

11. Managing Legal Departments Through the Financial Crisis - A Joint View from an Internal and External Perspective

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Since the financial crisis has put tremendous pressure on the economy worldwide, companies have cracked the whip on costs and called on their general counsel to cast a harsh eye over all expenditures, specifically on costs for external legal advice. At the same time, legal departments faced an increased workload, such as handling relationships with clients in difficulties or covering refinancing needs, but also had to cope with new issues, be it intensified regulatory pressure, changing governance requirements or M&A opportunities with often distressed sellers.

Being thus pressured from two sides, legal departments had to prove their value, struggling more than ever to find the ideal balance between business and legal considerations and objectives in the delivery of their services, maintaining a continuous focus on good corporate governance and preserving the independence of their function to ensure appropriate checks and balances throughout their organizations, and, simultaneously, demonstrating that their services are effective, cost-efficient and transparent. An additional key element of success revolves around the relationship between external law firms and legal departments.

This article outlines the most important findings from the financial crisis' impact on legal departments and on their relationship with external law firms, and suggests approaches to optimizing the value to the organization of such relationship - in difficult market conditions as well as in times of economic recovery.

I. Core Mandate of the Legal Function

All functions within an organization may need to be modified or readjusted dynamically to reflect strategic or other changes of the business in an ever shifting economic environment. Generally, however, the core mandate of any function within an organization should remain untouched, particularly in recessionary times.

Key elements of the legal department's core mandate are to enable the business to achieve its economic and strategic goals in line with applicable laws and regulations, and to manage legal risks. Besides being a business partner and legal risk manager, another key component of a legal department's core mandate is being an independent governance function to ensure checks and balances throughout the organization and to provide ongoing strategic advice to the board of directors and the management in corporate governance matters as a guardian of the company's reputation. The diversity of these tasks illustrates the complex multifunctional scope of the legal department's core mandate. To cope with this requires the legal function to have appropriate structures and processes in place. The effective, cost-efficient and transparent management of the legal function is considered an integral part of its core mandate.

A "state of the art" legal department serves as a trusted and strategic partner of the business combining legal expertise with a broad business perspective to add value to the company by business-oriented legal advice¹⁾. If successful, general counsel become an integral and indispensable part of their

companies' management and success²⁾ and can integrate relevant legal considerations into the corporate strategy, proactively working in concert with all constituencies to make legal expertise a competitive advantage.

As a trusted business partner, the legal function also has the responsibility to identify, evaluate, manage and mitigate legal, regulatory and reputational risks. Only a close integration into the business enables a legal department to identify and anticipate legally relevant risks at the earliest stage possible³⁾ and to proactively minimize risk by targeted legal advice - ideally without hindering the relevant business projects as such.

Notwithstanding its responsibilities as a business partner and legal risk manager, the legal department remains an independent governance function within an organization's internal framework mandated to continuously ensure checks and balances throughout the organization in accordance with international corporate governance standards. Moreover, it raises awareness and advises the board and the management with regard to current and emerging best practices of corporate governance to optimize a company's public perception and overall success.

II. Responding to Challenges of the Financial Crisis

In a difficult economic environment it is paramount for all functions within an organization to focus on their core mandate and address the recurring, but even more importantly the new issues that arise and reallocate resources depending on the company's specific needs⁴⁾.

1. Shifting Priorities due to the Financial Crisis

a) *Optimizing the Legal Department's Integration into the Business*

In order to be able to provide business-centric legal advice in difficult conditions, the legal department must strive to further optimize its integration into the business and its networking with internal stakeholders to even better understand and anticipate their often changing needs⁵⁾. A crisis can be an opportunity to proactively improve the efficiency of internal processes, e.g. by intensifying the dialog⁶⁾ and cooperation with the business thus ensuring an early involvement of the legal function in new strategies and projects⁷⁾. Such enhanced business proximity facilitates a legal department's providing client-centric solutions to achieve desired business outcomes.

b) *Prioritizing Legal Risk Management*

The need to prioritize risk management is probably the most significant lesson learned from the recent financial markets crunch. Even if legal departments have not been charged in this respect, putting a special emphasis on and dedicating increasing resources to legal risk management is of fundamental importance. Today, a legal department has to support the enterprise-wide risk assessment process by a timely and precise communication of all legal risks identified and analyzed, and has to ensure the appropriate handling of legal risks at the management and board level.

The intensification of regulatory scrutiny and reform activity of regulators and legislators that resulted from the financial crises contributed to a significant increase of regulatory and legislative risk. Therefore, a key feature of successfully managing a legal department through a crisis is to track and analyze those often numerous national and international regulatory and legislative developments to enable the board and management to understand the reform movements' potential impact on the business. Ideally, the public and political debate is continuously followed so that regulatory and legislative reforms can be anticipated and prioritized to be prepared at an early stage and ensure sustained and enterprise-wide compliance⁸).

c) Special Focus on Good Corporate Governance

The financial crisis and its regulatory aftermath clarified the importance of a legal department's mandate as an independent governance function to continuously ensure checks and balances throughout the organization. In addition, with regard to the danger of growing employee misconduct in difficult economic surroundings, a high commitment to corporate responsibility⁹) and a culture of integrity is indispensable. Simultaneously, the legal department is mandated to follow developments and trends in the area of corporate governance to advise the board and management in a timely, prudent and forward-looking manner. There are a variety of corporate governance issues, such as the composition of the board and the evolving role of non-executive directors, the balance of powers between the supervisory function and the management, or board oversight regarding enterprise-wide risk management, which gained importance in the public debate triggered by the financial crisis. Since prudent strategic advice on how to best deal with such crisis-driven challenges is crucial not only for a company's public image but also for a company's overall success, the legal department's effective involvement in this area can make a significant contribution to increasing shareholder value¹⁰).

d) New Challenges

A business will always face new issues in a crisis, although the nature of these issues may vary depending on the sector involved. Relationships between a company and its customers and suppliers can become more difficult, requiring material changes in the contractual relationship, e.g. regarding payment terms¹¹). Other new issues often relate to the capital structure of a company, such as the need for new equity, new forms of financing such as hybrid loans or the necessity to renegotiate loan covenants. If a company is in good financial shape, it might profit from the crisis by acquiring competitors in financial difficulties.

e) Cost Control and Transparency

Last but not least, a challenging economic environment requires all functions to focus on cost-efficiency, cost control and transparency. The crisis reinforced the notion that general counsel are expected to manage their function according to the same business principles as applied elsewhere in an organization, and are required to provide transparency with regard to their function's value added to the company which can also include benchmarking cost-efficiency externally¹²). Such analysis and constraints might necessitate a shift in priorities or a reallocation of resources but the overall goal of the legal department must remain the delivery of the best quality legal advice.

2. The Role of External Legal Advisors in this Environment

Many of the roles of a legal department described above cannot be outsourced to external law firms who generally lack the in-depth business know-how so important to provide business-centric advice. However, if carefully selected, external law firms can play an important role in providing an outside view and experienced advice regarding actions taken by

other clients in similar situations¹³). More generally, external legal advice is sought where the value added to the client is - considering the higher cost of external advice - bigger than what the legal function can provide, be it that the issues are non-recurring and thus not cost-effective to build the relevant know-how internally, be it that the legal department lacks the resources because it focuses on areas which cannot be outsourced to external law firms.

3. Optimizing Cooperation with External Law Firms

In the United States as well as in Europe, the enormous pressure on legal departments to deal with budget cuts, hiring freezes and, simultaneously, increasing work loads in existing and new areas has impacted and tested the relationship between them and external law firms. The crisis revealed the value of long-standing and trusted institutionalized relationships with law firms which know the company and its business well and provide legal advice of highest quality, particularly with regard to long-term issues and tail-risks.

Not surprisingly, the economic downturn caused many companies to reduce the amount of legal work sent to external law firms due to budget constraints¹⁴) which made it again more important to carefully consider which questions can be addressed with internal know-how and which legal matters are better or more efficiently dealt with by external counsel¹⁵). For those matters sent to outside counsel, it is crucial to focus on selecting the right firm for a given issue to ensure a maximum value from the engagement. Simultaneously, a legal department is required to be able to efficiently manage external counsel and to control which costs are generated by which external services¹⁶).

As outlined above, a legal counsel - whether in-house or external - must provide a precise, mindful and business-oriented legal analysis based on profound knowledge of the company and its business, its management and the relevant facts so as to create a solid foundation for sound business decisions¹⁷). Legal counsel need to be able to recommend certain business decisions based on their experience and analysis of the relevant business facts and after considering all legal risks involved. Solid advice will not just highlight legal concerns (as it is often done) but must show how to handle remaining uncertainties and doubts, and foster corporate decision-making.

Budget constraints also impacted billing methods and fee rates of law firms. First and foremost, the crisis pushed companies to scrutinize invoices more than before and to negotiate discounts or alternative fee arrangements such as volume discounts, or capped or flat fees. Further, the financial crisis provided an opportunity for general counsel not only to progressively (re)negotiate rates but also to set up billing guidelines¹⁸). This development is likely to have an impact on law firms as well over time, possibly reducing the leverage with which the firms operate, and putting more emphasis on partner time actually spent on client work.

Besides these financial aspects, general client-centricity gained increasing importance. Legal departments are looking for additional services from their preferred law firms such as regular newsletters and e-mail updates on new regulatory and legislative developments¹⁹), unbilled telephone advice or a certain number of free 30-minute phone calls, tailored seminars and workshops, regular relationship management meetings, secondments in both directions and other gestures of goodwill. These prepare the ground for a successful cooperation to help both partners gain familiarity with the business of the other and insight into their respective strengths and weaknesses.

III. Outlook

The crisis revealed that the legal department's effective delivery of quality legal services in each of its multiple roles as a "business enabler", a legal risk manager, a strategic advisor, and a provider of an independent governance function ensuring appropriate checks and balances throughout the organization, is key to its long-term success. At the same time, the effective, cost-efficient and transparent management of a legal department are significant factors in determining the function's performance in business terms. With regard to the cooperation between legal departments and external law firms, the cost pressure and modified client needs force law firms to rethink part of their business, giving increasing attention to cost-efficiency, client-centricity and the ability to provide truly business-oriented advice. To successfully manage these challenges requires a joint approach of intensified cooperation between in-house and external counsel – a partnering up for the benefit of both sides which will prove its value also in times of economic recovery.

- 1) See *Lataille, Nancie/Kilby, Gabriella*, *The Legal Function Transformed: Best Practices Of Today's General Counsel*, The Korn/Ferry Institute, 2008, 1 (2). The continuous focus to best serve its internal clients and stakeholders characterizes a legal function as one composed of business partners combining legal expertise with a broad business perspective and thus countervails the perception of a legal department as a mere "cost center". See also *Kübler, Philip*, *Leistung und Leitung von Unternehmensjuristen - Harte und weiche Faktoren zwischen Management und Recht -*, GesKR 4/2007, 335 et seq.
- 2) See *Duclos, Pascal*, *The Strategic Role of Today's General Counsel*, GesKR 3/2009, 293. With regard to the significant changes of the role of general counsel during the last decades, see *Frick, Hans-Peter*, *General Counsel: Ein Berufsbild im Wandel*, GesKR 2-3/2006, 91, and *DeMott, Deborah*, *The Discrete Roles of General Counsel*, *Fordham Law Review*, vol. 74, December 2005 (Duke Law School Legal Studies Paper No. 79).
- 3) In this regard, see also *Emch, Thomas*, *Der General Counsel als Risk Manager*, GesKR 2/2008, 95.
- 4) Covering these new needs might also necessitate to buy certain services from external providers or to outsource certain functions to them in order to be able to focus on particular issues.
- 5) See also *Duclos, Pascal*, *supra* note 3, 293 (294 et seq.), who sees the general counsel as provider of "preventive law".
- 6) A culture of open communication is the strongest form of governance that exists to avoid potential tension between the legal function and the business that it serves. See *Rodgers, Diane*, *Managing an International Legal Department*, *International In-house Counsel Journal*, Insurance Edition 2010, 79 (84).
- 7) Progressive organizations are using the legal function on a proactive basis, integrating it into every aspect of the business. See *Lataille, Nancie/Kilby, Gabriella*, *supra* note 2, 1 (11).
- 8) One example illustrating the rapidly changing regulatory landscape of the financial services sector is the ongoing debate on how to optimize corporate governance structures with regard to executive compensation. Since flawed executive pay structures are considered to have contributed to the financial crisis by encouraging short-term risk-taking at the expense of long-term security, remuneration systems are re-evaluated at a national, European and international level. The continuously evolving scale of relevant regulatory and legislative reform initiatives of regulators and international institutions such as the Financial Stability Board, the complexity and varying interconnectedness of these reforms presents a new and significant challenge, specifically for globally operating companies, to effectively track and manage such regulatory changes. For an in-depth analysis of internationally changing remuneration systems in Europe and the United States due to the financial crisis see *Hausmann, Yannick/Bechtold-Orth, Elisabeth*, *Changing Remuneration Systems in Europe and the United States in the Wake of the Financial Crisis*, EBOR, vol. 11/2010.

- 9) In the context of corporate responsibility, see also *Watter, Rolf/Spillmann, Till*, *Corporate Social Responsibility – Leitplanken für den Verwaltungsrat Schweizerischer Aktiengesellschaften*, GesKR 2-3/2006, 94.
- 10) See also the OECD's Key Findings on "Corporate Governance and the Financial Crisis" as of June 2009, according to which particularly four areas of corporate governance (remuneration/incentive systems, risk management practices, the performance of boards and the exercise of shareholder rights) are considered closely linked to recent failures contributing to the financial crisis.
- 11) In certain cases, the relationship needs to be restructured in a way to ensure the continuation of the relationship even in the case of the counterparty's bankruptcy.
- 12) While it will always be difficult to measure the value and cost-efficiency of a legal department as a business partner and strategic advisor in business terms on the basis of clearly defined key performance indicators, e. g. in the area of corporate governance, there are standard tasks and processes such as legal support of transactions in the area of finance and M&A, which allow, at least to a certain degree, a measurement of the added value and efficiency of in-house services as compared to the corresponding services of an external law firm. With regard to the performance of those advisory activities which are difficult to measure in business terms, the perception by the business and internal stakeholders is of significant importance to evaluate performance. Moreover, particularly in the area of corporate governance, the quality of strategic legal advice can be partly measured ex ante as regards to compliance with existing international standards of corporate governance. The added value of the effective provision of checks and balances, however, is a type of performance, which can be evaluated only from an ex-post perspective.
- 13) Even more important is their role in areas where the legal department could not build the know-how in pre-crisis times and lacks the resources to do so once the crises hits.
- 14) Notwithstanding this pressure, cost cutting should never be made at the expense of the quality of legal advice.
- 15) Such an assessment does not question whether or not to provide certain legal services in-house (in terms of the traditional question "Make or Buy?") but envisages a prudent decision, which services should be outsourced, for the sake of efficiency, and which legal matters can best be dealt with by the in-house legal services (e.g. due to better corporate insight and specific know-how). Frequently, the line between legal work to be dealt with in-house or to be outsourced will be drawn along a company's core business.
- 16) This includes the avoidance of billing for services or for additional lawyers which were not requested or needed. With regard to the danger of "overlawyering", see *Frick, Hans-Peter*, *supra* note 3, 91 (92).
- 17) See also *Kübler, Philip*, *supra* note 2, 335 (336, 339).
- 18) Such billing guidelines may contain, for example, an obligation of external counsel to approach the legal department upon reaching three-fourth of the budget.
- 19) Specifically with regard to the tracking and analyzing of regulatory and legislative developments potentially relevant for the company's business model.

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