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FREEDOM, FREE ENTERPRISE AND THE ACCOUNTABILITY PROCESS

An Address by

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This week witnessed the passing of one of this Nation's outstanding jurists -- William O. Douglas. Prior to his elevation to the Supreme Court, as you may know, Justice Douglas was an eminent scholar of corporate and securities laws, a member of the Commission's staff, a Commissioner and then its Chairman.

While associated with the SEC, Douglas played a critical role in shaping the future course that the Commission was to take. He oftentimes may have been critical of particular business actions, but Douglas also understood that a viable private business sector is the foundation upon which a free society can best be built. In his memoirs, he wrote:

> "[P]reservation of free enterprise seemed to me to be the best . . . . Free enterprise is not guaranteed by the Constitution, as are free speech and free press. But the First Amendment and free enterprise seemed to me to go hand-in-hand in a practical way." 1/

Most of the private bar, in my opinion, has long recognized the significance of the free enterprise system in maintaining a free and libertarian society. Accordingly, it has fiercely fought many government proposals and programs which it viewed as unwarranted intrusions into the

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1/ W.O. Douglas, Go East Young Man 307-308 (1974).

private sector's proper domain. Nonetheless, the bar has not adequately recognized a more subtle occurrence -- whose consequences may be more severe to the maintenance to an independent free enterprise sector than any proposal that has been dreamt up by a governmental authority. That problem is the continuing erosion of the public's confidence in our private economic system. Its genesis is in a growing sense that business no longer attempts to balance its interests and the public's, but rather focuses on its own narrow objectives.

The findings of one firm which has done extensive work concerning public attitudes toward business illustrates this skepticism. In 1968, Yankelovich, Skelly and White found that 70 percent of the respondents in a national survey agreed that business tries to strike a fair balance between profits and the public interest. Only two years later, in 1970, that figure had dropped to one-third. It reached a low point of 15 percent in 1976 -- a 55 percent loss of support over eight years. And it has not recovered significantly in the years since 1976. 2/

If these survey results, and others like them, are an accurate reflection of confidence in our private economic

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2/ Yankelovich, Skelly and White, Report to Leadership Participants on 1978 Findings of Corporate Priorities (1979).

system, then it is not difficult to understand why the political process frequently seems insensitive to measures which would improve the health of the free enterprise system. And correspondingly, it is these kinds of perceptions of business and its leaders which business needs to change.

You may ask "Why raise concerns of the public's perception of the business sector to a gathering of lawyers?" That question may be answered on three different levels. At the most practical level, lawyers serve as key advisers in shaping the corporate practices that could either incurease or undermine the public's confidence in business. At a more societal level, lawyers as judges, legislators, and administrators play a crucial role in de ermining the normative standards to be applied to corporate behavior. And, at its most abstract but most significant level, the personal freedom which seems to flourish best where a viable private sector exists is the fundamental logic upon which our legal system and our society is based.

I. The Issue -- The Accountability of Power

At the outset, it is useful to explore why the accountability of corporate power is an issue in our society today. Quite clearly, the American economic system has propelled us, in less than 100 years, from an under-developed, primarily agricultural country, to a society of

mass wealth and mass consumption. In the process, we have raised the standard of living in much of the rest of the world along with our own. And, most importantly, we have created a society which respects fundamental human liberties. This unprecedented phenomenon is a direct result of our private enterprise system. In the face of this tremendous success, why should any question arise as to the "accountability" of corporate power? A more natural reaction would seem to be, in the words of a former Office of Management and Budget Director, "If it ain't broke, don't fix it."

In my view, the answer to this particular contradiction lies in the fact that we have a deep-seated conviction that anyone who exercises power needs to be accountable to someone else for his stewardship. Most people would, I think, regard it as self-evident that anyone who is not accountable, whose word is final and who is not subject to review and risk of removal for failure to achieve acceptable results, may, over time, become autocratic, arbitrary, and arrogant. This situation was found by Justice Douglas in his visits to communist nations where, he later wrote, he "saw monolithic bureaucracy in all its crushing power, it exploited the common man and was beyond effective control

even by the Politburo." 3/ But, America is not immune from this institutional hardening of the arteries. There is a concern on the part of too many to ignore that this syndrome can and is occurring in aspects of American business as well as in American government. Today, I want to focus on this problem as it relates to the private sector.

Traditionally, two answers have served to alleviate concern over the question of whether economic power is accountable to the public good. The first prong of the response has been that the discipline of the marketplace checks, and ultimately destroys, those who are irrational in the exercise of corporate power. Whatever force it may once have had, however, this hypothesis has lost most of its vitality -- at least for the largest corporations. The difficulty is that the theory presupposes an open economic universe which is no longer the reality. We have substituted for that open universe of free competition a business environment designed to insulate against the hazards of a 19th Century economy. In fact, even what is left of the argument that the discipline of Wall Street will ultimately result in an inadequate management's replacement is being

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3/ W.O. Douglas, n. 1, supra, 306.

rapidly impaired by corporate defensive measures which, in many cases, effectively eliminate the discipline imposed by the possibility of an unfriendly takeover -- regardless of the performance of management or the price the outsider is willing to pay. Moreover, in exercising such defensive measures, management may refer to its very real responsibilities to persons other than its shareholders -- such as its social responsibilities -- as a reason for resisting a takeover, although until the takeover was initiated management often did not seem to give such concerns much heed.

The second argument most commonly used to challenge the need for mechanisms of corporate accountability rests on the theory that the board of directors, as the shareholders' surrogate, acts as the watchdog of management power. Again, however, the facts do not adequately support the theory. While the record of board performance is difficult to isolate and study, it shows that directors seldom turn ineffective management out and react exceedingly slowly to corporate deterioration. In his testimony before the SEC on September 30, 1977, Myles Mace pointed out that, for example, when boards have fired a chief executive,

> "the leadership of the [incumbent] was so unsatisfactory that even his mother thought he ought [to go] for the good of the company * * * before the board reluctantly moved."

And, this lack of oversight may apply to the growing, as well as the deteriorating, corporation, and to strong, as well as ineffective, management. In my opinion directors have not been sufficiently diligent in exercising their duty to ensure that large premium payments for acquisitions have an economic justification, and are not merely exercises in ego gratification by aggressive managers.

In short, what is missing from this environment is a force that has the practical capacity to effectively oversee management, and if necessary, make timely changes in policy or personnel. To the extent that the public perceives this accountability gap -- and concludes that it has suffered serious consequences because of it -- the pressure mounts for government to step in. I have little confidence, however, in government's ability to be prescriptive concerning corporate mechanisms without also being so oppressive as to destroy them. Thus, in looking for solutions, we need to concentrate on improving the overall effectiveness with which the present system functions rather than experiment with a totally new system of accountability. The issue is how to preserve the advantages of a strong management-based corporate system and still be assured of effective institutional discipline. In my view, the answer is to be found in the corporate board room.

II. The Role of the Board of Directors

A strong and effective board is a valuable corporate asset. Enhancing the perception of corporate accountability and thus reducing the pressure for a government role in corporate decision-making is a vital goal. However, both management and directors also share another, more fundamental, goal -- to develop a board which can bring the best, most informed, and most objective advice available to bear in solving the complex problems which confront the entity. If directors are timid or feel compelled to compromise rather than advocate their views forthrightly -- whether because of their personalities, their friendships, or their pocketbooks -- then, in the long run, the corporation is the loser.

In suggesting that an independent source of discipline is missing from many corporate environments, I do not mean to ignore the very real progress which many boards have made. Indeed, some boards already function most effectively, and many others are exploring ways to strengthen their role. The changes that the board is undergoing, or has undergone, have served to protect the basic system and to demonstrate its ability to evolve. I believe the basic sociology of the board room dictates that those companies which have not engaged in a searching examination

of the role their boards could play should do so, and that further changes should occur. These changes are, however, within -- not destructive of -- the basic board framework and the independent decision-making upon which the free enterprise system is grounded.

In speeches during the past several years, I have made a number of proposals concerning board composition, chairmanship, and committee structure which would, I believe, help to counteract these tendencies. The board construction I have proposed addresses what I consider to be the most common and objectively identifiable aspects of board structure and composition which can impede the effective functioning of the board. It obviously cannot deal with the sociology of the board room directly. Nor does it deal with the personal qualities of individual directors, whatever they may be. Yet, ultimately, the effectiveness of the board is determined by the attributes of the directors and by the attitudes and ethics which pervade the board room.

For that reason, rather than repeat my board structure proposals, I want to outline the concerns which underlie them. My objective is to encourage boards to explore the issues and their implications and relevance to them.

First, it is important to consider the role and number of outsiders on the board. This is not a novel concern.

Almost a half-century ago, Justice Douglas offered a description of this problem and a suggestion for a solution -- neither of which should be unfamiliar to the contemporary corporate bar -- when he wrote:

> "[B]oards wholly or dominately filled with 'shirt-sleeve' directors drawn from the executive management, without outside representation, are apt to suffer from myopia and lack of perspective. It is one thing to operate a business efficiently, but it is quite another to be sufficiently detached from the business to be able to see it in relation to its competitors, trade trends, and the like. * * * The minimal requirements in this regard are statutory provisions that a board of directors shall be composed of stockholders who are not employees or officers of the corporation * * *." 4/

Today such outside representation means individuals who are neither employees of the corporation or otherwise dependent upon it economically. That definition raises questions as to the status of many persons who have traditionally served as directors, such as corporate counsel, underwriters, bankers, major customers, and major suppliers. I am not suggesting that these individuals are necessarily ineffective as directors or that self-interest usually clouds their judgment. As I pointed out above, however, the sociological and psychological factors which pervade the board room limits

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4/ W.O. Douglas, Directors Who Do Not Direct, 47 Harv. L. Rev. 1305, 1313-14 (1934).

the ability of management members to perform the accountability function. Similarly, the "second hat" which corporate counsel and other "suppliers" wear with respect to the corporation raises an issue of whether their ability to contribute to both the reality and perception of accountability is diminished. Stated differently, directors who have business links to the corporation impose a cost on the accountability process, and we need to consider carefully in each situation whether the cost is a necesary one to incur, and whether the benefits can be achieved in other ways.

Second, board members need to examine the role of the corporate CEO as chairman of the board. The ties which board members will feel to the CEO and their basic desire to be supportive are compelling. The consequences of adding to that power the power of the chair and of the agenda process must be weighed cautiously. The Chairman's role is to create an open, contributing, and questioning environment. The CEO's role is to speak for management. These roles are not the same and can conflict.

The final broad issue which boards must consider is the specific responsibilities which the board needs to discharge and how best to approach these tasks. Board committees comprised of outside directors may have an important role to play in that process, especially when there are a significant number

appropriateness of the compensation packages for senior management, such a committee should, for example, examine key management compensation policies to assure consistency with the long-term interests of the company and to assess whether compensation practices encourage management to maximize short-term profit at the expense of long-term interests. Another aspect of this committee's mandate should be to consider the level of director remuneration. The nonmonetary rewards of these posts, such as the prestige and the desire to do the board or its chairman a "favor," are not now as compelling -- particularly when weighed against the increasing time demands and the risks of liability and other legal entanglements.

Additionally, depending upon the corporation and the particular circumstances extant, there may be need for other special function committee -- sometimes, even on an ad hoc basis. For example, recognizing that, when a corporation is the target of an acquisition attempt, there may not be a unity between the interests of incumbent management and those of the corporatin and its shareholders. There is need in such situations for a special committee of independent directors. This committee would, of course, address the offer in terms of its economic sufficiency. But such dollars-and-cents analysis should not end its inquiry.

For example, it should examine the likely effects of accepting the offer on the on-going existence of the corporation. And, whether accepting the offer would be in the best interests of long-term investors as well as short-term speculators. Moreover, the committee should look at the reasonable interests in the corporation's independent existence of persons other than its shareholders -- for example, its customers, suppliers employees and the communities in which it operates. Another important, but often overlooked role, of such a committee would be to monitor the statements and actions of its own management and counsel in response to the offer in what is often a very stressful period.

Before I turn to the role of management in the accountability structure, I want to outline what I do not advocate for the board. First, I do not favor constituency directors. In my view, the board is not a political body and cannot function effectively when populated by individuals who have special interests to champion and little concern or sense of responsibility for the overall welfare of the company. Additionally, some of those who advocate constituency directors seem to have in mind persons unconcerned with -- or actively hostile to -- the basic economic purpose of private business. For those reasons, I strongly oppose constituency directors.

Second, I do not desire or intend to convert the board room into an arena characterized by distrust of, or suspicion toward, management. The goal is an environment of accountability, not one of hostility. A chronically adversarial relationship between board and management would be equally as destructive of accountability as is a relationship characterized by board passivity. The board and management must be capable -- within the accountability framework -- of working with, not against, one another.

Third, I oppose federal legislation or regulatory action to charter corporations, to dictate board structure or even to impose my own suggestions. My goal is to underscore the responsibilities of corporate boards and how they might better carry them out so as to strengthen the case against legislation, and make it unlikely -- not to hasten its passage. While some apparently believe that legislation is the key to reform, I am concerned that federal encroachment into the board room would likely cripple rather than strengthen its functioning.

Finally, I am not suggesting that the board's power over corporate business expand at the expense of management's. The appropriate and most productive function of the board is to monitor, not to manage -- to support, to guide and, where necessary, to discipline, but never to usurp. To the extent

that effective functioning of the board cuts back on management autonomy, the board is assuming a role it had previously abdicated, not usurping a management prerogative.

III. The Role of Management

I want now to turn to corporate management. In considering the role of management, it is crucial to recognize at the outset that management's primary mission is economic and that the key to the success of any corporation is the capability of its management to carry out that mission. The purpose of the corporation is to provide customers with goods and services at an attractive level of quality and price. The profitability of the corporation is, over the long run, a measure of its success in discharging that underlying responsibility, rather than an end in itself. The profitability of corporations as a group is a measure of our society's success in providing jobs, goods, services, prosperity, and other economic underpinnings of the political freedoms which make our democracy possible.

How can managements reconcile their profit objectives and the need for the kind of accountability of which I spoke earlier? Simply stated, good management, concerned for the future of the company, achieves a harmony of profit and other goals; indeed, there is a very strong correlation between companies which think and respond in terms of

longer-range corporate responsibilities, including social and political overtones, and those with the best performance records over time. Moreover, it is impossible to separate the social environment of the firm from the ethical standards of the executives who manage it. The executive inevitably finds that his own moral code is the bottom line in his business decision-making, and it is not realistic, either psychologically or ethically, to expect the individual executive's actions as a businessman to be inconsistent with his personal sense of responsibility to society at large and to his own conscience. To contend that one can live a personal life by one set of ethical standards and a business career by another is either self-deception or hypocrisy.

Management, however, frequently and unwittingly creates a climate that tempts subordinates to compromise their ethics -- not on their own behalf, but on behalf of the company and the company measurement of performance. A company, in order to be prudent and moral, must be careful to avoid creating ethical conflicts for its employees. One management, in the course of developing a code of conduct for its employees, was shocked to learn from them the number of people in the firm who had faced a wide variety of serious ethical dilemmas and handled them on a case-by-case

basis with no guidance from top management. But more importantly, most cases had been resolved in favor of the course that would produce the greatest short-term profit. Management discovered that a number of expedient practices had been prevalent because of two employee attitudes. First, the company was perceived as always having placed great emphasis on rewarding those who made the largest contribution to immediate profits or growth. Indeed, immediate growth has become a goal in itself, even though over time it may exact a price in terms of future corporate efficiency and longer-term profits. Second, the firm had never evidenced any special concern for ethical standards. Consequently, most employees naturally concluded that cutting corners in order to maximize profits was a condition of employment.

The lesson of this example is that top management must set the moral tone in any organization, and it must personally see that the staff remains on course. If the standards of top management are high, the chances are excellent that the standards throughout the organization will be equally high. But if those at the top do not have high standards, or if they violate the standards, there is an ever-present danger that more honorable persons below will be influenced by attitudes of those above them, and the organization's tone will reflect it.

This is the core of the debate over corporate accountability. If an individual is in a business setting in which every action is justified on purely economic grounds and in which rewards and punishments are based on short-term economic performance, then, quite naturally, he will shape his conduct to maximize the immediate economic returns of the entity, even at the expense, if need be, of other social or ethical values or even the longer-term interests of the corporation and its shareholders. The result may be positive in the short run. Over the longer term, however, business may destroy itself if it pursues that course. I do not believe society will tolerate permanently a major institution in its midst which justifies itself solely on economic terms. Nor do I believe that people who staff the entity will be able indefinitely to pursue conduct in their business relationships which is not consistent with other dimensions of their lives.

IV. The Role of Inside Counsel

Because corporate decision-making cannot legally or practically be purely a matter of economics, corporate counsel is presented with unique opportunities and responsibilities in participating in the accountability process. Since I have previously talked in New York on outside counsel's role in this process, today I want to

specifically review the role of inside counsel, a sometimes overlooked actor in discussing corporate accountability. But I note that many of these ideas are applicable to all corporate counsel -- whether inside or outside the corporation.

Obviously, there are some hard ethical issues concerning inside counsel's proper relation to the corporation which are raised by virtue of his professional status. The profession presently is endeavoring to come to grips with many of these issues -- specifically through the efforts of the American Bar Association's Commission on Evaluation of Professional Standards to revise the Rules for Professional Conduct. We are all anxiously awaiting the results of that Commission's revisions. It will be interesting to see if the revisions result in stronger standards by which the bar addresses the problems of unprofessional conduct or if we see a movement toward watering them down to minimal, lowest common denominator standards.

Nonetheless, a few thoughts on inside counsel's role in the accountability process remain timely. It is a responsibility that springs not only from counsel's duties as a corporate legal officer, but also from his role as one of the few "generalists" in the corporate hierarchy.

Internal counsel's responsibilities run far beyond narrow legal issues. Although not the only officer who deals with corporate problems which are not exclusively related to the profit and revenue producing activities of the corporation, he is one of the few corporate officers who is likely to hear from all of the corporation's internal and external constituencies. Thus, inside counsel is uniquely involved in an assessment of risks and consequences in the types of situations which typically give rise to public concern and reaction.

Because they are corporate insiders, internal attorneys are in a unique position to help the companies which they serve, and through them the corporate community as a whole, to focus attention on the issues of corporate responsibility; to assess the consequences of alternative courses of conduct; to weigh the short- and long-term costs and benefits; and to decide on positive steps which, in the context of the objectives of each particular corporation, can help to promote accountability and thus retard the pressure for federal restraints. As in the case of outside counsel, the inside attorney's job extends beyond answering questions which focus only on what the law allows -- or what is worth the risk that the law does not forbid it. The inside attorney should also be concerned with the process by which the

company evaluates the potential impact on itself of conduct which could be construed to be unethical, albeit technically legal. And, a fundamental task is to be part of the process of sensitizing and informing management and directors regarding the implications of the public's expanding perceptions of corporate responsibilities. Finally, inside counsel is in a unique position to implement a program of preventive law. On the scene and in intimate contact with the management, he can help avoid many corporate decisions which fail to take into account those perceptions and their implications. Counsel has no monopoly on virtue, but sound legal advice should lead to a decision that is morally and ethically sound as well as legally acceptable. The advice should be textured to include the social purposes the law is intended to serve and the societal expectations flowing therefrom.

As more corporations establish the specific function committees to which I have referred earlier, the role and responsibility of inside counsel increase in importance. His input into questions of board structure and function can be vital to the effective performance by the board and its oversight committees of their accountability function. In this regard, I refer you to the ABA Committee on Corporate Law's Report on Overview Committees of the Board of Directors

[34 Business Lawyer 1837 (July 1979)]. While I might not agree with its conclusions in every respect it is, in general, an excellent analysis of the functions which such committees can and should play in the accountability process.

The role of inside counsel in the implementation of and compliance with the Foreign Corrupt Practices Act is another good example of these general principles. Part of his responsibilities is the obligation to recommend written policies, establish procedures and monitor their implementation. He is in a special position to know what an adequate internal control environment in his company requires, to understand the legal principles involved, and to advise as to their implementation and the methods necessary to monitor compliance. Compliance with the Foreign Corrupt Practices Act is a peculiarly appropriate activity for inside counsel, because he should know the business intimately enough to have a sense of the specific aspects and personalities which are most likely to present problems.

The inside counsel has dual obligations of loyalty. While he assumes a duty of service to his employer -- as must any employee -- he also must discharge his responsibilities as a professional -- as must any lawyer. In normal circumstances, these dual obligations do not conflict. There may, however, be situations in which the requirements of law or the obligations of the legal profession could

force even the inside lawyer to consider resignation, disclosure of unlawful conduct, or other measures which sometimes confront outside counsel and which are more traumatic for inside counsel since they involve a risk of ending the inside attorney's employement relationship. While the pressures on inside counsel may be qreater to play along with the team, and the disruption to his career should he feel compelled to resign or risk being fired far greater, his conduct obligations do not appear any less than those of outside counsel.

Inside counsel, if he is to be effective, requires independence. In some companies, of course, he lacks independence and his role is more circumscribed. Where that is the case, we must, at a minimum, recognize that he is performing, not as an attorney, but as a legal technician -- knowledgeable in the technicalities of the law, but disabled from exercising the independent judgment which is the hallmark of a professional. Anyone dealing with him should be aware of the incapacity.

V. Conclusion

I opened my remarks by noting Justice Douglas' recognition of the correlation betwen free enterprise and a free society. But, the future of the free enterprise system, in turn, will be shaped to a significant extent by the

public's perception of whether it is accountable to rational, objective decision-makers who are acting according to publicly acceptable norms. And, I also noted the unique opportunities and responsibilities of attorneys in the outcome of this question -- in their roles as key advisers to corporations; as judges, legislators, and administrators defining normative corporate behavior; and as professionals with an overriding obligation to preserve individual liberty.

I recognize that the challenge of continuing to find solutions to the concerns that I raised today and preempting an erosion of the free enterprise system is one which will demand the time, commitment, and talent of the legal profession -- both individually and through its professional institutions. But such an allocation of our resources is necessary because, as Justice Douglas recognized, the future of the free enterprise system will affect the future of this Nation as a free society.