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MILLSTONE LECTURE

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Because this lecture honors the memory of a great St. Louis journalist, I start by acknowledging that the source of my opening quote is a newspaper story. I liked this quote from *The Great Crash* by John Kenneth Galbraith so much, that I read the entire book in order to find this quote.

Galbraith is not well thought of by professional economists since his writing is accessible, witty and based on shrewd insight, rather than multiple regression theory. He is also hopelessly liberal. I hope you like the following passages that introduce the cheery topic of Enron and our other corporate scandals. I personally think it is one of the most elegant paragraphs ever written by an economist–although many of you may think that economic prose presents a low hurdle for elegance in writing. He writes:

> In many ways the effect of the crash on embezzlement was more significant than on suicide. To the economist embezzlement is the most interesting of crimes. Alone among the various forms of larceny it has a time parameter. Weeks, months, or years may elapse between the commission of the crime and its discovery. . . . At any given time there exists an inventory of undiscovered embezzlement in – or more precisely not in – the country's businesses and banks. This inventory – it should perhaps be called the bezzle – amounts at any moment to many millions of dollars. It also varies in size with the business cycle. In good times, people are relaxed, trusting, and money is plentiful. But even though money is plentiful, there are always many people who need more. Under these circumstances the rate of embezzlement grows, the rate of discovery falls off, and the bezzle increases rapidly. In depression all this is reversed. Money is watched with a narrow, suspicious eye. The man who handles it is assumed to be dishonest until he proves himself otherwise. Audits are penetrating and meticulous. Commercial morality is enormously improved. The bezzle shrinks.[1]

The good news is that there is no doubt that the "bezzle" in the U.S. economy is now rapidly shrinking. Unfortunately, our national income statistics, which didn't exist in the 1920s, do not report regularly on this

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1. JOHN KENNETH GALBRAITH, THE GREAT CRASH 1929, 137-38 (Houghton Mifflin Co., Boston 1972) (1954).

quantity. It is a serious problem for Alan Greenspan that he does not get a daily report on the amount of the "bezzle." It would be a good leading indicator. However it would be difficult to gather the data, as most companies would be reluctant to report it.

But let me get more serious. What was the form of the "bezzle" in the last decade of the 1990s? And just how widespread and large is it? The title of this talk raises that question. Was Enron a freak occurrence? If it was, what about WorldCom, Global Crossing, Waste Management, Tyco, Cendant, Dynergy, RiteAid, Sunbeam, Xerox and now a truly fancy name "Royal Ahold?" This very partial listing suggests Enron was not so freakish.

Let me answer the questions using public polls. A competent survey showed that 84% of the public believe that every American company engages in corporate wrongdoing.[2] About half of those believe that many of these companies will be exposed. If that is true, there is a journalistic feast ahead, but a disaster for the country. On the other hand, a shrewd, well-informed observer of American Business, Hank McKinnell, the Chair of Pfizer, an extremely well-governed company, has written that he is angry at the few malefactors, but believes they are "rogues" and that only 1% of American companies are so guilty.[3] I take a position decisively between these two bounds; the malefactors are between Hank's 1% and the general public's 100%.

Other public survey shockers include results reflecting that the American public believes that only 23% of CEO's can be trusted, which is slightly ahead of car dealers at 15%, but far behind military officers and people who run small businesses, 75% of whom the American public believes can be trusted.[4]

I will approach this analysis by examining just one company—Enron—and going through the following aspects of its spectacular failure that seem to me to represent system-wide issues for American companies: (1) the pernicious aspects of Enron's basic business model, (2) the flaccid performance of a seemingly excellent Board, (3) overdosing on stock options, and (4) Enron's conflicted auditor relationship.

We now know a good deal about Enron after all the investigations, congressional hearings, and even books. I even have a few anecdotes from my personal experience that affect my view of the Enron/Anderson debacle. Furthermore, Enron seems to have exhibited more of the system-wide failure than did the other corporate scandals.

2. *Street Sweep* (CNNfn television broadcast, June 13, 2002).

3. Hank McKinnell, *"The New Responsibilities of Business Leaders are as Old as Commerce Itself," available at* http://www.directorship.com/NewsletterPDF/January.2003.article.pdf (April 2, 2003).

4. *See* The Conference Board Commission on Public Trust and Private Enterprise (Sept. 17, 2002), *available at* http://www.conference-board.org/pdf.free/757.pdf (last visited April 2, 2003) [hereinafter *The Conference Board Report*].

The Business Model

One should start with the primary problem: the failure of the Enron business model. Enron captured, in four major ways, the greatest ambitions of the new economy of the 1990s. First, Enron seemed to demonstrate creative and imaginative responses to a new unshackled business—deregulation of the staid energy business. They stepped away from the dull, slow-moving building of energy sources in the form of power plants and pipe lines to focus on markets, trading, and fast-moving market manipulations. And why limit them to energy? As Enron developed markets in a variety of products, they saw no limit to what they might do.

Second, they had an extraordinarily high-performance work environment with the best and brightest from our finest business schools competing eagerly for jobs at Enron. Enron employees were totally devoted to work, to outdoing their competitors and each other, and to doing this with a total commitment to their exciting "New Economy" company.[5] They believed they were revolutionizing the business world and getting fabulously rich in the process.

The third way they reflected the new business model was that they had become a power player in national and local politics.[6] Ken Lay and his colleagues were movers and shakers in Washington DC, in every state capital, and every country of the world.

The fourth way was Enron's use of financial engineering. Enron's business model was also firmly based on financial engineering, another theme much admired by the contemporary world.[7] Complexity of their off-balance sheet structured financing became unfathomable – our CREF analyst recommended against buying the stock because "he couldn't figure out how they made money."

We should recall how much the business community, the media, the Houston and Washington, D.C. social worlds admired, envied, and emulated the aggressive, energetic, and fabulously successful style of Ken Lay's creation. In retrospect, Lay must be viewed as one of the truly great con men of the 20th Century.

The Enron mystique was based on deep and influential views about how a "new economy" American business should be run. Academic finance theorists once called for business cultures like that of Enron. We needed an *owner*

5. Holman W. Jenkins Jr., *Business World: Enron For Beginners*, WALL ST. J., January 23, 2002, at A23; *See* Barrie McKenna, *Enron Lavished Cash on Top Staff*, GLOBE AND MAIL, June 18, 2002, at B1.

6. Alan Clendenning, *Enron Influence Cast Wide Net*, ASSOCIATED PRESS ONLINE, January 25, 2002.

7. David M. Katz, *Financial Engineering: How derivative debacles and off-balance-sheet shenanigans sank a concept, available at* http://www.cfo.com/Article?article=8539 (Dec. 31, 2002) (last visited March 26, 2003).

mentality rather than a bureaucratic approach; we needed uncapped pay for performance where performance was focused, measurable, and derived from management by objectives. Employee interests were aligned with shareholders—the more specific the objectives the better. Stock options were the perfect form of compensation. The really great CEO took no salary and was paid entirely on the basis of the rise in the quoted price in the market for his company's stock. I say "him" in the masculine advisedly. Men seem to have a gender advantage when it comes to engaging in embezzlement, but probably not a total exclusion.

We now know how flawed the real Enron business model was and how it finally became a sham that the leadership of Enron did not acknowledge, even to themselves. If there is any justice in what happened to Ken Lay and his associates, it is that they were also wiped out financially by holding their Enron stock to the very end. Their business model has been called hyper-capitalism.[8] The term "hyper" is used in the sense of speed, rapid growth, trading instead of building, use of market mechanisms, and very quick accumulation of enormous personal fortunes.[9]

Another form of hyper-capitalism in the hands of "Chainsaw" Dunlap at Sunbeam degenerated into "pathological capitalism," where he seemed to get pleasure from destroying shareholder value through firing competent, hardworking people who were needed.[10] Sunbeam is another example of the widespread perverse effects of the ideas underlying Enron. The bezzle was growing in Enron with few people seeing the disaster that was to come. The ideas behind the Enron business model are widespread in American business, but are now being reconsidered by academics, regulators, and especially business participants.

Mike Jensen, a Harvard Business School finance professor, was one of the strongest energizing forces behind the new economy in the 1980s. He is now recanting and has become defensive about his ideas at the same time. He has coined a great phrase that overpriced stocks are like managerial heroin.[11] If the price went up 50% last year, we *have* to have another rise this year. How can we get it?

Enron's electrified culture was paired with a similar one at Arthur Andersen. I will address the Andersen independence issue later. There is an

8. *See, e.g.*, James P. Pinkerton, *History Confirms It: The Bull Market is Over*, NEWSDAY, June 18, 2002, at A31.

9. *Id.* (stating that "investors have been getting away with murderous winnings in recent years" and commenting on the "risk-taking, sharp practicing nature of globally competitive hyper-capitalism.").

10. *See, e.g.*, Jerry Useem, *Tyrants, Statesmen, and Destroyers (A Brief History of the CEO)*, FORTUNE MAGAZINE, Nov. 18, 2002, at 82.

11. *How To Pay Bosses—Michael Jensen Still Thinks He Has The Answer*, THE ECONOMIST, Nov. 16, 2002, *available at* 2002 WL 7248235.

important book recently released by Barbara Toffler, entitled *Final Accounting, Ambition, Greed and the Fall of Arthur Andersen*. She was the head of Andersen's Ethics Practice, which ironically advised only client companies on ethics but not Andersen itself. She describes the gung-ho training of Andersen "androids" to make sure they all represented the company in exactly the same way. The clash of culture between the high rolling consultants and the dull, beancounting auditors was poisonous.

Andersen created a giant consulting business, now spun off and called Accenture, that was worth many billions of dollars. But, all that was lost to the Andersen auditors and accountants when internal fighting between the cultures became self-destroying. The results are well-known.

But these cultural traits were not unique to Enron and Andersen. Many companies aspired to match them, or believed they could surpass them. The telecom companies may be the best examples. A solid company like Corning decided to focus itself on producing high-tech telecom cable and got rid of dull Corning Ware. They are now almost out of business.[12] A well diversified old economy company like Aetna recklessly abandoned the stodgy insurance business to become a highly-focused medical care provider.[13] They just missed going under.

I could expand endlessly, but the pressure on financial numbers in all of these failed enterprises surely generated significant bezzle in the economy.

Board of Directors

Let me turn to the second Enron Story, the Board of Directors.

What is terrifying to many in the corporate governance community—directors, CEO's, regulators, stock analysts, accountants and lawyers—is that Enron had an apparently excellent Board of Directors that performed horribly. "There but for the grace of God go I" is on the minds of countless board members. Which of us could have gone on that board and slowed the train or challenged the management, as our textbook theory of corporate governance would expect of directors?

A Stanford University Business School Dean, who was also an accounting professor, chaired the audit committee. Ken Lay must have bragged about that appointment over many years. The board had a nominal split between the Chairman of the Board and the CEO. This is an overrated protection in my opinion, but Enron had it. Did both or either Ken Lay and Jeff Skilling know the dangers of what they had created?

The other board members were able and savvy people. The board met all our most cherished goals for talent and even diversity. Frank Savage was an

12. *The Re-education of Roger Ackerman*, THE NEW YORK TIMES, Aug. 17, 2000, at 1.

13. *Aetna Buys Health Insurer New Firm Would Cover 23 Million People From Wire Reports*, THE PLAIN DEALER, Apr. 2, 1996, at 1.

African-American, a veteran investment analyst with a remarkable background heading Equitable's, and now AXA's, investment programs. Wendy Gramm (wife of the Senator Gramm) would have been on anyone's lists of the 10 most successful women in finance in the United States, and John Mendelsohn, a college classmate and friend of mine, was a brilliant scientist and administrator who headed Anderson Memorial in Houston, one of the most prestigious cancer centers in the U.S.. Others had excellent backgrounds in corporate governance. They were all clearly independent, by the sternest definitions. Yet the most fundamental protection for investors, the Board of Directors, utterly failed.

I can assure you that the Enron Board failure haunts American corporate leadership. As Galbraith says, after the bubble breaks, "Money is watched with a narrow, suspicious eye. The man who handles it is assumed to be dishonest until he proves himself otherwise."[14]

Even before the passage of Sarbanes-Oxley in July 2002,[15] the directors of public companies had begun probing, questioning, and spending *much* more time on their activities. This was especially true with regard to their audit committees, because so much "bezzle" grew on their watch. A topic for another talk would be the issue of the fundamental imbalance in American corporate governance—strong managers represented by powerful CEO's, weak boards as seen at Enron, passive owners, and the day traders and hedge fund managers who showed no interest in where Enron was headed.

Stock Options

Let me turn to the third source of Enron's collapse, the very wide practice of overdosing on stock options, to continue with Jensen's reference to "management heroin." I have recently been a member of a commission set up by the Conference Board, called the *Commission on Public Trust and Private Enterprise*.[16] Our first and most significant report was on executive compensation.

The Enron compensation plan had all the characteristics that our Commission described as "The Perfect Storm."[17] The six dangerous forces included a combination of excessive use of options, their speculative nature, the laxness of boards in monitoring compensation, the imbalance created by compensation consultants, the short-term management view encouraged by options, and the bull market that led to unanticipated and truly gross windfall

14. GALBRAITH, *supra* note 1, at 138.
15. 15 U.S.C. § 7201 (2002).
16. *See generally* The Conference Board Report, *supra* note 4.
17. The Conference Board, *The Myth of CEO Accountability*, (March/April 2003), *available at* http://www.conference-board.org.

gains that had little to do with management's operating performance. If you would like, I will expand on any one of these in the question period.

I believe that comes to six storms converging rather than the mere three that created the 100-foot waves that sank the Andrea Gail off the Newfoundland Banks in Sebastian Jungar's incredible story.[18] The overuse of stock options was extremely widespread and was clearly an issue for the entire American business system.

Enron's management focus on the stock price was extraordinary. When the stock passed $50 a share, a $100 bill was placed on every employee's desk.[19] This was a sort of spot bonus. It seems ugly in retrospect. For every dollar rise in the stock price, the already considerable fortunes of Lay, Skilling, Fastow, among others, would rise by still more millions. "Management heroin" is an appropriate phrase.

There is nothing wrong with shareholders getting rich. After all, investing in stocks is a risky business. Still, let me briefly list the obvious problems with stock options.

(1) There is no downside financial risk. Every incentive exists for senior management to take steps to increase the stock price, but no incentive exists to avoid loss.

(2) Certainly, dividends should be avoided if all of the focus is on the stock price; they provide cash to the shareholder, but they reduce the price of the stock. So, it is no surprise that dividend returns declined dramatically during the 1990s.

(3) Leverage is great because the price will rise and there are tax advantages. But the stock becomes much more risky. Like the perverse incentives in our S & L debacle, the stock option gave senior management the following simple strategy: gun the company with borrowed money. If it works, the senior management gets a fabulous payoff; if it fails, no financial loss for management results, but they give the company back to the shareholders. That was called looting or exploiting, and in the 1980s, S & L executives who followed that strategy went to jail. Again, is it surprising that American companies are significantly more leveraged today than in 1990, and many believe dangerously so.

(4) Also, should not senior management have some minimum threshold of returns before they get a huge payoff? For example, should they not, at least, give the shareholders the risk free rate of return on

18. SEBASTIAN JUNGER, THE PERFECT STORM: A TRUE STORY OF MEN AGAINST THE SEA (1997).

19. *Nobody Went Like Enron: Failed Energy Firm Spent Freely on Luxury and Image*, J. REC., Feb. 28, 2002, *available at* 2002 WL 4934187.

government bonds before they get their millions—or even more logically, match some index of stock market returns.

(5) And finally, why, in a rising market, due to the dramatic decline in interest rates during the 1980s and 1990s, should executives receive millions of dollars of "compensation" when the money should have gone to, say, Alan Greenspan or Paul Volcker?

I believe stock option abuse was extremely widespread. I haven't mentioned the phony accounting by which stock options were encouraged. Eye-popping compensation numbers had a greater impact on public distrust than any other corporate action. Our Commission set up by the Conference Board outlined the best practices that would go a long way toward curing those problems. I believe many companies have voluntarily moved forward. But clearly, a major emerging force behind the creation of "bezzle" was this extraordinary compensation form.

Auditing

Let me conclude with the auditing of Enron. There has been much dispute about the independence of auditors in recent years. Arthur Levitt was mostly defeated by the opposition of the accounting profession when he tried to address this problem. But, consider Arthur Andersen and Enron.

First, Andersen had been Enron's auditor for more than a decade, in effect during Enron's entire "new economy" existence. In short, they had always been Ken Lay and Jeff Skilling's auditor. Secondly, Enron's financial management was permeated by former Andersen partners and managers. Thirdly, Andersen received fabulous fees for doing non-audit work at Enron, bringing their total fees to $47.5 million a year.[20] With growth expected at minimally double digit rates, the capitalized present value of that annual amount would be valued by Andersen at $500 million—$1 billion dollars—a serious "asset." I can assure you that accountants know how to compute the value of a perpetuity.

Fourth, Andersen did all the internal auditing work for Enron. Fifth, Andersen went well beyond tax compliance in providing aggressive tax and accounting advice for the infamous off-balance sheet asset structure of Enron. They then audited that structure and found no difficulty with it. These five abuses of the idea of independence formed another kind of perfect storm.

Did *anyone* raise a question about Andersen's independence? I can assure you no one in the leadership of the accounting profession did raise, or would have raised, a question. I sparred with them in a Senate Banking Committee hearing on this issue and they were deeply offended at my questioning their integrity by suggesting that such conflicts might impair their independence.

20. Flynn McRoberts and Delroy Alexander, *'1-stop' tactic casts cloud on Andersen*, CHI. TRIB., Mar. 4, 2002, at pg. 1.

Did Enron's Audit Committee raise a question? Did the distinguished Stanford Dean see any problem? None — that is, at least on the record. Why didn't some of the highly compensated stock analysts whose research reports puffed Enron stock ask about Andersen's independence? They didn't have the wit to do so because they also were fooled when shown through the Potemkin Village trading floor at Enron.

I have one personal anecdote. I am a trustee of the International Accounting Standards Committee Foundation, which raised money to support the new international standard-setting mechanism two years ago. I served on the fund raising committee with Paul Volcker. Paul asked Ken Lay for an Enron contribution, as we did all major U.S. companies. They ended up pledging about half of what we asked. You will recall that David Duncan was the senior partner of Arthur Andersen in Houston overseeing the Enron audit. In the media disclosures of Duncan's famous e-mails, there was one to the Chicago office of Andersen asking if Ken Lay's gift to the Foundation would assure Enron influence over the standards to be adopted.[21]

I make two personal observations. The question obviously shows the venality of Lay and Enron, or simply a vivid example of using "new economy" morality to buy political power. Secondly, it shows extraordinary naiveté on Duncan's part. In Accounting 101, students learn about the accounting standards setting process, and the extreme efforts made to keep it independent.

What kind of senior partner had Andersen put in charge of a risky, high rolling account, with fees of $55 million a year, who had to seek guidance on such a question from his superiors in Chicago? Significantly, there was no e-mail response. One can imagine the unrecorded but blistering telephone call.

Sarbanes-Oxley, the new federal statute, creates strong powers for the new accounting oversight board.[22] There is hope in *that* government response, despite the fact that most of us fear the establishment of a new federal regulatory agency.

Other lessons from Enron concern the responsibility of the legal profession in advising and abetting Enron management. Investment bankers are also called on the carpet. But, the American public has the right, especially, to focus on the auditors' role. The auditor's specific job in our economy, sanctioned by the securities laws as a requirement for all public firms, is to limit the bezzle. They failed not only at Enron, but at many other companies. Between stock option abuse and the shock of failed audits, the public has come to distrust the whole system. We have much painful work to do with major changes in many of our most prestigious and respected institutions.

21. *Enron Lay: Won't Appear Today*, AMERICAN POLITICAL NETWORK: THE HOTLINE, Feb. 14, 2002, at 11.

22. 15 U.S.C. § 7201 (2002).

The broader question is how did we come to this state? What happened to corporate values and ethics in the 1980s and 1990s that led to such widespread abuse? The infamous Jack Grubman has a neat explanation: "a conflict [of interest] is now a synergies."[23]

I see us as having moved from a senior management sense of fiduciary duty and trust to a system of doing whatever the market permits, or a, "what I can get into my contract that will benefit me?" attitude. Everyone else does it. Or, where does it say I can't do it?

We could all list dozens of other Wall Street and American business practices that companies performed in the 1990s that we now see for what they were. IPO allocations were bribes, synergistic combination of commercial and investment banking led to abuses that Glass-Steagall prevented, corporate charitable giving was used to support personal benefits, and corporate-owned life insurance, once a marginal question, became a huge one as "janitor insurance." We could go on.

So far, the first decade of the 21st century has been the hangover decade. We all have splitting headaches from our 401(k) losses, we deferred plans for our retirement, and we subject ourselves to personal second-guessing, asking questions such as, "why didn't we sell our stocks when the bubble was so obvious?"

I can assure you that during our hangover decade, "[m]oney [will be] watched with a narrow, suspicious eye. The man who handles it [will be] assumed to be dishonest until he proves himself otherwise. Audits [will be] penetrating and meticulous. Commercial morality [will be] enormously improved. The bezzle will shrink."[24]

I suppose that is the good news.

23. Peter Elstrom, *The Power Broker: From His Wall Street Perch, Jack Grubman Is Reshaping Telecom and Stirring Up Controversy*, BUSINESS WEEK, May 15, 2000, at 11.

24. GALBRAITH, *supra* note 1.