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Symposium
Enron and the Future of U.S. Corporate Law
and Policy

Comment
***496 ENRON AND THE NECESSITY**
OF THE OBJECTIVE PROXIMATE MONITOR

by
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[Introductory note: Charles M. Elson is the Edgar S. Woolard, Jr., Chair in Corporate Governance and the Director of the John L. Weinberg Center for Corporate Governance at the University of Delaware. He is also "Of Counsel" to the law firm of Holland & Knight.

He formerly served as a Professor of Law at Stetson University College of Law in St. Petersburg, Florida from 1990 until 2001.

His fields of expertise include corporations, securities regulation and corporate governance.

He is a graduate of Harvard College and the University of Virginia Law School, and has served as a law clerk to Judges J. Harvie Wilkinson III and Elbert P. Tuttle of the United States Court of Appeals for the Fourth and Eleventh Circuits. He has been a Visiting Professor at the University of Illinois College of Law, the Cornell Law School, and the University of Maryland School of Law, and is a Salvatori Fellow at the Heritage Foundation in Washington, D.C. and a member of the American Law Institute.

Professor Elson has written extensively on the subject of boards of directors. He is a frequent contributor on corporate governance issues to various scholarly and popular publications.

He served on the National Association of Corporate Directors' Commissions on Director Compensation, Director Professionalism, CEO Succession, Audit Committees, Strategic Planning and Director Evaluation, was a member of its Best Practices Council on Coping With Fraud and Other Illegal Activity, and presently serves on that organization's Advisory Council. He is Vice Chairman of the ABA Business Law Section's Committee on Corporate Governance and a member of its Committee on Corporate Laws.

Additionally, Professor Elson served as an adviser and consultant to Towers Perrin, the international human resource management consultants, a director of Circon Corporation, a medical products maker; Sunbeam Corporation, the consumer products manufacturer; Nuevo Energy Company, an independent oil and natural gas producer and is presently, a member of the Board of Directors of AutoZone, Inc., the national automobile parts retailer, Alderwoods Group, an international health care services provider, HealthSouth Corporation, a healthcare services provider, and the Investor Responsibility Research Center, a non-profit corporate governance research organization.

The bankruptcy of the famed Enron Corporation was not only a seminal business event, as such a large and well-positioned company rarely fails, but also a watershed event in American corporate law and governance that has inspired numerous reforms in the corporate legal and regulatory regimes. The key question, critical to understanding the reforms demanded and enacted, is why did this company collapse? More specifically, who is responsible for this failure, and what could have been done to avoid it?

A number of commentators in this Symposium have concentrated on the failures of the gatekeepers--objective monitors such as the auditors, rating agencies, and investment analysts--who may have acquiesced in, done little to prevent, or even missed the problematic management activities that led to Enron's collapse. [FN1] These commentators have suggested that reform targeting the conduct and structure of these gatekeepers is necessary both to prevent a repeat of Enron and to restore public confidence in our financial markets. [FN2] I cannot quibble with much of this argument. Clearly, these "gatekeepers" or "objective monitors," as Professors Coffee and Macey alternately describe them, [FN3] failed miserably in their responsibilities. They were either incredibly negligent or sufficiently co-opted by Enron's management that they lost all objectivity and efficacy.

While I agree with my colleagues as to the nature of the problem, I disagree as to precisely where the focus of reform should lie. For instance, Professor Macey explores what he believes is a tradeoff between proximity and objectivity. [FN4] His premise is that directors who *497 are in close proximity to corporate management cannot be truly objective. [FN5] The implication is that reformers must focus on the objectivity of those who are not proximate--the outside monitors [FN6] I cannot accept this premise. I believe that while active, nonproximate monitors may be helpful, the real key to the prevention of Enron-type scandals centers on the proximate monitors, namely, the company's directors. As corporate insiders, they are in the best position to observe the activities of corporate management. The secret lies in making them more objective and engaged monitors.

An examination of classical corporate governance theory is helpful in understanding how directors can be made more objective and engaged. Under traditional theory, the board acts as an active management monitor for shareholder benefit. [FN7] Not only must the board decide when to engage and when to terminate a management team, but it must also oversee and review management activity between these two points. The goal of board oversight is to make company management accountable and, thus, more effective. [FN8]

The concepts of independence and equity are central to active monitoring. [FN9] To fulfill their oversight responsibilities effectively, directors must be independent of management and must hold a personally meaningful equity stake in the enterprise. [FN10] Independence involves the absence of any economic ties, either to management or to the company itself, other than equity ownership. It provides a director with the distance and objectivity necessary to examine management action in the most effective manner. [FN11] Economic relationships *498 with management, including consulting, service provision, or other indirect arrangements, may cloud a director's judgment and make it more difficult to review management conduct objectively. [FN12] A lack of independence can lead to ineffective monitoring if, for example, it makes a director too comfortable with management and its representations or places her in such a close relationship with management that she cannot effectively disengage herself in order to review management conduct objectively. Keeping directors distanced from company management allows them to conduct the reflective review of management practices that public shareholders expect and that is necessary to long-term corporate success.

Director independence is also important because of its impact on management activity. Insofar as management is concerned, director independence brings accountability and responsibility. Responsibility to a watchful intermediary will likely spur thoughtful decisionmaking and reflection on

management's part. [FN13] These results will not occur unless the intermediary is in fact independent of the examined party, [FN14] thus making board independence a critical component of modern governance theory.

Coincident and complementary to its emphasis on director independence, modern corporate governance theory also stresses the need for directors to hold an equity stake in the corporation. [FN15] While director independence promotes objectivity, the requirement that board members maintain equity ownership in the corporation gives the directors an incentive to exercise their objectivity effectively. [FN16] When management appoints the board of directors, and these directors have no stake in the corporate enterprise other than their board seats, the directors simply have no pecuniary incentive to actively monitor management. [FN17] When directors shirk their duty to monitor management, stockholder interests are left unprotected. The most effective incentive for directors to address their responsibilities to the shareholders is to make them stockholders as well. [FN18] By becoming equity *499 holders, the outside directors assume a personal stake in the success or failure of the enterprise.

Of course, when stock ownership is insubstantial in comparison to the other private benefits associated with being a director, the motivational impact is bound to be minimal. For example, while the outside directors of many large corporations often have a nominal equity stake in the company, they typically receive far more substantial compensation in the form of annual fees. [FN19] Such a compensation system is a wholly inadequate way to provide the kinds of personal incentives necessary to create an active board. The best way to align director and shareholder interests and to promote effective monitoring is to pay director fees primarily in the form of restricted company stock.

It is important to note that while equity ownership provides the incentive to monitor, it alone does not provide the proper objectivity to foster effective oversight. Independence creates this objectivity, and that is why modern governance theory demands both equity ownership and independence. Independent directors without equity ownership may be objective, but they have little incentive to engage in active oversight. Equity ownership provides the incentive to exercise objective oversight. On the other hand, equity-holding directors who are not independent may have the proper incentive but lack the necessary objectivity. Independence and equity ownership, acting in tandem, are the keys to effective corporate governance.

But how does this emphasis on director independence and equity relate to the board failure at Enron? The answer is straightforward: the Enron directors lacked independence from management. [FN20] They may have held company equity, but without the appropriate independence from Enron management, they lacked the objectivity needed to perceive the numerous and significant warning signs that should have alerted them to the alleged management malfeasance that led to the company's ultimate meltdown and failure.

Five specific signals should have induced greater board probing of management initiatives. Of these signals, the primary two concerned *500 management's activities. The first involved management's request, on two specific occasions, that the board waive the company's code of ethics prohibiting officer conflict-of-interest transactions. [FN21] The now infamous waivers allowed the debt-shifting, off-balance-sheet transactions that were allegedly designed to mask the company's precarious financial situation. [FN22] The second warning signal involved massive sales of company stock by numerous high-level insiders. [FN23] Management stock sales are never viewed as a good sign of the company's future prospects, [FN24] and they should have alerted the board to potential problems.

The third, fourth, and fifth signals involved the company's auditors, Arthur Andersen. Enron initially engaged Andersen as its external auditor. However, this role expanded dramatically over time. Operating in a climate in which numerous authorities, including the Chairman of the Securities and Exchange Commission, were calling for substantial reform of the auditor/company relationship, Enron's relationship with Andersen was problematic in several respects. First, in addition to providing

external auditing services, Andersen also served as the company's internal auditor. [FN25] Using a single company to execute both the internal and external audits generally encountered great criticism, as many thought that comingling these two oversight responsibilities would compromise the effectiveness of each. [FN26] Second, while acting as the company's auditor, Andersen provided substantial consulting services to Enron. [FN27] In 2001 alone, Andersen billed approximately \$27 million just for its consulting activities. [FN28] By this time, this sort of auditor/client consulting relationship was coming under increasing attack, as critics argued that it would compromise audits. [FN29] Finally, senior members of the Enron finance department *501 had been hired directly from Arthur Andersen. [FN30] This practice was problematic as well because the relationship between former and present firm employees had the potential to create unwelcome pressure on the external auditor. [FN31]

It is difficult to conceive how the highly respected, intelligent, and influential Enron board could have missed all five of these warning signals. Had the directors asked questions about these actions, they might have been able to discover and respond to the management misdeeds that hastened the company's collapse. What went wrong? Simply stated, the directors lacked the appropriate independence from management. As a result, they did not have the objectivity to appreciate the severity of the warnings they were receiving, and they became ineffective proximate monitors. Despite the fact that they were technically outsiders and not full-time company employees, a large number of Enron directors still had numerous financial or quasi-financial relationships with the company and its management. For example, several directors had direct consulting relationships with the company for which they were well compensated. [FN32] Others were officers of charitable organizations that were the beneficiaries of significant donations from either Enron itself or members of company management. [FN33] Still others had business dealings with the company. [FN34] A few had been directors for so many years that their board seats appeared to have become company-sponsored sinecures. [FN35] Interestingly enough, most of these directors would have been considered independent under then-existing Securities and Exchange Commission or New York Stock Exchange requirements. [FN36]

However, these directors were not in fact independent, at least not in the sense that corporate governance theorists would consider appropriate. Most theorists would consider an independent director to be someone who has no significant direct or indirect financial relationships with the company or its management. [FN37] The problem with these types of relationships is that they compromise the director's objectivity. They create a bond with company management that makes it more difficult to review management's actions objectively and dispassionately. That is likely what happened to the Enron directors; the *502 relationships they had with company management created a comfort level that made it possible for them to explain away or to miss completely the various warning signs before them. Their lack of independence did not necessarily make them bad actors, only much less sensitive ones. They were proximate monitors, but without independence from the management they were responsible for monitoring, they were wholly ineffective.

The failings of Enron's directors, however, should not suggest that proximate monitors can never be effective, or that reliance on the "objective" outside monitor is more appropriate. They failed not because of their proximity, but because of their lack of independence. Had they been both truly independent from management, and significant equity holders in the company, the Enron tale might have had a less dramatic and devastating conclusion. The lesson of Enron is not that proximate monitors are generally ineffective. Rather, it is that for proximate monitors to be inspired and to successfully protect shareholder value, they must have both independence and substantial equity holdings. Only then will we have created the kind of management monitoring that inspires public confidence and investment in the corporate enterprise.

Footnotes

[FNd1]. Charles M. Elson is the Edgar S. Woolard, Jr., Chair in Corporate Governance and the

Director of the John L. Weinberg Center for Corporate Governance at the Lerner College of Business and Economics at the University of Delaware. The author wishes to thank Christopher Gyves, Wake Forest University School of Law and Babcock Graduate School of Management, J.D./M.B.A. Class of 2004, for his excellent assistance on this project.

[FN1]. See John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 Cornell L. Rev. 269 (2004); Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 Cornell L. Rev. 394 (2004).

[FN2]. See Coffee, *supra* note 1, at 303-07; Macey, *supra* note 1, at 420-22.

[FN3]. Compare Coffee, *supra* note 1, at 279-87 (describing the role of corporate gatekeepers during the 1990s), with Macey, *supra* note 1, at 399-400 (describing the different types of objective monitors and their roles).

[FN4]. Macey, *supra* note 1, at 400.

[FN5]. See *id.* at 399.

[FN6]. See *id.* at 399-400.

[FN7]. See Charles M. Elson et al., *Corporate Governance Reform and Reemergence from Bankruptcy: Putting the Structure Back in Restructuring*, 55 Vand. L. Rev. 1917, 1922 (2002).

[FN8]. See *id.*

[FN9]. See, e.g., Jeffrey N. Gordon, "Just Say Never?" *Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 Cardozo L. Rev. 511, 521 (1997) ("[D]irector independence has become the mantra of corporate governance reformers. ..."); Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L. Rev. 325, 340-1 (2001) (noting that in the two decades following the NYSE's adoption of a rule requiring its members to have an independent audit committee, "the mantra that a board of directors should be composed of persons independent of management was spread around the world by regulators and institutional investors"); Claudia H. Deutsch, *The Revolution That Wasn't*, N.Y. Times, Jan. 26, 2003, § 3, at 1 (" [1993,] the so-called Year of the Sharp Knives ... [was to usher in] a new era, one in which directors would act solely in the interests of shareholders.").

[FN10]. The interests of shareowners are properly served only when a "strong, diligent and independent board of directors ... asks management the tough questions" The Conference Bd. Comm'n on Pub. Trust & Private Enter., *Findings and Recommendations* 6 (Pt. 2) (2003); see also Am. Bar Ass'n, *Rep. of the Am. Bar Ass'n Task Force on Corp. Resp.* 31 (2003), http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf [hereinafter ABA Report] (noting that boards need to engage in more "active, independent, and informed, oversight").

[FN11]. See Elson, *supra* note 7, at 1922.

[FN12]. See Nat'l Ass'n Corp. Dir., *Rep. of the NACD Blue Ribbon Comm'n on Dir. Professionalism* 10 (1996) [hereinafter NACD Report] (noting that independence means no consulting arrangements, no business connections, and no service provision to the company).

[FN13]. See Elson, *supra* note 7, at 1922.

[FN14]. See *id.*

[FN15]. See Charles M. Elson, *Executive Overcompensation--A Board-Based Solution*, 34 B.C. L.

Rev. 937, 981-83 (1993).

[FN16]. *See id.* at 982.

[FN17]. *Id.* at 981-83.

[FN18]. *See* NACD Report, *supra* note 12, at 5 (stating that directors should personally invest a meaningful amount in company stock so that director interests are decoupled from managerial interests and aligned with those of the shareholders); Elson, *supra* note 15, at 994-95 (observing that directors with equity ownership interests tend to exercise more effective oversight); Ellen Taylor, *Teaching an Old Law New Tricks: Rethinking Section 16*, 39 Ariz. L.Rev. 1315, 1348 (noting that "[m]any companies use stock options as incentive compensation for their employees and directors. ... to align their incentives with those of the other shareholders and thereby encourage them to work harder to make the company profitable").

[FN19]. *See* Pearl Meyer, *Board Stock Ownership: More, and More Again, Dirs. & Bds.*, Winter 1998, at 55, 55-56 (describing how the approach to director pay has changed dramatically over the past few years and noting that directors in many large corporations often receive more than \$90,000 per annum for attending a few board meetings).

[FN20]. *See* Marianne M. Jennings, *A Primer on Enron: Lessons from A Perfect Storm of Financial Reporting, Corporate Governance and Ethical Culture Failures*, 39 Cal. W. L. Rev. 163, 199-201 (2003) (detailing the conflicts of interest of the various Enron board members and noting that these conflicts contributed to Enron's collapse).

[FN21]. *See* Staff of Permanent Subcomm. on Investigations of the Senate Comm. on Governmental Aff., 107th Cong., *The Role of the Bd. of Dirs. in Enron's Collapse 23* (Comm. Print 2002) [hereinafter *Role of Directors Report*].

[FN22]. *See id.* at 24-28.

[FN23]. *See* Sharon Reece, *Enron: The Final Straw & How To Build Pensions of Brick*, 41 Duq. L. Rev. 69, 97 (2002).

[FN24]. Charles M. Elson, *A Commitment of Time and Financial Capital*, *Dir. & Bds.*, Summer 2002, at 19; *see also* Melita Marie Garza, *7 Enron Execs Made Millions from Stock*, *Chi. Trib.*, Jan. 24, 2002, at 1 (noting that high-volume selling by management generally indicates deepseated problems in a company).

[FN25]. *See* *Role of Directors Report*, *supra* note 21, at 53-54.

[FN26]. *Id.* at 54.

[FN27]. Enron Corp., Proxy Statement 14-15 (Mar. 27, 2001) [hereinafter *Proxy Statement*]; *see also* William C. Powers, Jr. et al., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. 3-5, at <http://news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf> (Feb. 1, 2002) (detailing Andersen's "extensive participation" in several Enron transactions).

[FN28]. *Proxy Statement*, *supra* note 27, at 14.

[FN29]. *See* *Role of Directors Report*, *supra* note 21, at 53-54.

[FN30]. William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 Tul. L. Rev. 1275, 1349 (2002); Chris Quick, *Old Boy Networks Are Alive and Kicking Despite New Rules*, *Times of*

London, Mar. 13, 2003, at 31.

[FN31]. *See id.*

[FN32]. *See* Role of Directors Report, *supra* note 21, at 51-52.

[FN33]. *See id.*

[FN34]. *See id.* at 51.

[FN35]. *See* Sanjay Paul, *Scandals a Painful Reminder: CEOs Are Human*, Green Bay Press-Gazette, Jul. 11, 2002, at 9C.

[FN36]. *See* Jennings, *supra* note 20, at 200.

[FN37]. *See* NACD Report, *supra* note 12, at 10.

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