

AFTER ENRON: AN AGE OF ENLIGHTENMENT?

Simon DEAKIN (University of Cambridge)

Sue KONZELMANN

The fall of Enron has again focused attention on the failure of mechanisms of corporate governance to protect investor interests. However, financial scandals of this kind are nothing new, particularly in periods of 'correction' following stock market bubbles. Moreover, there is no consensus on the wider implications of the Enron affair. Three distinct positions might be taken.

According to the first, Enron's collapse simply tells us that the existing corporate governance system is working. Once the company's plight became clear, the markets responded accordingly, marking down its stock value. The reputational damage to its senior managerial team and to its auditors, Arthur Andersen, provided appropriate sanctions for mismanagement and any breaches of fiduciary duty which may have occurred. Enron's bankruptcy will provide the opportunity for its assets to be shifted to more efficient uses and a new managerial team to take over. On this basis, there is nothing to be gained and much to be lost from regulatory reforms.

The second point of view is more skeptical. It acknowledges that some groups were harmed by Enron's fall, in particular certain outside investors (often representing the interests of present and future pensioners) and above all the company's own employees, many of whose pensions became almost valueless. The company's corporate governance exhibited serious failures of monitoring, which can be traced back to conflicts of interests on the part of board members and of its auditors Andersen. This view implies that changes to corporate governance rules are needed. These might include regular rotation of auditors, a strengthening of the role of non-executive directors, and increased rights to

information on the part of shareholders. Through these relatively minor adjustments to the regulatory regime, similar collapses can be avoided in the future.

The third view offers a radically different explanation for Enron's fall. It holds that Enron's business model exemplifies the pathology of the 'shareholder value' system which became dominant in the 1990s. The company's focus on short-term stock price appreciation, in large part the result of the share options granted to senior management, was the cause of its downfall. It was this which led to the use of 'special purpose entities' to conceal debts and artificially inflate the value of the company's stock. In pursuing an 'asset light' strategy at the expense of long-term growth, the company placed itself at risk of implosion once the business cycle turned down, as happened in the course of 2001. From this perspective, the fate of Enron is less important than the future of the business model which it came to represent. Unless the regulatory framework is adjusted to make this model unattractive, it will only be a matter of time before the same approach is tried again.

This third interpretation of events goes to the heart of the matter as far as Enron is concerned, and explains why this particular case has given rise to such widespread concern. If we are to take it seriously, nothing less than a fundamental rethinking of corporate governance practices and procedures is required. Above all, corporate governance must no longer confine its analysis to the relationship between managers, boards and shareholders. The narrowness of this focus is a major contributing factor to the present round of corporate scandals of which Enron is the most emblematic.

The case for shareholder value as the lode star of corporate governance was made by financial economists in the early 1980s as a means of minimizing agency costs arising from the separation of ownership and control. Contrary to what is often supposed, it did not derive from legal conceptualizations of the duties of company directors. These tend (still) to be framed in open-ended terms which provide management with considerable discretion in balancing the interests of different stakeholder groups. However, there is no doubt that, at least in the American and British systems, a norm of shareholder primacy

gained ground in the 1980s, initially as a result of the rise of the hostile takeover as the basis for a 'market in corporate control'. In the 1990s, this was reinforced by the growing influence and power of institutional investors (principally the pension funds). Novel accounting metrics, measuring corporate performance by reference to 'economic value added' and 'return on capital employed', expressed the new philosophy very clearly, as did the linking of managerial pay to stock price movements through the use of share options. The composition of the senior managerial class itself began to change, as companies increasingly prized financial skills and deal making above organizational ability and applied professional knowledge.

The implications for employees were far-reaching: restructuring and downsizing, once thought to be a sign of corporate weakness, became instead the source of share price gains. How far these gains were made as a result of improved efficiency in the use of productive resources, and how far they represent the effects of particular accounting conventions, remains hotly debated. What is not in dispute is that these changes put the post-war 'social contract' between labour and management under unprecedented strain.

Enron simply took the logic of shareholder value to its extreme. Its particularly aggressive approach to mergers and acquisitions, the unique 'rank and yank' system of employee appraisal, and the sheer scale of the stock options granted to senior managers, may have marked it out from its rivals. But in its essential respects, the path followed by Enron was no different from that being pursued by many other apparently successful companies during this period. This may help to explain the wider, negative stock market response to the revelation that Enron's strategy was built on sand.

If Enron's fall was the inevitable consequence of its rise, the question of what comes next is a pressing one. Tinkering with rules on conflicts of interests is unlikely to be the answer. There is already a substantial body of regulation on this issue, but it does not seem to work very well. It is far from clear that Enron's senior managers committed any legal wrongs in the course of the years and months prior to its collapse. Although the contracts made with the special purpose entities involved 'self-dealing' of the kind which

is closely scrutinized by corporate and securities law, these arrangements may well have passed tests of adequate disclosure. While board members may have been mistaken, with the benefit of hindsight, in waving through these deals, it does not follow that individual directors breached the duty of care they owed to the company; the protective 'business judgement rule' will ensure that as long as they acted in good faith, they cannot be held legally responsible for the consequences of these decisions. Breaches of fiduciary duty, or worse, may emerge in due course. The wider question is whether existing corporate governance mechanisms are sufficient to deal with the true mischief which Enron represents.

One lesson of Enron is that a regime based on disclosure can only take us so far. A possible direction of change is to restore to managers something of the autonomy which company law once sought to provide them with. This is not as counter-intuitive as it might seem. In the UK, the recent governmental review of company law proposed that company boards should aim to achieve 'enlightened shareholder value'. According to this notion, it is by balancing the interests of the different stakeholder groups in such a way as to promote voluntary cooperation between them, that the board can best promote the long-term interests of the shareholders. This also implies a redefinition of the shareholder interest. The ultimate beneficiaries of pension funds and insurance policies have a long-term interest in the sustainability of the system, a point which is being taken on board by a small but growing number of fund managers who regard the break-up strategies of the 1980s and 1990s with skepticism and seek to engage actively with management to promote long-term growth.

The argument that managers should be accountable to shareholders alone, leaving other economic and social interests to protect themselves through the interplay of market forces, is at the root of present difficulties in the Anglo-American systems of governance. It is not too late to revise this point of view, which is both more recent in origin and less institutionally embedded than is generally supposed. But if Enron's fall is to usher in a new age of enlightenment, a profound reassessment of recent orthodoxies is required.