Learning From the Goldman Sachs Debacle

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I’m pleased to be participating—for the fifth time—in Compliance Week’s annual conference. Saying that makes me feel a bit like Phil Connors, the weatherman played by Bill Murray in the movie “Groundhog Day,” who had to repeat the same day over and over again, until he finally got it right. In my case, I hope the folks at Compliance Week keep inviting me back, based on their assumption that, while I still haven’t gotten it right, I eventually might!

“Groundhog Day” also provides an apt analogy for the events of the past decade, continuing into the present one. If we look no further back than the start of this millennium, we’ve witnessed a parade of tragic, but clearly similar, events, including:

- Financial services firms’ converting research into sales literature;
- IPO “hot issues,” where firms took kickbacks before allowing their best clients to participate;
- Enron’s implosion, followed by many others, as a result of fraudulent financials; and
- Arthur Andersen’s demise, after destroying Enron audit records and certifying its fraudulent financials.

These preceded Sarbanes-Oxley’s overwhelming passage, with proclamations that the law “solved” false financial reporting and deficient corporate governance, only to be followed by:

- Mutual fund late trading and market timing;
- Unprecedented sub-prime mortgage defaults;
- Demise of financial service firms like Bear Stearns and Lehman;
- The worst economic and financial meltdown in at least 75 years;
- Government bailouts and ownership of entire industries;
- Belated discovery of Madoff’s and Stanford’s Ponzi schemes; and
- SEC charges that Goldman Sachs defrauded its clients.

This all culminated in the passage of the 1,500-page Senate financial services bill, now being reconciled with the similar-sized House effort passed last December, again amidst proclamations about how this will solve the problem (even though there’s no agreement on what the problem is or was). And, all this occurred in little more than the first decade of this new millennium!
It’s possible to view these events as isolated occurrences, reflecting solely the malevolence of those in the private sector, but that’s wrong, even if our political leaders delight in using this “bad people” thesis to further their agendas. Rather, common themes tie these events together. The 20th century’s greatest sage—Yogi Berra—could easily have been referring to this parade of horribles when he perceptively said, “it’s like déjà vu all over again”! Accordingly, in our time together, I’d like to discuss what these events have in common, and lessons we can learn from them.

Sorting through the rubble of failed businesses and regulatory inadequacy, however, requires determination and intensity—something we haven’t heretofore been able to summon. That’s probably why George Bernard Shaw bemoaned the fact that, “the only thing we ever learn from history is that we never learn from history.” The problem, of course, is that as our economy becomes more complex and interrelated with the economies of other countries, the consequences of not learning history’s lessons grow increasingly severe, as we’re still witnessing. Given the crash of 2007-2008—which isn’t over by any means—one shudders to think of what’s next.

To understand these events, and place them in context, requires those in power to acknowledge one axiomatic truth they’ve been constitutionally incapable of acknowledging: There’s absolutely no way government fiat by itself can change human nature. If merely providing consequences for misconduct were all that were required, we’d have eliminated or severely reduced the incidence of many crimes long ago.

This isn’t to say we shouldn’t outlaw improper conduct. Of course we must. And we must enforce the laws Congress enacts, to avoid allowing regulatees to choose which government edicts they’ll follow, and those they won’t. But to effect sustainable change, people must do so from within. Establishing standards of conduct and imposing serious consequences for unacceptable behavior can help those who are regulated summon the will to change, and the discipline to sustain that change. Merely prohibiting dangerous conduct by itself, however, can’t and won’t produce sustainable change, even if it were possible to identify what conduct should be considered dangerous for all times. Yet that’s precisely what’s wrong with our approach to financial services regulation. Government issues edicts, then we lament the twin flaws of our regulatory system: the ineluctable failure of some to abide by those edicts and government’s inability to prevent those failures from occurring, or discover them when they do.

It’s easy to say—as government repeatedly does—there’s a simple solution: To wit, do the right thing and make sure you have best-in-class compliance procedures in place. Companies must do that, but even so, that won’t prevent them from experiencing future problems. Nor do I accept government’s assurances that the latest legislation or newest regulations will solve the problems we’ve seen or prevent future ones. I’m from Brooklyn; so, if you believe those assurances, I’ve got a fabulous bridge to sell you!

Legislation, regulation, and enforcement efforts can’t solve what ails our already heavily regulated financial and capital markets. If it were otherwise, SOX should have prevented the sub-prime crisis and the concomitant economic meltdown by insuring better financial reporting and governance on the part of the likes of Merrill Lynch, Bear Stearns, Lehman Brothers, and so on. It didn’t, but now we’re witnessing pious pronouncements from our political leaders that their current legislative efforts will beat back the miscreants of Wall Street, and solve our problems forever more. Worse, even if legislation could solve our problems, this legislation surely can’t, and won’t.

We needed (and still need) legislative overhaul of our financial regulatory system; we just don’t need what we’re about to receive. The fact that we’re going to receive it anyway gives new meaning to the Bible’s teaching that “it’s better to give than receive!” More importantly, we need something far more difficult to acquire than anything legislators or regulators can ever give us: the true inculcation of appropriate values. No government edict can ensure that people won’t do those things we don’t want them to do. That’s one lesson we never seem to learn from history. And, while I’ve acknowledged that government can help facilitate our ability to learn from history, that presupposes that government itself can learn from history, something that doesn’t happen very often, if at all.

The ongoing economic crisis, and the parade of horribles leading up to it, tell us what we need to know, if only we’d pay attention. Famed cartoonist Walt Kelly, summarized it in his immortal Pogo quote, “We have met the enemy, and he is us.” Years later, Kelly explained that the message reflected his view that “all of us are responsible for our myriad pollutions, public, private, and political.” Unless and until we get that, we simply don’t get anything. And this plays out on many levels.
Exhibit A is a thoughtful piece in the May 22 *Wall Street Journal*, by Slate’s Hollywood columnist Edward Jay Epstein, titled “Goldman and Washington’s Wall Street Takeover.” Epstein argues the SEC case is weak, and was effectively designed to clinch government’s quest to control, not merely oversee, the financial services industry. The SEC—or at least 60 percent of the SEC—surely disagrees. But the real point’s fairly simple, and a commentary on both defenders and detractors of the merits of the Goldman lawsuit, its timing, its split authorization vote, or even the way Goldman’s lawyers were, or weren’t, notified a lawsuit was about to be filed. That point is, “So what?”

Even assuming, for argument’s sake, the SEC engaged in questionable conduct as Goldman’s CEO claimed the day the suit was filed—and I’m not agreeing it did—so what? The SEC filed a lawsuit accusing Goldman of fraud. Surely no one can dispute the SEC’s authority to investigate a registered broker-dealer’s conduct ultimately alleged as fraudulent. Nor does a 3-2 SEC vote to sue someone lose its validity, even if the supposedly secret vote becomes known as having split along political lines. If it were otherwise, scores of 5-4 Supreme Court decisions over two centuries would lack precedential effect, and we know better.

No, the question for you and me is not whether Goldman would win this lawsuit if it were litigated, as Mr. Epstein’s piece argues. Rather, because this lawsuit will never be litigated, the only question is how companies accused of fraud by their government avoid the disastrous consequences already experienced by Goldman, and others who previously followed the same unfortunate path.

This wasn’t an inconsequential lawsuit, mind you. Quite the contrary, what makes this lawsuit consequential, among other things, is that:

- Goldman lost $21 billion in market cap due to the filing of the lawsuit (spurious or otherwise);
- It has been leaked that the Justice Department is considering possible criminal charges;
- Senior Goldman managers were excoriated by senators for taking advantage of their customers, a charge business doesn’t easily withstand; and
- Foreign governments assert they’re now investigating whether they should act against Goldman.

The only explanation offered for Goldman’s initial posture was its lawyers’ asserted belief the firm has strong defenses to the charges. That position brings to mind Henry Clay, who avowed—after being denied the presidency he coveted yet failed to achieve several times—that he’d rather be right than president. Most politicians, I suspect, would disagree. More to the point, if being right means enduring the consequences already confronted by Goldman, we’d all do well to remember King Pyrrhus’ observation in 280 B.C., after defeating the Roman Army at an unbelievably devastating cost of his own men’s lives, “If we are victorious [like this] in one more battle with the Romans, we shall be utterly ruined.” Think Arthur Andersen!

It probably also matters in performing the calculus that strong defenses are not the equivalent of guaranteed victory. So, part of the effort requires an assessment of what could happen if the unthinkable occurs, and you lose a case you were morally certain you should have won. In Goldman’s case, the cost would be the potential loss of its right to manage other peoples’ assets, something no one at Goldman should ultimately be willing to risk. That means that if the SEC’s case survives motions to dismiss and/or summary judgment, Goldman simply can’t afford to see whether its lawyers were right!

So, what lessons should we be learning? As those who know me will recall, I always say I have 10 lessons to learn from any experience, and indeed I do. But the truth is, I never have 10. I only say I have 10 because if I told you I had 14, you’d tune out, and who could blame you? Here, then, are my top 10 lessons to be learned:

**Bad Things Happen to Good Companies.** As my mother, a veritable Mrs. Malaprop, was wont to say, “Sometimes, even the inevitable occurs.” She was right, of course. As a result, preparation for the inevitable is critical. Companies are often investigated by the government, albeit hopefully not yours. Still, just because you think your company’s doing things well doesn’t mean you are, or more importantly, that the government agrees. You need a game plan for how your company will react, if:
Avoid the Alexander Haig Problem. If a triggering event occurs, who’s in charge? Who’ll work the issue? What will they do? Who should be alerted? Can you reach everyone you need instantaneously? These are only a few of the questions your advance plan should address, irrespective of the precise problem that ultimately arises.

The Race Is to the Swift. When faced with a situation such as the prospect of an SEC inquiry or enforcement action, a common response can be to freeze like proverbial deer caught in the headlights, waiting to see if we’re hit. Of course, to avoid becoming road kill, doing nothing isn’t an option. This is precisely the time that thoughtful leadership, driven by decisive advance planning and action, is critical to resolve the issue and minimize collateral damage.

Tight Lips Sink Ships. During World War II, our government cautioned that “loose lips can sink ships.” And yet, one of the most surprising—but common—reactions to a potential crisis is for companies to keep information close to their vest, perhaps hoping everything will blow over. CEOs and general counsels often are concerned, understandably, that a nascent problem about which everyone knows little may become broadly known if directors are told too much, too soon. The critical lesson, however, is that if you worry that revealing confidential information to your directors may make the information common knowledge, you should rid the company of those directors before your next crisis hits, not refuse to share important information with the board.

Time and Tide Wait for No Man. When problems are first identified, it’s critical to get on top of them immediately. Lapses between discovery and action usually result in even worse things happening to good companies. Companies must put their game plan for defining the problem and its scope in motion immediately.

It Isn’t Passover, but Ask These Four Questions. When companies learn of a potential issue, there are at least four questions for which answers must be obtained, as quickly as possible:

- How did you learn about the problem? Put another way, is the problem already governed by some internal control mechanism, or were you lucky to pick it up?
- Is the problem systemic, or a one-off situation?
- Who, if anyone, has been harmed, and to what extent?
- What assurances are there that this problem is less likely to recur?

In a Crisis, Stay Away From Litigators. In “bet the farm” situations, decisions shouldn’t be made by those playing with your money. Litigators want to win the case, but you want to salvage your company. In general, litigation generally helps only one class of people: the litigators. It must be seen as a last resort.

Know When to Hold ‘em, Know When to Fold ’em. Before you stake out a position from which you can’t gracefully retreat, make sure you know exactly what’s at risk if everything goes South in a hurry. For Goldman, the issue should never have been viewed as one of who’s right; it should have been viewed as “what happens if we’re wrong.”

Let Sleeping Dogs Lie. No one ever obtained a desirable result from government by accusing it of being stupid, venal, and wrong. The government’s not some monolith; it’s an aggregation of humans, each of whom can feel every emotion you and I are capable of feeling. This should caution discretion from the get-go.

Don’t Burn Bridges. Even in a Democratic Administration, government regulators and prosecutors have memories like proverbial elephants! Regulated entities, or companies that can anticipate future interactions with the government,
should conduct themselves in a manner that permits them to look forward to those future interactions.

**You Don’t Have to Be Wrong for the Government to Be Right.** There’s nothing wrong with contesting government charges. Sometimes there’s no alternative. But, there’s plenty wrong with forgetting how your public statements will be viewed with other constituencies that may matter even more—namely, your clients, your shareholders, your directors, public opinion, and the media. What Goldman should have done when the suit was filed against it was to state something like: “While we intend to defend our conduct, we’re troubled that the government felt it necessary to accuse us of wrongdoing. Accordingly, the board has asked some independent folks to come in and review our policies to see how we can improve our overarching commitment to our clients.” No admission, no capitulation, but clearly a recognition that you woke up one morning and found yourself in a place where the sun doesn’t shine.

**In a Crisis, the Operative Word Is Candor.** Many folks want to wait until they’re sure what happened, or they know they have no choice but to disclose. Until then, they justify the controversy or their internal review as a basis for silence. That never works! What you know and what you don’t know can be disclosed in a well-crafted statement. After all, if the crisis has hit, who are you keeping this all from by keeping mum, anyway?

**Avoid Hubris.** Goldman’s CEO became infamous for responding to the firm’s critics that it was “doing God’s work,” as the firm reaped record profits notwithstanding America’s worst recession in nearly a century. It may be OK to think that, although I’m not even certain about that, but it isn’t especially smart to say it. As the boxer Robert Fitzsimmons poignantly observed before a bout against a bigger opponent he nonetheless expected to defeat in 1902, “The bigger they are, the harder they fall.” Don’t set yourself up for a big fall.

**Maintain a Sense of Humor.** Adlai Stevenson had it wrong back in the 1950s when he somberly intoned—after losing to Dwight Eisenhower a second time—“I’m too old to cry, but it hurts too much to laugh.” If you don’t laugh, the pain’s only that much harder to handle.

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In keeping with the need for a sense of humor, and in the interest of full disclosure, David Letterman beat me to the punch with his own list of Top 10 responses he speculated Goldman Sachs should have employed after the SEC’s charges were filed. Three of his 10 proposed responses convey quite a message:

- “You’re saying “fraud” like it’s a bad thing.”
- “Since when aren’t financial institutions allowed to screw their customers?” and
- “America needed a villain both Republicans and Democrats could hate.”

I don’t recommend that anyone employ Letterman’s suggestions, but they certainly provide food for thought.