

**BAR ASSOCIATION OF THE CITY OF NEW YORK**  
*COMMITTEES ON CORPORATION LAW & ON MERGERS & ACQUISITION*

**Corporate Governance Post-Enron**

**Remarks of William T. Allen**

Jack Nusbaum Professor of Law & Business  
*Director* NYU Center for Law & Business  
Of counsel, Wachtell, Lipton, Rosen & Katz

APRIL 1, 2002

I have been invited to talk to the illustrious City Bar Association about matters of corporate law – which generally means in the circles in which you and I travel, Delaware corporate law and federal securities law. My thought, when invited, was that I might talk some more or less recent Delaware decisions of note – particularly the most recent iteration of *Emerald Partners* by the Delaware Supreme Court and the interesting *Siliconix* case in the Court of Chancery. But events intervened. As I started writing out the talk I found myself compelled to address the topic of corporate law and corporate governance from a wider perspective. I resisted this urge of course. But in the end my resistance gave way. Forgive me. Enron made me do it.

Thus I have entitled these remarks Corporate Governance Post Enron. What I really want to talk about is what the systemic governance failure that Enron represents tells us about our system and about what changes we need to make and what changes we should resist making. In short I found the topics that Enron raises are too fundamental and the Enron failure itself is too compelling a narrative to ignore when we come together like this to talk about corporate law.

The fact that legal regulation of the organization, financing and governance of our large corporations present questions of compelling public interest can be evidenced pretty well by the fact that the greatly respected Chairman of the Federal Reserve Board, Alan Greenspan, appeared last week at his alma mater, NYU's Stern School of Business, and chose as his topic the subject of corporate governance. It was the first time that Mr. Greenspan had addressed this topic.

Dr. Greenspan's usual concerns of course are with the banking system, the money supply, inflation and, the direction and level of economic activity generally. What happens *within* in firms, in their compensation policies, in their marketing or M&A strategies, in the preparation of their financial reports, or at shareholder or board meetings were, until recently, not subjects that seemed to be on the Chairman's radar screen. But the Enron case changed that. That case powerfully demonstrates the inter-relatedness of corporate law, financial disclosure and accounting and the regulation of capital markets. Thus in his talk Chairman Greenspan properly moved beyond questions of CEO power, the role of independent directors and the problems of option compensation, when he addressed the topic of corporate governance.

Of course when the Chairman speaks others listen. In this instance he offered words of advice to Congress as it considers various legislative reactions to the Enron debacle. He also had words of advice for others who have a hand in shaping and operating the corporate governance mechanisms that play an important role in our capital market centered brand of capitalism.

The advice you may not be surprised to learn was to encourage moderation. Both moderation in any fixes that we design and moderation in our expectations of what independent directors can do when markets are "irrationally exuberant" -- although he did not use that famous phrase again. Chairman Greenspan's talk and his advice provide a useful place to begin in considering the topic of corporate governance today and what the Enron debacle discloses about our system of corporate governance.

The debacle of Enron has single-handedly riveted public attention as nothing since the great depression has done on the adequacy of our system of corporate governance, of financial controls, reporting and disclosure and on related aspects of the capital markets. At this moment a host of congressional committees are considering legislation to effect one set of changes or another, -- in fact, Senator Joseph Lieberman, Chair of the Senate Government Affairs Committee, spoke at the NYU Center for Law &

Business this very morning on this topic. The SEC is of course fully engaged. It has rule proposals in the works to address issues of the governance of the auditing practices; SROs like the NYSE and NASDAQ are issuing amended membership requirements or rules to mitigate problems that Enron's story disclosed; FASB has been stimulated anew; some investment banks, growing a little warm from the heat generated elsewhere, are making modest changes in the operations of their analysts, and even the American Institute of Certified Public Accountants, which some think has fallen to the status of a mere trade association, is seeking to be seen as a source of helpful professional reform. And corporate lawyers are trying to advise their clients as to how audit committees may safely and effectively function in this environment of unclear expectations. In all of this there is promise of useful reforms and of course the threat that we may over-react and limit the flexibility of a system that has it should not be forgotten been the marvel of the world for a century.

It is not surprising that all of us are fixated on this story. It is a compelling drama of human weakness – of greed, of cupidity, of misplaced reliance, and of injurious human loss: the loss of jobs, of savings and of reputations. While our reactions to this story of loss tend to fall across a

fairly wide range, at the polar positions of this range I think I see these two positions.

The first may be thought of as the somewhat jaded, man of the world response. "Fraud - so what is new. Fraud happens. Enron is a case of some clever, bad people lying, cheating, and stealing. It is only unusual in the complexity of the misrepresentations and in the size of the damage wrought. But (in this view) it is just a fraud. We can never eliminate fraud completely and there is no really persuasive evidence that fraud is systematically greater today than it was at any point over the last century. It probably is less". Thus this view sees no persuasive need for significant change in the ways in which we regulate financial markets and corporate governance.

The second polar reaction tends of course to see this event as seismic, as a systemic default that exposes previously unrealized weaknesses. In this view Enron is not just the hundred year flood of fraud but is in fact a warning that there are fundamental weaknesses that require immediate attention. In this view we need to make some fundamental changes in the way auditing firms are organized and governed; we need to make some changes in the way that investment banks do business; we need to look closely at the coherence and informativeness of our accounting rules and

principles and in the way they are established; and we have to look critically at the law governing the internal affairs of corporations.

Most of us I guess would locate ourselves someplace between these views, but we all I think can identify which of the polar views is closer to our own. For me, while the Enron story is undoubtedly a story of human weakness, it is a story of institutional weakness as well. From an institutional perspective, I think it is principally a story of weakness in our regulation of the auditing industry. But it is also an exemplar of weaknesses in our regulation of employee pension investing, in brokerage practices in banking and in board practices. Perhaps most fundamentally to my mind it is evidence of *the contemporary failure of the ideal of independent professions as self-regulating groups capable of accepting an obligation to constrain as well as to facilitate the desires of their clients.*

So I share Dr. Greenspan's desire not to see regulatory over-reaction, but I do not share the view of others that Enron was just the perfect storm – an ordinary deception by self-dealing men magnified in effect by an unusual congruence of circumstances. I don't think so! This was not just a case of a handful of clever persons enriching themselves through lies or self-dealing. What makes this failure so significant to me is the way in which it exposed

*the willingness of professionals at all points of the system to enable the frauds.*

Jack Bogle, who is a wise and wholly unbiased observer of the financial markets recently referred to the happy conspiracy of everyone to keep stock prices high.

*CEOs and senior management* are incentivized by options to take risks to raise stock price. The nature of these incentives would cause them to prefer greater risk than fully invested shareholders;

*Audit Firms* – who over the last two decades have come to think of themselves as partners of their clients in the business of value creation – have an incentive to co-operate within the limits of their imagination and the law to keep stock price up. This incentive of course comes in the form of increasing flows of fees for assorted services

*Investment bankers and their brokerage affiliates* – have incentives in the form of issuer commissions and fees – to keep issuers happy. Recent studies for example have shown the astonishing disparity between buy and sell recommendations. Reported growth rate predictions by analysts can be shown to be systematically optimistic by a very considerable amount;

*Even lawyers* who in modern times feel able to own shares of their clients stock – and in some cases take options I think as compensation – can be enlisted into the happy conspiracy.

And what is surprising about everyone wanting the good times to roll? It would be more surprising if we didn't. But our social interest is in accurate stock prices not in collective fantasy. Collective financial fantasy is dream that will turn into a nightmare. So Jack Bogle is right to call our attention to the network of professionals who make money because stock prices stay high. And in Enron we see a precursor of what could happen systematically if our financial reporting, capital market regulation and corporate governance mechanisms atrophy while the professions exercise their collective intelligence to try to keep the signal of health stronger than the patient really is .

To a significant extent the actual operations of these systems are dependent on the work of professionals. I want to focus for a minute on them and especially on the role professionals played in the Enron collapse. Auditors, lawyers, commercial bankers and brokers were not actually co-conspirators in the frauds that ultimately brought Enron down, but they all had strong financial incentives to please Enron and all of these professionals exist in a sufficiently ambiguous moral and legal context to become willing

enablers of the wrongs. They professionals exercised their technical knowledge with great imagination to cumulatively enable the Enron insiders to perpetuate a massive deception. I suppose it is naïve to believe that they were misled or fooled. They were, I think, gaming the system and were unable to see when they crossed over a line separating imaginative flexibility from participation in a fraud. Each of the professionals sought *plausible deniability of actual wrongdoing and presumably all believed that they succeeded in achieving that state of grace.*

But the fact remains that every system that investors, workers and creditors thought was in place to monitor management performance failed or more accurately was co-opted – was rocked to slumber by the soft rhythm of profits. Let me go through a list.

The corporate board at Enron was filled with important and influential people. They were “incentivized” by options and comforted with fees. Options have been the hero in the governance stories told by a lot of corporate governance mavens over the last few years. They will align managers with shareholders and thus reduce the core “agency problem” of management. Well yes stock ownership by management would be a good thing all others things to one side, and options instead of shares might be a useful substitute for stock for tax reasons. But we have not paid enough

attention to the serious agency problems that options can create. An option holder – especially one that may get a replacement grant if the stock drops below his strike price – has a much greater appetite for risk than has a shareholder with an investment basis in the stock. Wholly apart from the accounting problems that options have under today’s politically mandated system, this incentive inconsistency is a serious problem in, my opinion with some CEO grants of options and may be a problem on some boards as well. In all events, whether their options mattered or not to them the handsome board in this instance appears to have asked no tough questions and generally seems to have acted like window dressing. Unimaginably complex financial statements were reviewed in hour long audit committee meetings! Conflict of interest prohibitions were waived for weak reasons and thereafter the conflict transactions permitted were not monitored. Clearly the Enron board failed one of the major tasks that in theory the board is supposed to do – that is to understand the major risks that the firm faces and assure that controls respecting those risks are in place.

In the short Board meetings we have read about it does not appear that the board members were skeptical, probing and alert, as we would want them to be. They failed to ask the difficult questions. They accepted all that they were told and they don’t seemed to have been told all that much. They

seem to fit the self-description of T.S.Eliot's Prufrock, who was, "a lesser lord, deferential, glad to be of use".

Clearly in this instance the relevant board committees have no reason to be proud of their service. Whether liability is a high risk or low I will leave to others, but the shareholders would have wished for more than a board that avoided liability for breach of its duty of care. They would have wished for insight premised on knowledge and informed action based upon character and courage. What they and the workers and the creditors got, instead it seems, was standard, compliant advisors of senior management. Investors and others would have wished for a director who would have had the courage, when he knew for example that the so-called Raptor hedging transactions were without economic substance and were done entirely for financial statement effect to have raised an alarm in the board room. Without these transactions stock price would have fallen – and he would have been unpopular. But stock price should have fallen. If it had done so properly all along the company would not be in bankruptcy in all likelihood. But there was no hero on this board.

But the board failure was facilitated by the even more important failure: that of the public auditors. Boards, even when diligent and expert, cannot alone be expected to understand the details of the financial and

operating risks a firm faces. The board must rely on information brought to it by loyal agents.

Even an audit committee that is pro-active and alert cannot, independent of its advisors and corporate officers, bear responsibility to detect overly aggressive accounting or fraud within the firm operations. Principally directors must rely on officers and most importantly on the internal and external auditors. But while the Enron directors disappointed the grander hopes of those who want and expect boards to make a contribution, unquestionably the public auditors bear much greater responsibility for allowing this distressing narrative to develop and for the pain and injury that was caused.

Of course we do not know everything and never shall. A trial would provide the most reliable evidence, but report of a special board committee chaired by William Powers, the Dean of the University of Texas Law School -- lays out enough to let us know some of what went wrong. It seems very unlikely from that Report that the auditors were simply the first victims of deceptions practiced by the senior management. Rather they appear to be the principle enablers of the fraud. The auditors were not the primary designers of the off balance sheet transactions that hid the truth from the market, but they understood them; they were paid consulting fees with respect to the

design of the more significant partnerships. Some of these transactions were transparently designed to have no substantial economic effect at all, but intended to have a significant accounting effect. None seemed to have been at arm's length as intended. At best the auditors were compliant. At worst they were conscious manipulators intent on stretching principal to its ultimate point – which is a recipe for the disaster that followed.

But the auditors were not the only professionals that failed. Look at the banks. In finance theory it is conventionally believed that commercial banks add value in part because they monitor their debtors more closely than other providers of risk capital. In this monitoring role they can be seen as part of the capital market controls on weak management. But in this instance commercial banks are exposed as willing enablers of deception. Look at the swap transactions that have been discussed in the press in which a major bank agreed to camouflage substantial loans as off setting oil or gas swap transactions. As reported there was no underlying economic substance to these swap contracts at all. So why did the banks agree to them? The banks book the transactions as loans, but they enabled Enron to run them through its income statement as income and off setting expense. Did the lenders not understand that they were enabling a deception?

How about the investment banks? In theory information is disclosed in financial statements and sophisticated professionals analyze it and make recommendations to investor clients with respect to buying or selling securities. Of course the brokerage firms that supply this service also supply investment banking services to issuers, in which they make handsome fees. The obvious conflict has been recognized for years but managed with internal rules – Chinese walls – that are supposed to keep assure the integrity of each function. This fiction is getting increasingly difficult to accept. The investment banks of course were collecting fees from Enron for distributing their securities or providing other services and their analysts were recommending that their retail customers buy Enron’s even as the firm sank beneath the weight of its hidden bad investments. Last week in a fairly illuminating little detail, the press carried a story of a broker who worked for an investment bank that had had an advantageous relationship with Enron. This broker managed retail accounts for some Enron employee. A few months before Enron went not so “gentle into that dark night,” this broker concluded that there was great risk in the stock and so advised his clients. An Enron officer in charge of the relationship with the bank was outraged when he learned this. He complained immediately and in strong terms to senior bank officials. The senior bank official wrote an abject letter of

apology and immediately fired the broker. And this, as every experienced lawyer knows, is the way of the world.

Must difficult for us to know or understand is the role of the companies lawyers. We lawyers are proud of our ideology of loyalty to our client and zealous advocacy of the client's legitimate aims. The zealous advocacy ideal inspires us to exercise diligence and imagination in the construction of plausible stories to defend our client in court. That same ideology can, however, lead business lawyers and their clients into trouble when it inspires "aggressive" legal advice in planning transactions. We can easily see where our skills of argumentation can lead when deployed in transaction planning, if we look at the scandal of tax shelter design and marketing. This mentality of deploying legal imagination aggressively to assist clients to reach out to the far limits of the letter of the law, when a reasonable interpretation would tell us that the spirit of the law is violated is exceptionally dangerous. For those of you who know the Enron case, we wonder if – in the case of the off balance sheet entity known as the Chewco Partnership—the bogus legal arrangements that was meant to evidence the commitment of 3% of that entities capital as equity were blessed by lawyers. If so they were acting very aggressively and in fact assisting the perpetration of a fraud on those who chose thereafter to become Enron investors.

The lawyers role in corporate governance is of course very different from the auditors whose loyalty ultimately should be to the users of audited financial statements. But lawyers too have an obligation to exercise independent judgment on the clients behalf. Their duty is not to be enablers of every client desire but to be counselors and defenders.

## II

An overarching question of great importance that the failure of Enron raises is just how widespread are the sort of “aggressive” or “imaginative” financial reporting-driven transactions that were at the heart of the Enron deception. Unhappily we are given suggestions everyday that perhaps the fundamental forces at work in Enron have been at work elsewhere as well. When investors read for example as they did last week about Quest engaging with Enron in broadband capacity swap transactions that appear to have had no real business purpose, they doubtless wonder how reliable are the earnings reported in other firms. The signs are out there that Enron may be an extreme example, but that "management" of earnings became too aggressive in the boom of the late 90s. Already the markets are reacting to that inference. In a sense that is a good thing. One of the strengths of markets is their tendency to be self-correcting. But it also a worrying fact if markets have begun to distrust to even a small degree the accuracy, honesty

or relevance of financial reports. In the theory of investments, stock price represents the impounded value of expected future cash flows discounted to present value by a discount rate that reflects the risk associated with the cash flows. Everyone understands that, even when done in the utmost good faith, predicting future cash flows is a very imperfect business. One looks at historic experience, estimate future changes and makes an estimate. In recent years I suppose that while our market participants attempted to price all of the macro and firm specific risks that the business world presents, there was impounded in stock price little or no discount for the quality of the numbers presented in audited financial statements. The Big Five were in effect a single brand and the market trusted the numbers to which they affixed their attestation. But if the market now builds in a new or higher discount for the reliability of the numbers, the costs of capital will rise through out a major part of the economy. This is a serious matter. So it is no wonder that Dr. Greenspan is taking an interest in the complex of controls that he refers to as corporate governance.

### III.

In the end the Enron collapse raise to sets of questions for us. The first is what does justice require? That is, who should be prosecuted and for what offense? Who should be compensated and by whom and in what

amount? These questions are not at all standard questions since they entail such grievous losses and such significant consequences. I have nothing to say respecting the first set of issues.

No less important are system or regulatory questions which are in all of our minds. Certainly this event calls for changes, but what changes and to which parts of the system and what changes are appropriate?

The most pervasive or deepest source of system failure in my mind relates to the wide-spread failure of professions, who it might be thought appear no longer willing to exercise constraint in the pursuit of client and self interest. The source of systemic failure here is not I think any deterioration in the moral quality of persons in these firms, but lies in the much more competitive environment in which bankers, lawyers, accountants and others practice their "profession." Forty or even thirty years ago these professions were protected from competition to a substantial degree. The buffer that professions long enjoyed from the sharpest winds of price competition have been on continuous assault for a long time. Fixed commission fees, a ban on lawyer advertising, legally enforced separations of activities all of these helped these professionals view themselves as somewhat outside of the "morals of the marketplace" to use Cardozo's famous phrase. But as we have eroded these professional privileges we have

in effect forced professionals into an ever more commercial view of their activities. In this world, success is more likely to be measured by the single statistic of earnings and professionals drift into seeing themselves as partners of their clients in the business of value creation.

We are unlikely to reverse our long-term drift towards freer markets as a mode of organizing economic activity, nor should we. But nevertheless we can now be more cautious of steps to further commercialized professional services. Post Enron, I suppose we will not hear so much about the multi-service firm which will join auditing and law for example. And we will see more pressure to build audit firms that are free from the apparent temptation that additional lines of business can create.

But there are more targeted things that can be done. In my view the most obvious set of reforms would deal with regulating the auditing process and the establishment of standards for that process. Because I served as chair of the ill-fated Independence Standards Board, this is a subject with which I am somewhat familiar. We certainly need a new and better technique to govern the independence and quality control of audit firms. The SEC is considering the design of a new system now. It is wise that the SEC proposal contemplates a high level board appointed through a public process and funded with mandated fees from public companies and audit firms. The

board should be comprised predominantly of financially sophisticated persons with allegiance to investors. Chairman Pitt's proposal is a sound step in the right direction. It should go further however. The new structure should also include limited authority over the Financial Accounting Standards Board and the Auditing Standards Board. It should also re-establish an Independence Standards Board. The issues of accounting standards, auditing standards, and auditor independence standards are not issue that turn on simply controlling conflicts of interest. They go much deeper. They present issues of daunting intellectual complexity and of enormous public importance. They should not be left solely to professional self-regulation nor should they be delegated to government agents who inevitably are subject to more or less direct political pressures.

#### IV.

Let me skip over the issues that are presented by financial intermediaries activities in the Enron failure, because on this topic I am an amateur. And let me turn to the role of the Board of Director and the ability of the corporate law to make a further contribution to good governance. Plainly the Enron board did not act as an effective monitor of Enron's

complex activities to manage its reported earnings. Are there changes in corporate law or practices that can reduce the risk that another Enron will descend upon us in the future.

I am very skeptical that there is any change in statutory or regulatory law that can in fact make boards more effective monitors of management. Statutes or regulations written at one point and more or less frozen in that form for a long period are simply to blunt an instrument to optimally deal with the subtle problem of director incentives. Certainly Secretary O'Neill's suggestion that the liability standard for directors be changed at the federal level to that of simple negligence would likely be counter-productive. It is not in the social interest to dissuade competent successful people with business experience from serving. Nor do I think including in federal legislation duties for audit committees is a sensible approach.

The changes in audit committee expectation that we have witnessed over the least couple of years are a positive thing. But some of the newer practices may exist only on paper. The audit committee charter of Enron looks, roughly, like a state of the art document. But we know that the impressive lists of duties occupied the directors for less than a couple of hours at their quarterly meetings. And this despite the fact that they were dealing with an exceedingly complex financial institution. It is true that the

auditors appeared to have failed the audit committee in this instance, but it also appears true that the audit committee did not did not delve the way we would have hoped.

How can we get better assurance that that which is supposed to be attempted is attempted in good faith? I do not think it is beyond the power of courts to send a signal that we get the attention of corporate boards. And my expectation is that some such signal will sent at te first available opportunity. The Delaware courts can be expected to proceed cautiously and moderately in delivering a message to boards. Caremark was perhaps the last such message and it endeavored to deliver its message without strong liability threat attached. In my opinion this is the appropriate way to demand greater attention and skepticism from boards. But in the end if clear statements of obligation alone go unheeded ways will be found to force greater attention.

This of course is a risky strategy because it would be easy to discourage people of means from board service altogether. And Enron while does evidence a system failure, it does not itself establish that audit committees generally, or boards generally, have defaulted from the higher expectations of investors. But it is one dramatic data point!

Other ways for increasing assurance that board obligations of attention and independent judgment are being attended exist. Institutional investors, especially the most thought of them such as TIAA-CREF can be counted upon to support responsible best practice standards that are both more expertly crafted than judicial statements and more subject to adjustment when shown to need amendment.

The failure of the Enron board to be the heroes that might have saved investors, workers and creditors from some of the massive loss that has been suffered, does not alone justify fundamental change in the system of board governance and shareholder rights that our system has evolved. Progress in the evolution of governance has been made and more will be done. Perhaps the separation of the CEO's board role from that of Chairman should be tried in some firms, even though this is the least popular idea with CEOs. In the end however we cannot reasonably believe that through legal regulation we can force or incent directors in large numbers to be the sort of heroes that we would have wished had sat on Enron's board. Articulation by authoritative voices such as courts of the nature of the duty in general terms and more textured best practices standards from responsible agents of institutional investors – coupled with zealous protection of voting rights by courts – is the

best long term strategy to allow this part of the overall complex of governance constraints to make its contribution.