Sarbanes-Oxley Act

The Defense Contract Audit Agency ("DCAA") on October 8, 2003, issued its much anticipated audit guidance on the Sarbanes-Oxley Act of 2002 (the "Act")\(^1\) and Securities and Exchange Commission ("SEC") implementing regulations.\(^2\) The guidance instructs DCAA auditors to seek access to disclosures made to the contractor's auditors and audit committee of the board of directors, as well as any audit work performed in support of the contractor's financial statement certification, management assessment of internal controls, and external auditor attestation report. In the wake of the Enron, Arthur Andersen, WorldCom, and Global Crossing scandals, few would question the social value and importance of the Sarbanes-Oxley Act. Whether DCAA has a role to play in implementing the Act is another question altogether. This analysis examines whether DCAA has the authority to demand access to information the Act treats as confidential and privileged, and whether, in the absence of such authority, contractors should provide DCAA access.

Caveat Contractor:
DCAA's New Audit Guidance on the Sarbanes-Oxley Act And Contractor Internal Controls
BY KAREN L. MANOS

I. Sarbanes-Oxley Act of 2002

The Act is intended to protect investors and restore public trust in our capital markets by improving the accuracy and reliability of financial statements and corporate disclosures. The legislation combined provisions from H.R. 3763, the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, introduced by Rep. Michael Oxley (R-Ohio), chairman of the House Financial Services Committee, and S. 2673, the Public Company Accounting Reform and Investor Protection Act, introduced by Sen. Paul Sarbanes (D-Md.), ranking member of the Senate Banking Committee. The combined bill passed in the House by a vote of 423-3 and in the Senate by a vote of 99-0. It was signed into law by President Bush on July 30, 2002.

The Act established the Public Company Accounting Oversight Board ("PCAOB") to oversee audits of public companies (referred to as "issuers") that are subject to the federal securities laws. Section 101(c) of the Act requires the PCAOB to register public accounting firms that prepare audit reports for issuers; establish auditing, quality control, ethics, independence, and other standards relating to public company audits; conduct periodic inspections of registered public accounting firms; conduct investigations and disciplinary proceedings concerning registered public accounting firms and associated persons; and impose sanctions when justified; and otherwise enforce compliance with the Act, the Board’s rules, professional standards, and the securities laws. Among other things, the PCAOB’s auditing standards must require registered public accounting firms to prepare and maintain for at least seven years audit work papers, and other information related to any audit report, in sufficient detail to support the conclusions reached in the report. Section 102(b)(3) provides that by registering with the PCAOB, a public accounting firm consents to cooperate with any request for testimony or the production of documents made by the PCAOB in furtherance of its authorities and responsibilities under the Act. Section 105(b)(2) of the Act gives the PCAOB the authority to require testimony and production of audit work papers and other documents and information in possession of registered public accounting firms. Additionally, it authorizes the PCAOB to seek an SEC subpoena to require the testimony of, and production of any documents in the possession of, the companies audited by the public accounting firm.

Importantly, Section 105(b)(5) establishes an evidentiary privilege and Freedom of Information Act exemption for the documents and information prepared or received by the PCAOB in connection with any inspection or investigation. Moreover, the Act permits the PCAOB to share the information with certain enumerated federal and state agencies without loss of the information’s status as confidential and privileged, and requires the recipients to maintain the information as confidential and privileged. It is noteworthy that DCAA is not one of the authorized recipients.

Section 204 of the Act requires a registered public accounting firm to timely report to the company’s audit committee critical accounting policies and practices, alternative treatments of financial information that have been discussed with management officials, and other written communications between the accounting firm and management.

Section 302 of the Act directs the SEC to promulgate rules requiring that periodic reports filed in accordance with the Securities Exchange Act of 1934 contain certifications by the company’s principal executive officer and principal financial officer that, among other things, the signing officers are (1) responsible for establishing and maintaining internal controls, (2) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers, (3) have evaluated the effectiveness of the issuer’s internal controls within 90 days prior to the report, and (4) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date. In addition, the signing officers must certify that they have disclosed to the issuer’s auditors and the audit committee of the board of directors (1) all significant deficiencies in the design or operation of internal controls and identified for the issuer’s auditors any material weaknesses in internal controls, and (2) any fraud involving management or other employees who have a significant role in the issuer’s internal controls.

Section 404(a) of the Act directs the SEC to promulgate rules requiring that each annual report submitted pursuant to the securities laws contain an internal control report, providing an assessment by the company’s management of the effectiveness of its internal control structure and procedures for financial reporting. Section 404(b) requires the public accounting firm that issues the audit report for the company to attest to, and report on, management’s assessment of the effectiveness of internal control.

The SEC rules implementing Section 404 and revising the Section 302 certification requirements were published in the Federal Register on June 18, 2003, and took effect on August 14, 2003. Although companies may voluntarily comply with the requirement for a management report on internal control before required to do so, companies that are “accelerated filers” must comply beginning in their first fiscal year ending on or after June 15, 2004. All other public companies must comply beginning in the first fiscal year ending on or af-

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ter April 15, 2005. In adopting the new rules, the SEC expressly limited their scope to the element of internal control that relates to financial reporting. In comments accompanying publication of the new rules, the SEC stated that its “definition does not encompass the subset of internal controls ... that relate to effectiveness and efficiency of a company’s operations and a company’s compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements, such as the Commission’s financial reporting requirements.”

On October 7, 2003, the PCAOB proposed an auditing standard governing the independent auditor’s attestation to, and reporting on, management’s assessment of the effectiveness of internal control. The proposed rule would require the independent auditor to evaluate management’s assessment process, gather evidence regarding the design and operating effectiveness of the company’s internal control, determine whether the evidence supports or refutes management’s assessment, and express an opinion as to whether management’s assessment is fair. Many of the public comments have criticized the proposal as costly and unduly burdensome because it would effectively require the public accounting firm to perform an audit of the company’s internal controls in order to attest to management’s assessment.

II. DCAA’s Audit Guidance for Internal Controls

DCAA on October 8, 2003, published audit guidance on the SEC rules implementing Sections 204, 302, 404, 406, and 407 of the Act. The guidance, which took effect immediately, concedes that the “SEC rulings do not affect DCAA directly,” but asserts that the rulings “impact aspects of corporate management and financial reporting that [DCAA auditors] rely upon in conducting their audits.” The guidance states that it primarily affects the planning of internal control, incurred cost, and financial capability audits. With regard to the auditor reports to audit committees required by Section 204 of the Act, the audit guidance notes that DCAA’s “current audit program steps already require auditors to review the minutes of the board of directors and audit committee (if applicable) meetings and determine if they are acting effectively on all audit matters, including internal and external audit recommendations.” It advises auditors to be aware of the Act’s reporting and communication requirements because “they may disclose additional information about the company’s reporting and treatment of certain financial-related information that could have a bearing on the audit scope of certain audits or provide audit leads for subsequent audits.”

The audit guidance notes that the SEC rules implementing Section 302 of the Act do “not require the disclosures made to the company’s auditors and audit committee to be made available to the public as part of its SEC filings.” The guidance, therefore, instructs DCAA auditors to seek access to these disclosures, as well as disclosures related to material changes in the internal controls. Additionally, the guidance instructs DCAA auditors to seek access to the audit work performed in support of management’s assessment of internal control and the public accounting firm’s attestation report. Although the ostensible purpose for seeking access to internal and external audit work papers is to reduce DCAA’s audit effort, the audit guidance cautions that auditors must comply with the requirements contained in section 4-1000 of the DCAA Contract Audit Manual (“CAM”) before relying upon the work of others. The guidance states that “[i]dentification by corporate management of the specific internal controls evaluated, access to the related corporate working papers, and DCAA review of the working papers in accordance with CAM 4-1000 is minimally necessary prior to assessing a reduced level of control risk.”

III. DCAA’s Standard Audit Program for Internal Controls

The October 8, 2003, audit guidance supplements DCAA’s standard audit program for internal controls, dated April 2003. It is the internal controls audit program that requires DCAA auditors to review minutes of board of directors’ and audit committee meetings. However, in contrast to the SEC rules and PCAOB’s proposed auditing standards, DCAA’s audit program is not limited to internal controls relating to financial reporting. For example, it contains a section on “integrity and ethical values” which requires the auditor to verify that:

1. the contractor’s policies and procedures provide for an ethics training program by all employees;
2. the contractor performs periodic reviews of the company’s compliance with standards of conduct;
3. the contractor has a system for employees to report suspected misconduct;
4. the contractor’s policies and procedures provide for timely reporting to appropriate government officials of suspected violations of law and other irregularities in connection with government contracts; and
5. there are effective follow-up procedures on internal audit recommendations.

The audit program also requires the auditor to obtain the public accounting firm’s report of material weaknesses of internal controls, or management letter for the most recently audited year, and determine whether corrective action has been taken in response to any internal control weaknesses. After “verifying” the contractor’s policies and procedures, the audit program requires the auditor to assess the contractor’s compliance with them. That means, for example, that if the contractor had a “hotline” call reporting suspected misconduct, the auditor will want to see the list of hotline calls and the reports of any internal investigations to determine whether the contractor complied with its policies of pursuing corrective action and timely reporting the suspected irregularity to ap-

propriate government officials. For some contractors, it is only at this stage of the audit that the in-house counsel is consulted. The audit program instructs the auditor to identify any access to records problems that affect the auditor’s ability to assess the internal control. Additionally, the regulation mentions: “[d]ependent control weaknesses inherent in any Form 2000 or ongoing investigation.” The DCAA Form 2000 is used to report suspicions of fraud, corruption or other unlawful activity affecting government contracts.

IV. Scope of DCAA’s Audit Access

Nothing in the Sarbanes-Oxley Act or its implementing regulations mentions DCAA, much less expands the scope of its audit access. For the reasons set forth below, DCAA’s standard audit program for internal controls and Sarbanes-Oxley audit guidance exceed the scope of its statutory, regulatory, and contractual right of audit access. Title 10, section 2313 of the United States Code grants DCAA a right of audit access for two distinct purposes. First, it grants DCAA authority, until three years after final payment, to inspect the plant and audit the records of a contractor performing a cost-reimbursement, incentive, time-and-materials, labor-hour, or price-redeemable contract, or any combination of such contracts, made by the executive agency under this title; and

   (A) a contractor performing a cost-reimbursement, incentive, time-and-materials, labor-hour, or price-redeemable contract, or any combination of such contracts under a contract referred to in subparagraph (A); and

   (B) a subcontractor performing any cost-reimbursement, incentive, time-and-materials, labor-hour, or price-redeemable subcontract, or any combination of such subcontracts under a contract referred to in subparagraph (A).6

Second, it grants DCAA authority, for the purpose of evaluating the accuracy, completeness, and currency of cost or pricing data required under the Truth in Negotiations Act, to examine all records of the contractor or subcontractor related to the proposal, discussions conducted on the proposal, the pricing of the contract or subcontract, and the performance of the contract or subcontract.7 The Director of DCAA is authorized to issue subpoenas for the production of any records that DCAA is authorized to audit or examine under the foregoing authorities.8

The Federal Acquisition Regulation ("FAR") Audit and Records – Negotiation clause implements these statutory authorities.9 The clause contains four separate access-granting provisions. First, for cost-reimbursement, incentive, time-and-materials, labor-hour, or price-redeemable contracts, the clause requires the contractor to maintain, and grants an authorized representative of the contracting officer ("CO") the right to examine and audit, “all records and other evidence sufficient to reflect properly all costs claimed to have been incurred or anticipated to be incurred directly or indirectly in the performance of this contract.”10 The right of examination includes inspection at all reasonable times of the contractor’s plants engaged in performing the contract.11 Second, if the contractor is required to submit cost or pricing data in connection with any pricing action, the clause grants an authorized representative of the CO the right to examine and audit all of the Contractor’s records, including computations and projections, related to:

   (1) the proposal for the contract, subcontract, or modification;

   (2) the discussions conducted on the proposal(s), including those related to negotiations;

   (3) pricing of the contract, subcontract, or modification; or

   (4) performance of the contract, subcontract, or modification.12

Third, the clause grants the Comptroller General or an authorized representative “access to and the right to examine any of the Contractor’s directly pertinent records involving transactions directly related to this contract or a subcontract hereunder.”13 Fourth, if the contractor is required to furnish cost, funding or performance reports, the clause gives the CO or an authorized representative the right to examine and audit supporting records and materials for the purpose of evaluating (1) the effectiveness of the Contractor’s policies and procedures to produce data compatible with the objectives of these reports and (2) the data reported.14 With respect to all four of these provisions, the clause defines "records" to mean “books, documents, accounting procedures and practices, and other data, regardless of type and regardless of whether such items are in written form, in the form of computer data, or in any other form.”15

In addition to the Audit and Records – Negotiation clause, the Payments clauses for cost-type contracts and the Progress Payments clauses for fixed-price contracts give the government audit access rights for the purpose of verifying the contractor’s incurred costs.16 In construing these audit authorities, the cases have distinguished between the responsibility of the DOD Inspector General (“IG”) to investigate fraud, waste and abuse in federal procurement programs and DCAA’s responsibility to verify direct and indirect costs charged to cost-type contracts. This difference in roles and authorities is perhaps best illustrated by United States v. Westinghouse Electric Corp.17 and United States v.  

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8 10 U.S.C. § 2313(b)(1).
9 FAR 52.216-2, Audit and Records – Negotiation (Jun. 1999). Three other clauses contain some, but not all, of the access granting provisions contained in the Audit and Records – Negotiation clause: (1) FAR 52.214-26, Audit and Records – Sealed Bidding (Oct. 1997); (2) FAR 52.212-5, Contract Terms and Conditions Required to Implement Statutes or Executive Orders – Commercial Items (Feb. 2002); and (3) FAR 52.215-20, Requirements for Cost or Pricing Data or Information Other Than Cost or Pricing Data (Oct. 1997).
10 FAR 52.215-2, ¶ (b).
11 Id.
12 Id., ¶ (c).
13 Id., ¶ (d)(1).
14 Id., ¶ (e).
15 Id., ¶ (a).
16 See, e.g., FAR 52.216-7, Allowable Cost and Payment (Dec. 2002); FAR 52.216-13, Allowable Cost and Payment – Facilities (Feb. 2002); FAR 52.216-26, Payments of Allowable Costs Before Definitization (Dec. 2002); FAR 52.232-7, Payments Under Time-and-Material and Labor-Hour Contracts (Dec. 2002); FAR 52.232-16, Progress Payments (Apr. 2003); FAR 52.232-32, Performance-Based Payments (Feb. 2002); FAR 52.232-12, Advance Payments (Mar. 2001).
Newport News Shipbuilding and Dry Dock Co. \(^{18}\) Both cases involved subpoenas for a contractor’s internal audit reports and associated work papers: In Westminster, the subpoena was issued by the DOD/IG; in Newport News, the subpoena was issued by DCAA. In Westminster, the U.S. Court of Appeals for the Third Circuit upheld the enforceability of the DOD/IG subpoena, concluding that it was within the IG’s “broad powers to seek out fraud and waste in agency operations and programs.”\(^{19}\)

By contrast, the Fourth Circuit in Newport News held that DCAA did not have authority to compel production of internal audit reports, stating that: “Cost verification data, not the work product of internal auditors, is the proper subject of a DCAA subpoena. DCAA performs a critical auditing mission, but it is not running the company.”\(^{20}\) In reaching this result, the court analyzed the language and legislative history of the two statutes, now consolidated into 10 U.S.C. § 2313, that grant DCAA audit authority. Interpreting the first statute, 10 U.S.C. § 2313(a), the court reasoned that: “The words ‘audit the books and records’ suggest review of cost and financial data alone. Similarly, the words ‘performing a cost or cost-plus-a-fixed-fee contract’ imply that the statute covers only materials related to the performance of that contract.”\(^{21}\) The court found the legislative history of § 2313(a) consistent with its plain meaning, and concluded that:

The provision was intended to enable the government to determine whether charges made by cost-type contractors were in fact actually incurred for the purpose. There is no evidence that, as DCAA contends, § 2313(a) was meant to allow wide-ranging investigations into the general efficiency of any company that performs cost-type government contracts.\(^{22}\)

The court held that the audit provisions of 10 U.S.C. § 2306(f)(5), now found at 10 U.S.C. § 2313(a)(2), were similarly limited. The court observed that:

Certain limits on DCAA’s subpoena power are therefore apparent on the face of § 2306(f)(5). First, the material must be necessary for reviewing the “accuracy, completeness, and currency of the cost or pricing data.” Second, the requirement that the materials used for this purpose be “books, records, documents, and other data” indicates that the statute reaches objective factual information concerning contract costs, such as invoices, vouchers, and time logs, rather than the subjective assessments sought in this case. Finally, the material covered must be related to the specific contract involved.\(^{23}\)

Accordingly, the court held, “internal audits are not the type of documents that fall within the scope of DCAA’s subpoena power.”\(^{24}\) Consistently, the Armed Services Board of Contract Appeals in Grumman Aircraft Engineering Corp. observed that: “The auditor certainly has no right to roam without restriction through all of the contractor’s business documents which have no connection with the Government contract. But he has a right to satisfy himself as to items claimed to be part of the costs of performing the Government contract.”\(^{25}\)

In a subsequent case involving Newport News, the Fourth Circuit held that DCAA does have the right to compel production of the contractor’s Virginia State income tax returns because the returns are “objective factual materials useful in verifying the actual costs, including general and administrative overhead costs, charged by companies performing cost-type contracts for the government.”\(^{26}\) On remand from the Fourth Circuit, the U.S. District Court for the Eastern District of Virginia held that DCAA has the authority to compel production of workpapers for federal tax returns and profit and loss estimates because those documents “may reflect upon the accuracy of ... cost charges submitted by the government and assist DCAA in verifying costs charged.”\(^{27}\)

The internal audit reports and audit work papers to which DCAA seeks access in its October 2003 audit guidance are precisely the types of records to which the Fourth Circuit held DCAA has no right of access. The “integrity and ethics” segment of DCAA’s internal controls audit program is also squarely outside of DCAA’s authorized purview.

V. Risks Inherent in Disclosing Privileged Internal Control-Related Information to DCAA

Notwithstanding the lack of any statutory, regulatory, or contractual authority for the audit access sought in DCAA’s October 2003 audit guidance and internal controls audit program, some contractors may choose to accommodate DCAA’s requests. There are, of course, advantages to maintaining a cooperative working relationship with DCAA. However, there are risks inherent in granting DCAA access beyond that to which it is otherwise entitled.

It is generally better for the contractor to establish policies in advance for the extent of audit access that it will grant to DCAA, rather than disclosing information up to the point at which the contractor’s employees become uncomfortable with the auditor’s requests or decide it is time to consult with counsel.

Internal audits and investigations that are conducted by or at the direction of counsel or in anticipation of litigation are generally protected by the attorney-client privilege or attorney work product doctrine. All but one of the federal circuit courts of appeals that have consid-

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\(^{19}\) Westinghouse, 788 F.2d at 165.
\(^{20}\) Newport News, 837 F.2d at 170.
\(^{21}\) 837 F.2d at 166.
\(^{22}\) 837 F.2d at 167.
\(^{23}\) 837 F.2d at 168.
\(^{24}\) Id.
\(^{25}\) Grumman Aircraft Engineering Corp., ASBCA No. 10309, 66-2 B.C.A. (CCH) ¶ 5846 at 27, 143.
erred the issue have held that disclosure to the government of information protected by the attorney-client privilege or work product doctrine waives the protection as to all other adversaries. In Diversified Industries, Inc. v. Meredith, the Eighth Circuit held that a company’s disclosure of attorney-client privileged communications to the SEC during an SEC investigation did not waive the attorney-client privilege with respect to the documents as to other adversaries. The First, Second, Third, Fourth, Sixth, Federal, and D.C. Circuits have subsequently rejected the selective waiver doctrine. Moreover, one of the cases, United States v. MIT, involved disclosures made during the course of a DCAA audit. Thus, for example, if a contractor discloses privileged information to DCAA, the same information would be available in discovery to a shareholder bringing a derivative action, a disgruntled former employee bringing a wrongful termination suit, or a qui tam relator bringing a False Claims Act suit.

Even when attorneys are not involved, an internal audit or investigation may be protected by the self-critical

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28 Diversified Indus., Inc. v. Meredith, 572 F.2d 596, 611 (8th Cir. 1978).
29 See In re Columbia/HCA Healthcare Corp. Billing Practices Litigation, 293 F.3d 289, 304-07 (6th Cir. 2002) (disclosure to Department of Justice of internal audit reports waived attorney-client privilege and attorney work product protection, notwithstanding confidentiality agreement), cert. dismissed, 536 U.S. 203 (2003); United States v. MIT, 129 F.3d 681, 685-86 (1st Cir. 1997) (disclosure to DCAA of billing statements from outside law firms and minutes of corporation and its executive and auditing committees waived protections of attorney-client privilege and attorney work product doctrine); Genentech, Inc. v. United States Int’l Trade Comm’n, 122 F.3d 1409, 1417 (Fed. Cir. 1997) (rejecting limited waiver theory and holding that inadvertent, but negligent, disclosure of privileged documents in another proceeding waived the attorney-client privilege and work product protection); In re Steinhardt Partners, L.P., 9 F.3d 230, 235 (2nd Cir. 1993) (disclosure of attorney work product to SEC waived protection); Westinghouse Elec. Corp. v. Republic of the Philippines, 951 F.2d 1414, 1424-26 (3rd Cir. 1991) (disclosure of information to SEC and DOJ waived attorney-client privilege and attorney work product protection); In re Sealed Case, 877 F.2d 976, 980-81 (D.C. Cir. 1989) (disclosure of attorney-client privileged information to DCAA waived the privilege for the documents disclosed and all other communications relating to the same subject matter); In re Martin Marietta Corp., 856 F.2d 619, 623-24 (4th Cir.) (disclosure to DOD and Assistant U.S. Attorney during negotiation of administrative settlement agreement waived attorney-client privilege and attorney work product protection for all other communications and non-opinion work product relating to the same subject matter), cert. denied, 490 U.S. 1011 (1989); Permian Corp. v. United States, 665 F.2d 1214, 1220-21 (D.C. Cir. 1981) (disclosure to SEC waived attorney-client privilege and work product protection, notwithstanding confidentiality agreement).

analysis or self-evaluation privilege. That privilege, too, would be waived by disclosure to DCAA. The Sarbanes-Oxley Act recognizes this problem and creates a statutory self-evaluation privilege. It permits disclosure to the PCAOB and certain other federal and state entities without loss of the privilege. Had Congress intended to give DCAA access to this information, and intended for the information to remain privileged after disclosure to DCAA, it would have listed DCAA among the authorized recipients.

It is generally better for the contractor to establish policies in advance for the extent of audit access that it will grant to DCAA, rather than disclosing information up to the point at which the contractor’s employees become uncomfortable with the auditor’s requests or decide it is time to consult with counsel. At that point, the company’s abrupt change in position is likely to raise suspicion, even if the company is not trying to hide anything. Responsible companies have procedures in place to investigate problems, and, when appropriate, take corrective action and make timely disclosures to the appropriate government officials. That does not mean the company must, or even should, grant DCAA access to the same information, particularly before the company itself has had the opportunity to make an informed judgment about whether there is an issue and how it should be resolved.

VI. Conclusion

Corporate counsel are often consulted only very late in the course of a DCAA audit, in many cases after the company’s employees have already granted DCAA greater access than required. For that reason, it is well worth establishing audit access policies and educating the employees who regularly interact with DCAA auditors about the risks inherent in granting overly broad audit access and the importance of consistently following the company’s access policies.

30 See, e.g., Reichold Chems., Inc. v. Textron, Inc., 157 F.R.D. 522, 524 (N.D. Fla. 1994) (the self-critical analysis privilege “allows individuals or businesses to candidly assess their compliance with regulatory and legal requirements without creating evidence that may be used against them by their opponents in future litigation,” and that “[t]he rationale for the doctrine is that such critical self-evaluation fosters the compelling public interest in observance of the law.”); Bedice v. Doctors Hospital, Inc., 50 F.R.D. 249, 249-50 (D.D.C. 1970) (refusing to compel discovery of hospital staff meeting minutes in medical malpractice claim, and observing that: “Confidentiality is essential to the functioning of these staff meetings; and these meetings are essential to the continued improvement in the care and treatment of patients. Candid and conscientious evaluation of clinical practices is a sine qua non of adequate hospital care.”), aff’d without opinion, 479 F.2d 920 (D.C. Cir. 1973).