

# Corporate Ethics in an Age of Steroids

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*Jed S. Rakoff, United States District Judge for the Southern District of New York, delivered the following speech in the Public Affairs Luncheon Series of the Association, December 7, 2004.*

I am honored to have been asked to speak at this conference—but also a bit intimidated. I understand that past speakers in this series have included such distinguished judges as Chief Judge Kaye of the New York Court of Appeals, Judges Calabresi and Feinberg of the Second Circuit, and, most importantly, “Judge Judy” of TV fame. Now there’s a *tough* act to follow!

My assigned topic is “Corporate Ethics,” and I want to especially focus on the role of the corporate lawyer in fostering, or failing to foster, good corporate ethics. Let me say at the outset, however, that nothing I say here is being uttered in my judicial capacity, and may not be used to recuse me from any case now or in the future—at least not any good case. But, by the same token, I don’t suggest that I have any special expertise, judicial or otherwise, on the subject of corporate ethics. Rather, over the next few minutes, I simply want to suggest to you some ideas that you may or may not agree with but that hopefully will stimulate some discussion.

The title I’ve given my little talk here today is “Corporate Ethics in an Age of Steroids.” My ulterior motive in picking this title is to allow me to make reference to the true passion of my life: baseball. For those of you who could care less about baseball, or who wonder how any grown per-

son could become so passionate about what is essentially a child's game, I apologize. All I can say in my defense is that at least I'm a Yankees fan—although, as a matter of professional courtesy, I always root for the umpires.

My wife, by contrast, is a White Sox fan. Somewhat (indeed, long, long) before her time, the White Sox were enmeshed in what became known as the "Black Sox Scandal" of 1919, in which virtually the entire White Sox team agreed to lose the World Series in return for bribes from gamblers. This, one might concede, was a bit of an ethical lapse! But it was neither the first nor last to plague baseball. Most recently, we have seen the burgeoning steroids scandal, in which some of the best known players are alleged to have taken drugs to artificially enhance their performances. Just the other day, Senator McCain threatened federal legislation if organized baseball doesn't clean up its act, and Baseball Commissioner Bud Selig deplored the bad example that using steroids sets for young fans. (Presumably he prefers the good example that baseball sets by selling endless rounds of beer to intoxicated fans, who otherwise would have no place to go to get drunk once the basketball season was over.)

Both these baseball scandals—the Black Sox debacle and the steroids scandal—raise similar questions about the benefits and/or necessity of government intervention as compared with self-regulation. For my immediate purposes, however, it is worth spending a moment noting the differences between these two scandals in terms of conduct and motivation. With regard to the Black Sox scandal, while the conduct of the Black Sox players in taking bribes was indefensible, their motivation—a deep-seated resentment over the unbelievably abysmal pay given them by the White Sox owner, Charles Comiskey—was at least understandable, if not forgivable. By contrast, in the case of the steroids scandal, the conduct is at least superficially defensible: if an athlete can take vitamins to improve his performance, why not steroids—or so the argument goes. Indeed, steroids were not fully banned from baseball until two years ago. But the motivation of the steroids-consuming stars—essentially, the greed for even more money and status on the part of individuals who already have more fame and fortune than any of us will ever achieve—seems unsupportable.

Without pushing too hard, let me try to extend these baseball analogies to the corporate misconduct of recent years, as compared to earlier periods. All of you are doubtless aware of such huge corporate scandals as Enron and WorldCom (as am I, since a small part of the Enron case and a large part of the WorldCom case have been the subject of proceedings in my courtroom). These were raw accounting scandals in which literally billions of dollars in expenses were portrayed, fraudulently, as assets or

income or both. But you may not be as much aware of the endemic use in the late 1990's, by companies that would never think of themselves as unethical, of less clearly fraudulent but still highly questionable accounting practices that led to misleading financial statements.

One clear indicator of the size of this epidemic is a recent study by the General Accounting Office that shows that in the last five years at least 10% of all companies listed on the major stock exchanges have been obliged to restate their pre-2001 financial statements to correct for material overstatements. Another study, by the Huron Consulting Group, contends that the GAO study actually understates the problem and that the figure is closer to 15%. Both studies suggest that it is virtually unprecedented for there to be so many material restatements by so many public companies.

What is, if anything, even more remarkable, is that for a great many of these companies, business in the late 1990's was good, often very good. Yet they were still driven to materially inflate their financial numbers. What accounts for this?

Undoubtedly there were many causes; but I agree with those like Professor Coffee at Columbia who have suggested that a major cause was that top level business executives in these companies were seeking to get rich quick (or rather, get richer quicker) by taking excessive compensation, mostly in the form of stock options. Stock options are easy for a board to approve: they don't involve immediate expenditures of cash and there is an argument that they don't have to be expensed on the company's financial statements. But, of course, for an executive to get rich on stock options, the price of the company's stock has to rise and keep rising. Hence the motivation to inflate financial statements in order to jack up the price of the stock.

Such inflation does not necessarily involve outright fraud; often it simply involves stretching accounting rules beyond their natural limits, that is to say, conduct that is not necessarily illegal though it may well be misleading and, I would argue, unethical. The driving force behind such conduct, however, is not any benefit to the company as a whole but rather the desire of controlling executives to line their own pockets by inflating the price of the stock; in other words, it involves a clear conflict of interest, which the executives resolve in favor of their personal self-interest, that is to say, unethically.

Nor is such misconduct limited to inflating financial statements. Just this past Sunday, the *New York Times* described how even recently some executives have artificially arranged to have the purchase price of their

options pegged at what the market price is just before the company announces positive news, so that they can reap the immediate benefit of the increased share price. This may or may not be illegal, but in effect it represents company insiders profiting at the expense of their shareholders, and therefore is plainly unethical.

Of course, a desire to get rich quick is as old as human nature. But I want to suggest that most executives of say 50 years ago had a more permanent relationship to the companies for which they worked and so stood to gain less from short term manipulations that only benefitted themselves. Their ethical lapses, when they occurred, tended to be more institutionally focused—as in the case of the foreign bribe scandals of the late 1960's, where it was the company as a whole that directly stood to gain from the bribes that were being paid to obtain foreign sales.

Now, however, with institutional loyalties much reduced and mobility by top executives a commonplace occurrence, the ethical lapses, while affecting entire companies, tend to spring from more individualized motivations and concerns. In catchword of the 1990's, "it's all about me."

This lessening of institutional focus may also make ethical lapses of executives harder to detect and police. Which brings me to the role of corporate lawyers.

I am frank to assert that, in my view, corporate lawyers, including both inside and outside counsel, have historically functioned as the ethical consciences of corporations. This view may, of course, reflect a professional bias on my part; but I don't think so. Rather, it simply recognizes that lawyers, because of their training, their professionalism, and their immersion in the law bring a more refined, and a more objective, perspective to the determination of whether given conduct is ethically proper. To revert to my baseball analogy, a baseball player, and his agent, may be able to convince themselves that using steroids is just part of how you play the game; but I doubt very much that any player's lawyer, however much she might defend the player in public, would have any doubt that steroid use was a form of cheating. This is because a lawyer would be the first to recognize that the essence of any game is playing by the rules; and using steroids is against the rules.

Regretfully, however, the ability, or even desire, of private lawyers to try to influence the ethics of their business clients has been steadily eroding. The reasons for this are somewhat familiar, but worth reviewing. To some extent they mirror the decline in institutional loyalty that I have already referred to in the case of business executives.

Prior to the 1970s, most corporate lawyers had a life-time relationship to a single law firm, which in turn had a more or less permanent relationship to particular corporate clients. This gave the lawyer considerable power to say “no” to a corporate client without fear of losing the client. As a young associate at a large law firm, I repeatedly witnessed senior partners telling the senior executives of major companies that a particular approach, even if arguably legal, was too risky, and that there was another approach that, while a bit less lucrative, was the more prudent course. This, I suggest, was ethical advice thinly disguised as a legal opinion. What is more, the executive, who had learned from experience to rely on the lawyer’s caution and wisdom, frequently followed the lawyer’s advice, even when it was not the executive’s original preference.

However, as our economy became more regulated and our society more litigious, the cost of legal services grew exponentially. This had three immediate results. First, companies began shopping around for cheaper lawyers (not that these are easy to find). Second, where possible, companies sought to cut costs even more by assigning more of their legal work to their inside counsel. And, third, companies began looking for specialized lawyers, both inside and outside, who could address increasingly arcane regulatory issues.

What were the results of these trends? With respect to the increasing price competition among lawyers, whatever positive benefits it may have otherwise had, it led lawyers to feel the need to say “yes,” rather than “no,” to whatever a business executive who had influence over their hiring or firing wanted to do. This was, if anything, even more true in the case of the in-house lawyer, who could, in effect, be fired, or at least ostracized, at will. And lawyers, whether inside or outside, who specialized in some arcane area were not likely, in any case, to feel competent to address overall ethical issues, nor receive much attention when they did. At best they were the blind leading the blind.

A further result was the not-so-gradual extinction, at least in the corporate arena, of the so-called “lawyer-statesperson,” the Francis Plimpton or the Cyrus Vance, whose valued corporate advice always took account of the corporation’s social and ethical responsibilities. In turn, the absence of such figures resulted in more corporate excess and ethical insensitivity.

In short, a combination of trends in our profession, largely economic in nature, have limited our role in providing effective ethical advice to corporate executives, who may, in its absence, be too prone to prefer self-interest over ethical behavior.

It is easy to identify these problems and to suggest that, despite what

they preach at the University of Chicago, market efficiency is not an unalloyed benefit. But it is much harder to come up with solutions, because, for better or worse, a return to the old-fashioned relationship between lawyers and corporations is unrealistic. So what are we to do about it? Several modest initiatives are already underway, and I am enough of a pollyanna to think that they are all steps in the right direction.

First, of course, in both the legal and business professions, ethical education, not only in graduate school but also thereafter, has become increasingly required. It is sometimes said that ethics can't be taught, either you have them or you don't—but I totally disagree. The ethical issues that arise in a complex economy are themselves frequently complex or at least not always obvious, and a good ethical education can help sensitize both lawyers and businesspersons to such issues.

Second, there are the multitude of steps being undertaken under the general rubric of "improvements in corporate governance." This covers many different angles, not all relating to ethical issues, and I would take the liberty here of referring you to the report entitled "Restoring Trust" that was authored by the Special Monitor that I appointed in the WorldCom case, Richard Breeden, and that sets forth a comprehensive program for the improvement of corporate governance. As implemented in the case of WorldCom itself, these improvements include, among much else:

- strictly limiting the use of stock options as executive compensation and expensing such options as are issued;
- enhancing the powers of the independent audit committee of the Board and arranging for the General Counsel to meet with that Committee without the presence of the C.E.O.;
- appointing a Vice President in charge of ethics, with considerable powers not only to require ethical education on the part of employees but also to address ongoing ethical issues in the company;
- and giving whistleblowers direct and confidential access to the general counsel.

Not every company may require what WorldCom needed in the way of changes in corporate governance, but certainly there are few companies that could not ethically profit from some of these suggested improvements in their corporate structure.

Third, Congress and the S.E.C. have acted, chiefly in the form of the

Sarbanes Oxley Act and the regulations promulgated thereunder, to increase the powers of in-house counsel, by effectively requiring such counsel to monitor signs of company misconduct and, at a certain point, report it “up the ladder” to the independent members of the Board. While such legislation always carries a stiff price in regulatory cost and potentially abusive litigation, I think Congress and the S.E.C. are on the right track in recognizing that the inside general counsel is the person most naturally situated to play the role once played by the outside lawyer-statesperson, provided he is given both the power and the incentive to do so.

There may well be many more steps that can be taken. In an article published in last summer’s issue of *Litigation* magazine, I make the very modest suggestion that the energies of so-called senior lawyers, seasoned practitioners well schooled through experience in complex ethical issues, be more fully harnessed to the improvement of ethics in the profession and in the business context as well. If, for example, the requirement in WorldCom that the company appoint a Vice President in charge of ethics training and resolution catches on with other companies, senior lawyers of the sort I am describing would be natural candidates to assume such roles.

I am sure that there are many other improvements that might be made to re-establish a greater sensitivity to good ethics in the corporate context. Will they be enough? Who knows. We can but try. To return one last time to baseball, who could ever have imagined that the Red Sox would win the World Series? But in their refusal to accept the inevitable, they provide a lesson for all of us, even Yankees fans. There is nothing even remotely inevitable about the decline in corporate and legal ethics that helped precipitate the corporate scandals of the last few years. And it doesn’t really require a Curt Schilling to turn things around. It just takes the commitment of all of us.