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How Much Information Should Cos. Share With Auditors?

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One of the more challenging and fraught questions in advising public companies dealing with internal or external regulatory investigations is what information to share with their auditors, and how and when to share it.

It is not always an easy call; legitimate concerns exist that providing information to a company's auditor may later be deemed a waiver by the company of attorney-client privilege or work-product protection, leaving the company exposed to further demands for that information from regulators and adversaries.

That tension between transparency with the auditor and risk of waiver has long been a concern.

It's what led the American Bar Association and American Institute of Certified Public Accountants in 1975 to create a carefully crafted standard and shared understanding concerning how litigation and other legal contingencies should be communicated to the auditor in order for the auditor to obtain sufficient competent evidential matter regarding those contingencies without forcing some waiver of the company's privilege or other protection.[1]

Companies are therefore cautious about disclosing further detail regarding investigations or litigation, or substantive information uncovered during the course of an investigation, because that disclosure, some may argue, waives applicable privileges and protections.[2]

But in a world where regulators appear to be increasingly focused on so-called gatekeepers, auditors have reason to be concerned that the failure to obtain sufficient evidence exposes them to risks of their own. A few recent developments provide some useful guideposts in navigating disclosure to the auditors.

SEC v. Thompson

On one end of the extreme is U.S. Securities and Exchange Commission v. Thompson in the U.S. District Court for the District of Nevada.

On Sept. 22, the SEC brought an action against three officers of SPYR Inc., a technology company headquartered in Denver. The SEC's complaint alleges that the officers, including the CEO and general counsel, failed to disclose to two outside auditors an ongoing SEC investigation.

While the company disclosed the existence of the investigation to its auditor in 2014, when it was first commenced, the company provided no further update. Even in early 2018, when the auditors asked the executives whether they were aware of "any situations where the company may not be in compliance with any federal or state laws or government or other body regulations," the three officers answered "no."[3]

In actuality, the SEC had already issued a Wells notice, the company was amid settlement negotiations, which subsequently broke down, and the SEC enforcement staff had indicated that an enforcement action was forthcoming.[4]

When the company hired a subsequent auditor in 2018, the company allegedly made no disclosure of the investigation at all. Indeed, during a text exchange between two of the officers and the former chairman of SPYR's board, the chairman told the officers that "with the SEC complaint only days/weeks away from being served ... we really need to get this 10-K filed ASAP."[5]

Sure enough, the SEC filed a complaint against the company in 2018. The subsequent auditor, having allegedly heard nothing about the existence of any SEC investigation, withdrew its opinion, concluding it could no longer rely on management's representations given the nondisclosure of the investigation. In 2020, SPYR settled the 2018 matter wherein the company, the board chairman and a related entity collectively paid $2.5 million in disgorgement and penalties.[6]

The nondisclosure of the investigation led the SEC to subsequently charge the three officers with various violations of the Securities Act and the Exchange Act, including regulations prohibiting false or misleading statements to an auditor in connection to the preparation of periodic public reports.[7]

The three officers settled the charges, agreeing to be enjoined from similar conduct in the future, as well as a three-year director and officer bar, and agreeing to pay civil penalties ranging from $10,000 to $75,000.

No doubt about it, SEC v. Thompson is meant to send a message: The existence of litigation and regulatory investigations must be disclosed to auditors. That is not to say an investigation need be simultaneously disclosed to the investing public.

Public disclosure of an SEC or other regulatory investigation is an entirely different question, depending on various facts and circumstances.

For instance, the U.S. District Court for the Southern District of New York held in In re: Lions Gate that a company

> did not have a duty to disclose the SEC investigation and Wells Notices because the securities laws do not impose an obligation on a company to predict the outcome of investigations. There is no duty to disclose litigation that is not substantially certain to occur.[8]

By contrast, the U.S. Court of Appeals for the Second Circuit recently held in Noto v. 22nd Century Group Inc. that where a company had disclosed weaknesses in its financial controls, the company had a duty to disclose an SEC investigation of those weaknesses.

The court reasoned that "[b]ecause defendants here specifically noted the deficiencies and that they were working on the problem, and then stated that they had solved the issue, 'the failure to disclose [the investigation] would cause a reasonable investor to make an overly optimistic assessment of the risk.'"[9]

The point of SEC v. Thompson is that without disclosure of the existence of the investigation, the auditors never had a chance to perform their gatekeeping function. The auditor's job is to determine whether a company's financial statements, taken as a whole, present fairly in all material respects the company's financial condition in accordance with generally accepted accounting principles.

According to the Public Company Accounting Oversight Board, with respect to any potential loss contingencies arising from litigation, auditors obtain evidence regarding

> the 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; the period in which the underlying cause for legal action occurred; the degree of probability of an unfavorable outcome; [and] the amount or range of potential loss.[10]

It may be entirely appropriate for a company not to publicly disclose the existence of an investigation and not to record any associated loss contingency. But the auditor cannot make any assessment of the fair presentation of financial statements if the auditor does not even know an investigation exists.

And, of course, a failure to disclose such an important piece of information bears on management's overall credibility and whether the auditor can rely on management representations more broadly.

SEC v. RPM and In re: Grand Jury

On the other end of the extreme is SEC v. RPM International, which highlights the inherent tensions that companies face, after they do disclose the existence of an ongoing investigation to their auditor, when the auditor requires additional information about the underlying circumstances.

A majority of courts have held that sharing a document with an auditor does not waive the heightened discovery barrier otherwise enjoyed by documents that are privileged attorney work product, or documents prepared in anticipation of litigation.[11]

However, this consensus was called into question in 2020 when the U.S. District Court for the District of Columbia denied work product protection for interview summaries prepared by a law firm in connection with an audit in SEC v. RPM International.[12]

In that case, the SEC brought an enforcement action and sought interview memoranda produced during a law firm's independent investigation.[13] The entire reason for this internal investigation, and why these memoranda existed, was that that RPM's auditor had refused to sign the company's Form 10-K unless the special investigation took place.[14]

The district court granted the SEC's motion to compel, reasoning that the memoranda were not prepared because of anticipated litigation, but rather at the request of RPM's auditors, and that RPM waived any privilege when it authorized its auditor to disclose the findings to the SEC.[15]

Although RPM's interlocutory order was upheld by the U.S. District Court for the D.C. Circuit on a

petition for a writ of mandamus,[16] it has not been followed by other courts in the two years since it was issued. Indeed, even courts within the same district have shied away from requiring too much specificity in the litigation to be anticipated in order to meet the because-of test.

For example, FBI agents' forms to summarize interviews, even before a grand jury has been convened, have been held to have a sufficient nexus to anticipated litigation, when lawyers strategized about and directed the conduct of those interviews.[17]

Even communications between nonlawyer executives merely trying to avoid litigation have been found to be adequately protected by the doctrine.[18] This is the more sensible doctrinal approach when an enforcement action is clearly on the horizon, as it was in Thompson and RPM.

The U.S. Supreme Court may touch on this and related issues in deciding the In re: Grand Jury case this term, which raises the question of whether attorney-client privilege applies to a document created by a law firm that includes both legal and nonlegal advice.[19]

In that case, the district court held a law firm specializing in international tax issues in contempt for failing to produce communications that both provided legal advice and discussed the preparation of a client's tax returns.[20] In deciding the case, the court will likely need to resolve a circuit split over whether a document enjoys attorney-client privilege if it has a substantial legal purpose, or only if providing legal advice is the document's primary purpose.[21]

Conclusion

It is important for an issuer and its auditor to achieve a common understanding about what information is appropriate to be shared in the course of an audit, so that privilege can be appropriately protected while the auditor is able to obtain their required evidence.

When issuers deem it necessary to withhold information from the auditor, they should do so in a manner that is clearly communicated and provides comfort regarding management's integrity and, to the fullest extent possible, transparency.

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[1] Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information, available at https://pcaobus.org/oversight/standards/archived-standards/pre-reorganized-auditing-standards-interpretations/details/AU337C; Communication With the Entity's Legal Counsel, available at https://us.aicpa.org/content/dam/aicpa/research/standards/auditattest/downloadabledocuments/au-c-00501-a.pdf. There is, of course, no accountant-client work product protection. United States v. Arthur Young & Co., 465 U.S. 805, 817 (1984).

[2] See United States v. El Paso Co., 682 F.2d 530, 540–41 (5th Cir. 1982).

[3] Complaint at ¶ 5, United States Securities and Exchange Commission v. Thompson, et al., No. 2:22-cv-01609 (D. Nev. Sept. 22, 2022), ECF No. 1.

[4] Id. at ¶¶ 17–20.

[5] Id. at ¶ 32.

[6] Id. at ¶ 24.

[7] Id. at ¶ 54, 61, 64; 17 CFR § 240.13b2-2.

[8] In re Lions Gate Ent. Corp. Sec. Litig., 165 F. Supp. 3d 1, 12 (S.D.N.Y. 2016) (quotation omitted).

[9] Noto v. 22nd Century Grp., Inc., 35 F.4th 95, 105 (2d Cir. 2022) (quoting Meyer v. Jinkosolar Holdings Co., 761 F.3d 245, 251 (2d Cir. 2014)).

[10] Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments, Statement of Fin. Auditing Standards, §2505.04 (Public Company Accounting Oversight Board 2020).

[11] Westernbank Puerto Rico v. Kachkar, Civ. No. 07-1606 (ADC/BJM), 2009 WL 530131, at *7 (D.P.R. Feb. 9, 2009).

[12] No. CV 16-1803 (ABJ), 2020 WL 13158303, at *1 (D.D.C. Mar. 5, 2020).

[13] Petition for Writ of Mandamus at 10–11 In re RPM Int'l, Inc., No. 20-5052 (D.D.C. Mar. 12, 2020).

[14] Id. at 6.

[15] RPM, 2020 WL 13158303, at *2–3.

[16] Order, In re RPM Int'l, Inc., No. 20-5052 (D.C. Cir. May 1, 2020), Document No. 1840933 ("Petitioner has not shown that it has a 'clear and indisputable right' to the relief requested." (quoting Gulfstream Aerospace Corp. v. Mayacamas Corp., 485 U.S. 271, 289 (1988)).

[17] See Jud. Watch, Inc. v. U.S. Dep't of Just., 806 Fed. Appx. 5, 7 (D.C. Cir. 2020); see also Leopold v. U.S. Dep't of Just., 487 F. Supp. 3d 1, 11-12 (D.D.C. 2020) (arriving at the same conclusion for the same category of documents).

[18] See Mischler v. Novagraaf Grp. BV, No. 1:18-cv-2002, 2019 WL 6135447, at *8-9 (D.D.C. Nov. 19, 2019) (classifying such emails as fact work product).

[19] In re Grand Jury, SCOTUS blog, https://www.scotusblog.com/case-files/cases/in-re-grand-jury/.

[20] Petition for Writ of Certiorari at 3–7, In re Grand Jury, No. 21-1397.

[21] Id. at 9.