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GOVERNANCE FAILURES OF THE ENRON BOARD AND THE NEW INFORMATION ORDER OF SARBANES-OXLEY

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Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley

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(Prepared for the University of Connecticut Law Review Symposium
Crisis in Confidence: Corporate Governance and Professional Ethics Post-Enron)

ABSTRACT

This paper argues that the principal governance failure of the Enron board was to approve a disclosure policy that made the firm's financial results substantially opaque to public capital markets, despite also approving a compensation strategy that made managerial payoffs highly sensitive to stock price changes and despite its unwillingness to engage in intense monitoring of business results and financial controls. In comparable circumstances of constrained monitoring by public markets, LBO firms and venture capitalists undertake a vigorous monitoring role. Important provisions of the Sarbanes Oxley Act can be seen as correcting for a public board's probable inability to adequately monitor a complex corporate finance strategy, "corrective disclosure." But the Act also seems to contemplate immediate disclosure of material business developments even in circumstances where premature disclosure may well sacrifice shareholder value for very little gain in capital market efficiency. The paper criticizes such "price-perfecting disclosure." A further consequence of the Act's disclosure regime may be to shift governance authority away from management and the board toward shareholders, including in the case of hostile takeovers.

Keywords: corporate governance, Enron, Sarbanes-Oxley, takeover law

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Jeffrey N. Gordon

(prepared for the University of Connecticut Law Review Symposium, Nov. 2002: *Crisis in Confidence: Corporate Governance and Professional Ethics Post-Enron)*

Analysis of the corporate governance crisis that manifested itself in the United States at the turn of the millennium requires separating its various strands. The Enron debacle and the dot.com bubble and collapse, for example, share some common elements but in other ways are quite different. In both cases investors became aggressively enamored of an unsustainable business model. In the dot.com case it was the belief that an innovator in a rapidly growing market could attain powerful first mover advantages that would produce an eventual cascade of profits, so that a current and increasing stream of losses was not necessarily a valuation negative. In the case of Enron it was the belief that a firm could create and exploit unique trading opportunities in markets that it would then dominate.[1]

But there were significant differences as well. The dot.coms rarely claimed current profitability; investors were clearly buying "on spec." The fraud that occurred in some firms primarily related to revenues, markers of growth, not necessarily profits. The capacity swaps at telecom firms present a classic example of the odd fraud of the bubble: firms used the swaps to claim higher revenues but no greater profit, and indeed, reduced operating margins, ordinarily a negative. Enron, on the other hand, was allegedly a highly profitable firm and its profits were rapidly growing. Yes, the price/earnings multiple was high at Enron's peak, 60, but the business model had been proved out to the extent of significant and growing earnings. As we now know, Enron's profits were in significant measure illusory. They depended upon a series a irregular off-balance sheet transactions that became a way of hiding losses and generating profits despite the underlying results as reportable per appropriate accounting conventions.

The consequences of the two failures, certainly the changes in legal institutions, were quite different as well. The dot.com bubble burst in spring 2000. The ensuing regulatory reform has been relatively mild. The major focus has been the independence of securities analysts, whose optimism, even giddiness, coupled with an eagerness to aid their firms' effort to

[1] William W. Bratton, Enron and the Darkside of Shareholder Value, 76 Tulane L. Rev. 1275 (2002) (describing Enron's businesses).

underwrite high tech IPOs, may have helped lure investors into the bubble. This has been pursued in several ways: The New York State Attorney General discovered a new use for 80 year old state securities legislation as a vehicle for significant structural reform of the securities business that would provide significant protection of the independence of securities analysts and even a subsidy program to support disinterested securities analysis.. The NASD has brought actions under existing rules against specific individuals. Most notably, new federal securities legislation, Section 501 of Sarbanes-Oxley, calls for SEC rule-making "to foster greater public confidence in securities research, and to protect the objectivity and independence of securities analysts ...." Notwithstanding these reforms, the principle lesson for investors was taken to be, "diversify and don't be so dumb the next time."[2]

The fallout from Enron (and the other major accounting fraud at WorldCom[3]), revealed in late 2001, was quite different, despite the lack of evidence of such deep fraud across the broad swath of American public companies.[4] The SEC started with series of advisories and rule proposals aimed at forcing issuers to enhance disclosure about critical accounting matters. The NYSE and the NASDAQ followed with proposed new listing requirements that would work significant changes in corporate governance, particularly in the composition of key board committees. Finally Congress adopted the Sarbanes Oxley Act, which expanded mandatory disclosure, imposed new duties on the board of directors, and established new regulatory structures for accountants and attorneys. The sum total may portend the most far-reaching changes in American corporate governance since the original 1930s securities acts.[5]

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[2] Allocation practices for "hot" IPOs have also been a subject of investigation and some enforcement actions, particularly because some of those practices may have constituted price manipulation. Existing law has been thought adequate to the task.

[3] The WorldCom is an example of an accounting fraud of a different type, a mischaracterization of ordinary expenses as capital expenditures, so as to increase current earnings.

[4] My colleague Jack Coffee cites the increasing number and magnitude of accounting restatements over the 1997-2001 period as reflecting an increased management willingness to manipulate reported results of rather broad sweep. John C. Coffee, Jr., "What Caused Enron?: A Capsule Social and Economic History of the 1990's" (Colum. L&E W.P. 214 2003) (available on SSRN). Of course the restatement problem was well-known before Enron; SEC Chairman Arthur Levitt campaigned against the abuses of "earnings management." The shock of both Enron and WorldCom was that such accounting misrepresentations was not merely at the margins but went to the core of reported profitability. This reflected on the credibility of both the managers and the auditing/gatekeeper system in ways that marginal restatements did not.

[5] For an account of the cumulative effect of the NYSE, SEC, and Congressionally mandated governance changes, see William B. Chandler III and Leo E. Strine, Jr., The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State, – U Pa. L. Rev. – (2003). For a perspective questioning the

The Enron case has seemed particularly disturbing because the case represents a failed stress test for many of institutions of US shareholder capitalism, circa 1990s. As with most catastrophes, many separate systems simultaneously failed: auditing and accounting, executive compensation, internal monitoring by the board, and external monitoring by securities analysts. The corporate governance failures are particularly troubling to lawyers, who have been very influential in shaping the corporate governance of large public corporations, in part because Enron followed many of the "best practice" corporate governance procedures. In particular, the Enron Board was composed largely of outside directors of apparent independence and competence. The audit committee, which operated under a state of the art charter, was chaired by a Stanford Business School accounting professor.

The primary wrong doers in the Enron scandal were the individual officers who were principally responsible for the integrity of the company's transactions and financial disclosure and who orchestrated the misleading, sometimes fraudulent, transactions. Nevertheless a reliable corporate governance system ought to catch such wrongdoing before it becomes pathological and carries such destructive consequences for the shareholders, not to mention the other stakeholders. Post-mortems are particularly important where, as here, the firm's collapse was so unexpected.

In that spirit this paper considers the performance of the Enron Board. Nothing in the public record thus far suggests that the outside directors acted otherwise than in good faith, and nothing in my criticism of the Board's performance should be taken as setting forth a basis for liability on the part of any outside director. I agree with Prof. Eisenberg in the distinction between the duty of care as a conduct standard, the failure to attain opens a board to justified criticism, and as a liability standard, which is triggered by egregious behavior that in practice almost always raises questions of good faith or loyalty.[6] My observations are also based primary on the facts as revealed in the internal investigation undertaken by a special committee of the Enron Board in the immediate aftermath of the bankruptcy filing.[7] Subsequent investigations has revealed additional problematic transactions.

Here are two ways in which I think the Enron Board fell short of the desirable conduct standard. First, the interaction of Enron's high-powered stock-based compensation structure, the corresponding managerial temptation to manipulate financial results that would affect the stock price, and a financial disclosure approach that made the firm's financial performance

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wisdom of such significant changes in light of the general governance improvements of the preceding period, see Douglas Branson, Enron - When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform? (2003) (available on SSRN).

[6] Melvin A. Eisenberg, Corporations and Other Business Organizations 544-549 (2000 ed.).

[7] See Report of Investigation by the Special Investigation Committee of the Board of Directors of Enron Corp, Feb. 1, 2002 (hereinafter, "Special Committee Report").

substantially opaque to public capital markets, created an unusual risk that should have called forth unusual, intense board monitoring of business results and financial controls. The Enron Board failed in this responsibility. Second, although some of Enron's more controversial risk-hedging objectives can be defended in business terms, management's choice to create private entities fraught with conflicts rather than market-provided vehicles should have raised a red flag about the economic viability of the hedges in question. The Board did not bring its critical faculties to bear.

Understanding this particular failure helps explain some of the particular provisions of Sarbanes-Oxley that significantly limit board discretion in the release of material information to the market. It can also help us consider whether Sarbanes-Oxley draws appropriate limits for the exercise of that discretion. The Act mandates disclosure that corrects for the board's probable inability to adequately monitor a complex corporate finance strategy, "corrective disclosure." But the Act also seems to contemplate "real time" disclosure of material business developments even in circumstances where premature disclosure may well sacrifice shareholder value for very little gain in capital market efficiency. This I call "price-perfecting disclosure" and believe that eliminating the board's discretion to this extent may be unwise.

More generally, although various recent governance changes may give the appearance of strengthening the role of the board, in particular through augmenting the role and independence of the audit and compensation committees, I believe these changes in disclosure policy will, instead, strengthen the market's role in the governance of public corporations. This argument has two strands. First, the new disclosure will make more transparent the firm's financial capacities and constraints, and thereby enhance the power of capital suppliers (and even customers and merchandise suppliers) of the firm. Second, the new disclosure, particularly if expanded by proposed SEC rule-making, will undercut the board's claim of privileged access to firm specific information. This could have broad implications for the shareholder relationship generally and for control contests specifically, where a purportedly large information disparity between shareholders and the board has been cited as justifying target management defensive measures.

I. The Board's Monitoring Burden

1. Stock Options. One critical element in the Enron monitoring problem became a common feature of many U.S. public firms in the 1990s in light of the very strong shift in executive compensation packages toward stock-based compensation, especially stock options. For example, Murphy documents a shift in the composition of CEO compensation for the S&P 500 Industrials over the 1992-2000 period from 27% stock options to 51% stock options.[8] The

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[8] Kevin Murphy, Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options, 69 U Chi. L. Rev. 847, 848-49 (2002). Valuations are in 2001 dollars. The options were valued as of the grant day using a modified version of the standard Black-Scholes option pricing model. This will be a much lower figure than the value of the option when exercised after substantial market appreciation. See also Brian J. Hall and Kevin J.

median total compensation package was also increasing over the period from $2.3 million to $6.5 million, meaning that the median option grant increased from $630,000 to $3.3 million. Murphy also reports that on a broader definition of equity-based compensation that includes stock grants, for so-called "New Economy" CEO's the median equity-based portion of compensation shifted over the 1992-2000 period from 33.6% to 82.9% percent, and that for other top executives, the median equity-based portion shifted from 34% to 75%.[9]

Enron was the New Economy firm par excellence, and the stock option packages to senior managers reflected this. The stock-based portion of the Enron CEO compensation in 2000 looks to be 66% for Lay and approximately 75% for Skilling.[10]

Stock options are granted for numerous purposes: for recruitment and retention, as a reward for meeting objectives, and as a way of attracting executives who are aggressive, relatively less risk-averse, and willing to trade present compensation for upside potential. The value for shareholders is that stock options align the interest of managers and shareholders, because managerial wealth is increasing in the stock price. The evidence is that managers often exercise their options as soon as they vest (if in the money), that the typical period over which options vest is two to four years, and that companies frequently grant additional, later-vesting options during the original vesting period. Moreover, the Enron compensation package provided for performance-based accelerated vesting that may have turbocharged these features.[11] As the potential gains associated with options exercise grow in absolute amount – an increasing function in both the number of options granted and the rate of appreciation in the firm's stock – these granting and exercise practices may tempt managers to "take the money and run."

In other words, the managers' concern about the stock price can become pathological.

Since stock options payoff only on the upside but, unlike stock itself, does not penalize on the downside, a too-rich stock option package can create a distinctive moral hazard problem. The insufficiently appreciated problem with such stock option grants is not that they are excessively redistributive – that they shift too much of the firm's cash flow from shareholders to managers – but that they provide perverse managerial incentives. It's not simply that managers just "manage to the market," which some have criticized as relying on a contestable claim of market efficiency. Rather, it's that managers will be strongly tempted to produce the financial

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Murphy, Stock Options for Undiversified Executives, 33 J. Acct'g & Econ 3 (2002).

[9] Kevin J. Murphy, Stock-based Pay in New Economy Firms, 34 J. Acct'g & Econ. 129, 132.

[10] Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regard Federal Tax and Compensation Issues, and Policy Recommendation February 2003 (D166-170) (Towers Perrin Report). The Enron compensation structure

[11] See Stuart Gillan and John D. Martin, Financial Engineering, Corporate Governance, and the Collapse of Enron (WP Nov. 2002) (available on SSRN).

results the market "expects" through manipulation of financial results.

Compare, in this regard, stock options as against a cash bonus based on earnings targets. Ordinarily, bonus payouts will increase (decrease) linearly with earnings. Stock option payouts can increase (decrease) at a rate that can be almost exponential, because earning changes have a double effect on stock prices. First, earnings changes will be reflected in the stock price through the firm's price/earnings ratio. Second, earnings changes may affect the market's assessment of the firm's growth rate, which underlies the p/e ratio. To take an example: additional earnings per share of $.50 for a company with a p/e ratio of 20 can mean an appreciation in share price of $10. But if the additional $.50 per share leads to a multiplier of 25, the stock price will appreciate by $12.50 a share, 25% more. This interactive multiplier effect means that high-powered compensation like stock options raise special moral hazard problems in comparison to other forms of incentive-based compensation..

At first glance it might appear that achieving financial results through manipulation would be wholly irrational, and thus not so serious a threat. Eventually the firm's true condition will be revealed, the stock price will suffer, and presently held options may well become worthless. (This is not to mention the potential legal sanctions for fraud.) Meanwhile, however, the executive may have become rich through prior option exercises at the higher, manipulated price, the firm might reprice the worthless options or grant some new ones, the necessary earnings restatement may be buried with some other extraordinary adjustment, or a shift in market conditions may restore strong profitability. Even a significant restatement is unlikely to trigger an SEC enforcement action, much less a criminal prosecution, and any civil litigation will be resolved well short of a finding of fraud, meaning that either the D&O insurer or the company (but not executive) will fund any settlement. Thus as compensation comes increasingly to consist of high-powered incentives like stock options and as the absolute level of potential stock option payout over a short period of time increases, management's temptations grow. As a corollary, so do the monitoring demands to assure the integrity of the firm's financial reporting. The heavy use of stock option compensation by Enron created precisely this monitoring issue.

2. Financial disclosure and market monitoring. One of the strongest arguments for mandatory disclosure under prescribed accounting rules and conventions is to strengthen the monitoring of managers by facilitating intertemporal and cross-sectional comparison of results, meaning: comparisons across firms over time. This year's results can be compared to last year's; this firm's results can be compared to other firms in the industry. This is a powerful way to evaluate how a particular management team is performing. Although a firm's directors will presumably have access to own-firm information without mandatory disclosure, the mandatory system provides comparative firm information that otherwise would not be available. Accurate financial reporting is important for directors in monitoring managers. The mandatory disclosure system, supported by antifraud rules, helps secure the integrity of own-firm information that directors receive, and also, importantly, comparative firm data. In the large public firm, managers are also monitored through the stock market. That is, the firm's published financials become the basis for analysis and assessment by securities analysts, credit analysts, and sophisticated investors more generally. Their views are reflected not only in the firm's stock price, but also the "story" that is told about managerial performance that is reflected in analysts' reports, private discussions, and the business press. Price changes are signals that can be very valuable to the board in its monitoring. The "story" about the firm is also informative to the board. In other words, the board's monitoring capabilities are significantly augmented by public monitoring based on the firm's financial disclosure. One might go so far to say that there are two systems of monitoring public firms: explicit monitoring by the board of directors, and implicit monitoring by the market and related institutions.

Enron, however, was a firm whose financial results were remarkably opaque to the market. A significant part of its business was conducted through off-balance "Special Purpose Entities" ("SPE"), 4000 of them in fiscal year 2000. A simple list goes on for 45 pages in the company's Form 10-K. It turned out that a large percentage of Enron's reported earnings was tied up in transactions with some of these entities. For example, the retroactive consolidation of one off-balance sheet entity, Chewco Investments L.P. (and the related investment partnership), affected the Enron income statement almost as significantly as its balance sheet. Here are the income adjustments, reported in dollars and as a percentage of the prior reported income, for the applicable years:[12]

YEAR	PRIOR INCOME (*$ million*)	ADJUSTMENT (*$ million*)	PERCENTAGE
1997	105	28	27%
1998	703	133	19%
1999	893	153	17%
2000	979	91	9%

In the case of other SPE's, the so-called Raptors, which were set up to hedge losses in Enron's merchant banking investments, it turns out that Enron claimed to have earned $1.1 billion in transactions with the Raptores over the 2000-01 period, or *73%* of Enron's reported pre-tax earnings![13] That is, putting aside any questions of fraud, manipulation, or misapplication of the accounting conventions governing consolidation, an analyst or an investor relying on Enron's public financials could not truly understand Enron's business. The limited information disclosure simply hamstrung the capacity of the market to monitor the performance of Enron's managers.

[12] See Special Committee Report, at 42.

[13] Id. at 99.

Yet this strategy was the Enron Board's choice. Even if the accounting rules did not require consolidation of the SPE's and the Board wanted to follow those conventions, detailed footnote disclosure or MD&A disclosure would have been possible. Conceivably there were good business reasons for the pursuit of shade rather than sunlight. Perhaps the opaque disclosure regime shielded valuable business strategies from competitors' scrutiny and copying. One oft-stated explanation looked to the nature of Enron's trading business. Successful trading activity required access to low cost credit. The SPE's permitted Enron the flexibility to conduct various investment and entrepreneurial activities while maintaining a triple-A credit balance sheet at the parent level. So conducting the firm's business through off-balance sheet entities lowered cost of capital by satisfying the mechanical tests for creditworthiness, and thereby increased shareholder value.

But this is the point: the Board permitted Enron to be run in a way that significantly disabled the monitoring customarily provided by public market institutions for large public companies. In other words, of the internal and external monitoring dyad, the Board's decisions blinded the external monitors. The Board permitted this non-revelatory disclosure model while also knowing that the executives were receiving high-powered incentives that would make them highly sensitive to stock price changes and thus to financial disclosure that might affect the stock price. So the Board blinded the external monitors in circumstances where managers would face strong temptations to cheat and where the blinding would make cheating easier. There may have been business justifications for the strategy of opacity, but then it follows that the Board needed to step up to high-powered monitoring. The Board should not have hampered external monitoring unless it was prepared to substitute compensatory internal monitoring.

3. Some relevant comparisons. We have some relevant institutional comparisons that illustrate the necessary board role in cases where managers are highly incented with stock-based compensation and external monitoring is not available: leveraged buyouts and venture capital start-ups.[14] In both of those cases managers have high-powered incentives, stock and stock-options, and payoffs that are highly sensitive to financial results. In the LBO firm, managers typically receive a significant slice of equity in a highly-levered firm. If the managers achieve (and exceed) earnings targets, the debt is paid down and the managers end up with a significant ownership interest in a very valuable enterprise that can be realized through a subsequent reverse buyout that takes the firm public again. To be sure, pay down of debt requires cash, but favorable accounting earnings can be a basis for a refinancing that provides cash. In the venture capital startup, the founders retain a significant equity interest in the firm in the course of receiving VC financing. The goal is to typically prove out a successful business model in the manufacture and sale of a technological advance in preparation for an eventual IPO. The willingness of venture capital funds to continue to fund the startup through successive rounds is

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[14] On the structure of LBOs, see Ronald J. Gilson & Bernard S. Black, The Law and Finance of Corporate Acquisitions 399-01, 406-415 (2d ed. 1995). On the structure of VC funds, see Bernard S. Black & Ronald J. Gilson, Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets, 47 Journal of Financial Economics 243 (1998).

highly dependent on the achievement of technological and financial milestones, and of course the IPO exit price will also be very sensitive to the prior results. In light of the extraordinary multiples of high-tech IPOs, small changes can make a large different to the entrepreneurs.

In both of these private firm cases the board assumes a much more active monitoring role that can address the interaction of high-powered stock-based compensation and the non-availability of public monitoring. The LBO association (KKR, for example) typically has a majority of the board seats of an LBO company and will closely and extensively monitor the firm's financial performance. The VC organizations also have significant board representation and retain the right to replace senior executives. They also carefully monitor the company's operating and financial results. In other words, in two very important business domains it is well understood that high-powered managerial incentives without public monitoring should call forth high-powered internal monitoring as an important institutional complement.

4. An additional monitoring failure. Another monitoring failure that shows the problem with foregoing public monitoring without a strong board commitment to provide a substitute relates to the Enron Board's approval of off-balance sheet activities to hedge Enron's merchant banking investments.[15] This activity was under the control of Andrew Fastow, the chief financial officer, and was central to transactions that initially resulted in $1 billion in reported income over the 2000-01 period but whose unwinding in late 2001 drove the company into bankruptcy.

To understand the monitoring issues it is important to appreciate the logic of the Board's business objectives. Merchant banking activity added volatility to Enron's reported earnings, because under the equity accounting method, Enron was obliged to register gains or losses in the value of its investment stakes on its income statement. It was not unreasonable to think that this volatility could reduce the market price of Enron stock. To be sure, such a view is not consistent with modern portfolio theory, in which such idiosyncratic risks would be diversified away, and indeed on that view Enron would be penalized for incurring the transaction costs of arranging a hedge that diversified shareholders did not need. Nevertheless GE had become an institutional favorite in the 1990s in part because it delivered steadily growing earnings without surprises. So it seems that the Board thought it could increase shareholder value if it could find away to shift this volatility off its income statement.[16] The key was to find a third party who shared this view but who could better bear the volatility – perhaps because it was a private entity or perhaps because it had superior ability to hedge. The transaction could even be self-financing: Since the value creation would be reflected in the appreciation in Enron's stock price, Enron stock would be perfect consideration, since taking it would credibly demonstrate the third party's belief in the hedging strategy.

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[15] This account is based on the Special Committee Report, 148-173.

[16] Even when boards pursue financial strategies that theory would predict to be unnecessary from the shareholder point of view or value-reducing, they receive business judgment deference. See Kamin v. American Express, 383 N.Y.S.2d 807, aff'd, 387 N.Y.S.2d 993 (1st Dept. 1976).

The test of the strategy of course depended on finding a bona fide third party who would play at arms length. Did anyone actually believe in this valuation creation theory firmly enough to finance it? The Board was subsequently persuaded that partnerships headed by its CFO Andrew Fastow ("LJM") operating the Raptor SPEs could accomplish the hedging more efficiently, because Fastow's involvement would save on transaction costs and lower the information asymmetries in the valuation of the investment assets that Enron would transfer for hedging purposes. The Board chose to believe that management's recommendation against origination by market participants such as investment banks or hedge funds or pension funds in favor of a highly conflicted inside originator was an economizing move rather than a red flag.

The problem was, as events tragically showed, that such a structure provided no independent market check as to the validity of the strategy in conception or in execution. Indeed, the structure became a vehicle for a fee-generating fraud. In other words, in using a related party arranger, the Board deprived itself of market monitoring of these transactions. Its substitute was a program of internal monitoring that was subverted not only by management's failures and deceptions but also by the Board's own failure to realize the seriousness of its monitoring responsibilities. As the Special Committee Report stated: "The Board cannot be faulted for failing to act on information that was withheld but it can be faulted for the limited scrutiny it gave to the transactions between Enron and the LJM partnerships."[17] The relevant board committees gave the transactions only cursory review, insufficient "depth or substance" for such out-of-ordinary course transactions. Thus in this case too, the foreclosing of public market review required a concomitant step up in the Board's monitoring activity. This the Board failed to appreciate.

II. The Intervention of Sarbanes-Oxley

The approach of Sarbanes-Oxley is to reduce, if not eliminate, much of the board's discretion to permit the firm to operate with a financial structure that is opaque to securities markets. In this respect the Act is corrective not only of the particular scenario that produced the Enron debacle but also of what might be called the failure of incentive compatibility at the board level. In this sense Sarbanes-Oxley can be seen as attempting to calibrate the mandatory disclosure system to a world in which the board of a public corporation will have insufficient incentives to undertake high-powered monitoring of corporate finance and, therefore, market monitoring must be strengthened. However, some elements of the Act, as implemented by the SEC, may well push mandatory disclosure well beyond the Enron problem into an area where board discretion over information release is probably desirable. The ostensible justification for this intrusion, the desire for more accurate securities market prices, probably does not outweigh the costs to shareholder value from this narrowing of board discretion.

1. Corrective disclosure. Title IV of Sarbanes Oxley directly addresses the off-balance sheet entity problem that was so important in Enron. In particular, section 401(a) requires the

[17] Id. at 162.

SEC to issue rules calling for the disclosure in quarterly and annual reports of

> "all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses."

This has been implemented by the SEC through recently-promulgated rules that require extensive discussion in the "Management Discussion and Analysis" section of quarterly and annual reports of the various off-balance sheet arrangements, targeting especially "the means through which companies typically structure off-balance sheet transactions or otherwise incur risk of loss that are not fully transparent to investors."[18] The objects of disclosure, include, in addition to standard off-balance entities, (i) certain guarantee contracts, (ii) retained interests or contingent interests in assets transferred to an unconsolidated entity, (iii) derivative instruments that are classified as equity, and (iv) material variable interests in unconsolidated entities that facilitate financing . The disclosure threshold is whether the off-balance sheet arrangement has or is "reasonably likely" to have a current or future material effect.

These Section 401 rules (which will be reflected in amendments of Regulation S-K, Item 303), require extensive disclosure for these off-balance sheet arrangements. In particular the MD&A must address the business purpose of the off-balance sheet arrangements, their importance to the financing of the firm and otherwise, the revenues and cash flow that arise from the arrangements, and the events that would trigger the loss in their availability. On their face, these rules would require particular disclosure of the way that Enron used SPEs to generate profits and hide losses. The barn door of Enron-esque financial opacity will be closed for any reputable public firm.[19]

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[18] SEC. Rel. Nos. 33-8182; 34-47264 (Jan. 27, 2003), available on the SEC website, www.sec.gov. (Section 401 Implementing Release). The rules will be reflected in amendments to Regulation S-K, Item 303. See also the proposing release, which gives an account of the SEC's general regulatory objectives with respect to off-balance sheet arrangements. SEC Rel. Nos. 33-8144; 34-46767 (Nov. 4, 2002) (Sec 401 Proposing Release).

[19] Before Sarbanes-Oxley the SEC proposed additional MD&A disclosure of an issuer's "critical accounting policies." SEC Release Nos. 33-8098; 34-45907 (May 10, 2002). "The proposals would encompass disclosure in two areas: accounting estimates a company makes in applying its accounting policies and the initial adoption by a company of an accounting policy that has a material impact on its financial presentation." In the flurry of rule-making required by Sarbanes-Oxley, this release has not been acted upon. In the immediate wake of the Enron debacle the Commission issued a "caution" about the need for MD&A disclosure about critical accounting policies, SEC Rel. No. 33-8040 (Dec. 12, 2001), followed up by a "statement" on the subject in conjunction with the then Big Five accounting firms. SEC Release No. 33-8056 (Jan. 22, 2002).

These new disclosure requirements desirable because they correct some of the probable monitoring shortfalls of the board of a public corporation. Previously I sketched the board's monitoring obligation in the case of a disclosure strategy that makes the firm's financial structure and results opaque to markets. Sarbanes-Oxley makes such a disclosure strategy difficult if not impossible. This is wise, I believe, because the board of a public corporation – unlike an LBO organization or a VC – will rarely have sufficient incentives to exert the high-powered effort necessary to monitor a complicated financial strategy. Management and its advisors have the capacity to create endless shells under which to hide and move the peas. Especially now, as the board comes to consist increasingly of independent directors who cannot be expected to be familiar with operational detail, as significant stock ownership comes to be seen as inconsistent with such independence, and as the board's compensation veers away from heavily stock-linked, it is only realistic to think that the board's monitoring energies and capacities will be limited. Oversight of auditors may be possible but this falls well short of full awareness of a complicated financial strategy. So simply because the public corporation board cannot be counted on to monitor complicated corporate finance, it makes sense to reduce board discretion over the disclosure in this domain and to lock-in market monitoring.[20]

2. Price perfecting disclosure. The SEC has also gone beyond the off-balance sheet financing problem to require disclosure of the financial obligations associated with firm's various other contractual obligations. The SEC is also contemplating further "real time" disclosure of material business developments that go well beyond financing-related disclosure. The SEC's stated objective is "to improve the delivery of timely, high-quality information to the securities markets to ensure that securities are traded on the basis of current information," what might be called "price-perfecting" disclosure.[21]

Quite remarkably the Section 401 rules require companies to make extensive disclosure about the amount and timing of various contractual obligations. The MD&A must include in tabular form a summary of contractual obligations maturing over various time periods: less than

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[20] The obvious question, of course, is why assume that boards will, on average, exercise such discretion over disclosure unwisely: Isn't the Enron Board's unwise exercise of discretion a powerful object lesson that negatives the need for a mandatory rule? Won't shareholders post-Enron severely penalize firms with opaque financial disclosure? The general case for mandatory disclosure provides the answering framework, but deciding how much and which disclosure should be "mandatory" involves a granular evaluation that the general case cannot specify. If we assume that the prior level of financial disclosure is justified, then further disclosure that protects the integrity of that core disclosure may be necessary. Insofar as a corporate finance strategy can obscure or reverse the realities of an issuer's financial condition, then it similarly becomes appropriate subject of mandatory disclosure. Moreover, as demonstrated by widespread market reaction to the problems at Enron, a disclosure regime that is seen as permitting the inflation of financial results adds systematic risk.

[21] SEC Rel. Nos. 33-8106; 34-46084 (June 17, 2002). (8-K Release).

a year, one to three years, three to five years, and more than five years. The covered contractual obligations include long term debt, capital leases, operating leases, purchase obligations, and other identified long-term liabilities. The hook to Sarbanes-Oxley's principal concerns is that such disclosure "would improve transparency of a registrant's short- and long-term liquidity and capital resource needs and demands. It also would provide appropriate context for investors to assess the relative role of off-balance sheet arrangements with respect to liquidity and capital resources."[22] It would give investors "pertinent data to the extent necessary for an understanding of the timing and amount of the company's specified contractual obligations."[23]

There is no doubt that this amounts to significant disclosure of firm specific information. Although bits and pieces of this information are disclosed elsewhere in an issuer's public filings, this comprehensive summary is ordinarily the kind of information provided to a bank lender or indenture trustee under loan covenants or perhaps to a credit rating agency. Not only does it forewarn investors about potential cash flow crunches or vulnerabilities, but also capital suppliers and merchandise suppliers, who will now have earlier warning of potential financial distress, and competitors, who will be able to infer the terms of various business relationships and also to determine the firm's ability to respond to particular competitive moves. It could well change how firms are financed and managed.

Another disclosure provision, section 409 of Sarbanes-Oxley, captioned "Real Time Issuer Disclosures," requires issuers

> "to disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer, in plain English, which may include trend and qualitative information and graphic presentations, as the Commission determines, by rule, is necessary or useful for the protection of investors and in the public interest."

This section is not self-effectuating and has not yet been implemented by SEC rule-making, since rule issuance is not under the six-month time limit as for Section 401 and other key provisions. Nevertheless the section seems very much in the spirit of the SEC's proposed expanded disclosure under Form 8-K, put forth in June 2002.[24] The SEC's theory is that the speed-up in communications generally means that investors and securities markets "demand and expect more 'real-time' access to a greater range of reliable information concerning important corporate events that affect publicly traded securities." [25] As mentioned previously, this disclosure is said to be in service of "ensur[ing] that securities are traded on the basis of current

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[22] Proposing Release.

[23] Implementing Release.

[24] SEC Rel. Nos. 33-8106; 34-46084 (June 17, 2002). (8-K Release).

[25] 8-K Release.

information."[26] The SEC added 11 items that would trigger a Form 8-K filing and shortened the filing deadline from five business days (or 15 calendar days in some instances) to 2 business days. Some of these items are hardly controversial, such as a "conclusion or notice that securities holders should no longer rely on the company's previously issued financial statements or a related audit report." But the proposed new triggers include:

– Entry into a material agreement not made in the ordinary course of business (and any subsequent termination)

– Termination or reduction of a business relationship with a customer that constitutes 10 percent of the company's revenues

– Creation of a direct or contingent financial obligation that is material to the company

These disclosures related to sensitive business issues where in the past managements have had significant timing discretion. For example, in the acquisition context, firms apparently would be required to disclose letters of intent and other non-binding agreements, and the required disclosure would include description of the agreement, the parties, and material conditions to execution. Yet in the past, the recognition of the desirability from the shareholder point of view of giving management flexibility in deciding when to release information about an impending transaction has made courts and the SEC reluctant to impose an affirmative disclosure obligation. For example, the U.S. Supreme Court recognized in *Basic, Inc. v. Levinson*[27] the difference between a false denial or other misrepresentation and a "no comment."[28] On this understanding firms have developed a catechism of "we do not comment on rumors about such matters." Such an approach will often protect shareholder interests. Compelled disclosure of a non-binding agreement can disturb negotiations in at least two ways: first, by injecting publicity, including responses by competitors, into negotiations that have not gelled, and second, in anticipation of this effect, by changing the course of negotiations, for example, by avoidance of useful progress-markers such as non-binding letters of intent. Moreover, the increase in the expected failure rate of sensitive negotiations will reduce the likelihood that certain transactions will be undertaken.

"Real time" disclosure of a negative change in an important customer relationship also brings decidedly mixed blessings. Immediate disclosure of a cancelled contract usefully signals to prospective shareholders that a firm has new business problem, to be sure, but also to customers, suppliers, and rivals. This disclosure could easily be disadvantageous to existing

[26] Id.

[27] 485 U.S. 224 (1988).

[28] The SEC's prior guidance on premature disclosure of merger negotiations is consistent with *Basic*, as reflected in Section 501.06.d of the Commission's Codification of Financial Reporting Policies, 7 Fed. Sec. L. Rep. (CCH) ¶ 73,197.

shareholders, who might prefer that management be given some time to try to deploy existing capacity free of the exposed vulnerability, which could adversely affect the very terms on which substitute arrangements are negotiated. Moreover, this negative disclosure impact will give the counterparty additional leverage during the course of performance, especially in circumstances where the contract is material to the firm but not to the counterparty. In other words, the requirement of immediate disclosure in this domain is likely to reduce the value of the firm. Why would the diversified shareholder want that?

The driver of this expanded, quicker disclosure is a disclosure philosophy that seems to be a version of "the board reports; you, the investors, decide." The goal is more accurate prices and less space for insider trading. The Commission's focus is not simply more accurate and reliable information (i.e., less prone to fraud), but *more* information. What's missing in the analysis, however, is the articulation of a basis for such a potentially far-reaching disclosure vision. Reducing the risk of insider trading is a fine objective but there is no evidence of a current insider trading problem so pervasive that it should shape the content of the disclosure system in this way. Undoubtedly more accurate prices improve allocative efficiency, meaning the better deployment of scarce economic resources, but the real Enron-era problems in this regard were fraud, not the absence of speedy disclosure. So, for example, WorldCom's naked accounting fraud and perhaps the capacity swap misstatements of the telecommunications firms were so serious precisely because they misled investors about the profitability of telecom investments and, in turn, probably produced wasteful capital allocation to that sector and bad strategic countermoves by sector rivals. In this respect accurate prices are important. But there seems to be little advantage in compelling disclosure whose prematurity itself produces a loss in value.

The disclosure question might profitability be cast in terms of board capacity. The case for "corrective disclosure" is strong because market monitoring over financial strategy seems a necessary adjunct to the board's monitoring effort, especially given present executive incentive compensation packages and the reasonable limits on board activity. The case for "price perfecting disclosure" seems much less strong because it trenches on areas where board discretion over the information timing release question has been thought to serve shareholder interests and where board competence has not been called into serious question. Indeed, as classically recognized in *SEC v. Texas Gulf Sulphur,*[29] there is a legitimate space for timing disclosure in light of the board's business judgment. The prospective mining strike in that case exemplifies a series of instances in which the exercise of the discretion not to disclose a material development is desirable from the shareholder perspective. Public market monitoring may be an element of corporate governance but not its entirety.

3. *Potential governance changes*. There are many ways in which Sarbanes-Oxley straightforwardly works significant changes in corporate governance of public corporations. Section 301 requires firms to have an audit committee and charges this committee with responsibility for the "appointment, compensation, and oversight" of the firm's auditors.

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[29] 401 F.2d 883 (en banc), cert. denied, 394 U.S. 976, n.12 (1969)

Sections 303 and 204 emphasize the direct reporting relationship between the auditors and the board committee and take managements out of the loop. Section 407 requires disclosure about whether at least one member on the audit committee is a "financial expert." Section 305 expands the SEC's power to bar individuals from service as officers or directors of a public company. Section 402 bars personal loans to officers and directors, despite explicit permission for such loans in the corporate laws of many states. The Commission's implementation of the disclosure provisions of Sarbanes-Oxley would, in more subtle but perhaps more important ways, also change corporate governance by significantly affecting management's relationship to the market. This is because the new rules reduce the information disparities between managements and shareholders which have been the basis for management prerogative in many important settings. As management's decisions and strategy become more transparent it becomes harder for management to resist shareholder pressure on alternative strategies. In particular, institutional investors might well insist on more influence and a greater role. As prices become more accurate – as they more precisely reflect the firm's actual business prospects – it becomes harder for managements to claim that shareholders receiving a takeover bid suffer from "substantive coercion." That is, insofar as the new disclosures required by or stimulated by Sarbanes-Oxley reduce management's informational advantages, then it becomes harder for state courts to employ the traditional grounds to sustain target management defense tactics. The crystal ball is inevitably cloudy about long run effects of some of these regulatory interventions, but vigorous SEC "price perfecting" pursuit of the invitation in Section 409 for "real time issuer disclosure" would have far-reaching implications well beyond the Enron-related problems that set the legislative process in motion.

Conclusion

Sarbanes-Oxley intervened in many important areas of capital markets accountability and reliability. Its most famous provisions pertain to accountants, to lawyers, and to its determination to use criminal sanctions to deter securities fraud. But the information disclosure provisions are important. They change the received model of corporate governance in protective or corrective ways, but also in ways that may be overly intrusive. These provisions also will become part of the minuet between federal and state law that has been a distinctive feature of the governance of the large public firm in the United States.