Legal and Compliance Risk

A Strategic Response to a Rising Threat for Global Business

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Manifestations and Roots of Legal Risk

For their book *Managing Uncertainty*, Michel Syrett and Marion Devine conducted a survey of 205 senior executives from international companies and public sector organizations in various countries.[1] The respondents identified legal risk as the second highest risk category both in terms of level of uncertainty and impact. The only category which scored slightly higher than legal risks was political risks, and these, obviously, are closely related to legal risks. A research study published by Accenture in the year 2013 strongly supports these results; there, legal risk scored higher than any other risk, with 62 per cent of the executives interviewed mentioning legal risks as the top external pressure; moreover, with a score of 49 per cent, regulatory risks were the third most often mentioned risk class (see figure 1.1).[2]

In a similar survey conducted by the English law firm Berwin Leighton Paisner (BLP), 80 per cent of responding company executives said that they expected their business to experience material losses as a result of legal risks.[3] And they are right in this assessment. As a simple front page review over a short time will reveal (see section 1.4), big companies face huge fines, settlement costs, or penalties as a regular operational risk. Some of these costs have reached astronomical heights, such as the multi-billion fines which are now regularly paid by banks and other global companies. Also, legal and compliance failures are prone to have a high negative impact on a company's share price. A 2012 study by the international law firm Freshfields Bruckhaus Deringer found that crises triggered by reports of illegal or questionable conduct of a company or its employees, such as claims of corruption or breach of antitrust laws, may result in a share price fall of 50 per cent or more within a day of the event, which is considerably more than for any other class of

[1] Michel Syrett and Marion Devine, *Managing Uncertainty* (London: Economist & Profile Books, 2012) pp 13f.

[2] Accenture, "Risk Management for an Era of Greater Uncertainty", Accenture 2013 global risk management study, <http://www.accenture.com/microsites/risk-management-research/2013/Pages/home.aspx>, p 9.

[3] Berwin Leighton Paisner, "Legal Risks Benchmarking Survey" (11 October 2013), <http://www.blplaw.com/expert-legal-insights/articles/legal-risk-benchmarking-report/>, p 2.

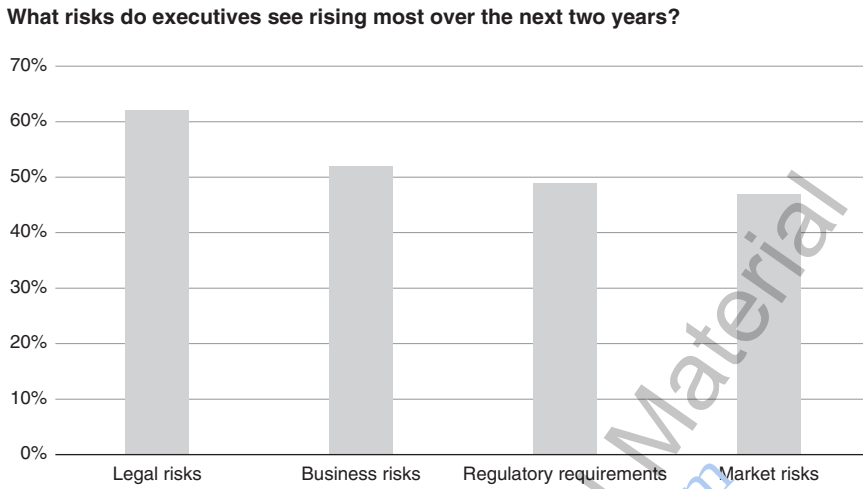

Figure 1.1 Top external pressures on global companies
Source: Based on data of Accenture, 2013 global risk management study

crises reviewed by the study such as operational, corporate, or informational events.[4] Based on all these surveys, we can easily conclude that legal risks are among the most salient risks for global businesses, and we could make a reasonable argument that they actually score higher than any other external threat for these companies. We also have to note empirical evidence that for banks legal risk now dwarfs their traditional number one business threat, ie credit risk.[5]

But then comes a paradox: whilst company executives in these surveys see a high exposure in terms of legal risks, they also have only a scant understanding of these risks. The BLP study concluded that legal risk is poorly understood outside of the general counsel's office. Only 25 per cent of chief executive officers (CEOs) and company directors said that they have a clear understanding of legal risk. A higher degree of confidence was expressed by the specialists in the field, the general counsels (73 per cent), the in-house counsels (52 per cent), and the risk and compliance professionals (50 per cent).[6]

[4] Freshfields Bruckhaus Deringer, "Knowing the Risks, Protecting Your Business", November 2012, <http://www.freshfields.com/en/insights/crisis_management/> and <http://www.freshfields.com/uploadedFiles/SiteWide/News_Room/Insight/Campaigns/Crisis_management/Knowing%20the%20risks%20interactive.pdf.PDF>, p 4.

[5] Neasa MacErlean, "Legal Risk Dwarfs Credit Risk for Banks", *The Global Legal Post*, 29 August 2014, <http://www.globallegalpost.com/big-stories/legal-risk-dwarfs-credit-risk-for-banks-40094006/>.

[6] Berwin Leighton Paisner, "Legal Risks Benchmarking Survey" (11 October 2013), <http://www.blplaw.com/expert-legal-insights/articles/legal-risk-benchmarking-report/>, pp 1 and 6.

Certainly, negative consequences from legal cases, such as lost litigation or an unenforceable contract, were there since the times of the Roman Empire. But the notion that legal risk has become *the* key risk category for big global companies is a fairly recent one. And why have the boardrooms of companies so poorly absorbed an understanding of this huge threat to business success? There might be a number of reasons. First, it is the relative novelty of this threat, and many business people simply have not yet accepted that the rise of legal risk is caused by some very fundamental changes in our society and, therefore, will not stop soon. Secondly, board members and CEOs of global companies have attended business or engineering schools which teach finance, marketing, strategy, operations, or engineering but rarely offer courses on legal risk management. Thirdly, dealing with legal issues is a hardship for many managers. They prefer entrepreneurial activities over dealing with bad news. Discussions on new products, or even the new brand logo, are simply more attractive than a compliance issue. This shyness vis-à-vis legal issues is further fostered by the existence, and abundance, of lawyers, compliance professionals, risk managers, internal auditors, and other experts who are more than willing to care about these things and create the impression that they have perfect technical and professional control of them, which they have not.

It is a key argument of this book that effective legal risk management is first of all a *leadership and strategy matter*. This starts with a need to *understand* the manifestations and root causes of legal risk. I do not mean this in a technical sense. Boards and CEOs must not lose themselves in fully understanding the legal system and how it evolved in history, but they should have a basic knowledge of the historical, political, economic, and sociological facets of legal risk. Board members and executives have to understand the essence of the phenomenon before they can turn to a strategy to manage it properly. This is the main thrust of this chapter.

The chapter is structured as follows: I will start with the *manifestations* of these risks such as the evolution from the certainty of law to the uncertainty of legal risk, legal pluralism and the entropy of law, the not so rare irrationality of legal processes, and the big cuts and costs when legal risk hits, as well as the expansion of law and the legal industry (sections 1.1 to 1.6). I shall then describe the historical and sociological *root causes* for the rise of legal risk such as globalization, societal pluralism, cultural clashes, increasing transparency and, most recently, de-globalization and growing fragmentation of the global legal system (sections 1.7 to 1.12). I have conceptualized my views and observations in Figure 1.2 where I make a distinction between *manifestations* (legal uncertainty etc), *roots* (globalization etc), and *reinforcing factors* (such as transparency).

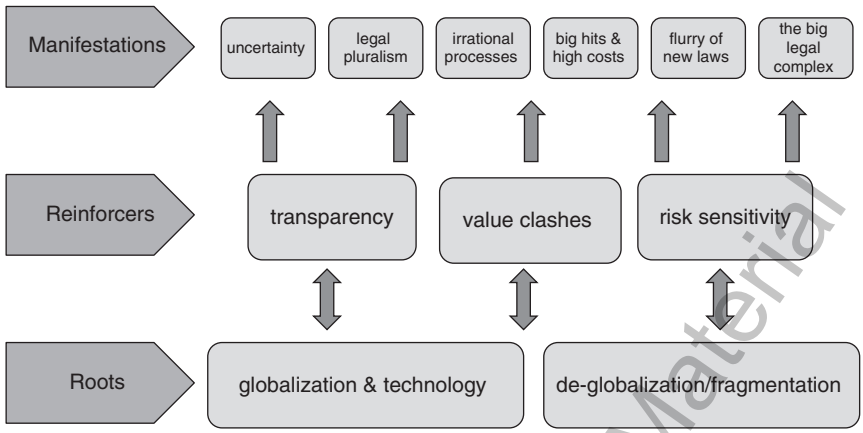

Figure 1.2 Manifestations and roots of legal risk

I said it in the introduction but out of caution to not deceive the reader I repeat it here: this is not a scholarly treatment, it is neither legal philosophy nor legal sociology; it is no more than my observations cast into an analytical framework.

1.1 From the Certainty of Law to the Uncertainty of Legal Risk

All of us have a concept of law. For me, and I would guess for most of my contemporaries who have been raised in similar circumstances in the European world, law simply means a *clear set of rules* which govern our everyday lives in a binding way. The predominant view of law in Western culture is a positivistic one: the law is what is written in a constitution, a statute, a decree, a regulation, or binding case law. Some of the ancient philosophers argued that there is a natural law above the positive law and that this natural law applies to every human being in the same way. Others believe in religious laws. But this is not what we normally attach to the term of law. Also, there is a clear distinction between law on the one hand and broader concepts such as morality or ethical rules which might emanate from natural laws, religious views, political inclinations, or ideologies on the other hand.

Legal rules may serve many purposes. First and foremost, they regulate the relationship between the government and private individuals. These laws start with constitutional freedoms but include such different things as

taxation, environmental protection, financial markets regulation, criminal law, traffic rules, and many more. Often, sanctions are attached to the violation of such "*public*" legal rules. Many of these sanctions are consequentially far-reaching. One might pay heavy fines, go to jail, be expelled from a country, or, in some places, even lose one's life.

Other legal rules govern the relations between private individuals in their many functions as members of a family, business persons, consumers, or even competing athletes. They can require behaving in a certain way, and sanctions can be attached to these rules: for example, if you do harm to my property, you pay damages. But in many other cases, these "*private*" rules create and govern elaborate institutions such as marriage, partnerships and companies, many types of contracts, charters, licences, and so on. The newly married or business partners can opt for a certain institution or contract type, and then the law stipulates the many rules which apply to them.

Whatever the nature of a specific law, we normally have clear expectations regarding it. The most important ones are *clarity* and *predictability*. Like in a tennis match, we want to know whether the ball is in or out of the field; thus we want to see a clear line, and it must be the same line the umpire sees. Ambiguity might be constructive in diplomacy, central bank policy, or romantic matters, but it undermines almost everything which we associate with the rule of law.

There are a number of notions associated with this concept of clarity and predictability: the law has to be known or at least be readily discoverable. No one wants to go on a wild goose chase to find out what crime and punishment is. Also, the law and its application should be reliable for the foreseeable future, and changed only through an accepted legislative process. The concept behind this is that one should be able to know the law, make clear decisions on the basis of this knowledge, and implement these decisions without fear of sanctions.

A second expectation is *due process* in case of a dispute. Whoever drags us into court, whether it be the government or a private adversary, we assume that we will receive a fair trial. Such are our expectations: each side of a legal dispute has an entitlement to present its case, bring appropriate evidence, call witnesses, and then justice will render a fair and balanced decision in due course; punishment is adequate and appropriate for the harm done; and decisions and sanctions will be swiftly and duly enforced.

In summary, in an ideal world, the concept of law means a set of rules which are clear and predictable in their operation, are discoverable with reasonable efforts, set and adjudicated in a fair legal process, and enforced in a timely and proper fashion. If the law fulfils these simple expectations, it

functions as the core fabric of a just society. It creates trust in government and peace among citizens.

This concept of law does not exist in the daily life of global businesses. They operate in many parts of the world. Often, there is no clear set of legal rules for their operations as we would expect under the concept of law. Rather, global business leaders are confronted with an abundance of legal requirements as well as with situations of complete legal instability. These requirements are often unclear, even opaque, and can arise retroactively. Legal processes which should lead to clarity within a reasonable time are often slow, biased, and unpredictable in their outcome. In the worst case, they are deeply corrupted and in the hands of officials and judges who seek bribes.

Even the known laws are often unknown in their consequences and application. Naturally, many laws are subject to interpretation. To limit the uncertainty, business people ask for legal opinions but these opinions, more often than not, are conflicting or subject to many qualifications, exceptions, and limitations. And so many managers have had a clear opinion letter on their desk, only to learn later that the authorities did not follow the learned advice of their lawyers. Laws are often applied in a surprising way and outside of the original intention of their makers.

The result of this is that leaders of global businesses do not see the law as a source of certainty and predictability, as a solid and reliable framework for their operations. Rather, these business leaders see the law as a constant threat, as a mainspring for creating risk and uncertainty on many levels of their enterprise. This is reflected in the survey results of Syrett and Devine which I quoted at the outset of this chapter.

Uncertainty was a key concern of all respondents in their survey. What is of particular interest for our topic is, however, that the managers interviewed identified legal risk as the second highest risk category both in terms of level of uncertainty and impact. The only category which scored slightly higher than legal risks were political risks.[7]

Political risks, however, are closely related to legal risks. When a government changes, the law changes too. While a peaceful transition after a democratic election may have a relatively modest impact on the legal system, there are more dramatic instances. This is obviously true for extreme inflexions such as the fall of the iron curtain or the Arab Spring. But even democratic transformations might create a complete break with a legal tradition. Take the example of Hungary. In 2010, the nationalistic Fidesz party won a landslide victory in the general elections and secured a two-thirds majority in

[7] Michel Syrett and Marion Devine, *Managing Uncertainty* (London: Economist & Profile Books, 2012) pp 13f.

parliament. The party leader, Victor Orban, took the helm of the new government and started with a massive programme of transformation which extended to many constitutional and legal aspects, including the role of judges, media politics, policy of the central bank, cross-border flow of capital, taxation, and favours for local entrepreneurs to the detriment of foreign investments. As a result, Hungary became a pariah for international business because the political and legal risks, the uncertainty and sense of instability, coupled with the negative image of doing business there, became too severe.

Similarly, *economic risks*, which are the third most important risks in the survey mentioned before,[8] have a direct impact on legal risks and might reinforce them considerably. Every lawyer in private practice knows this because the amount of litigation, regulatory, and bankruptcy work has surged on the tails of almost every economic slump. This is very visible in the aftermath of the Great Financial Crisis of 2007 to 2009. Enforcement activity and law suits against financial services institutions have reached record heights. Since 2009 banks have paid more than USD 250 billion in terms of fines and penalties to US governmental agencies.[9]

Thus, not only is legal risk a frontrunner of the risks as perceived by global executives, it also sits squarely with two other major risks, the political and economic uncertainties, which drive, correlate with, and reinforce legal risk to a considerable extent. These three risks together build the biggest and thickest cluster of uncertainty for a present-day manager.

1.2 Carina Nebula: The Chaos of Laws and Legal Pluralism

Business leaders witness the transformation of law into legal risk; they see heightened uncertainty and instability instead of a clear set of rules; they assess legal risk to be amongst their primary risks. But managers and entrepreneurs might be biased. They prefer opportunities over risks after all. They live on making things happen and they intuitively, and often emotionally, take a negative stance towards things which stand in their way. So we have to look at what someone has to say who presumably has a more distanced view on today's manifestations of the legal environment.

[8] Michel Syrett and Marion Devine, *Managing Uncertainty* (London: Economist & Profile Books, 2012) pp 13f.

[9] Robert Lenzner, "Too Big to Fail Banks Have Paid $251 Billion as the Cost of Regulatory Revenge", *Forbes online*, 29 August 2014, <http://www.forbes.com/sites/robertlenzner/2014/08/29/too-big-to-fail-banks-have-paid-251-billion-in-fines-for-sins-committed-since-2008/>.

In her fascinating book, *Law after Modernity*, legal philosopher Sionaidh Douglas-Scott describes modern law in terms of disorder, entropy, and chaos and asks herself whether or not law is like postmodern literature epitomized by writers such as Thomas Pynchon or Paul Auster. She reckons that this genre of literature "has as its focus the shifting through of signs and, ultimately, the possibility of deriving order from a chaos of conflicting clues and meanings. In many ways, this is what lawyers, too, try to do".[10] Douglas-Scott then goes on to compare modern law to a "blur of forces in motion" and so finds parallels to the chaos and entropy that figure in contemporary art and literature.[11] She further captures the legal landscape by the image of *carina nebula,* a vast complex of dust and stars 7,500 light years away from us: "there are black holes, dark matter and all manner of imponderable, perplexing shapes. This is a beautiful but disturbing image. With its hugeness, its mysteries and multiplications, its black holes,…it might be compared to the contemporary legal landscape."[12]

With her view of the law, Douglas-Scott follows *postmodernism*, a leading school of thought and art which sees the world more in terms of deconstruction and disorder than in terms of rationality and pure concepts.[13] Some people dispute this view and still see rationality in the legal system.[14] In many ways, however, Douglas-Scott's observations come very close to what the day-to-day exposure and experience of global businesses in the legal space are. Moreover, the postmodern view has a firm footing in a more rationalistic conceptualization of the law, *legal pluralism*.[15] Legal pluralism implies that there is not one single law for any given situation but that cases often fall under a multitude of legal rules. These rules exist in parallel, create conflicting demands, and often contradict each other. This legal pluralism constitutes a defining element of the legal risk environment. It is worthwhile examining it in more detail.

Everything starts with *local law*. This is the law which we often encounter in our daily lives, be it private or business. Local law is, by any

[10] Sionaidh Douglas-Scott, *Law after Modernity* (Oxford and Portland: Hart Publishing, 2013), p 102.

[11] Sionaidh Douglas-Scott, *Law after Modernity* (Oxford and Portland: Hart Publishing, 2013), p 104.

[12] Sionaidh Douglas-Scott, *Law after Modernity* (Oxford and Portland: Hart Publishing, 2013), pp 105–6.

[13] Cf Christopher Butler, *Postmodernism: A Very Short Introduction* (Oxford: Oxford University Press, 2002).

[14] Michael King, "Law after Modernity, by Siondaidh Douglas-Scott", 28 October 2013 <http://www.timeshighereducation.co.uk/books/law-after-modernity-by-sionaidh-douglas-scott/2006765.article>.

[15] Sionaidh Douglas-Scott, *Law after Modernity* (Oxford and Portland: Hart Publishing, 2013), p 106.

standards, the simplest and most transparent situation that you can have in any exposure to the law. You have no international conflicts, no transnational overlay, and few cultural clashes. Even our daily experience with law might, however, be complicated. The reason is that our local law consists of a number of competing sources. Many modern states have three layers of government: national (or federal) government; states or regions; and communities or municipalities. The relationship between these different levels varies considerably from one country to the next. There are countries which are, when it comes to legal matters, very centralized, such as France, England, or Austria. By contrast, there are other countries, such as the US, Germany, or Switzerland, which have a high degree of decentralization. Decentralization means that all levels of government, the national government, the states, and the municipalities, can set their own law and raise taxes to implement them. It may also mean that one level promulgates the law and another level administers or adjudicates it. This can lead to a myriad of conflicting situations. States or communities issue statutes and decrees which are then struck down by the constitutional court at the national level. Or the court of one state might construe a national law differently than the courts of the neighbouring state.

Still on the local level, there might be similar conflicts between different agencies, such as the labour department on the one hand and the immigration authorities on the other; or between the tax and the social security administrations; or the landmark protection officials and almost everybody else. But this is only the beginning; when we drill deeper into these legal conflicts and their origins we will see that different people have sometimes very different views on the same law or legal situation because they hold diverse values, have strongly diverging political or religious views, or are driven by monetary or other selfish interests which disallow any kind of balanced view on a specific law or legal situation. Under the pressure of such divergences, no law is ever final. It is under constant, sometimes stronger and sometimes subtler, forces to move in one direction or the other.

Thus, even modern states are far away from being highly rational bureaucracies as they have been described by Max Weber. Rather, they are in a state which many would describe as a legal jungle, as disorder, or entropy.

But our journey has only started. Once we leave domestic confines and enter the *international scene*, things get more complicated, very complicated indeed. Governments agree on simple matters such as shipping on the River Rhine or running a joint airport. They conclude complicated and far-reaching bi- or multilateral treaties. They set up supranational institutions such as the United Nations or create new forms of sovereignties which come very close to an entirely new level of government. The most salient example for this

latter phenomenon is the European Union (EU) which has its own governance bodies, its own courts, and issues directives and regulations. All these different forms of transnational cooperation are an unlimited source of legal conflicts and uncertainties.

This reality of transnational operation of law is aggravated by the fact that governments have very different views on the reach and confines of their own law and on how international law relates to internal law. Traditionally, law was a domestic situation within national borders; the law of a country applied, subject to international law, within the country and did not, absent very special circumstances, reach beyond this. America, however, developed over the years a concept of extraterritorial reach of certain laws, a notion which for a long time was strongly rejected by most European governments. In retaliation, the Europeans sometimes resorted to so-called blocking statutes which made it illegal for their citizens to follow US law to the extent that it applied extraterritorially. A similar conflict arises between America and many other nations in relation to the significance of international laws. Whilst European and other legal systems will normally accept a priority of international law, this is often not the case in America.

Finally, a particular complexity is added by the emergence of *soft laws* in transnational situations. "Soft laws" means rules and declarations which are not directly binding upon the parties involved or third parties, such as resolutions of international bodies like the United Nations, the policy coordinators like the G20, or the global standard setters like the Organisation for Economic Co-operation and Development (OECD), the Basel Committee, and the International Organization of Securities Commissions (IOSCO). The declarations, standards or policy intentions issued by these bodies do not have the force of law, ie, there are no direct sanctions attached to these soft laws in case they are violated; some of these bodies, like the G20, do not even have a formal constitution for their own organization. Thus, in the traditional sense, soft laws are no laws at all and are issued by bodies with very limited legitimacy. Nonetheless, they often have a *de facto* force which may go far beyond many "hard laws"; sometimes they can bring whole governments and big companies to their knees. They work through persuasion, discriminatory shaming, blacklisting in case of non-compliance, and have an indirect effect on how the laws of the member states or even those of third party governments are implemented; they also influence the rulings and reasoning of international courts and tribunals. Whereas the rule of law was attached to the classical nation state with clearly defined borders, soft law answers the more intentional and aspirational views of the global community including, in particular, its emerging new members. In many ways, soft laws epitomize the deconstruction of the traditional concept of law.

It is obvious that all of these many layers and forms of laws, and the conceptually diverging views on how they govern a case, lead to a high degree of legal complication. Many of the big contentions in the business law area revolve around this. We see it in a number of very important areas of international business law, such as competition law, data privacy, sanction regimes, banking regulation, securities laws, taxation, and extradition of wanted persons.

The situation is further complicated by some other fundamental changes in how, and to what extent, modern societies apply and enforce the law. Whereas the traditional law concepts focused on repression, we see now more and more situations where the law incentivizes compliant behaviour such as granting more lenient capital requirements to banks which are organized in a certain way or allowing tax deductions to businesses with low energy consumption; thus, law is now often more behavioural than repressive. Also, in the old days, the law was administered by courts and judges; now, many independent authorities and regulators enforce the law. Finally, businesses are now often incentivized or forced to participate in the enforcement actions against themselves by being mandated to make their own investigations or to self-report compliance breaches. With the American constitution, and later in the liberal revolutions of the nineteenth century in Europe, modern societies started with the notion that there is a clear demarcation between the powers of a limited government and the space of the free citizen. Now, this has become somewhat fuzzy and the law permeates ever more situations both in business and private life.

All these developments and phenomena create the disorder which the legal philosopher observes and which are the source of the many headaches of global enterprises.

1.3 The Lawsky Moment: When Law Becomes Irrational

But even if we see disorder more than order, we still might think that the actual operation of law follows a somewhat rational process where learned and reasoned lawyers and judges exchange views, in intellectual honesty and unbiased, until litigation or regulatory action is brought to a fair end. Frequently, this is not how it works in the modern world. Rather, modern "legal" ordeals are event-driven, aggressive, and emotional. Often they are held more in the media and social media than in any courthouse. And they operate through public disgrace ("naming and shaming") of companies and their executives rather than by legal reasoning.[16]

[16] Peter Kurer, "Mainsprings of Financial Services Regulations", in R Waldburger et al, *Wirtschaftsrecht zu Beginn des 21. Jahrhunderts. Festschrift für Peter Nobel zum 60. Geburtstag* (Bern: Stämpfli, 2005), pp 575–82.

Take the Standard Chartered Iran sanctions case as an example.[17] Standard Chartered is a British bank which is active in some 70 countries, mostly in Asia and Africa. It has a small US operation. Its worldwide dollar transactions are subject to the US financial sanctions regime. These sanctions essentially ban American firms from doing business with Iran, Cuba, Sudan, and a few other countries. At the relevant time, so-called "U-turn" transactions were exempted from the ban; U-turn transactions were dollar transfers from Iran and other sanctioned countries which, for clearing purposes, went through the American financial system but left it without staying there. These transactions, however, had to be disclosed in the electronic transfer information system. Standard Chartered, in a number of cases, went around this requirement by masking the relevant information.

In 2012, the bank became subject to an investigation by a number of American authorities such as the Federal Reserve, the Treasury Department, the Department of Justice, and a New York state bank regulator, the Department of Financial Services (DFS). It appears that at this time the investigation was in a relatively early stage, and the bank said it was aware of it but had no information about the timing of possible disclosures or the extent of the allegations.

In a surprise move on 6 August 2012, Superintendent Benjamin Lawsky of the DFS issued a press statement and an order to the bank to appear at a hearing on 15 August. In the statement released before the press, Lawsky called the bank, the reputation of which at that time was quite untainted, a "rogue institution". The statement quoted a few internal and compromising e-mails and accused the bank of grave violations of law which allegedly exposed the US financial system to terrorists and arms dealers. The bank was asked to explain its activities and why it should not be stripped of its banking licence at the forthcoming hearing.

In a first reaction, Standard Chartered conceded some minor breaches of the rules but overall strongly rejected the allegations and the factual presentations by Lawsky. But its position collapsed soon and dramatically. First, there was a media outcry, then investors got nervous and the share price dropped by some 25 per cent. The CEO of the bank, Peter Sands, called off his vacation, travelled to the US, and hastily agreed to a settlement at unfavourable terms, involving amongst other things a payment of USD 340 million, agreeing in

[17] This analysis is based on the coverage of the case by *The Economist*, including the online articles "Banking for the Bad Guy" (6 August 2012), "My Dollars, My Rules" (11 August 2012), and "Hush Money" (15 August 2012), as well as the announcements of the New York State Department of Financial Services including the "Consent Order under New York Banking Law § 44" (21 September 2012), <http://www.dfs.ny.gov/about/ea/ea120921.pdf>.

essence to the factual allegations of the DSF, and getting no release from further actions by other authorities. The consent order was issued on 14 August, one day before the announced hearing, and was agreed "without formal proceedings or hearings". It was signed by Peter Sands and Benjamin Lawsky.

Sands certainly must have thought that he had not encountered the law but something else. I call this something else the *Lawsky Moment*.[18] It was brought about by an ambitious regulator who was both clever and ruthless in the pursuit of his objectives. The Lawsky Moment connotes a sudden collapse of a legal position, *without formal proceedings or hearings*, which is realized not by a fair trial but by means which are beyond the rational operation of the legal process. Much of today's legal risk is triggered by the Lawsky Moment.

There are many elements to this, as the Standard Chartered case shows. The first is, obviously, that *something has gone wrong* in a complicated compliance process. But then comes the decisive inflexion from the norm: rather than carrying out a thorough investigation into the matter before reaching a decision, the regulator made a surprise move to go public. He decided to resort to the media as the forum of decision rather than a formal proceeding.

Hence *the media* is the second element of the Lawsky Moment. Certainly, publicity alone is not enough; there are many things out in the public domain which do not trigger a particular reaction. But here something else came into play: *emotions*. Lawsky played perfectly to the tune of societal sentiments after the Great Financial Crisis. There were a lot of negative feelings around banks in the wake of this crisis, and though Standard Chartered was one of the very few larger global banks that came through the crisis quite unscathed, it was a bank after all. And there was an even deeper emotional play. Since 9/11 many Americans are particularly sensitive when it comes to security issues. The Iran financial sanctions regime is a direct outflow of this. It aims at preventing banks from dealing with terrorists, arms dealers, and a rogue state. By calling Standard Chartered Bank a rogue bank, and by implying that the malfeasance was the intent of the top management, Lawsky exploited these emotions successfully.

The fourth element is the impact on *reputation*. Global brands are extremely exposed to loss of reputation. The matter appeared on the front

[18] I have coined the term "Lawsky Moment" for a rapid collapse of a legal position after the Minsky Moment which connotes the rapid collapse of asset prices under certain circumstances. After having written this chapter, I saw that the *Wall Street Journal* wrote about "Lawsky's Spitzer Moment", with an entirely different connotation, however, and essentially criticizing Lawsky for a Spitzer-like overreaching which did "more harm than good": *Wall Street Journal*, 16 August 2012, <http://online.wsj.com/news/articles/SB10000872396390444772404577587293183192290>.

pages of newspapers and in news programmes around the world and exposed the bank to shaming. Naturally, members of the public cannot understand the intricacies of a complicated regulation and why compliance breaches happen. Many journalists do not bother to explain them (some do, but others make it worse). The clever play between creating a sensation and banking on emotions was enough here to bring about a huge reputation loss.

The fifth element of the Lawsky Moment is the *modern perception of corporate governance*. During the last 30 years the concept of corporate governance has evolved. At the outset of the modern governance discussion, the shareholder interest approach shifted the focus from management to the board by designating the board as the primary fiduciary of the shareholders, and requiring the board to rigorously focus on the shareholders' interests. Later, the theory of stakeholder interests emerged. Under this concept, the board has to take much broader interests into consideration when making its decisions, such as the interests of employees, customers, the general public, or special interests as represented by non-governmental organizations (NGOs). Both approaches, however, overlap in the sense that responsibility lies very much at the top of the company. In earlier times a compliance breach or other wrongdoing would commonly be dealt with by a lower level of management; now, even mid-sized adverse events need to be resolved from the top. Blame is allocated accordingly. Lawsky played to this tune by stating that the transfers were not detected because there was a "documented willingness of its most senior management to deceive and violate US law". This sticks even if it is not true.

The final element of the Lawsky Moment is the impact on *investors and the capital markets*. Benjamin Lawsky's surprise move caused an immediate drop of Standard Chartered's share price by about a quarter of its value. Capital markets assumed that the allegations by the DFS might indeed lead to a devastating rescission of the banking licence in America; in addition, there was the reputational damage which had already materialized. This huge drop in the share price, and the concerns of the shareholders behind it, triggered the corporate governance duty of the CEO to travel to America and solve the matter *without formal proceedings and hearing*, whatever the costs were and regardless of whether or not *justice* was done.

Lawsky and Standard Chartered is an extreme case but it is only an evolution of a pattern which is dominant for many similar cases: regulators, prosecutors, and class action plaintiffs force companies into settlements before any court or other proceedings can take place. The companies acquiesce to this since they want to avoid further embarrassment, save the high costs and hazards of trial and pre-trial discovery, and make peace quickly with an enraged public and investor base. Almost all prosecutions of big companies,

all securities class actions, and most other class actions are resolved in this way; and it is no longer a US fashion. Bernie Ecclestone, the CEO of Formula One, recently settled a German bribery prosecution by paying USD 100 million to a German court. Ecclestone was probably more than happy to solve the matter by a payment since the allegations levelled against him were serious.[19] But the fact that the case was settled and not tried is as disturbing as what we see in many US cases.

1.4 Front Pages. Big Hits. Deep Cuts

During the short time span of writing this chapter I read the following on the front page of the European edition of the *Financial Times*:

- *24 September 2013*: Bribery claims dent sales of the UK drug company GlaxoSmithKline in China. Chinese authorities accuse the company of corruption with bribes totalling up to USD 500 million. GSK faces threat of substantial fines, the paper says, while investors start to speculate about the future of the company's leadership.
- *27 September 2013*: Jamie Dimon, CEO of JP Morgan Chase, meets Eric Holder, US Attorney General, with a view to settling claims relating to mis-selling mortgage securities. The package comprises a USD 7 billion cash payment and USD 4 billion in the form of mortgage relief for struggling homeowners. The FT adds that such a settlement would exceed the USD 4.5 billion settlement paid by BP to settle criminal charges over the Gulf of Mexico oil spill in 2010.
- *9 October 2013*: Goldman Sachs is linked to a Chinese corruption probe. Lei Yi, chairman of a large Chinese industrial metals group, allegedly received bribes from the chairman of an education company which was co-founded by Goldman Sachs. On the same day's front page is a news briefing informing that the hedge fund company SAC Capital Advisors has been given a settlement ultimatum by US prosecutors to settle criminal insider trading charges or risk paying more than the USD 1.8 billion on offer for settlement.
- *21 October 2013*: JP Morgan Chase has (now) agreed to pay USD 13 billion to US state and federal authorities in the mortgage securities case.

[19] John Gapper, "Ecclestone is a Chancer Who has Earned a Final Chance", *Financial Times*, European Edition, 7 August 2014, p 7.

The government used the implicit threat of criminal prosecution, which no bank would survive, to rake in this huge payment. About 80 per cent of the losses underlying the government's case were attributed to failed Bear Stearns and Washington Mutual, which JP Morgan Chase rescued during the financial crisis upon the insistence of senior US government officials. There is a widespread view that the government changed the rules to deliver on populist promises made by the administration.

- *21 October 2013*: The paper reports that the Federal Housing Finance Agency is seeking a similar fine from Bank of America in an amount of USD 4 billion. All in all, this agency has sued not less than 17 institutions asserting that they mis-sold mortgage-backed securities. The paper quotes analyst Mike Mayo of CLSA: "It's the example of the new Big Brother banking. The government is watching the banks and if you make a wrong step you're going to pay."
- *23 October 2013:* Dutch Rabobank is facing a settlement of almost USD 1 billion for the alleged Libor manipulation. This comes in the wake of fines paid by UBS and The Royal Bank of Scotland in the amount of USD 1.5 billion and GBP 390 million respectively. The settlement includes US, UK, and Dutch authorities.
- *30 October 2013*: A summary article reflects on another "day of reckoning" for large banks. In light of potential costs from litigation in the Libor manipulation scandal, regulators in Switzerland moved on UBS to increase its capital, while Deutsche Bank set aside EUR 1.2 billion for legal risks and Rabobank settled the Libor matter with an agreement to pay USD 1 billion.

The total amount of settlements and cases mentioned above is USD 24 billion; and these cases are not yet closed, which means that costs will substantially increase even further (which they did after I had written this). USD 24 billion is the equity of a mid-size international bank; the amount was collected in a month by the government and comes at a time where the same government struggles to force banks to bolster their equity. The USD 24 billion does not include the significant internal costs incurred by the affected institutions, which would have to be added for a full picture.

This might create the impression that the big fines are reserved for banks. This impression is wrong. Rather, as a matter of fact, prior to some of the record-breaking fines mentioned above, companies other than banks actually paid the highest fines and settlements:[20]

[20] Data retrieved on 14 July 2014 from Information is Beautiful, "Largest Corporate Fines and Settlements of the Last Seven Years", <http://www.informationisbeautiful.net/visualizations/punytive-damages-biggest-corporate-fines/>.

- BP (2010): Gulf of Mexico oil spill. Estimated at USD 34 billion in 2010 (110 per cent of income of that year);
- GlaxoSmithKline (2012): Illegal sales practices including paying doctors and manipulating research for antidiabetic drug Avandia. USD 3 billion (14 per cent of income of that year);
- AOL Time Warner (2005): Deceiving investors about the details of the merger with AOL. USD 2.4 billion (192 per cent of income of that year);
- Pfizer (2009): Misbranding the anti-inflammatory medication Bextra and promoting it for unsuitable uses. USD 2.3 billion (27 per cent of income of that year);
- Johnson & Johnson (2012): Illegal marketing of antipsychotic drug Risperdal and other medications. USD 2.2 billion (23 per cent of income of that year); and
- Siemens (2008): Kickbacks and bribes to win contracts in Iraq, Venezuela, Bangladesh, Israel, and Russia. USD 1.6 billion (19.5 per cent of income that year).

Also, big fines are no longer an exclusivity of the American government. The European Union frequently imposes high penalties for competition law violations. And the trend reaches less prominent industries too: in July 2014, the German antitrust authorities imposed a fine of EUR 338 million on the German sausage industry for price fixing.[21]

What these examples tell us is that the risk that a big global company faces a billion dollar fine these days is substantial. In particular, if a company is part of the cash-rich club of the big oil companies, the multinational banks, and the top brands in the pharmaceutical industry, it is exposed more than anybody else. Is it because such companies employ worse people? I would doubt it—there is at least no empirical evidence for this.

Apart from high fines and settlements, there are many more costs of legal failure. First there are high *legal fees.* Legal Cost Control LLC, a legal and accounting cost consultancy, has recently published a list of some of the largest fee cases in history.[22] Here is a partial excerpt from this list:

- Enron—USD 1 billion in legal and accounting fees;
- Adelphia—USD 563 million in legal and accounting fees;
- Delphi Corporation—USD 357 million in legal and accounting fees;
- WorldCom—USD 350 million in legal and accounting fees;

[21] *The Financial Times*, 15 July 2014, <http://www.ft.com/intl/cms/s/0/5746dcd8-0c01-11e4-9080-00144feabdc0.html#axzz39MQ7UjhO>.

[22] Legal Cost, "Legal Cost Control", retrieved on 14 July 2014, <http://www.legalcost.com/companyprofile/aboutus.asp>.

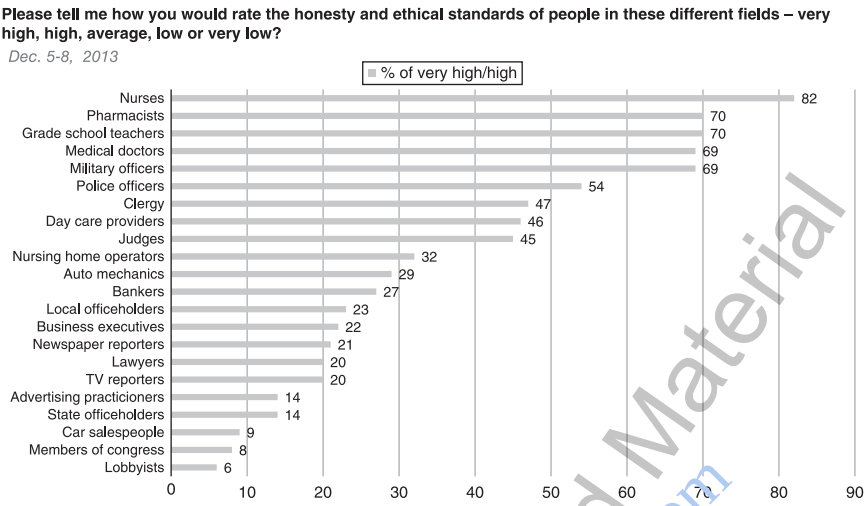

Figure 1.3 Honesty/ethics in professions

- RTC Litigation—USD 500 million in legal fees; and
- OCF/C&F Asbestos Litigation—USD 650 million in legal fees.

A further face of these big hits is the growing *personal exposure* of company executives who risk being fined or jailed if something goes seriously wrong in their sphere of responsibility and they are involved or turn a blind eye.

But the biggest hit is the *loss of reputation* which comes with these enormous legal cases. The continuous and increasing front-page exposure of big businesses and banks has considerably dented the reputation of business executives and bankers who need a flawless reputation to be successful in a sustainable way. Look at Figure 1.3 which gives the US picture on the basis of Gallup data.[23]

In terms of honesty and ethical reputation, bankers and business executives now trail almost all medical, teaching, law enforcing, and engineering professions; surprisingly, bankers do better than business executives, even

[23] Gallup, "Honesty/Ethics in Professions", 5–8 December 2013, retrieved on 14 July 2014, <http://www.gallup.com/poll/1654/honesty-ethics-professions.aspx>. European data tells a similar story. In a survey of the German Allensbach Institut, doctors and nurses were at the top (76 and 63 per cent) whilst lawyers, entrepreneurs, and bankers were ranked at the lower end of the table (with 24, 21, and 3 per cent respectively). IfD Allensbach, "Allensbacher Berufsprestige-Skala 2013", 13 August 2013, retrieved on 7 October 2014, <http://www.ifd-allensbach.de/uploads/tx_reportsndocs/PD_2013_05.pdf>, p 2.

after the Great Financial Crisis; and both of them still instil more trust than journalists, lawyers, or politicians.

And loss of reputation is sticky. Nestlé is still sometimes associated with the baby milk scandal of the seventies. Siemens will for many years be associated with the quintessential bribery scandal; BP for creating the largest environmental catastrophe in America ever. The handful of big global banks will struggle for a long time over the implication that they caused the most serious recession after World War II and brought misery for millions of people. That the same companies may have made meaningful contributions to the benefits of globalization which has lifted entire populations out of poverty may not be remembered. Nothing is more unforgiveable in the corporate world than the realization of legal risk.

And finally, there are second-order consequences of legal risk which have an effect beyond individual institutions and their executives: deep cuts in the business models of industries and whole markets. The Great Financial Crisis has led to a growing conviction that the big banks are too big to be managed and that they have to reduce both their size and complexity before they can be considered safe. Many regulatory reforms push and pull the banks into this direction and demand higher capital and liquidity requirements, ring-fencing, resolution regimes, and living wills. This is all well intended and will help the banks to reduce the risks and prevent future harm which they created for economies around the globe. But there are also a number of unintended consequences attached to this, and many financial and capital markets have become dysfunctional through a combination of the crisis fallout and the regulatory response to it.[24] Good examples of unintended victims are infrastructure financing, cross-border financing, cross-border capital flows, a credit crunch in many countries, and the corporate bond markets which are drying up.[25]

A similar effect is caused by the ever-increasing merger control and foreign investment approvals which are required for global dealmaking. In a big transnational transaction, companies might easily need approval from regulators in up to 100 countries.[26] An additional obstruction comes from the new approval requirements in emerging markets, first of all China. Overall, the *execution risk* for large mergers and acquisitions (M&A) transactions, driven by legal risk, has gone up considerably; the time lapse from

[24] Peter Kurer, "Some Thoughts on Global Banks and Global Finance", in *Financing Globalization: Lessons from Economic History* (Globalization and Finance Project, Blavatnik School of Government, University of Oxford, 2012).

[25] Tracy Alloway, "The Debt Penalty", *Financial Times-Europe*, 11 September 2013, p 5.

[26] Anousha Sakoui and David Gelles, "A New Bottleneck", *Financial Times-Europe*, 28 August 2013, p 5.

contract to closing gets longer, and a number of big international transactions have been considerably delayed or failed, due, amongst other things, to political, legal, tax, and regulatory issues—compare the delay in the case of Glencore-Xstrata, the failing completion of Publicis/Omnicom, or the early break-off of Pfizer/AstraZeneca. Whatever you think of mega-mergers, these complications and the rise of execution risks obviously have wide economic impacts and slow M&A activity and investments.

1.5 Ever More Laws and Regulations

There are ever more laws and regulations. We know it from our everyday experience. Surprisingly, however, it is not well-documented. One of the few countries which systematically keeps track of the amount and costs of regulation is the United States. The most common proxy holders to measure US regulatory activity are the number of federal rules issued annually (as reflected in Figure 1.4) and the total number of pages in the *Federal Register* (as shown in Figure 1.5).[27]

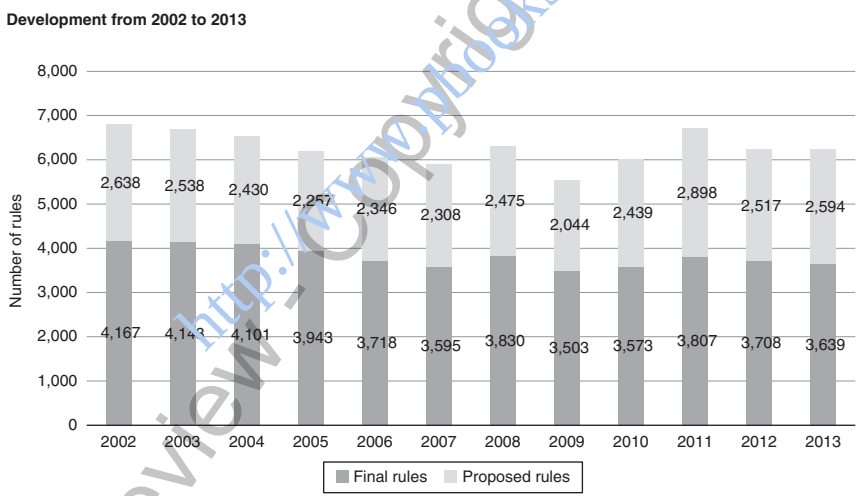

Figure 1.4 Number of rules published in the US Federal Register

Source: National Archives and Records Administration, Office of the Federal Register, as listed in Crews: Ten thousand commandments 2014, p. 19, Fig.12

[27] See Maeve P Carey, *Counting Regulations* (Washington DC: Congressional Research Service, 1 May 2013), <http://www.fas.org/sgp/crs/misc/R43056.pdf>.

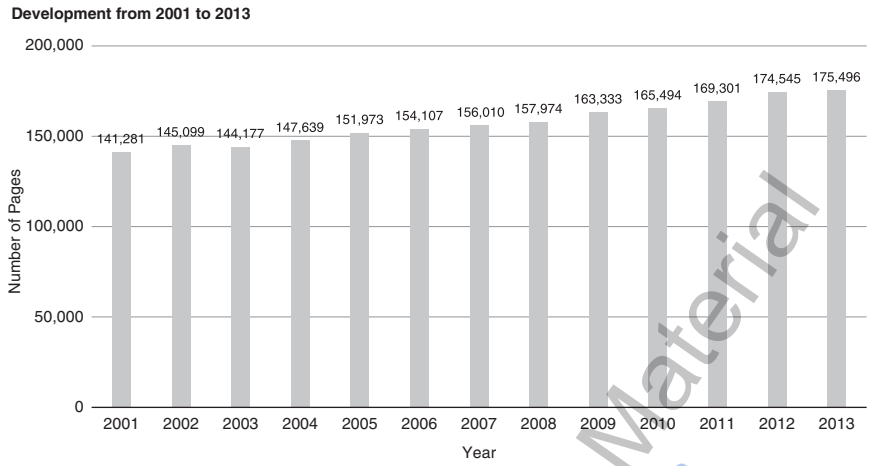

Figure 1.5 US Code of Federal Regulations, total pages

Source: National Archives and Records Administration, Office of the Federal Register, as listed in: Crews: Ten thousand commandments 2014, p. 21, Fig. 14

Federal rules are those regulations which federal agencies issue on the basis of statutory authority granted by Congress in order to implement policy. Measuring lawmaking activity through the number of rules and pages in the *Federal Register* leaves out many other sources of law, such as the statutes issued by Congress itself, the decisions of courts which *de facto* may contain new law, and all the activities of state and community bodies.

Nonetheless, the overall picture is quite clear: new regulation is piled on existing regulation, and the pace of issuing new rules becomes faster. The number of pages published annually steadily increased during the last few decades.[28] After the Great Financial Crisis, this development accelerated. During the first three years of the Obama administration, the rise of regulation was 7.4 per cent as compared to 3.4 per cent in the first three years of the Bush administration (as measured in numbers of pages in the *Code of Federal Regulations*).[29]

All of this creates huge costs to the economy and businesses. In 2010, the Small Business Administration, in a report prepared by economists Nicole

[28] Maeve P Carey, *Counting Regulations* (Washington DC: Congressional Research Service, 1 May 2013), <http://www.fas.org/sgp/crs/misc/R43056.pdf>, p 16.

[29] Penny Starr, "Under Obama, 11,327 Pages of Federal Regulations Added", *CNS News*, 10 September 2012, <http://cnsnews.com/news/article/under-obama-11327-pages-federal-regulations-added>.

V Crain and W Mark Crain, estimated regulatory compliance costs at USD 1.752 trillion for the year 2008.[30] Clyde Wayne Crews calculated the total cost of federal regulation to amount roughly to USD 1.8 trillion per annum (based on 2012), the largest contributors being economic regulation, tax compliance, and environmental regulation.[31] Regulatory costs now (2012) substantially exceed individual income taxes, dwarf corporate income taxes, and almost equal pre-tax corporate profits.[32] The total regulatory costs, referenced above, of USD 1.8 trillion for 2012 represent 11.6 per cent of the US gross domestic product (GDP).

Regulatory burden data for countries other than the US is scant, in particular for large parts of Europe. In many cases, data has become even rarer more recently. When my research assistant inquired with a governmental statistician as to the reason for this, he was told that governments do not like to show the level of their activities. However, where there are statistics it is the same picture as for the US. In Australia, the volume of new Commonwealth subordinate legislation went from roughly 500 pages in 1962 to about 7000 pages in 2006.[33] India is a classical red-tape country, and its new RBI governor and former Chicago economist Rahuram Rajan recently stated that the country's regulatory burdens pose a significant obstacle to economic growth[34]—a statement more telling than many statistics and one which could be made for China and many other emerging markets as well. For Switzerland, generally considered a country with reasonable levels of regulation, it was estimated that all existing regulations cost businesses, public administrations, and citizens together approximately 10 per cent of GDP.[35] New pages in the Swiss Federal Law register increased from 3,112 in 2000 to

[30] As quoted in Clyde Wayne Crews Jr, *Ten Thousand Commandments 2013* (Competitive Enterprise Institute, 2013), <http://cei.org/sites/default/files/Wayne%20Crews%20-%2010,000%20Commandments%202013.pdf>, p 6. These costs include broad categories such as economic regulatory costs, eg, price-and-entry restrictions and transfer costs; workplace regulatory costs; environmental regulatory costs; and paperwork costs for tax and other compliance work.

[31] Clyde Wayne Crews Jr, *Ten Thousand Commandments 2013* (Competitive Enterprise Institute, 2013), <http://cei.org/sites/default/files/Wayne%20Crews%20-%2010,000%20Commandments%202013.pdf>, pp 6–7.

[32] Clyde Wayne Crews Jr, *Ten Thousand Commandments 2013* (Competitive Enterprise Institute, 2013), <http://cei.org/sites/default/files/Wayne%20Crews%20-%2010,000%20Commandments%202013.pdf>, pp 6–7.

[33] Chris Berg, *The Growth of Australia's Regulatory State*, (Melbourne: Institute of Public Affairs, 2008), <http://www.ipa.org.au/publications/980/the-growth-of-australia's-regulatory-state-ideology-accountability-and-the-mega-regulators>, p 12.

[34] NDTV, "India has Too Many Regulations: Raghuram Rajan", *NDTV Profit*, 13 March 2013, <http://profit.ndtv.com/news/economy/article-india-has-too-many-regulations-raghuram-rajan-319448>.

[35] Schweizerischer Gewerbeverband, "Messung der Regulierungskosten für die KMU" (Gewerbekammersitzung: Lugano, 27 May 2010), <http://www.sgv-usam.ch/fileadmin/user_upload/deutsch/2010/Events/Gewerbekongress_Lugano/regulierungskosten_gewerbekammer_20100527_de.pdf>.

7,508 in 2012, a new record and again a sign that there was an additional surge in legislative activity after the Great Financial Crisis.[36] In Germany, the number of pages of the *Bundesgesetzblatt (Teil 1)* has now reached an average of 3,700 pages per year whilst in the 1950s the corresponding number was approximately 1,000 pages.[37] Both for the Netherlands and the United Kingdom, not dissimilar from America and Switzerland, the costs of regulation are estimated to amount to 10 per cent of GDP.[38]

1.6 The Big Legal Complex: The Costly Expansion of the Legal System

In the preceding sections, we looked at the many manifestations of legal risk from different angles: legal risk appears in the form of uncertainty as felt by senior managers, it comes through the many layers of conflicting and often chaotic legal rules as more neutral observers observe it, it may express itself in highly irrational processes, and it means high risk of getting involved in costly litigation and prosecutions; and there are ever more laws and regulations. But there is yet a sixth form of manifestation which I call the *Big Legal Complex*.

The first element of the Big Legal Complex is the economic *rise of lawyers* as business persons. Some thirty years ago, most lawyers understood their profession as an *officium nobile*, as a profession which was based on independence from clients, neutral advice, and the highest ethical standards. Today, at least when it comes to business and commercial law, lawyers, or rather law firms, are pure businesses which are run and managed like any other service-based business, except that most law firms are still organized as a type of partnership.[39] As a matter of fact, in America and probably in most Western societies, the legal service industry is the second largest professional service industry behind health services.[40] There are so many

[36] Urs Zurlinden, "Der unbegrenzte Eifer des Gesetzgebers", *Tages-Anzeiger*, 12 October 2013, <http://tagesanzeiger.ch/schweiz/standard/Der-unbegrenzte-Eifer-des-Gesetzgebers/story/11470997>.

[37] Klaus-Heiner Röhl, *Bürokratieabbau—Analysen und Handlungsempfehlungen* (Berlin: Konrad-Adenauer-Stiftung, 19 October 2013), <http://www.kas.de/wf/doc/kas_9322-544-1-30.pdf>, p 9.

[38] Better Regulation Task Force, *Regulation—Less is More* (London, March 2005), <http://www.berr.gov.uk/files/file22967.pdf>, p 12.

[39] See Peter Kurer, "Easy and Difficult at the Same Time", in Christoph Vaagt, *Law Firm Strategies for the 21st Century* (London: Global Law and Business, 2013), pp 29–44.

[40] Highbeam Business, "Legal Services" <http://business.highbeam.com/industry-reports/business/legal-services>, retrieved on 15 July 2014.

lawyers in America that it appears hard to count them. The US Bureau of Labor Statistics gives a number of 760,000 lawyers, while the American Bar Association says that there are as many as 1,100, 000.[41] An estimated 74 per cent (in 2000) of them work in private practice. Certainly, America is the leader in terms of lawyers per capita. According to one study, there is one lawyer per 270 persons in America; but many countries have numbers which are not far away from this: the population per lawyer is 271 in Spain, 450 in New Zealand, 454 in Italy, 490 in England, and 596 in Germany. At the other end of the spectrum, very low rates are reported for Japan, China, and India (6,373, 9,386, and 10,954 respectively).[42]

Or to look on the rise of lawyers from another perspective: when I became a partner with Baker McKenzie in 1985, the firm grossed about USD 150 million in revenue and was the largest law firm in the world. In 2001, it reported revenues of about USD 1 billion, and in 2013 of about USD 2.4 billion; the firm is still the biggest in the world and has increased the number of its lawyers from 1,000 in 1987 to 2,000 in 1997, to 3,000 in 2001, and to more than 4,100 now.[43]

This extraordinary growth is a reflection of the overall success of the profession. Wherever you look, business law firms have by and large doubled every 10 years between 1980 and the Great Financial Crisis in terms of lawyers employed, revenue, and profits. The most common performance indicator for law firm success is now the so-called profit per equity partner (PEP). According to a recent study of Seltzer, Fontaine, Beckwith, in the mid-1990s partners in top US firms earned between USD 300,000 and 400,000 annually. Today, PEP exceeds USD one million for most of the largest US firms; sometimes it goes up as high as USD 5 million.[44] According to another study by *Legal Business*, PEP for large English law firms has gone up by 157 per cent from 1993 to 2008, ie, by a factor of more than 2.5.[45]

[41] Harvard Law School, Program on the Legal Profession, "Analysis of the Legal Profession and Law Firms" (as of 2007), <http://www.law.harvard.edu/programs/plp/pages/statistics.php>. Numbers are for, or around, 2007. See also American Bar Association, ABA Market Research Department, "Lawyer Demographics" (2011), <http://www.americanbar.org/content/dam/aba/migrated/marketresearch/PublicDocuments/lawyer_demographics_2011.authcheckdam.pdf>, which reports 1,225,452 lawyers for 2010.

[42] Benno Hamssen, "Die Anwaltsdichte in der Schweiz, Österreich und Deutschland im Verhältnis zu anderen Staaten—Ein internationalere Vergleich" (2006) 10 *Anwaltsrevue*, pp 392ff, p 396, <http://www.bgfa.ch/scripts/getfile?id=1138>.

[43] For the numbers (except for the 1985 revenue number which is based on my own records) see <http://www.bakermckenzie.com/firmfacts/firmhistory/>, retrieved on 15 July 2014.

[44] Seltzer, Fontaine, Beckwith, "Pumping Up Profits per Partner", <http://www.sfbsearch.com/content.cfm/ID/20044>, retrieved on 15 July 2014.

[45] James R Faulconbridge and Daniel Muzio, "The Financialization of Large Law Firms" (2009) 9 *Journal of Economic Geography*, pp 641–61, p 648, Table 3.

Certainly, there are a good many indications that overall the profitability of firms has gone down somewhat during the most recent years in view of increased cost pressures from clients reflected in alternative billing methods such as caps, lump-sum assignments, or new forms of relationship management, including the purchasing of legal services through the central procurement departments of clients.[46] But the industry remains healthy and profitable, and it takes a heavy toll on the financial health of its clients. Though these numbers are not reported officially it is fair to assume that the costs for legal services easily dissipate 10 or more per cent of many global companies' profits.

Another aspect of the Big Legal Complex is the rise of in-house lawyers in the last 30 years. A few decades ago, a legal department of a large multinational company may have consisted of 30, 40, or so lawyers who did the routine legal work and who did not have any impact on the strategic management of the company. The legal department head was an important but not crucial position within the organization. This has completely changed. Legal departments of global companies have easily 1,000 or more staff members now, and the role of the leader has been transformed into a powerful and lucrative general counsel or chief legal officer position. The modern 'transformed' general counsel is a member of the top management of the company and acts as a key advisor to both the CEO and the board.[47] The general counsel and legal staff play multiple roles which are vital for the management of a multinational these days: they are involved in the strategy definition and the development of business plans; they run early warning systems on upcoming legal and compliance risks and follow trends in regulation and lawmaking; handle cases and transactions; give key governance and risk management input; and manage the difficult relationship between the company and its outside lawyers and other legal services providers with a view to getting the best quality at a reasonable cost. This transformation started many years ago in the US but has now become a global phenomenon.[48] In the meantime, at least in the Western world, the task of legal departments and general counsels

[46] Peter Kurer, "Easy and Difficult at the Same Time", in Christoph Vaagt, *Law Firm Strategies for the 21st Century*, (London: Global Law and Business, 2013), pp 29–44, p 43.

[47] See more on this in section 3.5 and see also, eg, Constance E Bagley and Mark Roellig, "The Transformation of General Counsel: Setting the Strategic Legal Agenda" (2013) in Stuart Weinstein and Charles Wild, *Legal Risk Management, Governance and Compliance* (London: Global Law and Business, 2013), pp 45–66. See also the contributions of Beat Hess, Ben Heineman, Leo Staub, and Karl Hofstetter in Sylvie Hambloch-Gesinn et al, *In-house Counsel im internationalen Unternehmen* (Basel: Helbing Lichtenhahn, 2010), pp 13–49 and 131–143; and Ben W Heineman Jr, *High Performance with Integrity* (Boston: Harvard Business Review Press, 2008).

[48] See David B Wilkins, "Is the In-house Counsel Movement Going Global? A Preliminary Assessment of the Role of Internal Counsel in Emerging Economies" (2012) *Wisconsin Law Review*, pp 251–304.

has become so important and complex that it attracts a growing interest of business management professors and consultants, an interest which did not exist 20 years ago and a reliable sign that legal departments have grown up and are considered to be a key function of management now.[49]

More recently, the *compliance industry*, which I see as part of the Big Legal Complex, has started to undergo a similar development to the legal profession. Chief Compliance Officers become more and more important within their organizations, and the compliance departments grow in size. HSBC says that it now employs 24,300 staff specializing in risk and compliance, almost 10 per cent of its total workforce; although this includes all risk areas, the choice of words makes it clear that a material part of this number comprises compliance specialists.[50] Again, like law firms in relation to in-house legal departments, a growing number of consultants and advisors cluster around the in-house specialists and seek lucrative assignments from them (I will expand on this in sections 4.7 seq and section 5.4).

The last element of the Big Legal Complex consists of the huge *bureaucracies of the myriad of regulators and government agencies* around the globe. Like the law firms, the legal departments, and the compliance departments in certain industries, these agencies have grown to be huge. The competition authority of the EU employs a staff of more than 700 people,[51] the US Securities and Exchange Commission (SEC) has 3,785 employees,[52] the UK Financial Services Authority (FSA), which has been dissolved and split into a number of new agencies, had about 4,000 employees,[53] the German Federal Financial Supervisory Authority (BaFin) has more than 2,300,[54] and the US Federal Drug Administration (FDA) 14,648.[55]

[49] See, eg, the research done by Mari Sako of Saïd Business School (University of Oxford): Mari Sako, *General Counsel with Power?* (Oxford: Saïd Business School/University of Oxford, 2011), <http://eureka.bodleian.ox.ac.uk/4560/1/General_Counsel_with_Power.pdf>, and (shorter version), <http://www.sbs.ox.ac.uk/sites/default/files/Novak_Druce/Doc/General%20counsel%20with%20power.pdf>; or McKinsey & Company: Philipp Härle, Andreas Kubli, and Christian Kurer, "Best Practices of High-performance Legal Functions in Large Multinational Corporations", in Sylvie Hambloch-Gesinn et al, *In-house Counsel im internationalen Unternehmen* (Basel: Helbing Lichtenhahn Verlag, 2010), pp 115–124.

[50] Martin Arnold, "HSBC Wrestles with Soaring Costs of Managing Compliance", *The Financial Times*, European edition, 5 August 2014, p 13.

[51] <http://ec.europa.eu/civil_service/docs/europa_sp2_bs_dist_staff_en.pdf>, retrieved on 15 July 2014.

[52] SEC Annual Financial Report 2012, <http://www.sec.gov/about/secpar/secafr2012.pdf#2012review>, p 8.

[53] FSA Annual Report 2011/2012, <http://www.fsa.gov.uk/pubs/annual/ar11-12/ar11-12.pdf>, p 20.

[54] BaFin, 'Function and History', <http://www.bafin.de/EN/BaFin/FunctionsHistory/functionshistory_node.html>, retrieved on 15 July 2014.

[55] FDA Budget Report 2012 (estimate for 2013), <http://www.fda.gov/downloads/AboutFDA/ReportsManualsForms/Reports/BudgetReports/UCM301553.pdf>.

Figures, however, are one thing; human aspects another: these agencies often serve as platforms for important political careers, as was the case with former US Attorney Rudolph Giuliani who went on to become the Mayor of New York, or New York State Attorney General Eliot Spitzer who later became Governor of New York. And, maybe even more importantly, they serve as a pool for important hiring to large law firms and legal departments. Look at the remarkable career of Mary Jo White. She started as a lawyer with the law firm Debevoise & Plimpton, then became head of the SEC enforcement division, went on to serve as American Attorney for the Eastern and then the Southern District of New York, in 2002 went back to Debevoise & Plimpton as head of the firm's litigation department, and finally, 10 years later she was picked by President Obama to chair the SEC.[56] These kinds of *revolving door careers* are typically associated with Wall Street but you can find them everywhere as the example of Hector Sants shows. He first worked with a number of investment banks (Warburg, UBS, DLJ, and CSFB) and then, in 2004, became Managing Director of the FSA, and in 2007 its CEO. In 2013 he went back into industry as Head of Compliance and Government and Regulatory Relations with Barclays Bank.[57]

Though rarely as prominent as the White and Sants moves, every year around the globe there are hundreds if not thousands of similar moves from regulatory or law agencies to law firms, from law firms to legal departments, and from legal departments into agencies. This *merry-go-round* is the glue and the very essence of what I call the Big Legal Complex. Most of these people that change from law firm to agency and back are smart, ambitious, and ethical. They serve as loyal civil servants and trusted lawyers. But at the same time, the system works as a well-oiled machine assuring that regulations increase, the case dockets on both sides of the table stay long, and the profits of the law firms remain healthy. It often serves the common good but sometimes it serves predominantly the legal profession. In any event, it is a legal risk in itself.

[56] SEC Biography, <https://www.sec.gov/about/commissioner/white.htm>, retrieved on 15 July 2014.

[57] 31 October 2013, <http://group.barclays.com/about-barclays/about-us/sir-hector-sants>, retrieved on 31 October 2013. Sants subsequently resigned on 13 November 2013 <http://en.wikipedia.org/wiki/Hector_Sants>.

1.7 Globalization and the Carbon Copy Prosecution

I now want to turn from the manifestations of legal risk to its *root causes*. There are many mainsprings for the rise of legal risk in modern society. Key drivers, however, are globalization and the technological developments that are behind it, as we will see in this section.

Local entrepreneurs, bankers, or traders know the law of the land; they grew up with it and have it internalized. Once these entrepreneurs, bankers, or traders cross national borders, the situation becomes more complicated for them. It starts with customs duties, new excises, a different tax system, other rules for the employment of people, setting up foreign corporations, or using agents. Often, this is the first time a business person resorts to the benefit of legal advice. And often, this is the first time a business is embroiled in a difficult legal case or a murky administrative process. In my experience, legal risk increases tremendously once a business leaves the confines of its own borders.

Global businesses operate in 60 or more jurisdictions, some of them are active in as many as 140 or more countries. They cross many borders, and therefore their legal risks grow at an exponential rate. Big international companies push the boundaries of their activities further and further. In the latest wave of globalization, many international companies have gone to the limits of the globe. They now operate, often under one global brand, in dangerous places where there was never a rule of law or due process but instead a total lack of political stability and deeply engrained corruption from the petty officials up to the highest ranks of government, and where protection against child labour, destruction of the environment, or fraudulent business activities is almost absent. Many of these global businesses become exposed to, and sometimes involved in, behaviours or activities which would be blatantly illegal, if not criminal, in their countries of origin.

Thus, a good argument can be made that the single most important source of legal risk for global companies is the fact that they are global. This warrants a closer look at the history of globalization itself, which is the defining economical and sociological development of today's world.

Early origins of transnational trade go well back many centuries before Christ. In these early times, the Phoenicians established a sea-based trading empire throughout the Mediterranean world, and the Nabataeans and Scythes did the same in the Middle East and Central Asia. Alexander the Great pushed this concept from Macedonia to the shores of the river Indus, connecting the Mediterranean world with the Indian subcontinent and creating a huge trade zone. A similar inflexion point of globalization was when

Columbus discovered the Americas, and many other conquerors sailed to all corners of the world, now bridging the New World with the Old World. Soon trading companies, such as the East India Company, the South Sea Company, the Dutch East India Company, and others, followed this expansion of the world. In all these instances, the push to faraway shores was already, as in today's globalization, a combination of technological development, love of adventure, and search for new riches, and the agents of it already fought with many different laws and customs of the world.

According to one account, the next and much more forceful globalization started with the industrial revolution and lasted, interrupted by the two World Wars, through to 2000.[58] When we talk of globalization, we normally mean what has happened since World War II. For these almost 70 years we can distinguish two waves: one lasting from the end of the war through to 2000 and the other since then.[59]

The first wave was triggered and enhanced by the liberalization of world trade and huge technical progress in transport and communication which brought about container shipping, dramatically reduced airline fares, and much lower charges for long-distance telephone calls; finally, this meant the end of the concept that goods are produced where they will be consumed. This wave of globalization was dominated by the multinational companies from the West and the North. They sold cars, engineering and construction equipment, branded goods, and computers to the emerging markets. And they formed new plants to produce things like textiles or cars more cheaply in the Third World.

What created our today's reality is the *second wave* which was a quantum leap and created, to use Tom Friedman's compelling framework to understand this new paradigm, a *flat world*.[60] This world has been brought about by groundbreaking innovations in computer technology, software, internet communication, and production technology. The foundation stones were the internet and search engines, highly standardized software, both in the office and production, allowing easy exchange of work products and working together on the same project over a distance of many thousands of miles. Production processes are now often fragmented: different parts of a value

[58] Thomas L Friedman, *The World is flat* (New York: Farrar, Straus and Giroux, 2005), p 9.

[59] Stefan Flückiger and Martina Schwab, *Globalisierung: Die zweite Welle* (Zürich: Verlag Neue Zürcher Zeitung, 2010), p 15. A similar distinction is made by Tom Friedman in his two books which give deep insights into (not just data on) these two eras of globalization: *The Lexus and the Olive Tree*, First Picador Edition (New York: Picador 2012, originally published in a somewhat different form by Farrar, Straus and Giroux, 1999), on the first period, and *The World is Flat* (New York: Farrar, Straus and Giroux, 2005), on the second one.

[60] Thomas L Friedman, *The World is Flat* (New York: Farrar, Straus, and Giroux, 2005), p 8.

chain are produced in different places and only the process is somewhat centralized. A friend of mine owns and runs a small company which produces a highly specialized niche product for textile manufacturers. He imports the motor for his machines from Taiwan, the cooler from Italy, and needles and belts from China. Only the process management, the engineering, and the assembly are done in Switzerland. Once everything is nicely put together here and checked out, the machines are shipped (back) to places like India, China, or Brazil. In a similar way, for a London consultancy or law firm, presentations or contracts might be written, redone, and finalized in Trivandrum or Hyderabad, India, overnight, making the process of this document production both cheaper and faster.

Such is this new world: truly global companies, even very small ones, are everywhere in this world. This implies that their exposure to legal risk is everywhere too: it multiplies by the mere fact of geographical expansion. Sometimes it grows exponentially by it; to explain, the further a global company pushes away from its own origins to new shores the less it has a natural and institutional knowledge of the law and will make mistakes. The mere fact that a company may have to, for example, heed a hundred different laws on data protection, will lead to the risk that something somewhere is overlooked and misunderstood. And then the multiplying effect will kick in: if a global company makes a serious mistake in one place this might create legal risk somewhere else: prosecution in one place will alert prosecutors in another place; or a blunder in a developing market might lead to a class action back home. *Carbon copy prosecutions* epitomize this. The term is *en vogue* amongst prosecutors and refers to successive, duplicative prosecutions in different countries for the same criminal conduct.[61]

1.8 The Global World is Made of Glass: The Force of Transparency

One defining element of the latest wave of globalization is the technologies which created an information transparency not seen before. Highly portable satellite uplinks and fast mobile data connections give TV journalists whole new ways to show what is going wrong in the world. Viewers contribute their own footage captured with their mobile phones. The internet makes a myriad of data easily accessible for everybody. And social media allows the exchange

[61] Andrew S Boutros and T Markus Funk, "The Rising Tide of a New International Phenomenon: Carbon Copy Prosecutions", in Stuart Weinstein and Charles Wild, *Legal Risk Management, Governance and Compliance* (London: Global Law and Business, 2013) pp 247–71.

of valuable observations, specialized knowledge, informed opinions, and justified anger, alongside unfiltered hate speech and other indecencies. More than 4 billion people in the world have a mobile phone (only 3.5 billion a toothbrush), and there are now globally 1.75 billion smart phone users.[62] Almost all human knowledge has been digitalized in the last few years, is easily accessible, and can be shared in an instant. This allows the electronic review of huge amounts of data, a phenomenon which is now commonly called Big Data (see more on this in section 6.3). One might add a few more things which create transparency: the mark-to-market pricing demanded by modern accounting rules; the requirement to disclose price sensitive information regarding public companies immediately; the disclosure rules for shareholder reporting and the registration of securities; the whistle-blowing and self-reporting requirements under an increasing number of laws; and the fact that more and more political bodies around the world hold public hearings with executives of companies.

The world is now *made of glass* for global companies. They can hide nowhere; and they cannot hide anything. The public eye rests on them every day, every hour. If anything goes wrong within their organization, or between them and the outside world, the chances are that the world will learn about it instantly. According to a report by Freshfields Bruckhaus Deringer, "more than one-quarter of crises spread to international media within an hour and over two-thirds within 24 hours".[63] The natural adversaries of global business have quickly understood how they can profit from this ubiquitous transparency and speed of information dissemination. A new breed of global and laser-focused NGOs have set their sights on specific industries or companies and they know how to exploit this fast and public transmission of information with the purpose of indicting bad corporate behaviour in the *eyes of the public*. Politicians, regulators, and prosecutors around the world do the same; they leak something here or ride an unanticipated public attack there. Journalists and media houses buy confidential information and hack into presumably private data, as we know since the Murdoch affair.[64] Disgruntled

[62] *eMarketer*, 16 January 2014, <http://www.emarketer.com/Article/Smartphone-Users-Worldwide-Will-Total-175-Billion-2014/1010536>, retrieved on 9 August 2014.

[63] Freshfields Bruckhaus Deringer, "Containing a crisis", November 2012, <http://www.freshfields.com/en/insights/crisis_management/> and <http://www.freshfields.com/uploadedFiles/SiteWide/News_Room/Insight/Campaigns/Crisis_management/Containing%20a%20crisis.pdf>, p 2.

[64] See Neil Chenoweth, *Murdoch's Pirates* (Sydney, Melbourne, Auckland, London: Allen & Unwin, 2012) and Tom Watson and Martin Hickman, *Dial M for Murdoch* (London: Allen Lane—Penguin, 2012).

bank employees and civil servants disclose or sell confidential information to the public or the media.

One consequence of this situation is that companies often lose their ability to manage the form and time of communication to the outside world. When they do not want to communicate a confidential plan, they might be forced to do so prematurely because there has been a leak; the form and content of what they would like to say is often restricted by legal and regulatory considerations; and when they communicate they are quickly contradicted in the social media, often by their own employees. These limitations and challenges often limit their ability to manage legal risk. Things simply develop faster and become much worse than they did in an earlier world of controlled communication and less transparency. The adversaries of big business, such as the NGOs that focus on specific industry issues and public prosecutors, experience these inhibitions and restrictions to a much lesser extent: the time and form of their communication is less restricted by disclosure requirements; their leaking to the press is an accepted practice now; and their risk to be contradicted in media and social media is much lower than for big business since they play to the tune of public sentiments.

You might commend or deplore this, or accept it as sober reality, but in any event, everyone dealing with legal risk has to be aware that the reality of present-day transparency often makes underlying and not yet visible legal risk quickly explode into disaster. The dynamics of this is almost like the impact that a fire accelerant has on a fire.

1.9 A Pluralistic Society, Failing Trust, and Cultural Clashes

Closely connected to globalization as a main source of the rise of legal risk is *growing pluralism* in society and the *collapse of trust*. In traditional societies, a handshake often made a deal valid. Against the background of a shared and closely knit value system, people knew the implied terms of a certain business transaction without the need to resort to long legal forms. They also knew that in case of default the other party had a number of very forceful remedies outside the courts, such as social discrimination within a narrow community.

Over the last few decades, our Western societies have become more and more pluralistic, and now they have become almost what one could call, pleonastically, *multi-pluralistic*. Pluralism has become a constitutional element of modern society since the liberal revolutions in Europe and the advent

of industrialization. Different forces within society, such as employers and the labour force, religious parties and liberal movements, pulled in different directions and were distrustful of each other, and all tried to influence government for their own interests; progress was only achieved when they found a social accord and defined a minimal consensus. In parallel to the creation of the (post)modern world of globalization, this pluralistic concept of society has now transformed into a particularly extreme form of pluralism. Interest groups are no longer broad groups which share many or most values amongst their members across the whole spectrum as the churches or the labour movement did. More and more political parties and social movements have become very narrow in their orientation and sometimes advance nothing else than one single cause, such as the environment, gender equality, animal protection, Third World causes, open sources and software piracy, the fight against immigration, vegan food, or inter-gender marriage.

Closely connected to this "multi-pluralism", and which may be a root cause of it, are growing cultural clashes within societies. There were always cultural conflicts but in olden times they were amongst tribes and nations, often delineated by clear geographic border lines. But we now see growing differences of cultures within our western societies. A short walk through any of the world's cities will prove the case. This multiculturalism means diverging values, morals, and ethical concepts which work as silent undercurrents of the legal system. The operation of law becomes influenced by them, and they pull in one direction here, and in another direction there; in other words, cultural clashes become embedded in the legal system.

The failure of trust and communality, the growing fragmentation of society, and cultural clashes have a direct impact on the increase of legal risk:

- The faithful handshake is replaced by extensive and costly documentation which often reflects a spirit of deep distrust between the parties. These contracts and deeds make transactions considerably more expensive and riskier, since long documents are open to interpretation and might contain drafting errors which lead to litigation;
- politicians have to cater to more and more narrow interests which leads to an increase in legislation and regulations as well as to fragmented policies of governments;
- specialized interest groups, now commonly called NGOs, press their narrow causes upon business and ask for acts of *social responsibility* in favour of their clients;
- they name and shame companies and executives who are not aligned with their views of the world; and

- whoever reads the reports on litigation and legal cases around the world will not leave unnoticed that from time to time judges, regulators, and prosecutors decide and act more in line with their own culture and values than based on a blindfolded application of the law.

Fragmented pluralism, failing trust, and cultural clashes are reinforced by the opportunities which are offered through the dynamics of a transparent world, and *vice versa*. And similarly, globalization is a major root cause for multi-pluralism. People migrate physically and so do ideas electronically, and often this results in increased distrust and clashes of cultures. This makes the world more open and interesting from many perspectives, and it offers many opportunities for global companies. But it also means more and often aggressive legal risk for them.

1.10 A Case Study on a Defining Cultural Clash: Legal America v Legal Europe

A most notable cultural clash is the one between European and American, and to a lesser extent all Anglo-Saxon, legal cultures. This clash of legal cultures has had a huge impact on the global legal environment since World War II, and explains many facets of the rise of legal risk for global companies. Interestingly, this often sharp clash does not abate; quite to the contrary, observers of more recent developments get the impression that the US legal system, which has always taken an aggressive stance towards foreign legal systems and other cultures, is now turning more and more into an instrument to implement America's foreign policy and commercial interests—some observers have said that America has replaced warfare by *lawfare*. The deeds and positions of the US administration, lawmakers, and regulators in relation to sanction regimes, global taxation, and surveillance of foreign entities cannot be read differently, even by those who see, as I do, the many advantages which American hegemony has brought to the world.

What is behind this clash of legal cultures?[65] The first and foremost difference between the American and European legal systems is the comparative

[65] I have expanded on this in Peter Kurer, "America: The Legal Nation", *IFLR*, 1 January 2007 <http://www.iflr.com/Article/1977379/Search/Results/America-the-legal-nation.html>. The article was also published in a slightly different form as Peter Kurer, "America: The Legal Nation", in Andreas Kellerhans, *60 Jahre Churchill-Rede in Zürich—Europa in der Globalisierung* (Zürich: Schulthess, 2007). The following contains paraphrases and quotes from this article.

importance of lawyers, who simply play a much bigger role in US society than they do anywhere else. Alexis de Tocqueville already observed this almost 180 years ago. In his famous book, *Democracy in America*,[66] he stated that in America there are no nobles nor literary men and that lawyers consequently form the most cultivated portion of society and the most influential political class. A few of these observations may no longer be true; America now has some of the best novelists, and inequality has reached such a level that many speak of a financial aristocracy in America. But lawyers continue to be one of society's most influential professions, although some of the noble veneer of lawyers has considerably worn off since de Tocqueville's day. Lawyers populated the Republic from the beginning—45 per cent of the framers of the constitution and almost two-thirds of all American presidents were lawyers. Today, more than a million Americans are in the legal profession and, however you count it, it is likely that no other country in the world has such a high percentage of lawyers among its population.

There are a number of particularities in the American legal system which brings it into sharp contrast to the European legal system. The first, and most obvious one, is the tradition of common law, the case law system, the jury, and the adversarial process. Whilst the European law normally starts with a statute, the Anglo-Saxon case law system is essentially a method whereby a law is made and refined through court decisions and individual cases. This involves a sophisticated concept of legal reasoning, comparing the facts of the case to be decided with the reasoning of earlier case law and the underlying facts of those precedents. By contrast, a European court would first look at the applicable statute and then at the facts, subsume these facts under the rule and then deduce whether or not, and how, the statute applies to the case. The first, the Anglo-Saxon method, is what in logics is called *induction*, the second, the European approach, is called *deduction*. Though many lawyers, and most business people who are advised by these lawyers, do not realize it, it makes a big difference whether you think lifelong in terms of deduction or in terms of induction. The former is thinking in principles, plans, and programmes—the latter is thinking in facts and refined and narrow rules derived from a complicated factual pattern. This is, indeed, a cultural divide.

The *trial and adversarial method*, as it exists in Anglo-Saxon legal systems, forces the lawyers to present facts and their view of the case in an adversarial clash before a jury and a passive decision-maker, the trial judge. The intellectual and emotional challenges of the legal reasoning underlying the case law

[66] Alexis de Tocqueville, *De la démocratie en Amérique* (1835).

and the adversarial system of the jury trial has sharpened the wits and abilities of whole generations of US lawyers. This is supported by an excellent system of *legal education* which, at its top end, is in my opinion superior to the continental European one. The best American lawyers come out of (mostly) private law schools where the teacher to student ratio might be as low as 1:8 whereas the comparable ratio in continental (mostly) state-run universities is 1:30 or higher. At American law schools, US lawyers are trained using the *Socratic method*. Students are engaged in the discussion of cases they have read before classes. The teacher calls on a student and asks progressively more difficult questions about the implications of the cases which the student has read. The interrogation exposes shortcomings in preparation and thinking and can be a painful, if not cruel, process; in any event, it is much more challenging than the more or less one-way presentations that continental European professors give to their students (some of the US law schools have now started to soften the Socratic method slightly to accommodate foreign students, particularly from China and other Asian countries—a small footnote to the ongoing globalization processes).

There are a number of areas where the cultural clash between the US legal system and a (continental) European approach to legal matters come to fruition. One is the *extraterritorial* application of law, another the treatment of international law in relation to domestic law which I have already discussed earlier. A further difference is the very strong *powers a plaintiff* has under the US civil procedure law. A US plaintiff can often sue a defendant under the so-called long-arm statutes in a place where, under Europe's jurisdictional rules, it could not sue. When people have similar claims against a certain defendant, they can bring the suit in the form of a *class action*. This helps to bring actions in cases where individual actions could be impractical because of the low value of the claims involved. The *pre-trial discovery* system, with early witness depositions and extensive document production, is another weapon in the hands of the plaintiffs. Under the (continental) European system, a plaintiff has to make specific allegations in a first round and then, in a second round, has to bring the evidence to prove these allegations. In the US system, a plaintiff can start a claim on the basis of general, even preposterous, allegations and then hope, through pre-trial discovery, to find a smoking gun. Pre-trial discovery often results in massive data and paper mining, and has become a major headache and cost item for companies involved in US litigation, as well as a major source of income for the law firms when they are not properly controlled. Also, *the jury system* often helps the plaintiff because juries can sometimes render favourable awards to plaintiffs on emotional grounds or with a clear sense for deep pockets. In certain cases, the system allows *multiple and punitive damages* where the actual sum

lost or compensation is multiplied for the total award. Moreover, US lawyers can bring actions on the basis of a *contingency fee* arrangement with their clients, an arrangement that is traditionally considered unethical in many other places. Also, losing plaintiffs *do not have to recompense* the winning defendants except under special circumstances, a principle which many see as the prime reason for the litigious climate in America.

So, under the US litigation system, plaintiffs can sue defendants with pre-trial discovery and multiple damages claims, and they run a much smaller litigation risk. This is tantamount to a real empowerment of plaintiffs and an encouragement to bring (class) actions against businesses. The combination of all these things usually means that business defendants have to settle cases that, by any objective legal standards, are unfounded claims; they do this to avoid continued litigation, the burden of pre-trial discovery, the risk of a runaway jury, and huge awards. Such, and similar, considerations have played a big role in many huge settlements in the area of securities class and mass tort actions. The political proponents of this system, who receive substantial campaign contributions from the plaintiff bar, see these easy victories as a good method to tame the exuberance and ruthlessness of banks and industrial companies. Such views have also led to numerous attempts by European countries to establish class action regimes or do away with the recompense of legal costs by the losing party which are perceived to be unfair. These efforts have not been very successful so far but they show that there is not only a cultural clash but also a mutual influence which slowly brings litigation costs up to US levels in a number of places.

One could go on with many other instances where the American system diverges considerably from the continental European system. The European regulatory and legislative method is more principle-based whilst the Americans prefer clear rules explaining what is permitted and what is not permitted. The Anglo-Saxon contract drafting is detailed and covers all contingencies whilst traditional continental drafting is often quite limited to the essentials of a transaction, relying on the back-up rules contained in the statutory law of contracts. Also, the American regulatory and enforcement authorities enjoy procedural and enforcement powers which are unmatched by most of their European counterparts. The outward sign of this is that the US regulators regularly charge fines and other penalties which are, with a few exceptions such as in the area of antitrust, considerably above those which the European authorities can impose in similar circumstances.

The cultural clash between the American approach to legal matters and the continental European system has to a large extent defined the legal landscape for global businesses over the last 30 years. It has led to numerous frictions and often businesses have had to navigate through the two systems like between a rock and

a hard place. But the phenomenon goes much beyond this. I would claim that, not necessarily the pure American legal way, but more broadly the Anglo-Saxon approach has influenced global business law to an extent that it is now the dominating paradigm. Contracts are now widely written in the English language and use Anglo-Saxon techniques (there is obviously a wide gap between English and American contract drafting but this is a detail which we can leave aside for this analysis). Pre-trial discovery has made deep inroads into international arbitration, even in cases where only continental European arbitrators sit on the panel. Class action concepts are established in many countries, and so are long-arm statutes. The rule-based approach in securities and other regulation is copied more and more around the globe. Finally, regulators outside the US learn quickly and eagerly from their American counterparts. In many ways, what was originally a cultural clash has now become an essential part of the fabric of global business. It is certainly one of many causes which have led to an increase in legal risks and legal costs around the globe.

The clash between the American and European legal cultures, which defines so much of our global legal environment today, is not the end of history. The centre of the world economy is shifting from the West to the East, from the North to the South, from mature markets to emerging ones. The culturally amalgamated Anglo-Saxon law travels easily on the back of these shifts. There will, however, be new cultural clashes over legal matters in this process. Many of the countries which now play a big role in the world economy have legal concepts which are very different from anything in the Western world. This is, in particular, the case with the new superpower, China. There one can observe minimal, if not totally absent, protection of intellectual property rights, arcane ways of handling regulatory matters, a failing distinction between politics, legal considerations, and the long-term party policy, and a distance between lawyers and the decision-makers within business. Thus, maybe, one day, after the Americans have flooded the world with busy business lawyers, the Chinese will chase them away.[67]

1.11 The Sensitivities of the Risk Society

As we have seen, global businesses face more legal risk simply because they take part in the process of globalization. The effects of globalization upon

[67] According to the presentation "The Challenge of China: Seeking Justice" by Edward E Lehman of the law firm Lehman, Lee & Xu, there were only 114,000 Chinese lawyers (0.009 per cent of the population) compared to 1,116,967 American lawyers (0.4 per cent) in 2005: Lehman, Lee & Xu, 2 November 2007, <http://www.lehmanlaw.com/resource-centre/presentations.html>. The numbers of Chinese lawyers go up sharply, and statistics are not reliable. According to another

business are multiplied and reinforced by total transparency, the reality of the media world, diverging values, and cultural clashes. There is, however, an additional, and in a sense more hidden and nuanced, cause as to why globalization creates more legal risk. This cause becomes visible when we resort to a paradigm which has been defined by the German sociologist Ulrich Beck and which he called the *Risk Society*. In a number of groundbreaking books, Beck has shown that we understand the (post)modern and global world better when we watch it through the concept of the creation and allocation of risks rather than in terms of the creation and distribution of wealth, as was the case in the industrial society.[68] Globalization creates new, huge risks (and opportunities), and at the same time creates a new and global awareness of such risks. Some of these risks are not directly, or only partially, attached to the activities of global companies; this is the case for risks created by geopolitics, like migration in the wake of the Arabic Spring, increased energy consumption, and the building of nuclear power plants, or climate change. But other global risks are a direct outflow of the activities of global businesses. Such is the case with the oil spills of global oil businesses, the hazards caused by defective products of global brands, the economic imbalances that have been created in particular by increased exports from China and other emerging countries, and the activities of huge global banks and other financial players that reinforced the effects of global imbalances and ultimately led to the Great Financial Crisis.

These risks are highly visible around the globe because they hit in many places at the same time, such as the Great Financial Crisis, or are, even if they affect only a confined area, so frightening, and subject to a perception of immediate repetition elsewhere, that they are seen as global risks nevertheless; take Fukushima or the Gulf of Mexico oil spill as examples. All of this is amplified by the realities of the limpid world and the means of modern communication, as we have seen in section 1.8. And because they are so big, so frightening, so visible, and so well communicated, these global risks create anxiety. As Beck has put it: "Angst bestimmt das Lebensgefühl. Auf der Werteskala verdrängt Sicherheit Freiheit und Gleichheit von der obersten Priorität" (Angst dominates our attitude towards life. Security replaces liberty and equality at the top of our value pyramid).[69]

report, the number of licensed lawyers reached 200,000 in the year 2011: *English People Daily*, 19 October 2011, <http://english.peopledaily.com.cn/90882/7620752.html>.

[68] Ulrich Beck, *Risikogesellschaft*, 21st edn (Frankfurt am Main: Suhrkamp, 2012, originally published in 1986); and Ulrich Beck, *Weltrisikogesellschaft* (Frankfurt am Main: Suhrkamp, 2008).

[69] Ulrich Beck, *Weltrisikogesellschaft* (Frankfurt am Main: Suhrkamp, 2008), p 28.

This *angst* and a desire for a more secure world are a driver for increased regulation and a source for more legal risks.[70] The transmission is simple: people are affected by the materialization of risks, or think they might be affected, they cry foul and shame, and ask for remedy. Then the media and other distribution channels of information take it up, and finally regulators and politics move in. The bursting of the dot-com bubble and the failures of Enron, WorldCom, and Arthur Andersen led to a flurry of new legislation, including the Sarbanes-Oxley Act, and has rewritten the corporate governance and risk management rules for almost all global companies. The Great Financial Crisis changed the landscape and intensity of banking regulation. Thus, risks created by global companies fall back upon them in the form of more aggressive law; or to put it the other way around, many of today's legal risks for global businesses are nothing but a reflexion of their own activities. It is an attempt by the Risk Society to put the risk back into the box.

1.12 Almost a Postscript: De-globalization and Fragmentation

Globalization means that companies are exposed to many and often conflicting layers of laws, and it also means that global companies create risks which in their turn lead to new legal risks. Globalization, however, has more recently, in particular after the Great Financial Crisis, taken a turn in a new and somewhat surprising direction which can be called *mental de-globalization or fragmentation* of the global world. It is a phenomenon which has many facets, and we do not yet know where it will lead us and what it will mean for global companies. But it is an observable fact that in many parts of the old world, the very concept of globalization has become increasingly unpopular because people consider that their jobs are being lost and relocated to far-flung places. Politicians react to this because they are liable to their local constituencies. Protectionist actions and economic nationalism is on the rise as can be seen, for example, in French industrial policy. As a consequence, many industries experience a growing fragmentation of their legal and regulatory environment which implies that regulatory and legal barriers of entry have become higher; businesses see new trade restrictions, difficulties in obtaining operating licences, growing divides in regulatory concepts, and even increased risks of expropriation. *The Economist* has recently used the term "*the gated globe*" to describe this emerging pattern.[71]

[70] Ulrich Beck, *Weltrisikogesellschaft* (Frankfurt am Main: Suhrkamp, 2008), p 28.
[71] *The Economist*, 12–18 October 2013, Special Report.

Beyond this, for the first time in modern history, the West and North have lost their dominance in the globalization process.[72] The power and the lead in the global development may have shifted definitively to the Southern and Eastern hemispheres. It is not a remote assumption that this might also lead to a dilution of some of the Western concepts which have supported and eased globalization such as deregulation, free capital exchanges, modern governance, transparent accounting, and global standards. Finally, there is the not too remote possibility that the whole world will fall into regional blocks which each cluster around a regional hegemon. These regional blocks will have a tendency to entertain their own zones of free trade and fend off outsiders, as is the case with, for example, the concept of the European Union. If this pattern prevails we will end up with a strange world indeed: there will still be global companies, operating on the back of global brands and processes, but there will be more and new barriers for these global champions in terms of legal restrictions and particularities which they have to observe. Should this thesis prove to be true then we are only at the beginning of a threatening rise in legal risk for global companies.

1.13 Summary

In this chapter, I have analysed the different manifestations and root causes of legal risk for global companies. I have also looked into some factors which reinforce the effect of the underlying root causes. The following is a short summary of this analysis which is also depicted in Figure 1.2:

The *manifestations* are:

- Global leaders see legal risk as one of the most salient risks to their operations. According to one survey, legal risks are, together with political risks, the main reason for *uncertainty* for these global leaders. The results of this survey are supported by others (see section 1.1 and Figure 1.1).
- The modern world is reigned over by an increasing complexity, if not disorder, of many different legal concepts and many layers of national and international laws, including emerging new concepts such as soft laws (section 1.2).

[72] See, eg: Stephen D King, *Losing Control* (New Haven and London: Yale University Press, 2010).

- Legal risk is often imposed upon global companies by ways and means which are a far cry from traditional rational legal processes and which operate according to the laws of *irrationality*. These new ways and means, as epitomized by the treatment of Standard Chartered Bank by New York regulator Benjamin Lawsky, involve an immediate resort to the media arena, public shaming and naming, playing on emotions, and the reactions from the stock market, and it is defined by almost an absence of any elements of due process (section 1.3).
- The front pages of the press are full of stories on *fines, penalties, and litigation costs* inflicted on big companies, and in particular on companies which have deep pockets. Since the Great Financial Crisis, the banks have paid USD 150 billion to US government agencies. BP's legal ticket over the Mexican Gulf oil spill will exceed USD 50 billion (section 1.4).
- There is tremendous growth in laws and regulations (section 1.5). It is estimated that the costs of the regulatory burden to business is around 10 per cent of GDP in mature economies.
- The world is firmly in the hands of a *Big Legal Complex*, which involves a rise of the legal profession to one of the most ruthless and profitable service industries in the world, judicial and regulatory positions becoming springboards for higher political careers, the rise of general counsels and chief compliance officers to the top of the corporate power pyramid, and a constant movement of lawyers and compliance specialists from government jobs to corporate or private practice and back again (section 1.6).

The *root causes* for the rise of legal risk and the factors which *reinforce* them are:

- The single most important source of the increased legal risk for global companies is the fact that they are global. In other words: *globalization and the technological change associated with it* are the mainsprings for the rise of legal risk. When companies do business in many places they are exposed to many differing laws, and often, the laws of one country might have repercussions elsewhere, such as when a global company is prosecuted for one deed in many jurisdictions. Thus, the rise of legal risk which a globalizing company experiences is not linear but exponential (section 1.7).
- For global companies, the world is now *made of glass*. The public eye, through media, social media, Big Data, and many disclosure requirements sees everything. Global businesses cannot hide anywhere, and they cannot hide anything (section 1.8).
- The world is witnessing a growth of *multi-pluralism and multiculturalism*. Due to globalization, migration, and the laws of total transparency, people and ideas move easily. This has an effect on the legal and political system

in many ways: documentation becomes more extensive and expensive, new laws are created to please minorities, NGOs ask for *social responsibility* favours for the benefit of their clients, and judges and prosecutors often react to public sentiments or based on their own cultural values rather than applying the law in an unbiased way (section 1.9).

- An exemplary cultural clash that has dominated the global legal arena for many decades is the friction and differences between the *American and the European legal systems*. The heavy influence of the American, and in a wider sense the Anglo-Saxon, legal system and legal culture on the global world has made the world not easier but more complicated (section 1.10).
- In many ways, the world has become a *Risk Society*, ie, modern society can be better understood in terms of risk allocation than in terms of wealth distribution. In this Risk Society people have become very sensitive to risks which, amongst other things, are created by global business, such as nuclear power plants, oil spills, and financial instability. They ask for, and get, more regulation and legal control of business (section 1.11).

In a kind of a postscript (section 1.12), I also said that the world has become more fragmented and has entered a sort of mental and legal *de-globalization* following the Great Financial Crisis. There is a considerable risk that the world will fall apart into regions which run their own hegemonial trade zones. Fragmentation and regionalization means more trade restrictions and legal impediments, and ultimately this might lead to a much more complicated legal life for global business. I do not hold a crystal ball, but if my apprehensions become reality then we would now be seeing only the beginning of the astonishing, and frightening, rise of legal risk in the modern global world.