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CORPORATE ACCOUNTABILITY AND THE LAWYER'S ROLE
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Banking and Business Law
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During my tenure as Chairman of the Securities and Exchange Commission, I have used many of the speaking opportunities offered me to discuss various aspects of the issue of corporate accountability and how it can be enhanced. I came to the Commission in large measure because of my concern about the continued erosion of the integrity of the capital formation process and of the private enterprise system generally. There are many dimensions to the problem, including tax policy, the impact of inflation, and the trend toward ever-increasing regulation. Another dimension is that public confidence in the accountability of business has been shaken -- confidence which must prevail if private capital markets are to survive and flourish and if the advantages of private enterprise are to be preserved. Questions have been raised, for example, about the integrity of corporate earnings, about whether American business is run in the best interests of its shareholders and the larger society of which it is a part, about whether our equity markets are an attractive and fair place for the individual investor to place his after-tax investment dollars, and about the inability of small businesses to gain vital access to capital markets. The answers to these questions are important, not only to

our economic future, but also in terms of the respective roles which government and the private sector will play in the future shaping of our economic and social structure.

For that reason, I am particularly pleased to have the opportunity to address the Section of Corporation, Banking and Business Law this afternoon. The gap which seems to have opened between public perceptions of business accountability and business's own conception of its role is important to those who practice corporate law for two reasons. First, lawyers are, in their many diverse roles, architects -- consciously or unconsciously -- of the accountability mechanisms in our corporate structure. Accordingly, if the private sector tends at times to be expedient, lacking in vision in assessing the future and what it holds, and reactive in attempting to meet the demands and expectations to which it must respond, its counsel must share in the responsibility for the consequences. Conversely, the corporate lawyer, in his role as counselor and advisor, can play a significant positive role. If lawyers choose to bring to bear the broader vision with which many are well-equipped, they can help to preserve the flexibility and vigor of the corporate system which has served our economy so well.

A second reason why this issue should be of vital concern to lawyers is that, because of their role as architects of the corporate structure, the blame for perceived corporate irresponsibility is not likely to be directed solely at the businessmen who run our large private economic institutions. Lawyers are likely to share in the spotlight of public scrutiny and -- whether it is fair or not -- to be touched by the legislative constraints which are almost certain to emerge if a consensus develops that business, by itself, will not take the steps necessary to insure that the power it wields over our national life is exercised with due regard for our public and social aspirations and expectations. Already the legal profession is under attack, and calls -- sometimes justified -- are being heard that we must, as a society, "de-lawyerize" or, at minimum, take some of the control over their profession away from lawyers. The question of who should exercise responsibility for the ethics and discipline of lawyers is a broad and complex one, and I will not attempt to deal with it here. I would, however, commend to your careful study the drama which is continuing to unfold concerning whether regulation of the independent accounting profession should be made a subject of federal legislation. That issue is one

which was born in revelations of certain highly publicized financial failures and of concealed political and foreign payments during the last decade, and it provides a clear and very relevant illustration of how the public and the legislative branch may seek to remedy perceived ills in the corporate sector with nostrums directed to those who render professional service to the business community. I suggest that, for these purposes, the similarities between the legal and accounting professions far outweigh the differences.

Before I turn to the lawyer's role in fostering accountability, I want to touch on a still broader point concerning the role of the lawyer and the law in our society. In my view, one measure of the health and strength of a society might be read from a graph which depicts two variables. One line on the graph would reflect the level of ethical behavior. The second line would reflect the conduct to which the law compels adherence. When the ethics line is significantly higher than the law line -- that is, when concepts of ethically acceptable behavior are significantly higher than the standards which the law imposes -- the society enjoys good moral health. If, however, the gap between the two lines

narrows, it may well reflect a greater dependency on the law and a decline in moral vigor. And, in the United States today, I believe that these two lines are coming much closer together. Increasingly, we as a society look to the law to define right and wrong, moral and immoral; the notion that the law sets the floor rather than the ceiling receives little currency. By the same token, the tendency to focus on the law leads to a withering of interest and concern for the ethical. The implicit assumption increasingly becomes that, if government has not forbidden it, it must be acceptable. This results in increased dependence on the legal process to define the limits, and the game becomes one -- as it has in tax law -- of avoidance and loophole-closing. The result is a fundamental change in the mores of the society.

Norman Redlich expressed a piece of this idea in these words:

"It is our burden and our glory that we are expected to live by a high professional standard and earn a living at the same time. We do not have the luxury of the clergy who can live in the temple and condemn the market place. We have to carry the standards of the temple into the market place and practice our

trade there. That is why a country which questions its moral behavior inevitably questions its lawyers." */

My concern is that, as we become increasingly obsessed with the law as a solution to social problems and as a guide to conduct, we leave less and less room for any conception of morality. And that is a trend which is unhealthy for the law, for lawyers, and for society.

The debate concerning what is often called "corporate accountability" or "corporate governance" is a good example of this tendency to look for legal solutions to what have traditionally been perceived as ethical questions. For example, demands are being heard, with increasing frequency, that Congress enact legislation to control the exercise of corporate power. As I have suggested in the past, in my view, the best antidote for such legislation is for corporations to take steps to assure the public that they are capable of self-discipline which is consistent with both the realities of the market-place and the noneconomic aspects of the public interest. Mechanisms which reinforce that assurance must become effective structural components of the process of governance

*/ Redlich, "Lawyers, the Temple, and the Market Place," in The Record, p. 200.

and accountability in the American corporation. In order to implement this concept, I have recommended that corporations constitute their boards exclusively of independent, outside directors with the exception of the chief executive officer; that the CEO not serve as chairman of the board; and that individuals with substantial professional or business relationships with the company, such as suppliers or outside counsel, not serve as directors.

I do not mean that all corporate boards, constituted differently than I propose, are necessarily ineffective. But I do believe that boards can be more effective and that, in many situations, they do not discharge their responsibilities to oversee the management of the affairs of the corporation.

Nor am I expressing a distrust of American business. To the contrary, I have enormous regard for American business leadership. And those who rely on notions like the "three martini lunch" and the misimpression that corporations typically maintain yachts and hunting lodges for the personal use of their executives deal in pejoratives which cloud the intelligent discussion of vital substantive issues. Yet it would be unrealistic and foolhardy to ignore the fact that corporate accountability can be improved, that

that not all boards are discharging their oversight responsibilities, and that the system should be strengthened. If business, and the corporate bar which serves it, fail to respond to the challenges which have been laid before them, we run the risk of further government involvement and the restructuring of our corporate system in ways which may ultimately create an economy inadequate to fund our future.

With those thoughts in mind, I want to discuss the lawyer's role in promoting corporate accountability -- that is, in widening the gap between the dictates of corporate ethics and the demands of corporate law. That role can, I think, be divided into several components -- the lawyer as corporate director, as counsel -- outside and inside -- and as a member of the organized corporate bar. I will turn first to the lawyer as director.

The Role of the Lawyer as Corporate Director

I believe that lawyers who serve as corporate directors have an opportunity to make valuable contributions to both the success of the enterprise and to the evolution and strengthening of the accountability mechanisms. Before I touch on that positive role, however, I want first

to discuss a negative. In my view, the lawyer who is also outside counsel to a corporation, along with investment bankers, commercial bankers, and others who might be characterized as "suppliers" to the corporation, should be excluded from board membership.

The suggestion that lawyers and others who supply services to corporations should not serve as directors has received both endorsement and criticism. Opponents of this suggestion have emphasized -- correctly -- that these categories include individuals who are among the most intellectually-qualified directors and often are those most willing and able to probe and criticize management. Some law firms and investment and commercial bankers have begun to decline to have their members serve as client's directors; others see no objection. The Corporate Director's Guidebook which this Section recently published, although indicating some possible problems, takes no position with respect to the lawyer's role as a director. A recent Lou Harris survey of outside directors (including some who would not qualify as independent) reported that, when asked whether legal counsel should serve on the boards of their clients, the response from 36 percent was that

they should, while 56 percent said that they should not. Of the companies on whose boards those surveyed sat, 30 percent actually had outside counsel directors.

Those favoring the proposition that counsel should serve on the boards of their clients have suggested that legal counsel frequently has special knowledge of litigation and other matters of vital significance to directors; that counsel has a special perspective on the day-to-day management; that board membership is necessary to place legal counsel in a position to deal as an equal with senior management; and that board membership makes the outside attorney more accessible to other members of the board. I do not disagree with these contentions, but I do believe that there are competing factors.

It is important that we come to grips with the conflict of interest problem created by the board membership of those whose income, in some significant measure, depends upon their business dealings with the management; with the obvious inhibitions on the other members of the board in terminating or criticizing the service rendered the corporation as a result of another director's business relationship; and with the public perception problem created

by that conflict. The subtle, and occasionally not so subtle, pressures imposed as a result of an employment relationship between a corporation and an individual lawyer or law firm suggest that the legal counsel acting as a director may have a pre-conditioned management view.

An additional problem arises, for example, if the board is considering a course of action fashioned with the involvement of the attorney-director's own law firm -- or indeed by the attorney-director himself. Is it realistic to expect that he will subject the proposal to a dispassionate and unbiased review? Is it realistic to expect that he will ever vote, as a director, against what he, as an attorney, has been involved in creating? These questions illustrate why the actual lack of independence and the appearance of the lack of independence -- which is inherent in an attempt to wear both the director and the lawyer hats simultaneously -- are both inconsistent with the ability of the board to discharge its oversight responsibilities and with the concerns which call for an independent board of directors.

Obviously, in many cases the corporation does benefit from having its outside counsel as a board member. Counsel can, however, always be invited to attend -- and they probably

should attend regularly -- but without actually serving as directors. Further, if lawyers make valuable directors -- and obviously many do -- then corporations could ask members of the profession other than those engaged in business relations with the corporation to serve on the board. The lawyer traditionally in our society has been independent and the advocate of unpopular as well as popular causes. To exclude the lawyer's qualities from the board room would be inconsistent with the diversity of viewpoint and independence of thought which are essential to the proper functioning of a truly independent board of directors. Why should a lawyer serve in this capacity if he is not counsel to the company? I think that accepting a position as an independent director should be viewed as part of the lawyer's public service obligation. And, if attorneys who are not also retained by the corporation decline to serve in place of those who do business with the company, perhaps we should ask ourselves what this tells us about the independence of retained attorneys as directors.

I want to emphasize that, in working to improve accountability, the point is not to devise a set of inflexible rules -- with respect to director independence or any other aspect of board membership -- which should be imposed on

every corporation. Rather, we should explore the principles which maximize accountability and the conditions which impede it, and the existing board structure in each particular corporation should bear the burden of justifying itself against these. There is an impediment to accountability -- to the detriment of the corporation -- when directors serve conflicting roles and interests. And there is a cost in terms of erosion in confidence in the accountability process as a result of the appearance of a conflict of interest. The crux of the problem is to assure that decisions concerning board composition can withstand a reasoned and thoughtful balancing of these costs against the benefits expected from a given director's board service. This determination itself should be made by the independent members of the board.

The Lawyer As Counsel

I want now to turn to the lawyer's role as counsel. It is in this area that the bar can have its greatest impact on the fostering of corporate accountability. In large measure, the role may be one which is not strictly "legal." I believe that counsel has an important role to

play in protecting the gap I mentioned earlier between ethical guidelines and legal requirements.

Unfortunately, however, instances are well-documented where counsel have been party to the process wherein management adopted positions or took actions that might have been technically legal but which were highly questionable ethically. We can all recite well-publicized business scandals of recent years where it might not be possible to prove that management acted illegally but where the public had reason to be incensed at the evident disregard of the public interest. Many of the problems and adverse publicity could have been avoided by strong counsel acting professionally and advising management to conduct corporate affairs in a manner that would bear inspection in the light of day. When the lawyer defines his role too narrowly, or does his job too timidly, the chance of trouble increases for everyone -- company, directors, and shareholders, as well as counsel -- and perhaps most importantly, the free enterprise system further loses public esteem and the prospect of increased government control is brought one step closer.

In addition to this need to restore some of the healthy tension between the requirements of the law and the standards of ethical behavior, counsel faces a second problem -- defining who the client is. Ethical Consideration 5-18 of the Code of Professional Responsibilities provides that a lawyer employed or retained by a corporation owes his allegiance to the entity and not to a stockholder, director, officer, employee, representative, or other person connected with the entity. While the general thrust of this proposition is certainly correct, it is a statement of very limited utility to the lawyer who, as a practical matter, must deal with the corporation's officers and employees. How is counsel to respond when he believes that management wishes to run a legal risk which the lawyer thinks is likely, in the long run, to prove injurious to the corporation? Indeed, how can counsel determine what is or is not in the interests of the "entity" of which EC 5-18 speaks, as distinct from the interests of its officers, directors, employees, and shareholders? I have no answers to offer for these questions. The problem is, however, one which the bar needs to address.

Another dimension to counsel's responsibility is presented by the Director's Guidebook suggestion that

directors must familiarize themselves not only with corporate affairs, but also with their legal duties. Lawyers owe an obligation to their clients to insure that directors are cognizant of the laws with which the corporation must comply. It is practically impossible for a director to make an informed judgment on a mixed economic and legal problem without knowledge of the purposes and spirit, if not the specifics, of the law.

Counsel's educative role has an additional, very practical, dimension. Recent opinions suggest that the protection against personal liability and judicial second-guessing afforded directors by the business judgment rule attaches only to good faith deliberations, and that an inadequately educated board cannot, therefore, make determinations that will carry with them that special legal significance. Indeed, where counsel is not properly educating the board, both directors and management should demand it, in their own and the corporation's self-interest.

Outside counsel

To provide the kind of education and advice needed to represent a public corporation, to advise its management,

and to assist its board in effectively performing its oversight functions, lawyers and law firms must insure that their advice and counsel are objective. This point is a complex one for a profession which, in most respects, has not traditionally been expected to be independent of its clients; thus, the corporate lawyer at one moment finds himself acting as an advocate and at the next as an adviser. As an advocate -- in the courtroom, for example -- except in unusual situations, his job is to vindicate the client's position, to justify what the client did in the past or wishes to do in the future. In the advisor capacity, however, the lawyer's role is different. It is there that he has the opportunity to bring considerations of both ethics and law to bear on the corporation's future conduct.

In order to alleviate the danger that, in the advisory role, the lawyer will shape his judgment to please the client, lawyers might borrow a leaf from the accounting profession. Accountants, of course, are expected to be independent of their clients, and have found such steps as second partner review and rotation of assignments to be useful methods of minimizing the natural blurring of objectivity which can result from longstanding personal

and professional relationships between the client's managers and the firm's partners. Similarly, lawyers in large, business-oriented practices might consider implementing a system in which partners with less of an economic or career stake in telling the client what it wants to hear would review proposed recommendations or opinions which the firm proposes to render to the client -- particularly in areas where there are obvious public interest factors and potential liabilities to weigh. Changing the senior lawyers on a corporate account on a periodic basis -- just as accountants rotate audit responsibilities -- may also tend to alleviate these pressures.

In short, the lawyer has a vital role to play in insuring that basic principles of corporate accountability continue to evolve and develop. In the terms I used earlier, the lawyer can help to open the gap between the ethical and legal lines on our society's graph by raising corporate ethical standards without raising the legal constraints. Constructive criticisms from the legal profession can, in my view, do more toward implementing the goals of corporate accountability than any form of federal legislation or regulation.

Inside counsel

The kinds of contributions which lawyers who sit as independent board members can make and the functions of outside counsel are relatively clear. But what of the internal counsel -- the lawyer who is permanently employed by the corporation?

The attributes of the insider lawyer do not lead to the conclusion that he lacks a role in insuring both the fact and the perception of greater corporate accountability. On the contrary, a lawyer's professional responsibilities are not diminished when he becomes an employee. Indeed, inside counsel can be the vehicle through which the corporate conscience can be activated. Inside lawyers play a daily role in shaping events as they occur, in determining corporate policies, and in establishing the moral tone and standards for the conduct of corporations.

Internal counsel's responsibility runs 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 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, individual internal attorneys are in a unique position to help the companies which they serve, and the corporate community as a whole, to focus attention on the issues of corporate responsibility, to weigh the costs and benefits, and to decide on positive steps which, in the context of each particular corporation, can help to promote accountability and thus retard the pressure for regulation. 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 help to evaluate the potential impact on the company of dropping below the ethics line even if corporate conduct remains above the legality line. The most fundamental task is to sensitize and inform management and directors regarding the implications of the public's expanded perception of corporate responsibilities.

The inside counsel has dual obligations of loyalty. While he must be loyal to his employer -- as must any employee -- he also must be loyal to his responsibilities as a professional -- as must any lawyer. In normal circumstances, these dual loyalties do not conflict. There may, however, be extreme situations in which the requirements of law or the ethical obligations of the legal profession force even the inside lawyer to consider resignation, disclosure of unlawful conduct, or other measures which sometimes confront outside counsel and which are likely to mean an end to the inside attorney's employment relationship.

Stated differently, inside counsel, if he is to be effective, requires a certain measure of independence. In some companies, of course, inside counsel lacks independence and his role is more circumscribed. Where that is the case, we must, at minimum, recognize that we are asking the attorney to perform, not as an attorney, but as a legal technician -- an expert in the law who is disabled from exercising the independent judgment which is the hallmark of a professional. Anyone dealing with him should be aware of that incapacity. Indeed, I believe that serious questions exist as to whether the ethical responsibilities of

someone holding himself out as internal counsel can be any less than those of outside attorneys.

The Role of the Organized Bar

Attorneys, perhaps more than any other profession, have a long tradition of acting to improve the state of their craft through the efforts of organized professional societies. Similarly, in my view, the organized bar has an important role to play in defining how lawyers and the corporate sector should respond to the challenge of corporate accountability.

The bar's canons of ethics and disciplinary procedures are, of course, a part of that process. The Code does not, however, deal comprehensively with the realities of modern law practice and should be revisited -- as a disciplinary, not a protective device. As lawyers, we cannot expect to be able to cloak self-serving behavior behind a code of ethics as successfully as we have in the past. I have mentioned some of the gaps I see in the present Code -- the definition of the corporate lawyer's client and the issue of the responsibilities of inside counsel are two examples of complex questions which need explicit treatment. Those in this room could, I am confident, significantly expand that list.

Many professions are undergoing rapid change and are having difficulty in fulfilling public expectations. This problem confronts the legal profession as well. If it is to continue to enjoy public confidence and to perform its functions responsibly, it must meet the legitimate needs of society. The primary test should be, "What is in the public interest?" and the legal profession should make certain that it has a Code of Professional Responsibilities which meets that challenge.

I believe, however, that an equally important challenge facing corporate lawyers is to synthesize -- from the day-to-day experience and expertise of individual practitioners -- guidelines for both lawyers and other actors in the corporate governance drama. The Corporate Director's Guidebook, prepared by this Section's Committee on Corporate Laws and recently published in The Business Lawyer, is an important positive step in that direction. It lays out, intelligently and thoughtfully, some important aspects of the rights, duties, obligations, and issues facing corporate directors. The Guidebook will, I think, prove an important addition to the literature of corporate accountability.

I do not mean to suggest, however, that the bar can safely view the Guidebook as completely discharging its

responsibilities to define new parameters in this area. The Guidebook is silent on very important issues, including conflicts of interest questions such as outside counsel's service on the board of directors and the obligation, if any, of directors, and indeed of attorneys, to disclose unlawful -- or proposed unlawful -- conduct on the part of the businesses they serve.

Conclusion

In a real sense, as I mentioned at the outset, the central problem which lawyers engaged in a corporate practice face is not one which can be resolved in legal terms. We must decide, consciously and deliberately, what role ethical considerations will play in the decision-making of American business. What is legal and what is ethical are not synonymous. We tend to resort to legality often as a guideline; in that sense, ethics is on the wane and the age of the legal technician is in full flower.

When we take this route, we must recognize that we are dealing in legal opinions, but not necessarily ethical or moral ones. The public, the public advocates, and many of the legislative and administrative authorities recognize the distinction even if we do not. When we

engage in development of products which create serious side problems, or in marketing and advertising practices in which our justification is that they are "legal," we are in a position we can no longer defend. We are avoiding a responsibility we can no longer avoid. Perhaps we are not immoral, but we are amoral -- we lack moral quality.

I have set forth some of the reasons why I believe that attorneys should devote their talents and ingenuity to the issue of corporate accountability and to closing the gap between corporate and public perceptions on that issue. Some of you already are. I have a great deal of faith in the ability of the private sector -- and specifically of the private bar -- to be creative and responsive in this area. Each of us who believes in the corporate system we enjoy today and the concomitant individual freedom which it has provided us, must give serious thought to his or her personal role in preserving it. Lawyers have to recognize that the system places heavy responsibilities on them. Because of the complexities of modern corporate affairs, the private sector lawyers who make the system work carry an especially substantial burden. If we, as a nation, lose faith in the effectiveness

and fairness of that system, the consequences will be felt, not simply by business alone, but by the bar and every other segment of our society.

Thank you and good afternoon.