ENRON AND THE NECESSITY OF THE OBJECTIVE PROXIMATE MONITOR

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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.¹ 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.² I cannot quibble with much of this argument. Clearly, these “gatekeepers” or “objective monitors,” as Professors Coffee and Macey alternately describe them,³ 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.⁴ His premise is that directors who

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² See Coffee, supra note 1, at 303–07; Macey, supra note 1, at 420–22.

³ 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).

⁴ Macey, supra note 1, at 400.
are in close proximity to corporate management cannot be truly objective. The implication is that reformers must focus on the objectivity of those who are not proximate—the outside monitors. 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. 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.

The concepts of independence and equity are central to active monitoring. To fulfill their oversight responsibilities effectively, directors must be independent of management and must hold a personally meaningful equity stake in the enterprise. 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.

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5 See id. at 399.
6 See id. at 399–400.
8 See id.
9 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. 925, 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.").
10 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").
11 See Elson, supra note 7, at 1922.
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. 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. These results will not occur unless the intermediary is in fact independent of the examined party, 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. 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. 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. 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. By becoming eq-

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13 See Elson, supra note 7, at 1922.
14 See id.
16 See id. at 982.
17 Id. at 981–83.
18 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
uity 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. 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. 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 con-
cerned 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.21 The now infamous waivers allowed the debt-shifting, off-balance-sheet transactions that were allegedly designed to mask the company's precarious financial situation.22 The second warning signal involved massive sales of company stock by numerous high-level insiders.23 Management stock sales are never viewed as a good sign of the company's future prospects,24 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.25 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.26 Second, while acting as the company's auditor, Andersen provided substantial consulting services to Enron.27 In 2001 alone, Andersen billed approximately $27 million just for its consulting activities.28 By this time, this sort of auditor/client consulting relationship was coming under increasing attack, as critics argued that it would compromise audits.29 Finally, senior members of the Enron finance department

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21 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].
22 See id. at 24-28.
25 See Role of Directors Report, supra note 21, at 53-54.
26 Id. at 54.
28 Proxy Statement, supra note 27, at 14.
29 See Role of Directors Report, supra note 21, at 53-54.
had been hired directly from Arthur Andersen. 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.

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. Others were officers of charitable organizations that were the beneficiaries of significant donations from either Enron itself or members of company management. Still others had business dealings with the company. A few had been directors for so many years that their board seats appeared to have become company-sponsored sinecures. Interestingly enough, most of these directors would have been considered independent under then-existing Securities and Exchange Commission or New York Stock Exchange requirements.

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. 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

31 See id.
32 See ROLE OF DIRECTORS REPORT, supra note 21, at 51–52.
33 See id.
34 See id. at 51.
36 See Jennings, supra note 20, at 200.
37 See NACD REPORT, supra note 12, at 10.
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.