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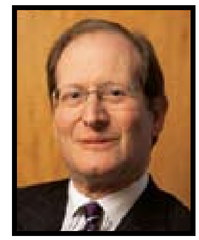
Caught in the Middle



By Ben W. Heineman, Jr.

THE GREATEST CHALLENGE for general counsel and other inside lawyers is to reconcile the dual—and at times contradictory—roles of being both a partner to the business leaders and a guardian of the corporation's integrity and reputation. Successfully resolving this tension is essential if a company is to attain the two fundamental goals of contemporary capitalism: high performance with high integrity.

Corporate counsel must guard their company's reputation and work well with the business side. GE's former GC explains how to reconcile those often competing roles.

In recent years many general counsel have failed as guardians. In this decade's first great wave of scandals, beginning with Enron Corp. and centering on fraudulent financial practices, the question was, "Where were the lawyers?" In-house counsel were either excluded from key decisions, or they failed to ask aggressive questions about whether problematic actions were legal or appropriate. But, compared to CFOs, they generally escaped formal sanctions.

In the recent wave of investigations relating to options backdating, general counsel are, once again, squarely in the middle of corporate improprieties—and in the line of fire. Formal investigations, indictments, pleas, and convictions are rising, and there is no end in sight. Moreover, in the highest-profile U.S. corporate scandal of 2006, the use of pretexting in the investigation of board leaks at Hewlett-Packard Corporation, the general counsel "touched" the issue on numerous occasions. But she was incurious about probing the legality of pretexting and indifferent to its appearance and propriety, although, unlike another legal department colleague, she avoided indictment ["Saw No Evil," January].

In the view of some commentators, such as Professor John Coffee of Columbia University in his recent book, *Gatekeepers: The Professions and Corporate Governance*, general counsel and other inside lawyers, while well placed to play a broad guardian role, will ultimately fail. They lack "independence" (they are subject to "pressure and reprisals" from business leaders), and they lack a strong reputation outside of the company.

By contrast, a November 2006 New York City Bar Association "Report of the Task Force on the Lawyer's Role in Corporate Governance" states that "the role of the general counsel of a public company is central to an effective system of corporate governance." (Disclosure: I was one of many people interviewed and cited by the task force.)

I do not believe that the choice for general counsel and inside lawyers is to go native as a yes-person for the business side and be legally or ethically compromised, or to be an inveterate naysayer excluded from core corporate activity. Indeed, I think resolving the tension between the partner and guardian roles is critical to the performance of each. But certain key conditions relating to the general counsel, line lawyers, the CEO, and the board must exist for this to occur.

ILLUSTRATIONS BY PETER HOEY

General Counsel. To be a key player in a corporation's quest for performance with integrity, the general counsel must have a job that is broad enough in scope to address the myriad business-in-society issues facing modern corporations. The GC, either as a lead or supporting actor, should be involved in: complying with law and regulations across the world; establishing global values and standards beyond what financial and legal rules require; shaping the company's governance, public communications, reputation, and role as a corporate citizen; and, ultimately, addressing questions of how to balance the company's private interests with the public interests affected by the corporation's actions.

In playing the business partner role, general counsel act first in their capacity as lawyers; they use law and policy affirmatively to help the corporation achieve business goals as quickly and effectively as possible. Partnership success with business leaders occurs, for example, by doing informative and constructive due diligence, helping to negotiate deals, simplifying contracts, and helping to enact important public policy provisions.

But general counsel (acting as partners) also have to act as business people (and for purposes of attorney-client privilege, they should obviously be sensitive to the distinction). In this capacity, they are using their general intelligence, knowledge, judgment, and experience to participate in discussions that help the CEO define and decide basic business issues.

In my experience, business leaders were enthused about inside lawyers who could help get things done. Furthermore, once that reputation had been established, the executives were also very receptive to counsel participating in core business discussions if the lawyers were also savvy about technology, products, markets, geographies, competitors, etc.

General counsel need credibility and guts—in addition to legal skills and business acumen—when they are playing the role of guardian of the company's integrity and reputation. Ultimately, they are the corporation's lawyer, not the business leader's lawyer. This is a distinction that senior executives may understand intellectually but balk at, because they invariably think their interests and the company's are the same. Credibility comes, in part, from a GC's character, experience, reputation, self-confidence, and the ability to explain issues forcefully, clearly, and concisely. And it will be strengthened by the basic trust that is created over time by working effectively as a business partner. The hard discussion of limitations and constraints in the present is made easier by business accomplishments in the past.

In the guardian role, the general counsel has to resist giving the quick, simplistic answer often demanded in fast-moving, complex situations—deals, major contract negotiations, demands from government regulators, operational problems in emerging markets, product safety questions, etc. As always, the basic job is to find the facts and to do the analysis. To be sure, if presented with a black-and-white issue, there is no reason to hesitate with the answer. Yes, the division of markets with a competitor is illegal.

But many mixed business-integrity issues are gray. In those (frequent) instances, I tried to give the decision makers options that, while all lawful in my view, had varying degrees of legal, regulatory, ethical, and reputational risk and were based on clearly articulated assumptions about the facts. If more facts were needed, that had to be weighed against real (not phony) time pressures. Typically, I felt it was important to make—and then defend—a recommendation, but only after carefully articulating alternatives for the person who had to make the decision. This approach avoids the simplistic "no" answer but requires work with others to develop business alternatives for achieving the ultimate end (though perhaps with additional cost).

Beyond credibility, guts are needed in the guardian role. CEOs are usually in a hurry. They may bridle at allowing time for needed legal analysis. They may not have the patience to listen to a nuanced presentation on the various risks involved and options available. Moreover, some of the toughest problems come in the form of crisis management, not stately strategic decision making.

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There is also the pressure of the group around the table, which may side with the CEO on the direction to adopt and the need to move quickly. (GCs should probably watch Henry Fonda in *12 Angry Men* about once a year.) And discussions at the top, to paraphrase Mr. Dooley's famous comment about politics, "ain't beanbag." CEOs have to be ferocious cross-examiners. They should push back. They should challenge key trade-offs and core considerations. They should be skeptical. And few CEOs like to be sharply contradicted in front of a group—such forays are rarely successful. For GCs, standing up for time to analyze the problem and to make a reasoned recommendation from that analysis—disagreeing, without being disagreeable or confrontational—isn't always easy, as readers of these pages know well.

Division GC and Line Lawyers. Another critical factor is employees' ability to elevate concerns. Whether through an ombudsman system, an internal corporate audit staff, or division GCs and line lawyers (and their equivalents in the finance and HR functions), employees at all levels of the organization must feel free to bring concerns about financial, legal, ethical, or reputational issues to the top. Employees must know that those matters will be fully investigated and resolved, and they must have no fear of retaliation. Indeed, they must know that they have a duty to raise such issues, with failure to do so resulting in serious sanctions, including termination.

As with the general counsel, outstanding division general counsel and line lawyers—hired from firms or promoted from within and placed deep in the organization—can gain credibility for the legal function as a whole by being strong business partners up and down the company. They also must serve as guardians in their direct dealings with peer business leaders.

These division general counsel and line lawyers have important responsibilities, as well, in three key channels for voicing concerns. First, these lawyers must investigate, along with finance and audit staffs, issues raised through the company's ombuds system. For the good of the corporation and the credibility of that system, these inquiries must be conducted promptly, professionally, and fairly. They must ignore internal political pressures (often with the help of more senior lawyers) and follow the facts where they lead.

Second, these lawyers have a core responsibility, with others in their business, to conduct energetic and committed "bottoms-up" compliance reviews. These reviews ask the lowest-level employee in the furthest outpost to express any concerns or thoughts about integrity issues, systems, and processes—how they are working (or not), how seriously the business takes them, etc. This practice of seeking candid integrity assessments occurs at every level (by locality, country, region) and builds up systematically to a compliance review of each global business division with the specific business leader and with corporate staff leaders (CFO, GC, HR). Additionally, the corporate audit staff checks this business compliance process with its own regular compliance audits—often based on audit protocols developed with the lawyers.

The third channel involves the division general counsel and the line lawyers themselves. They should have clear responsibility to report personal concerns about commercial, legal, ethical, and reputational risk directly up the line—and in the case of division general counsel, to the general counsel. Sarbanes-Oxley (17 CFR Part 205) requires certain inside lawyers (those representing the issuer before the Securities and Exchange Commission) to report threatened or actual material violations of relevant law directly to the general counsel. This is well and good.

But "up-the-line reporting" in the legal organization, which I consider a best practice (and which we instituted at GE), is far broader: It involves concerns, not just the likelihood of material violations; it should involve all lawyers across the globe, not just U.S. lawyers appearing and practicing before the SEC; and those concerns should include ethical, reputational, and commercial risk, not just legal issues. The purpose is to make absolutely clear that, as an inside partnership, more senior lawyers should be a check on a variety of sensitive issues facing the company.

The general counsel must earn the trust of the division counsel to make this reporting structure work (and the division counsel must earn the trust of the line lawyers). The GC must truly be available to counsel—to listen, to ask questions, to test ideas, to suggest possible actions, but not to assert control over the matter, not to substitute his judgment, not to run to the CEO and burn the division counsel with his business leader. If, in the GC's judgment, the issue is significant and the company CEO should know immediately about a matter, the GC should allow a short period of time for the division business counsel and the business leader to bring it forward themselves. (And, on those major issues, the GC must often assume joint or sole responsibility.)

OUTSIDE COUNSEL

Seeing the Big Picture

TWO WELL-DOCUMENTED AND MUCH-DISCUSSED TRENDS over the past 20 years have undermined outside lawyers' role as wise counselors who guard the broad, long-term interests of a corporation.

The first trend, of course, is the transformation of inside law departments. Specifically, their recruitment of high-quality in-house lawyers; those lawyers' assumption of a broad role counseling business leaders; their tighter control over firm retention; and their fragmentation of legal service providers through competition.

The second trend is the transformation of law firms into aggressive, highly specialized business entities. As a result, critics say, too often pressure to increase profitability has impaired professional standards. Too many firms don't see the client's broad interests as a whole. And too many lawyers are too willing to provide a desired answer. They're afraid to ask hard questions for fear of losing a billable client.

For outside lawyers, the tension between addressing the client's immediate, narrow matter and counseling on the corporation's broader self-interest parallels the partner-guardian tension that inside lawyers face.

Leadership from general counsel and heads of law firms can help rehabilitate, at least in part, the important "guardian" role for outside counsel—to the extent that it has been damaged by the structural changes in law departments and law firms.

To do this, general counsel should make it clear to firm leaders that they want advice on a particular legal issue, but that they also seek counsel on the matter's broader corporate impact.

I have spoken many times to law firms and am invariably asked, "What do you look for in outside counsel?" My answer includes: a customer and service ethic; cost-competitiveness and productivity; and diversity. But the most important factor is quality in two senses: being an outstanding technical lawyer (clear, succinct explanation of law, facts, and varying legal risk) and being a wise counselor.

I wanted thoughtful insights into all the nonlegal issues—ethical, reputational, and commercial—that would help lawyers on the inside resolve the partner and guardian tension in broadly assessing risks and opportunities for business leaders. Obviously, this kind of counseling opportunity won't exist in a tiny, discrete matter. But most companies are consolidating their outside firms—and this broader opportunity exists for those firms with substantial, if no longer dominant, positions, even if their representation is primarily in a specialty area. Corporations should be willing to pay for both astute lawyering and wise counseling. General counsel must also make this point clear to the cadre of inside lawyers—who may, especially further down the line, beat up firms to meet budgets and not fully appreciate the value that can be added for their benefit.

Second, leaders of law firms—like general counsel and CEOs—must create a firm culture that balances economic needs with professional aspirations. Partnership meetings that pay lip service to professionalism, don't discuss the counseling role, and then spend most of the time on profits per partner and leverage don't help.

Are firm leaders continually seeking best practices for achieving the right balance between business imperatives and professional ideals, between narrow lawyering and wise counseling, between respecting client wishes and recognizing questionable clients? Law firm leaders must also take the initiative to join with like-minded general counsel in ensuring that major ongoing relationships, and the assignments that follow, include a request from the company that particular matters be viewed from a broad corporate perspective.

The excuse that firms don't see the whole company anymore is lame. There is a large amount of public information about corporations, if outside lawyers are willing to collect it and read it (without billing the time): from annual reports and proxy statements, to citizenship reports and Web sites, to analysts' reports and newspaper and magazine articles.

Lawyers can also do something that is supposed to be a core skill: Ask questions. Inside counsel say that too often outside lawyers are good talkers but poor listeners. Moreover, they sometimes find that high-powered partners are overcommitted and don't have the time or inclination to "learn the company."

Addressing the leadership issues is not a panacea for a profession transformed by cost-conscious legal departments and "business-model" law firms. But paying closer attention to these issues could help expand the distinguished group of outside counsel who still perform the wise counselor/guardian role so well.

—B.H.

In return for that trust, division counsel and line lawyers must keep the general counsel informed about serious concerns. These attorneys cannot hoard sensitive information, or overzealously guard their relationship with their respective business leaders. In my view, repeated failure of division counsel to discharge this obligation is a firing offense (we never had to fire anyone for this at GE). A recurring if not constant failure is cause for a compensation hit (this did happen at GE—but infrequently and primarily with inside lawyers whom I inherited when I arrived at GE and who were loyal to their P&L leader).

In short, the company general counsel is ultimately responsible for reconciling the partner-guardian tension all the way down in the legal organization. In nearly 20 years of hiring senior lawyers at GE, the purpose of my interviewing never changed. The final candidates were all superbly qualified. The issue for me was chemistry and character. Could they work well with the business leaders? Could I trust them to communicate honestly with me, and never forget that the good of the company—not their business unit nor their business leader—was their ultimate concern?

As general counsel, I had a strong "dotted" line to lawyers in the field working in the business divisions and could thus help ensure that trust by having a major role in decisions about their cash compensation, equity grants, and promotions.

The CEO and the Board. The CEO is, of course, central to successful resolution of the partner-guardian tension. Beyond unquestioned personal integrity, he must want to create a high performance–high integrity culture where most people do the right thing. This culture must constrain internal pressures for income, cash, and stock price increases, and external pressures from corrupt markets, demanding customers, and unscrupulous competitors. Employees will act in an ethical way not just because they fear being caught by the company compliance system, but because the business's reputation for integrity is so strong and because company values are so widely shared.

> **Credibility comes, in part, from a GC's character, experience, reputation, self-confidence, and the ability to explain issues forcefully, clearly, and concisely.**

The principles and practices essential to this type of culture are interrelated and complex.[1] But the CEO's *explicit* recognition and support of the dual partner-guardian role for the GC is critical. This endorsement should occur in the CEO's hiring conversation with the general counsel; as part of the CEO's statement of performance-with-integrity principles; and, if it is to be credible, by the CEO's actions in numerous meetings in tough circumstances with senior people. Most importantly, the CEO needs to hire a strong, independent, credible, and reputable general counsel whom the organization recognizes as a significant producer on the business side but also views as a provider of unvarnished advice and counsel on integrity issues.

Although it is Corporate Governance 101 that the board's most fundamental task is choosing and compensating the CEO, the spec has changed. Directors must now focus not just on the candidate's commercial skills, but on the capacity and commitment of the prospective CEO to create the performance-with-integrity culture.

The Boeing Company board's choice of James McNerney (formerly of 3M Company and General Electric Company) as CEO, after several high-visibility scandals, is a good example of hiring a person who can provide strong leadership—both in making the numbers and in creating an integrity culture. But focusing on the candidate's capabilities in each dimension should occur before the house is on fire.

As part of this most fundamental task, the board should also confirm that the CEO and the general counsel are on the same page with respect to the dual role, especially because the guardian function is performed ultimately for the corporation. The management and compensation committee should review the general counsel slate, with a board representative interviewing the final candidate—just as the board should be intimately involved in the selection of the outside auditor, the CFO, and the head of the internal audit staff.

Further, just as the outside auditors, the CFO, and the head of the audit staff regularly meet alone with the audit committee, the board, too, should mandate that the general counsel meets alone on a periodic basis with the audit committee (or the board as a whole). This regularly scheduled meeting avoids or at least minimizes erosion of the critical trust that must exist between CEO and GC. (A special ad hoc meeting requested by the GC would be out of the ordinary and could be seen by the CEO as a potentially disabling act of disloyalty.)

General counsel candidates must also do their own detailed diligence on the CEO and the board. The position of general counsel has changed dramatically over the past 20 years, but one caution remains the same. The greatest risk of being the top lawyer in a corporation is still primary dependence on one person, the CEO. A CEO who does not seek the ultimate goal of high performance with high integrity, and who does not clearly understand the dual role, is a clear-and-present danger for the general counsel.

Independence. The critical relationship of trust and respect between the CEO and the general counsel may never "take" or may become frayed. On difficult issues, the general counsel may be excluded or ignored. And, acting with courage and independence can, to be sure, risk one's job, reputation (being fired), and financial interests (deferred compensation, stock options, restricted stock units) that have not unconditionally vested. The nature and degree of a general counsel's independence is summarized in three model scenarios (the real-world cases can be much more complex).

- Company A has a good CEO and a good board (basically the conditions described above). The general counsel has to have credibility and guts because of inevitable pressures at the top of companies. But with a CEO who is committed to high performance with high integrity and with board support, the basic structure is in place for the top staff leaders (CFO, GC, and HR leader) to resolve the partner-guardian tension.
- Company B has a CEO who has personal problems or is providing poor leadership on integrity issues, but a good, independent board. In this circumstance, the general counsel can report to the board on illegal, questionable, or negligent acts when recourse to the CEO is not possible or fails. The board can begin its own investigation, probably aided by outside counsel.

And, if the relationship between the CEO and GC is beyond repair (the likely case), the board can work out a separation that fairly protects the GC's reputation and financial interests. (If the CEO has committed the bad acts, it is possible that he would go and the GC would survive, although this would be highly unusual.)

[1] For a detailed discussion of this issue, see: Ben W. Heineman, Jr., "Avoiding Integrity Land Mines: An Inside Look at How GE Has Worked to Build a Culture That Sustains Both High Performance and High Integrity," *Harvard Business Review* (April 2007).

■ Company C has a bad CEO and a bad board. The toughest case and ultimate test of the GC's character is when both the CEO and the board ignore a general counsel's report of serious illegality. In this situation, the law or the ethics rules in some jurisdictions *permit* the general counsel to report certain threatened or actual illegality to outside regulators. (See the New York City Bar task force report for discussion of the intricacies and ambiguities of the rules: www.nycbar.org/pdf/report/CORPORATE_GOVERNANCE06.pdf)

But, if both the CEO and board are unresponsive, neither SOX nor the ethical rules permit the general counsel to breach the attorney-client privilege and report to regulators on "questionable" matters (that are not threatened or actual illegalities, but are clearly unethical). Thus, in the bad CEO/bad board scenario, a resignation may well be necessary to protect the GC's personal reputation, even if that means sacrificing nonvested financial interests. It will not be possible to stay when the GC reports out material illegalities to regulators, or when the GC gets no response from the board or CEO on questionable matters that cannot be reported out under the rules.

However, in the first two scenarios (a good CEO and a good board, or a problematic CEO and a good board), general counsel can seek to reconcile the partner-guardian roles. A growing number of CEOs are acutely aware of the importance of fusing performance with integrity. And the number of independent boards, the ones that don't practice crony capitalism, is also increasing.

If we want companies to fuse high performance with high integrity, the place to begin—and to be most effective—is inside the company itself. Outside regulators and gatekeepers can never be as potent and preventative as internal governance on the front lines from the CEO on down. In his book, Professor Coffee's prescriptions focus on outside gatekeepers (including outside counsel), with virtually no attention to how GCs and other senior staff leaders can be effective. He might say that, in the first two scenarios, I have defined the problem of independence away. I would argue that I have defined the problem.

The governance debate should now focus, first and foremost, on the conditions, principles, and practices within the corporation that can achieve high performance with high integrity. General counsel with experience, skills, credibility, independence, guts, and reputation are key, because, as both Professor Coffee and the New York City Bar report recognize, they are positioned to play a pivotal role as guardians—and partners.

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