

CHAPTER ONE

THE NEED FOR A PARADIGM SHIFT

A company uses aggressive accounting techniques and financial engineering to boost its earnings per share. On Wall Street, its market value soars and its senior management are among the most admired business leaders of their time. They reap huge salaries, even bigger bonuses, and lavish perks. One day the company's stock price falls and continues to drop precipitously. A subsequent investigation uncovers a financial rats' nest laced with conflicts of interest and self-dealing. The revelation rocks the marketplace to its very core and leads to federal criminal investigations, charges, individual indictments, and civil suits against the company, its accountants, and its bankers.

What went wrong here? What combination of decisions could create such catastrophic blindness and inertia? Was it an accident? Or were these results foreseeable and avoidable?

A textile manufacturer creates an innovative synthetic fleece fabric prized by the fashion community for its warmth and light weight. The company brands the product and obtains trademark protection for its brand name. Unfortunately it does not seek patent protection for the manufacturing process. Competitors are soon able to make the same fabric and sell it under a different brand name. The stiff competition ultimately drives the manufacturer into bankruptcy.

What do these two companies have in common? They both failed to manage their legal risk effectively. One tested the limits of the law, straining like a puppy on a leash. The other failed to take advantage

of the law's scope. Both miscalculated the legal consequences of their business decisions. Both failed to develop their business sweet spot—and both lost shareholder value. It was a tremendously heavy price to pay.

Classic economic theory teaches us that organizations make rational decisions. It further defines a rational decision as one that maximizes *utility*—economist-speak for what the rest of us call maximizing value. Decisions that fail to maximize utility represent lost opportunity and *opportunity cost*, a cost that in accounting parlance is both variable and avoidable. Economists further reason that if maximizing value is rational, then decisions generating opportunity cost are irrational—at least that's what classic economics teaches us.

When applying classic economics to our two management examples, calling all the decision makers who contributed to the scenarios irrational sounds a bit harsh and simplistic. It's unlikely they were intentionally playing Russian roulette with their company's future. They no doubt thought they had good reasons for making the choices they did. But the quality of their decision making was ultimately flawed.

Business is a complex endeavor. These scenarios did not materialize overnight. They evolved gradually through a series of decisions. Numerous motivations and factors contributed to the end result. But something blinded these managers and executives to the ultimate consequences of their actions. They could not foresee how the legal aspects would play out. As a result, the cause and effect of a series of small miscalculations snowballed and buried them.

ELIMINATING THE BUSINESS BLIND SPOT

Even smart, seasoned business professionals can significantly underestimate the legal consequences of their business decision making. I noticed this phenomenon early in my legal career and at first thought this behavior was a bit odd, if not irrational. After all, if these business professionals had adopted the law as a tool for achieving business objectives rather than defining it as an obstacle to be avoided, the majority of their legal problems could easily have been eliminated or reduced. If only they had a better understanding of how business and law are intertwined. If only they had asked the right questions earlier. *If only*. . . .

At the same time, however, I recognized that traditional legal training and business training stem from different pedagogy and paradigms. The young manager is taught to embrace risk, the young lawyer to banish it. One is the curious puppy eager to jump on the next deal, the other a curious cat looking to toy with it. Both are curious. Both are eager and both appreciate risk, but they approach it from totally different angles. Without some mechanism for rationalizing the two temperaments, putting them together in the same room could only make the fur fly.

Eliminating business blind spots is not necessarily about zero risk tolerance. It's about taking smart risks, calculated risks, and managed risks. It's about capitalizing on mutual strengths and finding a business sweet spot. It requires a sense of balance. Lawyers need to recognize that not all legal risks are created equal, that is, that distinguishing the severity and likelihood of a given legal risk and prioritizing it in business terms is more valuable and leads to better joint problem solving than overwhelming clients with legalese.

By the same token, managers need to be able to recognize potential legal hot spots. They need to develop a better understanding of the law and how it affects their business, so they can ask the right questions sooner. Fostering an interdisciplinary approach improves the organization's ability to foresee problems and manage them effectively. It eliminates predictable surprises, saves time and money, and allows the company to be proactive instead of reactive. Eliminating the business blind spot is therefore about making smart choices.

If only they *knew*.

TRANSLATING LEGALESE INTO BUSINESS SPEAK

Our frame of reference plays a critical role in determining how we perceive and analyze the world around us. A Cornell University finance professor once told me that he would not grade the most brilliant financial analysis higher than a C if it failed to include tax consequences. He reasoned that whether an investment was profitable or unprofitable, or even *how* profitable, was determined by tax law. *All* of the relevant factors need to be considered.

While the financial impact of tax law on the bottom line is direct and easy to trace, the impact of other laws is more indirect and

insidious. It's fragmented and scattered throughout the organization. But the cumulative trickle-down effect can nonetheless wipe out net earnings just as easily as a direct tax hit. The key difference between the two is that the cause-and-effect impacts of tax consequences are easier to identify and measure.

Business issues do not land on your desk with pre-labeled solution sets or answer keys. And they certainly do not come with a legal road map. Even if they did, the worlds of business and law speak different languages. How we frame the issues therefore greatly influence our success in managing them. Tax is one of the few legal topics that translate easily to the bottom line. But without the ability to connect law and business directly and systematically to financial consequences, the significance of the legal aspects easily gets lost in translation.

Traditional business education focuses on accounting, finance, marketing, and operations management. It does not focus on managing the legal risk associated with these functions. As a result, it is difficult for most managers and executives to recognize the avoidable opportunity costs the legal system imposes on them. It is simply not part of their vocabulary or analytical skill set.

Since 2001, the business environment in the United States and abroad has been rocked by multiple scandals, and the regulatory backlash has left many managers fearful of lurking liabilities. Although the wave of ethics training intended to respond to these management lapses is useful as far as it goes, it is no match for the intricacies of the legal system. Thus we are left with too many of today's managers learning about legal risk management the hard way, through expensive trial and error—or worse, error and trial.

According to quality guru Philip Crosby, it is cheaper to build quality into a process than to catch mistakes later and then fix them. Therefore, incorporating legal considerations at the beginning of the decision-making process in a systematic and thoughtful way can make the difference between turbocharging or overcharging your bottom line.

Competitive organizations are constantly looking for ways to improve their processes. They want to excel, to be the A Team, not the C Team. Yet when it comes to managing legal risk, many managers leave it to chance. It makes you wonder: *Who is responsible for the legal health of an organization?*

Many managers would shrug their shoulders and say, “That’s what lawyers are for.” Yes, indeed. But their answer simply raises another: Who calls the lawyers? Or more important, How do you know *when* to call them?

TIMING

All too often, lawyers are called *after* a legal risk has escalated into a full-blown problem. When a 2005 survey of CEOs asked where the general counsel adds the most value to the company, 58 percent of the respondents answered managing legal issues. Only 12 percent responded anticipating legal risk. It means lawyers get called in more often to fix problems than to avoid them. The focus is on being reactive rather than proactive.

The results speak volumes about how CEOs perceive and apply their company’s legal talent and how they view the role of law in their operations. In any other area of business a function expected to devote more than half of its time to firefighting would come under intense scrutiny. Inquiries would be made regarding what types of problems are being managed, and how the issues could be eliminated or reduced. A quality improvement program would immediately be kicked into overdrive.

Imagine for a moment interviewing a new vice president of manufacturing or sales and telling the candidates that most of their talents are to be focused on managing “issues.” They would no doubt walk away thinking the system was out of control. A task force would be created to study processes and customer complaints. Recommendations would then be made on how to reduce defects, improve efficiency, and increase customer satisfaction rates. The recommendations would be reviewed, evaluated, prioritized, and implemented. Simply stated, the objective would be to squeeze out avoidable costs and rationalize the process.

Why doesn’t the same thing happen with legal problems? Why does more than half of counsel’s time need to be devoted to fixing problems instead of eliminating or reducing their causes? Why is more time spent on getting out of trouble than on staying out of trouble? Why do we accept these inefficiencies?

Unfortunately, when it comes to law and lawyers we carry baggage. Our perceptions influence our decision making. We might

ask for legal help with litigation, complex financial transactions, mergers, acquisitions, and other high-profile events, but we prefer to handle routine transactions ourselves because the cost of a legal review is generally perceived to outweigh the benefit. *That's the way we've always done it* is often enshrined in the corporate culture along with a perception that *it's more trouble than it's worth*. As a result, legal risk is often trivialized and treated like an inevitable fixed overhead item, a mere cost of doing business.

A NEW FRAME OF REFERENCE

In recent years legal risk management has been given new prominence due to a string of high-profile business scandals in the United States and abroad. In 2001, just as some of the major scandals began to erupt, another survey of CEOs conducted by the Association of Corporate Counsel revealed that only 23 percent of the respondents identified legal risk management as a “critically important” role for their general counsel. Two years later, as the magnitude of the scandals unfolded and after the U.S. Congress adopted the Sarbanes-Oxley Act, a law intended to protect investors by improving the accuracy and reliability of corporate disclosures, the number of CEOs who thought legal risk management was important nearly doubled, to 44.2 percent.

Even though legal risk management was rising to the top of business agendas, the same Corporate Counsel survey also found that approximately 61 percent of the CEO respondents wanted their general counsel to focus more on corporate governance, the issue du jour, while only 37 percent ranked *anticipating* risk as the most value-added service provided by their chief counsel. As the memories of scandalous business headlines dwindle, so too does the perceived value of anticipating risk. By 2005 only 12 percent ranked it as the most value-added activity. What appeared to be the start of a paradigm shift has slid backward. Much legal risk is still being managed *after* a liability-triggering event has occurred, rather than in *anticipation* of it. The focus is still skewed toward getting out of trouble instead of staying out.

While a focus on corporate governance is commendable, from a risk management perspective it only addresses a small, albeit powerful, group of decision makers within the organization. Senior ex-

ecutives are, both figuratively and literally, only the tip of the legal risk iceberg. Below the waterline are hundreds of nongovernance decisions, large and small, routine and nonroutine, made throughout the organization each day. Each decision represents an opportunity to advance or detract from the bottom line. Each decision represents a link in the value chain of activities conducted by an organization to deliver goods or services.

THE VALUE CHAIN AND LEGAL RISK MANAGEMENT

The value chain concept was first used by Michael Porter, professor of business administration at the Harvard Business School, to describe the relationship among all the activities an organization performs to do business. More specifically, Porter says, “A business is profitable if the value it creates exceeds the cost of performing the value activities. To gain competitive advantage over its rivals, a company must either perform these activities at a lower cost or perform them in a way that leads to differentiation and a premium price (more value)” (Porter, 1985, p. 150).

When viewed in legal terms, the value chain lets us develop a better understanding of the organization’s risk profile. It acts as a prism, refracting responsibility for the legal health of an organization across the full spectrum of employee activity. Identifying how, when, and where these legal risks are embedded in the value chain gives us a better understanding of our vulnerabilities. Best of all, it allows us to reverse engineer these processes and helps us develop a road map for improvement, for filling in legal potholes and improving our legal risk profile.

As a result, the legal leverage corollary to Michael Porter’s definition looks like this:

A business is more profitable and more sustainable if the value it creates exceeds the cost of performing the value activities and the cost of the direct and indirect legal liabilities generated by the value activities. To gain and maintain competitive advantage over its rivals, a company must either perform these activities at a lower cost or perform them in a way that leads to differentiation and a premium price (more value) and eliminates or reduces unacceptable legal risk while simultaneously maximizing business success.

We all know from experience that a chain is only as strong as its weakest link. What is tougher to see is how several slightly weak links can be just as dangerous to the organization as one spectacularly compromised link. Pinpointing these cause-and-effect relationships allows us to control the impact of legal risk on the value chain. It identifies when and where we need to install controls to protect ourselves.

Take, for example, the experience of Huntsman Chemical Corporation. In the early 1990s certain types of specialized compliance information resided in the environmental health and safety (EHS) group, while manufacturing process knowledge resided at the plant level. Both of these links in the value chain went about their business independently as separate silos.

Their failure to communicate meant that the plant was unaware of how changes in manufacturing processes could alter effluent discharges and lead to violations of the plant's various environmental discharge permits. Similarly, the EHS staff was unaware of forecast changes and other operational issues that could affect permit requirements. Only by appreciating the relationship between these links in the Huntsman value chain could the organization build a more constructive relationship between the two. Once the disconnect was identified, improving the timeliness of the information led to more compliance and better accountability. A small adjustment created a much better overall result.

Maximizing and capitalizing on interdependencies in the value chain requires a holistic approach that goes beyond the corporate governance requirements inspired by the Sarbanes-Oxley Act. Unfortunately, when organizations try to examine legal inefficiencies they often focus only on the links with obvious legal tie-ins such as the Legal Department or regulatory compliance areas. Such an analysis is good but not great.

Regulatory compliance, like corporate governance, *does* play a significant role in helping to maintain the legal health of an organization. But beginning and ending the analysis there misses important links whose decisions create the risk in the first place. That's why cracking down on the legal or regulatory compliance departments as a method of managing legal risk does not address the source of the problem. It manages a symptom. It's like mopping up around the edge of the shower instead of turning off the spigot. Mopping more efficiently makes you feel productive, but it does not address the underlying source of the problem.

THE MALDEN MILLS LESSON

Remember the competitive edge lost by our synthetic fleece manufacturer at the beginning of this chapter? That manufacturer was Malden Mills of Lawrence, Massachusetts, maker of the high-quality surface-finished fabrics Polarfleece and Polartec. Malden's legal failing was not a result of breaking the law but rather of failure to secure its legal rights early and to capitalize on them.

The company obtained trademark protection for Polarfleece and Polartec but neglected to patent the manufacturing process. Traditional compliance programs would not have caught that error because no law requires the patenting of inventions. The law merely provides the opportunity. It is up to the company or the individual to recognize the opportunity, seize it, and use it strategically.

What is even more heartbreaking about the Malden Mills story is that it happened to a company whose owner, Aaron Feurstein, was heralded for his altruism. He was named "CEO of the Year" by George Washington University and his folk hero status earned him recognition during the 1996 State of the Union address from President Bill Clinton. In September 2005 he was awarded a Leadership in Ethics Award by the Washington, D.C.-based Ethics Resource Center.

Why? On December 11, 1995, a boiler explosion at Malden Mills triggered a fire that destroyed three of the factory's historic buildings and a substantial amount of its manufacturing capacity. The operations meltdown put 2,400 jobs at risk in an economically depressed area of Massachusetts, just two weeks before Christmas. Many speculated that the seventy-year-old owner would cash in his chips, collect the insurance proceeds, and retire to a sunnier climate, or relocate his operation overseas to take advantage of lower labor cost.

Instead, three days after the fire, a company press release announced that Feurstein's first priority was to help his employees and return them to their jobs "as soon as humanly possible." To make good on his promise he kept everyone on full salary and health insurance benefits for thirty days following the incident while working to rebuild the plant in Lawrence. Feurstein's generosity would ultimately continue beyond the original thirty-day window; and, true to his word 80 percent of Polartec production was churning out warm, wooly fleece by the end of January.

The salary and benefit continuance program during the reconstruction period cost Aaron Feurstein \$25 million. But rebuilding the factory cost \$400 million, \$140 million more than the insurance proceeds from the fire. The shortfall forced Malden Mills to borrow heavily. Unfortunately, the crippling debt load combined with increased competition in the marketplace proved to be too much. The insurmountable financial burden pushed the company into bankruptcy.

Had Malden Mills owned the Polartec process patent, the company's history might have been written differently. The near-monopoly conferred by a patent would have given Feuerstein the option of stopping competitors from using his process or requiring them to enter into a license agreement and pay royalty fees. Either path would have eased competitive pressures. One would have stopped the competitors cold in their tracks. The other would have had the added benefit of generating sorely needed cash flow. Either way, the patent would have been a strategic asset and contributed to the sustainability of the business.

A traditional compliance program would not have flagged the patent opportunity. Traditional compliance deals primarily with meeting existing legal requirements. It operates as a gatekeeper rather than a gateway for capturing legal opportunity. As a result, companies that take a narrow, compliance-oriented perspective on legal risk management are unaccustomed to the idea of recognizing and seizing legal opportunities, and ill equipped to do so when the occasion arises.

Managing a legal risk portfolio requires vision similar to that of financial portfolio management. It requires quality decision making and shrewd evaluation of performance processes. Risk needs to be anticipated and hedged as part of a systematic and progressive risk analysis process, which also needs to be synchronized and aligned with overall business performance objectives. It is a dynamic, not a static process. It is a process that is part of *everyone's* job.

LEGAL LEVERAGE: WINNING FROM THE BEGINNING

Courts use hindsight to judge business performance. Keeping courts out of your business therefore requires foresight. Recognizing the nexus between law and business sooner rather than later

will put you ahead of the game. Better decision making lets you decide how much legal risk you want to reduce, transfer, or avoid. It lets you take smarter, more calculated risks and manage problems while they are still small and relatively inexpensive to deal with. It lets you leverage the law for competitive business advantage and start winning from the beginning.

Legal leverage offers unprecedented strategic value for building sustainable shareholder value. With fewer black eyes to defend in court, organizations can reallocate scarce resources previously used for litigation defense and other claims. Balancing legal risk in a thoughtful and responsible way thus creates a business sweet spot.

Legal risk is not a random event. It can be anticipated and mitigated. One of the key factors to success, however, is timing. The longer you wait the less options you have available, and instead of helping to shape the facts as they unfold you are forced to play the hand that is dealt you. Timing can work either for you or against you.

If you want to start winning from the beginning you need employees, particularly executives and managers, to take a greater ownership of legal issues early in their business decision-making processes. Employees are strategically positioned within the organization to avoid or minimize the vast majority of organizational legal problems simply because they are the business decision makers. It does not matter whether the employees function in senior or entry-level positions or whether their decisions are large or small. The legal literacy of all employees plays a role in an organization's ability to exercise legal leverage. *Employees* shape the deals at each step of the value chain and create the goods or services that the enterprise is based on. They know what is going on long before the lawyers do.

Managing legal risk well adds value to the value chain. To be effective at the process, however, employees need to be equipped with the proper legal tools. Unfortunately, most are unprepared to recognize routine legal risks in their embryonic stage.

For example, one junior scientist, proud of his patentable breakthrough, bragged about it in a scientific Internet chat room. Thinking that patents were already applied for, the scientist acquiesced to his online colleagues' curiosity when they pressed him to reveal details. Little did he know that his Internet chitchat was a public disclosure that started the one-year deadline ticking for

protecting U.S. patent rights. When the scientist's employer delayed its U.S. patent filing to conduct more tests, the one-year deadline slipped by unnoticed until a patent was issued to a *competitor* for the same invention. Imagine the inventor's surprise. His lack of legal literacy translated into lost patent rights for his employer and lost competitive advantage. It probably detracted from his annual performance review, too.

Seemingly routine decisions can have a disproportionately large impact. A simple software agreement, for example, can present a serious business threat if the software happens to play a critical role in your business and vague warranty language leaves you without recourse if defects subsequently crash your servers and strangle your daily operations. "I would have thought the contract would be fairly standard, but evidently that's not the case" is what one manager told me once he realized that the simple business transaction had legal implications that in turn carried operational risk and huge financial implications.

Connecting the dots from a boilerplate contract to the bottom line helped motivate this manager to negotiate the deal further. It broadened his frame of reference and led to better protection for the company and a better deal. Instead of glossing over ambiguous or unfavorable contract language, he was able to seek clarification with the vendor and avoid the kind of misunderstanding that could later escalate into conflict or a lawsuit. By managing expectations well at the beginning of the transaction and reflecting them in the contract, he was able to shift unwanted legal risk while maximizing business objectives. He negotiated a fairer deal, transforming potential warranty liabilities into an asset. Such is the power of legal leverage.

IGNORANCE IS NO EXCUSE

Many employees and managers underestimate the complexity of the law and the risk that well-intended actions will later haunt them and their employers. They believe that if they act with integrity and simply follow their bosses' or customers' instructions, their good intentions will keep them and their companies out of legal trouble. Unfortunately, good intentions are not enough to keep you out of court, particularly in the United States.

Expecting vindication because you “didn’t know” is a losing strategy. It’s your business to know what is going on within your sphere of responsibility. When A. Alfred Taubman, the chief executive officer of Sotheby’s, the renowned international auction house, was accused of participating in an antitrust price-fixing scandal he tried the dumb-CEO defense; the jury didn’t buy it.

“Hey, the law’s the law,” shot back the Taubman jury foreman shortly after the verdict was announced. The juror’s message is clear: ignorance is no excuse. If you work in a position of responsibility you are *expected* to know the score.

When investment banker Frank Quattrone was convicted of obstruction of justice for e-mailing colleagues and telling them to “clean up those files” after his firm had already received a subpoena investigating the firm’s process of allocating shares in initial public offerings during the dot-com boom of the 1990s, one of the jurors said afterward, “We felt he had risen to the top of his profession: he was too smart to let this happen.” The crux of the case was the defendant’s intent, but the jury’s inference about Quattrone’s competency led them to believe that he knew or should have known that instructing a clean-up of company files relevant to the investigation was a problem and that the document purge was no accident.

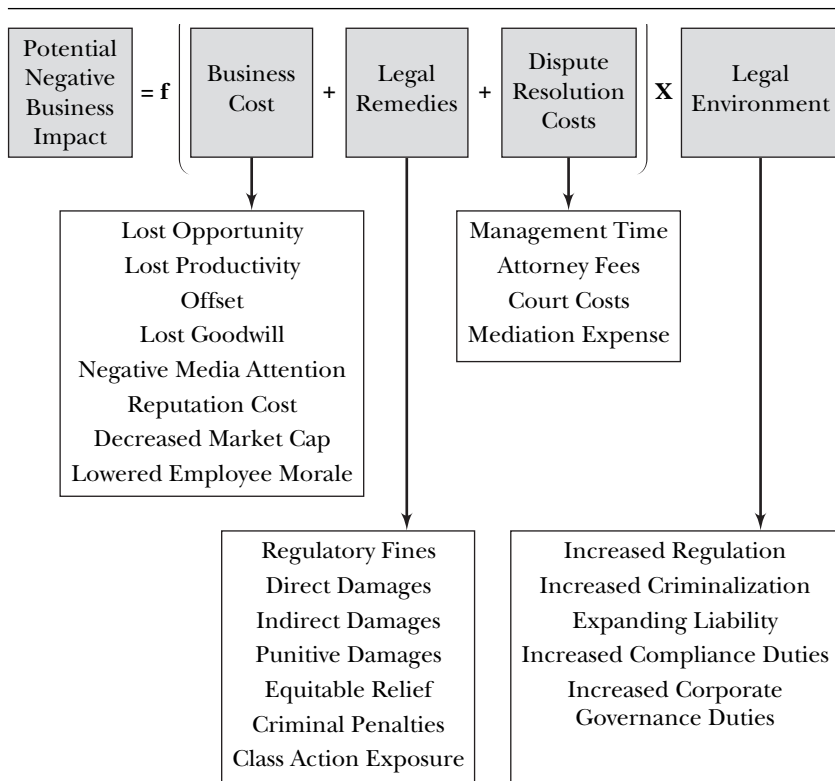
Having employees develop legal literacy and understand the legal aspects of their roles is good business. Most legal problems start small, with nothing more than missed signposts and missed opportunities. The inability to read those signs is like driving down a one-way street heading the wrong way. Misinterpreting street signs flirts with disaster. To strengthen the value chain, employees must be able to read and follow the legal warning signs that appear like pop-up Internet ads but are drowned out by the drone of the daily grind.

Creating a higher level of vigilance throughout the value chain requires a systematic approach. Unfortunately, formal legal risk training, to the extent that it exists within an organization at all, is often limited to an occasional compliance course taken to satisfy a policy or performance review requirement, or to the faint memories left by a college business law course. Most employees learn about the law on the job through trial and error, by rote, or not at all.

We make dozens of decisions every day at the office and well over a hundred thousand decisions in the course of a career. Exactly

how expensive our legal risk management mistakes are will depend on the business ramifications of our decisions. The opportunity cost, or potential for negative business impact, as illustrated in Figure 1.1, includes much more than the direct cost of a lawsuit, the court-ordered judgment, or a settlement (discussed further in Chapter Three). It also includes lost goodwill, ruined reputations, and negative public opinion that destroy market valuations as well as interfere with the sensitive windows of time that can make or break a new product launch. Without a proactive approach to identifying, prioritizing, and managing legal risk, employees are doing nothing more than gambling with their piece of the value chain.

FIGURE 1.1. POTENTIAL NEGATIVE IMPACT OF MISMANAGED LEGAL RISK.



LEVERAGING THE LAW FOR COMPETITIVE ADVANTAGE

Legal leverage seeks to systematically identify weaknesses in the value chain that threaten the company's legal risk profile, capture those missed opportunities, and translate them into profits. It is a process that assists decision makers in anticipating legal problems. It lets them use that knowledge to manage expectations, avoid lawsuits, build constructive relationships, and influence better business outcomes. The objective is to minimize, transfer, or avoid unwanted legal risk and to maximize business opportunity. It is not about hard-ball tactics, loopholes, or winning in court but rather about avoiding the courtroom brawl altogether if possible.

Anyone who has ever been involved in a lawsuit in the United States can testify to the fact that legal battles are no fun. At best, the process is time-consuming, expensive, and a diversion of scarce resources. At worst, in a criminal proceeding, it ruins careers, destroys families, and threatens the very existence of the organization. There are no winners, only those who lose less. The process can be expensive, unpredictable, and downright dangerous.

Few businesses have the luxury of generous legal budgets and even those that do are better off spending those resources building the business instead of defending it. Better resource utilization, including better return on investment, is one reason why smart decision making and doing what's right (instead of what's easy) make good business sense. Prevention is always a cheaper solution than going to trial or settling cases out of court.

Unfortunately, many managers discount the legal aspects of their business and brush them off as a cost of doing business. As with good nutrition and exercise, most of us know we should do better. But we struggle. It's not that we don't care, it's just that we treat other things as more important. We brush off the risk and justify the decision as a trade-off. But if we want better results, we need commitment and solutions—not casual trade-offs and excuses. Law needs to be an integral part of corporate life, part of the bedrock of our business belief system and operational protocol, not merely embroidered on mission statements. We need to change the way we think and act about legal risk and legal risk management. We need a paradigm shift.