

Report to Legal Management

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The Impact of Recent Scandals on Corporate Counsel

Four Questions Every General Counsel Must Answer

By Daniel J. DiLucchio and Marci M. Krufka

With a few exceptions, in-house lawyers have fared much better than most other stakeholders in the many corporate scandals that have occurred this year. Accountants, CEOs, investment bankers and stock analysts have undergone much public scorn and scrutiny. Corporate executives face incarceration. One of the five largest accounting firms is no more, and few investors have confidence in the regular “buy” recommendations from their brokers.

We have heard about Nancy Temple, the Andersen lawyer whose revised memo provided the jury with sufficient evidence of intent to find Andersen guilty in its criminal trial. We have heard many question the involvement of Vinson & Elkins and other firms in the structuring of Enron’s off-balance sheet partnerships; and, we have seen that firm and others named as defendants in the Enron shareholders’ class action.

Few have questioned, however, where the in-house lawyers at Enron were while the fraudulent activity took place. For that matter, few have questioned the involvement of in-house lawyers at WorldCom, Adelphia or any of the others.

But there are significant implications for in-house corporate counsel. The Chief Legal Officer, Deputy General Counsel, management-level attorneys and other legal department managers must be aware of the relevant issues in this new era of heightened scrutiny for corporate responsibility — and must be able to answer the following four questions to properly manage their departments.



Daniel J. DiLucchio



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Are Your Outside Counsel Truly Independent?

Because revenues from Enron were so significant, critics question the ability of their outside firm’s lawyers to adhere to the ethical requirements to maintain independent professional judgment. Enron’s independent outside counsel is reputed to have collected over \$25 million in legal fees from the client in 2001, more than 7% of its gross fee revenues. At a 30% margin (typical), loss of

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7% of revenues converts to a 21% reduction in average partner income.

Under such circumstances, what are the pressures on a law firm and especially on the lawyer handling the client relationship, whose compensation is largely dependent upon his or her fee production? Will the pressures lead to a compromise of objectivity and independence of advice to keep the client happy and paying? And what about firms whose largest client accounts for twenty percent of gross revenues? Thirty percent?

In recent years, many legal departments have instituted convergence programs and consolidated the number of outside firms handling the company's work. Convergence is not only a valid strategy for improved management of outside counsel, it also generally results in cost savings to the company. Consolidating your legal work to one firm in a particular jurisdiction, however, may mean that your company becomes the firm's largest client and carries the risks associated with that status.

If you are a firm's largest client, regular dialogue between legal department management and outside counsel is necessary. For what percentage of the law firm's revenue is your company responsible? Even if it is as low as five percent, the loss of your company's business would likely have a significant impact on partner income. So, it is crucial that law department management and outside counsel work to find the appropriate balance between a good working relationship and enough distance to remain impartial. What is the firm, and your legal team within the firm, doing to ensure its professional independence is not compromised?

Have Your Efforts At "Partnering" Gone Too Far?

For years, corporate clients have encouraged "partnering" between their outside professional advisors

and themselves. Typically, the goal of partnering is to enhance communication, systems and working relationships in a manner that best serves the interest of the client. Enron and Andersen's working relationship (and possibly Enron's relationship with outside law firms) may be an example of partnering that went too far. Did Enron and its outside advisors align their interests so much that professional independence was compromised? Once again, law department management must strive for an appropriate balance between a strong partnering effort and independent counseling and advice.

lawyer responsibilities and conduct. There is also information being released by the SEC, other governmental bodies, the stock exchanges, corporate professional associations and others.

Which of these position statements are merely editorial and which will have a meaningful impact on your company or your legal department? Do you have the people and systems in place to track the numerous changes in legal and regulatory requirements and the continuing policy debates? Devoting people and resources to these issues may require

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Do You Have The Right Systems In Place?

By the "right" systems we mean those that track and are kept current regarding relevant changes in corporate responsibility requirements. The Sarbanes-Oxley Act of 2002 provides for the most sweeping changes to federal securities laws in decades. Provisions of the Act have implications for Executive Officers and Directors, public company disclosures, audit committees, outside audit firms, company employees and attorneys. The provisions of the Act also have various effective dates, some dependent on the SEC's adoption of relevant rules.

Legal and other organizations are adopting positions on proposed changes and suggesting changes of their own. In July 2002, the American Bar Association Task Force on Corporate Responsibility submitted its preliminary report that contains recommendations on systemic issues relating to corporate responsibility and recommendations with respect to

additional investment, but the implications are so large that few would argue with the rationale for doing so.

Does Your Legal Department Facilitate Ethical Behavior?

In other words, do you have the three components necessary to facilitate ethical behavior? Providing internal ethics seminars or sending lawyers to outside CLE courses on ethics is "a good thing" to quote corporate scandal star Martha Stewart. But awareness of ethical obligations is only one of three key components necessary to ensure ethical behavior in your legal department. To truly facilitate ethical behavior, your lawyers and staff must have an awareness of the requirements of professional rules, the ability to effect change if unethical behavior is detected, and the values to act in accordance with those rules.

Basic awareness is developed through education. Many large legal

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departments have their own formal training programs, and of course, there is no excuse for a lack of understanding of ethical rules on the part of lawyers. Education regarding legal ethical requirements, however, is often limited to legal department attorneys. Department managers must make sure that every member of the department is aware of the legal ethical rules and can detect when something has gone awry. For example, legal staff may not clearly understand that the lawyer's duty is to the corporation and its shareholders and not to any one person or group of persons, what the concept of independent professional judgment means to the in-house lawyers practice or that confidentiality requirements (and exceptions) apply to them, as well.

It is also important that there are systems in place for anyone in the department to report fraudulent activity or even questionable situations. What good is an understanding of unethical behavior is if there is

nothing you can do about it once it is discovered? Department policies must provide the adequate systems and structure so that deviant behavior is detected quickly and reported promptly.

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Finally, the members of your legal department must have values that are in line with ethical requirements. This is the most challenging component from a management perspective. Regardless of staff education programs or reporting systems, if a lawyer or staff member does not have the appropriate values then he or

she will probably do nothing when faced with an ethical dilemma. There are psychological testing instruments available that measure values (i.e., to get a clearer understanding of what people value the most, not to label their values as “good” or “bad”). Absent this testing, it is really left to the judgment of management to make sure that the values of their people are consistent with the values of the company.

Conclusion

There are many challenges to managing a corporate legal department, and the recent corporate scandals merely add to those challenges. If your department can successfully answer the four questions posed in this article, however, it will likely be better able to endure during this turbulent phase and beyond. ♦

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