GOVERNANCE, ACCOUNTABILITY, AND TRUST: A COMMENT ON THE WORK OF TAMAR FRANKEL

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INTRODUCTION

This Essay addresses the role of trust and fiduciary responsibility in the field of corporate governance and accountability. It is a pleasure to comment on Professor Tamar Frankel's ideas on trust and fiduciary responsibility. Her work is richly researched, reflects a deep and subtle understanding of law, economics, and human behavior, and is clearly written. Both her ideas and the clarity of their presentation are gifts to the scholarly and practitioner communities.

The relationship between law and corporate responsibility has been the focus of scholarly research and practical concern for more than a century. The rise of corporations in the Nineteenth Century, and their dominance as the preferred organizational form for conducting business in modern times, has forced legislatures, courts, and citizens to confront the questions of *to whom* and *for what* are corporations responsible?[1] Efforts to codify the answers that communities have given to these questions have produced thousands of statutes, countless regulations, and innumerable court cases.

This body of law and public policy tries to define responsibilities and their limits, but also emphasizes that law is incapable of specifying how every decision should be made. People have freedom to make decisions, and they will inevitably make judgments, both wise and foolish. It is in this realm of decisionmaking that the concepts of trust and fiduciary responsibility are pivotal because they help us order our expectations for managers and fiduciaries.

Professor Frankel's definition of trust is appealingly straightforward: Trust is "reasonably believing that others tell the truth and will keep their

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[1] *See, e.g.*, E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1162-63 (1932).

promises."[2] Her concept is simple, clear, and compelling: honesty; truth-telling; keeping promises. Fiduciary responsibility, in turn, is a category of "high expectations," in which society is entitled to expect the best decisions, judgments, and the most faithful adherence to the concept of responsibility. Fiduciary responsibility falls most heavily on those trusted persons, such as corporate directors, whose actions affect the lives and fortunes of others. However, this remains an area of fertile legal thinking and changing business practice. Despite extensive efforts, no one seems to be happy with director performance. In the United States and other nations, calls resound for courts and legislatures to redefine the responsibilities of directors to take into account broader social concerns. One recent call from Brazil seeks redefinition of corporate directors' fiduciary duties in which the economic interests of shareholders are tempered by stakeholder considerations and awareness of broader social issues.[3]

Governance and accountability are two of the most critical problems in the management of modern organizations. As recent events demonstrate, those in power too often disregard their legal and moral responsibilities. Since the collapse of Enron, WorldCom, and other firms in 2002 and 2003, a long line of corporate failures and misdeeds has produced broad calls for reform, higher standards, and more vigorous enforcement of those standards. The recent financial crisis (2007 through 2009) has cost the nation trillions of dollars of wealth and intensified the debate as to whether corporate executives can be trusted to act in the public interest. As scholars examine the causes of the financial crisis, the question arises again and again: To whom and for what were these executives responsible? To which I add this question: In a time when the betrayal of trust is economically, politically, and socially corrosive, what can be done to promote trustworthy behavior?

I. COMPLEXITY, RISK, AND TRUST

Arguably, the need for improved means to promote trust and fiduciary responsibility has never been greater. As recent events demonstrate, the costs and consequences of organizational failures to promote trust and responsibility

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[2] TAMAR FRANKEL, FIDUCIARY LAW 271 (2011) [hereinafter FRANKEL, FIDUCIARY LAW] (quoting TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD 49 (2006) [hereinafter FRANKEL, TRUST AND HONESTY]) (internal quotation marks omitted).

[3] Carlos Eduardo Lessa Brandao, a member of the Board of the Brazilian Institute of Corporate Governance, recently wrote to members of Corporation 20/20, an international network of experts:

> I urge the network to address the critical issue of redefining fiduciary duty of corporate directors. If boards of directors consider that ESG [environmental, social, governance] factors are strategic and part of their current fiduciary duties, it could be a powerful lever for change. This, in fact, already is embodied in Brazilian corporate law.

Posting of Carlos Eduardo Lessa Brandao, celb@iname.com, to http://www.corporation2020.org (Jan. 12, 2011, 12:50 PM) (on file with author).

continue to rise.

On October 26, 2011, only a few days before this Symposium, the giant pharmaceutical firm, GlaxoSmithKline (Glaxo), agreed to pay a $750 million fine to settle civil and criminal charges involving the sale of contaminated products and fraudulent statements related to pharmaceutical products.[4]

The facts of this case are stunningly simple. Glaxo operated a plant in Puerto Rico, which was its largest worldwide production facility.[5] A history of quality control failures produced an agreement with the FDA to take corrective action.[6] The company assigned a new quality control manager – Cheryl Eckard – to lead the effort.[7] Over the course of several years, she identified safety problems and urged changes, but was repeatedly rebuffed by the company's senior management.[8] Meanwhile, the old violations continued and new violations occurred.[9] Ms. Eckard's persistent advocacy for quality improvements eventually resulted in her dismissal as a "redundan[t]" employee (i.e., she was fired from the company).[10] At that point, Ms. Eckard blew the whistle, contacting the FDA.[11] The FDA conducted further investigations and seized almost $2 billion in products.[12] Ultimately, Glaxo closed the entire Puerto Rico operation.[13]

The net result is a "lose-lose-lose." Virtually all of the company's stakeholders suffered injury: investors, employees, local communities, and the customers who depended on the safety and availability of the drugs in question. There is no way for GlaxoSmithKline to make all those stakeholders "whole."

The modern corporation is properly envisioned as a network rather than a hierarchy. Business exists and operates in a stakeholder world. Simply stated, the so-called "value chain" is actually an extended network, or "organizational field," of relationships. These relationships range from contractors, subcontractors, and suppliers on the supply side to an extended network of distributors, wholesalers, and retailers on the market channel side who distribute products and services to a globe-girdling community of buyers and users.

The size and complexity of these networks require higher levels of

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[4] Gardner Harris & Duff Wilson, *$750 Million Fine for Drug Maker of Tainted Goods*, N.Y. TIMES, Oct. 27, 2010, at A1.

[5] *Id.*

[6] *Id.*

[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] *Id.*

information and trust.[14] Power – private power – resides within these networks, but this power depends on trust. Independence and power become increasingly difficult to achieve in a networked world. The interconnectedness of economic actors in the modern economy requires more information sharing and more truthful behavior.[15]

When trust fails, parties must rely on other means to verify the honesty of their transactions. These "transaction costs" increase the cost of verification and, indeed, affect the costs and design of the entire transaction. Trust is an economically efficient device for promoting commerce; when trust is destroyed, the price of commerce rises. What does Professor Frankel have to say about this? Her definition of trust – "reasonably believing that others tell the truth and will keep their promises"[16] – promotes internal governance at minimum cost. As trust diminishes, however, the costs of governance and compliance rise. From an economic, as well as a moral, vantage point, promoting trust is a rational approach to management.

A second recent example of Professor Frankel's ideas in action is drawn from the Deepwater Horizon oil spill. The National Commission on the BP Deepwater Horizon Oil Spill and Offshore Drilling has issued its official findings of responsibility.[17] In October 2010, at the time of the Boston University School of Law Symposium, the first findings were being publicly discussed by the Commission staff. Among the initial disclosures was the Commission's conclusion that Halliburton, which supplied the drilling cement for the rig, knew that the cement was unstable.[18] Moreover, Halliburton failed to communicate that knowledge to BP in a timely and effective manner.[19] In a transmission letter from the Commission staff to the entire Commission, the Commission's lead investigator, Fred Bartlit, Jr., wrote: "There is no indication that Halliburton highlighted to BP the significance of the foam stability data or that BP personnel raised any questions about it."[20] This failure made it

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[14] *Cf.* FRANKEL, FIDUCIARY LAW, *supra* note 2, at 271-72 (arguing that trust in society is necessary because of reliance on others for goods and services).

[15] *See* JAMES E. POST, LEE E. PRESTON & SYBILLE SACHS, REDEFINING THE CORPORATION: STAKEHOLDER MANAGEMENT AND ORGANIZATIONAL WEALTH 1-2, 44 (2002) (discussing the central role of relationships in corporations).

[16] FRANKEL, FIDUCIARY LAW, *supra* note 2, at 271 (quoting FRANKEL, TRUST AND HONESTY, *supra* note 2, at 49) (internal quotation marks omitted).

[17] NAT'L COMM'N ON THE BP DEEPWATER HORIZON OIL SPILL & OFFSHORE DRILLING, DEEP WATER: THE GULF OIL DISASTER AND THE FUTURE OF OFFSHORE DRILLING (2011) (Report to the President), *available at* https://s3.amazonaws.com/pdf_final/DEEPWATER_ReporttothePresident_FINAL.pdf; John M. Broder, *Tougher Rules Urged for Offshore Drilling*, N.Y. TIMES, Jan. 12, 2011, at A12.

[18] John M. Broder, *Companies Knew of Cement Flaws Before Rig Blast*, N.Y. TIMES, Oct. 29, 2010, at A1.

[19] *Id.*

[20] Letter from Fred H. Bartlit, Jr., Chief Counsel, Nat'l Comm'n on the BP Deepwater Horizon Oil Spill & Offshore Drilling, to Bob Graham et al., Comm'rs, Nat'l Comm'n on

impossible for BP personnel to make informed decisions about the very procedures that ultimately led to the explosions that destroyed the oil rig.

The National Commission documented other examples of information gaps and communication failures among employees of the three major companies involved (BP, Transocean, and Halliburton).[21] The results – a catastrophic failure to contain pressure from the well – led to the deaths of eleven crew members, the destruction of the platform, and the release of about 200 million barrels of oil into the Gulf of Mexico.[22]

The high level of trust and confidence required of people and companies in such a high risk operating environment was not met. Why not? The workers apparently knew that information problems existed, yet they were unable or unwilling to halt the drilling process. Chapter 4 of the Commission's final report begins by quoting one crew member: "*But, who cares, it's done, end of story, [we] will probably be fine and we'll get a good cement job.*"[23] Apparently, this statement provides as good an answer as the Commission could find to describe the weak levels of trust and responsibility at the Macondo well. The Commission concluded:

> The most significant failure at Macondo – and the clear root cause of the blowout – was a failure of industry management. . . . Better management of decisionmaking processes within BP and other companies, better communication within and between BP and its contractors, and effective training of key engineering and rig personnel would have prevented the Macondo incident.[24]

The Deepwater Horizon accident illustrates how essential trust is to modern industrial activity. Plants, refineries, factories, and facilities of all types require cooperation, information sharing, and the reliable performance of hundreds of employees and contractors, often under the direction of multiple corporate leaders. Risk resides everywhere in the economy of the Twenty-First Century. As the Commission notes in the foreword to its final report, "complex systems almost always fail in complex ways."[25] This was certainly the case on the Deepwater Horizon rig. Tougher compliance standards are necessary, but not sufficient. Without trust, rooted in experience, good

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the BP Deepwater Horizon Oil Spill & Offshore Drilling (Oct. 28, 2010), *available at* http://graphics8.nytimes.com/packages/pdf/science/spilldoc.PDF.

[21] *See, e.g.*, NAT'L COMM'N ON THE BP DEEPWATER HORIZON OIL SPILL & OFFSHORE DRILLING, *supra* note 17, at 116, 119.

[22] *Oil Findings Boost Chance of Corp. Criminal Charge*, FOX NEWS (Jan. 6, 2011), http://www.foxnews.com/us/2011/01/06/oil-findings-boost-chance-corp-criminal-charge/.

[23] NAT'L COMM'N ON THE BP DEEPWATER HORIZON OIL SPILL & OFFSHORE DRILLING, *supra* note 17, at 89 (alteration in original) (emphasis added) (internal quotation marks omitted).

[24] *Id.* at 122.

[25] *Id.* at viii (internal quotation marks omitted). This statement was first made in the report of the Board that investigated the destruction of the Columbia space shuttle. *Id.*

practice, and sound collaborative processes, the risks of complexity will inevitably take their toll.

II. TRUST AND PUBLIC LEADERSHIP

The financial crisis of 2008 stands as a final, critical example of how modern commerce challenges trust and fiduciary responsibility. The near collapse of financial markets in the autumn of 2008 was the greatest economic crisis since the Great Depression.[26] The extraordinary intervention by the Federal Reserve Bank and U.S. Treasury Department demonstrated both the profound nature of the crisis and the collapse of traditional contractual, regulatory, and internal corporate protective measures.[27] As *The Economist* magazine opined, in October 2008 the global financial system stood at "the edge of a nasty recession."[28]

There were many corporate casualties in this extraordinary drama. Among the prominent survivors, however, was Goldman Sachs, one of the world's leading investment banks. The company's central role in the financial system, and its economic success during the crisis, raised many questions. Goldman Sachs has now become the focus of private and public litigation alleging violations of securities laws, contractual responsibilities, and ethical norms for its role in a significant number of transactions.[29] Considerable damage has been done to Goldman Sachs' reputation.[30] One consequence of the legal actions and public criticism was a decision by the firm's senior management and board of directors to undertake a major self-assessment and review by its newly created Business Standards Committee (BSC).[31] The Committee's work involved interviews with clients, employees, and experts.[32] The final report illuminates the range of issues challenging the industry and firm and includes thirty-nine major recommendations, many involving governance and

[26] Bob Willis, *U.S. Recession Worst Since Great Depression, Revised Data Show*, BLOOMBERG (Aug. 1, 2009, 12:00 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aNivTjr852TI.

[27] *See* Gregg Hitt & Deborah Solomon, *Historic Bailout Passes as Economy Slips Further*, WALL ST. J., Oct. 4, 2008, at A1.

[28] *World on the Edge*, ECONOMIST, Oct. 4-10, 2008, at 11, 11.

[29] *See, e.g.*, Charles Penty, *Goldman Sachs Suit May Prompt Wider Probe, Regulation (Update 1)*, BLOOMBERG (Apr. 19, 2010, 10:30 AM), http://www.businessweek.com/news/2010-04-19/goldman-sachs-suit-may-prompt-wider-probe-regulation-update1-.html.

[30] *Id.*

[31] *See Goldman Sachs Announces Publication of Business Standards*, BLOOMBERG (Jan. 11, 2011), http://mit.bloomberg.com/apps/news?pid=conewsstory&tkr=GS:US&sid=ahdftY4cXgk4; *Goldman Sachs Announces Publication of Business Standards Committee Report*, WALL ST. J. (Jan. 11, 2011, 8:45 AM), http://online.wsj.com/article/PR-CO-20110111-904196.html.

[32] GOLDMAN SACHS, REPORT OF THE BUSINESS STANDARDS COMMITTEE 1, 9-10, 53-54 (2011), *available at* http://www2.goldmansachs.com/our-firm/business-standards-committee/report.pdf.

accountability reforms designed to inspire greater client and public confidence in the integrity of Goldman Sachs.[33] The trust of clients is at the center of the firm's efforts.[34]

The complexity of modern networks is exacerbated by organizational size. The Goldman Sachs controversy – and the entire financial crisis – fueled a longstanding debate about the status of those few mega-banks that are, de facto, "too big to fail." While Professor Frankel does not address this issue specifically, her concerns about the essential role of trust in increasingly complex systems are warranted. The existence of systemic risk, revealed in the collapse of Lehman Brothers and near-collapse of AIG, exposed corrosion of the foundation of trust and fiduciary responsibility. The vulnerability of modern financial systems to failure is tied to problems of trust and verification. The size of the nation's largest financial institutions, in particular, has raised the question of whether these firms are "too big to fail." While business and political voices argue against too big to fail, size and complexity create the dangerous reality of a firm that is almost impossible to govern effectively.

Governance and personal accountability are core themes in the Goldman Sachs BSC Report.[35] The BSC notes the critical relationship between the firm's reputation and the potential damage that an employee can do to that reputation through poor judgment.[36] As the report states:

> Each employee of Goldman Sachs has responsibility for protecting the firm's reputation; an employee can do more to harm the firm's reputation through a single poor judgment than he or she can do to enhance it throughout an entire career. We believe that we must manage reputational risk with the same rigor as financial risk, and that each employee must focus on reputational risk.[37]

The challenge for organizational leaders is how to promote trustworthy behavior through governance processes and a corporate culture of personal accountability. If trust grows, reputation is enhanced and people are willing to remove the "friction" that can otherwise affect business relationships. If trust fails, however, both risk and transaction costs increase.

The temptations to undermine trust-promoting behavior are great. Only days before the BSC Report was released, Goldman Sachs' role as investment banker for Facebook, the social network firm, was made public.[38] To secure the deal, Goldman Sachs agreed to value the privately held Facebook at a

[33] *Id.* at 1.

[34] *See id.* at 18 ("In resolving potential conflicts and making business selection decisions, we will pursue a long-term and balanced approach that builds clients' trust.").

[35] *See, e.g.*, *id.* at 43.

[36] *Id.* at 55.

[37] *Id.* at 55-56.

[38] *See* Susanne Craig & Andrew Ross Sorkin, *Goldman Offering Clients a Chance To Invest in Facebook*, DEALBOOK (Jan. 2, 2011, 11:31 PM), http://dealbook.nytimes.com/2011/01/02/goldman-invests-in-facebook-at-50-billion-valuation/.

breathtaking $50 billion.[39] The firm made a $450 million investment in Facebook, and planned to make a portion of that share available to its clients.[40] In the offering sheet circulated to its private clients, Goldman Sachs added the caveat: "There may be conflicts of interest relating to the underlying investments of the fund and Goldman Sachs."[41] Indeed, another Goldman Sachs investment group, called Goldman Sachs Capital Partners, declined the opportunity to buy Facebook shares because the investment was not appropriate for the fund, which held pension funds as a fiduciary.[42] The net result was that while Goldman Sachs was pitching Facebook shares to its private clients, it was also refusing to invest money it held as a fiduciary based on the judgment that Facebook was overvalued and, therefore, an inappropriate investment.[43]

The situation bore some similarity to the 2007 sales of a mortgage-backed investment called Abacus when Goldman Sachs failed to inform clients that it allowed a hedge fund betting against the investment to help put together the deal.[44] Goldman Sachs paid $550 million to settle fraud charges filed by the SEC.[45] As *Bloomberg* reported:

> Goldman Sachs Group Inc. clients considering whether to buy shares in closely held Facebook Inc. should take heed: Wall Street's most profitable securities firm could unload its own holdings without letting them know.
>
> In the last sentence of a one-page investment profile sent to private wealth clients, the firm explains: "GS Group may at any time further reduce its exposure to its investment in Facebook (through hedging arrangements, sales or otherwise), without notice to the fund or investors in the fund."[46]

It is for these reasons, if no other, that management scholars and practitioners have a stake in Tamar Frankel's work. Her understanding and insights into the subtleties of these trust relationships offer us ways to defend ourselves as a society against the kinds of problems that the Glaxo, Halliburton, and Goldman Sachs examples represent. Leadership is the essential safeguard because leadership and organizational culture are "two

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39 *Id.*

40 Max Abelson & Christine Harper, *Goldman Sachs May Sell or Hedge Facebook Stake Without Warning*, BLOOMBERG (Jan. 6, 2011, 9:44 AM), http://www.bloomberg.com/news/2011-01-06/goldman-sachs-discloses-it-can-sell-hedge-facebook-stake-without-warning.html.

41 *Id.* (internal quotation marks omitted).

42 *Id.*

43 *See id.*

44 *Id.*

45 *Id.*

46 *Id.*

sides of the same coin," as Edgar Schein wrote.[47] Leadership is about beliefs and values. If trust is understood to be an organizational asset, as well as an essential ingredient of organizational life, it will be cultivated. If leaders do not recognize the value of trust, however, it will neither be nurtured nor supported.

CONCLUSION

The rule of law must promote trust-seeking behavior. In the fallout of cases from the recent financial crisis, very few individuals have been held accountable for their actions. Personal accountability is at the core of trust-promoting behavior in organizations. Shortly before the October Symposium at Boston University, Angelo Mozilo, former CEO of Countrywide Financial, settled with the SEC.[48] Under the settlement, he would pay $45 million for "ill-gotten profits" and $22.5 million in civil penalties, but admitted no wrongdoing.[49] The SEC used emails in which Mr. Mozilo described Countrywide products as "toxic" and "poison" to show that he had misled investors about the risks of the company's lending practices.[50] While he was allegedly misleading investors, Mr. Mozilo made $140 million selling company stock.[51]

Mozilo's agreement with the SEC did not acknowledge guilt, leaving the question unanswered of whether he ever accepted his responsibility for being truthful and trustworthy.[52] Agreements that allow defendants to settle without accepting responsibility do not foster a public climate of trust and responsibility. As Professor Frankel makes clear in her work, trust and fiduciary responsibility are vital to the modern economy and to social well-being.[53] In the world of corporate governance and accountability, her message is both timely and important.

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47 EDGAR H. SCHEIN, ORGANIZATIONAL CULTURE AND LEADERSHIP 3 (4th ed. 2010).

48 *Angelo Mozilo*, N.Y. TIMES (Oct. 15, 2010), http://topics.nytimes.com/top/reference/timestopics/people/m/angelo_r_mozilo/index.html.

49 *Id.*

50 *Id.* (internal quotation marks omitted).

51 *Id.*

52 Mr. Mozilo did not admit guilt in his settlement with the SEC, and, according to recent reports, federal prosecutors have dropped their criminal case against him. Gretchen Morgenson, *Case on Mortgage Official Is Said To Be Dropped*, N.Y. TIMES, Feb. 20, 2011, at A20.

53 *See, e.g.*, FRANKEL, FIDUCIARY LAW, *supra* note 2, at 271 ("Trust is generally essential to society, as we rely on others for the products and services we purchase, including the competence and ethics of physicians, lawyers, and financial services firms.").