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Managing Internal Audit and Investigations

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Agenda

1 The Roles of Internal Audit and the Legal Department

2 Audit Activities Can Raise Complex Legal Issues

3 Common Pitfalls

4 Best Practices for Internal Audit and Legal Coordination

The Roles of Internal Audit and the Legal Department

Complementary Objectives

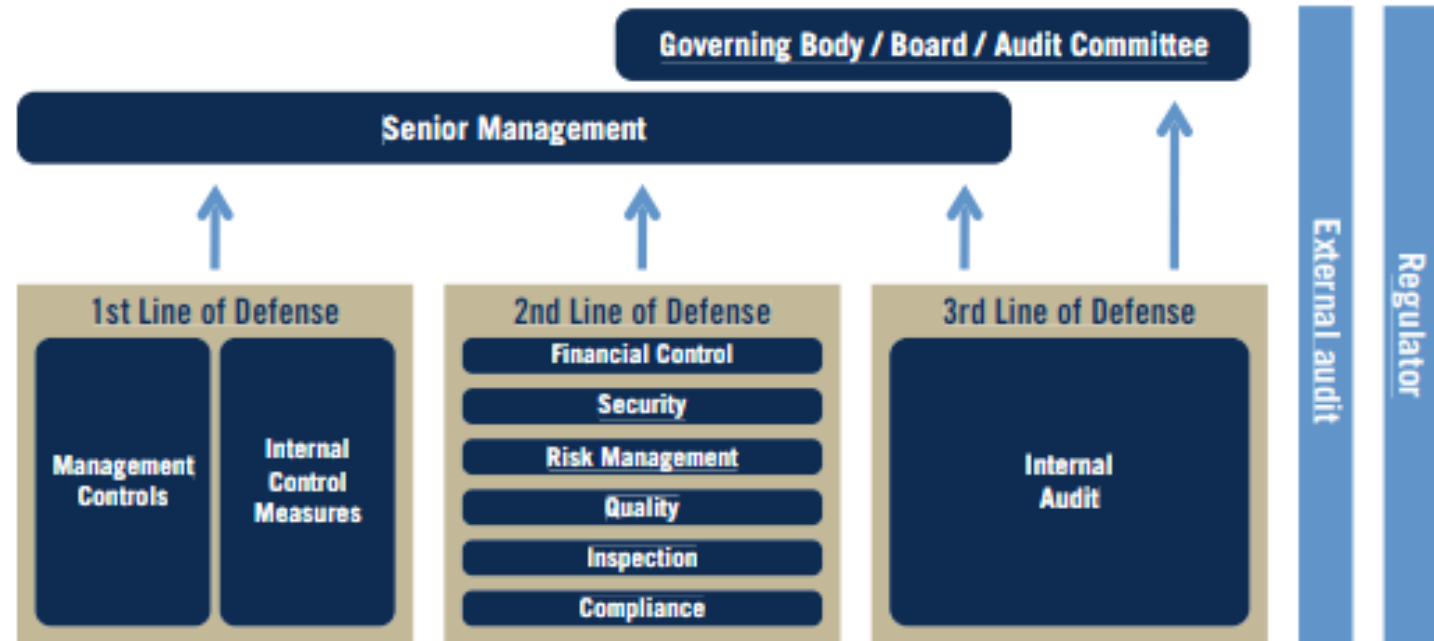
Internal audit and legal departments have complementary objectives, which may intersect when an audit examines issues around the company’s compliance with the law.

Internal Audit	Legal Department
Independent, objective assurance and advisory services provider.	Provides legal advice to organization.
Conducts audits ranging from operational to those required by law. Audits may focus on particular functions, processes, or controls.	Legal advice can include regulatory expectations, the organization’s approach to mitigating risk, and the adequacy of the organization’s compliance programs.
May include individuals with legal backgrounds, but focus is on checking the organization’s work and not interpreting legal requirements.	Interprets legal requirements relevant to an organization’s work and processes.

The Importance of Internal Audit

The Three Lines of Defense Model (2013)

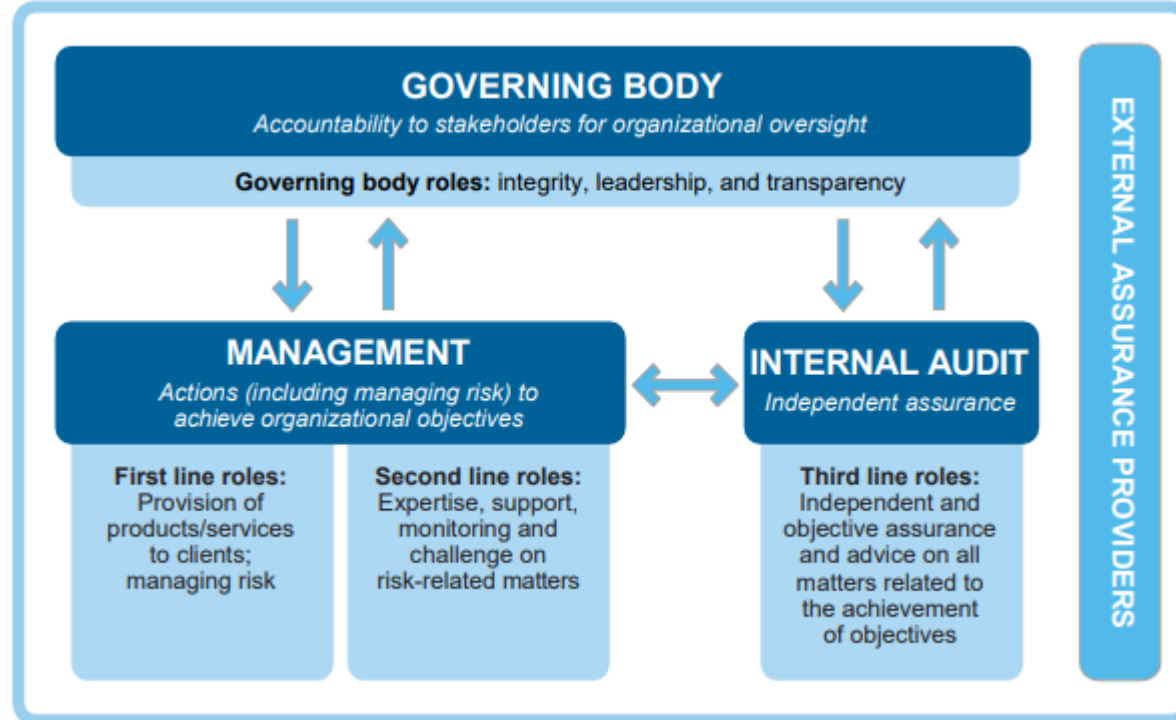
The Three Lines of Defense Model



IIA Position Paper: The Three Lines of Defense in Effective Risk Management and Control (Jan. 2013), adapted from ECIIA/FERMA Guidance on the 8th EU Company Law Directive, article 41.

The Importance of Internal Audit

The Three Lines of Defense Model (2020)



The IIA's Three Lines Model, An Update of the Three Lines of Defense (July 2020)

The Importance of Internal Audit

“A comprehensive, independent, and objective testing or audit function . . . ensures that entities are aware of where and how their programs are performing and should be updated, enhanced, or recalibrated to account for a changing risk assessment or sanctions environment, as appropriate.” – OFAC

“Voluntary audit programs play an important role in helping companies meet their obligation to comply with environmental requirements. Such assessments can be a critical link, not only to improved compliance, but also to improvements in other aspects of an organization’s performance.” – EPA

“[B]anks should have an internal audit function with sufficient authority, stature, independence, resources and access to the board of directors. Independent, competent and qualified internal auditors are vital to sound corporate governance.” – Basil Committee on Banking Supervision

“Due diligence and the promotion of an organizational culture that encourages ethical conduct and a commitment to compliance with the law . . . minimally require . . . [that the organization] take reasonable steps . . . to ensure that the organization’s compliance and ethics program is followed, including monitoring and auditing to detect criminal conduct.” – U.S.S.G. §8B2.1(b)(5)(A)

“As a company’s risk for FCPA violations increases, that business should consider increasing its compliance procedures, including due diligence and periodic internal audits.” – DOJ/SEC FCPA Resource Guide

The Importance of Internal Audit

DOJ Criminal Division Evaluation of Corporate Compliance Programs (March 2023 Update)

Prosecutors should evaluate whether “internal audit functions [are] conducted at a level sufficient to ensure their independence and accuracy,” as an indicator of whether compliance personnel are in fact empowered and positioned to “effectively detect and prevent misconduct.”

- How do companies determine where and how often internal audit will undertake audits?
- How are audits carried out?
- What types of audits would have identified issues relevant to the misconduct?
- Did those audits occur and what were the findings?
- What types of relevant audit findings and remediation progress have been reported to management and the board regularly?
- How have management and the board followed up?
- How often does internal audit conduct assessments in high-risk areas?

Audit Activities Can Raise Complex Legal Issues

Are audits privileged?

Audit work generally is not privileged.

Definition of legal professional privilege: the privilege (or right) of a client not to disclose confidential communications between client and attorney that were made for the purpose of seeking or providing legal assistance or advice.

- Legal professional privilege protects **communications**, not facts.

Generally speaking, internal audit reports and work papers are not protected by privilege:

- Attorney-client privilege does not attach **if the audit is not directed by counsel**.
- Work product protection does not apply **if the audit was conducted in the ordinary course of business** rather than “in anticipation of litigation.”

Internal audit reports may be subject to discovery.

Privilege and Primary Purpose

Nevertheless, some communications made during an internal audit may be privileged.

The relevant inquiry is whether the communication relates to the **provision of legal advice or opinions**.

This poses challenges because communications may have mixed purposes.

- “**The**” primary purpose versus “**A**” primary purpose.
- The Supreme Court left the standard unclear after dismissing the writ of certiorari in *In re Grand Jury*, 143 S.Ct. 543 (2023).

Communications that may be privileged can include:

- Requests for legal advice on the need to conduct an audit or risk assessment.
- Legal advice on the risks and benefits of conducting an internal audit or risk assessment.
- Legal advice regarding the implications of any information uncovered by an audit or risk assessment.

Communications that will not be privileged include:

- Requests for business advice, even if directed to, or provided by, a lawyer.
- Communications outside of the scope of a privileged audit or risk assessment.
- Communications transmitted to employees without a “need to know,” even if they contain legal advice.

Legal Developments

Although the privilege standard remains unclear, there has been greater endorsement of the “significant purposes” test.

Courts inquiring into the primary purpose of purportedly privileged communications have occasionally adopted a narrow, “**but for**” formulation of the primary purpose test. *See e.g., United States v. ISS Marine Servs., Inc.*, 905 F. Supp. 2d 121, 128 (D.D.C. 2012).

- There, the court held a communication would only be privileged if it “would not have been made ‘but for’ the fact legal advice was sought.”

This narrow application of the test was rejected by then-Judge Kavanaugh, writing for a unanimous panel, finding the test requires the request for or provision of legal advice to be “**one of the significant purposes**” of the communication. *See In re Kellogg Brown & Root, Inc.*, 756 F.3d, 754, 758-59 (D.C. Cir. 2014).

- The Court thought that the “but for” formulation was not appropriate because courts **cannot reasonably determine “the” primary purpose** for a communication **if there are mixed motives** for the communication.

At oral argument before the Supreme Court in *In re Grand Jury*, 143 S.Ct. 543 (2023), the government advocated for the primary purpose test **but endorsed the KBR approach** in cases where it is difficult to disentangle the legal and business purpose.

- The Supreme Court ultimately dismissed certiorari as improvidently granted shortly after hearing oral argument, so the standard remains unclear.

Privilege Waiver

Even if audits are performed under privilege, that privilege can be inadvertently waived.

Government enforcers often request audit findings in connection with ongoing investigations, resulting in the **sharing of documents and privileged interview summaries during “read-outs.”**

- These “read-outs” to the government (or other third parties) **may constitute a waiver of privilege.**

In *United States v. Coburn*, No. CV219CR00120KM, 2022 WL 357217, *7 (D.N.J. Feb. 1, 2022), the court found that even though these read-outs represented only summaries of the corresponding privileged interviews, the privilege was waived to:

- (1) all memoranda, notes, summaries, or other records of the interviews themselves;
- (2) underlying documents or communications used during the interview if their contents were conveyed during the read-outs; and
- (3) documents and communications that were reviewed and formed any part of the basis of any presentation to the government.

Sharing privileged documents **within a corporation** can also waive privilege.

- The relevant inquiry is “whether the documents were distributed on **a need to know basis** or to employees that were **authorized to speak or act for the company.**” *FTC v. GlaxoSmithKline*, 294 F.3d 141, 147 (D.C. Cir. 2002) (cleaned up).

Common Pitfalls

Legal Interpretation

Audit work may require application of legal standards.

Audit work may cover not only compliance with internal policies, procedures, and standards, but also areas that touch on compliance with legal standards.

There may be limited public guidance available regarding how legal standards should be applied in practice.

A company's internal legal position may be different from the position it would take in an adversarial action or investigation.

Auditors should be careful, therefore, not to include wording that could be construed as legal conclusions, which may be incorrect or may differ from the legal department's conclusions.

Questions About Compliance



Audit work may result in findings that raise questions about legal compliance.

An audit finding suggesting that a company is not in compliance with a legal requirement could trigger mandatory disclosures or self-reporting.

If provided to the government, audit findings that raise questions about legal compliance could be used as the basis of enforcement actions, particularly if remedial steps have not been taken.

Audit work may identify deficiencies in compliance programs.

Any deficiency needs to be addressed.

The adequacy of a compliance program is a significant topic in government investigations and enforcement actions.

Ongoing Investigations and Remedial Actions

Audit work may implicate topics that are currently in the government's focus or otherwise are already being investigated.

Audits may concern topics under investigation.

- This may include confidential topics not known outside of the legal department.
- Audits of such topics could implicate witnesses or subjects of the investigation.

Audit findings may provide support for civil and criminal allegations.

- During an investigation, government agencies regularly request audit reports.
- If such reports include findings that have not been remediated, the government can cite to these reports in bringing charges against a company.



Internal Audit and Government Actions

Internal audit may identify potential illegal activity at early stages and strong audit programs may be credited in enforcement actions.

PROTERIAL

Proterial Cable America, Inc. (f/k/a Hitachi Cable America Inc.) (2024): Proterial received a “declination with disgorgement,” resolving claims of wire fraud and conspiracy related to the company’s representations that motorcycle parts met federal safety performance standards. The company first identified the issue following disclosure by an employee during an internal audit, allowing the Company to promptly disclose the misconduct to the DOJ Fraud Section. In addition to the Company’s full and proactive cooperation, timely and appropriate remediation, and enhancements to its compliance program, among other factors, Proterial qualified for a presumption of a declination under DOJ’s CEP.



SAP SE (2021): SAP entered a non-prosecution agreement with the Department of Justice after it exported or caused the export of products to Iranians in violation of the Iranian Transactions and Sanctions Regulations. DOJ extended leniency to SAP, acknowledging the company’s voluntary disclosure after discovering the violation through its internal compliance program. DOJ also credited SAP for its “extensive internal investigation.”

Internal Audit and Government Actions

On the other hand, internal audit reports are routinely requested in government investigations and audit findings or failures may be used to support charges.



Albemarle Corporation (2023): In its cease-and-desist order, the SEC noted that Albemarle ignored a series of internal audit reports that “identified gaps in [the company’s] internal accounting controls” and failed to implement recommendations from the audit reports.



Clear Channel Outdoor (2023): In its cease-and-desist order, the SEC highlighted Clear Channel’s failure to remediate its China subsidiary’s internal accounting controls and compliance program despite multiple years of internal audit reports indicating an elevated bribery risk.



WPP (2021): The SEC alleged that the company “lacked meaningful coordination between its legal and internal audit departments” and management of its international operations. Management allegedly did not provide adequate oversight to ensure remediation of deficiencies identified by internal audit.



Deutsche Bank (2021): The SEC alleged that the company did not timely remediate internal audit findings that raised concerns about the use of a third-party business development consultant.

Internal Audit and Government Actions

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Novartis (2020): The SEC highlighted internal audit findings of alleged control deficiencies in clinical trials carried out by one subsidiary, and in equipment placements by a former subsidiary



Herbalife Nutrition Limited (2020): The SEC quoted email exchanges between Board Members and IA regarding 2016 internal audit findings allegedly showing excessive hospitality expenses by Herbalife employees in China



Mobile TeleSystems (2019): The resolution documents cited MTS's failure to implement adequate internal accounting controls and to enforce the controls it had in place. Among other deficiencies, MTS was cited for lacking a sufficient internal audit function to ensure corporate assets were not used to bribe foreign officials and failed to conduct adequate internal audits to detect and prevent criminal activity.



Stryker Corp. (2018): The SEC alleged that the company's internal controls were insufficient to detect the *risk* of improper payments in India, China, and Kuwait.



Panasonic (2018): Internal audit identified risks from payments to government officials and third-party providers.

Internal Audit and Government Actions

These enforcement examples emphasize the growing importance of internal audit, legal, and compliance functions working together to monitor and evaluate the effectiveness of companies' compliance programs and internal compliance controls:

- U.S. enforcers pay significant attention to internal audit teams' compliance work and findings.
- Internal audit is increasingly viewed as an appropriate evaluator of the effectiveness of companies' internal compliance controls to ensure their continuous improvement and sustainability.
- U.S. enforcers expect companies to follow up on and remediate audit findings, and the failure to do so can support charges against the company.
- Companies are expected to maintain adequate internal audit resources and promptly resolve internal audit findings; failure to address an internal audit finding may be viewed as a violation of the FCPA's accounting provisions.
- An effective internal audit team, well-versed in anti-corruption compliance and investigations, is a strong factor in arguing for corporate self-assessments.

Best Practices for Internal Audit and Legal Coordination

Higher-Risk Issues Require Special Attention

Audits involving **sensitive topics** may warrant conducting the audit **under privilege** and require specific policies to best protect applicable privileges.

Any audit for which **a primary purpose of the audit is to secure legal advice is a candidate for legal oversight.**

Audits, or portions of audits, concerning any of the following topics are potential candidates:

- topics relating to an **ongoing or likely lawsuit, investigation, or regulatory enforcement action**;
- the implementation of **legally mandated compliance measures**; or
- the **interpretation of legal requirements**, particularly when such interpretation is not settled.

Should Counsel Supervise?

A threshold question when sensitive topics are implicated by an audit is whether supervision by counsel is appropriate, and whether an audit is the appropriate activity to undertake (vs. a legally privileged investigation).

- Determine whether the sensitive topics are implicated by the investigation.
- Consider whether it is appropriate to involve Legal in the audit process or instead to segregate particular issues for investigation.
- Facilitate early coordination between Internal Audit and Legal to determine the scope and advisability of an audit, and later coordination to review draft reports and other work product.
- Deconflict Internal Audit with Legal in the event a related investigation or remedial exercise is already underway.
- Identify potential regulatory or litigation risks associated with sensitive audits.
- Following a decision to conduct an audit under privilege, either in part or whole, ensure that best practices for maintaining privilege are implemented.

Best Practices: Establishing and Maintaining Privilege

Establishing and Maintaining Privilege

Legal should **formally document** that Internal Audit is working at the direction of counsel.

Legal **should oversee, and be closely involved in**, all aspects of the audit, including scoping decisions, interviews, data collection, transaction sampling, and audit findings development.

- Non-lawyers can gather information and perform audit work **so long as the purpose of that work is to facilitate a lawyer's provision of legal advice** to the company.
- Work papers should be stored separately and **contain proper privilege designators**, such as “privileged,” “confidential,” and “prepared at the direction of counsel.”
- Communications regarding predominantly business advice or strategy generally will not be privileged.

Internal Audit should only communicate or share work product and findings with those on a **“need-to-know” basis**.

Best Practices: Limited Distribution of Information

Privilege and the “Need-to-Know” Principle

In order to maintain privilege of communications relating to a privileged audit or investigation, information must be shared only with those with a **“need to know.”**

To determine whether information was shared on a “need-to-know” basis, courts will consider

- how **widely the information was distributed**;
- the **precise role** of the individuals who received the information; and
- the **relevance of the specific subject matter** at issue to the work of the individuals receiving the information.

Companies should consider keeping the number of personnel receiving privileged materials, **including privileged audit reports and other formal or informal read-outs from privileged audits**, as small as possible.

Not all courts apply the same level of deference to non-lawyer auditors/investigators acting at the direction of counsel. This underscores the need to apply strict controls—such as controls on dissemination of reports—to make the best case for application of privilege.

Best Practices: Avoiding Legal Conclusions

Audit should use precise language that avoids legal conclusions in reports and communications that may conflict with the legal department's conclusions.

- The role of Internal Audit in conducting privileged audits is to develop information and analysis to support Legal's advice to the Company.
- For this reason, the focus of reports and other work product should be **on factual statements rather than subjective interpretations** of identified facts.
- Wording in audit reports should be precise, **avoiding sweeping or overly broad statements**, because words addressing legal exposure, risk, and liability can be taken out of context.
 - **For example:** "The five receipts submitted by John Smith from Restaurant X had sequential numbers despite being issued on different dates, and were not itemized, as required by the company's reimbursement policy."
 - **Not:** "John Smith submitted five falsified and fraudulent receipts from Restaurant X in violation of the FCPA accounting provisions."
- Be clear about if/when findings are limited.
- Ensure that recommended remedial steps are **practical and workable**, develop or implement a process **to follow through on any action items**, and ensure remediation actually occurs on such action items.

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