

Managing Legal Risk To Meet the Challenges Of the 21st Century

The Enron situation may lead to expanded government controls, tighter accounting standards and more explicit duties for boards of directors, auditors, and most likely, corporate lawyers. Using the Gateway Model and a new set of post-Enron action steps, CLOs will be able to manage this risk-heavy environment.

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The Chief Legal Officer of the 21st Century Advisory Group meets quarterly to develop and refine the Gateway Model for managing law departments in light of the serious new challenges facing corporations. The CLO 21 Advisory Group convened in Palm Beach, Fla., in January 2002, to discuss Gateway strategies for managing legal risk. During the meeting, the conference room lights did not go out as they did at the now-infamous Enron board meeting in Palm Beach a few years ago. Not surprisingly, group members were energized about legal risk because of the Enron collapse and the Congressional hearings probing the role of the Enron lawyers.

This report summarizes the discussion highlights and the post-Enron action steps that CLO 21 Advisory Group members encourage general counsel

to consider. Our report describes how many legal risk drivers are metastasizing, creating new minefields and a greater workload for law departments. We describe how the Gateway Model creates a rigorous approach for managing legal risk that strikes the best, right balance between effective support for business objectives and the implementation of internal controls that have teeth. We also present the Advisory Group's inventory of Gateway Legal Risk Building Blocks and discuss some of the key implications for implementing them. Finally, we report on the concerns of CLO 21 Advisory Group members about the cutbacks in law department resources that threaten sound legal risk management.

The Enron Meltdown

Thanks mostly to the shenanigans at Enron, "legal risk" has



become a popular topic at social gatherings, much to the delight of any lawyers present. Whereas this topic used to be discussed only in tedious corporate meetings about "internal controls," everyone with a 401(k) account or a Congressional parking permit is now batting the subject



around with aplomb. If this leads to a climate where more business executives pay attention to legal risk issues, it is not a bad development.

The Enron meltdown demonstrates that even in a company that goes to great lengths to set up internal con-

trols to manage legal and business risk, the culture of the company has an overriding influence as to what level of risk will be assumed. The Enron board assumed, with assurances from the auditors and executive officers, that risk controls were in place and working. However,

these controls were not implemented appropriately, and the board did not discover this until it was too late to prevent Enron's demise.

Executives who either did not correctly understand their roles or who manipulated the environment to sidestep them, inadvertently or deliberately thwarted these intended controls. Although the senior Enron lawyer working on the partnership deals correctly identified the risk issues and got corroborating advice from outside counsel, he was ineffectual in dealing with the legal risks. He either lacked the authority and standing in the company to force corporate actions to address the risks, or he lacked the leadership to take the issues to the board of directors.

According to testimony before the House, this lawyer sought the help of the general counsel who, apparently, was of no assistance. When the lawyer sought the help of the chief accounting officer and the chief risk officer, he was advised not to stick his neck out and to drop the matter.

The former CEO claimed he didn't know of the lawyer's efforts to seek his review of the matters or meet with him. The lawyer did not try to approach board members with the information, presumably because he felt he had gone far enough by advising executive officers of his concerns.

Would the board members have acted if the lawyer had informed them of his findings? Could the meltdown have been avoided if the board acted at that point? One can only guess, and the question as to whether the lawyer had a duty to go to the board is left for debate.

Many of us have seen situations similar to this one. No doubt, similar situations are being resolved because the

**“Legal Risk:
The risk that arises
from a perceived
or actual violation
of laws, regulations
or agreements leading
to costs, penalties,
liabilities or sanctions
imposed as a result
of the legal
process.”**

— CLO 21 Advisory Group

Legal risk used to be discussed only in tedious corporate meetings. Now, everyone with a 401(k) account or a Congressional parking permit is batting the subject around with aplomb.

lawyer in the hot seat takes the bull by the horns and keeps knocking on mahogany doors until he or she finds equally right-thinking people to deal substantively with the problem. However, absent the willingness of the lawyer to risk his or her position and career, many lawyers will accept the advice of higher-ups and simply drop the matter, even if reluctantly.

The general counsel is responsible for creating the culture in the law department wherein an individual attorney dealing with risk issues will either find support among colleagues or be left out on a limb. The general counsel does not operate in a vacuum, however. Every general counsel has to assess the overall culture of the company periodically and decide whether he or she is comfortable with the risk parameters that drive the business culture.

The general counsel is a control officer on whom the board must depend to ensure that internal controls are truly working and that lawyers are supported in their efforts to manage risk. It is very likely that

many boards, wishing to avoid the tarnish of “Enrust,” will re-evaluate the performance of all control officers, including the general counsel, and demand replacements for those who appear not to have the backbone and management skills to rigorously implement controls.

Legal Risk is Expanding At Breakneck Speed

Along with the promise of new opportunities in the 21st century, comes the realization that business and legal risk are expanding at a profound rate that may outstrip the abilities of corporate law departments to manage or control them. Possibly most alarming is that legal risk is frequently triggered by a relatively small group of people whose actions are difficult to predict, hard to control and usually extremely expensive to manage.

Three recent developments—the World Trade Center bombing, the Enron collapse and the proliferation of class-action lawsuits—have dramatically expanded the scope of legal risk that needs to be addressed by major companies.

This legal risk has resulted in dramatic increases in the cost of doing business, through increased insurance costs, precautions to ensure employee and corporate security and greater efforts to control and monitor corporate behavior. Perhaps most importantly, greater investor awareness of potential business and legal risks has led to lower stock prices and a further shrinking of capital markets during a global recession.

Other sensational corporate scandals have also rocked investor confidence. In 1906, the Armstrong investigation by the

New York legislature issued a damning report of abuses in the insurance industry. It found that life insurance companies were buying new issues from underwriters as part of the distribution of the securities (primarily debt) with the intent of reselling them as the underwriters found buyers. In effect, the securities were “parked,” and the underwriters did not bear the market risk of holding the securities during the distribution; the life insurers did. When the underwriters ultimately found buyers for the entire issue, the life insurers resold the securities to the new buyers through a member of the underwriting syndicate, which was a company owned by officers of the life insurance company. They took large commissions from the sale of the securities on their way through the underwriting company. As a result of the investigation, the New York legislature enacted stringent laws to prohibit numerous conflicts of interest between the officers and directors and their insurance companies. Many states copied these laws in the wake of the scandal.

And, as CLO 21 Advisory Group member Donald P. Horwitz reports, the Insull bankruptcy in 1932 was a key factor leading to the creation of the Securities and Exchange Commission in 1934. (See page 55.)

Great corporate scandals inevitably lead to new laws and regulations, and it is no surprise that the Enron situation will lead to the codification of expanded legal risks in the form of expanded government controls, tighter accounting standards and more explicit duties for boards of directors, auditors and quite possibly, corporate lawyers.

Post-Enron, insurance risk

DRIVERS OF EXPANDING LEGAL RISK

- Growth of laws and regulations
- Expanding access to the courts by plaintiffs
- Aggressive plaintiff bar
- Advances in science and technology
- Increasing costs of risk transference
- Increasing cost of internal legal staff
- Increasing cost of outside counsel
- Expanding business arena
- Increased scrutiny
- Anticorporate attitudes
- Procedural flaws in state court systems
- Unorganized corporate defense bar
- Increasing cost of internal resources (e.g., corporate representatives who must devote time to litigation)
- Increasing costs of outside audits

POST-ENRON ACTION STEPS FOR CHIEF LEGAL OFFICERS

BOARD-OF-DIRECTOR ISSUES

- Board members of many companies will ask management for greater substantiation of the prudence and soundness of internal practices, the rationale and wisdom of major deals and the reliability of audit and control processes.
- Many board members will be very concerned about their roles and their potential liability**, and they will need and want more specific advice and understanding of what action steps they should take to fulfill their roles and responsibilities.
- General counsel should be certain **that board members are well-educated** about the action steps that boards should take to avoid future problems with public credibility and/or government agencies, such as the SEC.
- Some board members **may request outside legal advice** on specific projects or issues, or just out of an abundance of caution. General counsel need to be prepared to address these requests and will want to be especially cautious in selecting a law firm with no conflicts of interest.
- General counsel should be **more proactive and demanding of the auditors** by asking more questions and reviewing more carefully what the auditors are doing to ensure the audit process has sufficient rigor and integrity (instead of just answering questions posed to them by the auditors).
- General counsel should **review the adequacy of the charter for the audit committee** and the guidance given to the audit committee about its role.
- General counsel may want to advise management about the **selection of future board members** so future members will possess significant expertise and leadership qualities. The goal is to ensure the board members have the competence and inclination to vigorously review management actions, not just comply with management's wishes. As one member of the CLO21 Advisory Group pointed out, it may not be in the company's interests to have sitting CEOs of other companies as the principals on the audit committee if these CEOs do not have adequate time to spend on audit committee business.

OTHER CONSIDERATIONS

- General counsel will want to ensure that members of the law department have a clear understanding of **the circumstances where a legal risk issue should be escalated to the general counsel**, so seemingly minor issues don't become huge problems due to insufficient risk analysis and review.
- Inasmuch as any type of accounting problem or restatement of financials may lead to disastrous rumors, general counsel will want to have a **plan and team in place to address the legal issues** arising from such a situation.
- General counsel may need to review **the company's document-retention policy** and audit the document-retention practices of the law department and business units to ensure the process is operating as required.
- General counsel may need to review:
 - **the management of the company's 401(k) plan** to ensure that it complies in every way with regulatory requirements and that all actual practices are consistent with the formal 401(k) plan in place;
 - **the crisis-communication plan** to ensure that the company has a plan and a team that is well-suited and well-prepared to manage any type of crisis that arises;
 - **the process of selecting outside counsel** in situations where the firm is expected to give legal opinions about potential company issues to ensure that the selected counsel is free from conflicts that would erode the credibility of their opinions;
 - **the company's policy on hiring the auditing firm for consulting assignments** to determine whether the law department should give advice limiting the range of assignments that are offered to the auditing firm; and
 - **the company's process for receiving and following up on employee and whistleblower complaints** to ensure that the process of follow-up investigations and reporting has integrity and does not engender additional risk as a result of ineffectiveness.

underwriters will be much more conservative in evaluating and pricing all corporate risks, especially directors' and officers' insurance, the cost of which is expected to increase precipitously. Insurance companies will certainly refrain from providing coverage for companies whose operations appear vulnerable to significant claims. Future litigation over coverage provisions is likely to skyrocket as insurance companies scrutinize corporate behavior and identify actions or omissions

which provide a basis for denying coverage under policy provisions.

The plaintiffs' bar shows every indication of refining the art of tapping corporate arteries to scientific levels. Funded by massive corporate settlements and awards that often dwarf the operating budgets of corporate law departments, the plaintiffs' bar has the ambition and resources to pounce on every possible corporate transgression. Here again, the insurance industry, already reeling from

crippling underwriting losses, is showing an increasing unwillingness to accept the transfer of risk. Corporations face severely limiting coverage provisions and rapidly escalating premiums, resulting in a greater degree of self-insurance that may ultimately need to be disclosed as material to the financial statements.

Another source of expanding legal risk is the degree to which science and technology can now push liability back onto corpora-

tions by revealing the level at which their products (or actions) were the original source of injury or contamination. One modest example is technicians who will likely be able to reveal the contents of many of the documents shredded by Arthur Andersen LLP by recovering the deleted electronic files found on PCs and network servers.

More significantly, advanced scientific methods are being developed that will enable researchers to detect the pres-



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The driving concept of the Gateway Model is to keep lawyers directly involved in the planning of initiatives that will help them manage risk.

ence of industrial contaminants in human DNA and potentially trace these back to specific manufacturers. Once the plaintiffs' bar masters the application of these new technologies, class actions will expand exponentially.

In light of these and other legal risk drivers, there has never been a time in the history of major corporations when the legal risks have been so great and the ability to transfer these risks so limited. This is particularly alarming considering the global implications of today's major companies. Enron's bankruptcy, for example, affects thousands of employees, creditors and shareholders all over the planet. That this global financial disaster was not prevented, because of a breakdown in internal controls ineptly supervised in part by a 245-attorney corporate law department, should cause every general counsel to lose sleep.

Gateway Building Blocks For Managing Risk

The members of the CLO 21 Advisory Group agreed that the drivers of effective legal risk management are:

- Ongoing discussion to refine the legal team's understanding of acceptable legal risk;
- Constant dialogue to review legal risk issues that arise;
- Early and continuing involvement in business partners' activities;
- Support from within the law department for attorneys who need help to prevent business partners from taking on legal risks that are over the line; and
- Ongoing education for business partners to ensure their understanding of basic legal risk-management concepts

and the roles they should play in helping to manage these risks.

In many law departments, these drivers must be implemented among legal team members who are based on different continents where business activities are governed by a variety of national laws, regulations and judicial systems. Given the size of some law departments, many attorneys will not have substantive personal dialogue with the general counsel more often than once every several years. In such an environment, the general counsel needs to have processes in place to ensure that each member of the legal staff develops a perspective on managing legal risk that is consistent with the department's standards.

The CLO 21 Advisory Group discussed an inventory of the Gateway strategies to implement these processes. While no general counsel will need to implement all of these strategies, the Legal Risk Management Building Blocks provide a comprehensive menu from which to choose the right combination for any given company.

One key problem addressed by the Gateway Model core competencies and business-integration strategy is that some law departments have been so focused on saying "no" that businesspeople have concluded this is the only word in the lawyer's vocabulary. So the businesspeople have been motivated to aggressively keep the lawyer out of key initiatives until the only task left to the lawyer is to manage the ensuing litigation. The illusion exists that the lawyer is managing legal risks because he or she says "no" so often, but the result

is really quite problematic: The lawyer never learns about details until after the fact. Businesspeople can be very creative at keeping lawyers at bay.

The driving concept of the Gateway Model is to keep the lawyers directly involved in the formulation and planning of initiatives to give them the opportunity to practice risk management where it belongs: at the birth of an idea and all the way through its implementation. This shifts the burden to the lawyers to be able to offer useful advice about how to structure initiatives to keep them on the right side of the risk. The lawyers must be creative and helpful without crossing the line to sanction unethical or illegal behavior. In the Gateway Model, lawyers must be prepared to say "no" when it is truly required, but only after alternative approaches to an initiative have been thoroughly explored and rejected. Lawyers who only say "yes" and lawyers who only say "no" are equal threats to the success and public reputation of their companies, each for different reasons.

Building a team approach to identifying and managing legal risk among tens or hundreds of inside and outside attorneys and paralegals is an extraordinary challenge. As Enron demonstrates, it may take only one errant situation where legal risk gets out of hand to demolish a company, if not by legal risks, then by reputational risks. In few other professions is the margin of acceptable error potentially so minuscule.

As one general counsel at the CLO 21 Advisory Group meeting put it, "I have to assume that each of my lawyers is not as clear

as he or she should be about our tolerance for legal risk until I hear for myself a mindset I can trust.” Lawyers who join the department from outside the industry or directly from law firms, for example, may need to rethink their concepts of legal risk in relation to their new employer.

In a global organization in which different business units have different risks, legal risk is decidedly a moving target. Legal risk tolerance must be constantly reviewed and refined as developments in the business environment occur. A court decision, a new regulation or a shift in public attitudes can be seismic events in the risk landscape.

While many general counsel rely on the precept that hiring the best lawyers with established good judgment paves the path to appropriate corporate legal risk-management, in a larger law department, there is bound to be at least one lawyer whose judgment or fortitude is less than “the best.” In most corporate debacles, isn’t it usually found that it was just such a lawyer who failed to manage as required?

Using the Gateway Model, a general counsel can create some deliberately overlapping strategies to help create a consistent view of legal risk within the organization and the checks and balances to ensure that legal staff is sophisticated, confident and effective in spotting and managing legal risks.

One inescapable problem confronting all general counsel, however, is how to manage expanding legal risk in the face of corporate cutbacks. Sounder strategies for managing legal risk will pay dividends in the long run. But in the short term, they require adequate staffing and realistic budgets.

Shrinking Law Department Resources

As widely reported, law departments are under pressure to contain costs, and many have been given specific directives to reduce costs below current levels. While it is true that many law departments can manage their work more efficiently through creative negotiations with outside counsel, better use of technology and more widespread adoption of best practices, this is not the time for CEOs to arbitrarily hold law departments to formulaic cost reductions that do not take into account the dramatic expansion of legal risks.

It is healthy for general counsel to be challenged by CEOs to reduce costs and become more innovative in the way legal services are delivered. But the challenge CEOs need to give general counsel is to thoroughly re-evaluate how legal risks are managed and fashion a legal budget designed to deliver on this mandate. In most companies, the total legal spending of the company constitutes a dollar amount that is lost in the rounding of final financial statements. However, as demonstrated by Enron and many other recent examples, a failure by the law department to adequately address and manage legal risks can be potentially catastrophic.

Unfortunately, today’s cost-containment goals are typically set in relation to the level of spending by the law department over the last several years. To set tomorrow’s spending levels based on the costs of managing yesterday’s legal risks is seriously short-sighted. What competent CEO would advocate that highway planning be based on the number of cars on the road over

the last three years as if current population growth and car sales trends were inconsequential?

It is wishful thinking to believe that all a company needs to prevent risks is to employ a law department comprised of bright, energetic and dedicated lawyers with the judgment and guts to tackle substantial risks as they appear on the playing field. What is often overlooked by budget cutters is that large law departments have responsibility for hundreds if not thousands of legal matters simultaneously. In today’s global mega-corporations, there are potentially hundreds or thousands of legal risks that have yet to be identified and are not yet being addressed.

Lawyers who are literally scrambling from one meeting to another often do not have the time or energy to review these risks as thoroughly as they should. The sheer velocity of deals underway hinders the lawyers’ ability to raise and review issues in a timely way to prevent the risks from being realized.

Moreover, the growth in demand for legal advice by clients is likely to increase dramatically as business executives and board members alike look for assurances from attorneys that they are not taking on undue legal risk. A recent survey of attorneys at large law firms conducted by The Affiliates, a legal staffing firm in Menlo Park, Calif., found that the 200 respondents receive an average of 48 e-mails a day—one every 10 minutes. In-house attorneys most likely receive a similar number. Which e-mails among the 250 received each week identify urgent risks?



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To set tomorrow’s spending limits based on the costs of managing yesterday’s legal risks is seriously short-sighted.

Our web site, www.lawexec.com, provides extensive background on the CLO 21 Advisory Group and the Gateway Model.

Board members, especially those on audit and finance committees, will certainly be more alert to the potential for personal liability and will weigh

carefully whether the modest director fees they receive provide adequate incentive to outweigh potential risks. As new laws and regulations are enacted,

such requests for legal advice will no doubt continue to increase.

Outside board members and auditors will also be more

demanding in their review of internal operations and risk issues. The law department will certainly be asked more frequently to review and comment on the

GATEWAY BUILDING BLOCKS FOR EFFECTIVE LEGAL

LAW DEPARTMENT LEADERSHIP

The law department periodically updates and distributes a comprehensive Legal Risk Assessment Checklist for the legal staff that can be readily utilized to help identify legal risks related to business projects in such categories as: compliance, business operations, liability, litigation, reputation and others.

The legal staff is provided with consistent and specific guidance as to the level of legal risk the company is willing to assume in its business operations and litigation activities.

The legal team uses consistent legal-risk terminology to enable “apples for apples” discussions about legal risks, with specific descriptions of how risks (particularly “high” risks) should be classified in a consistent manner.

There is a specific protocol in place that identifies under what circumstances and to whom legal risk issues are to be escalated (i.e., to general counsel and senior management) by members of the law department.

Law practice groups meet at least annually to review and discuss the legal-risk guidelines for their business partners and the risk profiles of key projects and activities.

BUSINESS PARTNER LEGAL RISK AWARENESS

The law department regularly distributes to business partners the current version of the Legal Risk Assessment Checklist to provide current insights about legal risk issues to which business partners should be alert.

The law department provides ongoing legal risk education for business partners—via online programs, seminars and presentations—about the company’s risk tolerance guidelines and steps they are expected to take to help manage legal risks.

Lawyers have a well-publicized open-door policy with business partners to discuss legal risk concerns.

Newly-hired executives at or above a designated level participate in a legal risk-management orientation programs provided by the law department to ensure they are familiar with the company’s legal-risk management guidelines, resources and protocols, and their responsibilities for helping to manage legal risk.

LEGAL RISK-MANAGEMENT COORDINATION

Each practice group has a designated legal-risk coordinator who is accountable for ensuring that the practice group’s legal risk-management activities achieve legal risk-management objectives.

A specific attorney is designated as the project legal-risk coordinator for each business project in which there are multiple lawyers participating in the project.

Project risk coordinators and legal colleagues utilize the Legal Risk Assessment Checklist to assess whether the information the legal team receives from business partners is timely and adequate to identify and evaluate project legal risks.

Practice group legal-risk coordinators meet quarterly to review and discuss their roles, the standards and processes for managing legal risk, emerging legal risks and risk case study examples.

There is a systematic process in place to ensure that practice group legal-risk coordinators discuss high-risk matters to identify potential overlapping risk areas and coordinate risk-management activities where such overlap exists.

Each practice group has a systematic process in place to correlate internal data on litigation reserves, audit letter inquiries and matter-tracking systems to ensure that law department legal risk determinations and actions are consistent for each matter.

There is a process in place to ensure that law firms handling high-risk matters submit updated legal-risk assessments on a quarterly basis (or more frequently) and that each legal-risk update is reviewed by the project risk coordinator, the practice group risk coordinator and the business project team and/or senior management when appropriate.

IDENTIFYING LEGAL RISKS

The law department has a systematic process in place to:

Review all customer, employee and investor complaints and suits to identify trends that may indicate potential legal risks that need attention;

full spectrum of business dealings, if for no other reason than to give executives the ability to provide assurances to the board that the “lawyers are OK with this.” Board members may well want more face-to-face opportu-

nities to question the lawyers about the level of diligence with which they reviewed the matters at hand.

General counsel need to engage executive management and their boards in serious discussions

about the best ways to measure the strategic value of their law departments to their companies. They must shift the discussion away from historic spending as the basis of determining future law department resources. ●

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RISK MANAGEMENT

- Review the final reports of all regulatory compliance examinations to identify trends that may indicate potential legal risks that need attention;
- Review proposed and enacted regulation and legislation to identify legal risks and advise business partners in a timely way of additional compliance and legal risk issues;
- Review litigation and regulatory actions against competitors to identify potential areas of legal risk that may apply to the company, and to advise business partners of potential exposure;
- Review trends in insurance coverage litigation and the terms of the company’s insurance policies to identify potential coverage-denial risks;
- Annually collect and organize the insights of legal staff about emerging legal risks facing the company and the steps the law department and others should take to address them; and
- Annually collect and organize the insights of primary law firms about emerging legal risks to which the law department and the company should be alert.

PROJECT LEGAL RISK MANAGEMENT

The project legal team prepares a risk profile of proposed projects and reviews this profile as appropriate with the business project team.

The project legal team periodically updates the risk profile for ongoing business projects and reviews the update with the business project team (at least quarterly for high-risk projects).

At the completion of major projects, the attorney designated as the project risk manager prepares an assessment of the open legal risks that still need to be managed on a going-forward basis. This assessment is reviewed with the practice group risk coordinator and others in the law department and business unit as appropriate. Ongoing legal obligations—such as payments, disclosure or reporting and compliance requirements—are identified.

At the completion of major projects, the lawyers involved with the project (possibly including outside counsel) review the steps taken to manage legal risks and make improvements in the way the legal-risk management process operates for future projects.

REPORTING TO SENIOR MANAGEMENT

Appropriate law department representatives meet quarterly with business unit heads (and other company control executives) to review the status of high-risk matters in the business unit and recommend appropriate action steps.

The general counsel and appropriate law department managers meet quarterly to review the status and management of high-risk matters in the company and identify appropriate action steps.

OUTSIDE COUNSEL

Law firms are provided with consistent and specific guidance as to the level of legal risk that the company is willing to assume in its business operations and litigation activities.

Law firm engagement partners are asked to confirm periodically that law firm staff working on assignments for the company has been thoroughly briefed on the company’s risk-tolerance guidelines.

Periodically or at the end of major legal projects, outside counsel are asked to submit a list of suggested action steps for improving legal-risk management.

Law firms’ performance in identifying and managing legal risks on behalf of the company is reviewed annually, and law firms are terminated or warned when their performance is not adequate.

LAW DEPARTMENT LEGAL RISK PERFORMANCE MANAGEMENT

Newly-hired lawyers and paralegals participate in a legal risk-management orientation program to ensure they are alert to the law department’s legal risk-management guidelines, resources and responsibilities. There is a process in place to track participation.

The performance of attorneys and paralegals in managing legal risks is reviewed at least annually by their supervisors, and those whose performance is inadequate are warned or terminated.