COMPLEMENTARY PERSPECTIVES ON "EFFICIENT CAPITAL MARKETS, CORPORATE DISCLOSURE, AND ENRON"

Yaniv Grinstein†

INTRODUCTION

In his Article, Professor Jonathan R. Macey observes three important points about the Enron fiasco and about the U.S. corporate governance system in general.1 His first observation is that Enron's failure represents the failure of both objective and proximate monitoring mechanisms to protect shareholders.2 His second observation is that the Enron case casts into doubt the effectiveness of disclosure rules,3 and the third questions how relevant the Efficient Capital Markets Hypothesis is after Enron.4 The following discussion provides complementary perspectives on each of these three important observations.

I

OBJECTIVITY AND PROXIMITY

Entities that monitor managerial actions comprise two groups.5 The first group includes entities that are very close to management and that are deeply involved in the activities of the firm,6 such as the board of directors. Board members meet on a regular basis with the corporate officers, participate in the decisionmaking process, and have easy access to corporate information. The second group consists of entities that are not close to management and that are not directly involved in the activities of the firm.7 Examples of such entities include the market for corporate control, analysts, and credit rating agencies.

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2 Id. at 403.
3 Id. at 413.
4 Id. at 417–20.
6 Macey, supra note 1, at 400; Boot & Macey, supra note 5, at 358–59.
7 Macey, supra note 1, at 401; Boot & Macey, supra note 5, at 359.
Professors Boot and Macey base their model of corporate governance on a tradeoff. A monitor belonging to the first group has timely information about the firm and can monitor proactively, but this monitor risks capture because of its proximity to management. A monitor who belongs to the second group does not have timely information about the firm, and can only monitor ex post, i.e., after observing managerial wrongdoing. Nevertheless, such outside monitoring is likely to be more objective and less at risk of capture by management.

Enron had monitoring mechanisms based on both proximity, (the board of directors) and on objectivity (analysts, credit agencies and other market agents). Both mechanisms failed to function properly.

Professor Macey convincingly explains the reasons why market agents had no objectivity: analysts were biased partly because of the relationship between their employer, the investment bank, and Enron. Credit agencies hesitated to downgrade Enron’s debt because they dreaded the overwhelming impact such a downgrade would have on Enron and the possibility that their judgment was incorrect. Finally, external auditors did not properly audit Enron partly because of the faulty incentive structure of partners within the accounting firms.

But what was wrong with the board of directors? Professor Macey argues that they were bound to be captured by the management because of their strong proximity. My comments focus on this issue.

Like other monitors, the board of directors should have the knowledge and incentives to execute its duties properly. In general, the sources of board incentives may be divided into three groups—ethical, legal, and monetary incentives.

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8 Macey, supra note 1, at 400; Boot & Macey, supra note 5, at 358. For the psychological theory underpinning proximity, see David G. Myers, Social Psychology 46–47 (1983) (explaining the “foot-in-the-door phenomenon,” which finds that individuals who agree to do a small request at first eventually tend to become increasingly involved over time).
9 Boot & Macey, supra note 5, at 359.
10 Macey, supra note 1, at 401.
11 Id. at 403.
13 Macey, supra note 1, at 404.
14 Id. at 405–06.
15 Id. at 407–10.
16 See id. at 400–01.
17 See Boot & Macey, supra note 5, at 361–64.
Board members should have high ethical standards and sufficient reputation concerns to properly perform their duties. How high were the reputation concerns of Enron's board? Table 1 shows that in 2001 Enron had fourteen board members, three of which (Lay, Skilling and Belfer) were employees or former employees of Enron. The rest of the board consisted of highly ranked corporate officers or former officers (Blake, Chan, Pereira, Savage, Winokur), distinguished academic personnel (Gramm, Jaedicke, Lemaistre, Mendelsohn), and distinguished public service personnel (Wakeham, Gramm).

Table 1: Enron's Board Members and Their Occupation, May 2001 (Taken from Enron's Proxy Statement, 2001)

<table>
<thead>
<tr>
<th>Director Name</th>
<th>Director Since</th>
<th>Age</th>
<th>Occupation</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROBERT A. BELFER</td>
<td>1983</td>
<td>65</td>
<td>CEO and Chairman of Belco Oil &amp; Gas Corp. Former employee of Belco Petroleum Corp., a wholly owned subsidiary of Enron.</td>
</tr>
<tr>
<td>NORMAN P. BLAKE, JR.</td>
<td>1993</td>
<td>59</td>
<td>CEO, Chairman and President of Comdisco Inc.</td>
</tr>
<tr>
<td>RONNIE C. CHAN</td>
<td>1996</td>
<td>51</td>
<td>Chairman of Hang Lung Group</td>
</tr>
<tr>
<td>JOHN H. DUNCAN</td>
<td>1985</td>
<td>73</td>
<td>Investor. Also a director of EOTT Energy Corp. and Group I Automotive Inc.</td>
</tr>
<tr>
<td>WENDY L. GRAMM</td>
<td>1993</td>
<td>56</td>
<td>Director of the Regulatory Studies Program of the Mercatus Center at George Mason University. Former Chairman of Commodity Futures Trading Commission in Washington, D.C.</td>
</tr>
<tr>
<td>ROBERT K. JAEDICKE</td>
<td>1985</td>
<td>72</td>
<td>Professor (Emeritus) of Accounting, Stanford University Graduate School of Business</td>
</tr>
<tr>
<td>KENNETH L. LAY</td>
<td>1985</td>
<td>58</td>
<td>Chairman of the Board, Enron</td>
</tr>
<tr>
<td>CHARLES A. LEMAISTRE</td>
<td>1985</td>
<td>77</td>
<td>President Emeritus of the University of Texas M.D. Anderson Cancer Center</td>
</tr>
<tr>
<td>JOHN MENDELSOHN</td>
<td>1999</td>
<td>64</td>
<td>President of the University of Texas M.D. Anderson Cancer Center for Energy and Leader of the Houses of Commons and Lords</td>
</tr>
<tr>
<td>PAULO V. FERRAZ PEREIRA</td>
<td>1999</td>
<td>46</td>
<td>Executive Vice President of Group Bozano. Former President and CEO of the State Bank of Rio de Janeiro</td>
</tr>
<tr>
<td>FRANK SAVAGE</td>
<td>1999</td>
<td>62</td>
<td>Chairman, Alliance Capital Management International</td>
</tr>
<tr>
<td>JEFFREY K. SKILLING</td>
<td>1997</td>
<td>47</td>
<td>CEO, Enron</td>
</tr>
<tr>
<td>JOHN WAKEHAM</td>
<td>1994</td>
<td>68</td>
<td>Former U.K. Secretary of State for Energy for Energy and Leader of the Houses of Commons and Lords</td>
</tr>
<tr>
<td>HERBERT S. WINOKUR, JR.</td>
<td>1985</td>
<td>57</td>
<td>CEO and Chairman, Capricorn Holdings, Inc.</td>
</tr>
<tr>
<td>Average</td>
<td>1990</td>
<td>62</td>
<td></td>
</tr>
</tbody>
</table>

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18 Cf. Michael L. Fox, To Tell or Not To Tell: Legal Ethics and Disclosure After Enron, 2002 COLUM. BUS. L. REV. 867, 887–913 (discussing the disclosure requirements imposed on attorneys as a result of the Sarbanes-Oxley Act).

The second source of incentives comes from fear of legal punishment. Shareholders, employees, and other stakeholders can sue board members who violate their duties. Apparently, Enron's board members had lots of reputation at stake, but concern for reputation and legal punishment failed to provide adequate incentives for board members of Enron to demand explanations for questionable deals.

The last source of board incentives is monetary. As agents of the shareholders, board members should be concerned with maximizing shareholder wealth. If board members have a long-term financial stake in the firm, maximizing shareholder wealth maximizes their own wealth. Thus, board incentives to monitor effectively are aligned with the shareholders they represent.

Table 2 shows the stock holdings of the board members of Enron in 2001.

\[\text{See Cheryl L. Wade, Corporate Governance Failures and the Managerial Duty of Care, 76 St. John's L. Rev. 767, 780-81 (2002) (stating that Enron's board of directors breached the duty of care to shareholders).}\]
Table 2: Enron’s Board Members and Their Shareholdings in Enron, May 2001
(taken from Enron’s proxy statement, 2001)\textsuperscript{21}

<table>
<thead>
<tr>
<th>Director Name</th>
<th>Audit Committee</th>
<th>Nominating Committee</th>
<th>Chairman of the Board</th>
<th>Voting Shares</th>
<th>Voting Shares Employees/Former Employees</th>
<th>Nominating Committee Shares</th>
<th>Audit Committee Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROBERT A. BELFER</td>
<td></td>
<td></td>
<td></td>
<td>8,438,839</td>
<td>8,438,839</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NORMAN P. BLAKE, JR.</td>
<td></td>
<td></td>
<td></td>
<td>24,611</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>RONNIE C. CHAN</td>
<td>x</td>
<td></td>
<td></td>
<td>19,199</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>JOHN H. DUNCAN</td>
<td></td>
<td></td>
<td></td>
<td>174,253</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WENDY L. GRAMM</td>
<td>x</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROBERT K. JAEDICKE</td>
<td>x</td>
<td></td>
<td></td>
<td>57,087</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>KENNETH L. LAY</td>
<td></td>
<td>x</td>
<td></td>
<td>5,392,718</td>
<td>5,392,718</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CHARLES A. LEMAISTRE</td>
<td></td>
<td></td>
<td></td>
<td>56,287</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>JOHN MENDELSOHN</td>
<td>x</td>
<td>x</td>
<td></td>
<td>5,563</td>
<td>5,563</td>
<td>5,563</td>
<td></td>
</tr>
<tr>
<td>PAULO V. FERRAZ PEREIRA</td>
<td>x</td>
<td></td>
<td></td>
<td>3,195</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FRANK SAVAGE</td>
<td></td>
<td></td>
<td></td>
<td>4,005</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>JEFFREY K. SKILLING</td>
<td></td>
<td></td>
<td></td>
<td>1,941,377</td>
<td>1,941,377</td>
<td></td>
<td></td>
</tr>
<tr>
<td>JOHN WAKEHAM</td>
<td>x</td>
<td>x</td>
<td></td>
<td>20,987</td>
<td></td>
<td>20,987</td>
<td></td>
</tr>
<tr>
<td>HERBERT S. WINOKUR, JR.</td>
<td></td>
<td></td>
<td></td>
<td>107,755</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td>16,245,876</td>
<td>15,772,934</td>
<td>26,550</td>
<td>106,031</td>
</tr>
</tbody>
</table>

\textsuperscript{21} Enron Corp., Proxy Statement (May 1, 2001) (on file with author).
Enron board members held a total of approximately 16,000,000 shares of Enron stock. This amount accounts for about 2.5% of the common shares outstanding, but employees and former employees held 97% of these shares. The six members of the audit committee held about 100,000 shares (average of only 18,000 shares per person), and the members of the nominating committee held even fewer. 22

With such low holdings, the board members’ monetary incentives were probably insufficient to maximize the value of Enron. Unfortunately, these low numbers are not unique to Enron. Outside, non-employee board members of large U.S. corporations often hold minuscule financial stakes in the firms they monitor.

How can board incentives improve so that directors are less prone to be captured by management? Scrutiny of board qualifications, independence, and increased penalties are important ingredients, but it seems that directors also need financial incentives to monitor properly. Board members should have large enough financial interests in the corporation, so that their actions matter not only to the shareholders they represent but also to themselves.

II

CORPORATE DISCLOSURE RULES

Professor Macey also examines corporate disclosure rules and the traditional theory of information disclosure based on signaling. 23 When shareholders cannot tell whether a firm is good or bad, the managers of that firm look for a mechanism that convinces the shareholders that the firm is good. Signaling mechanisms are important because they reveal information to the shareholders about the value of the firm. 24 A signaling mechanism can work only if it is credible. In other words, an essential ingredient of a signaling mechanism is that it should be less costly for a good firm to use than for a bad firm. In the famous lemon problem, a car buyer does not know if the dealer sells him a good car or a lemon in disguise. 25 The car seller would like to convince the buyer that the car is functioning because otherwise, the buyer places a low value on the car. The dealer can use a warranty to convince the buyer to place a high value on the car. With a warranty, the dealer commits to pay damages if the car is sub-par. However, a dealer of bad cars will not provide a warranty because such a warranty would be too costly. Thus, a warranty separates the dealer of good cars from a dealer of bad cars.

22 Id.
23 Macey, supra note 1, at 415–17.
24 Macey, supra note 1, at 396 & n.7.
The same theory applies to corporate disclosure. Good firms disclose information about themselves to distinguish themselves from bad firms.\textsuperscript{26} It is too costly for bad firms to disclose information because the information will reveal that they are bad.\textsuperscript{27} Investors, then, will invest in firms that disclose information and avoid firms that do not similarly disclose information.

But is disclosure of information such a good mechanism to separate the good from the bad firms? If firms can easily manipulate the information they provide and the penalty for cheating is not severe enough, information disclosure is not an effective mechanism for separating the good firms from the bad.

Professor Macey argues that in Enron’s case, the market was likely unaware that Enron failed to disclose all information so investors continued to believe that the value of Enron was high.\textsuperscript{28} The market believed that disclosure was a good mechanism for separating good firms from bad firms when, in fact, firms could manipulate their disclosure schemes and cheat the market.\textsuperscript{29}

Taking this situation as given, Professor Macey points to two interesting externalities of cheating. First, if firm A cheats and shows positive earnings, firm A will receive market support at the expense of firm B, who does not cheat and shows negative earnings. Thus, firm A will have strong incentives to cheat.\textsuperscript{30} Moreover, since firm B will lose from not cheating, firm B also will have strong incentives to cheat.\textsuperscript{31} Second, because firms that cheat do not internalize the entire cost of getting caught, they are not discouraged from cheating.\textsuperscript{32} The cost of Enron getting caught, however, is real enough: it is the public distrust of other firms and of the corporate system.\textsuperscript{33} If Enron had internalized these costs, it might have thought twice about whether to hide its debt.

These two alarming externalities portray a much worse picture than the one suggested by traditional models of corporate disclosure. To solve this problem, Professor Macey suggests increasing the threat of penalty for cheating “because a severe punishment for false reporting will eliminate firms’ incentive to cheat.”\textsuperscript{34}

I would like to take these arguments a step further. While the traditional model of information disclosure likely did not hold in the

\begin{footnotesize}
\begin{enumerate}
\item Macey, supra note 1, at 412.
\item Id. at 414.
\item See id.
\item Id.
\item Id. at 415–17.
\item Id.
\item Id.
\item Id.
\item See id. at 415.
\item Id. at 417.
\end{enumerate}
\end{footnotesize}
case of Enron, I believe it is still a relevant tool for understanding investor behavior in the future. The models of externalities presented above assume that the market is unaware that corporations can manipulate disclosure and that the market believes that the disclosed information is correct. The market's belief, however, is fragile. Once the market observes evidence that causes it to change its belief, the equilibrium that Professor Macey suggests no longer holds. Enron caused many investors to question their beliefs about the credibility of financial disclosure. See, e.g., Dennis K. Berman & Deborah Solomon, Analysts Fault the Accounting at Global Crossing, WALL ST. J., Jan. 30, 2002, at A8; Yochi J. Dreazen, WorldCom Suspends Executives in Scandal over Order Booking, WALL ST. J., Feb. 15, 2002, at A3; Kelly Greene, Dunlap Agrees To Settle Suit over Sunbeam, WALL ST. J., Jan. 15, 2002, at A3; SEC Formally Opens Probe of Adelphia, WALL ST. J., Apr. 18, 2002, at B11.


Firms can potentially use these mechanisms to increase shareholder confidence in them in the future.

III

Efficient Markets

With respect to the Efficient Capital Markets Hypothesis (ECMH), Professor Macey convincingly argues that the writing was on the wall, but no one read it properly. However, one can interpret these results consistent with the ECMH by assuming that investors did see the impenetrable accounting and the questionable transactions but believed the optimistic view of the analysts and interpreted these signs as harmless. Even if the market did not see these signs, one might optimistically conclude that the ECMH is still relevant after Enron. If we assume that, at least to some extent, the market learns from mistakes, then this event may actually increase efficiency in the future. The grim results of the Enron fiasco may provide incentives for all market participants to become more skeptical and alert.

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35 Id. at 414 (arguing that investors will reexamine their beliefs).
38 Macey, supra note 1, at 417–20. The ECMH posits that prices of shares in publicly traded companies will rapidly adjust to in accordance with new learned information. Id. at 396–97.