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P.M. Vasudev

Stock Market, Corporations and Their Regulation: A Few Glimpses Into Reality

EDITORS: Peer Zumbansen (Osgoode Hall Law School, Toronto, Director, Comparative Research in Law and Political Economy, York University), John W. Cioffi (University of California at Riverside), Lindsay Krauss (Osgoode Hall Law School, Toronto, Production Editor)

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Abstract: The paper examines events in three public companies – Enron Corp., Sycamore Networks and Amazon.com, from the perspective of corporate law and securities law. The events are interpreted in terms of the applicable law, and explain how it influences them. In particular, the paper demonstrates how the prevailing loose legal regime for corporations and the stock market-centricity of corporate arrangements give rise to specific varieties of negative behaviour. The paper adopts a critical approach, and is an effort to describe the consequences of the minimalist philosophy underlying corporate and securities regulation.

Keywords: corporations, corporate governance, stock market, securities law, corporate law, corporate behaviour, informational regime, corporate disclosures, efficient markets hypothesis

JEL classification: K22, K29, L20

Author Contact: P.M. Vasudev
Ph.D. Candidate, Osgoode Hall Law School
Senior Lecturer, Department of Commercial Law
University of Auckland Business School, Owen G. Glenn Building
12 Grafton Road, Auckland, New Zealand
Email: p.vasudev@auckland.ac.nz

STOCK MARKET, CORPORATIONS AND THEIR REGULATION: A FEW GLIMPSES INTO REALITY

P.M. Vasudev*

Now a frank gale of wind go with him, Master Frank, we have too few such knight adventurers. Who would not sell away competent uncertainties, to purchase, with any danger, excellent uncertainties? Your true knight venturer ever does it.

~ Eastward Ho (1605)

Public corporations and the stock market have verily emerged as the symbols of the present age, and are among the important institutions in the society. Indeed, the state of the stock market is understood as the barometer of general well-being. The law has a crucial role with respect to both corporations and stock market, and this paper examines how the legal regime for corporations and the stock market influences corporate governance and events in the stock market. This is done through a case-study of events at three public corporations – Enron Corp., Sycamore Networks and Amazon.com.

The paper is divided into five parts of which the first part sets out the theme of the paper, and explains the perspective of the analysis. The next three parts deal respectively with events in Enron, Sycamore Networks and Amazon.com. The concluding part articulates the tendencies engendered and encouraged by the present regime, and argues that we need a better and more reasonable theory for both the institutions – public corporations and the stock market. A sound and reasonable theoretical foundation, which reflects the knowledge we have gained from our experience with them and defines with some clarity the role we expect

* Ph. D. Candidate, Osgoode Hall Law School, Sr. Lecturer, Department of Commercial Law, The University of Auckland. The original research for this paper was supported by the Institute for International Corporate Governance and Accountability at The George Washington University Law School (IICGA), Washington, D.C., and the author gratefully acknowledges the support and encouragement extended by IICGA and its Founder-Director, Prof. Lawrence E. Mitchell of The George Washington University Law School.

them to play, is a prerequisite for public policy to effectively guide these institutions, and minimize the conflict between them and larger public and social interests.

A. STATE OF CORPORATE LAW AND ITS IMPLICATIONS FOR CORPORATE GOVERNANCE

Business corporations are legal entities organized under statutes. Delaware, with its loose corporate statute,¹ is the popular choice of jurisdiction for most listed corporations, and the ones selected for study here – namely, Enron, Sycamore Networks and Amazon.com are all Delaware corporations.² Delaware corporate statute engineers corporations almost purely as issuers of securities meant for trade in the stock market, and adopts a policy of encouraging trade in securities in the market.³ It has adopted a philosophy of minimalism with respect to the administration of corporations, and eschews efforts to regulate them.⁴ In result, a Delaware corporation can virtually be whatever it decides to be.⁵

* Sr. Lecturer, Department of Commercial Law, The University of Auckland. The original research for this paper was supported by the Institute for International Corporate Governance and Accountability at The George Washington University Law School (IICGA), Washington, D.C., and the author gratefully acknowledges the support and encouragement extended by IICGA and its Founder-Director, Prof. Lawrence E. Mitchell of The George Washington University Law School.

¹ Delaware Code, Title 8, Chapter 1.

² Enron Corporation was originally formed in 1930 Nebraska, and it is not clear if it was originally incorporated in Delaware. Amazon.com was incorporated in 1994 in Washington, but shifted to Delaware before it made its public issue in 1997. Only Sycamore Networks, a company formed in 1998 during the Internet boom in the stock market, was incorporated in Delaware.

³ See generally P.M. Vasudev, “Capital Stock, Its Shares and Their Holders: A Comparison of India and Delaware” Worldwide Junior Corporate Scholars Forum Conference, March 2007 Available at SSRN: <http://ssrn.com/abstract=913282>, June 2007.

⁴ See generally William Cary, “Federalism and Corporate Law: Reflections upon Delaware” (1974) 83 Yale L.J. 663.

⁵ The present state of permissiveness in American corporate law is very different from the highly regulatory environment in which corporations operated for about a hundred years from the formation of the United States in the 1770s until the 1880s. See generally J.W.

A powerful school of opinion favours the present corporate arrangement outlined above, and views it as the ideal, a state of perfection.⁶ Terming the Delaware statute as an “enabling” one, representatives of this school note appreciatively that it facilitates corporations to “write their own tickets, to establish systems of governance without substantive scrutiny from a regulator and without effective restraint on the permissible methods of corporate governance.”⁷ In result, corporate law has no influence on corporate governance for all practical purposes.

When companies are thus free to devise their own systems of governance, the question of incentives and rewards becomes important. What are the incentives which influence public corporations in selecting their governance systems? The answer to this question is, undoubtedly, the stock market in which the shares of companies are traded. The stock market has a position of pre-eminence in the present arrangement, and the prices which company shares command in the market are a powerful influence on corporations. Achieving increases in share prices, termed “shareholder value,” is considered a legitimate corporate objective, and managements constantly strive for it. Indeed, the performance of corporate managements is measured by the increase in share prices.⁸

In making decisions and taking actions, corporations are strongly guided by the consideration of how their decisions and actions would be received

Hurst, *The Legitimacy of the Business Corporation in the Law of the United States 1780-1970* (Charlottesville, Va.: University Press of Virginia, 1970).

⁶ For a scholarly debate on whether corporate and securities laws must be regulatory, see papers presented at the symposium, *Norms and Corporate Law*, (2001) 149 U. Pa. L. Rev. 1607-2179.

⁷ Frank H. Easterbrook and Daniel R. Fischel, “The Corporate Contract” (1989) 89 Colum. L. Rev. 1416 at 1417.

⁸ Jack Welch of General Electric is considered an exceptionally successful CEO, and this is mostly due to the “shareholder value” that he was able to achieve. In 1980 when Jack Welch became the head of General Electric, its market capitalization, meaning the aggregate value of its outstanding shares in the stock market, was \$ 14 billion. It had risen to \$ 490 billion when he retired in 2001. Rob Walker, “Overvalued: Why Jack Welch isn’t God?” *The New Republic*, 11 June 2001, also available online: http://www.robwalker.net/html_docs/welch.html, June 2007.

in the stock market, and how they would impact share prices. In this stock market-centric arrangement, market reaction is a primary consideration for corporate managements. The theory is that the stock market would reward good corporate performance with increase in share prices, and conversely, punish bad performance by lowering prices. This phenomenon is termed “market discipline,” and is affirmed as an article of faith.⁹ In this schema, the business of a corporation is, at best, collateral, and the stock market enjoys the primary position. Corporate business is relevant only to the extent that it influences share prices. In consequence, the business theme of corporations is undermined, and the financial theme gains ascendancy.

B. ISSUE OF SHARES AND GRANT OF OPTIONS BY COMPANIES

The capital stock, representing the pooled resources of many persons, can be termed the core of modern business corporations. Corporations issued shares, being units of capital stock, for raising the capital required for their business purposes. The shares had par values, and could only be issued for adequate consideration. Victor Morawetz (1882) accurately summed up the underlying principle when he observed:

Every shareholder in a corporation is entitled to insist that every other shareholder shall contribute his ratable part of the company’s capital for common benefit.¹⁰

If this were to be the guiding principle, there would be little question of companies issuing shares at varying levels of consideration to different persons. Nor could companies, at their discretion, grant stock options which entitle their holders to convert them into shares. In this setup, the capital stock of a corporation is treated with sanctity, and the idea that a

⁹ See e.g. Organization for Economic Cooperation and Development (OECD). “The Roles of Market Discipline and Transparency in Corporate Governance Policy” (Paper presented by William Wetherell, Director for Financial, Fiscal and Enterprise Affairs, OECD, at the Banque de France International Monetary Seminar, 16 May 2003), available online: www.oecd.org/dataoecd/21/4/2717763.pdf, June 2007.

¹⁰ Victor Morawetz, *A Treatise on the Law of Private Corporations*, 2d ed. (Boston: Little, Brown, 1886), Vol. 1, at p. 269.

person must pay his or her “ratable part” in order to acquire shares of capital stock is the central principle.

The observation of Morawetz also explains the rationale for voting rights in corporations. Contributors of capital had voting rights in proportion to the capital contributed by them, and the voting rights empowered them to elect or remove the directors who managed the corporations. Shareholders also held most of the other important powers in corporations.¹¹ Shares were recognized as valuable, and their issue was closely supervised in law.¹²

But these principles were gradually discarded in American corporate law beginning from later nineteenth century, and the law gradually permitted corporations to freely issue shares. The requirement of par value for shares was discontinued. Although the principle that consideration must be paid for shares is retained, the standards are diluted to the point of meaninglessness. Any amount of consideration determined by the directors is accepted, subject to the exception of fraud.¹³ Companies are also free to issue rights and options with respect to their stock and determine the terms of such rights and options.¹⁴ By early twentieth century, the loose position with respect to issue of shares and options by companies, outlined above, had emerged, and Roscoe Pound compared the grant of options by companies to feudal lords distributing estates.¹⁵

¹¹ For a description of shareholder rights in American corporate law until 1880s, see Morton J. Horwitz, “Santa Clara Revisited: The Development of Corporate Theory” (1985) 88 W. Va. L. Rev. 173.

¹² See generally Adolf A. Berle, “Corporate Powers as Powers in Trust” (1930) 44 Harv. L. Rev. 1049 at p. 1050-1060.

¹³ Delaware General Corporation Law, Section 152.

¹⁴ *Ibid.* Section 157.

¹⁵ Roscoe Pound, “The New Feudalism” (Address delivered at the Annual Meeting of the Kentucky Bar Association, 1930) (1930) 35 Com.L.J. 397.

The shares of listed companies have market value and salability in the stock market. They also have voting and participation rights.¹⁶ Voting rights entitle shareholders to elect or remove the directors who are in charge of corporate management, and participation rights place shareholders in a proprietary position with respect to the assets of companies. Ignoring these crucial characteristics, corporate law has discontinued the traditional circumspection with which it treated the shares of companies. Now, it casually empowers corporations to deal with their shares virtually as they please. The events at Sycamore and Amazon.com, discussed in the paper, demonstrate some of the implications of the prevailing loose legal position.

C. THE STOCK MARKET AND ITS REGULATION

We have noted that share prices in the stock market are understood as the disciplining factor for corporations,¹⁷ and this leads us to the questions, how are share prices supposed to be determined in the stock market and how is the market to be regulated? These questions are especially relevant given the history of speculation in the stock market and its habit of determining irrational share prices. These issues with the stock market are hardly secrets, and have been well-known from early eighteenth century when England had its brush with the South Sea Bubble in 1720.¹⁸

¹⁶ Participation rights of shareholders, termed “residual claim” in economic theory, entitle them to the assets of a company remaining after all its other liabilities have been provided for or met.

¹⁷ Mercifully, even the most ardent advocates of libertarianism, mainly the law-and-economic scholars, do not argue that there is no need to discipline companies. It is only that they profess faith in a crude carrot-and-stick approach that emphasizes the negative traits in human character, and attempt to appeal only to such qualities. This is given the term “liberty,” but this version could not be further removed from the ideal of liberty expounded by thinkers like John Locke (1632-1704) and Thomas Jefferson (1743-1826).

¹⁸ “South Sea Bubble” refers to the boom in the London stock market in 1720, initiated by runaway increases in the price of the shares of South Sea Company. The boom soon spread to other shares, and the market was in frenzy. However, the market collapsed after a few months, causing all round economic decline. For a recent account of the South Sea Bubble, see Edward Chancellor, *Devil Take the Hindmost: A History of Financial Speculation* (New York: Farrar Straus Giroux, 1999).

In the 1840s when the first corporate statute was enacted in Britain,¹⁹ it introduced a system of disclosures by companies. Companies had to make disclosures both at the time of issue of shares by them and on an ongoing basis, and this regime was adopted in the United States in the 1930s when federal laws were enacted for regulation of the stock market.²⁰ The federal regulations mandate extensive disclosures by companies, and the theory is that the market will apply the information disclosed by companies to determine the prices of their shares.

The informational regime in which companies must make disclosures is the lynchpin of securities regulations. Other than disclosures, securities regulations also deal with specific issues which affect the integrity of the stock market, such as trading by company insiders and market manipulation. These other provisions, such as those dealing with insider trading and manipulation, are special devices for checking specific and known ills in the market. The informational regime, on the other hand, defines the philosophy of the market, and is intended to promote market order on an ongoing basis, by making information available and facilitating the discovery of share prices.

D. THE INFORMATIONAL REGIME AND EFFICIENT MARKETS – AN OUTLINE

The informational regime, as we have seen, requires extensive disclosures by corporations, and its rationale has been described in the following words:

¹⁹ Joint Stock Companies Registration and Regulation Act, 1844, 7 & 8 Vict., c. 110 & 111 (U.K.).

²⁰ A system of financial reporting by public companies was being gradually developed in United States when the securities laws were enacted and made the reports mandatory. In this sense, the securities statutes only gave legal shape to the practices that had already emerged in the market. For an account of the development of the informational regime in Britain since mid-nineteenth century and its adoption in the United States in the 1930s, see P.M. Vasudev, “Equity Pricing, the Informational Regime and Efficient Markets: A Historical Perspective” (February 2007). Available at SSRN: <http://ssrn.com/abstract=969751>, June 2007.

In a word, a respectable open market appraisal, based on a compromise between the opinions of willing buyers and willing sellers was what was actually required.

Appraisal necessarily turns on information. If the open market view was to approximate a judgment of worth, it became essential that some material for such judgment should be provided.²¹

Regulation mandates extensive corporate disclosures towards this end. Companies must file quarterly and annual reports with extensive financial and other business data and information.²² The recently-enacted Sarbanes-Oxley Act of 2002 continues with the same theme of disclosure, and goes further. It provides for “real-time disclosure,” and companies must make immediate disclosure of important developments.²³ As Loss and Seligman put it, “[t]here is the recurrent theme throughout these statutes of disclosure, again disclosure, and still more disclosure.”²⁴

Taking a cue from the informational regime, a section in the economics discipline, with doctrinaire loyalty to the principle of laissez-faire and the perfection of market processes, formulated the Efficient Markets Hypothesis a few decades later. Eugene Fama, a leading proponent of the Hypothesis, explained:

An "efficient" market is defined as a market where there are large numbers of rational, profit-maximizers actively competing, with each trying to predict future market values of individual securities, and where important current information is almost freely available to all participants.

²¹ This description of the informational regime is by Adolf A. Berle, whose writings played an important role in the adoption of the regime in the United States in the 1930s. Adolf A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property* (New York: The Macmillan Company, 1932) at p. 293.

²² Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq. Section 13.

²³ Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745, Section 409.

²⁴ Louis Loss and Joel Seligman, *Fundamentals of Securities Regulations*, 5th ed. (Frederick, Md: Aspen, 2004) at p. 8.

In an efficient market, competition among the many intelligent participants leads to a situation where, at any point in time, actual prices of individual securities already reflect the effects of information based both on events that have already occurred and on events which, as of now, the market expects to take place in the future. In other words, in an efficient market at any point in time the actual price of a security will be a good estimate of its intrinsic value.²⁵

The Efficient Market Hypothesis predicates that the market will apply the information disclosed by companies and arrive at prices that reflect the “intrinsic value” of the shares of various companies. The limited role which the informational regime seeks to play is making information available to the market and facilitating price determination by the market.

E. CASES SELECTED FOR STUDY

The cases selected for study in the paper – Enron, Sycamore and Amazon.com – all bring out the clear intersection between the stock market and corporate governance. They deal with the twin aspects of market efficiency and corporate governance, and explain corporate and stock market tendencies.

1. ENRON

Enron, an established energy company, experienced steep increases in its share prices during 1996-2001. The case of Enron is selected for three reasons:

- Asymmetry between the business progress reported by the company and the rise in its share prices.
- Business adventurism on the part of Enron in the final years of its existence. Inspired by the high valuations given by the stock market to the shares of technology companies, Enron ventured into

²⁵ Eugene Fama, “Random Walks in Stock Market Prices” (1965) 21 *Financial Analysts Journal* 55 at p. 56.

the broadband business in 1999, and spending hundreds of millions of dollars. This was two years before it filed for bankruptcy in 2001, and raises questions about corporate responsibility and accountability, and the incentives offered by the stock market.

- Increasing stock market-centricity of governance practices at Enron, personified by the application of share prices, rather than business results as the yardstick to assess managerial performance.

2. SYCAMORE NETWORKS

Sycamore Networks was founded in 1998 at the height of the Internet boom in the stock market and made two public issues in a span of seven months in 1999-2000, at the height of the boom. The case of Sycamore is remarkable for the following reasons:

- The readiness of the investors, during the Internet boom, to pour money into the company despite the admitted fact that it had no business purpose for which it needed to raise capital.
- Acquisition of shares by the insiders at a low price, and subsequent sale at high prices in the public issue.
- Subversion of the principle of disclosure in the statutory filings of Sycamore, and demonstrating how the principle can be used to protect managements against legal action, rather than inform the investors.
- Finally, the mismatch between the business results reported by the company and the rise in its share prices during 1999-2000. Events in the market undermine the theory of the informational regime, and refute the Efficient Markets Hypothesis.

3. AMAZON.COM

Amazon.Com, another technology company and a pioneer in electronic commerce, is selected for its demonstration of the following:

- Amazon.com made a small public issue in 1997 during the Internet boom, and got its shares listed on stock exchanges. Like Sycamore, Amazon.com also exaggerated the risk factors, and used it mostly to protect the interests of the management.
- By taking advantage of the listing of its shares, Amazon.com issued shares of the value of over a billion dollars to acquire new

businesses. But in the next three years, it almost completely eliminated the businesses acquired by it, by writing off their value from its balance sheet. We look at the implications of the freedom allowed in law for such practices.

- Like in the case of Sycamore Networks, increases in the price of Amazon.com shares were contrary to the dismal business results reported by it. The additional feature in the case of Amazon.com is that the market was also apparently guided by the predictions of an investment analyst, Henry Blodget, and repeatedly increased the prices of Amazon.Com shares, despite the bleak results reported by the company. The behaviour of the market, in the context of the prediction made by Henry Blodget, demonstrates the grip that sentiment, rather than concrete information has on the stock market.

A common thread that runs through the tales of all the three companies is the significant dichotomy between their statutory reports on the one hand, and the other communications issued by them, on the other. Forecasts and statements in the statutory reports are, at best, sober and sedate (Enron), and at worst, gloomy and cynical (Sycamore Networks and Amazon.com). But other communications released by the companies around the same time, such as press releases and letters to shareholders, were bubbling with enthusiasm and optimism about the future. The contrast between the two sets of information from the companies raises questions about which set of information guides the stock market.

II. ENRON CORP.

Enron Corp., founded in 1930, is a company of longstanding. It belonged to what might be termed the “old world” business culture where value was derived largely from physical assets such as land, buildings and plants, and actual earnings. Enron filed for bankruptcy towards the end of 2001. The 1990s, which was the last decade of its business existence, were eventful in the history of the company. In particular, the last five years since 1996 were marked by hectic activity. Enron’s volume of business operations, assets, and share prices all rose to great heights in this short period, before

the dramatic collapse towards the end of 2001.²⁶ The events in this period are examined here from the perspective of the three issues outlined above – namely, share prices and disclosures, corporate business freedom and the incentives offered to Enron management.

A. SHARE PRICES AND DISCLOSURES

We are informed by efficient market theorists that “actual prices of individual securities already reflect the effects of information based both on events that have already occurred and on events which, as of now, the market expects to take place in the future.”²⁷ This indicates that prices are based on two sets of data – corporate financial statements that provide information on “events that have already occurred,” and forecasts made by companies about their future prospects. The forecasts would be an important input for the market to predict the events which it “expects to take place in the future.” In recognition of these factors, regulation requires companies to submit reports on their past – namely, the financial statements,²⁸ and forecasts for the future.²⁹

The years from 1996 onwards were, as noted earlier, eventful for Enron. The table below has the business data and share prices of Enron in the period 1996-2000.³⁰ In October 2001, Enron revised its business results for these years, and they are considered a little later.

²⁶ For a comprehensive account of the business practices of Enron, its efforts to influence energy regulation and the factors and developments that caused the subsequent fall of Enron, see Joseph E. Stiglitz, *The Roaring Nineties: The Seeds of Destruction* (London: Allen Lane/Penguin, 2003).

²⁷ Eugene Fama, Note 25, above.

²⁸ Securities Exchange Act of 1934, Section 13.

²⁹ Securities and Exchange Commission (SEC). Regulation S-B, 17 CFR Part 228, Item 303.

³⁰ Data taken from Enron annual reports in Form 10-K, filed with Securities and Exchange Commission. The reports for each fiscal year are filed after the end of the year, in the early part of the next year. Available online: www.sec.gov, under “Company Filings,” CIK “0001024401.” For 1996, see under CIK “0000072859.” May 2007.

Table 1

Enron Corp.
Business Data and Share Prices 1996-2000 – An Analysis

Description	1996	1997	1998	1999	2000
Earnings on Common Stock (\$ Million)	568	88	686	827	896
Earnings Per Share (\$)	2.31	0.32	2.14	2.34*	2.44*
Dividend Per Share (\$)	0.86	0.91	0.96	1.00	1.00
Price Range per Share (\$)	35 – 48	35 – 45	38 – 59	29 – 90*	42 – 182*
Dividend as % of Peak Share Price	2.45%	2.02%	1.62%	1.11%	0.55%
Outstanding Common Shares (Million)	251	307	331	358*	376
Shareholders' Equity (\$ Million)	3,723	5,618	7,048	9,570	11,470
Market Capitalization at Peak Share Price (\$ Million)	8,785	13,815	19,529	32,220	68,432
Earnings as % of Market Capitalization	6.46%	0.64%	3.51%	2.57%	1.31%

* Enron made a two-for-one stock split in August 1999. The figures for 1999 and 2000 in the Table are adjusted for the stock split.

The growth in the earnings on common stock and other fundamentals during the five-year period was consistent, except for a setback in 1997. There were hardly any dramatic improvements in the business fundamentals of Enron during the five-year period in which peak share prices, adjusted for the split rose from \$ 48 to \$ 182. We can interpret the business data and prices of Enron shares in the following terms, to assess the informational efficiency of prices in the stock market.

- Price/earnings ratio, which interprets share prices in terms of the earnings of companies, is an important tool for evaluating investments, and it is supposed to influence the price determination in the market. The earnings of Enron grew by about 57 percent during the five years, but the increase in peak share price was 404 percent in the same period.³¹
- Price/dividend ratio measures the price of shares in terms of the dividend paid by companies, and is another tool for determining the investment value of shares. The dividend paid by Enron on its common shares during 1996-2000 was, by no means, impressive, and the price/dividend ratio showed consistent decline, from 2.45 percent in 1996 to 0.55 percent in 2000. The dividends paid by Enron, therefore, hardly offered an attractive or even a reasonable rate of return
- Shareholders equity, which grew from \$ 3,723 million to \$ 11,470 million, saw an increase of 308 percent. This is closer to the increase of 404 percent in the share prices, although there is a sizable gap between the increase in share price and shareholders' equity.
- We cannot also overlook the two-for-one stock split made by Enron in August 1999. The trend of increase in share prices prompted the stock-split, which was obviously intended to sustain

³¹ The pattern of changes in the minimum trading prices during the period was erratic. From 35 dollars in 1996, it fell to 29 dollars in 1999 but recovered to 42 dollars in 2000. But the trend with peak prices was consistent increase. They are more relevant for our analysis here because Enron was, at that time, considered a good investment opportunity, and its shares were a popular choice for investment.

the trend. The effort was successful as the peak price, adjusted for the split, more than doubled in the next year..

It is difficult to justify the market valuations of Enron shares by the conventional standards, such as return on investment and underlying value. But then, Efficient Markets Hypothesis is not merely a number-crunching exercise with the financial data of past periods. Efficient market theorists emphasize that the share prices reflect not only the information “on events that have already occurred,” but also “events, which, as of now, the market expects to take place in the future.”³² The forecasts presented by Enron were generally positive, and the company presented a picture of continuous growth. The following extracts from its statutory annual reports are its official statements about the future. The extracts are rather lengthy, but they are quite necessary for our analysis.

1. FORECASTS FOR 1997

Enron provided forecasts for six groups of activities in 1997³³

Transportation and Operation

The transportation and operation segment should continue to provide stable earnings and cash flows during 1997. Various expansion projects underway or proposed by the Enron Gas Pipeline Group should enhance future earnings when completed.

Domestic Gas and Power Services

During 1997, ECT anticipates continued growth in the cash and physical business over the 1996 results. The existence of its substantial portfolio of contracts as well as the ability to benefit from the relationships between the financial and physical markets and the natural gas and electricity markets provide substantial opportunities for earnings. Continued seasonal volatility of natural

³² Eugene Fama, Note 25, above.

³³ Enron Corp. Form 10-K for fiscal year 1996. Item 7, Management’s Discussion and Analysis of Financial Condition and Results of Operations, at p. 39-50, available online: <http://www.sec.gov/Archives/edgar/data/72859/0000072859-97-000009.txt>, May 2007.

gas prices will provide additional opportunities for increased earnings.

Risk Management

[Enron] expects earnings from risk management to increase in 1997 as compared to 1996 as it continues to pursue opportunities in the European marketplace and continues to increase integration of financial products and its energy commodity portfolio, resulting in highly structured transactions.

Finance

In 1997, [Enron] will continue to expand its products and services in its role as a full-service provider of various types of capital. In addition, earnings are expected from equity-based investments which are carried by JEDI at fair value and are therefore subject to market fluctuations.

International Operations and Development

The objective of [Enron] [International] is to develop, finance, own and operate integrated energy projects in emerging markets through the utilization of Enron's extensive portfolio of products and services. Growth opportunities in the emerging international markets are expected to result from the current and projected demand for energy infrastructure and merchant, finance and risk management services.

Exploration and Production

[Enron] [Oil & Gas Company] plans to continue to focus a substantial portion of its development and certain exploration expenditures in its major producing areas in North America. However, EOG anticipates spending an increasing part of its available funds in the further development of opportunities in India, Venezuela and Trinidad. In addition, EOG will continue limited exploratory expenditures in new areas outside of North America.

2. FORECASTS FOR 1998

Enron classified its activities during 1998 into four categories, and the forecasts continued with their general tone of optimism and hope.³⁴

Exploration and Production

Enron plans to continue its significant investments in development and certain exploration expenditures in its major producing areas in North America. In addition, Enron anticipates increased spending for the continued development of its significant international projects in India, Venezuela, Trinidad and China. Enron has hedged its net exposure to Enron's natural gas prices for 1998 production and will continue to assess opportunities for hedging future production.

Transportation and Distribution

Transportation and Distribution should continue to provide stable earnings and cash flows during 1998, including steady growth over 1997 levels.

Wholesale Energy Operations and Services

Enron anticipates continued growth in Wholesale during 1998. Asset development and construction earnings are expected to increase as a result of Enron's extensive portfolio of projects in various stages of development. In the cash and physical business, volumes are expected to continue to increase. In addition, the existence of a substantial portfolio of contracts as well as the ability to benefit from the relationships between the financial and physical markets and the natural gas and electricity markets provide substantial opportunities for earnings. Earnings from risk management are expected to increase as Enron continues to pursue opportunities in the European marketplace and continues to

³⁴ Enron Corp. Form 10-K for fiscal year 1997. Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, at p. 38-55, available online: <http://www.sec.gov/Archives/edgar/data/1024401/0001024401-98-000009.txt>, May 2007.

increase integration of financial products and its energy commodity portfolio worldwide. In the finance and investing business, Enron will continue to expand its products and services in its role as a full-service provider of various types of capital. Further expansion into new products and international markets is expected to increase results in all of these businesses.

Retail Energy Services

During 1998, E[nron] E[nergy] S[ervices] will continue its focus on commercial and light industrial customers in the energy market, while developing new energy products and expanding its customer base. EES also plans to continue its efforts to improve the regulatory environment for retail gas and electricity, both on state and federal levels,³⁵ strengthen its marketing and sales organization and continue to enhance its transaction support capabilities. E[nron] E[nergy] S[ervices] expects that 1998 losses will approximate those incurred in 1997.

Enron tempered its projections for 1998 with a note of caution on “Financial Risk Management,” and quantified the risk at \$ 39 million.

3. FORECASTS FOR 1999

For 1999, Enron made its business projections under of four categories,³⁶ and among these, it was rather neutral, if not pessimistic, about the prospects of one – Exploration and Production. Forecasts for the other three lines of business were optimistic in their usual bland style.

³⁵ The reference to the “efforts to improve the regulatory environment” is significant, as it indicates the political lobbying undertaken by Enron, and the inevitable corruption that accompanies such efforts.

³⁶ Enron Corp. Form 10-K for fiscal year 1998. Item 7, Management’s Discussion and Analysis of Financial Condition and Results of Operations, at p. 38-58, available online: <http://www.sec.gov/Archives/edgar/data/1024401/0001024401-99-000007.txt>, May 2007.

Exploration and Production

EOG plans to continue to focus a substantial portion of its development and exploration expenditures in its major producing areas in North America. In addition, EOG anticipates additional spending for the continued development of its projects in India, Trinidad and China.

In December 1998, Enron received an unsolicited indication of interest from a third party with respect to exploring a possible transaction pursuant to which the third party would acquire Enron's shares of EOG common stock and offer to acquire the remaining shares of outstanding EOG common stock. There can be no assurance that any such transaction will be consummated.

This cautious statement marks a departure from the usual tone of optimism and hope, and is uncharacteristic of Enron.

Transportation and Distribution

Transportation and Distribution should continue to provide stable earnings and cash flows during 1999, including steady growth over 1998 levels.

Wholesale Energy Operations and Services

Enron anticipates continued growth in Enron Wholesale during 1999 due to further expansion into new products and markets. In the commodity sales and services business, volumes are expected to continue to increase as Enron maintains or increases its market share in the growing unregulated U.S. power market and the European gas and power markets. In addition, Enron expects to benefit from opportunities related to its substantial portfolio of commodity contracts. Enron also expects to continue increased integration of financial products with its energy commodity portfolio. In the energy assets and investments business, Enron will continue to benefit from opportunities related to its energy investments, including sales or restructurings of appreciated investments, and in providing capital to energy-intensive

customers. Equity earnings from operations are expected to increase as a result of commencement of commercial operations of new power plants and pipeline in early 1999 including the larger power project in India.

Retail Energy Services

During 1999, Enron anticipates continued growth in the demand for energy outsourcing solutions. Energy Services will focus on delivering these services to its existing customers, while continuing to expand its commercial and industrial customer base for total energy outsourcing. Energy Services also plans to continue integrating its service delivery capabilities, focusing on the development of best practices, nation-wide procurement opportunities, efficient use of capital and centralized decision making. Energy Services expects reduced losses in 1999.

Market Risk

The use of financial instruments by Enron's businesses may expose Enron to market and credit risks resulting from adverse changes in commodity and equity prices, interest rates and foreign exchange rates.

The theme of risk was present again in the forecasts for 1999. After making the brief initial statement, extracted above, Enron classified market risks into four categories – commodity price, interest rate, foreign currency exchange rate, and equity – and described them at some length. But it did not quantify the value of the risks.

4. FORECASTS FOR 2000

The number of business categories was five for 2000, but Enron presented forecasts only for four of them, all uniformly sunny.³⁷ For the fifth line of business, Exploration and Production, about which Enron had been cautious in the earlier year, it made no forecasts.

Transportation and Distribution

The Gas Pipeline Group should continue to provide stable earnings and cash flows during 2000, including steady growth over 1999 levels. Low operating costs, competitive rates and continued expansion opportunities enable the Gas Pipeline Group to continue to be a strong, efficient competitor in all markets.

Wholesale Energy Operations and Services

Enron Wholesale plans to continue to expand its networks in each of its key energy markets, as well as the market for broadband services. Worldwide energy markets continue to grow as governments implement deregulation or privatization plans. The market for broadband services is expected to increase significantly as demand increases for high bandwidth applications such as video. Enron will continue to purchase or develop selected assets to expand its networks, as well as grow its portfolio of contracts providing access to third-party assets. The combination of growing markets and Enron Wholesale's highly developed market-making skills should continue to enhance market opportunities globally for Enron over the next several years.

As a result, Enron anticipates continued growth in Enron Wholesale during 2000. In the commodity sales and services

³⁷ Enron Corp. Form 10-K for fiscal year 1999. Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, at p. 29-41, available online: <http://www.sec.gov/Archives/edgar/data/1024401/0001024401-00-000002.txt>, May 2007.

business, volumes are expected to continue to increase as Enron Wholesale increases its transaction volume in the growing unregulated U.S. power market and in the rapidly expanding European gas and power markets. In addition, EnronOnline is expected to significantly add to transaction volume and profit opportunities in the coming year. In the assets and investments business, Enron Wholesale expects to continue to benefit from opportunities related to its assets and investments, including sales or restructurings of appreciated investments, and in providing capital to energy-intensive customers. Equity earnings from operations are expected to increase as a result of commencement of commercial operations of new power plants and pipeline projects in early 2000.

Retail Energy Services

During 2000, Energy Services anticipates continued growth in the demand for retail energy outsourcing solutions, both domestically and internationally. Energy Services will deliver these services to its existing customers, while continuing to expand its commercial and industrial customer base for total energy outsourcing. Energy Services also plans to continue integrating its service delivery capabilities, focusing on the development of best practices, nationwide procurement opportunities and efficient use of capital.

5. FORECASTS FOR 2001

The final set of forecasts made by Enron was for 2001, the last year before it filed for bankruptcy.³⁸ Enron presented forecasts for four lines of business, but there was a new entrant – broadband. In starting this new line of business, Enron was quite obviously inspired by the Internet boom in the stock market, and we discuss the issue in detail in Section [b], below. Let us now take a look at the business forecasts made by Enron for 2001.

³⁸ Enron Corp. Form 10-K for fiscal year 2000. Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, at p. 28-43, available online: <http://www.sec.gov/Archives/edgar/data/1024401/000102440101500010/0001024401-01-500010.txt>, May 2007.

Transportation and Distribution

Enron Transportation Services is expected to provide stable earnings and cash flows during 2001. The four major natural gas pipelines have strong competitive positions in their respective markets as a result of efficient operating practices, competitive rates and favorable market conditions. Enron Transportation Services expects to continue to pursue demand-driven expansion opportunities.

Wholesale Services

In 2001, Wholesale Services plans to continue to fine-tune its already successful existing energy networks. In North America, Enron expects to complete the sale of five of its peaking power plants located in the Midwest and its intrastate natural gas pipeline. In each case, market conditions, such as increased liquidity, have diminished the need to own physical assets. For energy networks in other geographical areas where liquidity may be an issue, Enron will evaluate whether its existing network will benefit from additional physical assets. The existing networks in North America and Europe should continue to provide opportunities for sustained volume growth and increased profits.

The combination of knowledge gained in building networks in key energy markets and the application of new technology, such as EnronOnline, is expected to provide the basis to extend Wholesale Services' business model to new markets and industries. In key international markets, where deregulation is underway, Enron plans to build energy networks by using the optimum combination of acquiring or constructing physical assets and securing contractual access to third party assets. Enron also plans to replicate its business model to new industrial markets such as metals, pulp, paper and lumber, coal and steel. Enron expects to use its Ecommerce platform, EnronOnline, to accelerate the penetration into these industries.

Retail Energy Services

During 2001, Energy Services anticipates continued growth in the demand for retail energy outsourcing solutions. Energy Services will deliver these services to its existing customers, while continuing to expand its commercial and industrial customer base for total energy outsourcing. Energy Services also plans to continue integrating its service delivery capabilities, extend its business model to related markets and offer new products.

Broadband Services

Broadband Services is extending Enron's proven business model to the communications industry. In 2001, Enron expects to further develop the Enron Intelligent Network, a global broadband network with broad connectivity potential to both buyers and sellers of bandwidth through Enron's pooling points. In addition, Enron expects to further deploy its proprietary Broadband Operating System across the Enron Intelligent Network, enabling Enron to manage bandwidth capacity independent of owning the underlying fiber. Broadband Services expects its intermediation transaction level to increase significantly in 2001 as more market participants connect to the pooling points and transact with Enron to manage their bandwidth needs. The availability of Enron's bandwidth intermediation products and prices on EnronOnline are expected to favorably impact the volume of transactions. In 2001, Broadband Services expects to continue to expand the commercial roll-out of its content service offerings including video-on-demand. Enron expects the volume of content delivered over its network to increase as more content delivery contracts are signed and as more distribution partner locations are connected.

The annual report in Form 10-K for 2000 also had a lengthy discussion on risk factors, but again it did not quantify the value of the risks anticipated for 2001.

In general, the forecasts made by Enron for the five years 1997-2001 were characterized by a sense of optimism and hope. They gave little cause for concern. Applying the broad principles of the informational regime and Efficient Markets Hypothesis, the action of the stock market in giving progressively higher valuations to the shares of Enron during this period cannot be faulted. But the question raised here is with respect to the proportionality of increase or the sense of balance in market reaction, rather than the nature of the reaction or the quantum of increases.³⁹

As we noted earlier, the increase in peak share prices, at 404 percent, was out of proportion to the growth in earnings (57 percent), and the growth in shareholders' equity (308 percent). Also, the market appears to have almost completely ignored the cautions on risks sounded by Enron in its statutory filings. These raise questions about the seriousness with which the stock market treats the statutory filings whose stated purpose is to guide the market. The tone and spirit of the statements in the statutory filings, extracted above, were sober and sedate. There were no attempts to sensationalizing, nor was eloquence applied to paint a very rosy picture for the company.

The case was, however, quite different with the press releases issued by Enron during 1997-2001, particularly the ones issued in 2001 before the company filed for bankruptcy. The press releases used more direct and aggressive language in projecting the company. They were, quite obviously, intended to feed the stock market with stories of never-ending success and profits, and drive the price of Enron shares upwards.

The following are some prominent examples of the variety of information Enron released to the media.⁴⁰

³⁹ It is not possible to attribute the increases in the price of Enron shares to the "Internet boom," which gripped the stock market in the late 1990s. Enron had little to do with the Internet, at least until 1999 when the company ventured into "broadband networks," as we will see a little later.

⁴⁰ The complete list and texts of the press releases issued by Enron Corp. in 2001 are available online: <http://www.enron.com/corp/pressroom/releases/2001/>, May 2007.

- “Enron Announces Increased Earnings Target for 2001,” January 25, 2001.
- “Enron Reports Record First Quarter Earnings of \$ 0.47 per Diluted Share; Increases Earnings Expectations for 2001,” April 17, 2001.
- “Enron Reiterates Confidence in Operations and Earnings Outlook,” June 19, 2001.

These releases related to the profits and earnings of Enron’s business. Alongside, Enron issued a number of press releases that regularly extolled the other accomplishments of the company. They had headlines like “Enron Named Most Innovative for Sixth Year” (June 2, 2001).⁴¹ The runaway increases in the price of Enron shares can be traced more to the tone and contents of the press releases and media reports, rather than the sober and balanced language of the statutory filings.

The question here is which source of information received greater weight in the stock market? Was it the press releases and media reports, or the statutory filings? If the actual events in the market are inspired by corporate press releases, rather than the contents of statutory filings, then which of them is the source of the “information” stressed by the Efficient Markets Hypothesis? What is the actual significance of the elaborate informational regime? These questions are again articulated in the concluding section of the paper.

B. ACCOUNTING RESTATEMENTS BY ENRON

In October 2001, Enron restated its financial data for the years 1997 to 2000. This triggered a panic in the stock market, which led to a collapse in the price of its shares, and finally the company itself. The following is a summary of the accounting revisions announced by Enron.⁴²

⁴¹ Ibid.

⁴² Data taken from the Report of Special Investigative Committee of the Board of Directors of Enron Corp. (William C. Powers Committee), February 1, 2002, available online: www.news.findlaw.com/wp/docs/enron/specinv020102rpt1.pdf, May 2007

Table 2

Enron Corp.
Impact of Accounting Restatements Announced in October 2001

(All figures in \$ million)

Year	Earnings Original	Earnings Revised	Shareholders' Equity Original	Shareholders' Equity Revised
1997	88	60	5,618	5,360
1998	686	553	7,048	6,657
1999	827	579	9,570	8,860
2000	896	779	11,470	10,716
Net Change		- 526		

The revised information was, admittedly, not available to the market at the time when the prices were determined in the market in the above years, and they are not relevant for our assessment of the informational efficiency of the market with respect to the contemporary prices set in the market. But the revised data are relevant for what happened in the market after the revision.

According to the doctrine of the informational regime and the Efficient Markets Hypothesis, the market must have adjusted the prices of Enron shares in line with the revised data. The total revision in earnings was to the tune of 21 percent, and in the case of shareholders' equity, the revision was less than 7 percent. Going by the Efficient Markets Hypothesis, revision in the price of Enron shares must have been in the neighbourhood of these percentages. But it was not so. The market overreacted to the revisions, just as it had earlier overreacted to positive news from the company, and slaughtered Enron shares.

The reaction of the stock market to information was excessive on both occasions, earlier when Enron projected a very rosy future, and later when

it revised its earnings figures. The company did, after all, have its business and assets. The liquidity problems which led to the bankruptcy filing in 2001 were a passing phase, and there were no grounds to believe that the case was hopeless. The business of the company – namely, selling energy, was fundamentally sound. That the market perception about the value of Enron was wrong is proved by the fact that it has made disbursements of over \$ 11 billion since the bankruptcy filing until March 2007.⁴³

C. ENRON, BROADBAND NETWORKS AND BUSINESS ADVENTURISM

In 1999 at the height of the frenzy in the stock market in the shares of Internet companies, Enron ventured into broadband business. Those were also the heady days of growth at Enron, and starting new ventures was the order of the day. Enron, an energy company with 70 years' standing, was apparently mesmerized by the spell of Internet technology, and decided to take the plunge.⁴⁴ The following is an account of how Enron went about its broadband network venture.

Under American corporate law, as it developed in early twentieth century, corporate managements have complete freedom to take up any business activity. There are neither legal restrictions on their powers, nor even procedural safeguards.⁴⁵ It would be obvious from the following discussion that Enron jumped into the broadband venture investing hundreds of millions of dollars, without serious planning. The actions of

⁴³ Enron Creditors Recovery Corp. (formerly Enron Corp.) Press Release “Enron Distributes Approximately \$ 1.9 Billion to Creditors” 2 April 2007, available online: <http://www.enron.com/corp/pressroom/>, May 2007.

⁴⁴ For an entertaining account of the Net Frenzy in the stock market in the 1990s, see William Bonner & Addison Wiggin, *The Financial Reckoning Day: Surviving the Soft Depression of the 21st Century* (Hoboken, N.J.: John Wiley & Sons, Inc., 2003).

⁴⁵ For an account of the position that existed earlier in the nineteenth century when the business activities of corporations were subject to regulation, and the gradual changes that occurred, see Morton J. Horwitz, “Santa Clara Revisited: The Development of Corporate Theory” (1985) 88 W. Va. L. Rev. 173.

Enron described here raise questions about the decision-making process in large public corporations, the level of responsibility that informs the process, and accountability of corporate actors for their decisions.

The following table has the comparative data with respect to “capital expenditures and equity investments” of Enron for 1999. Plans of capital expenditure were given in the annual report in Form 10-K for 1998 filed in 1999, and the actual expenditures were given in the annual report for 1999 filed in 2000.

Table 3

Enron Corp.
Capital Expenditures and Equity Investments
(Figures in \$ Million)

Description	Estimates	Actual Expenditure	Difference
Transportation and Distribution	550	316	-234
Wholesale Energy Operations and Services	310	1,216	+906
Retail Energy Services	410	64	-346
Exploration and Production	40	226	+186
Corporate and Other	300	541	+241
Total	1,610	2,363	+753

It can be seen from the above table that there is no reference to any expenditure on broadband networks either in the plan figures reported in 1998 or in the actual expenditure reported in 1999. In particular, the absence of any reference in the estimates given as a part of the 1998 report indicates that Enron did not have any plans to venture into this new line of

business. On closer scrutiny, we find that the new line of business, broadband network, is tucked away under “wholesale energy operations and services.” The capital expenditure under this head (\$ 1,216 million) was about four times the estimate (\$ 310 million), but there is no explanation for the overrun. In particular, there is no information on the expenditure incurred on the broadband network. Given the size of the overrun and the fact that a new venture – broadband network – was taken up during the year, it is reasonable to assume that the expenditure on the new venture was to the tune of several hundreds of millions of dollars.

Against this background, disclosures made in the annual report for fiscal year 1999, the year in which the investment was actually made, are revealing.⁴⁶

- In the discussion of “Business” in Part 1 of the report, there is a rather abrupt reference to “communication assets including broadband services,” and they are included in “Wholesale Energy Operations and Services.” No efforts are made to introduce the fact that the company had entered the broadband business.⁴⁷
- The next reference to “broadband services business” has the prefix “new,” and this is the only indication that it represents a new line of business for the company.⁴⁸
- The report then has six paragraphs which generally extol the advantages of the “Enron Intelligent Network (“EIN”), a high capacity, global fiber optic network with a distributed server architecture, to provide services to the broadband market.”⁴⁹
- The lengthy discussion makes no efforts to identify how and by whom the decision to enter the broadband business was taken, nor does it disclose the amount of investment.

⁴⁶ Note 37, above.

⁴⁷ Ibid. at p. 1.

⁴⁸ Ibid. at p. 5.

⁴⁹ Ibid. at p. 11.

- The only references to the individuals involved in the new broadband venture are in the designations of Joseph M. Hirko, who is described as the “CEO of Enron Broadband Services,” and Kenneth D. Rice, who is also described as “CEO of Enron Broadband Services.”⁵⁰
- In the discussion of “Outlook” for 2000, as we have noted above, the report was quite eloquent about the potential of the broadband business.⁵¹

From the above, we can reasonably conclude that (a) the broadband network business was started rather suddenly in 1999, and (b) its cost ran into many hundreds of millions of dollars. The company folded up in the next two years, and the fate of the broadband network is not known. The variety of reporting done by Enron is also significant. It did not disclose the expenditure incurred by it on the new venture, the broadband network, nor did it discuss the venture in an intelligible manner.

The wide variance between the capital expenditure plans for 1999 disclosed in annual report for 1998 filed at the beginning of 1999 and the actual expenditure reported for 1999 indicate that Enron management had little respect for its own estimates. It casually overshot the estimates, and the total overrun was more than \$ 750 million. Neither corporate law, nor the informational regime has anything to say on such conduct. On the contrary, the defense of business judgment accepted by the courts would prevent them from examining such managerial decisions and actions, if they were to be questioned in court.⁵²

In terms of corporate accountability, the fact that Enron management could rush into such decisions and expend very large sums of (other peoples’) money is a commentary on the way public corporations are

⁵⁰ Ibid. at p. 20-21.

⁵¹ P. 18, above.

⁵² For a general critique of the business judgment rule, see Lawrence E. Mitchell, *Corporate Irresponsibility: America’s Newest Export* (New Haven, Connecticut: Yale University Press, 2001).

presently organized under the law. The cursory discussion made by Enron management with respect to the new business, ex post, is an indication of the efficacy of the informational regime. The company did not have to disclose the amount of money invested in the new business, the considerations which went into the decision or the identity of the individuals involved in the decision. The barebones disclosures actually made by Enron are sufficient compliance with regulation, but they are virtually useless in terms of promoting corporate responsibility or accountability.

The broadband venture of Enron was more in the spirit of Adam Smith's "speculative merchant" who

[e]xercises no one regular, established, or well-known branch of business. He is a corn merchant this year, or tea merchant the year after. He enters into every trade when he foresees that it is likely to be more than commonly profitable . . .⁵³

The criticisms leveled above can be countered with the argument, what if the broadband network investment had paid off? The question smacks of a gambling and speculative approach to business managed by a few for the benefit of many, and reinforces the earlier criticism about weak corporate responsibility and accountability. The amount of money in question was very large, and was not that of the persons who handled it. The decisions made by this handful of individuals would have serious consequences for many others, and it is imperative that a sense of responsibility informs the conduct of the persons in such positions of power. The freedom that business corporations are given in law, exemplified by consequences such as the broadband business venture of Enron, must also be examined from these perspectives.

Enron's annual report for the next year (2000)⁵⁴ is eloquent about the business advantages which Enron expected to derive from the broadband

⁵³ Adam Smith, *An Enquiry into the Nature and Causes of the Wealth of Nations*, Book 1, Chapter 10, Part 1. Available online: <http://geolib.com/smith.adam/won1-10.html>, June 2007.

⁵⁴ Note 38, above.

business. However, it actually lost \$ 60 million in 2000 from the broadband business. According to the annual report for 2000, Enron expected to incur further capital expenditure of \$ 436 million on its broadband network in 2000, and another \$ 700 million in 2001.

The argument here is that the high valuations offered by the stock market for the shares of technology companies in the late 1990s was the incentive for Enron to venture into broadband business, and the above is a brief tale of how it went about the venture. It is not that business enterprises must have no flexibility, but it is important that we combine it with adequate safeguards which would guide managements towards responsible decision-making, and promote accountability.

D. ENRON MANAGEMENT AND ITS INCENTIVES FOR PERFORMANCE

The managerial style at Enron became increasingly stock market-centric in the final years, and this is exemplified by the performance incentives offered to its senior management. Here, we examine the employment contracts of its CEO, Kenneth Lay, and his last two contracts with the company explain how stock market considerations emerged as the sole concern at Enron in its last years.. The incentives offered to Kenneth Lay were primarily geared towards achieving increases in share prices; improving business performance was only secondary.

Kenneth Lay had an employment agreement dated September 1, 1989 and there was a fifth amendment to the agreement in February 1994.⁵⁵ By this amendment, Kenneth Lay had the option to acquire 1.2 million shares of Enron at the then prevailing market price of \$ 34. The right to exercise the options was linked to Enron achieving 15 percent compounded growth in earnings per share in 1994, 1995 and 1996. This can be traced to the well-known tendency of the stock market to give higher valuations to the shares

⁵⁵ Text of the amendment is a part of the annual report of Enron in Form 10-K for 1993, available online: <http://www.sec.gov/Archives/edgar/data/72859/0000072859-94-000005.txt>, June 2007.

of companies that show growth in earnings. This tendency of the stock market is well-known.⁵⁶

Faced with growth targets for earnings, Kenneth Lay was able to achieve growth right on target, as evident from the table below.

Table 4

Enron Corp.
Earnings per Share Targets and Actual – 1994-96

Year	Earnings Per Share Target	Actual Earnings Per Share
1994	1.783	1.80
1995	2.050	2.07
1996	2.357	2.31

The accuracy with which Enron achieved the growth in earnings per share is remarkable. It raises questions about the quality of the financial statements of Enron for the relevant years (1994, 1995 and 1996), given its record of financial misstatements and restatements. The fatal restatements announced by Enron in 2001 were with respect to 1997, 1998, 1999 and 2000, but the closeness of the reported earnings for the earlier years with the respective targets is suspicious.

In the Roaring Nineties,⁵⁷ the use of stock options, and share price increases triggered by reported increases in earnings were both widespread. The annual growth rate target of 15 percent determined by Enron was neither accidental, nor uncommon. It was apparently the norm of the times. Edward Chancellor explained:

⁵⁶ The Conglomerate Boom of the 1960s, in which companies went on a spree of acquiring other companies with higher earnings, was an early symptom of this trend. See George Soros, *The Alchemy of Finance: Reading the Mind of the Market* (New York: John Wiley & Sons, Inc., 1987).

⁵⁷ The phrase has been used by Joseph Stiglitz, note 26, above.

Equity-linked bonus schemes provide a clear incentive for managements to fix the numbers. During the bubble period, the market tended to reward companies which managed to supply annual per-share earnings growth of 15% - a magic number chosen, it would seem, because it implied profits would double over five years. In the real world, in a period of low inflation, this was an absurd target. Nevertheless, it became commonplace. Earnings-growth targets were achieved through a number of ways. First, it became common to report to investors unofficial and unaudited earnings figures – known as “pro forma” – which ignored certain costs such as depreciation charges. Second, growth in earnings per share was frequently boosted by taking on debt to repurchase shares. Third, some companies looked to reduce normal business expenses, such as investment in research and development or marketing, in order to create the illusion of sustainable earnings growth. Fourthly, many companies – such as the conglomerates General Electric and Tryco – bolstered their earnings by acquiring other companies, whose share were less highly-valued.⁵⁸

The saving grace with the 1994 amendment to the employment contract of Kenneth Lay was that it at least linked improving the business performance and earnings of the company to the incentive offered to Lay. It was not directly concerned with managing share prices in the stock market. But these pretenses were dropped in the next employment contract of Lay, signed in December 1996.⁵⁹

Under the 1996 agreement, Kenneth Lay could get 637,500 shares of Enron on the condition that the price of Enron shares outperformed the Standard and Poor Composite Index. This was to be the new yardstick for measuring the performance of Kenneth Lay. The focus is entirely on share prices, and other considerations are irrelevant. Everything is subordinated

⁵⁸ Edward Chancellor, “Sold Out” *The Guardian*, 27 June 2002.

⁵⁹ The agreement is Exhibit 10.25 to the annual report in Form 10-K filed by Enron for fiscal year 1996, available online: <http://www.sec.gov/Archives/edgar/data/1024401/0000950129-97-001319.txt>, June 2007.

to the supreme goal of managing increases in share prices, and all corporate actions must lead towards this goal.

The actions of Enron during the fateful years, 1997-2001, can be better understood from the perspective of the incentives that were held out to its management, exemplified by the employment contract of Kenneth Lay. Excessive risk-taking, expensive efforts at influencing regulation through political and administrative corruption, unduly optimistic press releases, business losses and clumsy efforts to cover them up, all appear, in retrospect, inevitable, almost pre-ordained. They were beckoning, and Enron and Lay had to only grasp them.⁶⁰

III. SYCAMORE NETWORKS

Sycamore Networks is a representative of the technology companies which were started in large numbers during the Internet boom in the stock market in the late 1990s. A theory was presented that the business value of these companies was in their cutting edge technology, and the potential for profits was huge, virtually limitless.⁶¹ By implication, conventional standards like physical assets and earnings would have little relevance for such companies.⁶² This was an important distinction because it eliminated arguments that the high prices which the market gave to the shares of Internet companies could not be justified with reference to conventional standards. This was the milieu in which Sycamore Networks made its entry.

⁶⁰ The end of Kenneth Lay, the son of a poor preacher, was fittingly melodramatic. The trial court convicted him in May 2006 of various crimes, and he faced a long prison sentence. But Lay died in less than two months, in July 2006 before his sentence was determined. Significantly, the conviction of Kenneth Lay was vacated after his death, which means that his family would not be deprived of most of the wealth acquired by Lay.

⁶¹ For an entertaining and irreverent account of the exaggerations made about technology companies during the period, see William Bonner and Addison Wiggin, note 44, above.

⁶² For a discussion on such arguments, see Geoffrey Moore, "When private goes public" *Forbes*, 10 April 1999.

Sycamore Networks was incorporated in 1998, and quickly made two public issues – one in August 1999 and another in March 2000. Admittedly for neither of the two issues did it have any business needs for which it required capital. The Delaware corporate statute places no restrictions on the right of corporations to issue their shares.⁶³ It is not necessary that companies must have business need, or other legitimate reasons before they can issue their shares to the public. They are free to offer their shares to the public, and the only consideration is that there are willing buyers for the shares offered.

Neither does securities law require that companies must have business needs or other legitimate reasons for public issues.⁶⁴ It is sufficient for the purpose of securities law if a company making a public issue discloses its plans on how it would use the proceeds of the issue, or alternatively, state that it has no plans!

Neither corporate law nor securities law seek to regulate issues of shares by companies to the public.⁶⁵ The matter is left to the all-wise market, which is considered to be sufficiently capable of handling such questions. There is no role for public policy, represented by the law, to intervene in such matters. Sycamore Networks is a case-in-example of the possibilities in this loose regulatory framework.

As we noted earlier, Sycamore Networks was incorporated in February 1998, at the height of the Internet boom in the stock market. It made two public issues, one in August 1999 and the other, a “follow-up” issue, in February 2000. Both the public issues were made during the boom period, and the company and its management took full advantage of the prevailing sentiment in favour of technology companies. The company collected over \$ 1.5 billion from the two public issues, while insiders collected over \$ 260 million from sale of the shares held by them. We now examine how the company marketed its issues, and how it was received by the investors.

⁶³ Delaware General Corporation Law, Section 151.

⁶⁴ On the contrary, they expressly permit companies having no specific need for capital, termed “blank check companies” to make public issues. Securities Act of 1933, 15 U.S.C. 77a et seq. Section 3(b)(3) and Rule 419 (17 CFR Part 230).

⁶⁵ The issue of public issues and their legitimacy is discussed a little later.

A. SYCAMORE DISCLOSURES AND STOCK MARKET BEHAVIOUR

The rationale of the informational regime is that the disclosures made by companies will put the investors on alert, and enable them to make informed investment decisions.⁶⁶ The law does not seek to directly protect the investors, but merely requires companies to make disclosures. The theory is that the investors, armed with knowledge, would be able to assess the quality of public issues and protect themselves by making appropriate investment decisions. Among the disclosures which companies must make with respect to their public issues, “risk factors” are an important part. Information about the risk factors is supposed to put the investors on guard, and help them to decide about their choice of investments.

The other side of the informational regime is that once a company has made the necessary disclosures, it cannot be held responsible for the outcome of the investment decisions made by investors. The reasoning is that if the investors have been alerted by the risk factors disclosed, and if the risks materialize later on, the corporation which had already issued a warning about the risk can hardly be held to task.

Sycamore Networks, as we have noted, is a company formed during a particular tide in the stock market – the Internet boom – and it intended to take advantage of it. The events in Sycamore are more intelligible when viewed from this perspective. The first registration statement filed by Sycamore Networks under the Securities Act of 1933 began with the following caveat.⁶⁷

You should rely only on the information contained in this prospectus. We have not authorized anyone to provide you with information different from that contained in this prospectus.

⁶⁶ P.M. Vasudev, note 20, above, at p. 35.

⁶⁷ Sycamore Networks, Registration Statement in Form S-1, August 6, 1999, at p. 3. Available online: <http://www.sec.gov/Archives/edgar/data/1092367/0000927016-99-002819.txt>, May 2007.

The caveat is significant because the company, like Enron, was in the practice of issuing frequent press releases, and it was also often written about in the financial press. These reports generally projected the company in a favourable light, and the caveat was meant to shield the management against charges with respect to any information in the press releases or media reports. The caveat was followed by a lengthy account of the “Risk Factors,”⁶⁸ and it is necessary to extract the leading risk factors reported by the company, not despite but because of their length.

- We Expect that Substantially All Of Our Revenues Will Be Generated From A Limited Number Of Customers. We currently have only one customer, Williams Communications. Williams is not contractually committed to purchase any minimum quantities of products from us.
- Our Business Is Difficult To Evaluate Because We Have A Limited Operating History.
- Our Failure To Increase Our Revenues Would Prevent Us From Achieving And Maintaining Profitability
- We have incurred significant losses since inception and expect to continue to incur losses in the future.
- We Are Entirely Dependent On Our Line Of Intelligent Optical Networking Products And Our Future Revenue Depends On Their Commercial Success.
- Our future growth depends on the commercial success of our line of intelligent optical networking products. To date, our SN 6000 Intelligent Optical Transport product is the only product that has been shipped to a customer.
- We intend to develop and introduce new products and enhancements to existing products in the future. We cannot assure you that we will be successful in completing the development or introduction of these products. Failure of our current or planned products to operate as expected could delay or prevent their adoption.

⁶⁸ Ibid. at p. 6-16. The extracts here are mostly bare headings. For detailed warnings, see the document itself.

- Because Our Products Are Complex And Are Deployed In Complex Environments, They May Have Errors Or Defects That We Find Only After Full Deployment, Which Could Seriously Harm Our Business.
- The market for intelligent optical networking products is new. We cannot be certain that a viable market for our products will develop or be sustainable.
- Our Business Will Suffer If We Do Not Respond Rapidly To Technological Changes.
- Our Business Will Suffer If Our Products Do Not Anticipate And Meet Specific Customer Requirements.
- We Face Intense Competition.⁶⁹
- Our Business Will Suffer If We Do Not Expand Our Sales Organization And Our Customer Service And Support Operations.
- We Depend Upon Contract Manufacturers And Any Disruption In These Relationships May Cause Us To Fail To Meet The Demands Of Our Customers And Damage Our Customer Relationships.
- We Rely On Single Sources For Supply Of Certain Components And Our Business May Be Seriously Harmed If Our Supply Of Any Of These Components Is Disrupted.
- The Unpredictability Of Our Quarterly Results May Adversely Affect The Trading Price Of Our Common Stock.
- You should not rely on our results or growth for one quarter as any indication of our future performance.
- Undetected Software Or Hardware Errors And Problems Arising From Use Of Our Products In Conjunction With Other Vendors' Products Could Have A Material Adverse Effect On Us.
- Our Failure To Establish And Maintain Key Customer Relationships May Result In Delays In Introducing New Products Or Cause Customers To Forego Purchasing Our Products.
- Our Business Will Suffer If We Fail To Properly Manage Our Growth.
- We Depend On Our Key Personnel To Manage Our Business Effectively In A Rapidly Changing Market And If We Are Unable

⁶⁹ This contradicted the earlier statement, at p. 2, about the significant innovative features of the product of Sycamore Networks and its unique advantages.

To Retain Our Key Employees, Our Ability To Compete Could Be Harmed.

- Our Business Will Be Adversely Affected If We Are Unable To Protect Our Intellectual Property Rights From Third-Party Challenges.
- If Necessary Licenses Of Third-Party Technology Are Not Available To Us Or Are Very Expensive Our Business Will Be Seriously Harmed.
- We Could Become Subject To Litigation Regarding Intellectual Property Rights Which Could Seriously Harm Our Business.
- We May Face Risks Associated With Our International Expansion That Could Seriously Harm Our Financial Condition And Results Of Operations.
- We Face A Number Of Unknown Risks Associated With Year 2000 Problems.⁷⁰
- Any Acquisitions We Make Could Disrupt Our Business And Seriously Harm Our Financial Condition.
- Our Stock Price May Be Volatile.
- Management May Apply The Proceeds Of This Offering To Uses That Do Not Increase Our Profits Or Market Value.⁷¹
- Insiders Will Continue To Have Substantial Control Over Sycamore After This Offering And Could Limit Your Ability To Influence The Outcome Of Key Transactions, Including Changes of Control.
- Provisions Of Our Charter Documents And Delaware Law May Have Anti-Takeover Effects That Could Prevent A Change Of Control.
- Provisions of our amended and restated certificate of incorporation, bylaws, and Delaware law could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our stockholders.

⁷⁰ This is a rather strange statement from a company that has hardly commenced operations, and must be in a position to take effective steps to handle the perceived risks from the Year 2000 phenomenon.

⁷¹ This comes perilously close to admission of criminal intentions on the part of the management.

- There May Be Sales Of A Substantial Amount Of Our Common Stock After This Offering That Could Cause Our Stock Price To Fall.
- Our current stockholders hold a substantial number of shares, which they will be able to sell in the public market in the near future. Sales of a substantial number of shares of our common stock within a short period of time after this offering could cause our stock price to fall. In addition, the sale of these shares could impair our ability to raise capital through the sale of additional stock.

These dire warnings left nothing to chance. The authors of the document were, however, still not satisfied, and invoke the so-called “safe-harbour” in the Securities Laws for further protection.⁷² They add:

We believe that it is important to communicate our future expectations to our investors. However, there may be events in the future that we are not able to accurately predict or control. The factors listed above in the section captioned “Risk Factors,” as well as any cautionary language in this prospectus, provide examples of risks, uncertainties and events that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements. Before you invest in our common stock, you should be aware that the occurrence of the events described in these risk factors and elsewhere in this prospectus could have a material adverse effect on our business, results of operations and financial position.⁷³

Quite obviously, the registration statement has been prepared with a great deal of care to ensure that the management of Sycamore would be adequately protected if there were any allegations about the public issue and the prospects of the company. This is a neat subversion of the principle of disclosure which is the foundation of the informational regime. The disclosures required in law are meant to inform the investors, rather than to protect the persons who issue the securities. The case of

⁷² Securities Act, Section 27A.

⁷³ Sycamore Networks, Registration Statement in Form S-1, note 67, above at p. 16.

Sycamore is an illustration of how an apparently well-conceived regulatory instrument can be abused.

Subsequently in the discussion on “Business,” later in the document,⁷⁴ Sycamore Networks portrayed its product and business prospects in a somewhat positive light, but was careful to add some references to the uncertainty created by factors such as the “intensely competitive market”⁷⁵ and the possibility of “claims [of] infringement with respect to our current or future products.”⁷⁶ This is yet another example of clever legal drafting. A registration statement for securities, or to use the traditional term, “prospectus,”⁷⁷ cannot completely avoid any favourable description of the business of the company which plans to issue the securities. At the same time, the promoters would be at risk if the descriptions are very rosy and optimistic. Therefore, clever efforts are made to blend optimism with uncertainty.

1. PURPOSE OF FIRST PUBLIC ISSUE

After making dark predictions about the future, Sycamore explained the purposes for which it planned to make the public issue.

The principal purposes of this offering are to establish a public market for our common stock, to increase our visibility in the marketplace, to facilitate future access to public capital markets, to provide liquidity to existing stockholders and to obtain additional working capital.

We expect to use the net proceeds for general corporate purposes, including working capital and capital expenditures, and the

⁷⁴ Ibid. at p. 25-34.

⁷⁵ Ibid. at p. 33.

⁷⁶ Ibid. at p. 34.

⁷⁷ The older term “prospectus,” derived from the word “prospect,” was etymologically more accurate. A statement issued in connection with the issue of securities would describe the “prospects” of the project that was planned with the money to be raised from the issue. The current term “registration statement” is largely neutral in its import, and can be interpreted as a sign of a more “hands-off” approach in securities regulations.

repayment of outstanding amounts under our equipment lines of credit. . .

Although we may use a portion of the net proceeds to acquire businesses, products or technologies that are complementary to our business, we have no specific acquisitions planned. Pending such uses, we plan to invest the net proceeds in investment grade, interest-bearing securities.⁷⁸

The public issue of shares was, quite obviously, treated an end itself, rather than as means to the end of raising capital for substantive business activities.⁷⁹ The securities law makes no efforts to check this variety of public issues made for no clear business purpose.⁸⁰ In any case, Sycamore Networks was candid that a purpose of the public issue was to “provide liquidity to existing stockholders.” This takes us to the question of the track record of the “existing stockholders” and what they brought to the table at the time of the public issue, in terms of the business fundamentals of the company. Sycamore Networks presented the following financial data for the period until May 1999, prior to its first public issue in August 1999.

Table 5

Sycamore Networks
Financial Data as on May 31, 1999

⁷⁸ Sycamore Networks Registration Statement, note 67, above at p. 17.

⁷⁹ This neatly ties in with the portrayal of companies by Frank Easterbrook and Daniel Fischel (note 7, above at p. 1419-1420) as the sellers of securities, rather than entities raising capital for doing business. In the imagery of Easterbrook and Fischel, the business of companies is selling securities. The problem with this approach is not that it lacks truth, but it presents the situation as the ideal, a sort of perfect culmination of a process of rational development.

⁸⁰ This raises the larger question of a theory for the stock market, in terms of defining the role that we expect the institution to play in the socio-economy. Historically, the role of the stock market has varied from providing capital for legitimate business purposes at one end, to being a veritable gambling den at the other. The prevailing notions about the stock market affirm the need for a more comprehensive theory of the market, which is explored in the concluding part of this paper.

Description	Amount (\$ '000s)
Operating revenue	--
Operating Expenses	11,384
Accumulated operating loss	(11,384)
Shareholders' equity	(10,113)

The company had no sales, and accumulated operating loss was over \$ 11 million. The investors, for their part, were hardly deterred; neither the gloomy predictions made by the company, nor the absence of a well-defined business purpose for the issue, nor even the poor financial record of the company made the slightest difference. Sycamore's first public issue was completed in October 1999, and it was a resounding success. The company issued 7,475,000 common shares with a par value of \$ 0.001 at a price of \$ 38 per share.⁸¹ The gross proceeds from the issue were \$ 284.5 million. After deducting the expenses of about 21 million dollars incurred towards issue expenses, the company was left with 263 million dollars from the first public issue.

On listing, Sycamore shares were received in the stock market with even greater enthusiasm, and were actively traded in the months that followed. The price reached \$ 105 by the end of January 2000. The company did not lose the opportunity presented by the enthusiasm of the market for its shares, and opened a "follow-up public offering" in February 2000.⁸² It completed the second issue in March 2000, at a price of \$ 150.25 per share. This time around, however, there was a difference. Of the total of 10.2 million shares offloaded to the public, about 8.43 million were issued by the company, and the remaining 1.77 million shares were sold personally by the existing holders, who were the management team and its

⁸¹ Sycamore Networks, report for the quarter ended October 31, 1999 in Form 10-Q, at p. 8. Available online: <http://www.sec.gov/Archives/edgar/data/1092367/0000927016-99-003928.txt>, May 2007.

⁸² Sycamore Networks, report for the quarter ended March 31, 2000 in Form 10-Q, at p. 8. Available online: <http://www.sec.gov/Archives/edgar/data/1092367/000092701600002132/0000927016-00-002132.txt>, May 2007.

associates.⁸³ The details of the two public issues of Sycamore Networks are summarized in the table below.

Table 6

Sycamore Networks
Public Issues of Shares 1999-2000

Description	First Issue (August-October 1999)	Second Issue (February-March 2000)
Issue Price	\$ 38	\$ 150.25
Number of shares issued by the company	7,475,000*	8,428,401
Number of shares sold by management and associates	-	1,771,599
Gross Proceeds for the company	\$ 284,050,000	\$ 1,266,367,250
Gross Proceeds for the management and associates	-	\$ 266,182,750
Expenses of the Issue	\$ 21 million approx.	\$ 66 million approx.

* The company effected a three-for-one stock split in February 2000,⁸⁴ before the second public issue, and consequently, the number of shares swelled to 22,425,000.

2. SYCAMORE REPORTS AND SHARE PRICES

To recapitulate, the theory of the informational regime and the Efficient Markets Hypothesis is that the stock market will apply the information provided by the companies and determine share prices which reasonably

⁸³ Ibid.

⁸⁴ Ibid. at p. 22.

reflect the “intrinsic value” of the shares. As we have seen, Sycamore, a loss-making company, issued its shares at \$ 38 in October 1999, and the price rose to \$ 105 dollars by January 2000. The second public issue made during March 2000 was at \$ 150 per share.

We have also seen that the issue price of 38 dollars per share, determined by the market in October 1999, could not be justified with reference to its business fundamentals, such as assets or earnings. The dismal financial record of Sycamore and even more, the dark predictions it made about its future left little hope. But the market ignored the information, and offered a price of \$ 38 per share in October 1999.

Let us now consider the events in the market over the next few months when the price of Sycamore shares reached \$ 105 by January 2000, and for the second public issue made in February 2000, the market determined a price of \$ 150 per share. Following are the data for the six months ended January 2000, taken from the registration statement filed by Sycamore on February 17, 2002 before its second public issue.⁸⁵

Table 7

Sycamore Networks Inc.
Operating Results for Six Months ended January 29, 2000

Description	\$ 000's
Revenues	48,559
Cost of revenues and operating expenses	60,415
Loss from operations	(11,856)

In the eight months since May 1999 (see Table 6, above), Sycamore had indeed earned revenues, which were more than \$ 48 million. But it incurred expenses of over \$ 60 million to earn this revenue, resulting in an operating loss of almost \$ 12 million. But the market did not pay much

⁸⁵ Sycamore Networks, Registration Statement in Form S-1, February 17, 2000, at p. 20. Available online: <http://www.sec.gov/Archives/edgar/data/1092367/0000927016-00-000627.txt>, May 2007.

attention to these facts, and continued with runaway increases in the price of Sycamore shares.

3. DISCLOSURES FOR SYCAMORE'S SECOND PUBLIC ISSUE – FEBRUARY 2000

We can now take a look at the disclosures in the registration statement filed by Sycamore for its second public issue made in February-March 2000. As the data in Table 7 above show, the company incurred a loss of almost \$ 12 million from its operations during the six months ended January 29, 2000. A reasonable and responsible management would attempt to explain or justify the increase expenses during the period and the resulting loss. Sycamore, however, made no efforts at any explanation or justification. This is an indication of the low degree of responsibility that informed the management of Sycamore and complacency about the success of its second public issue despite the loss.

The description of “Risk Factors” in the second registration statement⁸⁶ is in the same vein as the first one.⁸⁷ The risks are described at length and in detail, bordering on relish. This is, again, clearly intended to protect the management against any possible legal claims in the future regarding the company and its prospects. The stated purposes of the second public issue, extracted below, are also no different from those of the first.

The principal purposes of this offering are to obtain additional working capital, create a larger public float for our common stock, facilitate our future access to public capital markets and allow for the orderly liquidation of a portion of the investments made by certain of our stockholders.

We expect to use the net proceeds from the sale of shares of common stock offered by us for general corporate purposes, including for working capital and capital expenditures, and to expand our sales and marketing operations, broaden our customer support capabilities, develop new distribution channels and fund research and development. We may use a portion of the net

⁸⁶ Ibid. at p. 6-16.

⁸⁷ Note 67, above.

proceeds to acquire businesses, products or technologies that we believe will complement our current or future business. However, we have no specific acquisitions currently planned. We will retain broad discretion in the allocation of the net proceeds of this offering. Pending such uses, we plan to invest the net proceeds in investment grade, interest-bearing securities.⁸⁸

As at January 29, 2000, the period for which Sycamore provided financial data before its second public issue, the company had “cash, cash equivalents and marketable securities” totaling over \$ 288 million, which were mostly the proceeds from the first public issue. There is no reference in the registration statement to any specific plan for the use of this large amount of money. It is, therefore, difficult to see why Sycamore needed more money for “general corporate purposes.” On the contrary, the statement about “orderly liquidation” of investments by existing stockholders is the clue to the real reason for the second issue.

Again, the market was hardly concerned either with the losses incurred by Sycamore Networks, its pessimism about its future, or the fact that it was approaching the market for a second time in seven months without any serious business plans. On the contrary, the market increased the valuation of the company almost four-fold, and offered more than \$ 150 for the shares this time around.

If we have understood the efficient market theorists correctly, the “profit-maximizers” in the market would ensure that “actual prices of individual securities already reflect the effects of information based both on events that have already occurred and on events which, as of now, the market expects to take place in the future.”⁸⁹ It is not clear how the theory can explain the almost four-fold increase in the price of Sycamore shares in a span of seven months, a period of time when the company reported worsening financials and continued to be pessimistic about its future.

To this question, the efficient market theorists might retort that the market was then in a boom phase. But we have not been told that the Efficient

⁸⁸ Sycamore Networks, Registration Statement in Form S-1, note 85, above at p. 17.

⁸⁹ Eugene Fama, note 25, above.

Markets Hypothesis would be suspended during times of boom or bust in the market. On the contrary, it is asserted that the market prices would, at “any point in time,” conform to the tenets of the Hypothesis.⁹⁰

4. SYCAMORE AND ITS DISCLOSURES – THE TWO FACETS

In the case of Enron, we made a brief comparison between the sober and balanced tone of the statements made by it in its statutory filings and the bubbling enthusiasm and optimism that characterized its press releases. A greater dichotomy is seen in the case of Sycamore Networks. We have just recounted the pessimism and hopelessness which characterized the disclosures made by Sycamore in its statutory filings. The company was, however, simultaneously issuing a number of press releases, which were completely different in their tone and content.⁹¹ They proudly announced the various accomplishments of the company, bristled with optimism, and painted a rosy future.

The press releases issued by Sycamore Networks during 1999 and 2000, which were the heydays for the company’s shares, were singular for their optimism and buoyancy. A few samples are given below, and they convey the dominant mood in the run-up to the first public issue in August 1999.

Table 8

Sycamore Networks Sample Press Releases: 1998-99

12/09/1998 Sycamore Networks Named One Of The Top 25 Startups For 1998

⁹⁰ What is remarkable about new-fangled theories like the Efficient Markets Hypothesis is not their content, which is bad enough. Rather, it is the fact that we have to put in so much effort and argue eloquently against these absurd theories flipped at us casually by scholars with a variety of agendas and representing special interests. It is quite despairing, but public interest demands that such efforts are countered with energy and determination, lest policy-making continue in the hands of special interests as has been the case in the last almost three decades.

⁹¹ Complete texts of the press releases issued by Sycamore Networks available online: <http://www.sycamorenet.com/corporate/news/index.asp?id=pressreleases&prType=archive>, May 2007.

- 03/08/1999 Sycamore Networks Announces Major Customer Commitment By Williams Communications⁹²
- 03/08/1999 Sycamore Networks Announces First Phase Of Intelligent Optical Networking Strategy
- 05/12/1999 Upside Magazine Names Sycamore Networks Among 1999 Hot 100 Private Companies
- 05/17/1999 Sycamore Networks Named One of Top 100 By Red Herring Magazine
- 05/24/1999 Sycamore Networks Selected By Millenium Optical Networks, Representing Another Major Customer Win
- 06/07/1999 Sycamore Networks Announces The Industry's First End-To-End Optical Network Management System
- 06/09/1999 Sycamore Networks Named Hot Startup By Telecommunications Magazine
- 06/16/1999 Fortune Magazine Selects Sycamore Networks As One Of The 12 Cool Companies For 1999

The dichotomy between the statutory filings and other communications from companies, such as press releases, raise vital questions about the efficacy of the informational regime. On the one hand, we have the statutory filings of companies in which companies make a set of disclosures and forecasts, which are, at best, guarded in their optimism. On the other, there are the press releases and media reports which are laudatory and buoyant, and they convey a different picture or image.

It is tempting to discount the media reports with the specious argument that they are not put out by the companies, but most news reports are based on information provided by companies. Companies release information to the media for specific purposes, mostly to present them in a good light and influence trade in their shares in the stock market. In any case, the case with press releases issued by the companies is quite

⁹² The wording of this headline and the contents of the press release are quite different from the reference to William Communications in the risk factors narrated in the registration statement filed by Sycamore Networks in August 1999, discussed earlier.

different. Companies are the authors of these materials, and there is no way we can sidestep their contents.

We now have to contend with two sources of information about public corporations – statutory filings, and press releases and media reports. Obviously, the informational regime expects the market to be guided by the information in the statutory filings. But the position of the efficient markets theorists on this issue – namely, whether the market is expected to derive its information from the statutory filings or other sources, is not clear. They might argue that the market will apply all the available information, but the difficulty here is that the information is conflicting. Therefore, it would not be possible for the market to make rational decisions.

The significance of the caveat entered by Sycamore that investors “should rely only on the information contained in this prospectus”⁹³ lies in the dichotomy among different sources of information. The company, in effect, warned the market to ignore other material, such as press releases issued by the company and media reports written about the company, in making investment decisions. This is, however, not our main difficulty because various statutory provisions, which are discussed a little later, as well as interpretations by the courts⁹⁴ make it clear that all materials would be relevant in considering the question of fraud or deceit in public issues by companies.

Rather, the difficulty with multiple sources and conflicting information about companies like Sycamore that their press releases are hardly untrue or factually inaccurate. Therefore, they would not be “fraud” or “deceit” either under the securities law or the common law. Let us now take a look at a few examples of statutory provisions intended to check fraud or deceit in public issues of securities by companies.⁹⁵

⁹³ Note 67, above.

⁹⁴ *Derry v. Peek* (1889), 14 App. Cas. 337 (U.K.), was an early case in which the standard of liability for company issuers was defined.

⁹⁵ For a commentary on the law on fraud in securities issues, see generally Louis Loss & Joel Seligman, *Fundamentals of Securities Regulation*, 5th ed. (New York: Aspen Publishers, 2004), Chapter 9.

- “employ any device, scheme, or artifice to defraud” (Section 17(a), Securities Act of 1933).
- “obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading (ibid.).
- “any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser” (ibid.).
- “make, regarding any security registered on a national securities exchange, for the purpose of inducing the purchase or sale of such security, any statement which was at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, and he knew or had reasonable ground to believe was so false or misleading” (Section 9(a)(4), Securities Exchange Act of 1934).
- “induce or attempt to induce the purchase or sale of any security . . . by means of any manipulative, deceptive or other fraudulent device or contrivance” (Section 15(c)(1)(A), Securities Exchange Act).

Quite obviously, it would be difficult to bring an action under any of these provisions with respect to the press releases of Sycamore.⁹⁶ The caution sounded by Sycamore at the beginning of the registration statement is specifically intended to guard against such efforts.⁹⁷ But it can hardly be disputed that the press releases contributed to the mood of euphoria in the

⁹⁶ Actions were, however, brought against Sycamore Networks and investment bankers with respect to the public issues and their dealings in the shares, as we will see a little later. The company has opted to make a settlement with the litigants, and has not defended itself against the charges.

⁹⁷ Here, we cannot also lose sight of the fact that the scheme of statutory provisions is designed for ex post remedy for the victims through contentious litigation. Their effectiveness in preventing cases like Sycamore Networks is rather limited.

market and to the success of the two public issues of Sycamore. They also encouraged active trade in Sycamore shares during the period. The existing regulatory framework, which has disclosures as its underpinning, has no answer to such situations.

The case of Sycamore illustrates the inadequacies of merely relying on disclosures. This approach is perfunctory and simplistic. Regulation mandates companies to make regular disclosures, and in particular, highlight the risk factors. It assumes that investors, acting in a vacuum and without being influenced by any other factors, will be guided only by the statutory disclosures and arrive at rational decisions on the basis of the disclosures.

5. ISSUE PRICE FOR SHARES – DISCRIMINATION BETWEEN INSIDERS AND THE PUBLIC

We have earlier referred to the license available in law for corporations to determine the consideration payable for the issue of their shares. Sycamore Networks offers an effective demonstration of the practical implications of this license. At the time of the first public issue in August 1999, the company had about 5.44 million shares of the par value of \$ 0.001 outstanding, and its paid-in capital was \$ 5.49 million.⁹⁸ This indicates that each share was issued at a consideration of about \$ 1, although it is not clear if the consideration was paid in cash. Needless to add, all these shares were held by insiders.

The company had also issued 15 million shares of its preferred stock to some private investors for a total consideration of \$ 40.77 million.⁹⁹ The average consideration for the preferred shares was, therefore, about \$ 3 per share. The funding provided by these investors, quite obviously, sustained the operations of the company in the early stages and in meeting the expenses of the public issue. The 15 million preferred shares issued to private investors were converted three-fold into 47.28 million common

⁹⁸ Sycamore registration statement, note 67, above at p. 18.

⁹⁹ Ibid.

shares on completion of the first public issue.¹⁰⁰ The average cost of the resulting common shares in the hands of these private investors was, therefore, about \$ 0.86.

Sycamore made the first public issue at \$ 38, and share price rose to \$ 105 by January 2000. This meant exponential rises in the value of shares issued to the insiders and the private investors, acquired at \$ 1 each or less. The deal was thus lucrative for all of them. In addition, shares were also issued under the Employee Stock Option Plans of the company.¹⁰¹

The insiders and their associates were apparently not satisfied with the windfall from the public listing of Sycamore shares. Just before the second public issue, the company made a three-for-one stock split in February 2000. This, of course, suited everyone; the insiders, their support group which had earlier acquired preferred shares, and the persons who had purchased the common shares in the public issue or in the market subsequently. Everybody's wealth tripled, just like that, and who could possibly object to that!

By these processes, the number of outstanding common shares increased from a humble 5.44 million before the first public issue shares in August 1999 to a phenomenal 236 million shares by January 2000, before the second public issue at \$ 152.50 per share.¹⁰² After completion of the second public issue, the number of outstanding shares was about 245 million.¹⁰³ Of this, the total number of shares issued to the public was only 7.5 million (first issue) and 8.4 million (second issue), or less than ten percent!

The insiders and their associates acquired their shares at a consideration of \$ 1 or less, and shares of the same class were issued to the public at \$ 38 in August 1999, and \$ 152.50 in February 2000. Neither corporate law nor securities law has anything to say on such issues. On the contrary,

¹⁰⁰ Sycamore quarterly report, note 81, above at p. 8.

¹⁰¹ Sycamore registration statement, note 85, above at p. 18.

¹⁰² *Ibid.*

¹⁰³ Sycamore quarterly statement, note 82, above at p. 3.

corporate law endorses the right of companies to indulge in such actions. The question is how the license in law for such practices defines the culture of corporations and the stock market, which are two important institutions in the society, and shapes their behaviour and the larger value systems in the society.

The personal profit made by the insiders at dubious technology companies during the .com bubble was a matter of debate after the bubble burst in 2001.¹⁰⁴ It is reported that Gururaj Deshpande, the founder-chairman of Sycamore, raked in \$ 726 million from the sale of his shares in the company.¹⁰⁵

B. PUBLIC ISSUES AND THEIR LEGITIMACY

We have seen that Sycamore Networks had no ascertained need for capital for either of the two public issues made by it. Taking advantage of the sentiment in the stock market favour of companies that had something to do with the Internet, Sycamore approached the stock market, twice in a span of seven months, and collected over one and a half billion dollars.

Public issues of this variety raise the question of legitimacy of public issues of shares by companies. The question of legitimacy of public issues is a longstanding one in the history of Anglo-American corporate law. The earliest official reference to public issues by dubious companies is found in a report of the Board of Trade in England, prepared in 1696.¹⁰⁶ In the United States, censoring of public issues was attempted in Kansas during early twentieth century, under the so-called “blue-sky laws.”¹⁰⁷ Companies required governmental clearance before they could make public issues.

¹⁰⁴ See e.g. Mark Gimein “Greedy Bunch – You Bought They Sold” *Fortune*, 2 September 2002.

¹⁰⁵ *Ibid.*

¹⁰⁶ See Ronald Ralph Formoy, *The Historical Foundations of Modern Company Law* (London: Sweet & Maxwell, 1923) at 16.

¹⁰⁷ See Jonathan R. Macey & Geoffrey P. Miller, “Origin of the Blue-sky Laws” (1991) 70 *Texas L. Rev.* 347.

The federal securities law regime, introduced in the 1930s, avoided such activist intervention, and stopped with requiring companies to make disclosures. The present position is that if a company does not have any need for capital but still makes a public issue, it has to state so. It is left to the investors to decide whether they want to invest in the shares of the company. Securities regulations designate companies without any need for capital as “blank check companies,” and expressly permit to make public issues.¹⁰⁸ However, such companies must deposit the proceeds from the issue in an escrow account or in specified securities.¹⁰⁹

The regulatory regime outlined above is clear that it would permit, rather than prevent public issues. This is a basic issue with the Securities Regime, as it has developed. It seeks to mostly to promote the stock market and trading transactions in the market. The systemic checks are quite few and limited, and are called into play only in cases of gross abuse or fraud. The securities regime is hardly concerned with the circumstances in which companies can approach the market. In other words, it ignores the question of legitimacy of public issues.

Sycamore Networks is an example of the consequences of this approach in which the law, representing public policy, has no concern for the legitimacy for public issues other than to require companies to state that they have no legitimate purpose for the issue! Let us now look at what Sycamore has done with the large sum of money it collected from the public for no specific reason. The following table gives the key financials of Sycamore since its second public issue in March 2000, until April 29, 2006, which is the latest date for which the company has submitted reports, at this writing in June 2007.¹¹⁰

Table 9

¹⁰⁸ Ibid. Section 3(b)(3).

¹⁰⁹ Regulation C (17 CFR Part 230), Rule 419.

¹¹⁰ Data are taken from the annual reports of Sycamore Networks in Form 10-K for the fiscal years ended July 29 of 2000-2005. Data for April 2006 taken from the quarterly report in Form 10-Q for the quarter ended April 29, 2006. Reports available online: www.sec.gov, under CIK # 0001092367, May 2007.

Sycamore Networks
Financial Data 2000-2006

	2000	2001	2002	2003	2004	2005	2006
	\$ '000s						(9 months)
Revenue	198	375	65	38	45	65	56
Operating results	-11	-352	-395	-78	-61	-40	-4
Interest income	41	85	40	23	16	14	27
Net income	31	-267	-380	-55	-44	-25	23
Cash and investments	1,512	1,249	1,044	996	961	955	971
Shareholders' equity	1,575	1,388	1,039	993	955	940	977

It is apparent that Sycamore Networks has been utilizing the money it collected from the public issues for funding the operating losses incurred by it year after year. Its business has been a nonstarter. As of April 2006, there was a balance of \$ 971 million, against the original sum of \$ 1,512 million collected from the public issues in 1999 and 2000. More than \$ 500 million have been expended in the period of six years, during which shareholders' equity declined from \$ 1,575 million (2000) to \$ 977 million (2006).

If we were to be guided by the registration statements of Sycamore, the outcome indicated by the financial results is not surprising. After all, the company did eloquently describe how bleak it expected its future to be, and its expectations have not been belied! Given the track record and tendencies of Sycamore, it was inevitable that lawsuits would be filed against it in connection with its public issues. Filed they were in July 2001, less than eighteen months after the second public issue, made in February-March 2000. The company made its first statement about the class actions filed against it in its report for the quarter ended April 29, 2001:

The amended complaint [against the company] alleges violations of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, primarily based on the assertion that the Company's lead underwriters, the Company and

the other named defendants made material false and misleading statements in the Company's Registration Statements and Prospectuses filed with the SEC in October 1999 and March 2000 because of the failure to disclose (a) the alleged solicitation and receipt of excessive and undisclosed commissions by the underwriters in connection with the allocation of shares of common stock to certain investors in the allocation of shares of common stock to certain investors in the Company's public offerings and (b) that certain of the underwriters allegedly had entered into agreements with investors whereby underwriters agreed to allocate the public offering shares in exchange for which the investors agreed to make additional purchases of stock in the aftermarket at predetermined prices.¹¹¹

These were the facts alleged against the company, and its response to the litigation was typically vague, evasive and non-committal. It stated:

The Company believes that the claims against it are without merit and intends to defend against the complaints vigorously. The Company is not currently able to estimate the possibility of loss or range of loss, if any, relating to these claims.¹¹²

But Sycamore Networks reneged on its statement about defending the claims, and has opted to make a settlement. This raises questions about the seriousness with which it made the above statement, and the complicity of the officers of the company in the wrongful acts alleged against them. The latest statutory report filed by Sycamore Networks is for the quarter ended April 29, 2006, and it has information about the litigation. The following extracts from the report explain the current position:

¹¹¹ Sycamore Networks quarterly report in Form 10-Q for the quarter ended April 29, 2002, at p. 31. Available online: <http://www.sec.gov/Archives/edgar/data/1092367/000092701602003167/0000927016-02-003167.txt>, May 2007.

¹¹² Ibid.

The Company, the Individual Defendants, the plaintiff class and the vast majority of the other approximately three hundred issuer defendants and the individual defendants currently or formerly associated with those companies approved a settlement and related agreements (the “Settlement Agreement”) which set forth the terms of a settlement between these parties. Among other provisions, the Settlement Agreement provides for a release of the Company and the Individual Defendants for the conduct alleged in the action to be wrongful and for the Company to undertake certain responsibilities, including agreeing to assign away, not assert, or release, certain potential claims the Company may have against its underwriters. In addition, no payments will be required by the issuer defendants under the Settlement Agreement to the extent plaintiffs recover at least \$1 billion from the Underwriter Defendants, who are not parties to the Settlement Agreement.¹¹³

But that is not the full story. Sycamore went on:

On March 20, 2006, the Underwriter Defendants submitted objections to the settlement to the Court. The Court held a hearing regarding these and other objections to the settlement at a fairness hearing on April 24, 2006, but it has not yet issued a ruling. There is no assurance that the court will grant final approval to the settlement. If the Settlement Agreement is not approved and the Company is found liable, we are unable to estimate or predict the potential damages that might be awarded, whether such damages would be greater than the Company’s insurance coverage, and whether such damages would have a material impact on our results of operations or financial condition in any future period.¹¹⁴

At this writing in May 2007, Sycamore Networks is under an investigation ordered by the audit committee of its board of directors with respect to

¹¹³ Sycamore Networks quarterly report in Form 10-Q for the quarter ended April 29, 2002, at p. 40. Available online: http://www.sec.gov/Archives/edgar/data/1092367/000119312506118073/d10q.htm#tx93808_11, May 2007.

¹¹⁴ Ibid. at p. 41.

grant of stock options, and has not filed statutory reports since April 2006. Its shares were in danger of being de-listed from Nasdaq due to the failure to furnish reports, but the action has been temporarily stayed.¹¹⁵

The events at Sycamore clearly illustrate the absence of responsible management in the company, and its opportunistic use of the stock market to make money, both for the company and its insiders. There is also empirical evidence that opportunistic corporate behaviour with respect to the stock market quite often translates into business failure.¹¹⁶

When we speak about legitimacy of public issues, it is not in any sense abstract. Thereby hang much larger issues, such as responsible corporate management, use of the stock market to raise capital for genuine and beneficial economic purposes, serious as against speculative investment in corporate shares, and so on. In other words, we are talking about the whole philosophy that underlies the stock market and corporate arrangements. We briefly touch upon these issues in the concluding part of the paper.

IV. AMAZON.COM

Amazon.com, a pioneer in trade through the Internet, or “e-commerce,” entered the stock market during the late 1990s riding on the Internet boom. It made a relatively small public issue of \$ 54 million in May 1997. The price of Amazon.com shares consistently rose during 1997-2001, contrary to the business reports of company, which betrayed an equally consistent worsening of its financial position.

The case of Amazon.com has some similarities with Sycamore Networks, which we have just discussed, but the distinctions between the two

¹¹⁵ Sycamore Networks press release “Sycamore Granted Stay to Remain Listed on Nasdaq” 17 April 2007, available online: http://www.sycamorenet.com/corporate/news/index.asp?id=pressrelease&command=live&news_item_id=832, May 2007.

¹¹⁶ See e.g. Jennifer H. Arlen & William J. Carney, “Vicarious Liability for Fraud on Securities Markets: Theory and Evidence” [1992] U. Ill. L. Rev. 691.

companies are more striking. Amazon.com was founded in 1994, before the Internet boom gathered momentum in the stock market, and made its public issue in 1997. Sycamore Networks, on the other hand, was founded in 1998 at the height of the Internet boom, and made two public issues in the following years –1999 and 2000.

Amazon.Com was originally incorporated in the state of Washington, and shifted its incorporation to Delaware just before its public issue in 1997. This indicates that a public issue of shares was not the primary consideration for the company. But it was different with Sycamore Networks, which was formed in Delaware. Quite obviously, the plan was to take advantage of the market sentiment in favour of technology companies, and make public issues as quickly as possible. In this plan of Sycamore Networks, Delaware's loose corporate law regime was an important element.

A second feature was that Jeffrey Bezos, the founder of Amazon.com, was particular about retaining control of the company even after the public issue, and prominently highlighted his intentions in the registration statement filed for the public issue made by the company in 1997. This indicates a degree of commitment on the part of Jeffrey Bezos to the company. Bezos laid emphasis on the long term, and in his first annual letter to the investors after the public issue, he warned:

Because of our emphasis on the long term, we may make decisions and weigh tradeoffs differently than some companies. Accordingly, we want to share with you our fundamental management and decision-making approach so that you, our shareholders, may confirm that it is consistent with your investment philosophy.¹¹⁷

The letter from which the passage is extracted was written by Jeffrey Bezos in March 1998, and the progress achieved by Amazon.com in the last ten years, which we trace in the course of our discussion here, is standing testimony to the business philosophy of the company. In contrast, we have seen that the operations of Sycamore Networks, a

¹¹⁷ Jeffrey Bezos' letter dated March 30, 1998, to the shareholders of Amazon.Com, at p. 2. Available online: <http://phx.corporate-ir.net/phoenix.zhtml?c=97664&p=irol-reportsAnnual, May 2007>.

younger company which collected over \$ 1.5 billion from the market are paralyzed, and the company is in decline. Amazon.com has been successful in establishing an e-commerce model for retail sales, and has displayed considerable grit and energy in the process of doing so.

A. AMAZON.COM PUBLIC ISSUE

As we noted earlier, Amazon.com, founded in 1994, made its initial and only public issue in May 1997. Three million shares, a relatively small number representing about a sixth of the total number shares outstanding after the issue, were offered to the public. The issue price targeted by the company was \$ 13 per share, but in the febrile conditions which prevailed in the market at the time of the issue, the company was able to get a price of \$ 18. The net proceeds from the issue, after deducting issue expenses, were about \$ 49 million.¹¹⁸

The market was apparently optimistic about Amazon.com and its prospects, going by the fact that the price of \$ 18 offered by it was more than the company's target of \$ 13. To assess how far the optimism was in accord with the disclosures made and information provided by Amazon.com, we must turn to the registration statement filed by it for the public issue. The registration statement started on a positive note, referring to "the opportunity for online book retaining," and the belief of Amazon.com that the retail book industry is particularly suited to online retailing for many compelling reasons."¹¹⁹ The company affirmed its intention "to use technology to deliver an outstanding service offering and to achieve the significant economies inherent in the online store model." It also reported that it had "grown rapidly since opening its first bookstore."¹²⁰

¹¹⁸ Amazon.com quarterly report in Form 10-Q for the quarter ended June 30, 1997, at p. 7. Available online: <http://www.sec.gov/Archives/edgar/data/1018724/0000891020-97-001148.txt>, May 2007.

¹¹⁹ Amazon.com registration statement in Form S-1, March 24, 1997, at p. 4. Available online: <http://www.sec.gov/Archives/edgar/data/1018724/0000891618-97-001309.txt>, May 2007.

¹²⁰ Ibid.

These statements reflect a sense of purpose and commitment, which were noticeably lacking in Sycamore Networks. But Amazon.com, like Sycamore Networks, had an accumulated deficit at the time of filing its registration statement, and it was to the tune of \$ 9 million. Again like Sycamore Networks, Amazon.com also had no specific business needs for raising capital from the market through a public issue of its shares. It described the use of proceeds from the public issue in the following words:

The principal purposes of this offering are to obtain additional capital, to create a public market for the Common Stock, to facilitate future access by the Company to public equity markets, and to provide increased visibility and credibility in a marketplace where many of the Company's current and potential competitors are or will be publicly held companies. The Company has no specific plan for the net proceeds of the offering. The Company expects to use the net proceeds for general corporate purposes, including working capital to fund anticipated operating losses and capital expenditures.¹²¹

Amazon.com made no efforts to hide the fact that it looked to the public issue for enhancing its profile. This is an illustration of the consequences of engineering corporations as finance mechanisms, rather than business vehicles. Public issue of shares and their listing on stock exchanges emerge as ends in themselves, and cease to be means for business ends – namely, raising capital for business needs. Amazon.com made the following further statements with respect to use of proceeds from the public issue.

A portion of net proceeds may also be used to acquire or invest in complementary businesses, products and technologies. From time to time, in the ordinary course of business, the Company expects to evaluate potential acquisitions of such businesses, products or technologies. However, the Company has no present

¹²¹ Ibid. at p. 14.

understandings, commitments or agreements with respect to any material acquisitions or investments.¹²²

These statements indicate that the company might use the proceeds from the issue to advance its strategy of business development through acquisitions. Amazon.com did, in fact, embark on a path of business growth through acquisitions, but hardly used the proceeds from the public issue for the purpose. Instead, it went on a spree of issuing fresh shares to acquire new businesses, as we will see in Section (c), below.

In describing the risk factors, Amazon.com shared the “gloom-and-doom” approach of Sycamore. The risk factors were described with eloquence bordering on relish, and a very uncertain future was predicted for the company.¹²³ The tendency of companies like Amazon.com and Sycamore Networks to take pains to paint bleak futures is an unintended consequence of the informational regime, and stresses the need for a more refined regulatory approach. The requirement for disclosure of risk factors is used as a shield for issuers, rather than a source of information to the investors.

But the market was unfazed by the gloomy future predicted by Amazon.com, and rewarded the company with a price of \$ 18 per share. The public issue of Amazon.com was successful. Not only did the market improve upon the expectations of Amazon.com with respect to the issue price, there were also huge increases in the price of Amazon.com shares when trading started in the stock exchanges during the heady days of Internet boom.

The public issue was undoubtedly effective in improving the financial position of the existing shareholders of Amazon.com. The company had over 15 million shares of common stock outstanding at the time of its public issue. In addition, its preferred stock had conversion rights on completion of the public issue, and the number of shares held by existing holders was over 20 million after the public issue. At the issue price of \$

¹²² Ibid.

¹²³ Ibid. at p. 5-13.

18 per share, the existing shareholders of Amazon.com were, in theory, put in control of liquid assets of the market value of about \$ 360 million.

The public issue gave the shares of Amazon.com a ready value and “liquidity,” or the ability to convert the shares into cash by sale in the stock market. These would prove to be crucial for the business development plans of Amazon.com in the following years, when the company used the market value of its shares to acquire a number of businesses. The business development strategy of Amazon.com and its implications are the subject of Section (c), below.

B. AMAZON SHARE PRICES AND FUNDAMENTALS

Amazon.com shares issued in May 1997 at \$ 18 per share reached \$ 100 in a year. The company apparently treated the \$ 100 price level as a watershed, and resorted to a two-for-one stock split in June 1998.¹²⁴ The number of Amazon.com shares doubled, but there was no let up in the enthusiasm of the market. In December 1998, six months after the split, the price reached a high of over \$ 360, and in the next month, January 1999, Amazon.com effected a second split, this time three-for-one. The number of its shares simply tripled!

The market took the second split also in its stride, and maintained the price of Amazon.com shares at over \$ 100 almost all through 1999, with the price reaching a peak of \$ 222 in April 1999. Only in August 1999, the price fell marginally below the \$ 100 mark, to \$ 98, and this lasted for a short while. Amazon.com resorted to yet another stock-split in the next month, September 1999, this time in the ratio of two-for-one. After this third round, the company has not made any stock-splits. Amazon.com shares touched a low of about \$ 6 in August 2001 when the .com bubble in

¹²⁴ We have earlier referred to the fact that Amazon.com shifted its incorporation from Washington to Delaware, just before the public issue in May 1997. The decision of Amazon.com to shift its incorporation to Delaware clearly indicated its intention to take full advantage of the lax and pro-stock market corporate law regime of Delaware. Delaware General Corporation Law (Delaware Code, Title 8, Chapter 1) does not specifically enable or authorize stock splits, but it recognizes the concept (Section 173).

the stock market burst, but it has gradually gained ground thereafter. At this writing in June 2007, the price is about \$ 70 per share.¹²⁵

Let us now take a look at the financials of Amazon.com, to understand how they relate with the movement in share prices during the first five years of trading in the shares of the company.¹²⁶

Table 10

Amazon.com
Business Data: 1997-2001

	1997	1998	1999	2000	2001
	(\$ '000s)				
1 Sales	148	610	1640	2762	3122
2 Operating results	-33	-112	-606	-864	-412
3 Net Income	-31	-125	-720	-1411	-567

If we were to be guided by the principles of investment outlined by Graham and Dodd,¹²⁷ which pay close attention to earnings and dividends, the shares of Amazon.com would be a nonstarter. The company was incurring huge losses during the period, and there was no question of any dividend. Nonetheless, the price of its shares saw runaway increases, which cannot be supported by the financial results reflected in the above table. Amazon.com was building up losses, and was able to survive only

¹²⁵ Historical prices of Amazon.com, and dates of stock-splits available online: <http://finance.yahoo.com/q/hp?s=AMZN>, May 2007.

¹²⁶ Data taken from the annual reports of Amazon.com in Form 10-K for the respective years. Forms available online: <http://www.sec.gov/cgi-bin/browse-edgar?type=10-k&dateb=&owner=include&count=40&action=getcompany&CIK=0001018724>, June 2007.

¹²⁷ Benjamin Graham and David Dodd, *Security Analysis*, (New York: McGraw-Hill Book Company, Inc.,

1934)

by taking on huge debt. But as we noted earlier, the new theory was that the conventional approach to investment in the stock market¹²⁸ was not valid for technology companies; the high valuation given by the market for technology companies was because of their future potential, rather than current fundamentals.¹²⁹ This takes us to the question of forecasts made by Amazon.com during the period.

The forecasts made by the company in the statutory reports filed during this period were on the side of pessimism. The report for 1998,¹³⁰ which presented the forecasts for 1999, is a good example of the trend. It began with statements on “anticipated losses”¹³¹ and “unpredictability of future revenues,”¹³² and these were followed up with forecasts of the following variety:

[t]he Company believes that it will continue to incur substantial operating losses for the foreseeable future and that the rate at which such losses will be incurred may increase significantly from current levels. Although the Company has experienced significant revenue growth in recent periods, such growth rates are not sustainable and will decrease in the future.¹³³

Due to the foregoing factors, in one or more future quarters the Company's operating results may fall below the expectations of

¹²⁸ It is an open question how far there are any conventions or standards with respect to investment in the stock market. Speculation and irrational prices have always been present in the financial markets ever since they came into existence in England in the late seventeenth century. See generally Stuart Banner, *Anglo-American Securities Regulation 1690-1860: Political and Cultural Roots* (Cambridge: Cambridge University Press, 1998) and Edward Chancellor, *Devil Take the Hindmost: A History of Financial Speculation* (New York: Farrar Straus Giroux, 1999).

¹²⁹ For a critique of the argument that technology companies had some hidden potential for enormous future profits, see William Bonner and Addison Wiggin, note 44, above.

¹³⁰ Available online: <http://www.sec.gov/Archives/edgar/data/1018724/0000891020-98-000448.txt>, May 2007.

¹³¹ *Ibid.* at p. 5.

¹³² *Ibid.* at p. 6.

¹³³ *Ibid.* at p. 15.

securities analysts and investors. In such event, the trading price of the common stock would likely be materially adversely affected.¹³⁴

We have already referred to the fact that Amazon.com was borrowing heavily to sustain its operations. It also disclosed that the agreements with its lenders placed restrictions on payment of “dividends and distributions to the stockholders.” This made the payment of dividends doubtful as long as the company carried debt. Adding to the air of gloom, Amazon.com also stated that the terms of its contract with the lenders “may reduce the Company’s operational flexibility and may limit its ability to pursue market opportunities.”¹³⁵ These were as far as the disclosures in statutory documents went. The tone and contents of other communications from the company were somewhat different.

Jeffrey Bezos’ annual letter to the shareholders written in March 1999, around the same time when the statutory report was filed, had little of the attitude of caution and pessimism which characterized the statutory report. Instead, the letter displays considerable optimism and a “will-do” spirit. The letter written in March 1999 continued with the emphasis on the long-term seen in the previous year’s letter, and asserted that:

Amazon.com has made a number of strides forward in the past year, but there is still an enormous amount to learn and to do. We remain optimistic, but we also know we must remain vigilant and maintain a sense of urgency. We face many challenges and hurdles. Among them, aggressive, capable and well-funded competition; the growth challenges and execution risk associated with our own expansion; and the need for large continuing investments to meet an expanding market opportunity.

The dichotomy between the tone and contents of the statutory report and statements made in the letter to the shareholders raise the same question we have raised earlier with respect to Enron and Sycamore Networks – which is the information that influences the stock market? If it is the practice of the market to mostly rely on non-official information, then

¹³⁴ Ibid. at p. 16.

¹³⁵ Ibid. at p. 30.

what is the whole point about the elaborate reporting mechanism mandated under securities law?¹³⁶

To reiterate, the increases seen in the price of Amazon.com shares cannot be explained by the information contained in its statutory reports. As we will see a little later, the company continued to issue shares every year, which added to the volume of shares in circulation. According to conventional economic theory with respect to demand, supply and prices, increases in supply ought to have resulted in lower prices, but that did not happen. On the contrary, prices continued to climb. This would indicate that demand increased at a quicker pace than supply, and the result was increase in prices even as the supply position improved.

A reason for the selection of Amazon.com as a case for study is, as noted earlier, the forecast made by Henry Blodget. Blodget was, at that time, an investment analyst working for the investment firm CIBC Oppenheimer. During late 1998, at the height of the Internet boom in the stock market, he made his famous forecast that Amazon shares would reach a price level of \$ 400.¹³⁷ Blodget made no reference to the fundamentals of the company while making his prediction about the price of its shares.

Apparently, Henry Blodget's forecast for the shares of Amazon.com was based on the demand-supply position for Internet stocks in the stock market of the time.¹³⁸ This is rather strange, because we have not been told by the efficient market theorists that demand and supply conditions in the market could affect share prices, or that the demand for the shares of companies could exist independently of the information available about them. In other words, there could be a huge demand for the shares of a company despite negative information reported by the company. Just to

¹³⁶ On this question, see generally Susan M. Phillips, *The SEC and the Public Interest* (Cambridge, Mass.: MIT Press, 1981).

¹³⁷ Dan Mitchell & Scott Martin, "Amazon up 46 percent; report "clarified," 16 December 1998. Available online: <http://news.com.com/2100-1017-219176.html>, May 2007.

¹³⁸ This is supported by the statements Henry Blodget made in "If I knew then what I know now" interview with eCompany Now, March 2001. Available online: <http://www.timeinc.net/b2/subscribers/articles/print/0,17925,513201,00.html>, May 2007.

make sure, we reexamined the Efficient Market Hypothesis,¹³⁹ but not could find any reference.

According to the Efficient Markets theory, it is information and only information that will guide the market. For reasons that are not clear, the market apparently believed that Henry Blodget was privy to some special information which was not known to others or that he had some prescience which others lacked, and readily accepted his guidance.¹⁴⁰ Amazon.com shares did not reach the target of \$ 400 set for them by Blodget, but at \$ 362, they came close enough. This is an illustration of the characteristic of reflexivity of the stock market, or its tendency for self-fulfilling prophecies, which has been pointed out by writers like George Soros¹⁴¹ and Robert Shiller.¹⁴² Quite often, share prices rise only because the market expects them to rise.

C. AMAZON'S BUSINESS DEVELOPMENT MODEL AND ITS IMPLICATIONS

The business of Amazon.com has indeed grown rapidly. We have seen that its sales climbed from \$ 148 million in 1997 to \$ 3,122 million in 2001. Sales have since grown to \$ 10,711 billion in 2006. Let us now take a look at the strategy employed by Amazon.com for its business growth. Table 11 below presents data with respect to the capital, long-term debt and "goodwill and other purchased intangibles" of Amazon.com for the period 1997-2001.¹⁴³

¹³⁹ Eugene Fama, Note 25, above.

¹⁴⁰ Henry Blodget has since been found guilty of market manipulation and is permanently barred from participating in the stock market. See SEC press release dated April 28, 2003. Available online: <http://www.sec.gov/news/press/2003-56.htm>, June 2007.

¹⁴¹ George Soros, *The Crisis of Global Capitalism: Open Society Endangered* (New York: Public Affairs, 1998).

¹⁴² Robert Shiller, *Irrational Exuberance* (New York: Broadway Books, 2001).

¹⁴³ Data taken from balance sheets of respective years, available in annual reports in Form 10-K filed by Amazon.com, note 126, above. Particulars of stock issued for business acquisition taken from the Consolidated Statement of Cash Flows in the annual report for

Table 11

Amazon.com
Share Capital and Related Data: 1997-2001

	1997	1998	1999	2000	2001
			(\$ '000s)		
1 Value of stock issued for business acquisitions	0	217	774	32	5
2 Goodwill and intangibles acquired or added	0	229	766	47	80
3 Goodwill and intangibles amortized or written off		43	215	522	363
4 Long-term debt	77	348	1466	2127	2156
5 Total paid-in capital	68	302	1198	1342	1467
6 Accumulated deficit	-38	-162	-882	-2293	-2861
7 Shareholders' equity	29	139	266	-967	-1440
8 No. of outstanding shares	145	318	345	357	373

In a span of four years from 1998 to 2001, Amazon.com issued shares of the value of \$ 1,028 million towards business acquisitions. Issue of shares for business development through acquisitions was an effective strategy adopted by Amazon.com. We have seen that the company had suggested in its registration statement filed in 1997 that it might apply a part of the proceeds from the public for acquisition of new businesses. Apparently, it did not do so. But it made use of the public issue and the resulting “liquid” character of its shares to go on a spree of acquisition of businesses by issuing its shares as the consideration.

The shares of Amazon.com, as we have seen, traded at high prices during the period, and quite obviously, the persons who sold their businesses to Amazon.com were willing to accept the shares as consideration. By issuing its shares towards purchase consideration, Amazon.com was able to acquire new businesses without any payment. This was important because Amazon.com, with its huge losses and debt, was in no position to pay any monetary consideration. As a business strategy, the issue of

1999, at p. 36. The outstanding share numbers given in the table are after considering the three stock splits made by Amazon.com, one in 1998 and two in 1999.

shares for acquisition of businesses can hardly be faulted. It was an effective method of acquiring business assets for the company.

The issue of shares for acquisition of businesses in the manner described above leads some interesting results. As we noted earlier, Amazon.com did not, in fact, could not pay any monetary consideration for its acquisitions. Taking advantage of the high price of its shares in the stock market, the company issued shares as the consideration, and the persons to whom the shares were issued could sell them in the market if they wanted money. In other words, Amazon.com successfully created an arrangement in which investors in the stock market will take care of payment for its business acquisitions, if the persons who sold their businesses to the company wanted cash.

The business acquisitions made by Amazon.com were accounted under “goodwill and other purchased tangibles,” which is explained in the notes to the financial statements for 1998:¹⁴⁴

Goodwill and Other Purchased Intangibles

Goodwill and other purchased intangibles represent the excess of the purchase price over the fair value of assets acquired. Total goodwill of approximately \$215.7 million and other purchased intangibles of approximately \$13.3 million are stated net of total accumulated amortization of \$42.6 million at December 31, 1998 in the accompanying balance sheet.

It was also clarified that “goodwill and substantially all other purchased intangibles are being amortized on a straight-line basis over lives ranging from two to three years.” This means that the asset, acquired at huge value by the issue of shares, would be worthless after a short period of two to three years. True to its word, Amazon.com wrote off assets of the value of \$ 1,122 million in the four years, 1997-2001.

Amazon.com, having acquired assets worth over a billion dollars over four years and issued shares towards the consideration payable for them, wrote

¹⁴⁴ Note 126, above.

off the assets and eliminated them from its financial statements. This is recognition that the assets had lost their commercial value. This was duly reflected in the huge deficits which the company accumulated, and in the erosion of its shareholders' equity.

However, the shares issued by Amazon.com for the acquisition of the assets that have been written off continue to circulate in the market, and they command significant value. This is a curious situation, to put it mildly. If we accept that the assets for which the shares were issued subsequently lost their value and were eliminated by the company, then there must be some impact on the shares issued towards their acquisition. But in the present arrangement, there is no such impact, and the shares continue in the market without the slightest disturbance.¹⁴⁵

It is difficult to characterize the wealth represented by the market value of the shares issued by Amazon.com as consideration for the assets which it acquired and subsequently eliminated. A possible term would be "fictitious" or "artificial" wealth, but that would be hardly accurate. After all, the wealth represented by these shares is real, and exists in the stock market; it is hardly fictitious or artificial in that sense.¹⁴⁶ But the question is whether this variety of wealth, made possible by the legal arrangements in the society, is desirable.

Before concluding, we must take note of the fact that the long-term commitment stressed by Jeffrey Bezos, the founder of Amazon.com, is paying off, and the company has consolidated its position in recent years. Its progress is evident from its business data for the last five years given in the table below, and they vindicate our earlier observation about the qualitative difference between Amazon.com and Sycamore Networks.

¹⁴⁵ In a more responsible system, there would be a requirement that the portion of capital represented by the eliminated assets must also be eliminated. As a result, the number of shares of the company would shrink proportionately, but such things are almost unthinkable in the stock market-dominated, libertarian corporate system now prevailing in the United States.

¹⁴⁶ In the context of the present monetary system in which money can be generated by the government at will, it is possible to argue that wealth is essentially artificial or fictitious. Therefore, there is nothing inherently wrong with the "wealth" represented by the market value of the shares issued by a company towards assets that have been written off.

Table 12

Amazon.com
Business Data: 2002-2006

	2002	2003	2004	2005	2006
	(\$ '000s)				
1 Sales	3923	5264	6921	8490	10711
2 Operating results	64	270	440	432	389
3 Net Income	-149	35	588	359	190
4 Long-term debt	2277	1945	1855	1480	1247
5 Total paid-in capital	1654	1893	2129	2267	2521
6 Accumulated deficit	-3010	-2974	-2386	-2027	-1837 *
7 Shareholders' equity	-1353	-1036	-227	246	431
8 No. of outstanding shares	388	403	410	414	416

* Amazon.com repurchased stock to the extent of \$ 252 million.

Amazon.com is proof that e-commerce is basically a viable business model, and neither the commitment of Jeffrey Bezos, nor the faith of the investors is misplaced. Amazon.com has done a good job of establishing the model, and has consolidated its business. But the nagging question that remains is whether all this could have been done in a more responsible and healthier manner. Could the business not have been developed without the stock market excesses, issue of shares by the company in a casual manner, speculative frenzy in the shares, and the resulting “fictitious” wealth to which we have referred?¹⁴⁷ Now that the company is on the path to reasonable financial health, it has not lost any time in making efforts to influence the stock market, which is evident from the repurchase of stock made by it in 2006. Amazon.com applied \$ 252

¹⁴⁷ To the extent that the practices of Amazon.com have contributed and continue to contribute to trade and “wealth creation” in the stock market, it is at least in line with governmental policy. Since the late 1980s, the financial markets have emerged as the defining feature of the American system. It has also been actively exported to other countries as part of the globalization movement. See generally Joseph E. Stiglitz, note 26, above.

million for the repurchase, when its net income was \$ 190 million and it still carried debts of over \$ 1.2 billion.

V. CONCLUSION

The close relationship between business corporations and the stock market is a self-evident fact.¹⁴⁸ The two institutions are governed by legislation; indeed, companies or corporations are the products of statutes, and would have no existence without sanction in law. At present, there is little effort to regulate corporations. Although an elaborate regulatory framework has been developed for the stock market, its effectiveness in checking market excesses and negative tendencies is questionable. The case-studies reported in this paper offer additional evidence of the limitations of the present regulatory regime.

The statutes under which corporations are created treat them almost exclusively as issuers of securities, and do not recognize any other role for them. This narrow approach of the statute ignores the reality of the large role played by corporations in modern societies. Lawrence E. Mitchell observed:

The modern corporation is a social and political institution - an institution in which people go to work not only to make a living but to help find meaning and friendship in the process; an institution that by the products it produces, the services it offers, and the methods by which it markets them has an enormous effect on the way we think about our lives and the goals we pursue; an institution that involves itself in the mechanisms of government to help determine the ways our laws are made and the way our wealth is distributed.¹⁴⁹

¹⁴⁸ Indeed, the first official document on the subject, a report of the Board of Trade in England prepared in 1696, emphasized the relationship between the nascent stock market and joint-stock companies. See note 106, above. This has since been the theme of most literature on corporations. See e.g. Adolf A. Berle and Gardiner C. Means, note 21, above.

¹⁴⁹ Lawrence E. Mitchell, note 52, above at p. 6-7

Corporate statutes pointedly ignore the reality of corporations described above, and confine themselves to (a) enabling the corporations to issue securities and (b) promoting trade in the securities in the stock market. Judge-made corporate law, another important source of law, is equally non-interventionist. The defence of business judgment accepted by the courts precludes judicial interference in corporate decisions and actions, except in cases of gross abuse or fraud. Courts are mostly concerned with the narrow fiduciary duties of corporate managements to the shareholders. Other than this, corporations have near-complete freedom in arranging their business and affairs, which has been accurately summarized by Easterbrook and Fischel.¹⁵⁰

When we turn to the stock market, the elaborate regulatory framework that governs the market, as we have noted earlier, is mostly concerned with making corporate information available. This approach, tried for the last 70 and more years, has proven its inability to handle the periodic bouts of speculation which afflict the market, and the market's tendency to set irrational and unsustainable price levels. The prospect of increases in share price is a major temptation for managements to indulge in negative behaviour, and Enron is (fallen) testimony to this reality. The theory that appraisal of share prices in the stock market would be guided by the information provided by companies¹⁵¹ is considerably undermined by the case-studies made in this essay.

When we consider the question of a role for the stock market, we find that it has been all of the following:

- a. A source of capital for companies for their business needs
- b. A venue for the public to invest their savings profitably
- c. A platform for existing business owners to divest their holdings, and broad-base the ownership of business enterprises
- d. A forum for trade in the securities of corporations, and enabling liquidity for the holders

¹⁵⁰ Frank H. Easterbrook & Daniel R. Fischel, note 7, above.

¹⁵¹ Adolf A. Berle and Gardiner C. Means, note 21, above.

- e. A forum for trade in corporate control through large-scale, concerted transactions of purchase and sale of shares
- f. A significant influence on governance practices in corporations
- g. A veritable gambling den

We must pause to question whether the present regulatory framework takes sufficient note of the multi-faceted role of the stock market, and whether it effectively deals with each of them. We must also determine which of these various roles must be encouraged and which ones discouraged. It would be a serious folly to have speculation in the stock market as the basis for economic arrangements or for “wealth creation” of a dubious variety. The need of the hour is a theory for the stock market that reflects policy choices made in a reasoned manner with due regard to the interests of all stakeholders.

Instability in the stock market and unhealthy corporate governance are two major current issues, and the present arrangements have proven that they are not capable of addressing them. The need of the hour is, therefore, legal reform of the two institutions – business corporations and the stock market. The reform effort must take into account the experience which we have gained with them, and pay sufficient attention to the practical consequences of the present arrangements and their underlying philosophy.

The prevailing political climate is hardly encouraging, and there can be little optimism on the prospects for reform. On the contrary, we can expect that the very mention of legal reform will provoke strong protests from business interests, supported by libertarian scholars. But the issues at stake are too important to be left in the hands of entrenched special interests and their supporters, although this has been the case for most of the last thirty years. We must, therefore, persist with a debate on reform, regardless of how bright or bleak the prospects for actual reform might appear to be. The case for the legal reform of corporations and the stock market is strengthened by the following:

- a. Business corporations are creatures of law, and when these creatures of law engage in harmful acts, it would be quite legitimate for the law to regulate them. The clear and undisputed status of business corporations as products of law, rather than

private arrangements provides a strong theoretical justification for the efforts to regulate them. Such regulation would not, in any way, curtail the liberties of the people.

- b. Stock market is the forum for trade in the securities issued by corporations. The market might be a societal arrangement that emerged without state intervention and the laws might have played little role in its emergence, but the subject of trade in the market are securities issued by corporations, which are legal creatures. The stock market hardly deals in natural commodities like food grains and vegetables, or manufactured commodities like textiles or industrial products. The securities traded in the stock market are legal instruments that have special characteristics in law, and they greatly influence and shape the trends and tendencies in the market. This distinction calls for a special variety of regulation.¹⁵²

The first step in a meaningful reform effort would be to formulate sound theories about the two institutions, in terms of the role that we expect them to play. This variety of theorizing about the law and legal framework, and preparing elaborate legal codes are alien to the common law tradition, which prefers to rely on spontaneous arrangements emerging in the society endogenously. While such a conception of the law would be natural and quite appropriate for self-contained local communities, they would be out of place even in small, nation-states, not to speak of the vast, interconnected and globalized society of the present.

Experience shows the limitations of the bureaucratic, command-and-control method of regulation tried in the last about 150 years of the welfare state, more particularly since the New Deal.¹⁵³ But there is also

¹⁵² Such complex arguments are necessitated by the doctrinal divide between “public” and “private” in the Anglo-American legal tradition. In more integral systems, they would not be as important. Moreover, with the adoption of democratic forms of government in which the laws are made by elected assemblies, the theory is that the laws represent the consciousness of the people, rather than “commands of the sovereign.” For this reason, the distinction between public and private ought to diminish, if not get effaced.

¹⁵³ See e.g. Milton & Rose Friedman, *Free to Choose: A Personal Statement* (New York: Harcourt Brace Jovanovich, 1980).

increasing realization that the deregulation tried since the 1980s and enlargement of the role of the state that has accompanied the process have mostly benefited the special interests which either hold or are close to controlling power.¹⁵⁴ It is, therefore, vital that any roadmap for reform avoids dogmatic and doctrinaire approaches either in favour of or against regulation, and works towards solutions that advance the common good, rather than special interests.

¹⁵⁴ See e.g. Joseph E. Stiglitz, note 26, above.