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812 Companies in Crisis: Ethical Issues Faced by Boards and Their Counsel

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Faculty Biographies

James M. Lord

James M. Lord is an assistant US attorney in Seattle. He is currently serving as the coordinator of the corporate fraud task force and as a computer hacking and intellectual property attorney. In these roles, Mr. Lord manages the multi-agency corporate fraud task force; overseeing and directing corporate fraud, securities fraud, cybercrime, intellectual property, health care fraud, and money laundering investigations and prosecutions; and conducting civil False Claims Act investigations.

Mr. Lord has supervised and managed over 300 complex multi-agency investigations and prosecutions; prosecuted over thirty federal cases resulting in jury trials and obtained convictions in all but one of those cases; interviewed witnesses and analyzed voluminous business and financial records in preparation for indictment and trial; provided legal guidance and training to law enforcement; coordinated prosecutions with other United States Attorney's Offices, the Department of Justice, and foreign governments; and worked closely with foreign investigators, prosecutors, and government officials in obtaining foreign evidence.

Mr. Lord also has experience as an associate attorney with Phillips, Hinchey & Reid in Atlanta, where he represented corporations in construction litigation matters, including preparing and filing complaints, motions, and other civil pleadings; propounding and responding to written discovery; taking and defending depositions; participating in arbitrations and mediations; and drafting commercial construction contracts.

Mr. Lord received a BA, cum laude, from Vanderbilt University and is a graduate of the Vanderbilt University School of Law.

Michael P. McCloskey

Michael P. McCloskey is chair of the litigation practice with Foley & Lardner LLP in the firm's San Diego office. He is a partner in Foley's securities litigation, enforcement, and regulation; white-collar defense and corporate compliance; and general commercial litigation practices. Mr. McCloskey's practice focuses on complex commercial matters involving federal securities fraud, state and federal derivative actions, and anticompetitive business practice claims. He defends publicly traded corporations and their officers and directors before the SEC and in major securities class actions. Mr. McCloskey also advises his clients on corporate governance measures and best business practices to minimize litigation risk.

Mr. McCloskey retired as a colonel in the Marine Corps Reserves with 30 years of service. Before his civilian practice, he spent six years prosecuting criminal cases and defending the Department of Navy and the Secretary of the Navy in federal district courts and circuit courts of appeal.

Mr. McCloskey received a BS, cum laude, from the University of Southern California and is a graduate of McGeorge School of Law, University of the Pacific, where he was a staff writer and managing editor for the *Pacific Law Journal*.

Companies in Crisis: Ethical Issues Faced by Boards and Their Counsel

Michael P. McCloskey

Question #1

- You are advised of significant misrepresentations in a prior SEC filing. What do you say?

Sarbanes-Oxley Act

- Adopted in 2002, it required the SEC to adopt, by February 2003, rules requiring attorneys to internally report material violation of securities laws
- SEC adopted SEC Rule 205 (17 C.F.R. Part 205), effective February 6, 2003

SEC Rule 205

- In-house attorney who becomes aware of a material violation of any federal or state securities law by his employer or any of its officers, directors, employees, or agents, has a duty to report such violation to the Chief Legal Officer (CLO) or both the CLO and the Chief Executive Officer (CEO)

SEC Rule 205

- Attorneys working for publicly traded companies or their wholly-owned subsidiaries are subject to SEC Rule 205

SEC Rule 205

- CLO must conduct an investigation of allegation, or refer to a qualified legal compliance committee
- CLO must advise reporting attorney of determination on legitimacy of allegation

SEC Rule 205

- If reporter is unsatisfied with response, he/she must report allegation to the employer's audit committee or its board of directors
- If still unsatisfied, reporter must provide statement of reasons why he/she believes company has not adequately responded to the allegation to the CLO, CEO, or board

SEC Rule 205

- Attorney who fails to comply with Rule 205 is subject to civil penalties, and disciplinary action by the SEC that can result in censure or revocation of right to practice before the SEC

SEC Rule 205

- Not a breach of client confidentiality to:
  - Use evidence of reporting in any investigation, proceeding or litigation in which compliance with Rule 205 is in issue
  - Advise SEC of material violation if it is likely to cause substantial injury to investors, or if company or employers are engaging in perjury or fraud in an SEC investigation

Confidentiality Ethical Rules

- Traditionally, disclosure limited to:
  - Preventing a crime
  - Death or substantial bodily harm
  - Protect lawyer in claims by client or criminal prosecutions
- Model rules amended to allow disclosure to comply with "other law" or a court order
- Some states (e.g., CA, FL) have not expanded exemption to include other compliance laws

Question #2

- You lose your job after you are advised of significant misrepresentations in a prior SEC filing and raise an objection under SEC Role 205. What do you do?

SEC Rule 205

- Reporting attorney who believes he/she was terminated because of reporting can notify the company board of suspicion

Sarbanes-Oxley Act

- Provides a private cause of action to anyone discharged, demoted, or otherwise impacted in their employment because of information provided to a federal regulator, law enforcement office or to a supervisor. 18 U.S.C. § 1514A

Other Claims for Retaliatory Discharge

- CA: recognizes general right of in-house counsel to pursue claims for retaliatory discharge. *General Dynamics Corp. v. Superior Court (San Bernardino)*, 7 Cal. 4th 1164 (1994)
- Other state courts — e.g., IL and TX — disagree, finding a broad public policy permitting client to discharge counsel with or without cause

Boards in Times of Crisis and Uncertainty

Lauren Neiswender

Boards in Times of Crisis and Uncertainty

- The financial markets and the financial well-being of companies around the world have changed dramatically in the last few months
- The financial crisis has spread beyond companies directly involved in sub-prime mortgages, and directors may have heightened concerns about their duties, role, and obligations in this rapidly changing world
  - In-house counsel plays an important role in helping boards understand their fiduciary obligations to the company and its shareholders
- Even in the most uncertain of times, fundamentals of directorship continue to apply
- Directors must responsibly oversee company affairs and the business judgment rule remains the standard for judicial review
  - It is the responsibility of the directors to oversee the affairs of the company and it is management's job to run the day-to-day business of the company
  - The degree of vigilance may change depending on the circumstances

The Business Judgment Rule

- The business judgment rule is a well-established standard of judicial review to encourage innovation and risk-taking by the board
- Under the business judgment rule, courts defer to the decisions of disinterested directors, absent evidence, that the directors did not act in good faith or were not reasonably informed, or that there is no rational business purpose for the decision that promotes the interests of the company or its shareholders
- The business judgment rule is not a duty, but is a defense to a claim of breach of duty
- In times of economic stress, directors must often make difficult choices – these choices must be guided, at all times, by their duties to the company and its shareholders

Loyalty

- Duty to give higher priority to corporate interests than to his /her personal interests
- *Conflict of Interest.* Directors should identify all potential conflicts that impair, or create the appearance of impairing, the ability of a director to discharge his duty of loyalty to shareholders
  - a compensatory, financial, professional or business relationship, or
  - a significant social, personal or family tie
- *Corporate Opportunity.* Directors may not use their strategic position for their own advantage to the exclusion or detriment of the company they represent.
- *Confidentiality.* The duty to keep company information confidential. Under the NYSE listing standards, listed companies must address the duty of confidentiality in their code of ethics.

Good Faith

- Most likely not an independent duty, but is a “subsidiary element” of the duty of loyalty
- The duty of good faith requires that directors act honestly, in the best interest of the corporation, and in a manner that is not knowingly unlawful or contrary to public policy
- Like a duty of care analysis, such review likely will focus on the process by which the board reached the decision under review

Candor

- DE courts have articulated a duty of candor that derives from the duty of loyalty and the duty of care
- Calls on directors to disclose to their fellow directors and the company’s shareholders all information that is relevant to them that is relevant to the decision under consideration

Care

- Directors must act diligently and with the level of due care appropriate to the particular situation
- According to the American Bar Association's Corporate Director's Handbook, directors should take the following actions to meet their duty of care:
  - committing time and regularly attending meetings
  - being adequately informed
  - relying on others in appropriate circumstances

Board Focus in Times of Crisis and Uncertainty

During market uncertainty, there are five main areas on which directors should focus their attention:

1) The state of the company’s business
2) The quality and depth of management
3) The company’s liquidity
4) The company’s risk profile
5) Ethics and integrity

#1—The State of the Company's Business

- In crisis and uncertainty, it is important to assess and question the sustainability and adaptability of the company's business model
- Focus should be on making sure the board fully and completely understands:
  - How revenue is generated
  - Operating costs – labor, costs of goods sold, and selling, general and administrative expenses
  - Business levers
  - The company's products, industry, and suppliers
  - Competition
- The board with management should run various business scenarios
  - Negative, flat and positive growth
  - Loss of key customers or suppliers
  - M&A
  - Sustained economic crisis
  - Loss of financing/credit

#2—The Quality and Depth of Management

- The board has an obligation to make sure senior management has experience, expertise, commitment, leadership ability, and depth
- Especially in times of crisis, the strength of the management is critical
- The board should feel confident that management is managing through the crisis (not sticking its head in the sand)
  - Rapid response
  - Good judgment
  - Communication with the board
- Adequate succession planning is a key function of the board
- Directors should be aware of information or decisions by management that may be "red flags" or those that seem "odd", inconsistent, or are not supported by the facts and circumstances
  - Remember Worldcom. The special committee found that the board and its committees "did not function in a way that made it likely that they would notice red flags" and "were distant and detached from the workings of the company."

#3—Liquidity

- Liquidity is important in a crisis
- The board should assess the company's current and projected cash flow
  - Seasonality
  - Forecast assumptions
- Management should actively monitor and manage the company's cash, and should report its cash management and investment policies to the board (or the audit committee of the board)
  - In light of recent events, it is critical for management to stay in close contact with all financial institutions where cash is invested and report such communications with the board
  - The company's investments should be closely monitored and should be re-evaluated in light of the current economic environment
- The board should understand the company's credit arrangements and any existing financial covenants
  - Is the company at risk of failing to meet financial obligations

#4—The Company's Risk Profile

- The board should – whether director or through the audit committee – review whether management has adopted and implemented proper risk assessment and risk management policies and procedures
- This risk assessment should be reviewed in light of the rapidly changing financial markets
  - New risks
    - Are customers, suppliers, products at risk?
    - What are the risks in a sustained economic down-turn
  - Mitigation strategies
    - Are there ways to mitigate or prevent a crisis
- When reviewing the company's risk matrix, it is important for boards to question how the company calculates and identifies risk
  - Is management ignoring risks or under pricing risks?

#5—Ethics and Integrity

- As a result of Sarbanes-Oxley's mandate to the U.S. Sentencing Commission, directors and senior executives assume greater responsibilities to ensure the existence of effective compliance and ethics programs. Directors and officers must:
  - Exercise due diligence to prevent and detect criminal conduct
  - Promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law

- The board must insist on good governance practices, transparency and an appropriate "tone at the top" where management acts in accordance with the highest levels of ethics and integrity
  - The tone at the top shapes corporate culture and permeates the company's relationship with investors, employees, customers, suppliers, and the community at -large
  - The CEO and senior management must be personally committed to high ethical standards, principles of fair dealing, full compliance with legal requirements and resistance to Wall Street pressures for short-term results

- Companies should assess their internal ethics compliance program, communicate with the board on their program, and should report violations of the Code of Ethics when appropriate

- SEC rules require a code of ethics in public companies to be a written standard that is "reasonably designed to deter wrongdoing and to promote:
  - Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships
  - Full, fair, accurate, timely and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant
  - Compliance with applicable governmental laws, rules, and regulations
  - Accountability for adherence to the code

When Ethical Issues Lead to Even More Serious Problems

JAMES M. LORD

*Nothing in this PowerPoint presentation should be construed as the official position of the U.S. Department of Justice, but rather reflects the personal views of the speaker

The President's Corporate Fraud Task Force ("CFTF")

- Established in July 2002 to investigate corporate fraud matters
- Members include the Deputy Attorney General, several U.S. Attorneys, and the heads of various departments and commissions
- The CFTF has brought charges for accounting fraud, insider trading, market manipulation, wire fraud, the FCPA, money laundering, and obstruction of justice
- Since 2002, the CFTF has obtained over 1200 corporate fraud convictions

What Constitutes an Effective Compliance Program?

- Corporate culture encourages ethical conduct
- Chief Compliance Officer (CCO) reports to Board
- CCO has sufficient authority and resources
- Executives and directors ensure effectiveness
- Due diligence to prevent and detect violations
- Effective training
- Anonymous reporting and no retaliation
- Periodic evaluation and modifications

What Can Company Do to Keep from Becoming Focus of CFTF?

- Have a culture committed to ethics and compliance with the law
  - Tone must be set at the top
- Make business decisions consistent with a corporate culture of ethics and compliance
- Develop, implement, and maintain an effective and robust compliance program

Role of Executives in Compliance

- Be a good role model
- Foster a culture of compliance
- Insist on compliance
- Actively support the program
- Implement the program fully
- Adequately fund the program
- Keep Board apprised

Role of Directors in Compliance

- Directors owe "duty of good faith" to corporation in oversight of program (*In re Caremark*)
- Board should define the scope of the program
- Board should approve key policies and procedures
- Board should require periodic reporting on compliance matters

DOJ's Corporate Prosecution Principles

- In evaluating a compliance program, the critical factors examined by DOJ include:
  - Whether adequate corporate governance mechanisms exist to effectively detect or prevent misconduct
    - Whether the Directors exercise independent review over proposed actions rather than unquestioningly ratifying officers' recommendations
    - Whether internal audit functions are conducted at a level sufficient to ensure their independence and accuracy
    - Whether there is an information/reporting system reasonably designed to provide management and directors with sufficient timely and accurate information to reach an informed decision

Corporate Prosecution Principles (continued)

- Whether a program is adequately designed for maximum effectiveness in preventing/detecting wrongdoing
- Whether management is enforcing the program or is tacitly encouraging/pressuring employees to engage in misconduct to achieve business objectives
- Whether the corporation has a staff sufficient to audit, document, analyze, and utilize the results of the corporation's compliance efforts
- Whether the corporation's employees are adequately informed about the program and convinced of the corporation's commitment to it

What Should a Company do if it Discovers a Violation or if the CFTF Knocks on its Door?

- Engage in a rapid fire response
- Initiate an internal investigation
- Strongly consider self-reporting the violation
- Contact the DOJ attorney assigned to investigation
- Offer full and complete cooperation
- At a minimum, cooperation should include:
  - Disclosing all relevant facts
  - Producing all non-privileged documents
  - Making key witnesses available

Obstructing the Investigation

- Purporting to cooperate, while in reality impeding the investigation is worse than not cooperating at all
- Examples of obstructive conduct:
  - Overbroad or frivolous assertions of the attorney client or work product privileges
  - Directions to employees not to cooperate
  - Misleading presentations or submissions
  - Failure to disclose illegal conduct known to company

Conclusion

- No matter what the issue, always act ethically and consistent with a culture of compliance
- As Warren Buffet said: “It takes 20 years to build a reputation and five minutes to ruin it”
- Nothing is worth damaging your reputation or, worse yet, jeopardizing your financial livelihood and your liberty
- Rather than just meeting the lowest compliance bar, strive toward best practices
- The GC, CCO, and the Directors are the gatekeepers responsible for ensuring that this higher standard is met

LESSONS LEARNED THE HARD WAY

Ten Flags of Possible Financial Mismanagement and Fraud

BY DEBORAH M. HOUSE

"History is a guide to navigation in perilous times."

—David McCulloch, author and historian

"Those who cannot remember the past are condemned to repeat it."

—George Santayana, author and philosopher

As CHIEF LEGAL OFFICERS (CLOs) watch the corporate financial debacles that ushered in this century and continue today, a silent prayer can nearly be heard: "Please. Not here. Not on my watch." For a very small few, such a request is about not getting caught. But for the vast majority, it is probably wishful thinking, closely linked to a silent admission that they do not really understand the CFO's complicated, green-eyeshade world.

Unquestionably, today's in-house counsel must have a greater knowledge of the accounting rules that affect the company. As Stasia Kelly, ACC board member, general counsel of American International Group, Inc., and former general counsel of MCI, Sears, and Fannie Mae advises: "Ten years ago, I would read an earnings release and trust that the CFO and the accounting folks knew what they were doing. Now, I make sure that I understand all the accounting items in the release, and I ask the questions: Are the one-time events truly one-time events? Are the reserve releases appropriate? Is there an earnings management issue?"[1]

This advice is well taken. However, the need for new expertise does not necessarily mean a return to school to acquire an accounting degree. There is much to be learned from examining history, including the publicly available reports of major corporate financial disasters (Independent Reports).[2] Lessons taken from these experiences instruct us on how to navigate in these perilous times and avoid repeating the past. Find out how to flag the activities that will alert us to potential dangerous waters ahead.[3]

The Stakes Are Too High

Wait a minute, you say. Don't in-house counsel already have enough on their plate? Must we have accounting expertise as well? Shouldn't accounting be left to the accountants? Won't increased knowledge subject me to increased liability? The answers to these questions, respectively, are:

1. You bet!
2. Afraid so.
3. No, it's like leaving war solely to the generals; scary to contemplate.
4. Perhaps, but it will also give you an opportunity to significantly decrease your liability by addressing these issues. The ostrich approach simply does not work well.

When a company goes under for financial mismanagement or fraud, or even if it survives, the human toll is significant. For a significant number of shareholders—many of whom are employees—retirement nest eggs disappear, college savings collapse, and mortgages go unpaid. Employees who have absolutely nothing to do with the financial misdeeds suffer the loss of their jobs or disruptive relocations, and humiliation by association. Those who may or may not have responsibility are the subject of extensive regulatory inquiry and may even be prosecuted.

The company itself fares no better. Even if it does not completely collapse, the practical impact of financial mismanagement—for good or for bad, deserved or undeserved—may be extreme. The corporation's reputation takes a nosedive. The stock plummets and languishes. Managers are replaced in droves. Internal reorganizations run rampant. A severe brain drain occurs as faulted and faultless long-time employees—involuntarily or voluntarily—leave the company for greener pastures. An army of independent investigators descends, and the sky is darkened with consultants who recalculate the company's numbers and redo its policies and systems. All of them bill by the hour in amounts that shock and cause a severe drain on the corporate treasury.[4]

Time previously spent by employees actually doing the work of the company is now focused on responding to investigators, regulators, consultants, plaintiffs, and prosecutors. For some, standing around the water cooler contemplating the company's gloomy outlook may become the favorite pastime. Other employees ruin their health and/or their home life working 24/7 to pull the company back up by its tattered bootstraps.

In-house counsel are not immune to any of this, as they too are shareholders and employees. For some, the price has been even higher. Their reputations are besmirched and they suddenly may find themselves in the deponent chair at the deposition table.

In-house Counsel Have Much to Contribute

The good news is that in-house counsel are well situated to address important aspects of many accounting matters.

- We are often able to see the big picture by having a vantage point that defies traditional corporate silos.
- Many of the factors underlying improper financial management belong to both the legal and the accounting worlds (e.g., what constitutes materiality, whether a conflict of interest exists, or whether risk has passed in a sale of assets).

- The CLO continues to play a significant role in corporate compliance, acting either as the chief compliance officer (CCO), as supervisor for the CCO, or as counsel to the compliance function. This is important because establishing and maintaining a corporate culture committed to compliance, providing compliance training, and monitoring for compliance—tasks often spearheaded by the CCO—are essential to avoiding financial mismanagement and fraud.
- The CLO often manages or participates in relationships relevant to proper financial management, including interaction with the SEC, other regulators, auditors, and the board's audit committee.
- Many transactions used as the tools to perpetrate accounting fraud cannot be accomplished without the participation or acquiescence of in-house counsel (e.g., establishing special-purpose entities that are used to move debt off the balance sheet). Where these transactions are structured and papered by outside counsel, in-house counsel are likely to be managing and consulting with them.
- In-house counsel understand how to establish rules, processes, and systems, combined with the overall corporate knowledge that helps assure compliance. In the post-Sarbanes world, these are essential talents.
- Because in-house counsel regularly deal with the ambiguities attendant to interpreting and applying the law, they may have a greater level of comfort raising questions about accounting concepts that also are not black and white.

To date, the role played by lawyers has gotten some bad

A company that **does not** have a culture committed to **compliance** just **"talks the talk,"** it doesn't **"walk the walk."**

As Stephen Cutler, former director of the SEC's Division of Enforcement, observed, "We have seen too many lawyers who twisted themselves into pretzels to accommodate the wishes of company management and failed to insist that their company comply with the law."

Perhaps this image could be transformed for the better if, as lawyer and statesman Elihu Root suggested, in-house counsel would tell their clients "they are damned fools and should stop."[5] Granted the message should be delivered a little more diplomatically, but certainly to the same effect if required. And required it may be—if your company is engaging in activities that may set the scene for or actually constitute financial mismanagement or fraud.

The Ten Flags

An examination of the Independent Reports reveals that companies who are alleged to have engaged in financial mismanagement and/or fraud evidence multiples of the following attributes in their operations and activities. Spotting one or more of these characteristics is certainly not determinative of possible mismanagement or fraud. However, they do serve as warning flags that should cause you to be alert.

1. The company does not have a culture committed to ethical conduct and compliance with the law.

The US Sentencing Commission was created in 1985 for the purpose of developing sentencing guidelines (Guidelines) to assure that comparable misconduct by similar offenders received similar sentences. Organizations are given a sentencing credit if they have an effective ethics and compliance program (Program). However, the Guidelines are not just about sentencing; they also serve as a benchmark for prosecutors and regulators in determining whether they are going to take action against a company.

Under the Guidelines, an effective Program "promotes an organizational culture that encourages ethical conduct and a commitment to compliance with the law. . ."[6] The Advisory Group recommending the 2004 revisions to the Guidelines stated that an appropriate organizational culture:

> *. . . is one in which compliance with the law is the expected behavior. Rather than solely emphasizing conduct restrictions and information gathering activities aimed at preventing and detecting violations of law, an organizational culture that encourages a commitment to compliance with the law also includes positive actions which demonstrate that law compliance is a key value within the organization. In general, organizational culture, in this context, has come to be defined as the shared set of norms and beliefs that guide individual and organizational behavior. These norms and beliefs are shaped by the leadership of the organization, are often expressed as shared values or guiding principles, and are reinforced by various systems and procedures throughout the organization.*[7]

Companies that allegedly engage in financial mismanagement or fraud do not have an appropriate corporate culture. This could be evidenced by the lack of an "open working environment," meaning that employees do not have opportunities to raise issues of concern and do not feel free to do so; employees justifiably fear retaliation, and retaliation is tolerated. Another attribute is the uneven application of the company's standards and procedures among the rank-and-file employees and senior management. Executives at these companies may enter into transactions and use corporate assets in a way that conflicts with the company's best interests, violates its standards of conduct, and generously lines their own pockets.

Another common attribute cited in the Independent Reports are arrogant CEOs (and CFOs) who portray a sense of entitlement and tend to "reign" rather than preside over the company's activities, who engage in strategies designed to tightly control the information provided to the board and limit its oversight, and who are not open to good-faith consideration of the views of others, including their own senior management. A company that does not have a culture committed to compliance just "talks the talk," it doesn't "walk the walk." Enron had the corporate slogan of "Respect, Integrity, Community, Excellence." Enough said.

In fact, rather than having a culture committed to compliance, the companies reviewed in the Independent Reports had the antithesis. They had financially driven cultures. Among the cultures cited were those committed to steady or double-digit earnings, consistently meeting Wall Street expectations, or constantly hitting targets that triggered lucrative executive compensation. Sometimes the culture had a mix of all of these characteristics.

2. The company is engaging in inappropriate earnings management.

Unquestionably the application of generally accepted accounting principles (GAAP) allows companies a great deal of flexibility in calculating earnings and other items of financial information. There are numerous legitimate variables in how companies value their accounts (e.g., is it collectible? when is it collectible?), their inventory (e.g., which cost valuation method to use? has the value changed, given new consumer tastes?), their assets (e.g., which depreciation method should be used? what is its useful life? what is the conversion rate for foreign cash?), and even their liabilities (e.g., what will happen to interest rates? what is the possibility of a plaintiff's success in a lawsuit?) Moreover, the line between treating an item as an asset or a liability, for example, can be razor thin.

However, quality financial information should reflect economic reality. When a company manipulates its financial information so that it achieves a desired target to the detriment of economic reality, that constitutes inappropriate earnings management and potentially constitutes fraud.[8] An example of such an activity would be WorldCom's alleged improper capitalization of operating expenses with the intended resultant effect of increasing its earnings per share to meet analysts' expectations.[9]

The questionable practice of inappropriate earnings management was highlighted as early as 1998 by then SEC Chairman Arthur Levitt, who warned that:

> *[Earnings management] has evolved over the years into what best can be characterized as a game among market participants. A game that, if not addressed soon, will have adverse consequences for America's financial reporting system. . . Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. . . . Managing may be giving way to manipulation; Integrity may be losing out to illusion.*[10]

Inappropriate earnings management has its genesis in the pressure placed on companies to meet Wall Street's projections. Because these projections are based in part on information provided by the companies themselves, meeting them not only speaks to the value of the company's shares, but the company's credibility as well. And the stakes are very high. Levitt cites an incident where a company's failure to "meet its numbers" **by one penny** resulted in a loss of 6 percent of its stock value in one day.

What form may inappropriate earnings management take? The Independent Reports, Levitt, other experts,[11] and the SEC[12] cite a significant number of approaches that are inappropriate if engaged in for improper reasons (e.g., meeting analysts' expectations, triggering executive compensation) and if not reflecting financial reality. They include:

- **Big Bath Charges:** Companies significantly restructure themselves with the intent of cleaning up their balance sheet. Sometimes the cost of such an effort is intentionally overestimated, and this cushioning subsequently becomes income when estimates change or earnings fall short. Analysts tend to treat the "big bath" as a one-time event and focus on future earnings.
- **Creative Acquisition Accounting:** Companies classify a portion of an acquisition cost as "in-process" research and development so that the amount can be written off in a one-time charge, removing any earnings drag. More recently, this has been replaced with goodwill impairment (i.e., marking down the carrying value to the fair market value).
- **Use of Cookie Jar Reserves:** Companies use unrealistic assumptions or intentionally oversize reserves for future liabilities. These reserves are then used to boost earnings during difficult times. Companies also purposefully understate reserve liabilities to improve their overall financial picture.
- **Accelerating (or Delaying) Revenue:** Companies intentionally recognize revenue prematurely or delay its recognition. Companies may accelerate or delay revenue by mischaracterizing contractual benefits and obligations. Accounting treatments may be particularly suspect where companies recognize revenue for one period while attributing associated expenses for another.
- **Accelerating (or Delaying) Expenses:** Companies intentionally prematurely recognize or unjustifiably delay expense recognition. One significant way that companies have accelerated expenses is recognizing a "nonrecurring" expense (a one-time charge-off). Expenses are often delayed by inappropriately capitalizing them.
- **Inappropriate Use of Special Purpose Entities (SPEs):** SPEs have long been used legitimately to isolate financial risk and remove associated debt from the reporting company's balance sheet. However, the SPE has to meet certain criteria relating to ownership, independence, and the transfer of assets. If these criteria are not met, off-balance sheet treatment is not appropriate.
- **Pro Forma Earnings:** This describes a financial statement prepared on a basis defined by the company and not in accordance with GAAP. Some would argue that it is a useful method of clarifying the company's financial picture. Others have dubbed it as "EEBS" for "earnings excluding bad stuff." Significant differences between GAAP and pro forma statements should be scrutinized.
- **Immaterial Accounting Errors:** Earnings management is often achieved through the misuse of the concept of "materiality." A subject near and dear to the hearts of accountants and attorneys alike, as a general rule it must be determined whether omissions or misstatements in a financial statement are material or immaterial deviations from GAAP accounting. If they are determined to be immaterial, then an auditor will allow them to be reported without taking issue with them.

Levitt criticized the practice of using a rule of thumb that deviations within a certain percentage of a registrant's net income or net earnings per share (e.g., under 5 percent) are immaterial. In repudiating this analysis, he noted that, "In markets where missing an earnings projection by a

penny can result in a loss of millions of dollars in market capitalization. I have a hard time accepting that some of these so-called nonevents simply don't matter. . . . I reject the notion that the concept of materiality can be used to excuse deliberate misstatements of performance."

At Levitt's direction, the SEC subsequently issued an accounting bulletin on this issue. It specifically rejects the notion that materiality determinations may be based on a quantitative analysis alone. Rather, it requires that "all the relevant circumstances" must be considered and concludes that "as a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements." Included among the qualitative considerations identified by the SEC are whether the misstatement:

- masks a change in earnings or other trends;
- hides a failure to meet analysts' consensus expectations for the enterprise;
- changes a loss into income or vice versa;
- concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability;
- affects the registrant's compliance with regulatory requirements;
- affects the registrant's compliance with loan covenants or other contractual requirements;
- has the effect of increasing management's compensation—for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation;
- involves concealment of an unlawful transaction;
- may result in a significant positive or negative market reaction; and
- involves a segment of the registrant's operations that is significant to the financial statements as a whole.[13]

ACC Extras on . . . Financial Mismanagement and Fraud

ACC Committees:

More information about these ACC committees is available on ACC Online℠ at *www.acca.com/networks/committee.php*, or you can contact Staff Attorney and Committees Manager Jacqueline Windley at 202.293.4103, ext. 314, or *windley@acca.com*.

- Financial Services Committee: *http://www.acca.com/php/cms/index.php?id=107*

Annual Meeting Course Materials:

Program material is available from the following courses at ACC's 2005 Annual meeting. *Vampires of the Bottom Line: A Look at Corporate Fraud*, ACCA, 2002.

Description: Discussion of various types of fraud, red flags that may indicate fraud, and factors that can contribute to or deter fraud *www.acca.com/resource/v3355*.

Quick Reference

Indicia of Corporate Fraud, http://www.acca.com/resource/v3685.

3. The board does not function independently or exercise appropriate oversight and permits management to determine the information it receives.

Serving on a board of directors, particularly on the audit committee, is not a task for the faint-hearted. Sarbanes-Oxley, the New York Stock Exchange listing reforms, the Federal Sentencing Guidelines, and other statutory and regulatory provisions have imposed a plethora of new requirements that must be met. Among other things they include: new elements of independence for the board's directors and its committees; executive session meetings; limiting board compensation; active board oversight of company activities; ensuring that audit committee members have appropriate financial expertise; publication of corporate governance guidelines and charters for key committees; board and key committee annual evaluations; and board training. Corporate boards have also been the subject of extreme criticism. The Delaware Chancery Court's decision in the *Disney* case, while finding that the board had not breached its fiduciary duty, lambasted it for having a culture that was "unwholesome" and in which "ornamental passive directors contribute[d] to sycophantic tendencies among directors."[14] The Independent Reports have similarly characterized the respective boards reviewed as "failing in its oversight duties," "deferring to management almost completely," and "not overseeing management's processes and decisions with an appropriately skeptical eye."

At a minimum, a properly operating board should demonstrate the following characteristics:

- Members are prepared and informed, request additional information when needed, and exercise appropriate oversight. They do not let executive management dictate their agenda or direct their course. Appropriate time is dedicated to their activities.
- Director qualifications and the activities and effectiveness of board committees are taken seriously.
- The criteria for executive compensation are carefully considered and established, and the compensation process and associated accounting concepts are monitored.
- Independent advice is acquired when needed.
- Board decisions (including the process) and other activities are appropriately documented.
- Conflicts of interests of executive management and appropriate use of corporate assets are considered and monitored.
- Corporate governance is taken seriously, benchmarked against appropriate standards, and modified as appropriate.

4. The financial or internal audit functions lack qualified personnel.

There are two aspects to this issue: (1) whether financial and audit personnel have the proper qualifications and competencies; and (2) whether they have sufficient staff and other resources.

As to the first, consider the likelihood that a CLO might not have a law degree. "Less than none" is the foregone answer. However, the Independent Reports reflect instances where the CFOs for huge corporations with complex financial activities were not CPAs and did not have other appropriate experience; similar situations existed with regard to the controller and the individual heading the internal audit function. In some instances, there was also rapid turnover or protracted periods during which no one held these positions at all.

As to the second aspect, the failure of a company to invest in appropriate financial or internal audit staffing can be financially disastrous if not fatal. It also reflects a lack of corporate concern with those things for which it should be concerned. The Independent Reports reflect that this was a recurring problem. Most telling is that after the axe fell, a frequent remedial measure was to rapidly staff up the financial and internal audit positions, sometimes to the tune of hundreds of employees.

5. Organizational structures with inherent conflicts of interests.

Many companies carefully establish appropriate standards and procedures to guard against potential conflicts of interests that might arise between the company and its employees' personal interests. However, they do not consider the conflicts of interests inherent in their organizational structures and certain internal practices and the problems these may present. Conflicts of this nature may cause companies to act in inappropriate ways. Examples reflected in the Independent Reports include:

- The personnel responsible for establishing financial standards and monitoring their appropriate use are also the ones responsible for applying them.
- Personnel are charged with monitoring the actions of their superiors (and their superiors' direct reports). For example, where the head of internal audit reports to the CFO who also supervises the financial activities of the company.
- Personnel who report to the audit committee (e.g., internal audit) have their performance evaluated and their compensation determined by the executive management whose activities they scrutinize.
- Where internal audit reports to the audit committee but has its communications with the board tightly controlled by the CEO or CFO.

Delegations of authority for making accounting-related decisions are not clear, if they exist at all. This allows accounting changes to be made "on the top" without the concurrence or knowledge of responsible personnel, and sometimes with their objection.

6. The company lacks adequate internal controls.

Section 404 of Sarbanes Oxley required the SEC to issue rules requiring registered companies to evaluate their "internal controls" and report on that assessment annually. While the SEC's response focused only on internal controls related to financial reporting, given the breadth of what goes into financial reporting, its practical effect was to require companies to take a hard look at many significant systems.

However, where financial control issues have not been identified or have not been corrected—or where the controls are nonfinancial in character and haven't been addressed—the lack of such controls can act as a factor in financial mismanagement or fraud for several reasons:

- It contributes to a corporate culture of "anything goes" rather than a culture committed to ethical conduct and compliance.
- It enables *ad hoc* decisions to be made that are designed to address the most pressing objective at the moment—perhaps an impermissible one.
- It enables individuals to exceed their authority and make decisions which they should not be making or which should not be made without the input of others (e.g., the review and approval of the CLO).
- It permits a Band-Aid® and chewing-gum approach to corporate activities, which may be based on the analysis of the moment, may not be properly documented, and may change radically and without explanation when the next problem arises.
- It disempowers lower level employees who might otherwise rely on the controls, standards and procedures to assure that an activity is carried out properly.

7. The executive compensation system is based on inappropriate incentives and has inadequate checks and balances.

A Delaware court recently noted that "[w]hile there may be instances in which a board may act with deference to corporate officers' judgments, executive compensation is not one of those instances."[15] From a financial mismanagement viewpoint, there are several significant reasons why this should be true.

First, under the Federal Sentencing Guidelines, one required component of an effective compliance and ethics program (which the board oversees) is to provide "appropriate incentives to perform in accordance with the compliance and ethics program."[16] Thus, it is imperative that the board link executive compensation to ethical and legal conduct. Compliance-related performance standards should be both qualitative (e.g., creating and maintaining an appropriate corporate culture) and quantitative (e.g., implementing internal controls, responding to audit findings). Moreover, these standards should be real and truly applied: "A college football coach can be told that the graduation rates of his players are what matters, but he'll know differently if the sole focus of his contract extension talks or the decision to fire him is his win-loss record."[17]

The importance of these standards is underscored by observations such as those of Boeing's chairman and CEO W. James McNerney, who indicated that the incidents that led to criminal investigations of the company, in part occurred because Boeing's previous management didn't place enough emphasis on ethical behavior. As a result, he scrapped an executive-compensation plan under which executives were rewarded for meeting primarily financial goals, and replaced it with one tied to broader criteria, including integrity and ethical leadership.[18]

Second, the board should take steps to assure that compensation is not linked to factors that may encourage inappropriate earnings management. The Independent Reports are replete with examples of earnings management by senior and executive management to achieve higher compensation. Accordingly, compensation linked solely to EPS or other Wall Street expectations may be problematic. The trend is to use specific targets that are less likely to be manipulated, fewer stock options, and more restricted stock and cash compensation. This is a subject suitable for experts, and the board should secure independent advice uncontrolled by management.

Third, the board should exercise independent judgment in evaluating whether appropriate performance standards have successfully been met. Such evaluations might be based on 360-degree reviews, employee surveys, and input from the compliance function.

SEC and Criminal Proceedings Against Inside Corporate Counsel Increasing

By John K. Villa, *ACC Docket "Ethics & Privilege"* columnist

SEC Civil Proceedings

The SEC initiated more than 30 enforcement proceedings against corporate attorneys from early 2002 through mid-2005. In the intervening 12 months, the SEC has initiated four more actions. The new actions allege fraudulent accounting and market-timing schemes and the making of false and misleading statements in filings and press releases. Two of the actions involve the companies' general counsel while the other two implicate senior in-house lawyers. In all of the actions, counsel's role involved the preparation of the false or misleading documentation to support and/or conceal the allegedly fraudulent scheme.

For example, the SEC alleges that the assistant general counsel of a reinsurance company drafted sham reinsurance contracts, and assisted in developing and then concealing side agreements. In a case that arose from a market-timing scheme, the SEC alleged that the general counsel of a hedge fund created entities with accounts having names designed to hide the fund's relationship to these accounts, and prepared annuity contracts that named himself and other employees as annuitants to further conceal the fund's identity.

In a fraudulent revenue recognition scheme, the SEC alleges that a senior in-house attorney drafted the terms of the transaction and supporting documents so as to ensure that the wording did not expose the schemers' efforts to circumvent GAAP, and actively sought to prevent the disclosure of undocumented side agreements. Finally, the SEC alleges that the general counsel of a biotechnology company drafted and approved SEC filings and press releases that failed to disclose or falsely described the regulatory status of a company product. The SEC also alleges that counsel sought outside counsel's advice, but failed to heed that advice. Two of the actions remain pending; two have settled. One counsel faces criminal prosecution for his conduct.

Criminal Proceedings

From 2002 through mid-2005, approximately eight criminal actions were brought against in-house counsel for their roles in fraudulent schemes. Since mid-2005, five more in-house counsel have been indicted. In a departure from prior prosecutions, two criminal prosecutions involve more than one in-house counsel: one involves two inside counsel who were employed by separate but related companies in which they held the position of general counsel; the other involves two inside counsel from the same company, the general counsel, and the associate general counsel.

One of the recent criminal prosecutions alleges a scheme to defraud the company for personal gain; all of them involve the manipulation of the company's financial statements. For example, one prosecution has alleged fraudulent diversion from a public company of millions of dollars through noncompetition agreements executed in connection with the sales of operations. The indictment alleges that the general counsel of the company, along with the general counsel of a related entity, prepared the closing documents and noncompetition agreements that falsely benefited another entity which was not entitled to compensation. Similarly, in another prosecution involving a scheme to mislead investors through fraudulent reinsurance contracts, the indictment alleges that the assistant general counsel crafted the sham contracts and the undisclosed side agreements that were part of the scheme.

The trend line evident in the last 12 months is that both SEC regulatory sanctions and criminal prosecution of inside counsel are increasing sharply, the nature of the conduct that prompts criminal prosecution for one lawyer is not distinguishable from conduct that elicits only SEC sanctions against another lawyer, and it can no longer be said with confidence that only the general counsel is at risk. All of these are disturbing trends and are not likely to change in the future.

Editor's Note: Mr. Villa's study excluded insider trading cases against corporate counsel. Mr. Villa's "Ethics & Privilege" column appears monthly in the *ACC Docket*.

8. There is a lack of candor and provision of information between the company's financial and business operations and internal and/or external audit.

A number of factors establish the foundation for the relationship between the financial and business operations and internal and/or external audit.

- Do senior managers set a good example in their relationship with the audit function (e.g., are they respectful of the function, do they exercise candor and provide full appropriate information in their own responses—and require it in responses they may supervise—to internal and external audit inquiries)?

Thus, it is **imperative** that the board link executive compensation to **ethical** and **legal** conduct.

- Do the internal/external auditors have the qualifications and level of competency that will create appropriate respect?
- Have adequate resources been allocated to the internal audit function?
- Is senior management's response to audit findings to appropriately address them in a timely fashion?
- Does the organizational structure for internal audit provide it with appropriate independence?
- Does internal audit have a place at the table in the company's power structure and within its operations?

Negative responses to the above questions may foreshadow financial and operational problems.

9. There is too much reliance on the external auditors.

"Run it past the auditors" is a common corporate phrase, as if securing their blessing is the appropriate final word on any accounting decision. However, external auditors may not always have the right answer. Look at KPMG's $22 million settlement with the SEC for its alleged role in Xerox's accounting problems, or Deloitte & Touche's $50 million SEC settlement of charges stemming from its audit of Adelphia Communications. Companies currently under fire for matters relating to stock option dating cite their auditors' approval of their actions. Finally, the Independent Reports are also strewn with instances where external auditors allegedly assured their clients that the actions subsequently criticized were appropriate, or allegedly failed to detect the mismanagement or fraud that was occurring that might have changed audit opinions. They also cite instances where external audit denied having reviewed a matter, although management asserted they had. Moreover, as Lynn Turner, former chief accountant of the SEC put it, the defense of relying on the auditors "isn't plausible anymore."[19]

This is not to say that the expertise of external auditors is not a valuable thing. It is. However, that expertise cannot be relied on as an alternative to having qualified, competent, corporate internal auditors and financial staff who have adequate resources. In short, while external audit's opinions are going to be helpful, total reliance on their advice may be a trip down a dangerous road.

10. Something is rotten in the state of Denmark.

The *Oxford English Dictionary* defines *corporation* as "a body corporate legally authorized to act as a single individual." But while it may be acting as a "single individual," company operations are carried out by many individuals. And those people write memos, make presentations, talk around the water cooler and in the conference room, and blanket electronic pathways with a rich abundance of emails. Some of the content of these communications is honest truth, some part fact and part fiction, and some unfounded gossip.

But it behooves in-house counsel to pay attention to these communications. For, as the palace guard advised Hamlet, sometimes what you observe and what you hear will cause you to know that "something is rotten in the state of Denmark." That information may alert you to the possibility of financial mismanagement or fraud. Examples from the Independent Reports include:

- Excessive use of corporate assets by executive management, including using corporate money for acquisitions of personal real estate, personal property, and payment of other expenses that individuals would normally be expected to pay for themselves.
- Use of corporate assets to make large donations to charitable organizations outside of a corporate-approved program, particularly where the contribution is attributed to the individual.
- Exclusions, intentional or otherwise, of the legal department from important decision-making processes—particularly if they relate to disclosure matters and complex, structured financial transactions.
- "Slush funds" or other initiatives that have no corporate-approved procedures and standards, which are used to reward employees as the CEO deems fit.
- Transactions that are primarily undertaken for accounting reasons and that have no other substantive benefit to the company, particularly at quarter or year's end.
- Transactions personally benefiting company employees (or their significant others) in a way that is detrimental to the company and excessive for the services rendered (if any) by the employee or related third party.
- Patterns of favorable earnings or other financial results that are inconsistent with the overall market or cannot otherwise be legitimately explained. If it seems too good to be true—it usually is not.

What Can In-house Counsel Do?

Quite a bit. For example:

- There should be an open working environment in the legal department where staff can raise important issues without fear of retaliation. This will not only help flush out issues to be resolved for the benefit of the company, but serve as an example to others.
- In-house counsel can use their big-picture vantage point to help assure that all the pieces come together for the greater good. Some of the fraud that was allegedly perpetuated was facilitated by isolating the financial management activities of one corporate unit from the other, or permitting one silo to act without scrutiny.
- In-house counsel can assure that the legal issues underlying proper financial management are properly and reasonably addressed. Delegations of authority should be clear and inviolate except in prescribed circumstances. "Materiality" determinations should consider qualitative factors. Conflicts of interest should be avoided or carefully monitored with appropriate checks and balances. Waivers of corporate standards (e.g., codes of conduct) should be few and far between and disclosed as required.
- The CLO can play a significant role in assuring that the corporate compliance program meets the requirements of the Federal Sentencing Guidelines.[20] Among other things, such a program should: include a corporate culture conducive to proper financial management; establish, communicate, and train personnel about appropriate financial and audit standards; establish compliance-related performance standards and evaluations; and monitor adherence to the program. When problems are encountered, they should be remedied immediately and the program adjusted accordingly.
- The CLO can play an important part in assuring that any internal investigations, including responses to whistleblowers, are appropriately conducted using the right resources—which may mean bringing in outside experts or being subject to criticism for failure to do so.
- Relationships in which the CLO participates—including those with the SEC, regulators, auditors, the CEO, the CFO, and the board—should be conducted in a manner that promotes appropriate financial management. Openness and integrity should be keystones.
- In-house counsel should review complex financial transactions. As part of that process they should raise appropriate questions about the accounting treatment for them. If the transaction is being undertaken simply for accounting purposes, without any other reasonable corporate purpose or benefit, they should take steps to terminate them.
- In-house counsel can assist clients in establishing internal written rules and processes that help promote financial good health. For example, there should be rules for posting on top changes to the general ledger or establishing and using reserves.
- In-house counsel know how to make reasonable legal interpretations. As part of the process, we weigh answers to questions like: What is the plain language of the applicable statutes and regulations? What does (or would) our regulator(s) say about it? Is there case law on point or that is at least instructive? Is the proposed interpretation being driven by a desired result? Would I feel comfortable about the proposed interpretation if I read about it in *The Wall Street Journal*? Lawyers can assist in making sure a modified form of this analysis is brought to accounting decisions as well.

Finally, in-house counsel can raise the questions that need to be raised when they spot one or more of the ten flags. It is ugly work, but somebody has to do it. The alternatives shouldn't happen on your watch.

Notes

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BUSINESS ETHICS: LOST IN TRANSLATION?

The business shelves at the local library and bookstore, Ben W. Heineman Jr. notes, are bursting with tomes that promise to teach you how to turn your business into a high-performance organization. Fewer titles deal with business ethics and corporate citizenship. But almost never, thought Heineman, did the two meet in books about the critical task of fusing high performance with high integrity—leaving a gap that desperately needed to be filled. Heineman felt strongly that business people needed to understand why this fusion was the foundation of the modern corporation and, just as important, the how of making it happen. Based on his 18 years of experience at GE, first as general counsel and later as senior vice president for law and public affairs, Heineman brings firsthand experience to the struggle many companies face in attempting to mesh globalized operations and localized concerns into a uniform high-integrity culture that knows no boundaries. His latest book, *High Performance with High Integrity*, is due to be published by Harvard Business Press this month.

The book grew out of an April 2007 article Heineman penned for *Harvard Business Review*, entitled "Avoiding Integrity Land Mines." "I tried to think, if I were invited to brief business leaders for a morning on performance with integrity, what would I say?" Heineman says. The reaction to the article was strong and positive, quickly sending it into the top 20 percent of *HBR* reprint sales. Clearly, Heineman's realistic advice was what readers were seeking. A book manuscript quickly followed, allowing him to flesh out his ideas in greater detail.

"It's tough out there for corporations and corporate counsel," Heineman says, noting that media, public, and regulator attention to "business in society" issues has increased dramatically from 1987, when he started at GE, to the present.

Heineman's main precept is that proper corporate governance is fundamentally the job of the CEO and senior managers, not the board of directors. Boards, he notes, meet only eight or nine times a year and have an important but limited oversight role. "The work is done by the CEO." "The governance debate has been wrongly focused [on board members]."

Another major point Heineman hopes to make is that high performance plus high integrity is where the rubber meets the road, and that corporations need to mean what they say. He believes that business must change specifications and compensation frameworks for CEOs and other senior corporate leaders to give integrity equal priority in the business equation: "It ought to be pay for performance *with integrity*, not just pay for performance."

> "**People** go to great companies to get tremendous **training** in **engineering, marketing, sales,** and **finance**, or whatever. We ought to have the same rigor in training **people** about **integrity** as we do about all these other elements of **business**."

Heineman emphatically advises corporations to take the necessary actions to create a culture of high integrity and drive it deep into the organization. "Unless integrity is operational, driven into the business, it won't work." One important principle in creating this culture is to give employees a voice. They must not be afraid to speak up; and employees must receive regular, ongoing education and training about how to make ethical business decisions and conduct business appropriately. At the center of most of the major corporate scandals of the past decade, he says, there has been a "culture of silence." Employees must be confident of a foolproof, no-exceptions system of checks and balances that protects whistleblowers and punishes offenders. Further, ethics training must be far more detailed and rigorous than simply handing out a booklet of policies.

"People go to great companies to get tremendous training in engineering, marketing, sales, and finance, or whatever. We ought to have the same rigor in training people about integrity as we do about all these other elements of business," he says.

Heineman notes that his 18 years at GE taught him more than pure research ever could. "I'm absolutely not arguing we did everything right; we didn't. We made mistakes. The point, instead, is that GE tried, and that its efforts in seeking to fuse performance with integrity should be the beginning of an important debate, not the end."

As a former general counsel, what does Heineman's book offer his corporate counterparts? He hopes the volume has great value for them as well: "They may be able to use the book as a strong but straightforward framework of core principles and key practices and as a means of communicating with their business leaders." After all, their advice is commonly sought on matters of integrity. He returns to his fundamental point: that integrity, ultimately, is the CEO's job.

"I always felt that my job at GE was not just to answer questions about whether things were legal, but to counsel the CEO on whether our actions were right."

Heineman admits that high performance with high integrity means making difficult choices. And often, it means holding senior leaders accountable, even if they have no personal knowledge of or involvement in the wrongdoing. Multinational corporations, he emphasizes, face especially complex issues, particularly in emerging markets. In the following excerpt, he outlines his reasoning for consistent global ethics policies. "Localization," he writes, is treacherous (and wrong) when applying core values. In particular, he discusses the potential minefields of improper payments, remote sites, and sourcing in the global supply chain—all perplexing issues common to multinational corporations. Within each issue, he briefly cites examples of how GE addressed each during his tenure.

Heineman is now a senior fellow at the Belfer Center for Science and International Affairs at the Kennedy School of Government at Harvard University and distinguished senior fellow at Harvard Law School's Program on the Legal Profession. In a November 2007 interview with *ACC Docket*, he described his mandate for change and called upon his fellow corporate counsel to play a role:

> *I'm trying in my own small way to shift this debate through writing and speaking, and I would hope the members of ACC would try to shift the debate too. Let's worry less about what directors can do in their eight meetings a year, and more about getting people to focus on internal best practices so companies can really achieve what I consider to be the twin goals of capitalism: high performance with high integrity.*

High Performance with High Integrity (excerpt)

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The Toughest Issues

The core principles and practices described in the previous section apply across the broad range of business operations. But they are particularly significant in dealing with recurring, complex, and vexing issues of this global era—issues that demand special CEO attention. These include emerging markets, acquisitions, crisis management, public policy, and reputation.

I'll consider these issues separately in the following pages. It's worth noting, though, that they are interrelated. A good reputation grows out of effective crisis management and defensible positions on public policy. Integrity in emerging markets depends, in part, on the effective integration of acquisitions.

Emerging Markets

During my time at GE, whenever I was asked what I lost sleep over, my answer was always the same: emerging markets.

In a sense, multinationals have conjured up a dilemma. For understandable reasons, they have embraced the potential of significant new growth in the developing world, touting it at analysts' meetings and in public speeches. (GE Asia's revenues were projected to grow from $18 billion to $36 billion between 2004 and 2008.) At the same time, they are quietly aware of the significant integrity and country risk minefields that threaten to impair performance and destroy margins: limited rule of law, endemic corruption, rampant conflicts of interest, erratic enforcement, money laundering, unscrupulous local competitors, and hard-to-assess economic and political risk. To meet their dramatic growth projections, transnational companies must navigate treacherous shoals.

Four practices are essential.

1. Build (and Insist Upon!) a Uniform Global Culture

The temptation to bend the rules in tough markets is great, especially for employees from the local culture. But the fundamental position for a transnational company aspiring to high performance with high integrity is crystal clear: across all international markets, the company culture must demand strict adherence to formal financial and legal rules, whether local or international, to the company's global ethical standards and to the employee values of honesty, candor, fairness, trustworthiness and reliability.

Easy to say, hard to do; nevertheless, the uniform precept cannot be compromised. Why? Because in a global company, with leaders and employees moving from nation to nation, the hypocrisy of selectively ignoring particular rules or standards—or treating different countries differently—fatally corrodes the fundamental value of integrity for *all* employees.

Some multinationals choose not to enforce global policies but instead to "decentralize" values and integrity, and let local managers "adapt" to local conditions. It's a bad approach. This look-the-other-way decentralization, despite companywide rhetoric, was an important contributor to Siemens's towering bribery scandal (hundreds of millions of dollars in improper payments in various business units) that led to the departure of the board chair and the CEO, and has created turmoil across the company.

Implementing the fundamental principles and practices discussed in section II across various businesses in the wide variety of emerging markets—with their different histories, cultures, institutions, and practices—takes time, effort, and money. This is especially true when the corporation begins to move from an export sales strategy to a strong local manufacturing, distribution, and sourcing strategy, as so many are doing. A laser focus on process mapping, risk assessment, risk mitigation, and controllership is essential. Top company leadership simply can't throw the emerging market dilemma in the laps of emerging market leaders, demand stretch performance targets, and hope for the best.

So granular, realistic estimates of the costs of building the integrity infrastructure must be baked into the numbers, after review by global business leaders who are responsible for creating an enduring emerging market organization. Without that consistent message from the top and without realistic business plans, the pressures for local leaders in emerging markets to seek performance and ignore integrity may simply be too great.

2. Spotlight the Endemic Problems

To achieve high performance with high integrity, the CEO and the business and functional leaders must spotlight special endemic risks. These include, for example, acquisitions, improper payments, sourcing, export control regimes, conflicts of interest, environmental health and safety, competitor contact, and nepotism. To head off problems in these realms, GE developed explicit policies, guidelines, education and training, checklists, and checks and balances beyond the basic performance-with-integrity systems and processes. Of course, each issue in each country presents its own complexities, but three brief examples—focusing on improper payments, remote sites, and sourcing in the global supply chain—can help illustrate the general approach.

Most **multinational** corporations have paper policies—whether **based on US** or local law—prohibiting **payments** of this sort.

Improper Payments. These come in many guises: direct bribes, payments to unsavory agents for help with government contracts, unlawful political or charitable contributions, inappropriate gifts and entertainment, company-financed vacations masquerading as "business trips," and many more. Most multinational corporations have paper policies—whether based on US or local law—prohibiting payments of this sort. But the challenge is to create a real program that reaches real employees and speaks to their real issues.

For example, the use of consultants or agents in government procurements—often required by local governments—is a fertile ground for abuse. In such cases, genuine due diligence is vital. Is the agent in-country? Does he have industry expertise? Are there obvious conflicts of interest? What is his reputation? How does the embassy view him? Is the fee within reasonable commercial limits? Is payment directed to a "clean" or a suspicious account? Can the work be specified? Are the contracts written to require consultants to certify ethical conduct, creating the company's right both to audit and to terminate, as necessary?

GE employees are trained to "have their eyes open," and are required to report requests for cash, inflated invoices, requests for customer-appointed partners or suppliers, and payments to third parties. Obviously, this is a difficult area. Recognizing that, the company recently has held summits for top employees in sensitive regions like the Middle East and Asia on third-party agents and distribution. The goal of these summits is to spread best practices, establish a consistent, cross-business approach on when to use third parties, implement automated monitoring, improve agent and distributor training, and develop goals and techniques for reducing use of such third parties by as much as 30 percent in the near term.

Remote Sites. Remote sites, where controllership and supervision tend to be attenuated, are a recurrent source of performance-with-integrity issues. Problems include misappropriation of funds, lack of proper third-party employment contracts, favoritism or retaliation in these small offices, and poor accounting systems. This emerged as a high-priority issue for GE as it expanded in emerging markets (and as problems mounted). Assessment tools were developed to rank risk at sites. Special disciplines—from cash management to SWAT team controllership reviews to special emphasis on the compliance infrastructure for new employees—were applied to the highest-risk locales.

Sourcing in the Global Supply Chain. This issue has received close scrutiny at GE as it increased exponentially over the past decade. As the company was first ramping up global sourcing in the mid-90s, clothing and toy manufacturers got into serious controversies over their sourcing practices. Observing this development, we concluded that before too long, the issue would affect all global businesses. We felt we had a basic responsibility not to support "outsourced" practices that GE itself would not engage in—to protect workers, to guard our reputation, and to sustain support for global economic integration.

An extensive sourcing white paper and other materials provide guidance to those in the field on the key program elements and hard issues: the relevant standards (e.g., no workers below minimum age, compliance with EHS laws or standards); due diligence protocols both at qualification and requalification; clear assignment of responsibility to sourcing leaders to manage the process; proper responses when nonconformances occur; how to monitor during the contract; and standards for second- and third-tier suppliers. Supply-chain integrity failures (most recently in imported food, medicine, and toys from China) have serious brand, reputational, and financial consequences for many companies, indicating that integrity concerns surrounding sourcing will be on the front burner for the foreseeable future.

To purchase this book, please visit http://www.amazon.com/high-performance-integrity-memo-ceo/dp/1422122956/ref=pd_bbs_sr_6?ie=utf8&s=books&qid=1207851424&sr=8-6.

How to Say NO to Your CEO

This is the first of a two part interview; the second will appear in the November *ACC Docket*.

An Interview with Ben W. Heineman, Jr.

Ben W. Heineman, Jr., the ACC'S 2007 Annual Meeting's keynote speaker, recently sat down with ACC President Fred Krebs and Vice President and Deputy General Counsel Deborah House to discuss challenges facing corporate general counsel when delivering difficult advice.

Ben W. Heineman, Jr., served as General Electric's senior vice president-general counsel from 1987-2003, where he was responsible for managing over 1,000 in-house counsel in over 100 countries. He retired from GE in 2005 as senior vice president for law and public affairs. He is a senior fellow at the Belfer Center for Science and International Affairs at the Kennedy School of Government at Harvard University. Heineman is also the first distinguished senior fellow at Harvard Law School's Program on the Legal Profession and a senior advisor to the Center for Strategic and International Studies. He also is senior counsel at WilmerHale.

Heineman holds degrees from Harvard College, Oxford University, and Yale Law School. A former Rhodes Scholar, he served as editor in chief of the *Yale Law Journal* and as law clerk to Supreme Court Justice Potter Stewart. He is the author of books on British race relations and the American presidency.

ACC: One difficult question that plagues in-house counsel is "How do you say 'No' to the CEO?" Investigations into many of the recent scandals at major companies reflect that the general counsel or the legal department were either purposefully excluded from the table, or more subtly, not included at the table. This is a complaint we often hear from our members. How do you get to the table as a meaningful partner who always receives an invitation, even in areas that clients may traditionally consider non-legal or in areas where clients may not wish you to venture?

Heineman: If you're starting the job, you should define the scope of your role first, both with the CEO and with the board of directors. In this day and age it is appropriate that the board of directors or members of the executive committee interview the final candidate for the general counsel's position. The general counsel's role is as a key player in the 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 and society issues facing modern corporations. The GC, either as a lead or as a supporting actor, should be involved in complying with laws and regulations across the world, establishing global values and standards beyond what financial and legal rules require, and shaping the company's governance, public communications, reputation, and role as a corporate citizen. It also includes ultimately being involved in addressing the question of how to balance the company's private interests with the public interests affected by the corporation's actions.

A different way of saying this is that the general counsel, as a member of senior management, should on most matters facing the company, assess them for legal, ethical, reputational, and, when knowledgeable, commercial risk. And then to take it to another level, this then involves being both a business partner to the business leadership, but most importantly being a guardian of the company. And as readers of the *ACC Docket* know, the general counsel's duty is to the company and not to the CEO. But clearly, to be effective, you have to be a partner to the CEO as well as a guardian of the corporation. Simultaneously resolving that tension is what the job, in essence, is all about.

I think the way you ensure this is that you establish this understanding when you are interviewing with the CEO and with the board, if you have the courage to raise these issues and you should. You should define and describe the scope and the kinds of risks you expect to evaluate. You describe the partner-guardian tension, and that you expect to be involved in virtually all fundamental decisions of the company. Now, in a large company you can't be everywhere. But you certainly should say that you ought to be involved in first order matters, even when they have legal dimensions but are not primarily legal—or have reputational, or ethical dimensions. And that is virtually everything from new products to new geographies to the business strategy.

And I think that if you clarify that going in with both the CEO and the board, you have a chance of being included in business matters, to be consulted as a business partner to get things done. But also you have the opportunity to speak as a guardian of the corporation with respect to, at a minimum, legal, ethical, and reputational risk, and conceivably commercial risk as well. But opportunity at the outset must, of course, be matched by subsequent performance.

ACC: In a recent article, you commented that the GC for Hewlett-Packard Corporation was "incurious" and that she failed to probe the legality and propriety of pretexting to secure confidential information. Ultimately that failure caused her to lose her job and another law department colleague to be indicted. Implicitly then, before a GC can come to the determination that they ought to be saying "Yes" or "No" to the CEO, he or she should have exercised appropriate curiosity in identifying and drawing conclusions about the relevant issues. How would you describe or define the appropriate level or scope of that curiosity?

Heineman: Let me talk about Hewlett-Packard. First, my comments on the general counsel were based on news reports; I have no personal knowledge about that situation.

What I think is instructive is that this was a case where the board of directors and senior management wanted something done. I don't think there's any question that this was a matter of the first order for the corporation. And, on those matters where the board asks the company to do something, or it's a priority of the CEO, those are quintessentially the kind of matters when the general counsel—as opposed to any of the general counsel's subordinates—should understand the legal, ethical, and reputational dimensions in some detail and with some care.

The second way to think about the question is: how big is the company? In a large company, there obviously will be division general counsel and corporate experts in tax, environment, employment transactions, IT, and other specialty areas. But even then, everyone should have the same orientation in terms of the scope of the job and the partner guardian role—the job of assessing legal, reputational, and ethical risk, as well as commercial risk. Then this flows down, again depending on how big the legal staff is, and how you're organized, to even the more junior lawyers. They all have basically the same role and responsibility and, if there are issues with respect to any of these dimensions, there needs to be a reporting relationship back up to the top legal officers, including the general counsel, depending on the magnitude of the issue.

A third dimension of this is problematic—and it certainly caused us problems at GE—accounting. One of the salient phenomena of the past five years, certainly since Enron, has been what I call the "legalization" of accounting. Obviously, lawyers are involved in what a company discloses in its 10Qs, 8Ks, public relations statements, etc., in terms of vetting it with disclosure committees for accuracy. But there are many complex accounting decisions that may be made at the end of the quarter or the end of the year, in terms of exercising judgments about how to treat things like revenue recognition.

I wouldn't want the chief financial officer telling me how to handle a merger clearance in Washington. So, what's the role of the legal function now that the SEC has made so many accounting issues fraught with le-

gal implications? This is an area where there is special expertise elsewhere in the company—in finance—and yet the implications are far different than they were 10 years ago. Ten years ago, if there were an accounting issue, most of the time the chief accountant of the SEC would talk to the comptroller of the company. They'd discuss it, and if the company agreed, they would change the matter prospectively on many questions. It would be a question of accounting judgment. Today, you're much more likely to have an investigation and the SEC enforcement division is going to be involved.

Take Fannie Mae. I'm not trying to judge that case, but Fannie Mae did have two accounting firms and a former head of the SEC enforcement division saying that their way of dealing with FAS 133—which is an accounting for derivatives rule that is hundreds of pages long and quite complex—was correct. But both OFHEO [the Office of Federal Housing Enterprise Oversight, Fannie Mae's regulator] and the SEC viewed it differently. It had enormous consequences.

That's a long way of saying that this is a particularly problematic area where 10 years ago there was church and state. Legal did the law; finance did the accounting. But now this particular area, because it has caused so much legal activity in companies, raises hard issues. I think one solution is to build stronger forensic accounting capacity into the finance function so it can deal with emerging legal trends relating to accounting, and not have the legal function involved in every controversial accounting decision.

I cite that as a special problem. But, as a general matter, I go back to what I said a moment ago: the legal function, from the general counsel down, should have a very broad scope of activity. It should be involved in discussing various kinds of risk, not just legal risk, and it should be involved in most of the major decisions as a member of the senior management team.

ACC: Legal advice is usually provided in gray situations, not black and white ones. For example, it is generally easy to tell a CEO that he or she cannot fix prices. It is a little more difficult if the proposed action is not *per se* illegal under the antitrust laws, but where a rule of reason comes into play. Perhaps then your advice is "maybe." In the latter scenario, how does your advice differ and how do you present that advice?

Heineman: When it's grey, it's not that the answer is "maybe." It is a question of time. CEOs are always in a hurry. They always want the answer tomorrow. In a fast-moving corporation, the first tension you've got to deal with is how much time do we really have to look at this problem? Let's assume that you can get a reasonable amount of time, even though a reasonable amount of time in a company is not necessarily what a law firm would consider a reasonable amount of time. Then your job is not to give the "maybe" answer. Your job is to say, look, here are the assumed facts, the essential facts as we know them today. This requires really being concise, precise, and knowing how to speak to business people, not an hour and a half later when they've fallen off their chairs and are asleep. Very concisely, but fairly, state what are the key facts and the key legal considerations. What are the legal risks that we have under options A, B and C. This may involve some discussion with business people to generate those options.

So basically what you're saying to the CEO is not "yes" or "no," you're saying "look, here's the line."

So basically what you're saying to the CEO is not "yes" or "no," you're saying "look, here's the line." We're in a gray area. How close to the line, how much legal risk do we want to take in a world where the law's unsettled and the regulators are uncertain? I'm going to give you, let's say, three options. One is risky because the law's uncertain here and we're going to be in this or that regional office of this or that regulatory agency and the person there has this reputation. I'm going to give you another one that's a little further away from the line. I'm going to give you still another one that's quite a bit away from the line. How much risk do we want to take? And that analysis of different levels of risk, all of them being legal but each one with lesser or greater risk, is really the first job on these gray area issues.

Then, the second job is to give your recommendation. In fairness to the CEO, unless it's illegal in which case the GC has a different obligation, the GC should give his or her advice as to which of the options described is, in the GC's judgment, the right one to follow. That doesn't necessarily mean the most conservative option because this might be extremely expensive; it might be quite onerous. You'll have to use judgment and explain why and you have to lay out the considerations.

Now, that's the ideal. And if you've got 24 hours to do it, you may not be able to do that much. There are very few things in companies though, that have to be decided with that rate of speed, even though a CEO likes to say that they have to be decided that quickly. They will press hard for your decision that quickly. So, to some extent, without being obstructionist, without losing the deal, or without having the newspaper write the story that demolishes you before you can respond, you have to be timely. All deliberate speed is a pretty good watchword.

I want to emphasize that good lawyers are good analysts. A wise businessman once said to me: "If I know the facts, every decision is pretty easy." It is getting the facts and asking the right questions. And that's the problem whether you're in finance, or law, or tech, or engineering, or whatever. There's always this time pressure in companies. That's what makes them fun. You're in a real world with real competitors with all sorts of things happening, with a real organization, people waiting to hear. Time is a really vital dimension in thinking about how to answer the question that you've posed.

I want to emphasize that good lawyers are good analysts.

ACC: There's the time issue and there's also just the sheer volume of information and detail that's available. So, to get to those facts you have to have an ability to sift through them.

Heineman: That's good lawyering. If you're going to trial and you've got three years of interrogatories and depositions and documents, what's the story that you're telling to the jury? You're certainly not going to tell three years worth. One of the things everybody learns, as they get older, is to make it simpler in the mathematical sense of "powerful and elegant." When you come out of law school you've been trained to see every issue and run every rabbit down its hole. That's how you get good grades on exams. When you're practicing, it is different. The difference between academics and practitioners is practitioners have to make complex things simple and sometimes academics make simple things complex.

ACC: On a practical basis, lawyer and statesman Elihu Root advised that sometimes you just need to tell clients that they are "damn fools and should stop." Can you comment on the advisability of that approach, particularly if it is outside the legal arena, and how you give such advice?

Heineman: There are three dimensions of this that we should discuss. The first dimension is the place that you give this advice, the second is the form, and the third is the style. Let's just take them in order.

The place. If you're in a group, most CEOs are testing ideas. There is a kind of debate. But if you're there with your peers in a group of seven or eight senior leaders, it is very hard to basically contradict the CEO if that's what saying "no" is. If there's an open debate and the CEO is taking his or her counsel and hasn't yet taken a position, then you can state the position quite clearly. If you're in a group, at least in my experience and certainly with [former GE CEO] Jack Welch, it was very hard to beard the lion in his den when the other lions and tigers were around the room and he was pretty dug-in on something. For obvious reasons, CEOs view their authority as being very important. They don't want it directly challenged. So, saying "no" in a big group can be done and sometimes needs to be done, but it's sometimes better if you can go in afterwards or find a place where you can be one-on-one to express the concern.

On the other hand, there was a danger, at least with Welch: he would say, "We're going to decide this by 4:00." He was a very shrewd person and had been around the bureaucracy a million times. He would say, "I don't want to have any end runs. I don't want to have you come in later. I don't want any sort of letters for the record. Say it all now or shut up." And that was fine, but when he was under full sail it was hard to get him to turn around sometimes at a meeting. So, one question is the place—group or alone.

The second dimension is the form. This goes back to the question of options. If you have the time and you can lay out different options with different kinds of risk, sometimes it will be pretty obvious, without saying "no," which is the right option. In other words, without saying "Mr. CEO, you jerk, you suggested an option X which is flat unlawful. We can't do that. And even option A which is close to the line has got way too much risk because of where the law's going or where we're going to be having this fight." And then you lay out B and C. Sometimes the option exercise can be a useful form, especially since you can engage without lobbying your colleagues.

You have to disagree without being disagreeable.

The last dimension of your delivery is the style. Sorry for the cliché—but they are true sometimes. You have to disagree without being disagreeable. CEOs can be very confrontational. Their strongest weapon, given that they have to be generalists, is hard questioning. They're used to playacting, including pushing the person to the wall in an aggressive way. People just have to understand and keep their eye above the mouth that is speaking across the

table at them somewhat aggressively. Just count to 10 and speak in a way you know may be disagreeing, but not in a disagreeable or angry way. It is hard to do under a lot of pressure and in tight situations, especially if the person is being close to abusive. But you normally don't win those kinds of fights with the CEO if you lose your cool.

Welch was the kind of person who heard everything. He was a brilliant man. So, after a while I learned that you could take him on and contest with him even though he had taken a different position and even though he had said the decision had to be made at 4:00. He would hear what you were saying. You didn't have to say it seven times. You could say it once or twice and he got it. And he would think about it and three days later he might end up where you or someone else was without ever saying "Oh thank you Mr. CFO for that great insight. You changed my mind." That wouldn't happen, but it didn't matter. Not all CEOs are able to hear that well. Some CEOs, obviously, when they have a position, they're just going to repeat it over and over again and not hear. That wasn't the case with him.

So much of this is really the delicate relationship that exists between the CEO and the top people. How much tension can there be without you being banished beyond the pale? And part of that is the judgment—if you're lucky enough to make a judgment going in and doing diligence going in—about what kind of person the CEO is. Many of them, even though they're going to be brusque and tough cross-examiners and push you, absolutely want you to push back. Some may not.

ACC: We discussed how you go about doing the best to establish your position, your responsibilities, and your role as an incoming general counsel. But how about the general counsel who are already in place, and who may be struggling to change a culture, struggling to make certain that their advice is heeded, or that it's safe to deliver unpopular advice. Do you have any advice for these GC? Or suggestions about how to bring about a culture change in the organization or to stop a bad culture change so they can do the right thing?

Heineman: I'm not big on advice because everyone faces their own circumstances and has to make their own judgments. I would just make the observation that there are two obvious places to go if the world's changing. The first is to your senior colleagues: the head of HR, the head of finance, or whatever the case may be. Talk privately about what's happening and what, if anything, you can do to help shape the CEO's thinking to change direction and go in a better way, a higher integrity way. If they are creatures of the CEO and part of the palace guard, you're sunk. But they may not be.

The second obvious place to go is to the board, if that is possible. One of the important changes because of Enron, and I think most of the changes after Enron have been good, is that the boards are, in reality, more independent. They are concerned about their reputations. Having independent directors is a good thing. The general counsel can always go talk to friends who are directors if they've been there awhile. Because I was secretary, I was at every board meeting. I was part of the board culture. Over time, I became extremely good friends with virtually all the directors. I never had to go see them, but I could have if I had a problem that I couldn't solve inside myself. I could go talk to them.

You have to look in the mirror and not be corrupted by the money.

But you do face the question of when do you have to resign and when do you have to give up your non-vested financial interests that are significant. That is the conflict and that is the hardest question, maybe one of the hardest questions for general counsel. You have to look in the mirror and not be corrupted by the money.

ACC: That's a perfect segue. Where should a general counsel draw the line or how should a general counsel draw a line in the professional sand at which time they depart from the company that fails to heed their advice? And what should they do before they finally go?

Heineman: One way to think about this is three simple scenarios.

First scenario, is good board, good CEO. Normally you can work it out. You may have had honest differences of agreement, but assuming that the company hasn't crossed over into the clear area of wrongdoing, to some extent it's a command structure. As long as you think you've had due process and issues have been presented fairly, it shouldn't be a problem staying even if you disagree with the decision as long as it is not illegal or grossly unethical. But there can be a lot of tension even in the good board, good CEO situation, just because of the speed, size, and complexity of these gray area decisions which come up all the time.

Second scenario is bad CEO, good board. The CEO has just gone over the deep end. The CEO wants to do things that are clearly improper, either in a legal, ethical, or reputational sense. At that point, let's say it has crossed the threshold for a U.S. general counsel. You can go talk to the board, but normally you won't win an argument with the CEO because killing the king is pretty tough. But you may be able to work out a deal of leaving with some honor. Just say, look we've come to differences. Here's the issue; I personally feel it's wrong. It is time for me to go home. And, depending, you may have a chance to work out an arrangement where you get a package and you go away quietly, assuming you don't have a obligation to report an illegality. Normally, just talking to the board is enough even though it is far more likely you leave because trust with the CEO has been shattered, even if the board tries to address the underlying issue with outside counsel. I should hasten to add for your readers, that anyone who is a general counsel and gets in these situations needs a lawyer. The rules in this area about when lawyers are obligated to overcome the privilege and report to outside authorities are about as complicated as any I've ever seen: when you have to report and to whom you report. There are local bar rules and special SEC rules if you're an SEC practitioner. It is an area fraught with ambiguity requiring counsel to get counseling.

Then the third scenario is bad board and bad CEO. You may have to report to the authorities under these different rules. But I wouldn't want to live my life in this compromised situation because what's happening is just wrong. Sadly, I'm afraid I don't have any good answer other than the resignation. I think people who go into the general counsel position, if they take a chance on a company that's on the edge, they need to have thought through what they're going to do if the situation arises. They could go and say hopefully it's a turnaround situation. New CEO. Bad culture. But if the new CEO doesn't change the culture, indeed is captured by it, they've got to be prepared. They're naïve if they haven't thought about the doomsday scenario of the flat resignation without the financial benefits.

ACC: Thank you so much. This has been very helpful and I am sure will be helpful not only to our general counsel who advise the CEO, but for all ACC members who sometimes have to deliver difficult advice to their client.

Part two of this interview will run in the November issue.