

The Corporate Governance Implications of Enron¹

by Elaine Sternberg

Recent scandals in the US have led to a renewed interest in corporate governance, and demands for more and increasingly stringent regulation. But though there have indeed been failures of corporate governance, the very nature of corporate governance means that the answer is not -- cannot be -- more regulation.

What went wrong?

The scandals have involved neither regulatory nor market failure: rather, individuals (singly and in concert) have failed in the performance of their corporate governance duties.

At Enron, for example, board members were apparently aware of questionable accounting, fundamental conflicts of interest, extensive undisclosed off-balance sheet operations, and excessive executive compensation. But in the words of the Senate permanent sub-committee on investigations, they "chose to ignore them"¹.

Enron's board failed to control conflicts of interest that were harmful to shareholders' interests. The Board approved and "exercised inadequate oversight"² of special purpose entities that realised hundreds of millions of dollars at Enron's expense. It allowed Andersen to audit those entities, even though Andersen had helped create them and earned more from that consultancy work than from the auditing. Some of the supposedly independent directors of Enron were compromised by having financial ties to the company.

Similarly, Enron's board failed to challenge questionable practices. The audit committee was regularly briefed by Andersen, and reportedly was warned that Enron's accounting practices were risky. Yet the board did not query them, even when they did not serve any bona fide business objective. The Board was also allegedly aware of the levels and methods of remuneration. But it failed to ask why the company paid out almost \$750 million in cash bonuses in a year when net income was \$975 million³; assured by the remuneration consultants that the payments were not out of line, the board apparently rubber-stamped them. The Board also failed to monitor and halt the abuse of multi-million dollar credit lines extended to Ken Lay, former chief executive.

Lessons to be remembered

So there have been genuine failures of corporate governance. What lessons should be remembered -- or learned -- from them?

First, and perhaps most fundamentally, is that although corporate governance has undoubtedly been defective in some prominent cases, there has been nothing to suggest a failure of the Anglo-American model of corporate governance. Some companies have declined in value, a few have even gone bankrupt, but that is what should happen to corporations that fail to achieve their shareholders' objectives. Moreover, the problems have been identified and penalties have been meted out by the market itself.

Several other lessons are direct consequences of the nature of corporate governance. Corporate governance is about ensuring that corporate actions, agents and assets are directed at the constitutional objectives of the corporation as determined by its owners, the shareholders.⁴ Accordingly, corporate

¹ This paper is a slightly modified version of a talk that was first delivered on 16 July 2002 at the Institute of Economic Affairs, in conjunction with a paper on the implications for accounting/ auditing by Prof. David Myddelton, Cranfield School of Management, and an overview by Martin Wolf, CBE, of the *Financial Times*.

governance should be the responsibility of the shareholders; it is up to them to monitor and protect their own interests. Furthermore, because the purpose of corporate governance is to ensure that the specific objectives of individual corporations are achieved, different mechanisms will be most suitable depending on each corporation's history, size, industry, jurisdiction and shareholder composition. The degree and sort of accountability wanted will appropriately reflect the particular circumstances of each set of shareholders and their organisation.

One of the key circumstances affecting corporate governance is where the corporation is domiciled. Because corporate governance is about corporations, and corporations are largely defined by the law, the legal aspects of corporate governance are jurisdiction-specific. The 50 US states are subject to 50 different systems of corporate law; the typical US system is significantly different from that obtaining in the UK. Consequently, reforms proposed for one jurisdiction are unlikely to be appropriate elsewhere.⁵

Even within any jurisdiction, regulation is not the answer to defective corporate governance. Regulation is ineffective against its major sources, which include conflicts of interest, asymmetry of information, and inadequate incentives for monitoring. And the chief wrongs involved in the recent scandals were already illegal. Like ignorance and risk, however, dishonesty cannot be eliminated by fiat.

Conversely, not everything that is desirable can or should be compulsory. It is important to differentiate between corporate governance measures that might sensibly be favoured, or even recommended, as general ways of increasing accountability to shareholders, and things that should be made mandatory via regulation/ legislation. Many proposals that merit serious consideration by particular shareholders and corporations would nevertheless be wholly inappropriate as mandatory requirements.

Regulation is part of the problem, not the solution

Typically, regulation is part of the problem, not the solution. Interestingly, the worst scandals have been in industries that have traditionally been heavily regulated: energy, telecoms, defense. Regulators notoriously tend to be captured by the industries they are meant to regulate. Moreover, the pronouncements of governments and regulators are at least as untrustworthy as those of the groups that they supervise. Consider the state of social security accounts in both the UK and the US⁶, and the accounts of the EU.⁷

Again, the problems come from the very nature of the subject. Laws made in response to perceived crises and hard cases are famously defective. Regulation is inflexible. All regulation imposes substantial costs, in terms of both funds and freedoms: even disclosure is not costless. And all regulations have consequences that are unintended, damaging and difficult to correct.⁸ The general rule, that '...anybody whom a mandate is intended to help is likely to suffer disproportionately from the cost of providing it'⁹ is certainly true of attempts to compel better corporate governance. In formalising and clarifying unwritten guidelines, regulation typically lowers standards; compliance no longer requires a margin of safety, but can be obtained by satisfying the letter of the law.¹⁰

Regulation constitutes an inherent moral hazard. In seeking to make equity investment 'safe', regulation tends in fact to make it more dangerous, by providing a perverse incentive for investors to be less diligent and vigilant. As the 'expectation gap' surrounding the role of auditors reveals, investors are all too ready mistakenly to believe that regulation is a guarantee of soundness.

Examples of Counterproductive Regulation

Examples of regulation producing more harm than good are not difficult to find. In the **UK**, for example, insider trading regulation and the takeover code, both intended to benefit investors, actually handicap them. Insider trading regulation encourages investors to refrain from acquiring information about their investments, lest they become contaminated and unable to trade. The Takeover Code discourages investors from acquiring a large enough stake in a company to exercise effective corporate governance.

In the **US**, the **tax code** increases two conditions that lead to bankruptcy -- high debt and risky

investments. The code encourages debt, because interest payments are a deductible expense, whereas dividends are not; dividends are indeed taxed twice. By decreasing the dividend payout rate, and increasing retained earnings, such rules enhance the role of corporate managers in the allocation of capital: managers have less need to seek external funds for proposed projects... and thus less need to justify those projects.

Consider as well **the official US treatment of options**: the rapid increase in their use has largely been promoted by the accounting and tax codes. For accounting purposes, option grants do not have to be shown as an expense. Although a grant of shares (even shares whose sale is restricted) typically leads to a reduction in reported earnings, a grant of options does not. Perversely, options linked to performance goals do have to be set against expenses. This has dissuaded most US companies from tying options to operational targets. To make things even worse, the use of options has also been encouraged by tax legislation.¹¹

Reforming Regulation

Regulation devoted to reforming corporate governance is necessarily counterproductive, insofar as it attempts to prevent shareholders from organising their own corporations in their own ways. Consequently, the proposals that have been made by politicians, officials and interested bodies should be resisted.

Even reforms whose proposals might well be largely sensible in particular companies should be opposed when presented as prescriptions for all. It would indeed be prudent for individual companies to reconsider and restructure their option schemes. But banning the use of options would needlessly handicap start-up companies without making remuneration any more responsive to performance. Similarly, company votes undoubtedly represent assets that should be used for the benefit of the shares' beneficial owners. But if voting were compulsory, uninformed and inertial, votes would as likely support incumbent managements, making reform by shareholders even more difficult.

The least damaging sorts of proposals are those which would increase the powers of shareholders to implement their own mechanisms. A reform that empowered shareholders to vote on remuneration packages, but did not require them to do so, would be worthier of serious consideration. Similarly, regulation that prescribed default positions, but allowed shareholders to opt out, would be better than that which provides no alternatives. The UK Combined Code is a constructive example.

Is there any role for government action? Definitely: the most valuable reforms would indeed be those correcting existing regulation, so as to free corporate governance from government-imposed obstacles.

In the US, for example, perverse incentives should be removed from the tax code. Unfair restrictions should be removed from securities legislation: when directors are allowed to sell their shares in response to market movements, so should other shareholders. Crucially, SEC restrictions that inhibit shareholders from nominating directors should be eliminated. Shareholders should also not be prevented by the law from proposing resolutions either about corporate elections or the 'conduct of the ordinary business of the corporation'.¹² Nor should shareholders be prevented by regulation from making proposals that are binding on the board.

Directors' duty of care and loyalty should be restored, by rejecting the 'business judgement' rule¹³ and repealing state laws that limit directors' liability. Moreover, laws requiring long and staggered terms for directors should be abolished. When such laws apply, no matter how many shares are acquired, only some of the directors can be replaced at any election. The others are effectively freed from any need to be accountable to the shareholders until their terms expire. In such circumstances, even takeovers have little effect.¹⁴

Is there anything positive that government could do to improve corporate governance? Yes: the standards and sanctions attaching to trusteeship could be improved. That would help strengthen what is perhaps the weakest link in corporate governance, that between institutional investors and the ultimate

owners of the assets they manage.

Although large amounts of personal savings are in the form of private pensions¹⁵, and most pension funds are structured as trusts, there are few mechanisms available for keeping pension trustees accountable. Most pensioners can neither influence the choice of the trustees governing their retirement funds, nor do anything to punish or replace them in the case of misconduct. But trustees are typically subject to serious conflicts of interest. Although they have a fiduciary responsibility to protect the best interests of the beneficiaries, they are typically employees of the plan sponsor. And their advisors are firms that seek to provide services to both the plan sponsor and to the companies in which the pension fund invests. Furthermore, sponsoring companies usually know how trustees vote their shares, but the beneficiaries do not.

The (UK) 1995 Pension Act required a percentage of member-nominated trustees, but did little either to increase the independence of company pension schemes from management dominance or to increase accountability. The minimum three year period for appointments makes it difficult to review or replace trustees. The requirement for member-nominated trustees to be members of the scheme is needlessly restrictive, and indicates a dangerous acceptance of the 'constituency' theory of representation. And the need for them to be approved and removed only with the consent of all the other trustees limits their independence. Similarly, the 2002 Myners Report, though detailing ways in which trustees appear defective, said nothing about increasing trustees' accountability.

Worthwhile Reforms

But most of the changes that are needed to improve corporate governance do not involve any regulation. They can and should be provided by the market. Individual companies are already introducing changes. Consider Coke's decision to join Boeing in expensing options, and the fact that investors are now voting down 23.4% of options plans vs. 16.2% five years ago.¹⁶

The best way to bring about beneficial changes would be to encourage maximum experimentation in the marketplace, and to allow forms of corporate governance to compete for investor support. The purpose of reforms should be to increase the power of the shareholders themselves to determine the degrees and kinds of accountability that they want to have.

The value of doing so is clear. According to a recent analysis of 1,500 stocks by the (US) National Bureau of Economic Research, companies with the most restricted shareholder rights had annual earnings and valuations between 1990 and 1999 that were almost 9% lower than companies with the fewest restrictions.¹⁷ Shareholder freedom is associated with both good corporate governance and superior corporate performance.

Underutilised Mechanisms

In keeping directors accountable to shareholders for achieving the corporate objectives, some mechanisms have been underutilised. The first is the **corporate objective** itself. It has been systematically undermined by corporate managers, and would be entirely abolished if the UK government had its way.¹⁸ Even though the doctrine of *ultra vires* has been substantially weakened, however, a clear, limited objective can be a valuable corporate governance tool. As Aristotle pointed out many centuries ago, it is easier to hit a target whose identity and location are known.

Specifying objectives helps to clarify both what the corporation should be achieving, and what it should avoid. A corporation intended to be a business, for example, could explicitly define its sole purpose as 'maximising shareholder value by selling goods or services'. Equally, investment trusts could specify more precisely the types of investments and strategy allowed. A specific and well-defined objective provides a clearer criterion for action and evaluation than the deliberately wide ranging but now commonplace 'general corporate purposes'. And whatever its objectives are, a company can make their achievement more likely by explicitly building them into its management measures and remuneration schemes.

A second useful device is the **governance committee**¹⁹, which could be charged with ensuring strict adherence to the corporate purpose. Theoretically, of course, this is the job of the board overall. To the extent that a board is subject to significant conflicts of interest, however, specific oversight of the corporate purposes might be prudent.

The governance committee could supplement or supplant the traditional audit committee. All auditors, internal and external, financial and other, could usefully be appointed by, and report to, the governance committee. In addition, the governance committee could ensure that the corporation's management accounts provided managers with the information they needed for achieving the corporate purposes, and that reports to shareholders provided the information necessary for assessing corporate performance. Finally, the governance committee could also serve as a conduit for concerns about the conduct of the corporation, including those of shareholders and those disclosed through the company's critical information systems.

Critical information is information that is vital for a company's proper functioning. As such, it can consist of information that is critical of a company's functioning. For a company to improve its performance or its governance, it must know in what ways its current activities fall short of its aims. Much of the damaging and counterproductive conduct of corporations occurs because people with critical information lack power, while those with power lack essential information. Organisations ignore whistle blowers at their peril.

Critical information systems²⁰ should ensure that managers and directors and owners are routinely confronted with, not shielded from, uncomfortable facts. Companies could therefore compete on the extent to which they made it more rewarding to identify and resolve problems than to ignore them²¹, and on the basis to which they used their stakeholders, particularly their employees and their customers, as a natural early-warning system. The entire marketplace could be employed to help promote good corporate governance.

To sum up, recent scandals provide no justification for government regulation to support corporate governance. Quite the contrary, the best way for governments to promote good corporate governance would be to stop preventing the free workings of the marketplace.

NOTES AND REFERENCES

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2. *Ibid.*
3. 'Silent watchdogs', Leader, *Financial Times*, 8 July 2002, p.18.
4. For an explanation and exploration of this concept of corporate governance, see Elaine Sternberg, *Corporate Governance: Accountability in the Marketplace*, Institute of Economic Affairs, Hobart Paper 137, 1998, especially Chapter 1.
5. Nevertheless, the UK DTI and Treasury are preparing to re-regulate in response to corporate scandals taking place in the US.
6. Biggs, Andrew G., 'Don't "Enron" Social Security? It Already Is', Cato Institute, 8 April 2002.
7. Criticised as 'insecure and unreliable' in a February 2002 internal draft Report by Colin Maynard of the European Court of Auditors; reported in Guerrera, Francesco and George Parker, 'EU controls over budget slammed as unreliable: Leaked audit report condemns 'waste of public funds'', *Financial Times*, 1 August 2002, p.1.
8. Even the Federal Reserve Bank now regrets the Glass-Steagall act; aimed at protecting depositors, it balkanised the US financial services industry for nearly six decades.
9. 'Tomorrow's economic argument', *The Economist*, 27 July 1996, p.21.
10. For example, the three year period that the Greenbury Committee recommended as the minimum period for assessing directors' performance promptly became the maximum. Plender, John, 'Hampel's rotten boroughs', *Financial Times*, 6 August 1997, p.18.
11. Since 1993, the direct compensation of corporate executives that can be deducted is capped at \$1 million a year, unless the compensation is "performance based". Options have typically been structured to provide a one way bet, further encouraging managements to engage in risky strategies.
12. SEC §240.14a-8.
13. "The business judgment rule gives directors a rebuttable presumption of correctness, meaning that anyone challenging a business decision has the burden of proving that it violated fiduciary standards. The courts will go to the greatest possible lengths to defer to directors' business judgment, unless there is a clear showing of fraud or bad faith." Monks, Robert A.G. and Nell Minnow, *Power and Accountability*, New York: HarperCollins, 1991, Chapter 3.
14. Bebchuk, Lucian Arye, John C. Coates and Guhan Subramanian, 'The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy', Harvard Law and Economics Discussion Paper No. 353, March 2002; available at http://papers.ssrn.com/paper.taf?abstract_id=304388.
15. In 1999, 19.6% of the UK equity market was held by company pension funds, and an additional 9.7% by unit and investment trusts and pooled pension vehicles; together they represented the largest category of investor. Paul Myners, *Institutional Investment in the UK: A Review*, March 2001, Table 1.1, p.27.
16. According to the Investor Responsibility Research Center. Reported in Henry, David, 'An Overdose

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17. Gompers, Paul, Joy Ishii, and Andrew Metrick, *Corporate Governance and Equity Prices*, NBER Working Paper No. 8449, August 2001.

18. The Company Law Review Steering Group, *Modern Company Law For a Competitive Economy, The Strategic Framework*, February 1999, Articles 5.3.18-19, pp.77-8 and *The Final Report*, June 2001, Volume I, Article 9.10, p.215.

19. Typically consisting exclusively of non-executive directors; this concept of the governance committee was discussed in Sternberg, Elaine, *Just Business: Business Ethics in Action* (second edition, OUP, 2000; first edition, Little, Brown & Co. UK 1994, Warner paperback, 1995).

20. For a description of the function, operation and structuring of critical information systems, see Sternberg, *Just Business: Business Ethics in Action, op.cit.*, pp.208-15, 224-6.

21. Though it should be recognised that it is better still for problems not to arise.