Comments in Response to The American Bar Association Task Force on Corporate Responsibility Preliminary Report

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Comments on the Preliminary Report of the ABA Task Force on Corporate Responsibility

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You shall not steal. *Ex 20:15*

Let him who stole steal no longer, but rather let him labor,
working with his hands what is good
that he may have something to give him who has need. *Eph 4-28*

And the thief, male and female: cut off the hands of both
Qur'an 5:42

I am determined not to steal
and not to possess anything that should belong to others
Bhagavad Gita

By "thefts" are meant thefts that are manifest and those not manifest,
which are effected by fraud and craft
under various pretenses to make them appear lawful,
or so done clandestinely as not to appear at all.
Apocalypse Explained 967

1. Introduction

Ladies and Gentlemen, on behalf of Jesse White, Illinois' Secretary of State and the people of Illinois, home to 321,754 corporations and 63,145 Limited Liability Companies, welcome to Illinois. Thank you for permitting me to share my thoughts on your preliminary report with you. I commend you for your motivation and effort in preparing this report at this difficult time for our country and its business community.

a. Jesse White is the Secretary of State of Illinois, and the Constitutional Officer charged with administration of Illinois' Business Laws. He has chosen, as had his predecessors back to Jim Edgar, to appoint a "Business Laws Advisory Committee" consisting of volunteer business lawyers from every part of our State, who meet monthly with the Secretary's staff to discuss the corporate and other business laws of our jurisdiction, and their continual improvement.

Since 1981, this Committee has rewritten our various corporation laws, our limited and general partnership acts, and has written and re-written our limited liability company act. We did not participate in the preparation of the Illinois Registered Limited Liability Partnership Act under which the accounting firm of Arthur Andersen and Company was organized..

b. Lin Hanson is my name.. I am a partner in the Park Ridge, Illinois law firm of

DiMonte and Lizak. I have been a member of the Secretary of State's Business Laws Advisory Committee since its formation in 1981, and I am its current serving Chair. My practice is transactional, with an emphasis on business. Inspired by your task force member, Roberta Cooper Ramo, I wrote The Illinois Corporation System for IICLE, as well as The Illinois LLC System. With my partner, Jeff McDonald and I own a controlling interest in ILForms, Inc. and we are suppliers of corporate and LLC software to the legal profession.

My great grandfather, grandfather and father were all lawyers. Two of my daughters are married to lawyers, and one is a lawyer also. I have been practicing law for 41 years. I feel I have a strong and personal interest in our shared profession.

My views expressed herein have not been approved by either The Secretary or the Committee which I chair, and should not be considered as representing the views of Secretary of State Jesse White or the Business Laws Advisory Committee.

2. Legislating Morality.

a. Your Report. We often say, or think "You can't legislate morality." You said it in your report, § I.B., p. 10, "No set of legal rules or guidelines can guarantee that such active care will be achieved in practice." In your footnote you cite The Business Roundtables's May, 2002 Principles of Corporate Governance to the same effect.

Congress has now enacted, and President Bush has signed into law the Sarbanes-Oxley Act of 2002, so there is no point discussing whether or not to adopt a legislative "fix." Its been done. We can go on to look at what additional fixes ought or ought not be adopted, and I take it that is the direction in which your report directs us.

All of us who serve on committees know how they work. We recognize and chuckle at the statement that "A camel is a horse designed by a committee." So I understand how you can start out recognizing that it is impossible to legislate morality, and then proceed for 50 pages to discuss how to go about doing it.

b. Professor Ribstein's Critique. One of our committee members, Larry E. Ribstein, a professor of law at the University of Illinois Urbana Champaign, has written a scholarly critique of the new legislation, "Market -vs- Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002" which you may care to examine in detail. You may read it in full at http://luna.law.uiuc.edu/~ribstein/enron.doc. Professor Ribstein has summarized his critique by saying:

"*The crashes of Enron and WorldCom and frauds or irregularities at many other companies have reinvigorated the debate over regulating corporate governance. Numerous pundits called for corporate regulation to restore confidence in the securities markets. These recommendations appear to be supported by the fact that neither the contracting devices that*

were supposed to control managers, nor efficient securities markets, worked to prevent or spot the problems. Congress responded with the Sarbanes-Oxley Act of 2002. But this article shows that, given the limited effectiveness of new regulation, its potential costs, and the power of markets to self-correct, new regulation of fraud in general, and Sarbanes-Oxley in particular, is unlikely to do a better job than markets."

c. Other critical comments. In the Sunday, September 15th edition of *The New York Times*, there was an article entitled "Reining In the Imperial C.E.O." The article addresses the effects of the Sarbanes-Oxley Act, and mentions "The recent corporate responsibility bill signed by President Bush does not specifically address severance packages...." Still looking for a legislative fix. The same edition of the paper also contained an article "From Investor Fury, a Legal Bandwagon" which portrays our profession in a less than favorable light, as birds of prey circling over the remains of these fallen corporate giants. The August 29 issue of *The New York Times* suggests that "split dollar" insurance may be an unintended victim of the new law. See "Insurance Plans of Top Executives May Violate Law." On the other hand, loan transactions commenced prior to the effective date of the new law continue. See Appendix B to these comments.

d. Costs and Complications of the Legislature Approach. One by-product of the "new" legislative fix as well as the other economic conditions arising out of the September 11th attack have been and will continue to be increased insurance costs for Director and Officer liability insurance. This will result in a reduction in such coverage provided by some companies, and thereby reduce the number of eligible candidates for Board positions. Additionally, the possibility of adverse press coverage itself may have a chilling effect on candidates for Board positions.

e. Public Opinion. Particularly at this time, public opinion may be a more effective tool in securing corporate responsibility. See Appendix C regarding surrender by former GE CEO, Jack Welch, of high profile post retirement benefits, apparently motivated in large measure by public criticism.

3. Internal Corporate Governance. Of the two action recommendations contained in your report, the first deals with several aspects of corporate governance.

a. Public/Non-public Companies. You have (correctly, I feel) made a distinction between the publicly traded corporation and the thousands of more closely held corporations, and chosen to apply your suggested actions only to the public corporations. Illinois has made a similar distinction in the treatment of its domestic corporations. See the Illinois Business Corporation Act, §12.55:

"*In an action by a shareholder of a corporation that has shares listed on a national securities exchange or regularly traded in a market maintained by one or more members of a national or affiliated securities association,....*"

and §12.56:

"*In an action by a shareholder in a corporation that has no shares listed on a national securities exchange or regularly traded in a market maintained by one or more members of a national or affiliated securities association.....*"

For ease of reference, a copy of our act is available on the Internet, through the offices of Secretary White, at:
http://www.legis.state.il.us/ilcs/ch805/ch805actstoc.htm.

b. Independent Directors. The six specific actions you have recommended in the area of corporate governance all hinge in one way or another on the concept of independent directors. You are recommending creation of Board Committees either entirely populated with independent directors, or with a majority of such directors, and that they function in an environment isolated from inside director/officers. Governance, Audit and Compensation committees are discussed in your report in detail.

i. Illinois Experience. Our Business Corporation act §8.60, has dealt with the concept of Independent Directors, calling them "Interested Directors" and "Disinterested Directors."

"For purposes of this Section, a director is "indirectly" a party to a transaction if the other party to the transaction is an entity in which the director has a material financial interest or of which the director is an officer, director or general partner.

The presence or absence of a majority of Disinterested Directors voting to approve a transaction shifts the burden of proof in determining fairness under our law. Very careful drafting is urged in this area. Too stringent a requirement of Independent Directors can cause corporate paralysis, as Illinois has learned.

ii. State Corporation Law. Your report indicates you are "not at this time addressing possible changes in state corporation law. You make reference to the activity of the ABA Business Law Section, and its Model Business Corporation Act. It seems to me that your suggestions lack any method of practical application without adoption by the states, or by the agencies and exchanges that regulate trading of securities..

iii. Guarding the Guards. Even if adoption of the rules and procedures your report suggests were accomplished, any attempt to "cure" through the mere requirement of Independent Directors without more should give little assurance of success. 2000 years ago Cicero inquired "But who will guard the guards?" No satisfactory answer has yet emerged. Your report's recommendation of Director training courses, with emphasis on fiduciary duties and compliance programs is an excellent suggestion, but of course, no guarantee.

4. Judicial Intervention. Your report, p. 16 also addresses the role of the judiciary. It is submitted that the ability of the judiciary is a major component in dealing with the problem of

Corporate Responsibility. One longs for a judiciary reminiscent of Mr. Justice Benjamin N. Cardozo. It is not difficult to imagine his angry countenance as he pronounced his opinion in *Meinhard v. Salmon* (1928), 249 N.Y. 458, 463-64, 164 N.E. 545, 546

> "*Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court*."

The language quoted was adopted verbatim by the Illinois court in *Labovitz V. Dolan* et al., 189 Ill. App. 3d 403; 545 N.E.2d 304 September 26, 1989.

5. The Conduct of Lawyers.

a. Rule 1.13. You have recommend expansion of the Model Rules of Professional Conduct to make it clear, under rule 1.13, that the obligation of the lawyer who becomes aware of misconduct by a corporate officer, where the misconduct involves crime or fraud, including violation of federal securities laws and regulations, is to go to higher authority in the organization, or in an extreme case, where higher authority fails to act, resigning from the representation, or disclosing confidential client information to a third party. Clarifying and emphasizing the obligation of counsel to "do the right thing" is an important statement which might make a critical difference in a particular circumstance.

b. Rule 1.6. You have recommended expansion of the rule on permitting (even mandating) disclosure in order to prevent client conduct known to involve a crime, including securities laws violations. This is a bold proposal which departs from traditional "confidentiality at all costs" doctrine. Tradition has always been that the confidential relationship encourages disclosure by the client, affording the attorney an opportunity to counsel against proposed improper conduct.

c. Communication with Independent Directors/Independent Counsel. Your report has recommendations regarding tailoring the terms of engagement to facilitate communication by in-house counsel with the independent directors and with independent counsel. Both commendable ideas which I would endorse.

6. Points for Further Study. In general, I think your focus should be on recommendations which can be accomplished by the ABA itself to the greatest extent possible. If changes need to be made in existing corporation law, what the ABA can do is act on its own Model Corporation Act.

If we require changes in the rules governing professional conduct, what the ABA can do is amend its model rules. I have a few other suggestions for consideration, as to things the ABA can do itself.

a. Law Schools. The American Bar Association should use every persuasive power available to influence additional study of ethics at the law school level. Over 40 years ago when I was a second year student at Michigan law school, we studied Chapter 20 of the Book of Exodus as being a fundamental foundation of all our law. On the other hand, our entire study of legal ethics consisted of two-two hour lectures in the evening. In my view, legal ethics ought to be taught as a classroom class, but also taught as a part of every class throughout the law school experience. Our graduating lawyers ought to emerge from school with a fundamental sense that there is a special version of right and wrong which applies to the members of our profession from the day of admission until the day they die. Ethical considerations should be a knee jerk reaction to every new engagement or employment. Of course ethical training should start long before law school (See Appendix A, attached).

b. CLE Programs. ALI/ABA programs and ABA programs should make ethical considerations a mandatory part of every speaker's material. Reviewers of content of written materials should be alert for inclusion/omission of this topic. We need to constantly remind our members of their ethical obligations as we hone their practice skills. Ethical considerations should not be a stumbling block to creative practice. Instead they should always be a selling point for the employment of counsel.

c. Study Groups. I belong to a men's Bible Study Group which meets weekly. It is an important part of my life, not only in a religious sense, but in an ethical one. We constantly refer to Proverbs 27:17 "As iron sharpens iron, So a man sharpens the countenance of his friend." when we try to explain the benefit of our group membership.

The American Bar Association ought to encourage the formation of small study groups of members who can meet regularly to discuss various aspects of practice and problems. Where does an attorney go to test his ideas, his objectives, his practice style? To his partners? Perhaps. To his church? Sometimes. My point here is to say that is would be a good thing to provide an outlet, a place where attorneys with issues can come to discuss these issues with others whose opinion is regarded as sound and informed. I was fortunate to be born into a family of lawyers. I am indeed very fortunate to have joined a firm of competent and caring partners to whom I can speak with candor, and listen with respect. Not everyone has this luxury, and for those who lack it, I recommend you consider the creation of discussion groups. Perhaps in person, but also perhaps on the Internet for the benefit of counsel who are geographically or temporally so separate as to make attending in-person meetings impractical or impossible.

d. Hot Line. Consider the creation of an e-mail hotline. This could be like a support staff on ethical considerations, staffed 24 hours a day, 7 days a week. Attorneys seeking ethical guidance could submit their issues for quick response, perhaps with followup later. Think about it. There is a point of no return where one must either disclose, participate or quit. At that critical point,

there ought to be someone, somewhere to whom the troubled attorney can submit his concern, and get a response. If a month has gone by, or longer, the time for decision/action may well have passed. It is within the possible actions of the American Bar Association, through the use of the Internet, and, yes the telephone, to provide a voice of detached reason at a time when one is needed.

7. Conclusion. In conclusion let me once again state the obvious: You can't legislate morality. If public opinion and pressure makes you try, no one should be too critical. But I hope you will consider other alternatives to elevate the level of our profession. To provide the kind of mentoring that can be a real force for good in the legal profession and the world. It is good to recommend procedural safeguards in the area of corporate governance, and to encourage open and independent consultation between counsel and the directors and outside counsel.

What the American Bar Association should be about, however, is lawyers. Lawyers helping lawyers. Lawyers supporting each other in times of doubt, stress and crisis. Lawyers reminding each other of their obligations to the client, the public and the profession. Truly there is strength in numbers. Not the strength of a mob, but also the strength of conviction, reinforced by the conviction of others, to ***Do the Right Thing***.

Thank you.

Appendix A

(The following Article appeared in the September 15, 2002 Edition of the Boulder Daily Camera)

Cote: The brief life of a lemonade stand: A business fable

It was a sad day on Mullberry Street when Stevie Norne broke the news to his co-workers. They were shutting down the lemonade stand.

The 12-year-old executive said the company could not pay the bills — $5 a week to his older brother, Jimmy, (who built the stand with two old office doors he found at the dump) and another $5 to his cousin, Bobby, who had been supplying them with five cans of concentrated lemonade (pilched weekly from the family freezer in the garage).

Plus, they all had to go back to school and who had time to run some stupid lemonade stand anyway?

Twin sisters Sally and Jesse Williams, 10, were pretty miffed since their Pomeranian puppy, Snoodles, had been the stand's star, prompting neighborhood kids to stop by on their bikes and grownups to actually slow down for the speed bump, sometimes even long enough to buy a cup of lemonade and a chocolate chip cookie (made by the twins from scratch, thank you).

Stevie had promised the twins $5 each after the stand paid its bills, but all they had to show for their work were the leftover cookies they baked that they hadn't sold yet. And those looked pretty mushy after sitting out in the sun all day.

They weren't too miffed to be suspicious, however. Why was Sonny Anders always snooping around the cash box? He wasn't even part of the club, but Stevie always let him hang around. Sonny would leave for a while and come back with Tootsie pops for him and Stevie. Sonny wasn't around today, but wasn't that a new mountain bike he was riding last night? And his birthday was three months ago.

When the stand first opened, business was great. It hadn't rained for weeks and the site of a white posterboard with the words "LEMONADE — 50 CENTS" lured customers like an oasis. That Saturday, Stevie, Bobby and the twins could barely keep up with demand.

That's when they made the mistake that would spell their doom: When they ran out of concentrate, they gave Bobby $5 and he ran home. But he said all he could find was lemon-flavored powder drink mix.

They all agreed this was just a temporary measure, because of the emergency, of course. And it was cheaper, too. The twins asked Stevie why Bobby didn't give back some of the extra money, but they didn't wait for an answer because they still had customers to serve, and boy were they thirsty ones!

It wasn't until a week later, when some of the first kids on the block to try their lemonade came back, that Stevie, Bobby and the twins suffered their first taste of sour customers.

"Hey, this stuff tastes like Kool-Aid!" one high school kid said before he dumped it on the grass without paying. He took two cookies, too. A few of the younger kids in line bought lemonade anyway, but they made funny faces and said they wouldn't be coming back.

But that was all old news. At least the twins still could still play outside after school. When Stevie Norne's mother found out that he had "borrowed" money from her purse to pay for the lemonade, she grounded him for a month. His older brother got in trouble, too, for charging so much for the lemonade stand he built and making Stevie do his chores, too.

But Sonny still had that new bike. And the last time they saw Jimmy, he was setting up another lemonade stand on a different corner.

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Appendix B

CEOs still enjoy sweet loan deals

By Matt Krantz, USA TODAY
September 17, 2002

As revelations of wrongdoing by executives seem to surface every day, at least one aspect of Congress' recent crackdown on white-collar misdeeds seems to not be having much effect.

The Sarbanes-Oxley Act bans companies from making new loans to executives and changing terms of existing loans. But executives who struck deals before the act became law July 30 can keep their loans and associated perks, such as 0% interest and the right to be forgiven from paying the money back.

Executive loans have become a sore spot with investors after their potential dangers have become clear from alleged abuses at Tyco and WorldCom.

Hundreds of executives owe cash they borrowed when companies made loans freely. More than a quarter of the largest 350 U.S. firms made loans to executives in 2001 and 2000, says Mercer Human Resource Consulting. The average loan: $832,000.

Those loans aren't covered by the law, so executives will still get to cash in on some sweet deals. For instance, after his job was eliminated, Microsoft's former president, Rick Belluzzo, was allowed to keep $15 million he borrowed in exchange for returning worthless stock options. Microsoft says the arrangement is proper because it was part of the original loan terms.
Executive Compensation Advisory Services says these are some of the most lucrative loans still outstanding:

Mattel. CEO Robert Eckert borrowed $5.5 million in May 2000 and doesn't have to repay if he stays with the toymaker until May. If he stays another year, Mattel pays the estimated $2 million in taxes due on the forgiven loan.

Home Depot. CEO Robert Nardelli borrowed $10 million from the company when he joined in 2000. About 20% of the loan's value is forgiven each year over the next five years. So if he is still there in 2005, he owes nothing.

HealthSouth. CEO Richard Scrushy borrowed $25.2 million in 1999. And he doesn't have to pay the money back until 2006.

FedEx. Executive Vice President Michael Glenn has a $3.9 million interest-free loan to help exercise stock options. The loan has no due date.

The Sarbanes-Oxley Act still could make some executives regret they borrowed — especially those who took big loans assuming they wouldn't have to pay them back anytime soon.

For instance, Abercrombie & Fitch CEO Michael Jeffries borrows money from the retailer each year — basically replacing an old loan with a new one. He now owes nearly $5 million. But when the loan comes due Dec. 31, he will not be allowed to get a new loan. The company did not return calls for comment.

Banning new loans will stop abuses, some hope. "Executives at a lot of companies have been using the company bank account as a personal treasury," says Alan Bromberg, law professor at Southern Methodist University. "That's not going to be available anymore."

Appendix C

Former GE Chief Gives up Perks, but Sec Is Investigating

NEW YORK (Reuters) — General Electric said Monday it has received an informal inquiry from the Securities and Exchange Commission into the compensation of former Chairman and CEO Jack Welch.

The news came hours after Welch said he had given up free use of company planes, a company apartment and other generous benefits in his retirement agreement after facing withering criticism since the perks were revealed.

GE said it would cooperate fully with the SEC request

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Welch, who retired from GE a year ago after 21 years as chairman, said in a signed essay on the editorial page of *The Wall Street Journal* that he had asked the GE board to modify his post-employment contract "by eliminating everything except the traditional office and administrative support given for decades to all retired GE chairmen and vice chairmen."
Welch said the board, headed by Jeff Immelt, his successor as chairman and chief executive, agreed to his proposal last week.

Welch said he estimates he will be paying GE between $2 million and $2.5 million a year for such services as use of company aircraft and the company apartment. He also said he would provide no-cost consulting services to GE on an as-needed basis.

Details of Welch's compensation and perks — both from his years as CEO and his retirement — were revealed recently in court papers filed by his wife, Jane Beasley Welch, who has filed for divorce in a Connecticut court.

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"Papers filed by my wife in our divorce proceeding became public and grossly misrepresented many aspects of my employment contract with General Electric," Welch wrote. "I'm not going to get into a public fight refuting every allegation in that filing."

Nevertheless, he said that one of the things he learned as CEO of GE was that perception matters, especially during a time when news of lavish compensation packages and executive malfeasance have soured public confidence in American business."And in these times when public confidence and trust have been shaken, I've learned the hard way that perception matters more than ever," Welch wrote. "In this environment, I don't want a great company with the highest integrity dragged into a public fight because of my divorce proceedings."He concluded, "In the end, this decision may not satisfy everyone, but ***it sure feels right in my gut***." (Emphasis added)