

**Lessons from Enron:
A Symposium on Corporate
Governance
October 16, 2002**

Dinner Speech

**21st Century Corporate
Responsibility—“Evolution,
Revolution, or Back to the
Future?”**

by Alfred P. Carlton, Jr.*

It is indeed a privilege to sound the “opening bell” on this *timely* symposium. Yes, tomorrow we will tackle the new world of corporate responsibility and the role of lawyers, pause to consider their effect on compliance and enforcement, and then delve into specific corporate governance reforms and the role of accountants. We will be challenged both intellectually and philosophically on an issue that, I believe, underlies the number one problem facing this nation’s

* Member, Kilpatrick Stockton LLP, Raleigh North Carolina. President, American Bar Association (2002-2003). Admitted: North Carolina Bar (1975); United States Supreme Court (1993). University of North Carolina at Chapel Hill (B.S., 1969); University of Dayton (M.P.A., 1973); University of North Carolina (J.D., 1975).

economy—confidence in our capital markets. It is timely. It is not only relevant, but important. So I thank Mercer University for sponsoring this event. I hope that I can provide some perspective and food for thought to assist us in our deliberations.

I think it would be helpful if I begin my remarks by focusing on the average, everyday American *citizen* and the average, everyday American *investor*.

This great country is nothing but a collection of 250 million individuals, each of whom operate under an essential economic contract. The contract goes like this: If you work hard, obtain skills, and show some ingenuity and creativity, you will go far in this economy. Success certainly is not guaranteed to anyone, but the American form of capitalism does hold the promise that talent, aggressiveness, and hard work will be the criteria on which individual success is either realized or denied. The promise that our unique brand of capitalism *does make* is that when you and I put our money on the table and make a bet, we will win or lose that bet based on its true merits, its true worth—a fair understanding of the risk taken and on what specifically is being wagered. This is a fundamental principal of our economy. We believe in a free and *fair* capitalist economy supported by the rule of law. We believe that when we harness the power of individual economic creativity and motivation, we collectively prosper.

In the last decade ordinary Americans have become directly involved in investing as have no other generation in history. Traditional pensions have given way to 401(K)s—with the added features of substantial 401(K) investment in the employer by the employee and dramatically increased use of stock options. The Internet has made access to the stock markets and other investment institutions as easy as a few clicks of a mouse. We have witnessed the grand democratization of our economy through increased participation in the capital markets.

But in some ways it seems like “*déjà vu* all over again.” History seems at times more cyclical than linear. Similar openings to the marketplace occurred in the 1920s, when we saw more people take an active role in their own investments. Unfortunately, folks at that time started investing euphorically by wildly speculating, many on margin. Marketplace abuse and capital market structures assisted and abetted in a market collapse, resulting in a sudden avalanche that wiped out entire fortunes and changed the entire landscape of this country.

So this country dusted itself off, learned from its mistakes, and implemented a real change to how the marketplace works through Depression-era legislative reforms resulting in dramatic *de novo* marketplace regulation and real protections from marketplace abuse,

reforms which previously had been thought to be un-American and anti-free enterprise.

Today we find ourselves in a similar situation. Dusting ourselves off. Who among us a year or two ago would have predicted that the U.S. capital markets would lose over a third of their value? That abusive, breathtaking corporate fraud would result in an almost unprecedented national loss of confidence in American capital markets? Thus, the parallels of the euphoria of the 1920s and the irrational exuberance of the 1990s, and their results, are telling and instructive.

Once again we must come to terms with the realization that a free and fair market does not occur by its own operation. That without rules and restrictions and without a structure of corporate governance that counteracts marketplace manipulation in an effective manner, a marketplace will trend in a destructive and decidedly undemocratic fashion—out of round—violating the promise of the American capitalist system. Violating it not just in a macro sense, but in a microsector sense—my thought being that marketplace manipulation can occur outside of central market mechanisms—or in one sector of the market that will lead to a chain reaction, destroying the one essential element that makes the market work—investor confidence. A sobering statement? You bet. So, it is today with irrational exuberance being replaced with irrational doom. So to what do we look to shore up the market?

I have heard others say, when speaking to the current corporate governance crisis, that “you can’t legislate morality.” Well, yes you can! And you can also engage in social engineering! As Exhibit A, I offer up the Securities & Exchange Acts of 1933 and 1934.¹ Whether it is utilizing the rule of law against the ultimate immoral act, murder, and on down the line, including unprecedented public corporate thievery, we do not rely on conscience alone to govern ourselves or to regulate the economic marketplace to assure its openness and fairness.

So in this light, what do we seek from the law? What do our markets need from the law? Our historical answer has been to utilize the rule of law to force a market to act in a transparent manner—to assure that investors, big and small, play on a level field of accurate information and with principals playing by the rules.

And we know that a transparent, abuse-free economy is nothing more than a collection of transparent, law abiding corporations. The current malaise tells us we need more than just full, fair, and free marketplace information—we need corporate *accountability*. Corporations where investor representatives are “accountable for being accountable.”

1. Securities Act of 1933, 15 U.S.C. §§ 77a-77z, 77aa (2000); Securities Exchange Act of 1934, 48 Stat. 77 (2000) (codified as amended in scattered sections of 15 U.S.C.).

Dysfunctional corporate governance is viewed as the primary culprit in the current market dislocation, or perhaps semi-collapse. We are now embroiled in that, and the public wants to know if those who watch the watchdogs—who are being called “gate-keepers”—have forsaken their responsibility as well, thus forcing a meltdown in the American corporate governance structure.

In any event, today it is widely thought that too many supposedly “independent directors” have forsaken their responsibility to be the watchdogs of corporation. I will not get into a speculative discussion on what motivates otherwise prominent, independent, and talented corporate directors, who are aggressive and forthright in their own professional lives, to become acquiescent in their roles as outside directors. However, I do think the problem will *only* be solved by a re-engineering of corporate governance structures. And some of the best minds in American business agree.

In his new book, *Managing in the Next Society*, noted management guru and futurist Peter Drucker speaks of corporate governance in the years to come. He says, and I’ll quote:

I am absolutely certain that fifteen years from now the governance of corporations will be substantially different from the present. The reason I can be so sure is that we are seeing a fundamental change in the corporate ownership structure and this invariably goes hand and hand with changes in governance.²

Drucker goes on to say that “particularly in developed countries financial considerations are ultimately driving ownership interests,” forcing “new ownership structures” requiring new forms of oversight.³

He notes the importance of pension plans and mutual funds; how and where they are invested; and the influence, the makeup, and the concerns of their corporate owners and supervising investors and fiduciary responsibilities, all of whom have their own governance structures to contend with.⁴

He thinks we are getting to the end of management avoiding the issue of governance by hiding behind the misguided mantra of “[w]e are running this place for the short-term interests of the shareholder.”⁵

2. PETER F. DRUCKER, *MANAGING IN THE NEXT SOCIETY* 80 (St. Martin’s Press 2002).

3. *Id.*

4. *Id.* at 80-81.

5. *Id.* at 81.

He concludes that “[n]ot only governance, but its related concepts and tools, will need to be confronted and transformed”⁶ The book was published in July 2002.

I think this transformation needs to begin with a fundamental reaffirmation of the essential question: “Who is the corporation?” Everyone knows, intellectually, that the corporation is the combined constituent economic self-interest of its shareholders and that anyone else involved (from directors on down) is hired at and for the pleasure of the shareholders.

However, it has become apparent that while today’s culture of corporate governance may know this as a matter of *principle*, apparently it does not as a matter of *practice*. The results have been catastrophic. So changes are necessary. Revolutionary and evolutionary changes—“something old, something new—something borrowed, and” Yes, just as in the early 1930s, something heretofore unimaginable, structural legal reform on a scale not seen since those post-Depression capital market reforms of seventy years ago [is necessary].

This revolution in corporate governance will take place through a variety of institutional and legal reforms. Boards of directors will need to consist perhaps almost entirely of truly independent outside directors (I call them “IODs”) who are incentivized to be true watchdogs for the corporation and its shareholders. Independent director committees will need to be established and strengthened to make sure that the necessary channels of good governance remain strong. Audit and compensation committees (exclusively made up of IODs) will need to be reinvigorated and take a more proactive and “*hands on*” approach. Compensation committees will need to step up to the plate and understand that to be “part of the team” is not necessarily “part of the job.”

Inside directors will become a separate “business class” of directors, participating in visionary and strategic business decisions and tactically managing the company, but with “*hands off*” primary oversight functions. All of this dictated, perhaps, and most likely, by new, hitherto unimaginable corporate law and regulation.

And what about the gatekeepers—those who support and watch the “watchers”? For starters, inside the corporate structure, the whole role of the general counsel might need a review. Ultimately, the general counsel is part of management, but is also the only member of management who has a higher ethical duty to the “real” client—the corporate entity and shareholders. Thus, regular, closed door mandatory meetings between the corporation’s general counsel and independent oversight

6. *Id.*

committees, such as audit and compensation, should be established and perhaps mandated (by bylaw or law), with direct lines of everyday communications being created between the general counsel and oversight board functions. And it should be recognized that the job of general counsel only becomes more complicated in the event the general counsel also serves as a director.

The ABA's Task Force on Corporate Responsibility, which you will be hearing more about tomorrow and which is considering many of these kinds of reforms, will be making specific recommendations to governance issues and suggested legal and regulatory reforms next spring for consideration at our ABA annual meeting next August. I trust you have had a chance to review its preliminary report as well as my response to that report by way of testimony before the task force last month.⁷

This revolution or evolution of corporate governance is of the highest concern for the country's economic welfare because of the inseparability between small, everyday investors (both through 401(K)s and other investment streams) and American corporations. And, for better or for worse, *perceptions* are as important as *reality*. Good corporate governance is the key to restoring a system that not only enjoys *true* integrity, trust, predictability, and transparency, but also enjoys the *perception* of integrity, trust, predictability, and transparency—and thereby earns investor confidence.

And so it goes beyond transparency and on to tinkering with, and perhaps restructuring, the time honored director-shareholder relationship—a truly revolutionary (or evolutionary?) idea.

But what of the gatekeepers? Please allow me a short, additional excursus because, for all of us here, this is far more than a footnote to the general discussion.

* * * * *

Besides concerns related to general corporate governance, there remains the question about the role of the gatekeepers—"independent" accountants, bankers, and lawyers—both in the current mess and also in the solution for the future.

Aside from "independent auditors," a description some might, in jest, describe as an oxymoron, and "investment banker/analysts," which are great fodder for other public dissertations, I often get asked: "Where are the lawyers in all of this? Why are they not in the dock?" Questions have arisen as to whether lawyers representing the Enron Corporation

7. See "What's New," "Read the Preliminary Report!," and "Chicago, IL, September 20," available at <http://www.abanet.org/buslaw/home.html>.

might have known about, or even somehow been complicit in, fraudulent or criminal activities of their client.

However, the public does seem to view the legal profession, at worst, as indirectly complicit in the recent corporate shenanigans. Yet, there also seems to be a brooding, undefined thought process that we were more than casually involved somehow, if only by not being involved when we should have been. The reality is that media attention and public concern have brought, and are bringing, complex questions about lawyers' involvement in corporate affairs into sharp focus. An interested, activist Congress has been energized to propose and pass the Sarbanes-Oxley legislation,⁸ which not only directly attacks what are seen as the sources of the current disaster, but which directed the SEC to develop revised standards of conduct for lawyers—standards that may not only exceed current ethical norms in their reach, but even be in conflict with those norms.

Tomorrow those of you who are gathered here will be attempting to deal with the nitty-gritty detail of what lawyers' responsibilities are in corporate America and the extent to which they can be clearly identified in proscriptive rules. That, it seems to me, is the *objective* of this conference. However, the *reason* that you and I, as corporate lawyers, legal scholars, and bar leaders are here is somewhat different. Our involvement here grows out of two traditions, one strictly legal and one highly professional.

The *legal* tradition I am talking about is the one that holds that the regulation of the practice of law is best placed in the hands of the judicial branch of state government, and I believe that the overwhelming majority of us believe that that should continue. But that is likely to remain the case only so long as the rules adopted by the judicial branch for lawyer regulation address and facilitate, as best they can, the professional obligations of lawyers and are perceived by the public as doing so. We have seen that when the rules are perceived as ineffective, unclear, or wrong, other regulation threatens to encroach upon this tradition.

The *professional* tradition I refer to is the tradition of the organized bar, and especially the ABA, to stage the debates and promulgate professional standards, then adopted by the states. This tradition needs to be frequently undertaken to assure its effectiveness. In order to respond to seismic social and economic shifts, those of you who are here stand in real time, 2002, as the leaders of that professional tradition.

8. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

At the risk of oversimplifying the debate and discussion about lawyers' rules regarding corporate responsibility, I suggest that there are three issues before us:

The *first*, and most obvious and important, is whether the rules are sufficiently clear and substantively correct in their balancing the goals of corporate representation with the goals of appropriate public and investor protection.

The *second* is whether the rules are recognizable by the public—that is, whether they are understood by readers of daily American newspapers, in which, lately, half of the front page articles discuss alleged corporate wrongdoing and, increasingly, the rules of lawyers with respect thereto.

And the *third* is whether the rules are being followed by lawyers and applied by disciplinary agencies when they are not followed.

Until we are reasonably comfortable that the answer to *all three* of these questions is “Yes,” there is going to be *no end* to the challenges to judicial branch regulation of the legal profession and no end to the public's questioning of the legal profession's role in assisting corporate chicanery.

As to the first question, the clarity and “correctness” of the rules, the enormous efforts that have been undertaken in the last twenty years to review and revise the rules of professional conduct for lawyers suggest that maybe we ought to have them “right” by now. The former ABA Code of Professional Responsibility was subjected to a six-year-long review process from 1977 to 1983, which led to some very major revisions in both format and substance of some of the standards. Then again, from 1997 to 2001, the ABA's Ethics 2000 Commission went back and reexamined the revised rules and proposed further changes to them, most of which were adopted by the ABA House of Delegates to serve as models for adoption by the states. Incidentally, I was a member of the House of Delegates in both 1983 and 2001 and participated in both debates. What remains with me from both exercises is the genuine differences of opinion that have heretofore existed in the profession.

But of course we all know how the devil is in the details. When we look more precisely at the particular rules that have the greatest significance in the context of corporate responsibility, we can see that there is a continuing question of “correctness.” Rules such as the rule that all client information is confidential,⁹ and the scope of (limited) exceptions to that rule are where the difference of opinion mainly exists and remains unsettled. The ABA is still hearing frequent calls for

9. MODEL RULES OF PROF'L CONDUCT R. 1.6 (2001).

further amendment to that rule—to broaden the scope of exceptions—and hearing post-Enron calls as well to amend the rule governing conduct of corporate counsel in reporting fraudulent conduct within the corporation.¹⁰ The ABA's corporate governance task force will understandably lend its call for reform as well.

More importantly, and most significantly, many of the states, which have traditionally followed the ABA's lead, have departed significantly from the model in adopting (or not adopting, as the case may be) Model Rule 1.6. We might ask if the ABA just might "have it wrong" after all.

Indeed, the calls for change in both ABA and state standards on client confidentiality (and excepted, permissible disclosure) have not gone in a simple straight line or even moved in a single direction over time. The policy change from the Model Code to the Model Rules in 1983 brought *greater restrictions* to the exceptions by making a *wider variety* of information *subject* to the confidentiality rules and by *limiting* the exception for permissible disclosure of intended future criminal acts to those with certain types of results, rather than permitting disclosure of any crime. These greater restrictions placed upon the exceptions were made against the advice of the group proposing the 1983 rules and marked a departure from pre-existing (broader) exceptions.

Interim proposals from the ABA's Task Force on Corporate Responsibility echo, in part, the original proposals made in 1983, and again in 2001, that it would perhaps better serve the public interest to permit—or perhaps even require—more, rather than less, disclosure by employing a broader scope of exceptions.

Such proposals thus bring us *back to the future*—with Enron in the rearview mirror—closer to where we were under the old Code of Professional Responsibility's model Disciplinary Rule 4.101(C), which prevailed prior to 1983. And it would bring us closer to where *forty-one* of our states *already are or have remained since 1983*.

Further, and more poignantly, if a substantial majority of the states have rules that differ from the ABA model (allowing broader disclosure of fraudulent corporate conduct) and the conduct of lawyers has presumably been in compliance with those differing state rules, why does there still appear to be such a problem? *I am NOT sure that anyone will be proving, in the immediate future, that it was state ethics rules that either facilitated or thwarted lawyer participation in alleged corporate misdeeds.*

Without drawing any premature conclusion that the problem does not lie in the substance of these rules—a proposition that many of you may

10. MODEL RULES OF PROF'L CONDUCT R. 1.13 (2001).

find yourself advancing here tomorrow—or that members of the ABA House of Delegates may find themselves advancing at future meetings of the House—I suggest that the other two questions I cited earlier bear looking at too.

Secondly, we answer the second question in a lawyer's way—with a series of questions. Do those who would regulate our profession from outside the judicial branch of the states, such as the Securities and Exchange Commission or the Federal Trade Commission, understand the real nature of lawyers' professional obligations in corporate America? Does the public understand it? Should perceived changes in corporate governance practices in America require changes in lawyers' rules? Do those who observe the process of corporate representation from "outside" need a clearer understanding of what is going on? And inherent in these questions—though certainly not the controlling question—is whether the "worst cases" that have received so much attention in recent days are the examples of current practice that should drive our discussion and debate? Or, instead, are they exceptions to the general, ethical practices of the practicing bar?

Finally, I come to that third question of enforcement of the rules of professional conduct. It is a fact—always a disappointing fact, but nevertheless a fact—that some lawyer conduct falls outside the range of acceptability. Our profession has realistically acknowledged and responded to that fact by developing the most extensive and committed regulatory framework of all of the professions for dealing with it. That part of the legal community needs to be part of the debate and discussion on issues of lawyers' corporate representation. Some of you may know that Chairman Harvey Pitt of the Securities and Exchange Commission suggested recently that the Commission was unsatisfied with the results of its referral of potential disciplinary matters to state agencies created to investigate them.

Whether Chairman Pitt's comments hit or miss the mark (I suspect they are somewhere in the middle), I do believe that it will be important that our disciplinary community participate actively in all the attempts that are underway to address the problems we are talking so much about. We must appear to be appropriately "taking care of our own" as well as doing so in fact, and we must demonstrate that fact adequately to the public.

So, in the end, at least from where I sit, 21st century corporate governance will indeed be evolutionized and revolutionized with a real dose of back to the future prescribed for the legal profession.

The call is coming for greater corporate accountability *and* for less restrictive limits on retention of client confidences by lawyers not only in the context of corporate reform, but also in other contexts, such as

balancing of national security concerns with privacy rights and the advent of international law regulating “gatekeeper” conduct.

So get ready for the ride, and let’s all enjoy the trip—as only good lawyers can.

Last May, I gave three law school commencement addresses. What on earth do you tell people who will be practicing law in 2050? You tell them that American lawyers are the best educated in the world. You tell them that we practice law on a global stage with a competitive advantage. You tell them that despite its critics, their chosen profession is a time-honored and noble profession. And you tell them that it is all of these things *because* their predecessors have held fast to their profession’s core values and professional independence—while other professions have not—and that they should take heart in our stubborn insistence on these values. Finally, you tell them that it is their responsibility to stay the course.

And so it is with 21st century corporate governance. Once again, as was the case post-Depression and post-Watergate, post-Enron lawyers, while ordering their own house, must lead this country out of a crisis of confidence.

And it will fall to us, the lawyers, to re-engineer corporate governance of American business, and I have no doubt that we will be up to the job.

And as I have said every time I get the chance, it’s a great time to be an American lawyer and I am proud to be one.

God bless and thank you.