
METHODS
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How Companies Can Keep Their Sensitive Information Away from Adversaries but Still Cooperate with Auditors

This article explores the tension that exists between a company's duty to disclose information to auditors about litigation exposure while also guaranteeing the confidentiality necessary to ensure that such communications remain protected from discovery.

BY JOHN JETT AND JOSHUA C. HESS

Companies with audited financial statements increasingly find themselves between the proverbial rock and a hard place. On one hand, these companies wish to cooperate with their auditors, who are increasingly asking for confidential—even privileged—information about the companies' litigation exposure. On the other hand, a company's candid assessment to auditors about potential litigation losses, or a document a company discloses to an auditor on that subject, may find its way into an adversary's hands during discovery. Simply put, a tension exists between a company's duty to disclose information to auditors about litigation exposure while also guaranteeing the confidentiality necessary to ensure that such communications remain protected from discovery. This article explores this tension and discusses approaches companies and their counsel may consider to address auditors' requests for confidential information about litigation.

Background

Financial accounting standard ASC 450-20 requires companies' financial statements to disclose information about possible litigation losses.[1] If a company will "probab[ly]" suffer a loss and can "reasonably estimate[]" the loss amount, the financial statements must disclose the loss as a "charge to income."[2] The financial statements also must disclose a potential litigation loss that is a "reasonable possibility," though not necessarily probable.[3] In such disclosures, the company's financials must include "[a]n estimate of the possible loss or range of loss or a statement that such an estimate cannot be made."[4] Concerning "unasserted claim[s]" (e.g., a possible but not pending lawsuit), a company must disclose such claims if they are "probable" and the company faces a "reasonable possibility that the outcome will be unfavorable."[5]

Auditors verify that financial statements comply with these obligations to disclose potential litigation losses. Historically, auditors have done so by requesting that companies' lawyers provide audit letters about the company's litigation (and potential losses in litigation).[6] These audit letters traditionally provide limited information, likely because the American Bar Association's "Auditor's Letter Handbook" encourages counsel to minimize disclosures to auditors.[7]

Since Congress passed Sarbanes–Oxley, however, auditors have sought more detailed, sensitive information about possible litigation losses.[8] Reportedly, auditors sometimes seek even attorney-client privileged information.[9] And no wonder. Regulators have ratcheted up pressure on auditors to investigate advice attorneys have given to audited companies about possible losses.[10] For example, the Public Company Accounting Oversight Board faulted Deloitte & Touche LLP for failing to obtain "a copy of a letter to the issuer from its counsel containing legal advice on which the issuer had based its conclusions" that "an accrual was not required."[11]

The Risks of Disclosing to Auditors Confidential Information About Litigation

Pressure from auditors to disclose sensitive information, even privileged documents, is a potential problem for companies embroiled in litigation with adversaries who might seek that information. Under some circumstances, complying with those requests makes the sensitive information easier for an adversary to obtain in discovery. For example, consider an auditor's request for a pre-existing, attorney-client privileged document such as a confidential memorandum from an attorney to the company analyzing an adversary's claims. Such documents remain privileged only if they remain confidential.[12]

A minority of states (including Georgia) do recognize an accountant-client privilege that might make a company's communications with auditors confidential.

In most jurisdictions, auditors do not have a confidential relationship with companies or companies' counsel.[13] So a company or attorney would waive the privilege by disclosing the memorandum to the auditor, thus placing an adversary one step closer to obtaining the documents.[14] Similarly, consider a scenario in which counsel responds to an auditor's inquiry by memorializing sensitive information in a letter counsel created specifically for the auditor. Because a letter to an auditor is not sufficiently confidential, the letter was never attorney client-privileged at all—which again increases an adversary's odds of obtaining the sensitive information in discovery.

A minority of states (including Georgia[15]) do recognize an accountant-client privilege that might make a company's communications with auditors confidential.[16] In those jurisdictions, a company might argue that it may disclose to auditors attorney-client privileged documents without waiving that privilege. That is little comfort, however, to companies who face litigation in varying jurisdictions because most states do not recognize an accountant-client privilege.[17]

Companies may also invoke the work-product doctrine to protect a document about litigation they disclose to, or create for, auditors. That doctrine protects from discovery documents or communications a lawyer or client prepares in anticipation of litigation.[18] Compared with the attorney-client privilege, that doctrine's protections are harder to waive. Generally, one may do so only by disclosing the communication or document to an adversary or a conduit to an adversary.[19] Most (but not all) courts—including the D.C. Circuit Court of Appeals in a relatively recent decision—hold that auditors are not companies' adversaries for those purposes.[20] They explain that whatever "tension" might arise "from an auditor's need to scrutinize and investigate a corporation's records" does not make an auditor a company's true adversary.[21] Those courts further explain that an auditor is not a conduit to a company's adversaries because the auditors' code of professional conduct requires auditors to obtain client consent before disclosing confidential information.[22]

By way of illustration, a company might invoke the work-product doctrine to protect an internal attorney memorandum about pending litigation even though the company has forwarded the memorandum to an auditor (thus waiving any attorney-client privilege). The memorandum is work product, the argument goes, because the attorney had prepared the memorandum to help with pending litigation and thus "in anticipation of litigation." Because the auditor is not (according to most courts) an adversary or conduit to an adversary, the company does not waive the work-product doctrine's protections by disclosing the memorandum to an auditor. For similar reasons, a company might argue that the doctrine protects a letter an attorney prepares specifically for an auditor about ongoing litigation.[23]

But the work-product doctrine is no guarantee against an adversary's discovery requests for sensitive, litigation-related information that a company or attorney discloses to, or creates for, an auditor. To begin, the "in anticipation of litigation" requirement is more complicated than it appears. It requires two things, one about timing and one about motivation. First, as to timing, the litigation must be sufficiently likely when the attorney or client prepares the documents or communications. Courts are inconsistent about how likely is likely enough,[24] but at a minimum a company would need to show that the expectation of litigation was reasonable.[25] Second, as to motivation, in some (but not all) jurisdictions, the work-product doctrine applies only if an attorney or client sends a communication or creates a document primarily to assist with litigation rather than for a business purpose.[26] For example, in *United States v. Gulf Oil Corporation*, the court held that the work-product doctrine did not protect a letter from a company's general counsel to an auditor because the counsel's "primary motivating purpose" was to help the auditor prepare a financial report, not to help with litigation.[27]

What documents might these rules leave vulnerable to an adversary once a company discloses them to an auditor (thus waiving any attorney-client privilege)? One example is an attorney memorandum to a client about a hypothetical case that someone might file, but that does not yet appear likely. In that example, the threat of litigation might be too remote for the attorney to contend that he sufficiently anticipated litigation when he wrote it and thus too remote for the attorney to assert the work-product doctrine. Likewise, these rules might withhold work-product protection from, for example, a memorandum that is about pending litigation, but that the attorney prepared specifically for the auditor rather than to help with the litigation.[28] In that

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instance, the attorney might be unable to show that litigation was his primary motivation in preparing the memorandum and thus unable to show that the work-product doctrine applies.

The work-product doctrine has still other limitations. According to a minority of courts, the work-product doctrine protects written materials only rather than oral communications.[29] So courts in those jurisdictions would hold that neither the work-product doctrine nor the attorney-client privilege would protect sensitive oral communications between an auditor and corporate counsel about pending litigation.

Additionally, the work-product doctrine provides limited protections even when applicable. For example, if a document or communication qualifies as work product, but discloses factual information (or information other than legal opinions or legal strategy), the document or communication is likely ordinary fact work product, rather than opinion work product.[30] An adversary may obtain ordinary work product if he shows "substantial need" for it, which generally depends on the evidence's relevance and the risk that the party will suffer prejudice without the evidence.[31] According to the D.C. Circuit, showing substantial need does not require proof that the evidence is "essential to [his] claim or probative of a critical element."[32]

This rule might make the following examples of documents vulnerable to discovery, even if a lawyer or client prepares the document in anticipation of litigation: portions of a memorandum that a lawyer creates for an auditor and that discusses a witness's statements in an interview with an attorney; portions of a similar memorandum that reflect large data compilations from which one could not discern an attorney's theories or strategy; or litigation-cost forecasts that an attorney prepares for an auditor and that project costs for groups of cases rather than what an attorney estimates for a particular case.[33] All of those things provide factual information rather than opinion or analysis.

Even if work product does reflect an attorney's opinion or strategy,[34] an adversary may still obtain the work product in exceptional circumstances, such as when a party places the attorney's opinion at issue in a case.[35] For example, in *RCA Corp. v. Data General Corp.*, a company disclosed to an auditor an attorney's opinion about a patent's validity and whether the company had infringed the patent.[36] The company's litigation adversary later requested that the auditor disclose the attorney's opinion. The court ordered the auditor to disclose the document, even if "attorney work product," because the company had placed the attorney's advice at issue by asserting an advice-of-counsel defense.[37]

We do not wish to overstate the risks of relying on the work-product doctrine to protect litigation-related documents one discloses to, or creates for, an auditor. In most jurisdictions, the work-product doctrine will likely keep an adversary from discovering a company's or lawyer's oral or written communication with an auditor (or disclosed to an auditor) about a pending or reasonably imminent case—especially communications that predict a case's outcome.[38] Indeed, most courts would hold that the company or lawyer sent such communications or prepared such documents "in anticipation of litigation" because litigation was sufficiently likely or ongoing and because the company or lawyer sent the communication "because of" litigation.[39] Moreover, if those communications are about a case's outcome, they are opinion work product rather than less secure fact work product.[40] Most courts would hold that one does not waive these work-product protections by disclosing the communications or documents to an auditor because auditors are neither a company's adversaries nor conduits to those adversaries.

But companies and counsel do face some appreciable risk, as explained above. They may therefore wish to take precautions that minimize an adversary's chances of obtaining sensitive information or documents that the company or counsel prepares for an auditor.

How to Minimize Risk in Audit Disclosures

Companies and counsel should consider the following precautions to minimize the risks: (1) that an adversary may use discovery to obtain a document or communication that a company or counsel provides to, or creates for, an auditor, and (2) that a document or communication an adversary does obtain is one with sensitive information.

First, avoid disclosing to an auditor any confidential communication between the company and counsel, such as an attorney memorandum to the company or emails between company personnel and counsel. Such communications are likely attorney-client privileged in the first instance, but would lose their privilege if the company or counsel divulges them to an auditor. Companies can likely find alternative ways to provide auditors the necessary information.

Second, consult the ABA's "Auditor's Letter Handbook." The Handbook advises companies and counsel to limit disclosures about litigation to auditors. For example, the Handbook says that "the lawyer should normally refrain from expressing judgments as to outcome except in [the] relatively few clear cases."[41] Further, the Handbook advises that, usually, companies should ask counsel to provide auditors information about "unasserted" claims (i.e., hypothetical lawsuits) only if a claim is "probable" and "there is a reasonable probability that the outcome . . . will be unfavorable" and "material."[42]

Following the Handbook may help in many respects. For example, if a company or counsel follows the Handbook's advice and keeps disclosures (like audit letters) to the point, they are more likely to create documents that omit extraneous, sensitive information of interest to an adversary. Likewise, a company that limits disclosures also limits opportunities to inadvertently disclose attorney-client communications, thus avoiding a waiver. If an attorney follows the ABA's guidance to opine about pending cases only rather than hypothetical cases, then he is more likely to create documents that satisfy the work-product doctrine's "in anticipation of litigation" requirement.

Third, draft audit disclosures as attorney-opinion work product rather than less-protected, fact work product. To that end, disclosures should not include detailed factual summaries (especially of nonpublic facts), disclose verbatim witness statements, include litigation-cost projections that lump multiple cases' costs into one estimate, or discuss the adequacy of a company's aggregate litigation reserves.

Fourth, anticipate the risk that the company could litigate in one of the minority jurisdictions that applies the work-product doctrine only to those materials a client or attorney prepares primarily to assist with litigation. If an attorney gives an opinion in an audit letter, for instance, then he could state that he formulated that opinion in the course of the litigation rather than for the auditor's benefit.

Fifth, if an auditor insists on an attorney's analysis to support a company's conclusion about a likely case outcome, then the attorney could stick to facts and analyses that are already public. For example, he could rely on points that are already in briefs filed with the court or in court opinions. The attorney could also explain in generic terms how he reaches such conclusions typically. These steps will ensure that, if an adversary does obtain an audit disclosure, the disclosure will contain little sensitive information about which the adversary was previously unaware.

Finally, consider explaining to the auditor the company's quandary in disclosing potentially privileged information. Work with the auditor to find a mutually agreeable way to give the auditor the information needed.

In sum, today's companies face increasing pressure to disclose sensitive information about litigation to auditors. If they do so, then they increase an adversary's odds of obtaining that information in litigation, although the work-product doctrine still offers significant protections. To minimize that risk, companies should work with auditors collaboratively to balance the auditor's need for information and the company's need to avoid privilege waivers. ●

John Jett is a litigation partner in the Atlanta office of Kilpatrick Townsend & Stockton, LLP. He primarily represents intellectual property owners operating in the retail, franchising, technology and entertainment industries. He is a graduate of Stanford University and the University of Georgia School of Law.

Joshua C. Hess is a litigation associate in Kilpatrick Townsend & Stockton, LLP's, complex commercial litigation practice group. His practice focuses on securities and shareholder litigation. He graduated from the University of Virginia School of Law in 2009 and clerked for Hon. Raymond Kethledge on the U.S. Court of Apeals for the Sixth Circuit and for Hon. Amul Thapar on the U.S. District Court for the Eastern District of Kentucky.

Endnotes

1. *See generally* Aaron J. Rigby, *The Attorney-Auditor Relationship: Responding to Audit Inquiries, the Disclosure of Loss Contingencies and the Work-Product Privilege*, 35 Sec. Reg. L. J. 176, at § I.c. (2007).
2. FASB ASC 450-20-25-2.
3. FASB ASC 450-20-50-3.
4. FASB ASC 450-20-50-4.
5. FASB ASC 450-20-50-6.
6. Rigby, *supra* n.1, at § I.d.
7. Rigby, *supra* n.1, at § I.d.
8. *See generally* Rigby, *supra* n.1, at § II; David M. Brodsky, Pamela S. Palmer & Robert J. Malionek, The Auditor's Need For The Client's Detailed Information vs. The Client's Need to Preserve the Attorney-Client Privilege and Work Product Protection: The Debate, The Problems and Proposed Solutions, at 3-6 (Apr. 2006), https://www.lw.com/thoughtLeadership/auditors-vs-clients-needs-attorney-client-privilege; Daniel M. Reach, Note, Keep Your Friends Close but Your Auditors Closer: Corporations Risk Waiver When Independent Auditors Request Work Product, 23 U. Fla. J.L. & Pub. Pol'y 29, 30-31 (2012).
9. Brodsky, Palmer & Malionek, *supra* n.8, at 3-4.
10. Brodsky, Palmer & Malionek, *supra* n.8, at 3-5.
11. Pub. Co. Accounting Oversight Bd., *Report on 2003 Limited Inspection of Deloitte & Touche LLP*, at 21 (Aug. 26, 2004), http://pcaobus.org/Inspections/Reports/Documents/2003_Deloitte_and_Touche.pdf; Brodsky, Palmer & Malionek, *supra* n.8, at 3-5.
12. Restatement (Third) of the Law Governing Lawyers § 68(3) (Am. Law Inst. 2000).
13. *See, e.g.*, United States v. El Paso Co., 682 F.2d 530, 540 (5th Cir. 1982).
14. *See, e.g.*, *id.* at 539-41; United States v. S. Chicago Bank, No. 97-849-1, 1998 WL 774001, at *2-3 (N.D. Ill. Oct. 30, 1998); First Fed. Sav. Bank of Hegewisch v. United States, 55 Fed. Cl. 263, 269 (Ct. Fed. Cl. 2003); SEC v. Brady, 238 F.R.D. 429, 439-40 (N.D. Tex. 2006); Vacco v. Harrah's Operating Co., No. 07-0663, 2008 WL 4793719, at *5 (N.D.N.Y. Oct. 29, 2008); *see also* Brodsky, Palmer & Malionek, *supra* n.8, at 11 (stating that most courts hold that disclosing to auditors communications between a client and an attorney waives the attorney-client privilege); Rigby, *supra* n.1, at § I.a.i. ("Courts have consistently held that sharing information with independent third parties, including outside auditors, that are not agents of the client or counsel waives the attorney client privilege.").
15. *See* O.C.G.A. § 43-3-29 (2014); *In re* Tidewater Grp., Inc., 65 B.R. 179, 182 (Bankr. N.D. Ga. 1986); Say v. Deloitte & Touche, LLP, 295 Ga. App. 128, 130, 670 S.E.2d, 818, 821 (2008).
16. Brodsky, Palmer & Malionek, *supra* n.8, at 11-12, 29 & n.89.
17. Robert J. Tepper, *New Mexico's Accountant-Client Privilege*, 37 N.M. L. Rev. 387, 425 & n.317 (2007) (noting that only about 15 states have an accountant-client privilege); Brodsky, Palmer & Malionek, *supra* n.8, at 29 & n.89.
18. Restatement (Third) of the Law Governing Lawyers, § 87 & cmt. a.
19. *Id.* § 91(4).
20. United States v. Deloitte, LLP, 610 F.3d 129, 140 (D.C. Cir. 2010); Merrill Lynch & Co.. v. Allegheny Energy, Inc., 229 F.R.D. 441, 447-48 (S.D.N.Y. 2004); *In re* JDS Uniphase Corp. Secs. Litig., No. 02-1486, 2006 WL 2850049, at *1 (N.D. Cal. Oct. 5, 2006); SEC v. Roberts, 254 F.R.D. 371, 381-82 (N.D. Cal. 2008); *but see, e.g.*, Medinol, Ltd. v. Boston Scientific Corp., 214 F.R.D. 113, 114-16 (S.D.N.Y. 2002); United States v. Hatfield, No. 06-0550, 2010 WL 183522, at *3 (E.D.N.Y. Jan. 8, 2010); *In re* Diasonics Secs. Litig., No. C-83-4584-

RFP (FW), 1986 WL 53402, at *1 (N.D. Cal. June 15, 1986); SEC v. RJ Reynolds Tobacco Holdings, Inc., No. 03-1651, 2004 WL 3168281, at *7 (D.D.C. June 29, 2004).

21. *Deloitte*, 610 F.3d at 140 (citation omitted).
22. *See, e.g., id.* at 142.
23. *See, e.g.*, Lawrence E. Jaffe Pension Plan v. Household Int'l., 237 F.R.D. 176, 180-83 (N.D. Ill. 2006); Tronitech, Inc. v. NCR Corp., 108 F.R.D. 655, 656-57 (S.D. Ind. 1985).
24. 2 Edna Epstein, Am. Bar Ass'n, The Attorney-Client Privilege and The Work Product Doctrine, 839 (5th ed. 2007).
25. Restatement (Third) of the Law Governing Lawyers § 87, cmt. i.
26. *See, e.g.*, United States v. El Paso Co., 682 F.2d 530, 542-43 (5th Cir. 1982) (holding that whether someone prepared tax analysis in anticipation of litigation depends on the creator's "primary motivating force"); United States v. Textron Inc. & Subsidiaries, 577 F.3d 21, 28-32 (1st Cir. 2009); *see also generally* Richard P. Swanson, *Status of Attorney-Client Work Product Privilege Protection of Litigation Reserve and Tax Accrual Workpapers Turned Over to Outside Auditors*, ST004 ALI-ABA 235, 239-40 (2011); *but see Deloitte*, 610 F.3d at 136-37 (noting that "most circuits" hold that an attorney or client prepares a documents in anticipation of litigation if the attorney or client does so "because of" litigation).
27. United States v. Gulf Oil Corp., 760 F.2d 292, 296-97 (Temp. Emer. Ct. App. 1985).
28. *See, e.g., Gulf Oil Corp.*, 760 F.2d at 296-97; Indep. Petrochem. Corp. v. Aetna Cas. & Sur. Co., 117 F.R.D. 292, 298 (D.D.C. 1987); Cantu v. TitleMax, Inc., No. 5:14-CV-628 RP, 2015 WL 5944258, at *3-5 (W.D. Tex. Oct. 9, 2015); *but see, e.g., Lawrence E. Jaffe Pension Plan*, 237 F.R.D. at 180-83.
29. *E.g., In re* Pfohl Bros. Landfill Litig., 175 F.R.D. 13, 27 (W.D.N.Y. 1997); *In re* EchoStar Commc'ns Corp., 448 F.3d 1294, 1301 (Fed. Cir. 2006); Informatica Corp. v. Bus. Objects Data Integration, Inc., 454 F. Supp. 2d 957, 963 (N.D. Cal. 2006), *aff'd*, No. C 02-3378 JSW, 2006 WL 2329460 (N.D. Cal. Aug. 9, 2006).
30. Restatement (Third) of the Law Governing Lawyers § 87(2); *Deloitte*, 610 F.3d at 136; Lake Shore Radiator, Inc. v. Radiator Express Warehouse, No. 3: 05-cv-1232-J-12 MCR, 2007 WL 842989, at *4 (M.D. Fla. Mar. 19, 2007); United States *ex rel.* (Redacted) v. (Redacted), 209 F.R.D. 475, 478 (D. Utah 2001).
31. *See generally* 8 Charles Alan Wright & Arthur R. Miller, Federal Practice & Procedure § 2025 (3d ed.); Restatement (Third) of the Law Governing Lawyers § 88 cmt b.
32. FTC v. Boehringer Ingelheim Pharm., Inc., 778 F.3d 142, 156 (D.C. Cir. 2015); *but see* Nevada v. J-M Mfg. Co., Inc., 555 F. App'x 782, 785 (10th Cir. 2014) ("A substantial need exists where the information sought is essential to the party's defense, is crucial to the determination of whether the defendant could be held liable for the acts alleged, or carries great probative value on contested issues.") (quotation marks and citation omitted).
33. *See, e.g., In re* John Doe Corp., 675 F.2d 482, 493 (2d Cir. 1982); SEC v. Cuban, No. 3:08-CV-2050D, 2013 WL 1091233, at *5 (N.D. Tex. Mar. 15, 2013); Portis v. City of Chicago, No. 02-3139, 2004 WL 1535854, at *3 (N.D. Ill. July 7, 2004); SEC v. R.J. Reynolds Tobacco Holdings, Inc., No. 03-1651, 2004 WL 3168281, at *7 (D.D.C. June 29, 2004).
34. Although documents that reflect an *attorney*'s opinion or strategy are the most common opinion work product, Federal Rule 26(b)(3)(B) indicates that work product reflecting other client representatives' opinions or strategy are also highly protected, opinion work product.
35. *See generally* Restatement (Third) of the Law Governing Lawyers § 89; 8 Wright & Miller, *supra* n.31, at § 2026.
36. RCA Corp. v. Data Gen. Corp., No. 84-270, 1986 WL 15693, at *1, 2 (D. Del. July 2, 1986).
37. *Id.* at *2.
38. *See In re* Pfizer Sec. Litig., No. 90-1260, 1993 WL 561125, at *4 (S.D.N.Y. Dec. 23, 1993); *see also* S. Scrap Material Co. v. Fleming, No. 01-2554, 2003 WL 21474516, at *9 (E.D. La. June 18, 2003).
39. *See Deloitte*, 610 F.3d at 136-37 (noting that "most circuits" hold that an attorney or client prepares a document in anticipation of litigation if the attorney or client does so "because of" litigation).
40. *See In re Pfizer Sec. Litig.*, 1993 WL 561125, at *4; *S. Scrap Material Co.*, 2003 WL 21474516, at *9.
41. Am. Bar Ass'n Audit Responses Comm., Auditor's Letter Handbook 5 (2d ed. 2013).
42. *Id.* at 4.