Corporate governance after Enron: recommendation and legal responses

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Introduction
Between 1989 and 1995, Enron was named “America's Most Innovative Company” by Fortune magazine. It won various awards for its corporate citizenship and environmental policies. In 2000, it was also the seventh largest company in the United States, by market capitalization. Despite that, the company filed for bankruptcy in 2001. Enron came to be considered one of the biggest failures of corporate governance and to represent subsequent similar scandals.

The facts of the case, and Enron’s business and its corporate governance structure, including their changes over time are well described in many papers and articles (Palepu and Healy, 2003; Sridharan, Dickes and Caines, 2003; Gordon, 2002),¹ books (McLean and Elkind, 2004) and even an Oscar-nominated documentary (Gibney, 2005). This paper therefore will not examine the case itself, but rather will review how Enron, and subsequent large corporate scandals, influenced current theories of corporate governance and shaped the new legal framework.

There is a traditional dispute between the supporters of the stakeholder model and the supporters of the shareholder model of corporate governance. Stakeholder model supporters tend to view the Enron scandal as further proof of the unsustainability of the shareholder approach.

In contrast, advocates of the shareholder model argue that Enron only illustrates the importance of understanding the unique role of shareholders and of protecting their interests by minimizing the management’s discretion stemming from the stakeholder approach.

¹ Note the reference to the involvement of McKinsey and Company and the $2.6 billion exposure of J.P. Morgan described in Sridharan, Dickes and Caines (2003).
The first part of this paper examines the conflicting recommendations that arise from these different theories, and summarizes other recommendations that have widespread support. The second part briefly describes the legal response to Enron and subsequent cases. The situation of the USA and the UK is presented in more detail as developments in these countries provide the strongest, quickest and most illustrative examples.
Recommendations

Sachs and Rühli (2005), in line with others, support the stakeholder view of a corporation and point out that the shareholder perspective is too narrow to account for some aspects of knowledge-oriented businesses. They criticize the current incentives for management based on investors’ policies, and argue that such incentives do not consider the broader range of constituencies. They conclude that managers may need to change their values in order to better implement the stakeholder view in strategic thinking.

Sachs and Rühli (2005) hypothesize that the common feature of successful implementations of the stakeholder approach to corporate governance is the focus on the knowledge contribution of employees and their participation in the strategy creation process.

Also Tipgos and Keefe (2005) argue that employees must be recognized as key participants in the corporate process, instead of being seen merely as a production factor. They see the origins of the recent corporate scandals in the excessive power that is concentrated in the hands of top management. They argue that a new and revolutionary approach to corporate governance is needed; one that takes into account the current imbalance to prevent fraud in the future. To reach this goal a comprehensive structure of corporate governance is needed.

Tipgos and Keefe (2005) see the core of this restructuring of corporate governance as the empowerment of main constituencies—shareholders, directors, top management and employees—through a shared vision of the goals and objectives of the corporation. The role of the board in the new paradigm is to form and sustain a structure that ensures harmony and cooperation between management and employees while they pursue the company’s goals and objectives, as opposed to just officially authorizing management’s actions.

Ray (2005) sees a solution to the current problems of corporate governance in more heterogeneous boards that are elected in a more democratic fashion. He stresses the
importance of electoral competition and term limits. Furthermore, the board selection process should be simple, and nominations should be allowed by senior management, existing board members, employees and shareholders—employee nominations would require a petition supported by some reasonable portion of the workforce.\(^2\)

To justifying his theory that more democratic and more heterogeneous boards are the solution, Ray (2005) makes two essential arguments. First, he asserts that homogeneous and self-perpetuating boards are vulnerable to the negative outcomes of “group-think” and the limitations of dominant corporate logic.\(^3\)

Second, he argues that today’s corporations influence the lives of the general public through their impact on environment, their ability to change consumption patterns, their global operation, their employment practices etc., and thus, from the perspective of many who are affected, the economic future of the society may be shaped by board directors, who are nominated and elected without any formal process of representation or legitimacy.

However, there are opponents to the stakeholder approach. Norman (2004) criticizes supporters of the strong corporate social responsibility theory.\(^4\) He asserts that shareholders must be taken more seriously in the post-Enron era, and explains that shareholders have a special position among other stakeholders due to the fact that the return on the capital they provide to the company is not fixed. On the contrary, it depends on the performance of the firm.

\(^2\) In industrial companies with a large unionized labor force, a union representative might be a candidate for a board position, while in knowledge-based companies, employees could nominate independent candidates.

\(^3\) This is regardless of whether they are independent or not (the one of Enron, for example, was independent in nominal sense).

\(^4\) Advocates of strong corporate social responsibility demand that top executives should work for the benefit of all stakeholders even if this means reduction of profit and shareholder value. In other words, they see profit as a necessary condition for sustainability of the business, but they argue that it cannot be more important than the interests of other stakeholders.
Norman (2004) emphasizes that shareholders are not intrinsically more important than other stakeholders, because they “own” the firm, but rather, he says, they have a special position due to the nature of the contractual relationship they have with firm. In other words, shareholders’ interests are special based on corporate governance considerations, not based on resource ownership, and due to their “unusual” contractual position and incentive structure, shareholders are natural candidates to serve as the supervisors of managers who actually control the company’s resources.

Reacting to the corruption scandals represented by Enron, Norman (2004) argues that new ways of holding senior executives accountable in a stakeholder-oriented (multiple-objective) firm must be found. He calls for reducing the discretion given to the managers in choosing between profit maximization and multiple stakeholder benefits.

Norman (2004) alleges that the board of directors cannot effectively judge whether the top management is doing a good job if it does not have a specific exclusive measurable target. The standards for measuring improvement in some areas of stakeholder benefit are likely to be flexible, if not ambiguous. Therefore, the board has to assume that management is deeply committed to a corporate social responsibility mission. That, however, cannot be verified. Moreover, accepting the existence of moral hazard, the corruption of agents is likely to appear, in which case the program of multiple stakeholder benefits may become not only inefficient, but fraudulent.5

Despite the seemingly contradictory viewpoints there are recommendations that find support in both camps. Vinten (2003), for example, suggests that more attention be devoted to the proper induction, training and development of board members. He criticizes the old-fashioned

5 Norman (2004) refers to the old finding of political philosophers when suggesting that the governance system should not assume that it will be run by saints, but rather it needs to enable the board of directors to easily distinguish incompetent or corrupt senior executives.
view of directors who “were born not made” and asserts that directors should be mentored and
even certified and chartered through appropriate institutions.⁶

Along the same lines, Johnson (2002) calls for additional training to achieve a more
professional director role. He emphasizes that such professionalism should not create a class
of individuals who have the directorship as their sole occupation, but rather it should reflect a
process that educates directors to be effective shareholder representatives.⁷

In situations where board directors are ineffective, Johnson (2002) advises that institutional
investors find and nominate alternative candidates. He points out that if this approach is taken
by a sufficient portion of institutional investors, it could overcome current fears of changing
the established (bad) practices. Furthermore, the greater possibility of director replacement
could motivate nominating committees to try to find better candidates to begin with.

Another point of agreement seems to be the need for industry-sponsored research on corporate
governance. Vinten (2003) suggests that this is key to benchmarking good practice. Johnson
(2002) states that an interdisciplinary approach to corporate governance research could
identify, assess and evaluate:

- the impact of the investors’ investment horizon on a company’s success in creating
  and maintaining value;
- the employee retention associated with the use of stock options versus restricted stock;
- the impact the amount of time a director’s stock ownership interests are locked up has
  on his or her decisions;⁸
- the impact of term limits on the director’s responsiveness to shareholder interests;

⁶ He uses the Institute of Directors of the UK as an example.
Investment Board, University of Wisconsin, Harvard University, University of Chicago, Wharton, TIAA-CREF
Institute, Kennesaw State University, University of Delaware Corporate Governance Center as examples of
institutions which already provide director training programs.
⁸ That is, whether they are in line with the interests of the shareholders or the interests of the management.
- the impact of diversity of age, sex, race, income, and other factors on the effectiveness of boards in particular industries;
- what approaches that tend to make a new or dissident director most effective;
- the relationship between shared CEO/chairmanship positions and corporate governance failures;
- the effect of CEO compensation on CEO decisions and actions;
- whether directors are more effective if they regularly interact with shareholders;
- the implications of public disclosure of director votes on particular issues for board decisions; and
- the implications of the existence of a competing candidate for a director’s position.

A last recommendation with relatively broad support concerns publishing codes of ethics. Bernardi and LaCross (2005) surveyed a sample of 97 Fortune 500 companies in order to find out to what extent they publish their codes of ethics. They discovered that since the fall of Enron companies generally give increasing emphasis to the code of ethics, which can be seen as a positive development. There were also no significant differences in the disclosure rates between different industries. One surprising finding was that in 2002 none of the former clients of Andersen revealed ethics policies on their websites and even in the following years their level of disclosure was below the rest of the sample.
Legal responses

Based on the theories that were outlined in the previous section, different authors came up with specific recommendations to improve corporate governance and prevent failures such as Enron from happening in the future. For example, Johnson (2002) mentions requirements that directors own and continue to hold a significant amount of company shares during and after their functional term, term limits, proxy reporting on the track record of a director at other corporations where he or she also serves on the board, limits on the number of board posts a single individual can hold, splitting the position of CEO and chairman, requiring an independent director when the board performs any kind of self-evaluation, disclosure of individual directors’ votes on important issues (e.g., executive compensation, option expensing, appointment of auditors, merger decisions etc.), and finally adjusting director compensation appropriately to the devoted time and efforts.

These and similar suggestions are often reflected in the discussion about new laws and in the final legal framework itself. The collapse of Enron influenced policies related to corporate governance in many countries, but the strongest and quickest reactions were in the USA and the UK.

Morrison (2004) summarizes the main US legal responses. In the USA, corporate governance is regulated by several authorities. Corporations are subject to federal legislation, SEC rules and state laws. The most comprehensive reform of corporate governance law since the Securities and Exchange Act of 1934 was the Sarbanes-Oxley Corporate Reform Act of 2002 (SOA).

As Morrison (2004) notes, SOA is not a new code of corporate governance, but rather a set of statutory reforms concerning financial controls, auditing and accounting. In a nutshell, most of the provisions of SOA concern the independence of members of the audit committee, a ban
on auditors performing certain types of non-audit work, a revision of accounting standards for debts of special purpose entities, the disclosure of off-balance sheet transactions and the protection of so-called whistle-blowers.\(^9\)

According to SOA, the CEO and the CFO must also certify annual reports, and may face criminal penalties in cases of reckless certification. SOA also prohibits personal loans to directors and disgorges incentive-based compensations and stock sales profits if accounts are overstated. It also requires senior financial officers to disclose their corporate code of ethics. The first requirement demands greater accountability of top management, as recommended by stakeholder theorists, while the following two could be seen as revisions of the original shareholder model.

SOA does not address the problem of independent board directors, per se. Neither does it regulate equity-based compensation. These issues are however dealt with in the updated 2002 NYSE Listing Standards. According to which (1) the majority of the board should not have any material relationship with the company; (2) directors must hold meetings without managers present; (3) former employees of the company and its auditor must wait five years before serving on the board; (4) the audit committee must have sole responsibility for hiring the audit firm; (5) nominating and compensation committees must consist entirely of independent directors; and (6) shareholders must approve all share-based compensation.

Dewing and Russell (2003) summarize the legal responses to Enron and similar scandals in the UK. Long before Enron’s demise, the Cadbury Report of 1992 was the first ad hoc study that reacted to the rising importance of corporate governance. Its findings were incorporated in the so-called Combined Code.

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\(^9\) Whistleblowers are generally people who reveal wrongdoing within a corporation to the public or to those in a position of authority.
In 2002, Derek Higgs was chosen by the UK government to review the role and effectiveness of non-executive directors.\textsuperscript{10} The Higgs Report maintained the “comply or explain” principle\textsuperscript{11} established by the Cadbury Report. Furthermore, it made over fifty recommendations, of which Dewing and Russell (2003) consider the following as the most controversial: (1) a senior independent director should be identified; (2) at least half of the members of the board should be independent non-executive directors; (3) a chief executive of the company should not become the chairman; (4) the roles of chairman and chief executive should be strengthened; and (5) the senior independent director should attend a sufficient number of the regular meetings of management with major shareholders to develop a balanced understanding of the themes, issues and concerns of shareholders.\textsuperscript{12}

These recommendations aimed to improve the board’s autonomy, make the decision making process more transparent, and prevent conflicts of interest. One of the main criticisms was that the constraint that half the board members be non-executive directors could prevent the promotion of talented executives, and result in cumbersome boards and poorer company performance.\textsuperscript{13}

Critics also objected that the Higgs Report recommendations could result in the application a one-size-fits-all template to companies that are in essence different. However, considering the “comply or explain” principle maintained by the Higgs Report, this objection could be

\textsuperscript{10} The main issues considered by the Higgs Report included the role of the non-executive director, the chairman, the board of directors and the senior independent director; independence; recruitment and appointment; induction and professional development; tenure and time commitment; remuneration; resignation; audit and remuneration committees; liability and finally relationships with shareholders.

\textsuperscript{11} The principle requires listed companies to report on whether they comply with the detailed provisions of the Combined Code, and if not, then they need to explain why not.

\textsuperscript{12} The senior independent director should then communicate these views to the non-executive directors and to the board.

\textsuperscript{13} Dewing and Russell (2003) quote the results of the study conducted by the Henley Management Collage, which found a negative relationship between the representation of non-executive directors on the board and the company performance.
dismissed because it is after all up to the companies to convincingly explain to the shareholders their deviations from the Combined Code.

In September 2002, another group chaired by Sir Robert Smith was set up to review and develop rules for audit committees to be included in the Combined Code. Based on both the Higgs Report and the Smith Report, the UK government delegated the Financial Reporting Council to take the reports’ recommendations into account when drafting the new Combined Code.

The response of policy makers and public authorities to the collapse of Enron and subsequent scandals could also be seen beyond the USA and the UK. Leeds (2003) writes that the European Union considered tighter regulation of auditors of public companies, new codes of conduct for securities analysts, and new rules for dealing with financial derivatives. In Germany, the Finance Minister proposed the creation of a special task force to fight accounting fraud and to better protect private pension funds investors.

Corporate governance issues also rose in importance in developing countries. The OECD\textsuperscript{14} published the Principles of Corporate Governance to develop the foundation for internationally acceptable corporate governance standards and practices. According to that document, a high priority should be placed on the interests of shareholders, as recommended by Norman’s (2004). The principles covered in the OECD document also became the agenda for roundtable meetings with high-level policy makers and business leaders in Central and Eastern Europe, Asia and Latin America organized by the International Finance Corporation.\textsuperscript{15}

\textsuperscript{14} Organization for Economic Cooperation and Development
\textsuperscript{15} International Finance Corporation is an affiliate of World Bank.
As Leeds (2003) notes, scandals represented by Enron, can have the positive impact of increasing the public’s awareness about corporate governance. It seems there is no longer a need to explain what is meant by corporate governance regulation and why it is important. Leeds (2003) suggests that better-informed and more alert stakeholders have at least the same potential as new legislation to increase the level of integrity in the marketplace.

Leeds (2003) also observes that the recent scandals served as a reminder that even a well-functioning market economy must constantly strive to balance private and public governance responsibilities. Well-designed and enforced legislation defines positive and negative incentives, to encourage behavior that strengthens the fair and efficient operation of the marketplace.

At the same time, personal integrity, good judgment and other essential qualities cannot be prescribed by law, but must be embedded in managers. Tipgos and Keefe (2005) support this idea. They say that although legislation is important, it cannot prevent management fraud. Fraud can be only stopped by the management itself, and corporate executives and their advisors have a vast public responsibility similar to civil servants.
Conclusion
Enron’s failure initiated broad debate not only over what went wrong, but also over how to revise corporate governance standards. While some authors see flaws in the current prevalence of the shareholder model and support a broader application of the stakeholder model, others argue that the shareholder perspective is more important than ever before.

Advocates of the stakeholder model focus on the knowledge contribution of employees and call for their participation in the strategy creation process. They further stress the importance of eliminating of imbalance between top management and the remaining constituencies, and of a shared goals and objectives. Finally, they maintain that corporate boards should be more democratically selected and should more broadly represent those whose lives are impacted by the company’s business.

Some critics of the strong corporate social responsibility theory object that the discretion given to the managers in choosing between maximizing profit and other stakeholder benefits causes inefficiency and stimulates fraud. Advocates of the shareholder approach explain that shareholders have a special position not because they “own” the firm, but rather because of the special nature of their relationship—the rate of return on the capital they provide depends on the firm’s performance.

However, there seems to be a consensus on several issues. Enron’s case highlighted the importance of properly inducting, training and developing board members, and also the importance of allowing institutional investors to find and nominate replacements for ineffective directors. Company-sponsored research on governance has the potential to create benchmarks for good practice, and publishing a code of ethics could be the first of such good practices.
The fall of Enron and subsequent large corporate scandals provoked a relatively quick response from policy makers all over the world. In the USA, the Sarbanes-Oxley Corporate Reform Act became the most comprehensive reform of corporate governance law since the Securities and Exchange Act. It requires greater accountability of top management and revised the original shareholder model. In the UK the recommendations of the Higgs and Smith Reports were used by the Financial Reporting Council to draft the new Combined Code. Among other issues, the reports addressed the independence of corporate boards, the transparency of decision making and the prevention of conflicts of interest. In order to develop a foundation for internationally acceptable corporate governance standards and practices, the OECD published the Principles of Corporate Governance.

Higher public awareness can be seen as a positive result of high-profile corporate failures and it can be argued that better-informed and more alert stakeholders have at least the same potential to bring more integrity to the marketplace as new legislation.

Enron’s collapse teaches us that even well functioning market economies must constantly adjust the balance between private and public governance responsibilities. An appropriate legal framework is indispensable, but qualities such as personal integrity, good judgment and ethics can be only be partially influenced by law.
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