Corporate Governance in the U. S.: Post-Enron

By Patrick Kenny

[Editors' Comment: The following is the text of Mr. Kenny's remarks at the SECOND EUROPEAN CORPORATE GOVERNANCE CONFERENCE, which was organized by the Vlerick Management Institute and the University of Gent, Belgium, and held at the Belgian National Bank, Brussels, 28 & 29 November 2002. The conference, which was convened by Professor Lutgart Van den Berghe of the University of Gent, was dedicated to the intensive debate over the marks and characteristics of "European Capitalism" in light of the international corporate governance debate, which has been affected by the recent earthquakes in the confidence of investors, shareholders and stakeholders precipitated by the corporate scandals of Enron, Worldcom, Global Crossing and others. The conference also took note of the impact of America's new Sarbanes-Oxley *legislation, which seeks to respond to the wave of corporate scandals, on the international corporate governance debate.*

The conference in Brussels brought together lawyers, financial analysts, law-makers, academics and practitioners from a wide range of countries. Just before the deliberations began, a thorough study of current trends in corporate governance was published by the conference's host, Professor Van den Berghe; the book's theme, which was taken up by a number of speakers, turned out to be a guiding theme throughout the conference. Professor Van den Berghe's inquiry into possible trends of convergence or divergence in corporate governance principles opened up fertile ground for discussion.

The debate during the conference clearly took place against the background of a very active, international debate over the future prospects of corporate governance, of shareholder versus stakeholder capitalism and the wider ranging issues of the political economy of the company. The inquiry into "European Capitalism," the debate over the future of "Rhenish Capitalism" seems to be gaining new ground, even ten years after Michel Albert's influential book CAPITALISME CONTRE CAPITALISME. And there are, this became clear at almost every point during the conference, good reasons for this: the oppositional stands erected between an allegedly pure, market driven system of shareholder value and a stubbornly corporatist and inefficient system of company law that is more (or less) oriented towards stakeholder protection, is too simple a description to capture the intricacy of post-modern, contemporary capitalism and company law. As is reflected, for example, by a rich political science literature and the work predominantly produced by British corporate law scholars and economists, the historical roots and traditional embeddedness of company organization escapes the model of just two opposed models of company law. While it

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remains, for the time being, uncertain whether Enron (and the others) will turn out to be mere ripples on the sea of a well established capital market system with its (allegedly) exclusive focus on shareholder value, or whether the discussion around executive responsibility for accounting issues and integrity will have a healthy influence on a more thorough discussion of different systems of capitalisms, the recent conference in Brussels certainly contributed to the latter. Yet, a seemingly self-assured refuge taken to a system of "European Capitalism" as a sort of stable, well-defined and by nature virtuous panacea for today's troubles, which was occasionally displayed by some speakers at the conference, is to be rejected. The issue of company organization plays far too vital a role in today's and tomorrow's economies to allow for the assumption of one simplistic explanation in exchange for another.]

A. Introduction

There's no doubt that globalization continues to remake the economy of virtually every nation in the world. But we've learned in recent years that capital markets don't necessarily take care of themselves without restrictions and regulations.

Once we believed, at least in the United States, in the natural power of unfettered markets. Now, we are painfully aware of the ways in which excesses can occur. On the one hand, there was old government regulation that was thought to inhibit the free flow of ideas and capital. Take for example, the old separation between banks, brokerages, and insurance. That was perceived to be bad. Looking to the future, we saw a new elegant international system of international commerce, free from regulation and as natural as could be. That was good. In truth, we've learned that "unchecked" is not always good.

Much has been learned about market conduct, regulation and corporate governance since the debacles of Enron and Worldcom and a growing number of other companies in the U.S. and elsewhere. Sadly, the lessons learned come after significant damage has been inflicted on investor and employee trust, savings and investments.

We like to say we're more clear-eyed today about the potential problems inherent in an unchecked market. And we've been taught that regulation must play an important role in corporate governance and that the global markets will benefit from that.

B. The Role of Regulating the Market

Many people in the U.S. have forgotten that this is not the first time scandal has caused widespread response. The McKesson Robbins scandal in the early 1930's spawned the Securities Act of 1933 and the Securities Exchange Act of 1934. It also impacted the way auditors work: requiring independent observations of physical inventories and confirmations of accounts receivable.

Notwithstanding the past, in the U.S. post-Enron, we've moved quickly, under intense political pressure, toward revised regulation. Financial leaders, politicians, shareholders and the investing public agree that regulation that goes beyond the enforcement of basic contracts and property rights is needed. When corporate law does not keep pace with the changes in the financial world, change is needed and will come.

The issues arising from corporate scandals are now being addressed in the U. S. after a series of high-profile arrests and convictions in the corporate world.

I. The Recent U.S. Legislation: *Sarbanes-Oxley*

The U. S. Congress has passed legislation, named *Sarbanes-Oxley* after the legislators who sponsored it, which is perhaps the most sweeping corporate governance legislation to pass in a generation. The changes address five major areas:

First, is the issue of regulation of accountants. The new law restricts accounting firms from performing audit and consulting services for the same client. It also requires that the lead auditor partner be rotated every five years (previous SEC practice rules had said seven years).

Perhaps there was no more dangerous an arrangement than Arthur Anderson's consulting assignments with Enron. It caused conflicts of interest on a massive scale. Possibly more important, however, was the size of Enron's fees - making them the second largest client and by far the largest in the Houston office.

As a result, all accounting firms have taken the initiative to restructure their businesses to avoid conflict ... and to put a wall between their auditing and consulting services. The lesson is clear: to fail to avoid such compromising conflicts is to -eventually - fail altogether.

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Second, there are new prohibitions regarding Executive Compensation. Laws now prohibit most corporate loans to senior executives. And the Securities and Exchange Commission (SEC) is studying whether or not to require companies to provide more details on compensation packages. In many cases these have fallen below the disclosure radar screen.

In the U. S., no greater corporate titan than Jack Welch of GE has become the most recent example because of revelations of the perceived lavish corporate perks he received *after* retirement, most of which were undisclosed before coming to light in a divorce case.

Third, addressing corporate and executive liability, the new law creates a new securities anti-fraud statute and increases the maximum penalties for criminal violations. This is a response to those who think that there has been a double standard when it comes to prosecuting corporate executives and "white collar" crime.

Fourth, to avoid conflicts of interest, all members of Board audit committees are now required to be outside directors. This has been a requirement of the NYSE (*New York Stock Exchange*) Companies in the past. And there are now new obligations for corporate lawyers to report securities law violations to the chief executive. And there are good reasons why such violations should also go to the Audit Committee of the Board. Also, the law is looking to the stock exchanges to create rules to address abuses by research analysts and investment banks and their clients.

What the Enron case made clear is that there was a chain of questionable practices extending out from the company to banks, brokerages, and research analysts. This law is hoped to help cut that chain. This is an area, in my view, where personal greed and egotism manifest themselves. The clearest example of this in the U. S. being the infamous Martha Stewart case.

Fifth, in the area of prompt disclosure, the new law requires chief executives and their financial officers to personally certify quarterly and annual reports, and requires corporate insiders to disclose stock trades within two days of trade, rather than up to 40 days.

Companies also must file their annual financial statements 60 days after the end of the year, rather than 90 days. These measures put corporate executives on notice that their reputations, and that of their companies, are on the line if financial results are not reported quickly and accurately.

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The concept has previously existed that everyone should know or have access to information at the same time. This merely reinforces that requirement and tries to close the loop on "insider information."

There are still some issues to be resolved regarding the *Sarbanes-Oxley* law, and probably one of the most significant is its extra-territorial provisions.

II. What the Regulators have not touched

These are all positive changes in how corporations govern, and the new laws will go a long way in helping correct abusive practices. But there are also some very important things to say about what *hasn't* been addressed in the recent reforms. Just as worthy of comment is the question whether or not leaving these items on the table will dilute the effects of other measures passed.

For one thing, the U. S. Congress refused to address the issue of companies accounting for stock options issued to executives as expenses in corporate financial statements. This has led to a sharp divergence and conflict between companies that will expense such options and other who say that they will not. There is evidence and there are good reasons to believe that pressure is mounting and that we are seeing more companies voluntarily move in this direction.

And the U. S. Congress did not restore an old law that held investment banks, lawyers and accountants liable in investor lawsuits as "aiders and abettors" of fraud. Passage of this would have enabled investors to go after advisors to companies.

For example, much news had been made regarding the complicit role of investment bankers in such cases as Enron, Merrill Lynch is one company that comes to mind, and whether in that role they were aware of and involved in the fraud.

Also, the laws do not change how directors are selected in a corporate voting system, which generally offers shareholders no choice of competitive slates of candidates. We have all seen examples of the "buddy" system or the "good old boy" network.

No effort was made to reign in huge compensation packages of executives, although they must be disclosed more accurately. I think we are in for more activity related to this. Increased shareholder activism and poor performing stock markets are going to target our highly compensated - and underperforming CEOs.

Congress took no action to reduce the conflicts of interest of directors. Some directors still function as "consultants" to companies on whose boards they sit.

And most significantly, Congress is still to debate and decide on revisions on laws governing worker retirement funds. This is a key issue given the fact that many employees suffered total losses in their retirement funds due to the problems of companies like Enron. At issue here is whether Congress will make changes to permit employees to sell company stock held in their retirement funds or diversify their investments in the future.

Further investigations are now focused on shareholder losses and how these can be restituted. The latest twist in this story now comes from New York. There, the state Attorney General has just sued top officials of five telecommunications companies, contending that they steered investment-banking business to Citigroup in exchange for inflated ratings on their companies' stock and preferential treatment in the issuance of new shares of other companies.

The suit calls for the former chairmen of companies to give back millions and millions of dollars in ill-gotten personal gains to the shareholders of the companies they ran. This includes profits on shares of initial public offerings and far larger gains on stock and options of their own companies. This lawsuit is now being made against such companies as WorldCom, Qwest Communications, Micromedia Fiber Network and McLeod USA, all major players in telecommunications.

The New York suit details how each corporate chief reaped gains of several million dollars on shares allocated through a practice called "spinning." In turn, the executives directed their companies to pay Citicorp millions of dollars in investment banking fees.

Following new measures adopted by Congress, the stock exchanges in the U. S. are also mandating changes designed to strengthen corporate governance.

C. What Lies Ahead

All of these corporate governance issues have taken on more vitality given the decline of the U.S. stock market. And these issues took on greater political significance in recently concluded mid-term elections. That corporate America has been given a black eye is not in doubt. What is in question is how far will current changes go to correct the situation and how will corporations address issues within their organizations to restore public trust and confidence.

At the end of the day, new regulations and securities laws will change the climate in business in the U. S. But will business enterprises refocus their efforts towards the collective aims of their company, and less on individual interests of high-ranking and powerful executives and directors?

Laws, and the penalties for violating them, are one thing. But, it should not be the ultimate answer. Good corporate governance starts at the top of the organization.

It is an attitude that says we will operate ethically, morally and legally in all that we do. And we do not need the U. S. Congress or anyone else to tell us this.

In Enron's case, there was no corporate culture of morality and the rules became obstacles to overcome rather than guidelines to follow. Corporate executives must take the lead or their institutions will be doomed to failure; they must strengthen corporate culture to achieve greater collective achievements. The leaders of tomorrow will generate sustained returns to shareholders but will also be known for the corporate culture they create. It's a critical juncture for American business.

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