form 10-K), at 58 (Feb. 19, 2002).
29. Hillenbrand Indus., Inc., Annual Report (Form 10-K), at 46 (Feb. 22, 2001).
30. *Id.* (emphasis added).
31. Citigroup, Inc., Quarterly Report (Form 10-Q), at 9 (Aug. 4, 2004).
32. Citigroup, Inc., Annual Report (Form 10-K), at 8 (Feb. 28, 2004).
33. *See* Citigroup, Inc., Quarterly Report (Form 10-Q), at 9 (Aug. 4, 2004).

an Enron class action lawsuit.[34] In its annual report filed on March 2, 2005, JPMorgan simply had announced that this "trial is scheduled to commence in October 2006."[35]

These brief examples reveal a process that is not working. Although accounting rules only require companies to *record* a reserve when a loss is "probable," those standards mandate *disclosure* of potential additional losses when the risk is "reasonably possible."[36] Under the present system, risks of material losses are not being disclosed in advance so that investors can make meaningful decisions before final judgments are rendered on the litigation.

B. *Do the Right Thing*

1. Sarbanes-Oxley Brings Reforms

The Sarbanes-Oxley Act of 2002[37] was enacted in the wake of recent financial fraud. Among its provisions, it requires executive officers to certify the accuracy and completeness of their companies' financial disclosures.[38] In addition, Sarbanes-Oxley makes it a crime to mislead an auditor.[39]

2. The ABA Resists Enhanced Disclosures to Auditors

Despite reform momentum, the legal profession steadfastly resists any deviation from the ABA's Statement of Policy (SOP).[40] Recently, one major audit firm requested lawyers to confirm "that all illegal activity of which counsel is aware has been reported" to the auditors.[41] Members of an ad hoc ABA committee unanimously agreed that it would not be appropriate to make even that simple confirmation.[42] The committee additionally emphasized that any oral communications by lawyers to auditors should never provide any information not already available in the written response otherwise authorized by the SOP.[43] Finally, the ABA report advised that lawyers should avoid

34. Press Release, JPMorgan Chase & Co., JPMorgan Chase Agrees to Settle Enron Class Action Litigation (June 14, 2005), *available at* http://investor.shareholder.com/JPMorganChase/press/releasedetail.cfm?ReleaseID=166173&ReleaseType=Current.

35. JPMorgan Chase & Co., Annual Report (Form 10-K), at 7 (Mar. 2, 2005).

36. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 5: ACCOUNTING FOR CONTINGENCIES § 10 (1975) [hereinafter SFAS No. 5], *available at* http://www.fasb.org/pdf/fas5.pdf.

37. *See* Sarbanes-Oxley Act of 2002, 15 U.S.C.S. §§ 7201–66 (LEXIS current through P.L. 110-2, approved Feb. 2, 2007).

38. *Id.* § 7241.

39. *Id.* § 7242.

40. *See, e.g.*, ABA SEC. BUS. L. ADHOC COMM. ON AUDIT RESPONSES, *Report on Listserv Activity (Inception to August 3, 2004)*, *available at* http://www.abanet.org/buslaw/newsletter/0027/materials/listserv.pdf.

41. *Id.*

42. *Id.*

43. *Id.*

providing any assessment of a potential loss by the client due to uncertainty of the ultimate outcome.[44]

The ABA's rigid application of the SOP contrasts starkly with recent encouragements by the SEC staff to promote effective communication of companies' risks to their shareholders.[45] The SEC staff has expressed its dismay regarding the frequency with which "zero" is set by companies as the low end of the range of reasonably possible losses in litigation for every moment "right up until a large settlement is announced."[46] The SEC has observed that a risk of loss should ordinarily be fully disclosed in a company's financial statements far in advance of the actual settlement or jury verdict that eventually requires recording of a final loss amount.[47]

3. The SEC Pushes for Greater Transparency

The SEC is especially critical of "vague or overly broad disclosures" that fail to fully inform shareholders about management's evaluation of the risks.[48] Although companies naturally are hesitant to reveal their true analyses of lawsuits they are defending, the SEC counters that "confidentiality concerns do not excuse violations" of accounting or disclosure rules.[49] The SEC reasons that compliance with its rules is a duty that companies voluntarily assume when they decide to take advantage of public markets.[50]

Regarding attorney cooperation in the audit process, the SEC has been uncompromising: if a company's law firm is unable or unwilling to supply its expert opinion about its client's litigation to the auditor, then the auditor must evaluate whether it will be unable to complete the audit for the client.[51] After Sarbanes-Oxley, the SEC staff sternly has observed that lawyers must "ensure they are working to help clients follow [the] laws, rather than find ways around them."[52] This means that lawyers, auditors, and company management must look beyond past practices to respond in a way that ensures investors re-

44. *Id.*

45. *See, e.g.*, Scott A. Taub, Acting Chief Accountant, U.S. SEC, "The Future of Financial Reporting": Remarks at the Leventhal School of Accounting SEC and Financial Reporting Institute (June 8, 2006), *available at* http://www.sec.gov/news/speech/2006/spch060806sat.htm.

46. Scott A. Taub, Deputy Chief Accountant, U.S. SEC, Remarks at the University of Southern California Leventhal School of Accounting SEC and Financial Reporting Conference (May 27, 2004), *available at* http://www.sec.gov/news/speech/spch052704sat.htm.

47. *See id.*

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.*

52. Scott A. Taub, Deputy Chief Accountant, U.S. SEC, Speech by SEC Staff: The SEC's Internal Control Report Rules and Thoughts on the Sarbanes-Oxley Act, May 29, 2003, *available at* http://www.sec.gov/news/speech/spch052903sat.htm.

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ceive "the information they need to evaluate the company."[53] Amid the voluminous regulations in the Sarbanes-Oxley Act, its key standard is simple: "act in the public interest."[54]

II. The Need and the Rules

A. *Investors Rely on Published Financial Disclosures*

Warren Buffett, the world's wealthiest investor, relies on the most readily available source of investment tips: annual financial reports from the target companies themselves.[55] The U.S. Supreme Court also has identified company annual reports as a primary information basis for investor decisions.[56] The Supreme Court has explained that the SEC requires independent reports on management presentations in financial statements "to control the accuracy of the financial data available to investors."[57] The end product of the audit is an opinion stating whether the financial statements present fairly the financial condition of the company.[58] But an important part of the independent audit report is an evaluation of the adequacy of the company's reserve for potential losses and the reasonableness of related disclosures.[59]

"Fundamental analysis" is a time-tested mathematical approach used by investors and financial planners to identify securities for purchase.[60] This investment strategy uses published financial results as a basis to predict future earnings growth and to calculate a present value of the underlying security.[61] The predictive techniques rely on measures such as "Earnings Per Share" and the "Price/Earnings Ratio."[62] The essential component of those measures—earnings—depends on the accuracy of the underlying financial statements.

An important rule of financial accounting requires companies to book losses that are *probable* as a result of existing lawsuits.[63] That same rule requires companies to disclose additional estimates for losses that are merely *reasonably possible* to occur.[64] The reporting company's management is responsible for the amounts and disclo-

53. *Id.*
54. *Id.*
55. Mark Tier, The Winning Investment Habits of Warren Buffett & George Soros 16 (2005).
56. United States v. Arthur Young & Co., 465 U.S. 805, 810 (1984).
57. *Id.* at 810–11.
58. *Id.* at 811.
59. *See id.* at 812.
60. Sid Mittra et al., Practicing Financial Planning for Professionals 13–42 (9th ed. 2005).
61. *Id.*
62. *Id.* at 13–44.
63. SFAS No. 5, *supra* note 36, § 8.
64. *Id.* § 10.

sures made in its financial statements.[65] An auditor's responsibility is to express an opinion regarding the fair presentation of the company's reporting.[66] But the independent auditor often lacks knowledge of those matters apart from information provided by the company's management.[67]

B. *The ABA's 1976 Statement of Policy Discourages Legal Risk Disclosures*

Various SEC regulations require independent CPAs to audit the books of public companies and to report on the accuracy of their published financial statements.[68] But the U.S. Supreme Court has distinguished the role of independent accountants from the role of outside attorneys.[69] Long-settled law preserves attorney-client privilege for the "mental processes" of lawyers,[70] and the attorney work-product doctrine has been codified to protect "mental impressions, conclusions, opinions, or legal theories of an attorney . . . concerning the litigation" against discovery by an opposing party.[71] In contrast, the U.S. Supreme Court has rejected the notion of an accountant-client privilege.[72] One appellate court succinctly explained the distinction by noting that attorney work-product privilege exists "to promote the adversary system" rather than merely to protect client confidences.[73]

The first sentence to the preamble of the ABA's SOP emphatically states the legal profession's priority in audit disclosures: "The public interest in protecting the confidentiality of lawyer-client communications is fundamental."[74] The SOP argues that a requirement to supply information to auditors about client matters is "destructive of free and open communication" between the law firm and its clients.[75] Despite agreeing to certain procedures with the AICPA, the preamble cautions that the disclosures might become public and cause a financial loss that otherwise might not occur.[76] The SOP almost grudgingly acknowledges the legal profession's responsibility to promote confi-

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65. AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, RESPONSIBILITIES AND FUNCTIONS OF THE INDEPENDENT AUDITOR, AU § 110, *available at* https://www.aicpa.org/download/members/div/auditstd/AU-00110.PDF (last visited Sept. 7, 2007).

66. *Id.*

67. *Id.*

68. United States v. Arthur Young & Co., 465 U.S. 805, 811 (1984) (citing 15 U.S.C. § 77aa for registration of new stock; 15 U.S.C. § 78l(b)(1)(J)–(L) for listing securities on an exchange; 17 CFR 240.14a-101 for filing proxy statements; and 17 CFR 249.310, 249.460 for filing of annual reports).

69. *See id.* at 817–18.

70. *See* Hickman v. Taylor, 329 U.S. 495 (1947).

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

72. Couch v. United States, 409 U.S. 322, 335 (1973).

73. United States v. Am. Tel. & Tel. Corp., 642 F.2d 1285, 1299 (D.C. Cir. 1980).

74. *SOP*, *supra* note 1, at 1709.

75. *Id.*

76. *See id.* at 1709–10.

dence in public financial reporting.[77] Accordingly, in response to proper requests made by auditors, the SOP permits the disclosures of information about:

- pending or overtly threatened litigation;
- contractual obligations that the client specifically has listed; and
- unasserted possible claims that the client specifically has listed in its request letter.[78]

Regarding opinions of possible outcomes for the matters listed, the SOP encourages the lawyer to "refrain from expressing judgments" unless the prospects of the client winning are extremely doubtful.[79] The SOP acknowledges that a lawyer may be asked to provide a dollar estimate of a potential loss from a lawsuit, or a range of possible losses.[80] The SOP advises that normally such an estimate will be "inherently impossible" to make.[81] The SOP concludes, "In most cases, the lawyer will not be able to provide any such estimate to the auditor."[82] If a lawyer chooses to provide an estimate, the SOP warns that the estimate "might be treated as an admission" by an opponent.[83]

In framing a lawyer's response, the SOP advises that phrases such as the "litigation is being defended vigorously" or "the client has meritorious defenses" can be used without purporting to convey any message whatsoever about the probable actual outcome of the lawsuit.[84] The SOP emphasizes that a lawyer's comments on some unasserted possible claims and silence regarding other possible claims should not be interpreted to mean that the disclosures to the auditor completely address all possible claims of which the lawyer is aware.[85] The SOP explains that "it would be inconsistent with [a lawyer's] professional obligations" to volunteer information about the client's possible future legal problems.[86]

III. The Broken Process: Disconnect Between the AICPA's Objectives and the ABA's Policy

A. *The AICPA's Objectives and Requests for Attorney Input*

In an attempt to gather expert opinion about the litigation risks faced by their client, auditors solicit input from their client's legal counsel to corroborate company management's representations about

77. *See id.* at 1710.
78. *Id.* at 1712.
79. *See id.* at 1713.
80. *Id.* at 1714.
81. *Id.*
82. *Id.*
83. *Id.* at 1717.
84. *Id.* at 1722.
85. *Id.* at 1723–24.
86. *Id.* at 1724.

its lawsuits.[87] Unfortunately, responses often only repeat the same bare factual information that management has provided to the auditors without adding meaningful analysis.[88] Such lawyer responses fill pages with flowery prose that means nothing.[89] One commentator has observed that the auditor might be better served by directly reading the litigation documents on file at the local courthouse.[90]

The auditor attempts to provide blanket assurance that a company's financial position is fairly disclosed.[91] But the CPA's standard report usually does not bring any attention to a company's legal proceedings even though those risks may be material to its financial condition.[92] The standard report of an independent public accountant contains three boilerplate paragraphs:

- The first paragraph identifies the financial statements being addressed, emphasizes that those financial statements are the responsibility of the reporting company's management, and clarifies that the accountant's job is limited to expressing an opinion of the financial statements based on an audit;
- The second paragraph confirms that the audit met the standards of the U.S. Public Company Accounting Oversight Board, describes the nature of the procedures performed, and concludes that the audit provides a reasonable basis for an opinion about the financial statements; and
- The final paragraph provides the auditor's opinion that the company's financial statements are fairly presented in accordance with generally accepted accounting principles.[93]

B. *Attorney Responses in Accordance with the ABA's SOP Fall Short*

Compliance with the SOP by attorneys who respond to auditor letters typically follows a multi-step process.[94] It begins with receipt by the lawyer of a properly written request from the client.[95] To preserve privileged status of the attorney's response letter to the auditor, an authorized executive at the client company must sign the client's re-

87. M. Eric Anderson, *Talkin' 'Bout My Litigation—How the Attorney Response to an Audit Inquiry Letter Discloses as Little as Possible*, 7 TRANSACTIONS: TENN. J. BUS. L. 143, 148 (2005).

88. *Id.* at 144.

89. *Id.*

90. *Id.*

91. *See generally* AUDITING STANDARD NO. 1—REFERENCES IN AUDITORS' REPORTS TO THE STANDARDS OF THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, 146 (May 14, 2004), *available at* http://www.pcaobus.org/Rules/Rules_of_the_Board/Auditing_Standard_1.pdf.

92. *See id.*

93. *Id.*

94. *See* John W. Allen, *Walking Through the Minefield: Ethical and Liability Risks in Auditor Response Letters*, 77 FLA. B. J. 10, 14 (Jan. 2003).

95. *Id.*

quest.[96] After receiving the request, the law firm cannot simply delegate the response to a single individual.[97] Under the SOP, the lawyer's response letter implies that it encompasses the knowledge of all attorneys at the firm.[98] Accordingly, the lead attorney must conduct an investigation to determine the scope of the firm's knowledge of client litigation and loss contingencies.[99] This investigation typically involves routing the request letter along with an explanatory memo to all lawyers in the firm.[100] For attorneys who respond that they have devoted attention to legal matters for the requesting client, more specific questionnaires must be circulated to gather and report on the nature of those legal issues in a centralized place.[101] Next, the coordinating lawyer must evaluate the matters for proper disclosure under the SOP, including making an evaluation of ranges of potential losses.[102] Finally, the attorney must meet with the client to communicate the findings and to confirm the completeness of the matters disclosed.[103]

Whenever an attorney evaluates a client's loss exposure for a third party, the attorney must be truthful.[104] But the SOP permits the law firm to limit the content of its response letter.[105] Commentators have advised that broad generalizations such as "we believe the company should prevail" can satisfy the disclosure requirements to the auditor.[106]

To comply with the SOP, lawyers must adopt a strict policy for dealing with requests from auditors.[107] First, lawyers should ensure that they never disclose any confidences from their clients because those disclosures may be discoverable in court.[108] Second, lawyers should set a dollar limit with the requesting auditor below which the auditor agrees any disclosure would not be material.[109] The responding attorney should insist that this threshold level for disclosure of potential losses is included by the client in its request letter and is repeated by the law firm in its response letter.[110]

96. *Id.*
97. *See id.*
98. *Id.*
99. *See id.*
100. *See id.*
101. *See id.*
102. *Id.*
103. *Id.*
104. *Id.* at 15 (citing Tew v. Arky, Freed, Stearns, et al., P.A., 655 F. Supp. 1571 (S.D. Fla. 1987), *aff'd*, 846 F.2d 753 (11th Cir. 1988)).
105. *See id.* at 14.
106. *Id.*
107. *Id.* at 15.
108. *See id.* at 14.
109. *Id.*
110. *Id.*

Finally, lawyers must hone the verbiage of the final disclosure letter to ensure strict compliance with the SOP but to limit the disclosure to the absolute minimum required.[111] The prevailing consensus among attorneys holds that it is usually not possible to determine the ultimate outcome of a lawsuit or other potential liability until the end of the litigation process.[112] Accordingly, attorneys are advised simply to provide statements such as "the litigation is being defended vigorously and the client has meritorious defenses."[113] Inevitably, those meaningless responses provoke a phone call from the auditor to the attorney in an attempt to learn more; however, lawyers are to avoid providing any additional disclosure orally beyond what is written in their response letters.[114]

The SOP provides an example of a five-paragraph boilerplate response to the auditor's request for use by the General Counsel of a company:

- The first paragraph acknowledges that a General Counsel has general supervision over the Company's legal affairs, including review of litigation and consultation with outside legal counsel when deemed appropriate;
- The second paragraph lists any litigation that the General Counsel considers to represent a material loss contingency;
- The third paragraph comments on claims, if any, that were specifically identified by the audit firm in its request letter;
- The fourth paragraph notes the date on which the lawyers began their internal review procedures to prepare the auditor response, and it disclaims any responsibility to update the response beyond that date;
- The final paragraph—a comprehensive qualification and limitation of the scope of the lawyer's response—is quoted below:

> 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

111. *See generally* Anderson, *supra* note 87, at 143–44 (explaining that lawyers exist in an adversarial system and thus want to disclose as little as possible to the other party, yet still disclose enough to comply with the SOP).

112. *See* Allen, *supra* note 94, at 14.

113. *Id.*

114. *See id.*

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> 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.[115]

IV. BARRIERS TO REFORM

A. *Concerns about Waiving Attorney-Client Privilege*

1. Courts Often Compel Attorneys to Disclose Their Audit Letters

Lawyers must be wary of their responses to auditor requests because missteps can bring punitive consequences.[116] Justifications for lawyers' reluctance to provide meaningful information to auditors include lawyers' concerns about waiving attorney-client privilege and harming client interests through potential discovery of audit letters during litigation.[117] More ominously, failure to follow the SOP could expose the responding attorney to civil liability[118] or even criminal charges.[119]

Attorneys' fears of trial disclosure of their letters to auditors may be well-founded because federal law does not recognize any auditor-client privilege.[120] In one particularly expansive decision, a federal district court emphasized that the work-product doctrine does not cover materials produced to comply with public disclosure requirements not specifically tied to the litigation at hand.[121] The court additionally concluded that the attorney-client privilege was waived for matters disclosed by lawyers to auditors.[122]

When Independent Petrochemical Corporation sued its insurance companies to require them to honor coverage for its environmental liabilities, the insurance company defendants sought disclosure of letters written by Petrochemical's lawyers to auditors at Peat, Marwick, Mitchell & Co. (PMM).[123] The insurance companies contended that the attorneys' letters might lead to admissible evidence implicating Petrochemical's misrepresentations on its applications for the environmental insurance coverage—specifically whether Petrochemical failed

115. *SOP*, *supra* note 1, at 1734.
116. Allen, *supra* note 94, at 10.
117. *See* Anderson, *supra* note 87, at 155–57.
118. *See* Allen, *supra* note 94, at 15.
119. *See* Sarbanes-Oxley Act of 2002 § 303, 15 U.S.C.S. § 7242 (LEXIS through P.L. 110-2, approved Feb. 2, 2007).
120. *See* United States v. Arthur Young & Co., 465 U.S. 805, 817 (1984).
121. *See* Indep. Petrochemical Corp. v. Aetna Cas. & Surety Co., 117 F.R.D. 292, 298 (D.D.C. 1987) (mem.).
122. *Id.* at 297.
123. *Id.* at 293.

Texas Wesleyan Law Review, Vol. 14 [2022], Iss. 1, Art. 3

to disclose the extent of its dioxin contamination when it applied for insurance.[124] The court held that attorney-client privilege did not extend to the attorneys' letters to the auditors because PMM "was not the client, nor was it an agent of the client . . . but rather it was an independent auditor of the financial affairs of the corporation."[125] The court concluded that the attorneys' letters were not intended to be covered by attorney-client privilege and, regardless of that intent, the privilege had been waived by the lawyers' disclosure to the third-party auditor.[126] The court then considered whether the letters represented attorney work-product.[127] The court emphasized that work-product privilege does not cover a document unless that document was "initially prepared in contemplation of litigation, or in the course of preparing for trial."[128] The court explained that Petrochemical's attorneys' letters to PMM did not satisfy the requirements for work-product privilege because the letters were drafted to assist PMM with its audit and not in connection with present litigation.[129] Because the court concluded that the lawyers' letters were not covered by either the attorney-client privilege or the attorney work-product doctrine, it compelled the lawyers to provide those letters to the insurance companies.[130]

Cases that permit discovery of letters from lawyers to auditors are especially common when the plaintiff represents the U.S. government or a regulatory agency.[131] A federal court permitted discovery by the Department of Energy (DOE) of lawyer letters to auditors that provided opinions about potential litigation.[132] In that case, the DOE subpoenaed copies of letters provided by the attorneys for Cities Services Oil & Gas Corporation (Cities) to its independent audit firm, Arthur Young & Company.[133] The DOE sought information relating to Cities' lawyers' assessments of the company's request for a declaratory judgment regarding pricing of some oil transactions.[134] The DOE also sought production of several related documents prepared for internal use that had not been shared with Arthur Young.[135] The court undertook an extensive discussion of attorney-client privilege and at-

124. *Id.*
125. *Id.* at 297.
126. *Id.*
127. *See id.* at 298.
128. *Id.* (citing Coastal States Gas Corp. v. Dep't of Energy, 617 F.2d 854, 865 (D.C. Cir. 1980)).
129. *Id.*
130. *See id.*
131. Allen, *supra* note 94, at 16.
132. *See* United States v. Gulf Oil Corp., 760 F.2d 292, 293 (Temp. Emer. Ct. App. 1985).
133. *Id.*
134. *Id.* at 294.
135. *See id.*

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torney work-product doctrine.[136] It explained that attorney-client privilege protects confidential information to ensure that confidence is preserved but that any voluntary disclosure of those communications would waive the privilege.[137] In contrast, the attorney work-product privilege protects the "fruits of an attorney's trial preparations from the discovery attempts of the opponent."[138] Applying those principles to the letters from Cities' attorney to Arthur Young, the court concluded the letters were not privileged because: (1) they were not created to assist in potential litigation; and (2) they were created for the business purpose of preparing the company's financial statements, which is not a privileged activity.[139] The court rejected Cities' suggestion that its holding would chill attorney-client communication with auditors of public companies.[140] Instead, the court expressed its confidence that attorneys would not abandon their ethical obligations to provide candid, complete opinions to a company's auditors when requested to do so by their clients.[141]

In another case, a federal appellate court permitted the Internal Revenue Service to gain access to lawyer correspondence that discussed potential tax-exposure items.[142] The court noted that an attorney is required to preserve confidentiality to retain privilege because the client's communications are made with the expectation that they would not be disclosed.[143] But the court reasoned that the "need to cloak these communications with secrecy . . . ends when the secrets pass" to third parties.[144] The court found that the company had provided the contents of its discussions with attorneys to the company's independent auditors.[145] That disclosure destroyed confidentiality and "[w]ith the destruction of confidentiality goes as well the right to claim the attorney-client privilege."[146] The court also held that the attorney work-product doctrine was not applicable because the tax-exposure analysis was not prepared "in anticipation of litigation."[147]

Despite many cases permitting discovery, some courts have protected both the attorney-client privilege and the work-product doctrine by refusing requests to disclose letters that lawyers wrote to auditors.[148] One federal district court case analyzed both the *Gulf Oil* and *El Paso* cases mentioned above but rejected their holdings and

136. *See id.* at 295.
137. *Id.*
138. *Id.*
139. *Id.* at 297.
140. *Id.*
141. *Id.*
142. United States v. El Paso Co., 682 F.2d 530 (5th Cir. 1982).
143. *Id.* at 539.
144. *Id.*
145. *Id.* at 539–40.
146. *Id.* at 540.
147. *Id.* at 542.
148. *See* Allen, *supra* note 94, at 16.

refused discovery of lawyer letters to auditors.[149] That court emphasized the need to prevent information about the lawyers' opinions regarding the settlement value of a case from reaching the hands of an adverse party.[150]

In addition, in a portion of the *Gulf Oil* case, the federal district court rejected the Department of Energy's request for discovery of letters written to Gulf's audit firm.[151] But that court concluded its separate opinion with an important caveat that it was "not herein saying all communications between corporate counsel and its independent auditing firm are impressed with the attorney work-product privilege."[152] Instead, it concluded that each case must be determined based on its "particular facts and circumstances."[153]

Considering the cases rejecting disclosure of lawyers' letters to auditors, concerns about full discovery of confidential communications by lawyers to auditors may be overstated. Granted, lawyer letters to auditors generally are not prepared in anticipation of trial or litigation.[154] But, more generally, federal law requires a court to "protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney . . . ."[155]

2. Both the "Primary Purpose" and the "Because of Litigation" Approaches to Courts' Analyses Expose Lawyer Letters to Disclosure

A recent case analyzed precedents dealing with lawyer letters to auditors by separating them into two categories.[156] The first category follows a restrictive "primary purpose approach" whereby letters to auditors fail to qualify for privilege because their primary purpose serves to produce financial statements rather than to prepare for litigation.[157] A less restrictive approach preserves privilege when the court concludes that the letter exists only "because of" anticipated litigation, and it reveals "mental impressions, conclusions, opinions, or theories concerning the litigation . . . ."[158]

Courts that apply the "primary purpose approach" to evaluate privilege of lawyers' letters to auditors will almost certainly permit discov-

149. Tronitech, Inc. v. NCR Corp., 108 F.R.D. 655, 655–57 (S.D. Ind. 1985).
150. *See id.*
151. United States v. Arthur Young & Co., 1 Fed. R. Serv. 3d 448, 449–50 n.1 (N.D. Okla. 1984) (citing United States v. Gulf Oil Corp., 1984 U.S. Dist. LEXIS 17732 (S.D. Tex. 1984)).
152. *Id.* at 453.
153. *Id.*
154. Allen, *supra* note 94, at 16.
155. Fed. R. Civ. P. 26(b)(3).
156. *In re* Raytheon Sec. Litig., 218 F.R.D. 354, 357–58 (D. Mass. 2003).
157. *Id.* at 358.
158. *Id.* at 357 (quoting United States v. Adlman, 134 F.3d 1194, 1195 (2d Cir. 1998)).

ery of the letters because by definition the letters are prepared for the audit and not directly for litigation. But even under the "because of litigation" test, the protection from discovery is not certain.

For example, when the New York State Common Retirement Fund (NYCRF) sued Raytheon and its auditor, Pricewaterhouse Coopers (PwC), for issuing fraudulent financial statements, NYCRF was barred by the Magistrate Judge from obtaining audit opinion letters from Raytheon's lawyers because the Judge found the letters to be attorney work-product prepared in anticipation of litigation.[159] However, the District Court overruled the Magistrate Judge and ordered Raytheon and PwC to produce the lawyers' letters for an *in camera* review.[160] The District Court observed that, even under the less restrictive "because of litigation" approach, the work-product privilege does not cover any information that accounting rules require to be publicly disclosed.[161] To justify the need for discovery of information supplied to auditors, the court noted that the auditor's "responsibilities to creditors, stockholders, and the investing public . . . transcend the relationship with the client."[162]

B. *Some Attorneys Use Disclosures about Legal Risks for Tactical Advantage in Litigation*

In addition to using legal-risk disclosures during an actual trial, some attorneys also point to advantages that the disclosures can provide during pretrial negotiations.[163] Specifically, a public company's discussion of lawsuits in its financial statement footnotes or within the "Management's Discussion and Analysis" portion of its SEC filings may reveal the amount for which it would be willing to settle or the amount for which it already has provided as a reserve against its profits.[164]

Often the subsequent actual settlement of a lawsuit closely matches the amount that the defendant company was required to publicly disclose.[165] For example, AstraZeneca reached an agreement to settle fraud charges by agreeing to pay $355 million approximately six months after it was required to provide a reserve of $350 million in its published financial statements.[166] In another situation, AutoNation reported a reserve of $670 million to cover under-reporting of disputed income taxes in its 2002 annual report and, a few months later, settled with the IRS by agreeing to pay approximately $550 million

159. *Id.* at 356.
160. *Id.* at 361.
161. *Id.* at 359.
162. *Id.* at 360.
163. *See* Matthew J. Barrett, *New Opportunities for Obtaining and Using Litigation Reserves and Disclosures*, 64 Ohio St. L.J. 1183 (2003).
164. *Id.* at 1183.
165. *See id.* at 1183–85.
166. *Id.* at 1185.

(arguably achieving savings of $120 million, or 18%, compared to the original estimate).[167]

The ability to avoid disclosure of litigation reserves may have tangible benefits. For example, Citigroup was able to report a financial-statement *gain* of $94 million[168] after it settled claims of insufficient tax payments with the Japanese government by paying less than half of the amount that it had reserved for the potential legal risk within its accounts.[169] Because no disclosure of the potential additional Japanese tax liability was made in Citigroup's financial statements,[170] the Japanese government lacked any public information from which to gauge Citigroup's estimate of the higher amount for which the company potentially would have been willing to settle.

Successful litigators are advised to review their opponent company's published financial statements, including tabular disclosures, to glean information for use in settlement negotiations and in actual trial practice.[171] Using the required disclosures as a foundation, lawyers will request production of documents that support the public disclosure, submit interrogatories, and depose witnesses to probe even the most cursory mention of matters in the financial statements.[172] To the extent that savvy litigators are successful in advancing these inquiries, the effect may well further entrench resistance by attorneys against providing any meaningful information to the auditor during the financial-statement review process. Considering the potential damage that disclosure could cause to a client's ability to defend a lawsuit, reticence of the responding attorney is understandable and, arguably, the only responsible alternative.

167. *Id.* at 1185 n.10.

168. Press Release, Citigroup, Inc., Citigroup Reports Second Quarter Earnings (July 14, 2003), *available at* http://www.citigroup.com/citigroup/press/2003/030714a.htm.

169. *See Tax Office: Loan Firm Concealed 50 Billion Yen*, DAILY YOMIURI, May 31, 2003, at 2, *available at* 2003 WLNR 2353512 (reporting a tax settlement of ten billion yen, or $85 million at an exchange rate of 118 yen to the dollar). [Ed. Note: From March 2000 through March 2003, including the period in which the subject reserves were provided but not the period in which tax penalties were assessed, the Author served as Chief Executive Officer of Citigroup's consumer finance subsidiary in Japan.]

170. *See* Citigroup, Inc., Annual Report (Form 10-K) (March 3, 2003).

171. Barrett, *supra* note 163, at 1194–95.

172. *Id.* at 1195.

C. *A Hobson's Choice: The Conflict Between Satisfying the Client and Complying with Sarbanes-Oxley*

The Sarbanes-Oxley Act of 2002[173] included several provisions affecting lawyers.[174] Among other things, Sarbanes-Oxley makes it a crime to mislead an independent accountant in a way that causes a company's financial statements to be misleading.[175] But the provision causing the greatest consternation among lawyers[176] is a rule that requires attorneys to report any "material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof" to senior executives of the client company.[177] That provision applies both to external attorneys and to lawyers working within the commercial company itself.[178] When an attorney becomes aware of inappropriate conduct at a client company, the attorney must ensure that responsible officers of the client are informed of the bad conduct.[179] In addition, the lawyer must monitor the company's response to ensure that appropriate remedial measures are taken.[180] This responsibility exposes lawyers to sanction by the SEC if they fail to report or fail to monitor the client's behavior satisfactorily.[181]

The bad-behavior-reporting requirement, for all its good intent, creates a dilemma for the professional attorney.[182] In this regard, ABA rules of professional conduct provide that a corporation's lawyer represents the corporate entity itself and not its stockholders, directors, officers, or employees.[183] But that rule arguably enables a perverse situation that subjugates the interests of the shareholders—who are the "closest human manifestation of the client"—to the interests of a corporate entity that is a legal fiction.[184]

When confronted with corporate wrongdoing, a lawyer must resolve whether reporting the bad acts is consistent with the attorney's ethical duty to the corporation.[185] Normally, upward disclosure of informa-

173. Sarbanes-Oxley Act of 2002, 15 U.S.C.S. §§ 7201–66 (LEXIS through P.L. 110-2, approved Feb. 2, 2007).

174. *See* Simon M. Lorne, *An Issue-Annotated Version of the SOx Rules for Lawyer Conduct, October 2005*, 2006 PRACTICING LAW INSTITUTE, CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES, PREPARATION OF ANNUAL DISCLOSURE DOCUMENTS 25, *available at* 1523 PLI/Corp 21 (Westlaw).

175. 15 U.S.C.S. § 7242(a).

176. Lorne, *supra* note 174, at *26.

177. 15 U.S.C.S. § 7245.

178. *See* Lorne, *supra* note 174, at *30.

179. *See* 15 U.S.C.S. § 7245; *see also* Lorne, *supra* note 174, at *30.

180. Lorne, *supra* note 174, at *30.

181. *See id.* at *31.

182. *See generally* H. Lowell Brown, *The Dilemma of Corporate Counsel Faced with Client Misconduct: Disclosure of Client Confidences or Constructive Discharge*, 44 BUFF. L. REV. 777 (1996) (analyzing a lawyer's alternatives after discovery of corporate wrongdoing).

183. MODEL RULES OF PROF'L CONDUCT R. 1.13 (2006).

184. Brown, *supra* note 182, at 780–81.

185. *Id.* at 788.

tion learned in the course of performing legal services is not a problem, but when the required disclosure implicates the senior executives of the company, the lawyer may be compelled to inform the audit committee or other outside parties.[186] Additional complications could arise if internal reporting fails to induce corrective action by the client.[187]

External reporting poses a dilemma when the lawyer's duty to disclose clashes with a duty to preserve client confidences.[188] When continued representation of a client, either as an attorney-employee or as external counsel, poses an irreconcilable conflict between a lawyer's duty to disclose and the duty to preserve confidence, the lawyer has no alternative but to resign.[189]

A lawyer who becomes aware of wrongdoing (such as a material misstatement of financial statements) must inquire regarding the facts and advise the company of its rights and obligations.[190] But the ABA rules caution lawyers not to mistake differences of opinion concerning policies, even risky ones, with legal breaches.[191] Also, the lawyer has no duty to investigate the client generally for illegal acts or contingent risks: that role falls on the shoulders of the independent auditor.[192] However, ABA rules impose on lawyers a general duty of competence,[193] and counsel's obligation to investigate potential misconduct has been inferred by some commentators to arise under that general duty.[194]

V. The Breakthrough Needed: A Report by an Independent Legal Counsel

The process for disclosing legal risks must be re-engineered. While auditors struggle to evaluate lawsuits facing a public company, the client's attorneys generally ignore the auditors' pleas for help. To solve this problem, the independent accountant should step aside from the process of evaluating disclosures of legal risks by public companies, and an independent attorney should step in to fill the void.

The Independent Legal Counsel's activities would preserve attorney-client privilege because information gathered from the client's various lawyers would never leave the circle of legal counsel. Also, the independent attorney would be versed in the applicable law and able

186. *See id.* at 791–92.
187. *Id.*
188. *Id.* at 787–88.
189. *Id.* at 788–89. *See also* Model Rules of Prof'l Conduct R. 1.16(a)(1) (2006).
190. Brown, *supra* note 182, at 789.
191. *Id.* at 789–90.
192. *See* Allen, *supra* at note 94, at 10.
193. Model Rules of Prof'l Conduct R. 1.1 (2006).
194. *See* Brown, *supra* note 182, at 789 n.35.

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to evaluate the merits of potential defenses, recognize probable losses, and disclose potential additional future losses.

The Author proposes the following wording for an annual report by the Independent Legal Counsel:

> Report of Independent Legal Counsel
> To the Board of Directors of AB Company
>
> We have examined the accompanying disclosure of legal contingencies of AB Company as of December 31, 2007. This disclosure is the responsibility of the Company's management. Our responsibility is to express an opinion on management's disclosure based on our examination.
>
> We conducted our examination in accordance with generally accepted professional standards. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether the disclosure of legal contingencies is free of material misstatement in accordance with Statement of Financial Accounting Standards No. 5.
>
> As Independent Legal Counsel, we have reviewed litigation and claims threatened or asserted involving the Company and have consulted with outside legal counsel with respect thereto where we have deemed it appropriate. We believe that our examination provides a reasonable basis for our opinion.
>
> In our opinion, the disclosure referred to above presents fairly, in all material respects, the legal contingencies of AB Company as of December 31, 2007.[195]
>
> Very truly yours,
> Independent Legal Counsel

VI. CONCLUSION

Part I of this Comment revealed failures in the present system to disclose legal risks by public companies. Part II described the professional standards applied by accountants and lawyers in their attempts to satisfy disclosure obligations from their differing perspectives. Part III illustrated the disconnect between the auditors' objectives and the lawyers' responses to requests for information. Part IV highlighted the barriers to reform, including justifiable fears of sacrificing attorney-client privilege and attorney work-product privilege in ways that ultimately could be damaging to client companies. Finally, Part V proposed a specific solution: an Independent Legal Counsel should

195. The Author merged existing standard disclosures to create this proposed new report. *Compare with* PUB. CO. ACCOUNTING OVERSIGHT BD., *supra* note 91, *and SOP*, *supra* note 1 (providing the illustrative wording presently used by auditors and attorneys, respectively, for litigation disclosures).

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report annually on a public company's legal disclosures—freeing the independent accountant to disclaim any opinion on legal risks.

By creating the important new role of the Independent Legal Counsel, the legal profession not only would generate a new fee-based practice for its members, but also would eliminate inefficiency and avoid unnecessary attorney-client privilege risks. Most important, the independent lawyers' report would enhance public confidence in the integrity of published information by public companies. Simply stated, it would achieve the key objective of Sarbanes-Oxley: it would serve the public interest.

James S. Johnson