



Outside the Courtroom – Auditing Under Legal Privilege

Houston IIA Conference

Some Interesting Statistics

- Around 25% of frauds are uncovered due to employee tips, while 19% are uncovered through internal audit and 11.5% from external auditors.
- About 80% of corporate frauds involve asset misappropriation, with cash being the target 90% of the time.
- Corruption in various forms accounts for about 13% of frauds.
- The average scheme takes about 18 months to detect. About 25% of companies hit by fraud fail to fix the problems that made them vulnerable.
- Around 25% of companies victimized by fraud do not present the case to prosecutors, with the most common stated reason being fear of bad publicity. Other reasons include evidentiary weaknesses and fears of counter-lawsuits.

Topics

1. The Mindset: Auditors versus Lawyers
2. Concept of Privilege
3. Mechanics of Conducting an Audit under Privilege

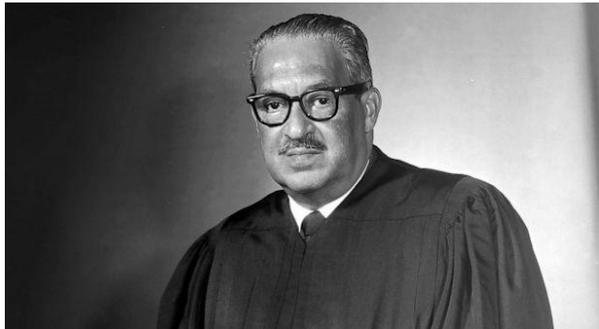
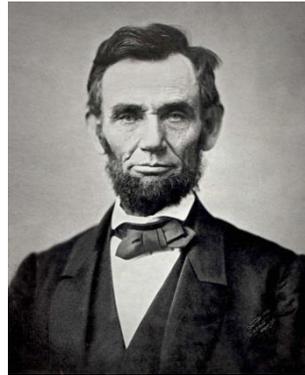
Different Roles and Responsibilities

The role of internal audit is to provide independent assurance that an organization's risk management, governance and internal control processes are operating effectively.

The role of the in-house lawyer is to provide legal advice in the best interests of his or her client, while being an officer of the legal system.



Lawyers Come in All Shapes and Sizes



Lawyers Also Wear Many Hats

- Business partner
- Minimize company's legal risks
- Minimize company's reputational exposure
- Detect and remediate ethical wrongdoing
- Create a culture of compliance



What does it mean to be “Privileged”?

To withhold information, from any legal proceeding, without suffering legal consequences.



Search for the Truth

Right to privacy for
communications
made in confidence

Privileges Potentially Applicable to IA

Accountant-Client

- Protects information shared by a client and accountant

Self-Critical Analysis

- Protects self-evaluative materials and results of candid assessments of compliance with laws and regulations

Attorney-Client

- Protects information shared by a client and attorney made for the purposes of obtaining professional legal advice or assistance

Work Product

- Protects work prepared in anticipation of litigation

Attorney-Client Privilege: Requirements

- Protects communications that are:
 - between the corporation/client and the attorney
 - when the attorney is acting as an attorney (and not, for example, as a business advisor)
 - for the purpose of seeking legal advice, and
 - in confidence
- The Attorney-Client privilege does not protect communications when the privilege is waived
- Privilege is the client's to assert and invoke
- The form of communication is irrelevant
- Merely stamping “privileged” or “confidential” on a document does not alone establish privilege

What Does Privilege Not Protect?

- Identity of client
- Attorney's observations of client's demeanor or mental capacity
- E-mail replies to communications that are not privileged themselves are likely not privileged.
- Communications given/received by the attorney acting in another role (business advice versus legal advice)
 - Generally, communications by or to in-house lawyers regarding business matters are not privileged
 - When legal and business communications are intertwined, the legal advice must predominate

Work Product Privilege

- The attorney work-product doctrine protects from disclosure confidential work product prepared by or for attorneys in **anticipation of litigation**
- Does not apply to internal audit reports *conducted in the ordinary course of business*
- Even if the purpose of an internal audit is to identify circumstances that may lead to litigation, many courts still do not consider such a review to be in “anticipation of litigation,” and therefore do not extend the privilege to such internal audit reports.

Internal Audits

- Good tools for measuring
 - Compliance with laws and regulations
 - Compliance with internal policies and procedures
 - Effectiveness of policies and procedures
- Mechanism for preventing, or at least mitigating, problems before they create significant legal risk
- Government regulators and Plaintiffs' attorneys regularly request internal audit reports as part of external litigation and investigations



Attorney-Client Privilege: Internal Audits

- Audits conducted as part of regular business operations by internal auditors will not be protected
- Only applies where an attorney directs the review
- Key is whether the audit will aid counsel in the provision of legal advice to his or her client or in anticipation of litigation
- Must *involve* counsel in the creation of the documents and the process

What should you do?

You are an internal auditor for ABC, a U.S. company that manufactures aircraft for use by defense services and law enforcement agencies around the world. One of ABC's largest customers is XYZ, a company that provides narcotics counter-intelligence services to foreign governments. Last year, XYZ secured a contract with the Colombian army in which it agreed to use ABC aircraft.

One day, while performing a disbursement audit, you notice as part of your sampling a payment of \$20,000 by ABC to a vendor called Slushco. The payment confirmation shows that the money was wired to a bank account in Colombia shortly before XYZ announced that it had won the contract.

What else would you like to know?

What should you do?

You see that the \$20,000 payment to Slushco appears to have been requested and approved by Barney Gumble, ABC's Director of Operations for South America. There is no supporting documentation.

Should you contact Gumble at this point? If so, what should you ask him?

Should you run a Google search on Slushco?

When to Call Legal

When you have reasonable suspicion to believe that a fraud or other irregularity may have occurred

What should you do?

When asked for support, Gumble provides you with an email from the Vice President of Government Relations requesting that Gumble arrange the \$20,000 payment. In the email, the Vice President indicates that Slushco is a Colombian lobbying firm that needs the funds to make a “legitimate” campaign contribution to a member of the Colombian Senate who will be influential in deciding the type of aircraft that should be used on the XYZ contract. The email notes that “timing is of the essence” to “ensure that ABC aircraft are selected.”

Are you now ready to call the Legal Department?

What steps should be taken in order to preserve privilege?

When Legal May Call You

Assistance with investigating a possible legal or procedural violation

Steps for Triggering Legal Privilege

- Pick up the phone first and speak with in-house counsel
- Send in-house counsel written correspondence requesting legal advice or, alternatively
- In-house counsel will send you written correspondence requesting you to perform an audit, under his or her direction, in furtherance of providing legal advice to his or her client (likely senior management) and/or in anticipation of litigation

What should you do?

Following a phone call, Associate General Counsel Lionel Hutz advises in writing that, in order for him to provide legal advice to senior management and in anticipation of litigation, he would like you to audit all of ABC's payments to Slushco for the previous 3 years.

Lionel then heads to the golf course.

You begin the audit and note that dozens of payments are within scope. Supporting documentation generally consists of emails from the Vice President of Government Relations to Barney Gumble. You really want to know whether these other payments were for the making of "legitimate" political contributions.

Should you go talk to the Vice President of Government Relations? Barney Gumble?

Corporate Miranda Warnings

- Given to employees being interviewed as part of a corporate internal investigation.
- Tells the employees that the purpose of the investigation is to provide senior management (or the BOD or Audit Committee) legal advice and in anticipation of litigation.
- Tells the employee that the interview is being conducted at the direction of the Legal Department.
- Tells the employee that the lawyer who is present represents the Company's interests and not the employee individually.
- Tells the employee that the interview is confidential in nature and subject to the attorney-client and/or work product privileges.
- Tells the employee that only the Company can choose to waive the privilege by sharing its contents to third parties, including government regulators.

Maintaining Privilege Throughout Audit Process

- Limit information to need-to-know stakeholders
- Keep documents secure
- Mark documents privileged and confidential when they are created
- Maintain privileged files separate from business files
- Limit access to privileged and confidential materials



ATTORNEY-CLIENT
PRIVILEGE

What should you do?

Lionel Hutz schedules interviews with Barney Gumble and the Vice President of Government Relations. You attend the interviews and ask some questions relating to supporting documentation of the payments. During his interview, the Vice President maintains that all of the Slushco payments were for “legitimate” campaign contributions to the Colombian Senator. Gumble says he knows nothing.

Can you take notes during the interviews?

Your audit uncovers 51 separate payments to Slushco over the prior 3 years, all of which ranged between \$5,000 and \$30,000. Lionel Hutz does some quick legal research and discovers that the maximum allowable campaign contribution to a Colombia Senator is the equivalent of \$1,000 per election cycle.

Based upon the evidence that you have seen, what is the just outcome of this investigation?

What should you do?

You have informed your audit manager of the progress of investigation, but no one else. While sitting at your desk, you receive a phone call from the Senior Vice President of Administration, who asks for a status report on the investigation and, in particular, your audit findings.

What should you tell her?

Privilege Can Be Waived

- A privilege can be waived if you disclose privileged information to third parties, including:
 - Other employees who are not part of the investigative team
 - Outside consultants or contractors
 - Government authorities
 - External auditors

What should you do?

Back to that disbursement audit report, which your manager is now demanding by the end of the week. With regard to the original \$20,000 payment to Slushco, you note in your report the lack of documentation, absence of approval authority, and segregation of duties deficiencies. You also write, “Interviews of the managers who requested and approved the \$20,000 payment did not reveal the existence of a legitimate business expense. The internal investigation concluded that the payments violated either the U.S. Foreign Corrupt Practices Act (FCPA) or, alternatively, laws that prohibit U.S. companies from making contributions in foreign elections.”

Lionel Hutz faints when he sees the draft of your report, which you have been kind enough to show him.

How should you have worded your report?

Should you draft a separate report related to your forensic audit of all payments to Slushco?

Conclude Audit with Privileged Report

In order to receive protection under the attorney-client privilege, internal audit reports prepared by attorneys should clearly state that the report constitutes legal analysis and advice, rather than general business consulting.

Auditors and Lawyers Should Share a Common Goal

Maintaining the integrity and effectiveness of the internal audit, while protecting the outcome from disclosure



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