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The role of the chief legal officer in corporate governance

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ABSTRACT

The CLO shapes and enforces corporate governance, but is faced with a dual-role paradox that requires her to act as both monitor of corporate governance and executive of the firm. We study the role of the CLO under environments that are most likely to impact governance and pressure the firm to either emphasize or marginalize the CLO's role as monitor or facilitator. Using the financial shock of a securities class action lawsuit on large corporations, we measure changes in CLO value through the metrics of total and relative compensation of the CLO and other C-suite members. After controlling for relevant variables such as growth and total assets, we find that when firms have more insiders on their board of directors, the CLO's compensation declines when the preceding year's Tobin's Q is high. CLO compensation increases under conditions of high opacity, but that compensation partially erodes in high Tobin's Q environments. We also find that a lawsuit increases CFO and CEO turnover but not the CLO's. Our results have implications for corporate governance, the dual and potentially conflicting role of CLO as gatekeeper and monitor, executive compensation, and agency costs.

1. Introduction

Addressing the principal agent problem represents one of the fundamental challenges for the firm. With the separation of ownership and control (Berle et al., 1932), and the presence of asymmetric information, the principal cannot ensure that the agent acts in its best interest (Jensen and Meckling, 1976). Corporate governance mitigates agency costs by protecting outside investors from exploitation from insiders, as well as aligning the financial and other incentives of insiders with those of the principal (Core et al., 1999; La Porta et al., 2000). A substantial literature now exists on the impact of corporate governance on outcomes ranging from executive compensation to firm performance to operating and financing decisions (e.g. Gompers et al., 2003; Shleifer and Vishny, 1997). The weight of this research has focused on exploring the association between board of director and investor attributes with the ability of managers to extract rents from shareholders (Jagolinzer et al., 2011).

The literature remains underdeveloped, however, on those tasked with shaping and enforcing internal corporate governance. These executives, known as gatekeepers, serve as reputational intermediaries who verify and certify information to the market (Coffee, 2002). The most prominent gatekeeper in the firm is the Chief Legal Officer (CLO).[1] The CLO is responsible for monitoring for firm misconduct, supervising internal and external legal resources, and advising the CEO and the board of directors on matters of compliance (DeMott, 2005; Morse et al., 2014). The Sarbanes Oxley Act of 2002 designates the CLO as one of two main recipients of a report of evidence of a material violation and has special responsibilities for handling such reports. This responsibility, plus the fact

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[1] We identify the general counsel, chief legal officer, or head attorney for the legal function of the firm as the CLO. The CLO typically reports directly to the CEO and serves as a legal advisor as well as an overseer of all the firm's internal and external legal functions such as a regulatory compliance, acquisitions, contract negotiations, and internal monitoring of corporate governance.

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that regulators perceive the CLO as the main point of contact, have essentially deputized the CLO as the main gatekeeper between the firm and the market (Kim, 2005).

In spite of this gatekeeper role, the CLO is also expected to serve the role of facilitator. As a facilitator, the CLO participates as a member of the management team and serves the firm with the same interests and goals as fellow executives. CLO compensation may reinforce the facilitation role, granting performance-sensitive compensation to reward increases in firm value (Dzienkowski and Peroni, 2002). As a result, CLO may discount her gatekeeping function in order to align her incentives with the CEO and CFO (Nelson and Nielsen, 2000). This alignment by the CLO toward management may reduce barriers to management misconduct and inhibit the monitoring function valued by investors (Hammermesh, 2012).

The result is a "paradox of executive lawyers" whereby CLOs, and by extension their legal staff, are forced to serve both as legal guardians that improve corporate governance and as corporate executives that augment firm value (Morse et al., 2014). CLOs that aggressively engage in their monitoring function may fulfill their gatekeeper role, but isolate themselves from the networks of top management with whom a collaborative relationship is necessary to function (Nelson and Nielsen, 2000). Those that prioritize their executive role may harmonize easily with management, but allow corporate governance to degrade and suffer a loss of reputational capital when misconduct becomes public (Kim, 2008). Such attorneys may devalue the integrity of the justice system of which they serve (Beardslee, 2010) and even be implicated in corporate misconduct of their own (Lee et al., 2010; Bainbridge and Johnson, 2004). The sanction of CLOs for such misconduct may be greater than their C-suite equivalents, because the CLO is subjected to strong bonding costs arising from their obligations to their profession and the judicial system (MRPC, prmbl., 2013).

In addition to better illuminate how CLOs resolve this paradox, we are also motivated by the underexplored question of how highly compensated CLOs impact firm value. Fig. 1A shows that when the CLO is one of the top five highest paid executives in the firm, firm 24-month four-factor BHAR increases by over 1% in sample firms compared with firms where the CLO is not so highly compensated. This is a fairly modest gain compared to the 3.5% 24-month BHARs realized by firms with CFOs in the top five by pay relative to those where the CFO is not, shown in Fig. 1B. The spread in abnormal performance by CLO importance is significant at the 1% level, and the CFO result is significant at the 5% level.

However, the effect of the CLO's importance on firm performance increases dramatically in firms that are at risk of an external legal shock, which in our data are firms that become targets of a securities class action lawsuit in the sample period. As shown in Fig. 2A, these firms realize 24-month BHARs 3.8% higher for those with highly paid CLO's compared to ones with their lower paid counterparts.[2] This is an economically significant result given that within our sample of S&P 500 firms, approximately half of all firms during the 10 year sample period were targets of securities class action litigation. Furthermore, when a firm is sued, the CLO is six to eight times more likely to be one of the top five highest paid executives during those years. It is also statistically significant at the 1% level, and is greater than the 3.4% BHAR observed in at-risk firms stratified on CFO importance, which is significant at the 5% level. Finally, as Fig. 3 shows, there is no significant difference in the 24-month abnormal performance firms not targeted by lawsuits when stratified on CLO importance in Panel A, with performance similar to prior results when stratified on CFO pay in Panel B. While the four-factor risk model does control for broad risk exposure in firms, these results admittedly indicate correlation rather than causality. However, they do raise the intriguing question of why and how "chief legal officers have more power than ever before" and are "now one if the mightiest figures in the C-suite" (Economist, 2012).

In spite of a potentially substantial impact a CLO may have on firm value, little empirical evidence exists examining under what conditions CLOs can remain effective in their potentially conflicted dual roles. We differ from prior work by examining how the CLO's impact and effectiveness on corporate governance is influenced by such conflicts. Similar to our work is Morse et al. (2014), who use incentive pay to examine the gatekeeper-facilitator conflict and find that lawyers receiving equity incentives divert their attention away from monitoring and toward value creation. We expand upon their work and further explore the gatekeeper–facilitator conflict by introducing a financial demand shock for the CLO's services through the number securities class action lawsuits filed against the firm each year. We also introduce a variety of frictions into the principal agent relationship in order to better understand the impact of the CLO on corporate governance in varying institutional environments of large corporations.

We first examine the impact of a securities class action lawsuit (SCA) on CLO compensation. A significant literature exists on the impact of private securities litigation on managerial decisions and firm policies (Cheng et al., 2010; Humphery-Jenner, 2012). Firms that have weak corporate governance tend to settle litigation more quickly (Haslem, 2005). SCAs have also been found to be a catalyst for CEO and CFO turnovers and pay cuts (Humphery-Jenner, 2012), as well as a trigger for a negative reaction from the market (Humphery-Jenner, 2012; Niehaus and Roth, 1999). SCAs are also associated with lower bonus compensation (Collins et al., 2008). Although an SCA is harmful to the firm, a CLO may not be substantially penalized because of her reduced ability to deter financial wrongdoing compared to the CEO and CFO and her prominent role once a lawsuit is filed. Even if CLO error causes the litigation, the CLO's legal expertise combined with her firm specific knowledge may facilitate efficient settlement. We isolate this specialized-knowledge effect further by measuring the change in CLO compensation post-lawsuit when the CEO also has a law degree, thus potentially providing a substitute for the CLO's expertise and firm knowledge.

Second, we examine whether composition of board control has an impact on relative influence of the CLO. Insider board control has been associated with inferior corporate governance and a decrease on shareholder wealth (Rosenstein and Wyatt, 1997). This may be due to the potentially close relationship such board members have with the CEO. There is also support that outside directors, by contrast, perform beneficial monitoring and advisory functions for shareholders (Fields and Keys, 2003). However, other empirical evidence has not found that outside directors substantially improve performance, with studies uncovering small and insignificant

[2] We subset firm BHARs by whether the firm incurred a shareholder class action (SCA) lawsuit at any point in the sample, past, present, or future. For firms that are sued in the future the effect of the SCA may be anticipated and the principal-agent problems that lead to the SCA may already be present.