

Benefits of a Legal Audit

Legal Audits are Valuable for Successful Businesses

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Introduction

Successful companies periodically perform legal audits to ensure there are no lurking legal problems which could cost them significant money or could interrupt their business. Audits are excellent preventive tools to improve legal processes and legal compliance. Every company has hidden legal problems and statistics prove that if companies can uncover and resolve these hidden legal problems, they will prevent significant losses. For example, a real estate company discovered top executives often signed off on documents without really looking at them. As a result, cross-checks of contracts and leases were instituted. Also, you should not perform audits only when you have problems; audits can uncover new revenue possibilities.

Many legal problems arise from outdated forms, failures to account for new laws, or never properly establishing a process. An audit will precisely identify non-compliance and develop steps to eliminate the problems. Lastly, audit-

ing your processes can build a culture of compliance which will lessen the need for audits and reduce the chances of a catastrophic financial interruption to your business.

What is a Legal Audit?

Audits examine chosen issues, processes or areas. The company's documents, practices, and activities in these areas are thoroughly, but cost-effectively, inspected to determine if the business operations are in compliance with existing local, state, federal, and international laws and regulations. The legal audit and subsequent analysis will evaluate the company's current and future legal issues in light of the company's needs and industry standards. The complexity of the audit will depend on your company culture, your industry, whether the business is regulated, where you are in your growth objectives and lifecycle, the number of shareholders, employee population, and other factors. Each audit is unique and must be based on the factors unique to the company and the audit subject. After the audit is complete, an Audit Report will produce specific recommendations. Some or all of the recommendations will be quickly, cost-effectively implemented. Investors and lenders believe that audits are good business and laud company management for conducting audits.

How a Legal Audit Works

The first step is to determine the audit goals and audit scope. It is critical to properly define the audit goals and



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A legal audit is good business and the risks of not conducting an audit can be too high to ignore.

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scope. The scope will be based on past company legal issues, your regulatory environment, the operational area involved, possible future legal issues, and common legal problems in your industry.

A good legal audit is efficient and unobtrusive to the company. The attorney will create a draft Audit Plan for review and comment by the company. The attorney and senior management representatives should then discuss the draft Plan.

After the Plan is agreed, the attorney will create a questionnaire and Request for Information (RFI) and distribute these to people knowledgeable of the involved area. The Questionnaire will cover a myriad of topics and will request that documents be submitted for review by the audit team. For example, the questionnaire would ask about company past practices, the location of documents, the identity of

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personnel, current legal forms and when the forms were last reviewed, the nature of the business, claims and disputes with competitors, customers and vendors, past government investigations, current competitive environment, future legal issues, legal expenditures, whether and how your attorney advises the company, how the business operates and more. A good questionnaire will not be out-of-the-box, but will be well-tailored to the scope of the audit and the individual business.

The documents and responses will then be reviewed by the audit team. The audit team will also interview appropriate employees by phone or in person. Next, the attorney will analyze the information. The initial findings will be presented to company executives and your advisors (e.g., your accountants). The company's first responses may lead to another round of inquiries. However, if the answers are fairly straightforward, only one round of inquiries can be satisfactory.

After the review is complete, the attorney will analyze the findings and generate recommendations. This will be contained in an Audit Report. The Report will state whether (and how) the company is out of compliance with the laws. It should contain practical, actionable recommendations.

Important consideration should be given to how the audit team describes the problems in the Audit Report. A good auditor's recommendations are circumspect and damaging conclusions need to be carefully stated; baseline assumptions need to be double-checked. If an attorney conducts the audit, the results may be attorney-client privileged. If this privilege is allowed, the attorney's conclusions will not be able to be used in any court proceeding by your opponents. This often tips the scales in favor

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of an attorney leading the audit rather than a lay person. Nevertheless, in case the audit uncovers significant problems, the auditor should be careful how she states her conclusions.

The Audit Report contains all the key information obtained during the legal audit. This report will allow business executives and managers to have easy access to information for future use.

Then, the company will create the plan to implement the recommendations. It is common that the audit will lead to creating or revising procedures and manuals. These revised procedures and manuals will help prevent future problems. Training is also commonly part of an audit team's recommendations.

After the Audit is Complete

After the audit, you must maintain your improved procedures and compliance systems. To do this effectively, you need to ensure the new systems are ingrained in your company's operations. You will also need to periodically review these systems. Find a person in your company to be responsible for each

of these areas. These people should report the results of these spot checks to the top of the organization, preferably the “C” level of management, or one level below.

Benefits of a Legal Audit

The most important benefit of a legal audit is to reduce the company’s potential legal liabilities. A successful audit will show companies how to fix procedures and policies before their practices result in lawsuits or even criminal penalties. Successfully implemented audits will improve the functioning of the area which was audited. For example, a litigation audit can also help companies minimize liability from current litigation, manage current lawsuits better, avoid future lawsuits, respond to important

Finding these compliance problems and fixing them early will reduce your company’s losses.

pleadings quicker, retain the proper documentation for trial, maintain better communication with outside lawyers, and better predict litigation costs.

A legal audit helps companies remain compliant with existing laws. Both federal and state governments heavily regulate modern businesses and can impose heavy, Draconian penalties for non-compliance. For example, a business will likely need to comply with mandates such as the Sarbanes-Oxley Act, the Equal Employment Opportunity Act, workers’ compensation laws, securities laws, Federal Trade Commission (FTC) rules, trade regulations, environmental laws, to name a few. A legal audit will reveal precisely how to comply with these laws and myriad state and local laws. Finding these non-compliance problems and fixing them early will reduce your company’s losses.

The last benefit is that the audit could help the company identify positive opportunities such as new licensing revenues from a patentable technology uncovered during the audit. The audit also sets the stage for an environment of on-going compliance.

Audits Can Generate New Revenue Opportunities

Many times an audit will identify possible new revenue opportunities. For example, your company could have numerous patents or trademarks but might not have reliable methods to ascertain that infringements exist. Your executives may believe it is acting upon infringements, but an audit can tell you that there is in fact no such effective process. Or, executives may believe employees know how to identify and protect intellectual property developed by the company. Without specific training, this may not be the case. Other revenue opportunities can include opting out of class action settlements such as pricing settlements from utilities, trash haulers or other vendors. Some companies have made millions from these settlements by not settling with the class. When this happens, the audit can more than pay for itself.

When Should You Conduct an Audit?

The earlier problems are discovered, the less costly it is to resolve problems. I recommend an audit be conducted every three to five years depending on your company. Your last audit can give you guidance as to when you will need your next audit. If you have never conducted a legal audit, now is a good time for an audit.

The Risks of Not Complying

The risks of legal non-compliance are that undiscovered problems can have a significant adverse impact on the company and its owners. These risks include:

- If the company does not keep proper books and records, creditors of the company could seek to have a Court disregard the corporate shield, possibly resulting in the owners having personal liability for debts of the company.
- Fellow owners could sue each other alleging that corporate minutes were not followed or that directors exceeded their authority according to the minutes.
- Losing intellectual property and competitive advantage if employees or vendors/suppliers

- do not sign Confidentiality Agreements or if customer lists aren't protected.
- Fines, penalties or even closure of the business if you fail to obtain or maintain permits or licenses.
- Contested proceedings with agencies such as the IRS, EEOC (Equal Employment Opportunity Commission), EPA, or SEC.
- Liability from the federal government or from ex-employees if you do not have employment handbooks, policies and employment applications.
- Litigation can become more costly and less easy to settle.
- Directors could be shown to have violated their fiduciary duties to the company, possibly resulting in personal liability to the other directors and shareholders if the directors do not properly document or keep records of their decisions and justifications for decisions (i.e., the discussion among board members) or if directors have a conflict of interest.
- The company could be debarred from providing goods or services to federal or state governments if the company fails to follow GSA or state procurement reporting and compliance requirements.

Key Operational Areas to Audit

Legal audits can address many different areas:

- Contract Compliance
 - Are you providing required reports to the GSA?
 - Do your employees use the proper contract form each time?
 - What contract changes are allowed in the manager's discretion? Which changes require higher level approval? Are these rules in writing, easily accessible, and understandable?
- Corporate Structure
 - Choice and structure of entity
 - Acts of the directors and documentation of

- their decisions
- Estate planning for the owners
- Operational
 - Sales and collection practices
 - Obtaining security interests in financial assets
 - Insurance coverage
 - Distribution methods such as dealer networks
- Litigation
 - How is counsel chosen? Compensated? Critiqued?
 - Do you have a 90-day Litigation Early Evaluation Process?
 - Do you use Litigation Plans? Do you review progress of the Plan and do you modify it as required?
 - Do you use ADR? Has it been successful?
 - Are you knowledgeable of advanced risk analysis techniques?
- Acquisitions
 - Do you have a due diligence template?
- Human Resources/Employment
 - Do you properly classify employees and independent contractors?
 - Hiring, firing and promoting employees properly
 - Do you have published employment policies in required areas such as discrimination and harassment?
 - Do you have standard employment documentation and is it always properly used?
 - Are employees trained in your HR procedures?
- Intellectual Property
 - Do you know when protectable IP is being created? Do your employees know what is protectable and know the process to submit it for legal protection?

- What are you doing to protect it?
- Does all advertising and sales copy pass legal review?
- Do you have unquestioned title to your IP?
- Are you sometimes caught unaware by IP claims against you?
- Securities
 - Proper transfer of company stock (keeping stock records, checking whether transfer is allowed and obtaining securities exemptions for transfers)
- Antitrust compliance
- Product liability
- Internet and Web

- Antitrust
- IT and Software
- Environmental Law

Conclusion

A legal audit is good business and the risks of not conducting an audit are too high to ignore. Conducting an audit is more than beneficial- it is necessary. If the executives discover latent legal problems during an audit, they can fix the problems before the company incurs any unnecessary liability. Not only can future legal costs be reduced, but a legal audit can also reveal unknown business opportunities. Overall, a legal audit can help a business achieve its goals with the least risk to its owners or shareholders.

This article does not constitute the giving of legal advice. Please seek legal counsel who can assess your individual legal situation in compliance with the law.

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