Risky Business

Effective Legal Risk Management Requires Strong Leadership from General Counsel

By Michael C. Ross

The subject of this article grew out of a panel discussion on the role of corporate boards of directors in financial and legal risk management that took place at Stanford Law School's annual directors' college earlier this year. The popularity of that discussion underscored the importance of the subject in this era of mismanaged risks of both types.

For purposes of this article, I will leave financial risk management to board members, CEOs, CFOs and other financial experts. The focus here is on managing the risk of future illegal conduct, not the consequences of past wrongdoing, which often include investigations, criminal prosecution or civil litigation and liability. Plenty has been, and will be, written elsewhere on the management of legal risk in those situations.

Legal risk management differs from financial risk management because companies can and should take financial risk, often significant ones, to protect existing values and create new ones. Examples include investments, acquisitions, capital expenditures, debt incurrence, hedging, labor negotiations and hiring decisions. With financial risk, the keys are for boards of directors and senior management to determine intelligently what risks *may* be taken and then to ensure that only authorized risks *are* taken. Some of these financial risks come with legal risks attached, and it is those that must be addressed.

With legal risks, boards, particularly of public companies, will often adopt a zero-tolerance policy when it comes to illegal conduct by employees. To quote Vice Chancellor Stephen Lamb from Delaware's Court of Chancery, the board's edict should be simply: "Obey the law." The practical reality of companies, however, is that ideals, principles, values and codes are only a start. The attitude and culture of the organization toward obeying the law will be dictated more by action than by words alone. The effectiveness of legal risk management is dependent upon the accuracy and thoroughness of risk identification and assessment, clarity and frequency of communications, allocation of resources, monitoring compliance and reflecting results in employee evaluation, compensation and employment termination decisions.

Identification and Assessment

The starting point for legal risk management is identification and assessment of risks. Substantive risks will vary by industry and from company-to-company but often include employment (discrimination, harassment, wage-and-hour regulations and safety), securities (fraud, insider trading and disclosure), antitrust (price-fixing and unfair competition), regulatory, environmental, theft, privacy, consumer safety and tax.

Assessments of the likelihood of occurrence and magnitude of consequences are important in setting priorities and allocating resources. Assessments should be reviewed annually and promptly following material changes in circumstances, e.g., changes in company operations, industry developments and applicable laws or regulations. Selection of priorities is necessary because there are many foreseeable risks, and some risks deserve more immediate and thorough attention than others. Internal assessment should be compared to external disclosures of risk, e.g., in securities filings (including quarterly MD&A), and to Wall Street analysts and customers. Material discrepancies may be a sign of legal trouble to come.

Management

Without a sensible structure, legal risk management is unlikely to be effective. Although there is no one-size-fits-all formula, successful structures have some common features.

The board of directors must set policy and clearly communicate it to management. The

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board should require periodic reports on the results of legal risk management/compliance programs, recognizing management's inherent bias in favor of reporting success rather than failure. The board must also require that adequate financial resources and expertise are devoted to compliance. The better board members know the CEO and key members of senior management, the greater the chances are that organization-threatening risks can be avoided.

The board should have a special relationship with the general counsel. The general counsel should have relevant expertise and sound judgment and should be fully aware that he or she owes fiduciary duties to the company and the board. The general counsel can provide early warning of potential legal trouble. The general counsel's gatekeeper role, however, can be difficult because he or she usually reports to the CEO and must be viewed by senior management as part of the team in order to be effective as counsel. In order to avoid having the general counsel serve the individual interests of senior management, the board should create a relationship with the general counsel that fosters integrity and reliability.

To that end, the board should be involved in the hiring process by having several members review candidates' qualifications and references and conduct independent interviews of finalists. It should also understand and have input into how the general counsel is evaluated and compensated. The board should have a good sense of the general counsel's relationships with the CEO and senior management; relations that are either too close or too distant could be red flags. Board members should engage the general counsel in discussion during board and committee meetings. Often board members listen politely while the general counsel reports on legal matters (generally at the end of the meeting, while members are eyeing the clock or packing their bags). To the extent practical, some members should spend time with the general counsel in non-work settings. Personal strengths and weaknesses are often revealed in social situations.

Senior management, particularly the CEO, must lead by example. Although the board can set policies, only senior management can see to it that those policies are executed and reflected in the company's culture. The culture of a company in which the CEO stresses short-term profits may be quite a bit riskier than one in which the CEO emphasizes long-term growth and sustainability. Allocation of responsibilities must be clear, particularly in conglomerates and international businesses. Senior management must determine what resources are adequate and commit them to legal risk management. Senior management is also responsible for monitoring results and ensuring that those results are fairly reflected in employee evaluations and compensation. In some cases, there is no alternative, even for members of senior management, to termination of employment.

Codes of Business Conduct are only a start. Although most codes include rules, codes that emphasize values and principles are more likely to be effective.

Compliance programs must be presented periodically so that they remain current and reach new employees. Effective programs include: (1) explanations of the rationale for the code, i.e., the benefits to the company and its employees of enforcement of the code; (2) clear and concise explanations, using lay language and examples; (3) opportunities for questions; and (4) multiple reporting systems. Methods of delivery will vary and include written materials and acknowledgements, videos that are specially tailored to the company's issues and remote Web-based training.

Verification by senior management — and occasionally by the board — of the effectiveness of legal risk management is important. It can be accomplished in numerous ways, such as through organizational channels, with employee hotlines and exit interviews, from customer and supplier feedback and by monitoring regulatory activity. Analysts' reports and governance ratings may be useful, but each may be skewed by conflicts of interest and hidden (or not so hidden) agendas. Independent counsel, accountants or consultants may be appropriate or necessary in certain circumstances.

Effective and efficient legal risk management requires sound judgment and coordinated efforts of a company's board of directors, senior management and legal (and, if applicable, compliance) departments. That judgment and coordination is unlikely without the strong leadership of the general counsel. ◆

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