The Ethical Playing Field: Have the Refs Changed the Rules?

Audit Letter Presentation

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I. Audit Letter Background

In 1972, the Committee on Corporate Laws of the Section of Corporation, Banking and Business Law of the ABA (the "Section") began work on the subject of attorneys' responses to auditors' requests for information. This work provided the background for an article in The Business Lawyer that expressed many concerns regarding audit letter responses by attorneys.\(^1\) As a result of these and other expressed concerns within the field, the ABA established the Section's Committee on Corporate Law and Accounting in 1973 (the "Accounting Committee"), which assumed responsibility for addressing issues that arise in the relationships between attorneys and accountants. The Accounting Committee worked closely with the American Institute of Certified Public Accountants (the "AICPA") as well as the Bar to reexamine the definition of the term "contingent liability." In March 1974, the ABA decided to defer formal action on audit letter responses by attorneys in order to permit the Section's Committee on Counsel Responsibility and Liability (the "Counsel Responsibility Committee") to also give detailed consideration to the matter.

In late 1974 and early 1975, after hearing reports from the ABA Accounting Committee, the ABA Counsel Responsibility Committee and the ABA Committee on Corporate Law Departments, the Section appointed a special seven-member Ad Hoc Committee that prepared a draft of Proposed Guidelines, entitled "Scope of Lawyers' Responses to Auditors' Requests for Information."\(^2\) In January of 1975, the Section approved the draft of Proposed Guidelines with some exceptions and established the new Committee on Auditors' Inquiry Responses (the "Committee") to maintain responsibility for the further development of the Guidelines.

Following the foregoing actions by the ABA, the Auditing Standards Executive Committee of the AICPA issued Auditing Interpretations Concerning Lawyer's Letters. Thereafter, in March of 1975, the Financial Accounting Standards Board issued Statement of Accounting Standards No. 5, entitled "Accounting for Contingencies" ("FAS 5") [discussed below].

As a result of the adoption of FAS 5, the Committee revised the Guidelines by reformulating them into a Statement of Policy and accompanying Commentary (the "ABA Statement"). The purpose behind the Committee's revision was to integrate the position with then current accounting and auditing literature, and to outline the appropriate limits on the lawyer's role in the audit process and in determinations regarding the accrual or disclosure of loss contingencies. Subsequently, the ABA Statement was officially adopted by the Board of Governors of the ABA on December 8, 1975.

Similarly, the Auditing Standards Executive Committee of the AICPA issued a counterpart to the ABA Statement of Policy, Statement on Accounting Standards No. 12, entitled "Inquiry of a Client's Lawyer Concerning Litigation, Claims and Assessments" ("SAS 12") [discussed below]. This counterpart statement was officially adopted by the AICPA in January of 1976.

Since the adoption of the ABA Statement, the Committee has issued two reports regarding initial implementation of the ABA Statement.\(^3\) In addition, the Subcommittee of the Committee of Law and Accounting (formerly the Committee on Auditor's Inquiry Responses) issued a report regarding the areas of confusion that arose from the ABA Statement.\(^4\) The Committee of Law and Accounting (formerly the Committee on Auditor's Inquiry Responses) also issued a report in 1996 regarding issues that have arisen with the ABA Statement.\(^5\) These reports have not been approved by the ABA, and therefore, do not constitute official statements.

Also, since the adoption of SAS 12, the AICPA has issued auditing interpretations in 1977, 1983, 1990, and 1997. These interpretations are found in \textit{AU Section 9337} entitled "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretation of AU Section 337."\(^6\)

\section*{II. Policies and Guidelines}

To understand the audit letter process, refer to the controlling policies and guidelines. Auditors follow SAS 12 (and their own firm's guidelines) in gathering information from clients regarding any litigation, claims, and assessments that have arisen within the audit period.\(^7\) Attorneys representing clients must abide by FAS 5 in reporting their loss contingencies to auditors.\(^8\)

Because auditors do not want to make legal conclusions based on the information that clients provide them, auditors request that clients send a letter of inquiry to those attorneys that assisted the clients with any litigation, claims and assessments during the audit period. The ABA Statement guides attorneys in their responses to auditors.\(^9\)

It is generally acknowledged by commentators that the rules in the guidelines are confusing, and many of the law review articles or other statements concerning the audit letter process interpret the rules in an inconsistent manner. For example, articles often refer to SAS 12 and the ABA Statement as "the Treaty" or the "ABA/AICPA Compromise," yet this reference is not consistent among all of the publications discussing audit letters. Nonetheless, SAS 12 and the ABA Statement's slight differences have not been significant in practice.\(^10\)

Therefore, because of the similarities among the aforementioned guidelines, attorneys must be familiar with the ABA Statement, SAS 12, and FAS 5. These guidelines are the agreed upon-standards within the accounting and legal communities that govern attorneys' responses to auditors.

\(^5\) Auditor's Letter Handbook 5, Supp., p. 3.
\(^7\) American Inst. of Certified Pub. Accountants, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments" (1976).
The ABA has reprinted these statements in the Auditor's Letter Handbook, and all citations in this memo shall refer to it. This publication is available from the American Bar Association Order Fulfillment Department, 750 North Lake Shore Drive, Chicago, Illinois 60611 (refer to Publication No. 507-0232 when ordering).

III. Questions Regarding Audit Letters

A. Why do auditors want audit letters? Audit letters provide auditors with information regarding claims, litigation, and assessments that may affect a client's assets and/or liabilities. As such, auditors' responses from audit letters provided by clients and their attorneys assist in their evaluation of a company's presentation of their financial condition.

According to SAS 12, auditors must obtain information regarding the following:
I. Existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments;

II. The period in which the underlying cause for legal action occurred;

III. The degree and probability of an unfavorable outcome; and

IV. The amount or range of potential loss. Id. at 58.

In practice, attorneys provide sufficient information so that the auditors can consider whether it is necessary to refer to the litigation or claims in their auditors' report or to require the client to disclose them in a footnote to their financial statements. Sometimes, the financial statements and the auditors' opinion is to be included in a prospectus regarding a risk that should be disclosed to prospective investors.

The attorney's task in responding to the auditor is to corroborate what the client has disclosed to the auditor. Thus, auditors need attorneys in this process to assess the litigation, claims, and assessments to determine whether or not disclosure to the auditor is necessary. A client's rejection of his attorney's advice to disclose information to the auditor would almost certainly require the attorney's withdrawal from employment in accordance with the ABA Code of Professional Responsibility. [See, e.g. Disciplinary Rule 7-102 (A)(3) and (7), and Disciplinary Rule 2-110 (B)(2)].

B. What is the attorney's liability? Within the last few years, the Attorney Liability Assurance Society ("ALAS"), a major insurer for law firms across the country that insures 49,000 lawyers through 377 law firms of 40 lawyers or more in about 45 states, "has observed an increasingly aggressive attitude by auditors toward exploiting ambiguities in the ABA Statement and SAS 12, and toward asserting third-party claims against law firms. The ABA Statement and SAS 12 have worked effectively for more than a generation primarily because auditors have

13 Auditor's Letter Handbook 5 at 60.
14 Id. at 21.
accepted the attorneys' statement that they have not reached a professional opinion about the outcome of litigation without arguing that the attorney is obliged to provide an entire evaluation of the case. In addition, auditors generally have accepted the attorneys' inclusion of clients' views in audit response letters without claiming that the recitation of such views imposes a further disclosure requirement on an attorney to express the attorney's view on the same subject. Both of these principles are called into question by the increasing assertion of third-party claims against law firms by their auditors.\footnote{15}

The panelists were unable to locate any reported cases that hold an attorney liable for an insufficient audit letter response (but see \textit{Arky Freed} case hereafter where an attorney was found not liable). It is generally believed by commentators and members of the Committee on Law and Accounting that the liability for an attorney is the same as the attorney's liability for issuance of a third-party opinion letter.

Liability for third-party legal opinions is guided and interpreted by the Restatement of Law Governing Lawyers (the \textit{"Restatement"}); TriBar II, a report issued by the TriBar Opinion Committee; and a document entitled \textit{"Legal Opinion Principles"} approved and released by the ABA Business Law Section Standing Committee on Legal Opinions. These three reports provide a comprehensive and consistent description of legal opinion practice as it exists today. According to one commentator, "they constitute the best sources currently available on legal opinion issues."\footnote{16}

In the interest of simplicity and brevity, this memo will refer to the Restatement in discussing an attorney's liability associated with giving audit letter inquiry responses. Through a breach of the duty of care to nonclients (e.g. auditors), attorneys may be liable under the claim of professional negligence.\footnote{17}

Section 95 of the Restatement sets forth the guidelines for an evaluation undertaken for third-party liability as follows:

(1) In furtherance of the objectives of the client in a representation, a lawyer may provide to a nonclient the results of the lawyer's investigation and analysis of facts or the lawyer's professional evaluation or opinion on the matter.

(2) When providing the information, evaluation, or opinion under Subsection (1) is reasonably likely to affect the client's interest materially and adversely, the lawyer must first obtain the client's consent after the client is adequately informed concerning important possible effects of the client's interest.

(3) In providing the information, evaluation, or opinion under Subsection (1), the lawyer must exercise care with respect to the nonclient and to the extent stated in § 51(2) and not make false statements prohibited under § 98.\footnote{18}

Comment (f) of § 95 specifically addresses an auditor's request for information. This comment makes reference to the ABA Statement and SAS 12 by stating that any attorney's duty of care under § 95(3) is satisfied by the standards agreed upon by the accounting and legal


\footnote{17} Restatement (Third) of Law Governing Law. § 48 (2000).

\footnote{18} Id. at § 95.
professions (i.e. the ABA Statement and SAS 12). Thus, if the provisions of the ABA Statement and SAS 12 are properly evoked and followed by the auditors and the attorneys, it appears from this comment that the attorney's duty of care has been satisfied.

Even though the ABA Statement and SAS 12 appear to shield attorneys from liability under the Restatement, attorneys should still be familiar with the duty of care an attorney owes a nonclient in the context of rendering a legal opinion—especially since it is generally acknowledged by those attorneys issuing audit letters that auditors are more frequently refusing to accept responses constituting less than required by the ABA Statement and are frequently demanding more. In light of the demands being placed upon auditors in the post-Enron era, it can only be assumed that the pressure for more disclosure will increase.

An attorney owes a duty of care to a nonclient when and to the extent that the lawyer, or (with the lawyer's acquiescence) the lawyer's client, invites the nonclient to rely on the lawyer's opinion or provision of other legal services, and the nonclient so relies; and the nonclient is not under applicable tort law, too remote from the lawyer to be entitled protection.

Because auditors fall under the class of nonclients to whom a lawyer owes a duty of care, the duty of care is the competence and diligence normally exercised by lawyers in similar circumstances. In addition, under § 98, a lawyer communicating on behalf of a client with a nonclient may not:

V. Knowingly make a false statement of material fact or law to the nonclient;

VI. Make other statements prohibited by law; or

VII. Fail to make a disclosure of information required by law.

C. What policies should your firm have re audit letters? In its May 1977 bulletin, the Section on Corporation, Banking, and Business Law issued an outline of policies that a firm should implement. The outline provides a six-step internal procedure that law firms should follow in responding to audit inquiry letters, and is attached hereto as Exhibit A. In addition to these procedures, attorneys should include in their engagement letters to clients a provision regarding attorneys' fees as they relate to responding to auditors' inquiries.


D. What is required in your response and what is optional? The ABA Statement sets forth the following requirements that limit an attorney's response to auditors:

VIII. The substantive attention requirement,

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19 Id. at Comment (f.).
20 Id. at § 51(2).
21 Id. at § 52(1).
22 Id. at § 98.
IX. The materiality requirement, and

X. The loss contingencies requirement.24

Each requirement must be satisfied in order for the attorney to disclose any information to an auditor.

(i) Substantive Attention. According to the ABA Statement, an attorney may limit his response to matters that he gave substantive attention. Moreover, an attorney's response is limited to his professional engagement of counsel; therefore, the attorney does not have to disclose information that he receives in a different role (i.e. when the attorney serves as an officer or director of the client).25

The term substantive attention is not defined in the ABA Statement. Therefore, consideration should be given to defining the term in the response (i.e. stating in the response that a minimum of five hours of billable time is needed to constitute "substantive attention").26

(ii) Materiality. Paragraph 3 of the ABA Statement and its correlating commentary declare that attorneys' responses are limited to items that are individually or collectively material to the presentation of the client's financial statements.27 Usually the materiality requirement manifests itself in a dollar amount (e.g. matters over $10,000 must be reported).28 If no materiality standard is provided, then the attorney preparing the response should not exclude matters from the response on the basis of materiality.29

(iii) Loss Contingencies. The loss contingency requirement involves three categories of loss contingencies: overly threatened or pending litigation, contractually assumed obligations, and unasserted claims.30

As defined by FAS 5, a loss contingency is an existing condition, situation or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more events occur or fail to occur. Resolutions of the uncertainty may confirm the loss or impairment of an asset or the incurrence of a liability.31

An attorney may disclose the loss contingencies of his client only if the auditor properly requests (this does not apply to overly threatened or pending litigation).32 A proper request involves a client requesting the attorney to comment on the loss contingency through an inquiry letter and an identification of the loss contingency through the same means.

26 Lipman, Frederick D., "Responding to Auditor's Letters," 15 No. 7 Legal Econ. 23 (1989).
31 Auditor's Letter Handbook 5, at 23.
32 Id. at 8.
An attorney may comment as to overly threatened or pending litigation even if a client does not properly request it. Overly threatened or pending litigation means a potential claimant has communicated to the client a potential awareness of and present intention to assert a possible claim unless the likelihood of litigation or settlement is remote.

To comment on a contractually assumed obligation or an unasserted claim or assessment, a client must instruct his attorney to do so in the inquiry letter and identify the obligation or claim or assessment. Furthermore, for disclosure by the attorney to be appropriate, a client must determine that it is probable that a possible claim will be asserted, that there is a reasonable possibility that the outcome (assuming such assertion) will be unfavorable, and that the resulting liability would be material to the financial condition of the client.

A client may consider an unasserted claim probable only when the prospect of the claim being asserted is reasonably certain, the prospects of non-assertion seem slight, and the claim is supported by extrinsic evidence strong enough to establish a presumption that it will happen.

(iv) Gain Contingencies. Historically, in their inquiries to attorneys, auditors have focused their concern on litigation, claims or assessments that present loss contingencies. Paragraph 17 of FAS 5 provides: "contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue before its realization." Paragraph 17 also warns that although disclosure should be made of gain contingencies, great care must be taken in disclosing them as to not mislead implications as to the likelihood of the realization. Thus, the disclosure requirements for gain contingencies follow those limits established in the ABA Statement.

E. When explaining negatives and exceptions, like litigation, how detailed must your response be? In terms of loss contingencies, when properly requested by a client or in the case of overly threatened or pending litigation, attorneys may disclose an identification of the proceedings, the stage of the proceedings, the claim(s) asserted, and the position taken by the client (i.e., contest case vigorously or seek settlement). However, attorneys should not express any judgements as to the outcome of litigation except in those few undeniable instances where it appears to the attorney that an unfavorable outcome is either probable or remote.

As indicated by the ABA Statement, an unfavorable outcome is probable if the prospects of the claimant not succeeding are judged to be extremely doubtful and the prospects for success by the client in its defense are judged to be slight. An unfavorable outcome is remote if the prospects for the client not succeeding in its defense are judged to be extremely doubtful and the prospects of success by the claimant are judged to be slight.
A longtime member of the Committee on Law and Accounting suggests that given the uncertainties of litigation, the wiser course for attorneys is to state, "we are unable to determine at this time if an unfavorable outcome is either probable or remote," and then just give a factual background of the case and its procedural posture. An accounting expert on the other hand believes that such a response is appropriate only if no other conclusion can be reached.

F. Are responses privileged, and, if not, how can you protect important details of the case or settlement strategy from being disclosed? This remains a central issue in the audit letter process. Nonetheless, the case law in this area is relatively sparse and is split down the middle as to whether or not attorneys' responses are privileged. A few articles in this area have specifically addressed the issue of audit letters responses and privilege.

(i) Accountant-Client Privilege. The accountant-client privilege is not recognized in federal court when an action is based on federal law, but is recognized by statute in thirty states (not including California). 44

According to the court in Tronitech, audit letter responses should be protected by the accountant-client privilege to the extent the privilege is recognized because they contain information not available from public sources. The plaintiff, Tronitech, was unsuccessful in trying to obtain a copy of the audit letter provided to NCR's accountant's by NCR's legal counsel. The court held that the audit letter was not discoverable because the audit letter contained legal opinions concerning the financial implications of the lawsuit between Tronitech and NCR. 45

Taking a different approach, the court in Hillsborough Holdings held that audit letters are not protected by the accountant-client privilege because they request information that would be used in the preparation of financial statements to be disclosed to the public. That case involved Hillsborough Holdings and later Jim Walter Corporation ("JWC") seeking to prevent the defendants, asbestos makers, from gaining access to attorney audit inquiry letters between the attorneys of JWC and Price Waterhouse, the accountants of JWC. The court compelled JWC to produce the audit letter response to the defendants thereby holding that the accountant-client privilege did not prevent disclosure because the information in the audit letter response would be released to the public through the corporation's prepared financial statements. 46

(ii) Attorney-Client Privilege. This privilege has generally not been successfully invoked to protect audit letter responses because the courts tend to view auditors as an outside third-party to the attorney-client relationship. For example, in United States v. Under Seal, the government sought production to the grand jury of drafts, notes, and memoranda generated in connection with audit letter responses to an outside auditor. The parties conceded that the final audit letter responses were not privileged but sought to protect the underlying drafts and notes as privileged under the attorney-client privilege. The Fourth Circuit rejected this argument, following reasoning similar to that of Hillsborough Holdings, that the attorney-client privilege does not apply to communications in a proposed public disclosure. 47

47 United States v. Under Seal, 33 F.3d 342 (4th Cir. 1994) and Hillsborough Holdings Corp., supra.
Also, in Vanguard Savings and Loan Ass'n v. Banks, a law firm issued audit inquiry responses to the Pennsylvania Department of Banking with opinions relating to litigation, claims, and assessments. The court did not allow the responses to be protected under the attorney-client privilege because the audit letter inquiry responses by the law firm only relayed facts to the Pennsylvania Department of Banking, and did not involve privileged communications between client and attorney.48

(iii) Work-Product Doctrine. The attorney work-product doctrine is an additional avenue by which attorneys may be able to quash unauthorized disclosure. As stated in Gulf Oil, if the document was not created primarily or exclusively to assist in litigation (i.e. created for some other business purpose), it is not eligible for work-product doctrine protection.49

Gulf Oil Corporation merged with Cities Service Oil & Gas Corporation. Pursuant to the merger agreement, Cities prepared documents for its auditors, Arthur Young & Company, which included legal evaluations regarding ongoing litigation with the Department of Energy. The Department of Energy sought discovery of the documents prepared for Arthur Young claiming that Cities had waived its work-product privilege in disclosing the documents to Gulf Oil Corporation pursuant to the merger agreement. The court held that documents were discoverable and were not afforded work-product doctrine protection because they were created for some other business purpose, namely the merger between Gulf Oil Corporation and Cities.50

However, according to other courts, communications and material prepared because of existing or potential litigation will be afforded protection.51 The court in Adlman noted the caveat in the Advisory Committee Notes to Rule 26(b)(3) that work-product doctrine protection does not extend to those documents that are prepared in the ordinary course of business, or that would have been created in essentially the same form.52

Adlman was the attorney and vice president of Sequa Corporation, which contemplated restructuring the corporation through mergers. Because Adlman knew that such restructuring might be challenged by the IRS and result in litigation, he asked an accountant/attorney at Arthur Anderson & Co. to evaluate the tax consequences of the restructuring. The accountant/attorney provided Adlman with a fifty-eight page memo discussing the potential litigation with the IRS and other legal analysis. After Sequa restructured the corporation, the IRS requested that the corporation produce the fifty-eight page memorandum drafted by the accountant/attorney. The court held that the work-product doctrine protected the memorandum from disclosure because it was prepared because of potential litigation with the IRS.53

Vanguard followed the same reasoning as Adlman by adopting the line of reasoning that communications and material prepared because of existing or potential litigation will be afforded protection. In reaching its conclusion that the audit letter responses were protected, the court held that the response letters were not created in anticipation of litigation, but were protected anyway because they contained opinions about the outcome of litigation that revealed metal

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50 Gulf Oil Corp., 760 F.2d 292.
51 United States v. Adlman, 134 F.3d 1194 (2nd Cir. 1998); Tronitech, supra; Vanguard, supra.
52 Adlman, supra at 1202.
53 Adlman, 134 F.3d 1194.
impressions, thoughts, and conclusions of an attorney in evaluating a legal claim. Vanguard, supra.

(iv) **Waiver**. Because attorneys provide auditors with confidential information, litigation has arisen with regard to waiver of the work-product doctrine. Policy suggests that the work-product doctrine is not waived as easily as the attorney-client privilege because the work-product doctrine exists to protect the adversary system. Thus, waiver only occurs if a disclosure runs counter to the adversary system.

The court in Tronitech held that the work-product doctrine might be waived only through disclosure to an adversary, and auditors are not adversaries. As a cautionary note, the court in Vanguard stated that a disclosure made concurrently with a guarantee of confidentiality does not necessarily constitute a waiver of the work-product doctrine. The court in Vanguard also stated that if the disclosure is either inadvertent or made to a non-adversary, it is appropriate to ask whether the circumstances surrounding the disclosure evidenced conscious disregard of the possibility that an adversary might obtain the protected materials.

Furthermore, while the issues of disclosure and privilege have varying results, the importance of keeping responses to audit inquiry letters confidential should not be overlooked. The information given to auditors can be of a highly sensitive nature and could be discoverable by a client's creditors or an adversary in litigation. Thus, attorneys and clients must work together in drafting responses that preserve the confidentiality of information given to auditors.

As suggested by Policy 17 of the ALAS Prototype Lawyers' Manual, it is important not to disclose confidential information to a client's auditors without first fully discussing the consequences with the client and receiving the client's informed consent. The client should also review and approve a draft of the proposed response where applicable.

**G. How should you handle an atypical audit letter request?** According to a member of the Committee on Law and Accounting, attorneys should not respond to requests and inquiries that go beyond the scope of the ABA Statement. For example, a client that requests his attorney to comment on the legality of a merger between the client and a parent corporation would be considered an atypical audit letter request that goes beyond the scope of the ABA Statement. Therefore, the attorney should reply by stating that the inquiry or request does not conform to the ABA Statement, and thus, a response is inappropriate.

**H. Should the client review and approve the response in advance?** An article in the American Bankruptcy Journal specifically addresses the relationship that an attorney should have with his client in the audit letter process and strongly advocates a diligent effort between clients and attorneys to work together. The Journal refers to specific steps that attorneys and clients should take together.

55 Tronitech, supra at 657.
57 Id.
58 1999 ABI JNL. LEXIS 104.
I. Are there any cases finding attorneys liable for an insufficient audit letter response? There seem to be no cases specifically finding an attorney liable for insufficient audit letter responses. Conversely, at least one reported case has held in favor of an attorney and a law firm that relied upon the ABA Statement and SAS 12 in responding to audit letter inquiries.\(^59\)

Plaintiff Tew, a receiver and trustee in bankruptcy, sued Defendants Stephen Arky and Arky, Freed, Stearns, Watson, Greer, Weaver & Harris, P.A. ("Arky Freed") for failure to disclose the financial condition of a client, ESM, to its auditors Alexander Grant & Co. Tew argued that Stephen Arky had a duty to disclose the insolvency of ESM to the auditors. Arky had discovered the insolvency at a meeting six weeks before ESM's collapse.\(^60\)

The Southern District of Florida relied upon the ABA Statement and SAS 12 in granting summary judgment in favor of Stephen Arky and Arky Freed. The court based its rulings on the principle that the Stephen Arky and the firm no duty to advise ESM's auditors of alleged knowledge of the company's financial problems. The court found that there was no evidence that the lawyer had been retained to devote substantive attention to the problems or that the client identified its financial problems in its inquiry letters or that the client requested that the lawyer comment on ESM's financial problems in the response letter to the auditor. By way of this reasoning, the court held that Stephen Arky and Arky Freed were not liable.\(^61\)


\(^{60}\) Tew v. Arky, 655 F.Supp. 1571.

EXHIBIT A

PROPOSED LAW FIRM AUDIT LETTER POLICIES

SUGGESTED INTERNAL PROCEDURES TO BE FOLLOWED BY LAW FIRMS IN RESPONDING TO AUDIT INQUIRY LETTERS

A. FIRST STEP: Approval of Inquiry Letter. Committee should review and approve all Inquiry Letters received by firm.

1. Check each Inquiry Letter to see if it is in acceptable form.

2. Accept only Inquiry Letters which conform (at least substantively) to the ABA suggested form.

3. Do not accept an Inquiry Letter which:

   (a) asks something to the effect "please advise auditors of all claims against client of which you have knowledge"; or

   (b) follows suggested form letter by indicating that the client has represented to the auditor that the law firm has not advised the client of any unasserted claim which is probable of assertion and must be disclosed, but then states: "Please furnish to ABC Auditing & Co. an explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated"; or

   (c) makes reference in any manner, other than the exact words of the last paragraph of the suggested form of Inquiry Letter attached as an exhibit to the ABA Statement, to the client's representation to the auditor that there are no unasserted claims which the attorney has advised are probable of assertion; or

   (d) is not executed by a client representative with sufficient officer authority; or

   (e) indicates client has been required to specify unasserted claims without regard to FAS 5 standards (see paragraph (5) of ABA Statement); or

   (f) indicates that the client has been required to specify all unasserted claims as to which legal advice may have been obtained (see paragraph (5) of ABA Statement).

4. Without prior discussion with, and informed consent of, the client, do not prepare Response Letters which would:
(a) encompass matters intended to be covered by an attorney-client privilege; or

(b) involve disclosure of unasserted claims.

B. **SECOND STEP: Assignment of Drafting Responsibility for Response Letter.** With respect to each approved Inquiry Letter, the Committee should assign the responsibility of preparing the Response Letter to an attorney ("attorney-in-charge") in the firm who either (i) is the primary client contact for the firm, or (ii) primarily handles litigation filed against the client.

C. **THIRD STEP: Internal Retrieval of Facts Needed for Response Letter.** Attorney-in-charge initially circulates Inquiry Letter to each attorney in the firm who has had responsibility for any client matter since the prior year's Response Letter was prepared or who supplied information utilized in the prior year's Response Letter (see discussion under caption "Lawyer's Procedures" and "Retrieval" of First Report).

1. **Point to Remember:** Determination of attorneys who performed services for the client can perhaps be done best by examining time or bookkeeping records.

2. Active files pertaining to "asserted claims" against client should be reviewed by attorney-in-charge as well as any litigation docket procedures maintained by firm.


4. **Point to Remember:** Law firm is not expected to make investigation to determine existence of unasserted claims (see discussion under caption "Retrieval" of First Report). However, if law firm has documented discussions with the client about disclosure of an unasserted claim, review perhaps should be given to that information.

5. **Point to Remember:** With respect to asserted claims, SAS No. 12 contemplates that the client may list and describe facts concerning asserted claims in the Inquiry Letter and ask the attorney to comment thereon. This is not preferable.

D. **FOURTH STEP: Preparing Draft of Response Letter.**

1. Follow carefully the ABA Statement in preparing Response Letter and, in particular, ABA suggested form of Response Letter.

2. Attorney-in-charge oversees other attorneys involved in preparing Response Letter. Questions of interpretation of ABA Statement are directed to Committee.

3. The Attorney who is attorney for same matter falling within scope of an attorney's response under the ABA Statement should probably be the one to prepare an appropriate description of such matter.
4. Final draft of Response Letter should be circulated among and reviewed by all attorneys who participate in the preparation of the Response Letter.

E. **FIFTH STEP: Committee's Review and Approval of Final Draft of Response Letter.**

1. No approval by the Committee should be required of "plain vanilla" Response Letter (i.e., no asserted or unasserted claims are described or mentioned therein and letter otherwise conforms to firm's standard form of Response Letter).

2. Committee review and approval should be required where a Response Letter either:
   
   (a) Does not conform strictly to ABA recommended form or the guidelines of the ABA Statement; or
   
   (b) Includes an evaluation of pending litigation or some other asserted claim; or
   
   (c) Includes any disclosure or other treatment of an unasserted claim; or
   
   (d) Involves response to approved Inquiry Letter which does not satisfactorily conform to ABA recommended form of Inquiry Letter.

3. Any Response Letter falling within one of the categories of subparagraph 2 above should be presented to and discussed with the client before it is sent to the auditor – probably constitutes required consent if full disclosure of legal consequences are made to client.

F. **SIXTH STEP: Execution of Response Letter.**

1. Attorney-in-charge should execute "plain vanilla" Response Letters and at least one other attorney involved in the drafting of the Response Letter should initial a copy of the final form to evidence their respective review and approval.

2. In case of Response Letter requiring Committee approval as stated above, Committee should execute and the attorney-in-charge should initial a copy of the final form to evidence their respective review and approval.

3. Copy of Response Letter (with the corresponding Inquiry Letter attached thereto) should be kept in single client file.

4. **Observation:** Often auditors will phone or otherwise orally confer with attorneys for the purpose of obtaining information which they might otherwise not obtain via the Response Letter, e.g., off-the-cuff evaluation of claims. Auditor will then prepare a memo to his file of such conversation with the attorney. SAS No. 12 recommends that the auditor sometimes confer orally with the attorney (see paragraph 10 of SAS No. 12). However, with limited exceptions, communications with auditor should be limited to Response Letter.
(a) \textit{Point to Remember:} Consideration should be given by the law firm to adding a sentence to the ABA recommended form of Response Letter to the effect that "This letter represents the only authorized communication from this firm, and is the only communication from this firm upon which you may rely, regarding 'loss contingencies' of XYZ corporation and the other matters discussed herein" unless the law firm intends otherwise.

(b) \textit{Point to Remember:} Standard form of Response Letter might also request that auditor provide law firm with copies of any memos which they may have prepared concerning oral conversations with the attorney or confirm that no such memo exists.

5. Any special oral discussions with auditors concerning matters covered by or relating to the Response Letter should be documented by the attorney for later reference if matter is sensitive in nature.

6. Response Letters involving evaluations, special legal considerations, treatment of unasserted claim or some other special matter should be kept in a master file for later reference by the Committee.

7. The ABA recommended form of Response Letter might also be expanded to indicate the attorney's reliance upon the First Report and the Second Report. This would be helpful in making sure the auditor understands the law firm's view of its professional responsibility covered by paragraph 6 of the ABA Statement.
EXHIBIT B
SAMPLE AUDIT LETTER RESPONSE

[Auditor's Name & Address]

Re:  [Company X]
[c/m#]

Dear [Mr. or Ms. Z]:

[Company X] ("Client") has asked us, pursuant to the enclosed letter, to act in our capacity as attorneys for Client in furnishing you with the information normally requested of attorneys by accountants conducting audits for mutual clients.

This response is limited to a report of contingent liabilities with respect to Client existing through: (i) the one-year period under audit from and including [date of first day of audit period] (first day of audit period), through [date of last day of audit period] (last day of audit period); plus (ii) the period through [effective date of the audit letter response], the effective date of this letter. This means that contingent liabilities (i.e., pending or threatened litigation or unasserted possible claims or assessments) which may technically have existed on [date of last day of audit period] (last day of audit period), but which are resolved in a manner which eliminates them as contingent liabilities on the effective date of this letter are not disclosed in this letter. Pursuant to our client's request, this letter is further limited to litigation claims and assessments involving amounts exceeding [$XXXX] individually or [$XXXX] in the aggregate. The matters referenced in this letter are limited to matters with respect to which we have been engaged by Client to represent or advise it professionally and to which we have devoted substantive attention. A minimum of [X.XX] hours of billable time is needed to constitute "substantive attention." We also disclaim any undertaking to advise you of changes that arise after the effective date of this letter. In addition, every representation and disclosure made in this letter is qualified by each of the specific limitations set forth in this letter.

1. LOSS CONTINGENCIES

   A. Pending or threatened litigation (excluding unasserted claims): [None] OR [Identification of the proceedings, the stage of the proceedings, the claim(s) asserted, and the position taken by the client (i.e., contest case vigorously or seek settlement)]

   B. Unasserted claims and assessments: [None] OR [Identification of the claims and assessments]
2. INDEBTEDNESS TO [FIRM NAME]

Client owed this form no fees for services or costs as of [date of last day of audit period] OR As of [date of last day of audit period] Client owed this firm [SXXXX] for services and costs.

We confirm that where in the context for services for Client it has become clear to us that: (i) Client has no reasonable basis to conclude that assertion of a claim is not probable (employing the concepts enunciated in the ABA Statement of Policy of Lawyers' Responses to Auditors' Request for Information, December 1975); and (ii) given the probability of assertion, disclosure of a loss contingency in the Client's financial statements is required beyond reasonable dispute, we have so advised Client on the question of such disclosure and the applicable FAS 5 (Statement of Financial Accounting Standards Board, March 1975).

We make no representations regarding any matters beyond those which fall within the limits set forth in this letter, because, while this firm represents Client on a regular and continuing basis, our engagement is limited to specific matters about which we are consulted by Client. Consequently, legal matters may exist about which we have not been consulted and which could have a bearing on the financial condition of Client.

We are not undertaking to comment upon other contingencies including, without limitation: (i) the possibility of losses from wars, strikes, catastrophes not ordinarily insured against or otherwise provided for, currency re-evaluations or a business recession; (ii) the possibility of tax assessments resulting from challenge in the future of items and tax returns for open years; (iii) the possibility of a trustee in bankruptcy or a debtor in possession asserting that transactions involving Client are voidable as preferences within the meaning of bankruptcy law; and (iv) except for those matters defined as material contingent liabilities, the possibility of assertion in the future of claims by governmental agencies or private parties.

Unless requested by Client to comment on a specific contractually-assumed liability, we are not undertaking to comment upon such contingent liabilities, because we understand that you can satisfy yourself about those liabilities through other audit procedures. Our response, therefore, does not cover contractual loss contingencies, except as they are specifically included and defined in this letter.

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975) and, without limiting the generality of the foregoing, the limitations set forth in that Statement on the scope and use of this response are specifically incorporated in this response by reference, and
any description in this response of "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and its accompanying Commentary, which is an integral part of the Statement. In preparation of this response, our procedures have been limited to an endeavor to determine from lawyers presently in our firm, who have performed services for Client since the beginning of the fiscal period under audit, whether such services involved substantive attention in the form of legal consultation or representation concerning material contingent liabilities as limited and defined in this letter. Accordingly, it is to be noted that we have made no independent review of any of Client's transactions or contractual arrangements for the purposes of this response.

By making the request set forth in its letter to us, Client does not intend to waive the attorney-client privilege with respect to any information which Client has furnished to us. Moreover, please be advise that our response to you should not be construed in any way to constitute waiver of the protection of the attorney work-product privilege with respect to any of our files involving Client.

This letter is written at the request of Client and is solely for your information. No part of this letter, nor the fact of its existence, is to be published, filed, referred to, or otherwise disclosed to any person without the prior written consent of this office. This letter may, however, be disclosed and furnished to others in compliance with court process or in connection with any challenge of your audit by Client or by government regulatory agencies.

This letter represents the only authorized communication from this firm, and is the only communication from this firm upon which you may rely regarding "loss contingencies" of Client as of [Audit Date], and for the one-year period under audit then ended and the other matters discussed herein.

If you need further information, please contact me.

Very truly yours,

[Responsible Attorney]