The Wavering Future of Auditor Privilege

In-House News:

The Wavering Future of Auditor Privilege
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The Texas Supreme Court made a momentous final decision regarding the ongoing battle between AES Wolf Hollow and The Shaw Group, Inc., that allows third parties access to auditor-privileged documents on April 28.

This case, which has been widely followed by in-house attorneys and auditors, has many major repercussions; but before delving into what they might be, here is the background of this titillating story:

It seemed like a simple construction contract. In March 2002, Virginia-based global power company AES Wolf Hollow offered $99 million to The Shaw Group to complete an electric power plant in Texas.

The Shaw Group was commissioned to complete the project that Parsons had partially engineered within a certain time frame, but was delayed by certain extenuating circumstances. For each day that the project was left incomplete, a fine was tallied. In total, AES billed Shaw $40 million.

Unable to resolve the dispute themselves, Shaw filed suit against AES for breach of contract, nonpayment, and misrepresentation; and AES issued a subpoena for Shaw's auditing records.

What the Texas-based AES overlooked was the fact that both Shaw and its auditor, Ernst & Young, are Louisiana-based; and in Louisiana, auditor-client privilege represents a pact of strict confidentiality.

After several years of struggling, Judge Ralph Walton, Jr., granted AES' discovery request in May 2005 at Hood County, TX, ordering Ernst & Young to comply with the discovery request by handing over necessary financial documentation.

In an attempt to keep their finances private, Shaw appealed to the Texas Supreme Court before Ernst & Young transferred private information to AES, arguing that its public filings with the Securities and Exchange Commission detailed more than enough information. Any request beyond that would be a breach of privacy.

After almost a year of debate and deliberation, the Texas Supreme Court overturned Shaw's confidentiality, allowing AES access to Shaw's financial records in May 2006.

Subsequently, Shaw filed a motion for rehearing, expressing numerous reasons why the court should not allow AES access to its auditing records. The company shared information with Ernst & Young in its Louisiana office, trusting in the maintenance of the state's auditor privilege.

Furthermore, the flow of information that runs a company and its auditors should be not be breached by a motion to enforce discovery. Shaw contends that businesses share revealing financial information with their auditors because they believe that the confidentiality will be upheld.

If the Texas Court allows AES to breach the fort of confidentially that the auditor privilege supposedly ensured for Shaw, many companies will not only withhold complete and accurate financial reporting, but they will also hesitate before conducting future business transactions in Texas for fear of discovery.

Shaw's motion was denied on April 28, 2006.

The court decision regarding auditor-privilege has many ramifications for the corporate-legal world. The American Bar Association (ABA), the Association of Corporate Counsel (ACC), and numerous other in-house attorneys see this ruling as a red flag.

Ever since the Sarbanes-Oxley Act (SOX) passed in 2002, auditors had to conduct even more stringent investigations on public companies—including the reporting of liabilities, litigation, enforcements matters, internal investigations, and legal counsel regarding regulatory and transactional issues—even if there is attorney-client privileged information. Auditors have more access to private information than they ever did before.

Furthermore, SOX has a new provision that will make it mandatory, beginning in January 2007, to identify and divulge any high-risk legal areas that affect a company's finances.

Not only does this decision seem to nullify auditor privilege, but it clearly endangers the attorney-client privilege, because auditors must investigate documents that are protected by this privilege.

in-house counsel must opt to surrender sensitive, attorney-client privileged information to auditors, thereby risking the chance that an outside entity will gain access to the information and jeopardize the financial vigor of the company.

Or they must decide to withhold information from auditors, forgoing a clean audit report.

ACC delved into this issue in its amicus brief, saying, "Corporate counsel are concerned that communications with clients on sensitive matters [that involve financial compliance or relate to financial reporting], which are then requested by accountants, will place clients in a 'Hobson's choice' situation in which they must choose between their right to confidential legal counsel and their responsibility and interest in cooperating fully with auditors to ensure accurate accounting practices and stakeholder confidence."

ACC continued ominously, "[Eroding the auditor and attorney-client privilege will] chill communications between companies and their accountants and punish those who cooperate fully with their auditors."

There is much uncertainty regarding the protection of privilege. In a *Corporate Counsel* article, C. Lee Cusenbary, Jr., General Counsel of Mission Pharmacal Co., said that his company "relied on [the audit] privilege in sharing all our information with Ernst & Young [in its annual audit]. Now all that means nothing?"

The verdict that came out of the AES vs. Shaw case has joined many in the fight to strengthen their privacy privileges, but the wavering condition of these

privileges is of no comfort. Because of these weakened privileges, clients, in-house counsel, and auditors will now have to hesitate before revealing sensitive information.

Of the outcome, it is clear that—at a time when regulation and compliance are essential—this case has gridlocked progression towards honest reporting.