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Common Discovery Disputes in Accountant-Liability Litigation

By George J. Coleman

Courts across the nation are allowing more discovery, and accountant-liability cases are no exception. Nowadays it's a given that the accountant's work papers and time records for the engagement in question will be produced. After that, a variety of discovery disputes routinely arise. Young lawyers are often directly involved in responding to discovery requests and filing motions to compel discovery responses.

Because both sides, especially in audit cases, usually can find ample case law to support their positions, the case law usually isn't determinative. (For that reason, citations are largely omitted from this article.) It usually comes down to the court's exercise of its discretion. Courts weigh relevance against burden and prejudice, often fashioning remedies that employ protective orders, redaction of irrelevant or proprietary material, and in camera reviews to allow some but not all of the requested discovery. Given the arcane nature of some accounting issues, expert opinion sometimes comes into play, and courts have appointed independent accountants as discovery masters to help resolve these disputes. Courts frequently order some production, but only after narrowing the request to, for example, just those portions of the audit manual that are mentioned in the work papers.

Documents Frequently Requested in Accountant-Liability Cases

> **Marketing materials.** As the accounting profession has become more of a business, with increased competition for clients, the materials used to attract those clients have come to play a prominent role in litigation. Such documents can include advertisements, marketing brochures, newsletters, RFP responses, and "beauty contest" materials. Their content can range from generic pamphlets to fact-specific client proposals, and their audience could be everyone on the firm's mailing list or just one prospective client. Plaintiffs often can obtain helpful statements from the firm's website.
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> Plaintiffs want these to show what the accountants promised about their expertise so that they could get the business in the door—and often these materials do tout the accountant's abilities and qualifications and, for better or worse, create high expectations. Plaintiffs will suggest that the firm misrepresented its qualifications and/or didn't deliver what was promised, and may argue that the materials fraudulently induced the client to hire the accounting firm. These materials may also be used to expand the accountant's duties beyond the scope of a weak engagement letter. They often describe work the firm

offers that the accountants believe they weren't hired to do, but that plaintiffs now say was promised to them.

Defendants can argue that the materials are irrelevant if the client did not rely on the document when entering into the engagement, and that they are irrelevant to negligence issues. Defendants also argue that industry- or client-specific promotional materials (or lists of to whom generic materials were sent) contain proprietary marketing strategies. General requests are often burdensome because most firms don't keep records of what is sent out: Would it include, for example, business-development letters sent out by individual accountants from different offices to prospective clients in different industries?

Courts may order production of some of these materials, but often narrow requests to materials on the precise subject of the engagement at issue, specific to the industry that the client was in, generated by the particular accountants or office of the firm that did the work in question, and prepared at or about the time of that work. Defendants have also successfully offered to produce samples with client references redacted.

As a practical matter, even if the accountant wins the discovery fight, a tenacious plaintiff will still get some of these materials—from the accounting firm's website, the coffee table in the firm's reception area, or the firm's competitors. And any solicitation letter the firm sent will be in its client's files. Many professional-liability cases these days have the plaintiff exploiting these often embarrassing documents, and the defendant trying to reduce the sting by arguing reliance, puffery (believe it or not, still a viable doctrine) and, in some instances, that what the marketers said was true: The firm *was* the "industry leader in internal controls" and the engagement team *did* have "bone deep" expertise.

Personnel files and performance evaluations. Plaintiffs want these to attack the individual accountant's qualifications, to show the individual was in over his or her head and the firm knew it, and/or that the firm intentionally or recklessly assigned young and inexperienced people to make the audit more profitable. These documents can also show the firm's emphasis on marketing and business development. These materials typically are subject to some discovery, often subject to a protective order.

Defendants argue relevance (if the evaluations don't discuss performance on the audit in question), the "self-critical analysis" privilege (which has not been widely recognized), privacy rights and confidentiality, and that production would be against public policy by invading privacy rights and discouraging firms from candidly and frankly criticizing their employees' performance for fear that such documents would be used against them in litigation. A case accepting some of these arguments and finding personnel files not to be discoverable is *New York Stock Exchange, Inc. v. Sloan*, 22 Fed. R. Serv. 2d 500 (S.D.N.Y. 1976). A case allowing discovery is *In re The Hawaii Corporation*, 88 F.R.D. 518 (D. Haw. 1980).

Courts usually weigh relevance against the individual's privacy expectations. One court found them discoverable only if the staff member worked more than 40 hours on the audit, *In re Alert Income Partners*, MDL 915, No. 92-2-9150 (D. Colo. 1992); another required that plaintiff first show that the firm was negligent in using the particular employee on the audit, *In re One Bancorp. Sec. Lit.*, 134 F.R.D. 4 (D. Me. 1991). Courts have also allowed redaction of non-relevant information such as evaluations of work done after the work in question was performed and the names of other clients.

Peer review materials. Plaintiffs want these third-party reviews to attack the accountants' technical training and proficiency. Reasons not to produce include the self-critical analysis privilege and that the peer review is irrelevant if its end product does not state what engagements or firm offices were reviewed. Courts often limit production to review of the office and the accountants who actually did the work at issue. Some states have statutes protecting peer reviews from discovery.

Expense reports and promotional budgets. Plaintiffs want these to attack the auditor's independence. Expense reports can show how close an individual auditor is to his or her client (expensive dinners, Super Bowl tickets, etc.); budgets can show how important that client is to the office.

Defendants can question the relevance: Is independence really at issue in the lawsuit or is the request a fishing expedition? Some courts require the plaintiff to first make a fact-specific showing of relevance. Defendants sometimes argue that the materials contain proprietary marketing information and ask to redact irrelevant information such as the identity of other clients.

Time and billing files. Plaintiffs want these (if detailed time entries were kept) to learn more about the engagement work. These almost always are discoverable for accountants who worked on the engagement in question but for that engagement only. Things get interesting when plaintiffs insist on obtaining time records for work done by the engagement accountants on *other* engagements or for *other* clients.

Plaintiffs want these additional time records to try to show that the accountants were overworked and thus prone to mistakes, or underworked such that an auditor independence issue arises because of a motivation to keep the client. They can also be used to attack independence if, for example, they show that this client accounts for most of the partner's total billings.

Defendants can argue relevance and, if the court thinks the information may be relevant, offer to produce a summary of the total hours worked. Defendants also can argue that they must only produce records for this particular client and redact references to other clients together with data for that work. Indeed, if a firm's other clients are impacted, they may appear on their own behalf to seek a protective order.

Internal audit manuals. These manuals set forth the firm's interpretations of Generally Accepted Auditing Standards (GAAS) and suggest what steps auditors should take to comply. Plaintiffs want these to show that the auditors didn't even bother to comply with the firm's own procedures and to suggest the standard of care. Defendants routinely resist production, resulting in perhaps more reported decisions on this issue than any of the others discussed in this article.

Defendants have made several arguments over the years for why these should not be produced. The strongest is that their manuals are not relevant because GAAS, not the firm's internal standards, set the standard of care. *See In re Worlds of Wonder Sec. Lit.*, 147 F.R.D. 214, 216 (N.D. Cal. 1992); *Tonnemacher v. Sasek*, 155 F.R.D. 193, 195 (D. Ariz. 1994); *In re CIS Corp.*, 123 B.R. 488, 491 (S.D.N.Y. 1991). Indeed, the plaintiff already has the work papers that show how the audit was conducted (the manuals don't show that), and experts can review those work papers and opine as to whether the audit complied with GAAS. While this argument is strong in negligence cases, in a fraud case, plaintiffs will argue that the degree by which the firm's guidelines were departed from is evidence of recklessness/scienter.

Defendants also argue that production would be against public policy because judging auditors by the standard set in their manuals would encourage firms to set low internal standards. *See Worlds of Wonder*, 147 F.R.D. at 217. Another argument is that the manuals contain proprietary trade secrets. *See Tonnemacher*, 155 F.R.D. at 195; *Worlds of Wonder*, 147 F.R.D. at 216, *Peat, Marwick, Mitchell & Co. v. Creditor's Committee*, 65 B.R. 886, 887, (N.D.N.Y. 1986). In that regard, defendants can argue that a protective order is inadequate because the plaintiff's consultants/experts often are or could be the accountant's competitors and "it would be naive to think [they] will erase the audit manuals from their minds at the close of the case." *Worlds of Wonder*, 147 F.R.D. at 217.

Courts frequently will narrow overbroad and burdensome requests to only the manual portions pertinent to the audit issues in dispute (e.g., related party transactions), to only the manual portions referred to in the work papers or that the auditors actually used and relied on (*e.g., In re Crazy Eddie Sec. Litig.*, 1998 WL 127457 (E.D.N.Y. Nov. 18, 1988)), to only those manual portions that the plaintiff's experts say they need to better understand the work papers, or to only the manuals in effect when the audit was performed.

When manuals are produced, plaintiffs will use them. Defendants respond by having their witnesses explain that manuals are not gospel. Each audit is unique and a manual directive may or may not be applicable; manuals are a menu of possible different approaches and not a recipe of required ingredients.

Training materials. Plaintiffs want these to attack the accountant's technical training and proficiency, to show the accountant didn't do what he or she had been taught, or had been taught poorly to begin with, or to show that the accountant recklessly didn't attend training. Such documents include continuing professional education (CPE) logs, training materials from in-house and outside courses, and sometimes in-house training materials from important courses the accountant did not bother to attend.

As with audit manuals, defendants have argued that GAAS and not the firm's training materials provide the standard of care, and that the firm's internal training materials are proprietary trade secrets. Courts are likely to order some production, but sometimes narrow the scope to only the accountants who worked on the engagement in question, and to only their training on the issues in dispute in the litigation (e.g., internal controls).

Work papers from the firm's audits of other clients in the same or similar industry (e.g., other insurance clients). Plaintiffs want these to show negligence—that the firm generally follows certain audit steps when auditing this industry but didn't follow them on the audit in question.

Defendants have argued, sometimes with the help of an expert affidavit, that the materials are not relevant because GAAS provide the standard of care (not what the firm may or may not have done on other audits), and also because each audit is unique and tailored to a particular client (that a certain test was employed for one insurance client does not necessarily mean that it was appropriate for another).

Client confidentiality also comes into play. Sometimes the other client appears and moves for a protective order saying it will be harmed if its competitors gain access to sensitive work papers. Defendants have also argued that the request is overbroad and will needlessly expand the scope of depositions. Courts sometimes narrow the request to work papers dealing with the specific issue in dispute (e.g., loss reserves).

Work papers for other engagements performed for the same client. Such other engagements might include prior- and subsequent-year audits, agreed-upon procedures, consulting work, tax work, etc. Other audit work papers may show that the accountant employed a significant test in one year but not another. Especially with large firms, the tax team may learn something and document it in the tax work papers that would be pertinent to the audit but not communicate it to the auditors. Because most courts will impute the knowledge of one department to a different department within the same firm, this can impact, for example, an auditor's subsequent event responsibilities.

Reasons not to produce include that GAAS provide the standard of care (not what was or wasn't done on a different audit), relevance (because only a particular year's audit work is in question), and that each engagement is unique and based on the circumstances and facts existing at the time. (That a test was employed in one year but not another may be because the client had different internal controls.)

Practice Tips

Young lawyers, who are most often tasked with handling these discovery disputes, should be mindful that plaintiffs will, more often than not, get a good chunk of these materials in discovery. Although the defense may lose the discovery battle, it may not lose the war. The real fight is over admissibility—just because it was discoverable doesn't mean a jury needs to see it. (Arbitration, of course, can be a different story.) Defendants can try to lay the predicate for exclusion when they depose the plaintiff's representatives: If the CFO never saw the marketing brochure and never visited the firm's website, but instead decided to hire the accountants on the recommendation of his college roommate, those materials can't form the basis for a fraud claim. The rubber hits the road when these issues are argued on a motion in limine or after a voir dire at trial.

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