Challenges to Effective Legal Risk Management

Roundtable Essay
Five Key Findings

1. **Legal crises are spreading and becoming more severe.**
   Over the past five years, European legal departments have significantly increased their number of legal risk management activities: new compliance programs, new training, ERM, expanded legal review of business decisions, etc. But in spite of these efforts, the number and severity of legal crises—defined as a lawsuit, legal investigation, or regulatory action with a reasonable likelihood of generating substantial financial or reputational harm—is climbing.

2. **The sources of crises can (and should) be predicted.**
   While conventional wisdom holds that the cause of a crisis cannot be known ahead of time, this is largely untrue. Empirical analysis shows that a small set of employees and a small set of issues are disproportionately likely to spark a legal crisis. Legal departments should reprioritize their efforts based on this information.

3. **Failing to assess preventive activities’ value leads to poor investments in risk management.**
   Legal departments appear to undertake a number of preventive activities without an objective analysis of these activities’ actual reduction in legal risk, their drag on the speed of the business, and the amount of department time consumed.

4. **Legal departments devote insufficient attention to anticipating emerging risks.**
   Despite CEOs’ mandate to general counsel to better anticipate and proactively address future areas of risk, most legal departments have not made sufficient progress in meeting this mandate. In contrast, a small number of departments have developed straightforward approaches at little to no additional cost.

5. **Legal departments often underestimate the power of crisis readiness.**
   A thoughtful and rehearsed response plan is the final (and usually missing) component to effective preventive lawyering. Full-blown legal crises often occur when the initial response to an issue is bungled.

Source: General Counsel Roundtable research.
The Expansion of Risk Management

**Faced with demanding new governance requirements...**

<table>
<thead>
<tr>
<th>Regulation</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>KonTraG</td>
<td>1998</td>
</tr>
<tr>
<td>Turnbull Report</td>
<td>1999</td>
</tr>
<tr>
<td>Sarbanes-Oxley Act</td>
<td>2002</td>
</tr>
<tr>
<td>Tabaksblat Code</td>
<td>2004</td>
</tr>
</tbody>
</table>

**Percentage of Companies with Formal Enterprise-Wide Risk Assessment Processes**

<table>
<thead>
<tr>
<th>Region</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Europe</td>
<td>79%</td>
</tr>
<tr>
<td>Asia-Pacific</td>
<td>62%</td>
</tr>
<tr>
<td>North America</td>
<td>52%</td>
</tr>
</tbody>
</table>

**...companies have formalized risk management processes...**

**New Regulations Prompting Investments in Risk Management**

**...created separate risk functions...**

**Q: Have You Appointed a Chief Risk Officer (CRO)?**

<table>
<thead>
<tr>
<th>Response</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>45%</td>
</tr>
<tr>
<td>No Plans for CRO</td>
<td>31%</td>
</tr>
<tr>
<td>No, but Planning to Appoint CRO</td>
<td>24%</td>
</tr>
</tbody>
</table>

**Annual Corporate Compliance Spending Worldwide**

<table>
<thead>
<tr>
<th>Year</th>
<th>Spending in Billions of Euros</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>€12.0</td>
</tr>
<tr>
<td>2007 (Projected)</td>
<td>€21.6</td>
</tr>
</tbody>
</table>

Legal’s Involvement: Risk Management and Cross-Functional Engagement

Legal departments invest significant amounts of time identifying and mitigating legal risks...

Proportion of European Departments Conducting Selected Legal Risk Management Activities

<table>
<thead>
<tr>
<th>Activity</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal Risk Assessment Process</td>
<td>55%</td>
</tr>
<tr>
<td>Broad-Based Contract Review</td>
<td>61%</td>
</tr>
<tr>
<td>Broad-Based Compliance Training</td>
<td>65%</td>
</tr>
<tr>
<td>Senior Management-Focused Compliance</td>
<td>74%</td>
</tr>
<tr>
<td>Supplier Compliance Standards</td>
<td>74%</td>
</tr>
</tbody>
</table>

...and are increasingly involved in cross-functional risk management initiatives

Percentage of European Legal Departments Participating in a Cross-Functional Risk Committee

<table>
<thead>
<tr>
<th>Participation</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Participate in Cross-Functional Risk Committee</td>
<td>58%</td>
</tr>
<tr>
<td>Do Not Participate in Cross-Functional Risk Committee</td>
<td>42%</td>
</tr>
</tbody>
</table>

Percentage of European Legal Departments Participating in a Company-Wide Risk Assessment Process

<table>
<thead>
<tr>
<th>Participation</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Participate in Company-Wide Risk Assessment Process</td>
<td>68%</td>
</tr>
<tr>
<td>Do Not Participate in Company-Wide Risk Assessment Process</td>
<td>32%</td>
</tr>
</tbody>
</table>

Source: 2006 GCR Risk Management Survey; General Counsel Roundtable research.
A DEEPENING MALAISE

Despite Increased Risk Management Focus, Legal Liability Continues to Climb

Indicia That Legal Crises Are Becoming More Problematic

I. Increasing Litigation

II. Rising Financial Penalties

Change in Volume of Litigation at European Companies, 2003–2006

2006 GCR Risk Management Survey

More Litigation

68%

Less Litigation

16%

No Change

13%

n = 31.

Fine, Settlement, or Damage Award in Cases Examined, Millions of U.S. Dollars

GCR Legal Crisis Analysis

<table>
<thead>
<tr>
<th>Year</th>
<th>Median</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>$57</td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>$65</td>
<td>$246</td>
</tr>
</tbody>
</table>

n(2003) = 94,

Note

Analysis of legal crises at European companies shows that financial penalties are on average higher and have grown faster than those for other companies, with the median fine or settlement rising from $68 million in 2003 to $90 million in 2005.

Source: 2006 GCR Risk Management Survey; GCR Legal Crisis Analysis, 2006; General Counsel Roundtable research.
THE COMPONENTS OF ROUNDTABLE ANALYSIS

I. Legal Crisis Data
   - Analysis of hundreds of major corporate litigation and regulatory actions from the past three years
   - Reveals patterns that will assist general counsel in reprioritizing preventive efforts according to area of law, seniority of employees, etc.
   - Analysis includes companies from Europe, Asia, and North America involved in U.S. litigation and regulatory actions.

II. GCR 2006 Legal Risk Management Initiative
   - Survey of worldwide general counsel opinion on specific legal risk management activities—costs, benefits, etc.
   - Pinpoints which activities legal departments find most effective and which do not reduce risk enough to justify their costs

III. GCR Legal Risk Management Case Study Anthology
   - Summary of five years of Roundtable research on best practices in legal risk management
   - Identifies case studies with demonstrated results, high cross-industry applicability, and ease of implementation with limited resources
**Key Finding: The Sources of Crises Can (and Should) Be Predicted**

**Three Specific Areas of Concern**

*While four problems spark 80% of major legal crises...*

Percentage of Crises by Area

2006 GCR Legal Crisis Analysis

- Illegal Sales/Marketing: 27%
- Accounting: 24%
- Anticompetitive Practices: 18%
- Consumer Protection: 12%
- Environmental Damage: 7%
- Employee Relations: 7%
- Intellectual Property: 5%
- Money Laundering: 1%

≈ 80%

*...only three of the four cause 80% of the legal liability...*

Percentage of Total Fines, Settlements, and Damage Awards by Area

2006 GCR Legal Crisis Analysis

- Accounting: 40%
- Consumer Protection: 19%
- Anticompetitive Practices: 18%
- Illegal Sales/Marketing: 13%
- Intellectual Property: 6%
- Environmental Damage: 3%
- Employee Relations: 2%
- Money Laundering: 0.3%

≈ 80%

*...and provoke the biggest shocks to share price*

Median Share Price Low Within 30 Days of Legal Issue News Break

2006 GCR Legal Crisis Analysis

- Accounting: (15%)
- Consumer Protection: (13%)
- Anticompetitive Practices: (9%)

Other drivers cause less than 10% share shock:

- Illegal Sales/Marketing: -6%
- Intellectual Property: -6%
- Employee Relations: -4%
- Money Laundering: -2%
- Environmental Damage: No Impact

Source: 2006 GCR Legal Crisis Analysis; 2006 GCR European Risk Survey; General Counsel Roundtable research.
Focus on the Top of the House

Two of the three most damaging causes of legal crises usually involve direct reports to the CEO...

Seniority Level Involved in Key Legal Crisis Types, 2003–2006

<table>
<thead>
<tr>
<th>Seniority Level</th>
<th>Anticompetitive Practices</th>
<th>Accounting Violations</th>
<th>Illegal Sales/Marketing</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEO and Direct Reports</td>
<td>72%</td>
<td>74%</td>
<td>79%</td>
</tr>
<tr>
<td>Other</td>
<td>28%</td>
<td>26%</td>
<td>21%</td>
</tr>
</tbody>
</table>

...and their misconduct accounts for the majority of legal liability

Total Value of Fine, Settlement, and Damage Awards by Seniority Level, 2003–2006

<table>
<thead>
<tr>
<th>Seniority Level</th>
<th>CEO and Direct Reports</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>59%</td>
<td>41%</td>
</tr>
</tbody>
</table>

n = 383.

Source: 2006 GCR Legal Crisis Analysis; General Counsel Roundtable research.
The Most Severe Crises Tend to Be Caused by Intentional Employee Behavior

Percentage of Intentional Versus Unintentional Conduct, by Crisis Area

Proportion of Legal Crises

<table>
<thead>
<tr>
<th>Crisis Area</th>
<th>Intentional</th>
<th>Unintentional</th>
</tr>
</thead>
<tbody>
<tr>
<td>All</td>
<td>66%</td>
<td>34%</td>
</tr>
<tr>
<td>Illegal Sales/Marketing</td>
<td>77%</td>
<td>23%</td>
</tr>
<tr>
<td>Anticompetitive Practices</td>
<td>75%</td>
<td>25%</td>
</tr>
<tr>
<td>Money Laundering</td>
<td>75%</td>
<td>25%</td>
</tr>
<tr>
<td>Accounting</td>
<td>68%</td>
<td>32%</td>
</tr>
<tr>
<td>Employee Relations</td>
<td>62%</td>
<td>38%</td>
</tr>
<tr>
<td>Consumer Protection</td>
<td>49%</td>
<td>51%</td>
</tr>
<tr>
<td>Intellectual Property</td>
<td>46%</td>
<td>54%</td>
</tr>
<tr>
<td>Environmental Damage</td>
<td>29%</td>
<td>71%</td>
</tr>
</tbody>
</table>

n = 383. n = 102. n = 70. n = 5. n = 91. n = 26. n = 45. n = 18. n = 26.

Source: 2006 GCR Legal Crisis Analysis; General Counsel Roundtable research.
Introduction to Roundtable Legal Risk Management Survey

An Online Survey Captured Perceptions of the Costs and Benefits of Common Legal Risk Management Activities

Screen Shot from Survey

2006 GCR Risk Management Survey

Data Gathered (Selected)

Preventive Activities
- Which of 23 preventive activities (listed) are employed
- Degree to which activity is believed to reduce legal risk
- Degree to which activity is resource-intensive for legal department
- Degree to which activity creates drag on business speed
- Rationale for not conducting certain activities

Overall Success Measures
- Satisfaction with legal department’s risk management efforts overall
- Change in amount of litigation over past 3 years
- Change in legal liability over past 3 years
- Extent to which change in legal liability is result of risk management efforts

Analyses Performed (Selected)
- Frequency of use for each preventive activity
- Average risk reduction rating
- Average resource-intensity rating
- Average drag on business rating
- Correlation with changes in litigation activity
- Correlation with changes in legal liability
- Correlation with overall satisfaction with legal risk management efforts

Source: 2006 GCR Risk Management Survey; General Counsel Roundtable research.
Salient Findings from the Risk Management Survey

1. **Nothing beats the ROI of shock tactics.**
   “Preventive shock tactics”—the use of unexpected or unorthodox compliance messages, presentations or training—are the highest-ROI activity and impose the lowest drag on business operations of all 23 activities. However, only 36% of European departments use this cost-efficient approach.

2. **Assigning lawyers to business units is perceived to be very effective at reducing risks.**
   Simply assigning lawyers in the legal department to specific business units seems to be very effective. General counsel gave these types of activities some of the highest rankings in risk reduction, and this activity is strongly correlated with reduced litigation.

3. **Broad-based contract review tends to generate low ROI.**
   General counsel rank broad-based contract review #1 in actual legal risk reduction, and most departments review nearly all contracts their clients produce. However, broad-based contract review does not seem to have strong correlation with reductions in litigation, liability, nor with overall satisfaction with risk management. In addition, as general counsel report in the survey data, such a comprehensive approach to contract review comes at high cost in terms of legal department resources consumed (dead last in cost ranking) and drag on the business (also dead last).

4. **Universal compliance training imposes high costs for uncertain return.**
   While general counsel rank universal compliance training as one of five activities that most reduce legal risk, they readily admit the steep costs of the approach—ranking it 17th in terms of department resources consumed and 21st in terms of drag on the business (both out of 23). Given these costs, it is particularly concerning to see no correlation with reductions in litigation or legal liability.

5. **Enterprise risk management efforts frustrate general counsel, but appear linked to reductions in risk.**
   European general counsel are considerably more likely to participate in ERM initiatives and cross-functional risk committees than their peers in other geographies. Perhaps frustrated with those experiences, European general counsel rank these forums almost last in terms of perceived risk reduced. However, the Roundtable’s (global) analysis shows participation in ERM efforts is strongly linked to reductions in litigation and legal liability.

6. **Focusing compliance efforts on senior managers is time intensive, but linked to significantly reduced liability.**
   General counsel report that senior management-focused compliance efforts cause one of the highest amounts of drag on business operations, no doubt because of the high opportunity cost of senior managers’ time. However companies that focus compliance on senior managers are twice as likely to report reductions in legal liability (probably because, as Roundtable analysis shows, senior executives are disproportionately responsible for legal crises).

7. **Failing to assess preventive activities’ value leads to poor investments.**

8. **Legal departments devote insufficient attention to anticipating emerging risks.**

9. **Legal departments often underestimate the power of crisis readiness.**

Please see pp. 17–19.

Source: 2006 GCR Risk Management Survey; General Counsel Roundtable research.
Key Finding: Failing to Assess Preventive Activities’ Value Leads to Poor Investments

Flying Blind

Legal Departments Are No More Likely to Engage in High ROI Activities Than Low ROI Activities

Preventive Activities by GC Assessment of ROI

Activities Ordered by GC Assessment of ROI

What Works?

“We are really struggling to understand which aspects of our compliance and preventive lawyering are not working so we can make meaningful improvements.”

General Counsel
Manufacturing Company

Source: 2006 GCR Risk Management Survey; General Counsel Roundtable research.
**Looking Backward**

*Despite CEOs’ mandate in 2003 to better anticipate legal risk…*  

CEO Opinion of General Counsel’s Role  

2003 CEO Survey

| Question to CEOs:  
| “How does the GC contribute the most value to the company?”  
| **Ranking of CEO Responses**  
| #1 Manage Legal Risk  
| #2 Anticipate Risk  
| #3 Advise Business Units  
| #4 Manage Legal Department  
| #5 Manage Outside Counsel |

*…most departments still have not progressed against this goal*  

Proportion of Departments Conducting Selected Activities  

2006 GCR Risk Management Survey

- Use Existing Matter Data to Track Risk Trends: 23%
- Track New Legislation/Industry News: 49%
- Conduct a Legal Risk Assessment: 51%
- Perform All Three Activities: 10%

**A Missed Opportunity**

- Roughly ¾ of legal departments have a matter management system.
- Departments that use their matter management data to track risk trends are:
  - More likely to report reductions in litigation
  - More likely to report reductions in legal liability

Most legal departments do not have crisis response plans... 

Percentage of Legal Departments with Key Response Plan Elements

<table>
<thead>
<tr>
<th>2006 GCR Risk Management Survey</th>
</tr>
</thead>
<tbody>
<tr>
<td>Have a Legal Crisis Response Plan</td>
</tr>
<tr>
<td>Have Crisis Response Communication Tools</td>
</tr>
<tr>
<td>Rehearse Their Crisis Response</td>
</tr>
</tbody>
</table>

n = 155.

Correlation analysis reveals a strong relationship between conducting rehearsals and lowering damages, settlements, and fines—the relationship is the strongest of all 23 risk management activities.

...leaving them at risk to bungle their response to an important event

Case Study: Tone of Response Often—More Important Than Facts

Chi Chi’s Restaurants

1. Six hundred-fifty people fall ill and four die from salmonella traced to onions from Chi Chi’s Restaurants in October 2003.
2. Company executives avoid direct contact with the media, instead relying on brief, legal-sounding statements read by outside counsel; non-executive employees refuse to offer their own views on the situation.
3. Company appears defensive and more concerned about litigation than customer well being.
   End Result: More than $40 million in damages, settlements, and fines paid. Company later liquidated.

Sheetz Convenience Stores

1. Four hundred people contract salmonella from tomatoes traced to Sheetz convenience stores in July 2004.
2. Company executives lead the effort to answer questions and communicate their desire to help anyone affected by the crisis; their responses appear unscripted.
3. Non-executive employees also display genuine contrition.
   End Result: 21% sales growth in 2004, so far no lawsuits filed and most settlements minimized and negotiated.

Source: 2006 GCR Risk Management Survey; General Counsel Roundtable research.