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The Role of Outside Counsel in the Creation of Economic Value

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THE ROLE OF OUTSIDE COUNSEL IN THE CREATION OF ECONOMIC VALUE

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I. INTRODUCTION

As general counsel of a regional bank holding company, a significant portion of my time is spent managing the corporation's relationships with its outside counsel. These relationships vary in size, quality, and history. All of them are works in progress and all are affected by the forces that are revolutionizing the financial services industry: (1) the growth, efficiency, and power of capital markets; (2) the deregulation of the financial services industry and the attendant increase in competition among banks and between banks and nonbank competitors; and (3) the revolutionary developments in information and communications technology. Whether we like it or not, my company and the lawyers who represent it find ourselves in an increasingly competitive environment where change is constant and there is no end in sight.

Given this environment, it is important to continually assess my company's relationships with its outside counsel and to adapt these relationships to the realities of the marketplace. This Article summarizes my current thinking about Centura's relationships with its outside counsel and the way they relate to the primary mission of the firm: the creation of economic value.

II. THE CORPORATE MISSION

The fundamental mission of a corporation, whether it is a financial services firm or other corporation, is to productively employ the capital of its shareholders. Writers have spilled a

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significant amount of ink in legal and management literature about the responsibilities of corporations to "stakeholders" or "constituencies" other than shareholders. While there is value in this analysis, a corporation cannot meet its obligations to these other constituencies unless and until it has met its obligations to its capital providers.

In my company, this fundamental mission is expressed as the attainment of positive "economic value added" (EVA).[1] Positive EVA is achieved by generating net operating profits after taxes that exceed the cost of the capital employed in generating such profits. The primary tasks of management under this analytic framework are to deploy resources to activities that generate positive EVA, to withdraw resources from activities that do not, and to manage expenses carefully. Tactically, these tasks can be expressed as market management and risk management. The nature of these activities and their relationship to the corporate mission are set forth below.

A. Market Management

Market management involves attracting, retaining, and deepening profitable relationships with customers. To paraphrase a financial services expert who was active earlier in this century, this is where the money is. Given the competitive realities mentioned above, significant market management activities currently engaged in by successful competitors in the financial services marketplace include:

(1) Product Line Extension. In order to compete successfully, financial services firms must offer a range of services that include not only traditional banking services but also insurance, securities, and other related financial services. Development and marketing of such services involves navigation in a variety of regulatory regimes and, when necessary, arbitrage between them.

(2) Information Technology. Successful competition also involves the effective use of technology. The telephone and personal

1. "EVA" is a registered trademark of Stern, Stewart & Co. The definitive work on this concept is G. BENNETT STEWART, THE QUEST FOR VALUE: A GUIDE FOR SENIOR MANAGERS (1991).

computer are increasingly becoming efficient and effective channels for the delivery of financial services. Further, intelligent management of customer relationships involves the collection and use of information regarding customer conduct, attitudes, and preferences. This information is generated through internal and external data bases.

(3) Mergers and Acquisitions. An expensive but effective way of generating new customer relationships and, as a result, spreading the cost of the line extensions and technology investments mentioned above, is through mergers and acquisitions.

B. Risk Management

Risk management involves: (1) analyzing and understanding the potential for loss associated with the corporation's activities; and (2) taking the steps necessary to assure that such potential is properly reflected in the conduct of the corporation's business, particularly in the areas of corporate control and pricing. This task of management is, of course, integrally related to market management and is necessitated by the requirements of both capital markets and regulators. The major categories of risk are:

(1) Strategic Risk. This category involves conducting an analysis of opportunities and threats to the corporation's business and involves taking actions necessary to insure that the corporation is growing at the expense of its competitors rather than *vice versa.* Attainment of sustainable competitive advantage is the goal; the market management activities described above are the tools to get there.

(2) Credit Risk. This is the risk management category commonly associated with "bank work." The underwriting, documentation, and collection of loans is a major component of credit risk management; however, it is not the only one. Underwriting and management of the risks associated with investment securities and derivatives are also important.

(3) Operating Risk. This category includes virtually everything not covered above, specifically: (1) lender liability; (2) systems integrity and safety; (3) maintenance of the corporate control environment; (4) maintenance of insurance; (5) regulatory

compliance; and (6) litigation. In general, the inquiry here is whether management has inventoried the possible causes of loss associated with its operations and has taken steps to minimize or insure them. I also include reputation risk in this category, although it is sometimes treated as a separate category.

Market and risk management, as defined above, are not exclusive or exhaustive. Although corporate managers deal with numerous other matters in addition to those mentioned above, the discussion that follows will focus on market and risk management because, warts and all, these tasks involve significant sources of economic value to a corporation. This economic value is important in terms of both the generation of revenue and the optimization of expense. Further, significant legal issues are associated with virtually all of the activities included in my definitions of market and risk management, and the analysis set forth below can be applied to tasks not included in my definitions by those who are so inclined. All of this having been said, let us turn to a discussion of how I deal with such issues.

III. ALLOCATION OF CORPORATE RESOURCES TO ACHIEVE THE CORPORATE MISSION

My role as general counsel is to allocate internal and external resources to the resolution of the legal issues associated with the market and risk management activities of my company. The "resources" in question are primarily people and comprise, in ascending order of cost: (1) corporate personnel who are not lawyers; (2) internal professional staff; and (3) outside counsel. The objective of this allocation is to capture the value associated with a legal matter using the least resources possible. I try to achieve this objective by assessing the value and frequency of occurrence of the matter and handling it with the lowest cost resource appropriate to the task.

As noted above, the first step in capturing the value of a matter is to assess its value and frequency of occurrence. For purposes of this analysis, "value" means either generation of revenue or prevention of loss. "Frequency" means what it implies: frequent matters are common and recurring in the conduct of a business and infrequent ones are not. Diagram 1 presents a matrix of representative matters categorized as to value and frequency.[2] The upper right quadrant of the diagram represents those matters that are infrequent and create value ("Bet The Company"); the higher and farther to the right the coordinates, the bigger the deal. The upper left quadrant represents matters with relatively high frequency that create value ("Why We Get Paid"); in general, these are matters where a competent person properly employed should create value. Lower left quadrant matters are ordinary and recurring and add little or no value ("Another Day At The Office"); they are the mundane, humdrum stuff of everyday life. The lower right quadrant represents matters with low frequency that do not create value ("The Bone Yard"); nonetheless, these matters must be handled. I have included a few examples on the diagram by way of illustration. I suspect that readers will have a few of their own favorites to add.

Allocation of resources to these matters will vary with the size of the corporation and the operating philosophy of the general counsel. I tend to allocate outside resources to Bet The Company matters, internal professional resources to Why We Get Paid matters, internal nonprofessional resources to Another Day At The Office matters and, if possible, internal nonprofessional resources to The Bone Yard matters. I believe this allocation matches high cost resources with high value added matters and uses internal resources to the extent they are available. Differing situations require changing this allocation of resources, of course, and in my case, a relatively small professional staff mandates that outside counsel be employed on some Why We Get Paid matters. The most frustrating and risky matters in my experience are in The Bone Yard. Such matters often migrate to the legal department and are time-consuming and value-destroying. Further, if not carefully handled, such matters can move into other quadrants, including Bet The Company.

General counsel in larger companies often apply internal professional resources to a wider range of matters, including Bet The Company matters. This decision is based on the theory that the use

2. For the record, any similarity between the matrix contained in the chart and the work of Stephen R. Covey is purely coincidental. Same for the work of the battalions of consulting firms that have used matrix analysis since the beginning of time. Perhaps there is a collective unconscious.

of internal resources captures more value for the corporation by the avoidance of relatively expensive outside representation. However, the added value is offset by the increased cost, both financial and psychic, of managing a larger staff. There is no correct answer to this trade-off. Each corporation must make its resource allocation decision based on its overall culture and operating doctrine including, particularly, its definition of the skills that it designates as core competencies of the firm.

Where outside counsel is retained, the general counsel must choose a lawyer or firm to represent the corporation with respect to the matter in question. This choice can be viewed as either: (1) a purchasing decision, similar to any other purchase of services; or (2) an investment decision involving the formation of a strategic alliance. The way the choice of outside counsel is viewed will depend on the nature of the matter involved and the general counsel's view of his or her role in the corporation.

If the general counsel is operating on the assumption that his or her primary contribution to the creation of economic value is to reduce or minimize corporate expense, then selection of outside counsel will be treated as a purchase of services. Under this approach, selection will be based on service quality, as defined by the general counsel, and price. Further, the operating philosophy of the general counsel will be to "commoditize" the services which the corporation receives from outside counsel in order to move the services to internal resources or at least to increase bargaining power with the firms that represent or wish to represent the corporation.

While I have not done any research on this question, it is safe to bet that the "cost control" operating philosophy as described above is the predominate view among my colleagues. I have based this opinion on several factors. First, such a philosophy is consistent with the overall trend among corporations to minimize overhead of all kinds. Second, the results of this method of dealing with outside counsel are measurable. Third, the revolutionary trends mentioned at the beginning of this Article work in favor of the cost control approach. A combination of the competitive pressures in the legal services marketplace and the efficiency effects of communications and information technology is putting pressure on billings in all but the most arcane areas of practice. All of this having been said, this operating philosophy also has weaknesses, including: (1) the adversarial relationship that it can create between a corporation and its outside counsel; and (2) the failure to fully employ the intelligence and experience of outside counsel as an asset of the corporation in furtherance of the primary mission of economic value creation.

An alternative way of looking at the relationship with outside counsel is that it is a strategic alliance in furtherance of the corporate mission. This approach looks beyond any single matter toward the development of a shared operating philosophy and body of experience that benefits both parties. Further, this approach involves a shared investment in learning as the corporation and its outside counsel confront new developments in the marketplace and the law. This approach is not as "new age" as it sounds. I believe that the traditional relationship between financial institutions and their "regular" counsel, to the extent that they still exist, are characterized by this approach. The strength of this approach is that it can harness the full intelligence and experience of outside counsel to the corporation's benefit and that it can create value in itself by establishing the common understanding of the corporate mission which enhances the quality of service. The weaknesses of this approach include: (1) it is "soft" and thus difficult to measure; (2) the relative investment and benefits of the parties are hard to assess with particularity; and (3) it does not adequately recognize the need of the corporation to manage costs.

As a matter of personal preference, I favor the strategic alliance approach. Properly applied, I believe it can result in a "win/win" situation for both the corporation and outside counsel. In addition, it can serve as a vehicle for the growth and development of each, particularly in the area of shared learning. As noted above, a corporation's relationships with its outside counsel are works in progress. Achieving the full benefit of this approach will require relationships based on the primary mission of the corporation: the creation of economic value. General counsel and outside counsel should define their work together in the context of this mission and in doing so should consider:

(1) Accounting for the Relationship. To the corporation, the relationship with counsel should not be viewed solely as a cost;

rather, it should be viewed as a corporate asset to be employed in the creation of value. Outside counsel should also view the relationship as an asset and not just a receivable or group of receivables. While cost on the one side and revenue on the other will continue to be important aspects of the relationship, a focus on the creation of value through the relationship should put short-term financial matters in proper context.

(2) Defining Areas of Mutual Advantage. Substantial legal issues are associated with virtually all of the activities included in my definitions of market and risk management. This being the case, the corporation and its outside counsel should define those areas where counsel's training and experience can be employed to augment internal resources implementing such activities. Where the areas of interest are new to the parties, they should discuss the merits of investigating them together and the investment that each is willing to make to do so.

(3) Proper Employment of Technology. Given the ongoing nature of a strategic alliance, the parties should use communications and information technology to work together efficiently and profitably. The generation and sharing of information through this technology should make the parties better able to respond to the market quickly and efficiently. Both corporations and law firms have invested significant sums in this technology; it is time to put it to work.

(4) Sharing the Value Created by the Relationship. Proper definition of the value created by a legal matter should allow the corporation and its outside counsel to properly assess the cost of the service provided by counsel. Experimentation with alternative billing arrangements is a good first step and should be continued, as the best and fairest practices in this area will only be developed through trial and error. Sooner or later, hourly billing will have to go.

I realize that much of the discussion of the strategic alliance approach is fairly abstract. However, I believe that the realities of the marketplace in both financial services and law will favor the corporations and their outside counsel who try this alternative. Such an arrangement will require mutual trust and respect and, as noted above, will probably evolve through trial and error.

IV. CONCLUSION

It has become something of a cliché to discuss the rapidly changing world in which we all live and work. Cliché or not, the marketplace in which financial services firms and their outside counsel compete is rapidly changing and ever more competitive. All of us, corporations and counsel alike, have numerous choices to make as to how we confront this environment. Fundamentally, the choice is between doing what we are doing in the same way we have been doing it or rethinking our way of doing business in order to take full advantage of the opportunities the changing environment presents us. The easy course is to stay with the operating philosophy and methods with which we are comfortable: cost control management by general counsel and hourly billing by outside counsel. We will not be criticized for choosing this course unless and until it is too late. Further, it is possible that this course of operation will continue to suffice. However, I believe that the better choice is to pursue the creation of value, even if it requires leaving our respective comfort zones. Only time will tell which course of action is the best choice.

DIAGRAM 1

Valuation of Legal Issues