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# COMPLEMENTARY PERSPECTIVES ON “EFFICIENT CAPITAL MARKETS, CORPORATE DISCLOSURE, AND ENRON”

Yaniv Grinstein†

## INTRODUCTION

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

## I

### OBJECTIVITY AND PROXIMITY

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

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<sup>1</sup> Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394 (2004).

<sup>2</sup> *Id.* at 403.

<sup>3</sup> *Id.* at 413.

<sup>4</sup> *Id.* at 417–20.

<sup>5</sup> *Id.* at 400–01; Arnoud W.A. Boot & Jonathan R. Macey, *Monitoring Corporate Performance: The Role of Objectivity, Proximity, and Adaptability in Corporate Governance*, 89 CORNELL L. REV. 356, 356–57 (2004).

<sup>6</sup> Macey, *supra* note 1, at 400; Boot & Macey, *supra* note 5, at 358–59.

<sup>7</sup> Macey, *supra* note 1, at 401; Boot & Macey, *supra* note 5, at 359.

Professors Boot and Macey base their model of corporate governance on a tradeoff.<sup>8</sup> A monitor belonging to the first group has timely information about the firm and can monitor proactively, but this monitor risks capture because of its proximity to management.<sup>9</sup> A monitor who belongs to the second group does not have timely information about the firm, and can only monitor *ex post*, i.e., after observing managerial wrongdoing.<sup>10</sup> Nevertheless, such outside monitoring is likely to be more objective and less at risk of capture by management.

Enron had monitoring mechanisms based on both proximity, (the board of directors) and on objectivity (analysts, credit agencies and other market agents).<sup>11</sup> Both mechanisms failed to function properly.<sup>12</sup>

Professor Macey convincingly explains the reasons why market agents had no objectivity: analysts were biased partly because of the relationship between their employer, the investment bank, and Enron.<sup>13</sup> Credit agencies hesitated to downgrade Enron's debt because they dreaded the overwhelming impact such a downgrade would have on Enron and the possibility that their judgment was incorrect.<sup>14</sup> Finally, external auditors did not properly audit Enron partly because of the faulty incentive structure of partners within the accounting firms.<sup>15</sup>

But what was wrong with the board of directors? Professor Macey argues that they were bound to be captured by the management because of their strong proximity.<sup>16</sup> My comments focus on this issue.

Like other monitors, the board of directors should have the knowledge and incentives to execute its duties properly.<sup>17</sup> In general, the sources of board incentives may be divided into three groups—ethical, legal, and monetary incentives.

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<sup>8</sup> Macey, *supra* note 1, at 400; Boot & Macey, *supra* note 5, at 358. For the psychological theory underpinning proximity, see DAVID G. MYERS, *SOCIAL PSYCHOLOGY* 46–47 (1983) (explaining the “foot-in-the-door phenomenon,” which finds that individuals who agree to do a small request at first eventually tend to become increasingly involved over time).

<sup>9</sup> Boot & Macey, *supra* note 5, at 359.

<sup>10</sup> Macey, *supra* note 1, at 401.

<sup>11</sup> *Id.* at 403.

<sup>12</sup> For details of the Enron scandal, see, for example, Marianne M. Jennings, *A Primer on Enron: Lessons from A Perfect Storm of Financial Reporting, Corporate Governance and Ethical Culture Failures*, 39 CAL. W. L. REV. 163, 167–97 (2003).

<sup>13</sup> Macey, *supra* note 1, at 404.

<sup>14</sup> *Id.* at 405–06.

<sup>15</sup> *Id.* at 407–10.

<sup>16</sup> *See id.* at 400–01.

<sup>17</sup> *See* Boot & Macey, *supra* note 5, at 361–64.

Board members should have high ethical standards and sufficient reputation concerns to properly perform their duties.<sup>18</sup> How high were the reputation concerns of Enron's board? Table 1 shows that in 2001 Enron had fourteen board members, three of which (Lay, Skilling and Belfer) were employees or former employees of Enron. The rest of the board consisted of highly ranked corporate officers or former officers (Blake, Chan, Pereira, Savage, Winokur), distinguished academic personnel (Gramm, Jaedicke, Lemaistre, Mendelsohn), and distinguished public service personnel (Wakeham, Gramm).

TABLE 1: ENRON'S BOARD MEMBERS AND THEIR OCCUPATION, MAY 2001  
(TAKEN FROM ENRON'S PROXY STATEMENT, 2001)<sup>19</sup>

Director Name	Director Since	Age	Occupation
ROBERT A. BELFER	1983	65	CEO and Chairman of Belco Oil & Gas Corp. Former employee of Belco Petroleum Corp., a wholly owned subsidiary of Enron.
NORMAN P. BLAKE, JR.	1993	59	CEO, Chairman and President of Comdisco Inc.
RONNIE C. CHAN	1996	51	Chairman of Hang Lung Group
JOHN H. DUNCAN	1985	73	Investor. Also a director of EOTT Energy Corp. and Group 1 Automotive Inc.
WENDY L. GRAMM	1993	56	Director of the Regulatory Studies Program of the Mercatus Center at George Mason University. Former Chairman of Commodity Futures Trading Commission in Washington, D.C.
ROBERT K. JAEDICKE	1985	72	Professor (Emeritus) of Accounting, Stanford University Graduate School of Business
KENNETH L. LAY	1985	58	Chairman of the Board, Enron
CHARLES A. LEMAISTRE	1985	77	President Emeritus of the University of Texas M.D. Anderson Cancer Center
JOHN MENDELSON	1999	64	President of the University of Texas M.D. Anderson Cancer Center
PAULO V. FERRAZ PEREIRA	1999	46	Executive Vice President of Group Bozano. Former President and CEO of the State Bank of Rio de Janeiro
FRANK SAVAGE	1999	62	Chairman, Alliance Capital Management International
JEFFREY K. SKILLING	1997	47	CEO, Enron
JOHN WAKEHAM	1994	68	Former U.K. Secretary of State for Energy and Leader of the Houses of Commons and Lords
HERBERT S. WINOKUR, JR.	1985	57	CEO and Chairman, Capricorn Holdings, Inc.
Average	1990	62	

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

<sup>19</sup> The information contained in the table of board members and occupations comes from Enron's 2001 proxy statement. ENRON CORP., PROXY STATEMENT 5-8 (Mar. 27, 2001).

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

The last source of board incentives is monetary. As agents of the shareholders, board members should be concerned with maximizing shareholder wealth.<sup>20</sup> If board members have a long-term financial stake in the firm, maximizing shareholder wealth maximizes their own wealth. Thus, board incentives to monitor effectively are aligned with the shareholders they represent.

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

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<sup>20</sup> See Cheryl L. Wade, *Corporate Governance Failures and the Managerial Duty of Care*, 76 ST. JOHN'S L. REV. 767, 780-81 (2002) (stating that Enron's board of directors breached the duty of care to shareholders).

TABLE 2: ENRON'S BOARD MEMBERS AND THEIR SHAREHOLDINGS IN ENRON, MAY 2001  
(TAKEN FROM ENRON'S PROXY STATEMENT, 2001)<sup>21</sup>

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

<sup>21</sup> ENRON CORP., PROXY STATEMENT (May 1, 2001) (on file with author).

Enron board members held a total of approximately 16,000,000 shares of Enron stock. This amount accounts for about 2.5% of the common shares outstanding, but employees and former employees held 97% of these shares. The six members of the audit committee held about 100,000 shares (average of only 18,000 shares per person), and the members of the nominating committee held even fewer.<sup>22</sup>

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

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

## II

### CORPORATE DISCLOSURE RULES

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

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<sup>22</sup> *Id.*

<sup>23</sup> Macey, *supra* note 1, at 415-17.

<sup>24</sup> Macey, *supra* note 1, at 396 & n.7.

<sup>25</sup> George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488, 489-92 (1970).

The same theory applies to corporate disclosure. Good firms disclose information about themselves to distinguish themselves from bad firms.<sup>26</sup> It is too costly for bad firms to disclose information because the information will reveal that they are bad.<sup>27</sup> Investors, then, will invest in firms that disclose information and avoid firms that do not similarly disclose information.

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

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

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

These two alarming externalities portray a much worse picture than the one suggested by traditional models of corporate disclosure. To solve this problem, Professor Macey suggests increasing the threat of penalty for cheating "because a severe punishment for false reporting will eliminate firms' incentive to cheat."<sup>34</sup>

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

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<sup>26</sup> Macey, *supra* note 1, at 412.

<sup>27</sup> *Id.* at 414.

<sup>28</sup> *See id.*

<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at 415-17.

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *See id.* at 415.

<sup>34</sup> *Id.* at 417.



case of Enron, I believe it is still a relevant tool for understanding investor behavior in the future. The models of externalities presented above assume that the market is unaware that corporations can manipulate disclosure and that the market believes that the disclosed information is correct. The market's belief, however, is fragile. Once the market observes evidence that causes it to change its belief, the equilibrium that Professor Macey suggests no longer holds. Enron caused many investors to question their beliefs about the credibility of financial disclosure.<sup>35</sup> Between November 2001 and June 2002, the market saw more and more cases of corporate earning scandals, including Enron, WorldCom, Global Crossing, Sunbeam, Adelphia, and others.<sup>36</sup> This mounting evidence alarmed investors, and regulators reacted to these concerns by implementing the Sarbanes-Oxley Act and tougher SEC measures.

Besides disclosure, financial economics literature points to other ways in which firms can signal their true worth. One such mechanism is the payment of dividends.<sup>37</sup> Firms can potentially use these mechanisms to increase shareholder confidence in them in the future.

### III

#### EFFICIENT MARKETS

With respect to the Efficient Capital Markets Hypothesis (ECMH),<sup>38</sup> Professor Macey convincingly argues that the writing was on the wall, but no one read it properly. However, one can interpret these results consistent with the ECMH by assuming that investors did see the impenetrable accounting and the questionable transactions but believed the optimistic view of the analysts and interpreted these signs as harmless. Even if the market did not see these signs, one might optimistically conclude that the ECMH is still relevant after Enron. If we assume that, at least to some extent, the market learns from mistakes, then this event may actually increase efficiency in the future. The grim results of the Enron fiasco may provide incentives for all market participants to become more skeptical and alert.

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<sup>35</sup> *Id.* at 414 (arguing that investors will reexamine their beliefs).

<sup>36</sup> *See, e.g.*, Dennis K. Berman & Deborah Solomon, *Analysts Fault the Accounting at Global Crossing*, WALL ST. J., Jan. 30, 2002, at A8; Yochi J. Dreazen, *WorldCom Suspends Executives in Scandal over Order Booking*, WALL ST. J., Feb. 15, 2002, at A3; Kelly Greene, *Dunlap Agrees To Settle Suit over Sunbeam*, WALL ST. J., Jan. 15, 2002, at A3; *SEC Formally Opens Probe of Adelphia*, WALL ST. J., Apr. 18, 2002, at B11.

<sup>37</sup> Sudipto Bhattacharya, *Imperfect Information, Dividend Policy, and "the Bird in the Hand" Fallacy*, 10 BELL J. ECON. 259, 260-63 (1979).

<sup>38</sup> Macey, *supra* note 1, at 417-20. The ECMH posits that prices of shares in publicly traded companies will rapidly adjust to in accordance with new learned information. *Id.* at 396-97.