Law is never enough to guarantee fair practice
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Published: August 23 2002 5:00 | Last Updated: August 23 2002 5:00

Seismic waves from the collapse of Enron continue to rip through boardrooms across the world. The full story about the company's collapse has yet to emerge. But it is clear that Enron, once the envy of Wall Street, was using purportedly independent "special-purpose entities" to make transactions off the books that resulted in large financial risks and, eventually, losses. Once the transactions were properly accounted for, reported earnings plummeted. It became apparent that Enron had committed a massive fraud, inflicting huge damage on its investors and employees. According to Lynn Turner, the former SEC accountant, Enron common stockholders lost around $63bn, and the financial fallout continues.

What can managers learn from the disaster? One could teach an entire business school course on the case - from accounting malfeasance to pension fund law. I focus here on lessons related to the corporate governance of large business organisations.

**Law and ethics**

Business enterprises are socially constructed entities that bring together different interests under a common legal and economic structure for the advancement of the business as a whole. Inevitably, some people will care much more about themselves than the collective aims of the enterprise. In extreme cases, some people will have only their own interests in mind, despite the fact that they occupy high-ranking positions that demand fiduciary obligations to others.

In unscrupulous hands, rules and procedures that are designed to channel self-interest towards collective ends become merely obstacles to be overcome rather than norms to be followed.

Corporate law, securities regulation and accounting standards assume that most people agree implicitly to be bound by their rules. Yet given the inevitability of corporate "wrongdoers", to use US president George W. Bush's term, law and its enforcement are required.

Enron raises important questions of how corporate and securities law, as well as accounting rules, should be changed. The Sarbanes-Oxley Act recently passed in the US gives an initial answer. It creates an accounting oversight board, strengthens auditor independence, requires executive certification of financial statements, expands rules governing conflicts of interest and heightens criminal penalties.

At the same time, Enron shows that law is never enough. Good corporate governance, as my Wharton colleague, Nien-hê Hsieh, observes, requires business ethics at several levels: individual decision making, corporate culture and an overall understanding of a collective business purpose that balances different interests and values.

**Conflicts of interest**

Conflicts of interest are endemic to corporate organisations, and need to be managed through a combination of negotiations and bargaining, disclosures and approvals, and reliance on basic underlying rules of trustworthiness and fair dealing. Enron illustrates how checks and balances designed to manage internal conflicts of interest can fail. Its problems began at the top. The special-purpose entities were approved by the board of directors even though the board knew that Andrew Fastow, its chief financial officer, would stand on both sides of transactions. The prohibition of self-dealing in the company's code of ethics was repeatedly waived.

The US Senate committee of government affairs report on Enron found that the board of directors, including

its audit committee, had missed a number of other "red flags". For example, the board knew that the company was "pushing the limits" of legitimate accounting treatment of the special-purpose entities and their transactions, but approved them nevertheless.

Outside advisers also faced conflicts of interest. Accountants at Andersen were paralysed by the tension between their consulting fees and auditing responsibilities. Further, when Enron hired a law firm to look into reports about accounting problems, it called on Vinson & Elkins, which had been providing advice on the very matters in question.

In a large corporation, it is the chief executive's job to harness the different interests in the organisation to work for a common objective. The board and its committees must monitor the chief executive, and the shareholders must monitor the board. Everyone within a corporation and making transactions with it - including not only directors and officers but also other employees, creditors and shareholders - must appreciate the inevitable pervasiveness of conflicts of interest. An interlocking monitoring system is required to manage these conflicts.

**Limits of delegation**

Even where the Enron board understood conflicts of interests such as those presented by the special-purpose entities, it demonstrated another common failure in corporate governance: it did not follow through with recommendations and make sure they were implemented.

Complex corporate structures depend on various groups working together to monitor each other's behaviour. But such structures can break down when one part thinks another is doing the monitoring and vice versa. Enron's board made an exception to its corporate prohibition against self-dealing to permit Mr Fastow's role in managing the special-purpose entities on the understanding that both the chief accounting officer and chief risk officer would review and approve all transactions made by the entities. The board did not follow up, however, and the accounting and risk officers did not share the board's understanding of their new roles.

Enron's board also appears to have relied too heavily on outside accountants and lawyers. To some extent, it is reasonable for board members to rely on expert advice, but there are legal limits. Delegation cannot come at the expense of a director's duty to understand the nature of the transactions that are approved. Complex transactions sometimes make business sense, but complexity can also mask fraud.

**Leading and listening**

Managers should listen when subordinates tell them bad news. Too often, the easy response is to shoot the messenger. Instead, corporate leaders should encourage criticism and questioning from their employees and others - what another of my Wharton colleagues, Michael Useem, calls "leading up".

Kenneth Lay, Enron's chief executive, apparently failed to listen when Sherron Watkins, vice-president, warned of the accounting problems. (Or perhaps he already knew what she was talking about.) Two other executives told a board committee of the financial risks created by the special-purpose entities. An internal lawyer wrote to his superiors that it could appear that "the financial books at Enron are being 'cooked' in order to eliminate a drag on earnings that would otherwise occur under fair value accounting". Managers should resist the temptation to ignore warnings from below.

**Need for regulation**

Enron teaches that regulation must play an important and ever-evolving role in corporate governance. Some movement toward revised regulation after Enron has already occurred in the US. In addition to Sarbanes-Oxley, the New York Stock Exchange and the National Association Securities Dealers have called for stricter rules for independence of board members. Whether these reforms will prove to be sufficient remains to be seen.

At least, the recent scandals at Enron and elsewhere may serve to silence those who advocate deregulation as the highest good in corporate governance. The management problem is not only one of owners monitoring the "shirking" of agents. Regulation is needed also to prevent the "sharking" of self-dealing managers who subvert structures of power for their own gain at the expense of collective company interests.

Laws against self-dealing, insider trading, manipulation of accounting reports and other breaches of fiduciary duties are essential. The relationships of contract, property and agency in modern business organisations are too complex to rely on prescriptions of caveat emptor. Regulation beyond the enforcement of contracts and property rights is needed. The Enron-era scandals show that when corporate law does not keep pace

with underlying changes in the financial world, reform is needed and eventually will come.

**Global governance**

After Enron, WorldCom and so on, it is no longer possible to hold up the US system of corporate governance as the ideal for the rest of the world.

Previously, a few leading US academics had proclaimed "the end of history for corporate law". They said the Anglo-American model had triumphed over its competitors in continental Europe and Japan. After Enron, however, the Anglo-American model has lost lustre. History will continue with debates in different countries about where to strike the regulatory balance among managers, directors, shareholders, creditors and employees. Managers operating in different cultures will need to adapt accordingly.

Even though worldwide convergence on a US-style system is neither inevitable nor recommended, it would be wrong for those countries lacking a shareholder culture to cast out its best features. Public capital markets with broad participation in them remain the best hope for future global economic growth, with the proviso of effective regulatory oversight.

In the post-Enron world, new international rules for corporate governance will be needed. Perhaps the next generation can build on the lessons of the past - including Enron - to create a transparent and responsible governance system that will protect the interests of all corporate citizens.

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