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Corruption, Fraud, and Corporate Governance: A Report on Enron

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The United States has the best corporate governance, financial reporting, and securities markets systems in the world.
(Business Roundtable, *Principles of Corporate Governance*, 2002)

Accounting Fraud

Enron, WorldCom, Adelphia Communications, and Arthur Andersen are company names that have in the early twenty-first century become metaphors for falsified balance sheets, corruption, and fraudulent bankruptcy.¹ Some commentators have referred to these scandals as a 'Watergate' in the world of business and have prophesied a long-term loss of trust in the American financial markets. An extensive history could be written about each of these bankruptcies, but the intention here is to summarize the most important charges and to illustrate them with examples primarily but not exclusively from the Enron case. Above all, this analysis of the empirical evidence should answer three questions:

First, are the bankruptcies of Enron or WorldCom the result of deceptive strategies for which certain *individual* executive managers are

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¹ Enron filed for Chapter 11 protection on 2 December 2001; Adelphia Communications on 25 June 2002; Sunbeam on 6 February 2001; Global Crossing on 28 January 2002; WorldCom on 21 July 2002 (the largest bankruptcy claim in US history). Arthur Andersen was the accounting firm for Enron, WorldCom, Sunbeam, Waste Management, Global Crossing, and Qwest. Each of these firms has been charged with forging the financial reports. Arthur Andersen was found guilty of obstructing justice (15 June 2002); the firm ceased to be an auditor on 31 August 2002 (*New York Times*, 31 August 2002, p. B3).

responsible? If (**here starts p. 160**) so, then the actors in the Enron drama would only be particularly greedy specimens of the species *homo economicus*, and their behavior could be explained by citing a quote from David Hume ([1741] 1994*b*: 59): ‘Avarice, or the desire of gain, is an universal passion, which operates at all times, in all places, and upon all persons.’

Second, are these cases of fraud rather the result of institutional failures? In this case, the bankruptcies would have to be explained by the structure of the economic *institutions* in the United States.

Finally, what motives should we attribute to the actors in order to make their behavior comprehensible? Is greed ‘an universal passion’ or perhaps a *culturally specific* pattern of behavior?

The first two questions are used to present two competing hypotheses. The third question is posed in an effort to link the perspective of the actors (the defrauders) with the level of institutions. In the end, the aim is to explain and understand a *singular* event (Enron) by applying the methods and theories of social science.

First, let us summarize the most important charges.²

Accounting fraud. By using complex procedures that made it extremely difficult for an outsider to follow, the companies falsified their balance sheets. Arthur Andersen is accused of having supported and covered up the fraud. The purpose was almost always to fulfill the profit expectations of the financial markets. The actors ‘tweaked’ the books as much as was necessary to ensure that the earnings per share would correspond down to the penny to the expectations of the analysts.

[Enron’s] executives conceived a plan to take advantage of a group of power plants under construction in the Midwest. . . . If Enron could sell contracts tied to the output of some of the plants well in the future, the company could book the long-term profits immediately, even if it did not receive a dime up front. But when no energy company could be found to participate in such a deal, Enron turned to its banker, Merrill Lynch, which operated its own energy trading unit. . . . The plan was] to create a kind of mirror swap in which Enron would purchase energy contracts from Merrill and Merrill would simultaneously purchase energy contracts from Enron. (*New York Times*, 8 August 2002: C12).

² A brief summary of Enron’s ‘accounting gimmicks and deceptive transactions’ is given in Senator Levin’s ‘Opening Statement: The Role of the Board of Directors in Enron’s Collapse’ (Permanent Subcommittee on Investigations 2002).

Even though Arthur Andersen and Merrill Lynch were troubled by the structure of the deal, it was completed within 10 days. 'Enron executives benefited tremendously from the deal. Because Enron met its profit targets, dozens of top executives collected millions in stock and bonuses' (*New York Times* 2002: C12).

(here starts p. 161) *Special purpose entities.* Enron set up numerous special purpose entities (SPEs). The creation of such off-balance-sheet entities is a strategy that facilitates falsified balance sheets and fraud. Debts can be removed from the books of the corporation and 'transferred' to the books of a subsidiary company. The corporation then (apparently) has less debt. Very risky investments and business transactions can also be transferred out through the SPEs. Should the executive managers miscalculate the risk, the losses resulting from their mistakes can be 'hidden' for a while in the SPE. 'By the time of the collapse, Enron held almost 50% of its assets off its books.'³

In March 1998, Enron acquired a \$10 million block of shares in *Rhythms NetConnections*, a high-speed Internet service provider. Enron was not allowed to sell these shares until the end of 1999. In April 1999, Rhythms went public and its stock soared to where Enron's investment was now worth \$300 million. Because [Enron] could not sell the shares for several months, it wanted to get insurance against a significant decline in Rhythms.⁴ The standard way to acquire such insurance is through the purchase of a put option. Enron's problem was that [Rhythms] was so risky that there was no one on Wall Street willing to provide this insurance. Fastow's⁵ solution was to create a company [SPE] that he would run *that used Enron stock as its capital* to sell the insurance on Rhythms stock to Enron. . . . Because Enron was essentially insuring itself . . . there really wasn't any insurance. (Fusaro and Miller 2002: 133–4, emphasis added).

This is clearly a violation of all accounting procedures and principles, and apparently one that Arthur Andersen approved. . . . It led to a \$1.1 billion reduction in Enron's equity and a \$700 million reduction in earnings. These same people knew that a partnership run by [Fastow] was benefiting greatly from these transactions. All of them, and an

³ Permanent Subcommittee on Investigations (2002: 8, pdf-version). The transfer of money-losing assets to SPEs allowed Enron to make itself appear more attractive to Wall Street investment analysts and credit-rating agencies.

⁴ *Rhythms NetConnections* filed for Chapter 11 protection on 2 August 2001.

unquestioning Board of Directors, did nothing. (Committee on Energy and Commerce 2002: Part 3)⁶

Self-enrichment. A company that fulfills the expectations of the financial markets can count on rising share prices. The falsified balance sheets of Enron fulfilled these expectations and enabled Enron top managers to increase their yearly personal income to \$100m or more, chiefly through stock options.

(here starts p. 162) Before the Permanent Subcommittee on Investigations, Dr Charles LeMaistre (chairman of the Compensation Committee of Enron's Board of Directors) testified that the total income of Kenneth Lay for the year 2000 was \$141m, of which \$131m—93 per cent of total income—came from stock options. Andrew Fastow collected \$30m in side payments from Enron on the fraudulent insurance on Rhythms stock.⁷

Corruption. Enron, an energy trader, was only able to expand so quickly because the market for electricity in the United States was deregulated. In this liberalized market, Enron organized numerous ostensible transactions, which led to an artificial shortage of electricity in California and to a dramatic increase in the price of electricity.⁸ During the course of this energy crisis, Enron was able to increase its profits by several billion US dollars. Therefore, the company had a direct interest in the deregulation of the energy market. The following three examples show that many politicians received contributions from Enron:

1. 'Of the 248 senators and House members on the committees investigating Enron's collapse and its accounting practices, 212 have received contributions from Enron or Arthur Andersen, its auditor, since 1989.'
2. Managers from Enron contributed \$1,836,865 to Republicans and \$175,699 to Democrats in the period between 1989–2001; roughly 44 per cent of these contributed funds came from Mr and Mrs Kenneth Lay.

⁵ Andrew Fastow was the Chief Financial Officer of Enron and the 'villain of the piece'. On 3 October 2002, Fastow was indicted for fraud, money laundering, and conspiracy before a US court.

⁶ The loss to which the Committee refers came mainly from the SPEs called 'Raptors', a name inspired by the dinosaurs in the movie *Jurassic Park*.

⁷ Kenneth Lay was CEO of Enron until 23 January 2002. LeMaistre (2002); Powers Report (2002); *New York Times*, 8 August 2002, p. C12. See also transcript of the interview with the wife of Kenneth Lay at www.msnbc.com/news/695478.asp#BODY (February 2002).

⁸ On 6 April 2000, Enron moved electricity from California to Oregon and back from Oregon to California. Enron dealers repeated this phony transaction *seven times on that day* (*Wall Street Journal*, 16 September 2002, p. A8). For a detailed description of similar practices see: *New York Times*, 7 May 2002, p. A11, and 8 May 2002, p. C1, C6. Cf. also Hogan (2002: 126).

3. The energy industry in the United States is one of the economic sectors that spends the most on political lobbying (\$159.1m in 2000).⁹

Conflict of interests (cf. Saunders 1985). On the one hand, accounting firms are supposed to guarantee that the balance sheets they audit reflect a realistic portrait of the financial situation of the company in question; on the other hand, these accounting firms are being paid by the companies themselves for (**here starts p. 163**) the audit.¹⁰ Not infrequently, accounting firms are pressured by their clients to confer legality upon a business transaction that is only semi-legal. Such procedures are known as 'creative accounting' among professionals, that is, 'standards which are so flexible that profits can be called losses or vice versa to suit the client's needs' (Buckley and O'Sullivan 1980: 7).

The analysts of the major investment banks also find themselves faced with a similar conflict of interests: On the one hand, they are supposed to provide an 'objective' evaluation of the future development of a company whose shares they recommend to the public. On the other hand, the analysts are paid by the investment banks, and their income is often determined to a certain percentage on the number of shares the investment bank can sell to the public.¹¹ The following example shows what sanctions are leveled against analysts who think that their first responsibility is to *shareholders*.

Chung Wu, an analyst at UBS Paine Webber, sent an e-mail containing this warning to 73 of his clients: 'Financial situation is deteriorating in Enron. . . . I would advise you to take some money off the table.' A copy of the e-mail landed at Enron. Wu was fired the same day. (Fusaro and Miller 2002: 72–3)

⁹ By comparison, the drug industry spent \$75.3m on lobbying in 2000. Sources for (1) through (3): Center for Responsive Politics, data from the Federal Election Commission at: www.NYtimes.com/Enron (August 2002) and *New York Times*, 19 September 2002, p. C2; www.opensecrets.org/news/enron/andersen_totals.asp

¹⁰ For auditing and consulting services, Arthur Andersen received about \$52m from Enron in 2000 (*Business Week*, 12 Aug. 2002, pp. 52–5.) See also Bazerman et al. (1997).

¹¹ Some contracts promise 3% to 7% of all the investment banking revenues that analysts help to generate. The investment bank Salomon Smith Barney raised about \$24.7bn for WorldCom. Salomon's fees then totaled \$140.7m. Jack Grubman, chief analyst of Salomon, recommended the stock of WorldCom until 22 April 2002 ('buy'); in July 2002 WorldCom went bankrupt (*Business Week*, 13 May 2002, p. 39–40 and 5 Aug. 2002, p. 36).

This brief account illustrates that the Enron managers were integrated into a network of collaborators¹² without whose help they could not have realized their goals: Arthur Andersen had to approve the booking of virtual profits as real profits; Merrill Lynch had to cooperate in the dubious energy swap transactions; the California Independent System Operator (ISO), which monitors California's electricity network, had noticed Enron's fraudulent energy trade but declined to pursue criminal prosecution against the company;¹³ the California Public Employees Retirement System (CalPERS) cooperated in several of the Special Purpose Entities organized by Enron;¹⁴ Enron's Board of Directors neglected to audit the company's accounting books closely; and so forth. It was the *convergence* of these various 'institutional failures' that enabled Enron to commit fraud 'on a grand scale.'

(here starts p. 164)

The Spirit of Capitalism

In *The Protestant Ethic and the Spirit of Capitalism*, Max Weber writes ([1905] 2002: 152):

The 'pursuit of profit' has actually nothing to do with capitalism. . . . Such striving has been found, and is to this day, among waiters, physicians, chauffeurs, artists, prostitutes, corrupt civil servants, soldiers, thieves, crusaders, gambling casino customers, and beggars. One can say that this pursuit of profit exists among 'all sorts and conditions of men,' in all epochs and in all countries of the globe.

Up to this point, this passage could also have come from David Hume. But then Weber makes a major distinguishing point: 'A fully unconstrained compulsion to avarice cannot be understood as synonymous with capitalism, and even less as its "spirit". On the contrary, capitalism can be identical with the *taming* of this irrational motivation, or at least with its rational tempering.'

¹² Gourevitch (2002: 1) points to a 'collusion among 'reputational intermediaries' (accountants, bond and stock analysts, banks, lawyers).'

¹³ 'On July 20 [2001] ISO caught Enron and Sempra Energy collecting fees for relieving congestion without moving any power' (*Wall Street Journal*, 16 September 2002, p. A8).

¹⁴ The name of the SPE was Joint Energy Development Investments (JEDI). The joint venture with CalPERS provided pension fund money for financing Enron's energy deals.

Irrational greed is transformed into a rational aspiration for monetary gain through the institutions of capitalism.¹⁵ The 'spirit of capitalism' cannot be reduced to 'avarice' but is the result of a process of rationalizing and modernizing Western societies. Unbridled greed is not only irrational, it is also inefficient, because the success of capitalist enterprise is based on continuous and calculable profitability.

For Hume ([1741] 1994a: 55), 'passions' are the spur of the capitalist economic process: 'Avarice, the spur of industry, is so obstinate a passion . . .'. This view places him squarely in the tradition of Adam Smith, who considered 'interests' to be the motor of capitalism. The 'invisible hand' causes the pursuit of individual interests eventually to serve the general welfare.¹⁶

In the case of Enron, the 'invisible hand' evidently failed. Yet Enron is not an isolated case. The historical development of American capitalism has experienced recurring waves of fraud and corruption.¹⁷ Enron is an example of the unavoidable transaction costs of a system whose dynamics are spawned by market competition that is little regulated by institutions.

With illustrations from the Enron case, the 'institutional failures' are to be discussed in greater detail in the following sections. For the moment, the analysis is succinctly presented in six theses. The first two theses can be labeled as 'push factors' while the rest refer to the opportunity structure for fraud and corruption.

(here starts p. 165)

Push factors

1. 'Socially deviant behavior [is] just as much a product of social structure as conformist behavior' (Merton 1968: 175).
2. Intensified *competition* forces companies to operate in the gray area between the 'legally permissible' and the 'criminal'. In the professional terminology of public accountants, this is called 'aggressive accounting', meaning the use of accounting practices that push the law to its limits.

Pull factors (opportunity structure)

¹⁵ For Max Weber, such rational tempering was naturally the work first and foremost of the religious institutions of Protestantism.

¹⁶ The relationship between passions, interests, and institutions cannot be discussed in detail here. See Hirschman (1977: 17): 'The idea of harnessing the passions of men, of making them work toward the general welfare . . . was put forward [already] by Bernard Mandeville.'

¹⁷ 'If early capital formation in an economy could be explained only by Marx or fraud, there is no doubt to which camp the American evolution of 1870–1910 would belong' (Buxbaum 1979: 244). See also Perrow (2002); McCormick (1981).

3. Each information asymmetry between two market actors which is based on economically usable knowledge improves the opportunity structure for fraud.
4. The 'economics of intangibles' has further intensified the information asymmetry between insiders and outsiders and has improved the opportunity structure for (fraudulent) manipulation in the financial markets.
5. Stock options for corporate executives create a systematic incentive to manipulate the balance sheets, to exploit insider knowledge, and to selectively give preferential treatment to analysts who evaluate the company as 'positive'.
6. Corruption facilitates the colonization of the political system by the major corporations and reduces the autonomy of political institutions.

In the following section, we will define corruption and fraud. Afterward, these six theses will be discussed.

Corruption and Fraud Defined

Perrow (2002: 14) offers this description of the 'legal' regulation of the railways in the state of New York at the end of the nineteenth century: 'If one [railroad] had bribed a judge for a favorable ruling, the other [railroad] could quickly travel to an otherwise remote county, and purchase another ruling, and send it back instantly by telegraph. . . . once the railroad made it easy to go from one county judge to another, the railroads could shop for a judge that would give them the best verdict.' This example illustrates well what corruption is.

Modern societies are divided into subsystems, and in every subsystem exchange processes are transmitted by a specific 'medium'. In the political system the medium is (legitimate) 'power'; in the economic system, it is 'money'; in the legal system, it is 'justice'; and in the scientific system it is 'truth.' The *autonomy* of a subsystem is upheld through the use of only one specific medium—the one constitutive of the system operations of a subsystem—as the *legitimate* 'currency' to transmit exchange processes. The 'operations' in the scientific system are based on the code 'true/untrue', in the **(here starts p. 166)** legal system 'legal/illegal', in the economic system 'profitable/unprofitable' (Luhmann 2000).

Corruption is defined as an exchange between subsystems in which the specific code of a system is violated. Firms that buy 'justice' or 'politics'

and politicians who use power in order to force scientists to produce a politically useful truth violate the code of each respective system.¹⁸

On the system level, corruption blurs the differentiation within a social system by causing subsystems to lose a degree of their autonomy. On the values level, corruption leads to a loss of legitimacy for specific operations and, on the functional level, to the collapse of system operations. If enterprises buy politicians, the political system is being 'colonized' by business: political decisions lose their legitimization, and the difference between economics and politics tends to disappear.

Fraud is a breach of trust. If I do not trust a person, it will be hard for this person to cheat me. Financial markets become a 'market for lemons' (Akerlof 1970) once investors lose their trust in them. It was also a loss of trust that led to the demise of the firm Arthur Andersen, one of the five largest accounting firms in the world.

After he resigned his job as CEO of Arthur Andersen, Joseph Berardino expressed the point in this way: '*Andersen sells trust!*'¹⁹ Unfortunately for the firm, this insight came too late. Enron was not the first case of manipulated accounting and bankruptcy in which Andersen was involved. Waste Management, Sunbeam, and Baptist Foundation of Arizona had all previously been down that same road. First a massive accounting fraud was uncovered, then came bankruptcy. In each of these cases, Andersen had been the auditor.²⁰

Fraud is a zero-sum game played among the actors *within* a system. What the insider wins on the stock market, the outsider loses. The profits bagged by Enron executives have to be set against the losses suffered by the employees and stockholders.

Social Structure and Deviant Behavior

In a classic article written in the 1930s, Merton argues (1968: 175) that 'Socially deviant behavior [is] just as much a product of social structure as **(here starts p. 167)** conformist behavior'. He goes on, 'Some social structures exert a definite pressure upon certain persons . . . to engage in

¹⁸ Cf. Parsons (1969: 342): 'At various points in the societal system, power is exchanged both for other generalized media, notably money and influence, and for intrinsically significant rewards.' (Given the context of fraud and corruption being analyzed here, Parson's statement is ambiguous.)

¹⁹ Speech at the Commonwealth Club, San Francisco, 4 June 2002.
www.commonwealthclub.org/archive/02/02-06berardino-audio.html

²⁰ 'Andersen was under an injunction reached as part of a settlement in the Waste Management case, which prohibited the firm from engaging in future wrongdoing and significantly increased the penalties if it was found to have done so' (*New York Times*, 8 May 2002, p. C6).

non-conforming conduct' (1968: 186). To answer the question of the conditions under which a specific social structure 'pressures' individuals to behave in a deviant manner or at least insinuates that such behavior would be a rational adaptational reaction, Merton refers to a structural conflict. If the main cultural values of a society are success, wealth, and upward mobility,²¹ but the legal means to fulfill these aims are available only to a minority, then deviant behavior is a rational adaptational strategy. Especially relevant to the topic under discussion, Merton believed that this conflict was particularly pronounced in American society: 'Contemporary American culture appears to approximate the polar type in which great emphasis upon certain success-goals occurs without equivalent emphasis upon institutional means' (1968: 190).

What Merton had in mind when he wrote the first version of this article in 1938 were the high crime rates in cities like Chicago or New York; of lesser concern to him were such exclusive managerial circles as are being discussed here. At any rate, it cannot be argued that a 'lack of institutional means' is what drove the corporate executives to commit fraud. The problem was rather an overabundance of 'institutional means' (opportunity structure).

Therefore, we modify Merton's thesis by introducing two further assumptions. First, not until a dominant set of values (wealth and success) *connects* with the *competitiveness* that permeates all aspects of life does there emerge the 'pressure' that Merton identifies as the cause of deviant behavior. The 'villains' in the Enron drama were top managers from the highest executive levels. In such positions, competition does not decrease, it increases exponentially. And competition not only dominates business life but also affects private lifestyles.²² A former manager of an energy company is on record as having said:

I swear, my voice mail machine was jammed every day with bankers trying to pitch me something. They'd come in with their Power-Point slides telling us why we needed to buy this or that and how if we didn't

²¹ Cf. Kalberg (2001: 310): 'the pursuit of wealth is extolled.'

²² 'L. Dennis Kozlowski, 55, the son of a Newark police officer who as chief executive helped build Tyco into an international conglomerate . . . is accused of using the money [of Tyco] to pay for everything from an apartment on Park Avenue and homes in Boca Raton, Fla., to jewelry from Harry Winston and Tiffany's. [He] is also accused of having the company pick up half the cost of a multi-million-dollar 40th-birthday party on the Italian island of Sardinia for his wife, a former waitress at a restaurant near Tyco's headquarters in New Hampshire' (*New York Times*, 13 September 2002, p. A1). 'Conspicuous consumption' is not only openly displayed as a manifestation of the American ideology on 'from rags to riches' success, it becomes a social *obligation* in the social circles of those whose income is published in the Forbes' rankings.

we'd be left in the dust by the guys down the street who were doing a deal a minute. (*New York Times*, 21 August 2002, p.16)

(here starts p. 168) Both Enron and WorldCom grew almost exclusively by buying up other companies. In a matter of only a few years, for example, WorldCom bought sixty-five telecommunications companies.²³ The investment bankers who conducted these transactions earned fortunes through the 'deals'. The energy trader articulated the competitive pressure to which executives in the market for corporate control are exposed: either buy or be bought.

Another example should further clarify this point. Arthur Andersen compiled a 'risk profile' for each of the 2,500 firms it audited. The firms (clients) were then divided into four categories: 'Maximum, high, moderate, and low risk. Enron was one of some 50 clients deemed 'maximum risk' while 700 more were considered 'high risk' (*Business Week*, 12 August 2002, p. 53). 'High risk' companies are those that stretch their accounting practices to the limits of what is legally permissible, that is, they engage in 'aggressive accounting'.

Why do executives take the risk of teetering on the edge of legality? There is one explanation that at first has nothing to do with 'avarice': the more a company is exposed to competition in the market for corporate control—meaning the greater the danger that the company will be bought up and thereby lose its autonomy—the more important the share price of the company becomes. High share prices offer a relative protection from (hostile) takeovers. Among other factors, the share price is determined by what the executive managers publish in their *financial statements*.

Not until the specific values of a culture (for example, extolling the pursuit of wealth) link up with a pervasive competitiveness in all aspects of life do those dynamic effects emerge, the 'fallout' of which we can observe in the Enron case.

Our second modification of Merton is the observation that the cultural values that Merton assumes are not equally distributed throughout society. Individuals for whom wealth and a high income are very important will attempt to secure positions in the *economic system* and will reject positions in the scientific or welfare systems because these offer relatively few opportunities for substantial income earning.²⁴ Such *self-selection* is intensified by the

²³ 'For WorldCom, acquisitions were behind its rise and fall' (*New York Times*, 8 Aug. 2002, p. A1).

²⁴ This process of selection and self-selection operates already at the level of college education (preference for a particular university subject: for example, history versus business administration). It can be seen here that the generalized mediums of

selection process in hiring. The 'assessment centers' of companies ensure that only those applicants are hired who indicate that a large income is important to them. If the personnel of a company were indifferent to the idea of earning a lot of money, the company's incentive system could not work (for example, stock options). In other words, through a process of selection and self-selection, those individuals who aggressively pursue large incomes (**here starts p. 169**) congregate in the economic subsystem.²⁵ Within the economic system, they gather foremost in those companies offering particularly ample opportunity due to their rapid growth. Enron belonged to this group of companies.²⁶

This modification of Merton's thesis has two advantages. First, it avoids the assumption that *all* members of a society have internalized the pattern of values Merton postulates: that is, we assume that 'avarice' is not equally distributed among social subsystems. Second, certain value patterns do not automatically produce deviant behavior; not until they are 'unleashed' in a specific institutional structure do they develop these dynamics (competition).

Even if individuals are willing, however, to seek large incomes with aggressive and (in borderline cases) criminal means, it does not mean that they are successful. They need a certain 'opportunity structure' in which they can test their talents. This is the topic of the following section.

The Opportunity Structure for Fraud

Cloward and Ohlin argue that every society has a dual opportunity structure at its disposal. There are legal and criminal careers. 'We believe that each individual occupies a position in both legitimate and illegitimate opportunity structures' (1960: 150).

If someone wants to successfully (that is, professionally) rob a bank, this person needs access to a specific opportunity structure, meaning information, social networks, technical training, and so on. Most bank robbers (fortunately) are dilettantes.

exchange (truth, justice, money) can be interpreted as patterns of preferences internalized during the socialization process (Windolf 1995).

²⁵ Cf. Etzioni's typology of compliance relations within organizations (1961: 12–17): The processes of selection and self-selection are likely to produce a congruent type of compliance in large organizations, that is, the motivation of organization members (calculative) is congruent with the power resources of the organization (remunerative).

²⁶ 'Enron preferred to recruit its employees straight out of school so that they would know only the Enron way of doing things' (Fusaro and Miller 2002: 147; see also 48–51).

What does the opportunity structure for (accounting) fraud look like? With the help of the two following examples—information asymmetries and the increasing importance of ‘intangible assets’—we will see how economic structural change clearly improved the conditions to successfully use accounting to defraud.

Information Asymmetries

During the 1990s, the catchwords ‘knowledge society’ and ‘knowledge worker’ have been used to point to the increasing impact of science and technology on almost all facets of life (Neef 1998; Kleinman and Vallas 2001). In many studies two developments are emphasized: the amount of knowledge available to society has grown exponentially, and the knowledge that individuals have at their disposal is becoming increasingly diversified. (**here starts p. 170**) Society ‘knows’ more and more, but the intersection of *common* knowledge shared by all individuals is becoming smaller and smaller.

A medical specialist may know a great deal about a rare disease, but she probably knows almost nothing about the future prospects for the development of a certain technology. In turn, a stock analyst who specializes in this area knows a great deal about this technology, but almost nothing about the chances of success for a certain therapy. The relationship between the doctor and the analyst is characterized by a strong information asymmetry.

Should the stock analyst become ill, he is ‘at the mercy’ of the doctor, while the doctor will be able to judge the value of the analyst’s advice in matters of financial investment only after the fact (that is, when it’s too late). For this reason, most professions have a ‘code of ethics.’

Thesis 1: Each information asymmetry between two market actors which is based on economically applicable knowledge improves the opportunity structure for fraud.

Thesis 1 is plausible only if an additional assumption is introduced. There has always been an information ‘asymmetry’ between doctor and patient, but that is not to say that patients are constantly being cheated. Yet here it is being *additionally* assumed that the process of individualization has weakened the codes of ethics of the professions. Only when the members of a profession view their code of ethics as no longer or only marginally binding can they transform the information asymmetries into market opportunities and income generators. Arthur Andersen is a particularly impressive example of

'creative accounting' in which the code of ethics of the profession was violated and the victims were the (uninformed) Enron shareholders and employees.²⁷

Thesis 2: The opportunity structure for fraud improves the more market relations become detached from social relations (disembeddedness), the less 'tacit knowledge' exists in economic relations, and the more market actors are forced to rely on abstract and generalized knowledge (Polanyi 1997).

A bank that grants a company credit knows the management of this firm personally, and often a bank executive sits on the supervisory board of the company. In addition, the bank is integrated into networks in which information is circulated about this company. However, an investment fund in Luxembourg, relying on Standard and Poor's ratings, will purchase shares in a Korean company although it has never seen this company and does not know its management.

(here starts p. 171) In communication processes, we can distinguish between digital and analog codes (Watzlawick et al. 1967). 'Hard facts' are transmitted through digital code. The testimony of a witness in court or the financial statements of a company are considered to be 'hard facts'. Through analog code, information is transmitted that qualifies the digital statements: whether they are meant seriously or only lightly; whether a person harbors a hostile or friendly attitude. A great deal of information is transmitted through analog code that enables us to judge the *trustworthiness* of a person.

The information defined here as 'tacit knowledge' is that which is derived from social contexts, which is often communicated through analog code, and which cannot be formalized and standardized and is therefore unsuitable for dissemination worldwide. The hypothesis presented here is that an extensive loss of tacit knowledge has occurred in connection with the globalization of the financial markets, and that this loss has improved the opportunity structure for fraud.²⁸

Intangible Assets

²⁷ The 'code of ethics' not only prohibits the (fraudulent) exploitation of information asymmetries, it also regulates the competition between members of the profession. See the Registered Public Accountants' Association Code of Ethics: www.rpaa.org/ethics.htm; Carey (1969: 3).

²⁸ Charles Tyson Yerkes, the traction magnate in Chicago who was involved in the fraudulent bankruptcy of the National Bank of Illinois (1905), was considered by Marshall Field to be 'not safe' (Tarr 1966: 454). It is this kind of 'tacit knowledge' that is lacking in globalized, standardized, and professionalized forms of knowledge (for example, a balance sheet).

A conveyor belt, an office building, or a truck belonging to a transport business are all 'tangible' assets. The value of these assets is measurable and can be credited according to the standard rules of Generally Accepted Accounting Principles (GAAP). The *business idea* behind amazon.com, the Universal Mobile Telecommunications System (UMTS) licenses that Telecom (Germany) purchased for €8.5bn, the *brand name* of Coca-Cola, the insider knowledge of an energy trader at Enron are all examples of 'intangible' assets. More and more, the assets of companies that are a part of the 'new economy' are not tangible assets but intangible ones. The new economy is a knowledge economy (Lev 2001).

Yet another distinction needs to be made in order to underscore the relevance of intangible assets to the problem being discussed. How do we determine the 'value' of a commodity? There are two different definitions.

Under the first definition, 'The value of any commodity is determined by the amount of labour socially necessary for its production' (Marx [1867] 1970: 39). This is the definition found in the labor theory of value, which dates back to Ricardo and Marx. In an updated version, we can say that the value of a commodity is determined by the production costs. This definition bases the value on the costs incurred during production (that is, *past costs*) and therefore the value can be measured with relative precision.

(here starts p. 172)

Table 7.1 Assets and values

<i>Concepts of Value</i>	<i>Types of asset</i>	
	<i>Tangible</i>	<i>Intangible</i>
<i>Production cost</i>	Coal-mining cartel	Religious services
<i>Capitalization</i>	Old economy	New economy (Enron, WorldCom)

Under the second definition, the value of a commodity is determined by the sum of the future earnings that can be expected with this commodity (capitalization). In this case, a commodity is considered to be an investment commodity. What counts is not its concrete value in use but only its ability to generate income in the future. This definition bases value exclusively on *future* events and developments, which cannot be predicted at all or only with great uncertainty (for example, earnings per share two years hence).

In Table 7.1, the two pairs of terms are matched up, thus creating four possible combinations. In the coal-mining cartel existing prior to the First World War, the price (value) of coal was determined by the production costs and what was considered a reasonable profit.²⁹

The value of a company in the new economy is marked by a double dose of uncertainty. For one, it is not clear what assets a company actually possesses (intangibles); for another, the value determination of these assets is strapped with a high degree of uncertainty. It is easy to credit the UMTS licenses purchased by Telecom for €8.5bn as an 'asset' worth the price the company paid. At the same time, however, it is obvious that the value of these assets is totally fictitious according to the first definition of value (production costs) and is extraordinarily uncertain according to the second definition (capitalization).

If the value of intangible assets is so uncertain and if the earnings that can be made with these assets cannot be rationally calculated, it is understandable why the new economy has improved the opportunity structure for fraud. Companies whose share prices increased tenfold on the stock market within **(here starts p. 173)** a short period of time could assert that their intangible assets deserved to be valued so highly. When stockholders became suspicious and asked to see and 'touch' these assets, they were informed that the wealth of the company was 'intangible'.

From this we can derive two hypotheses. First, the opportunity structure for fraud becomes more favorable as the following three indicators increase: the percentage of firms in a country that are financed through the stock market (and not through bank credit), the percentage of companies whose value is based primarily on intangible assets, and the degree to which share prices are influenced by predictions of expected earnings on intangible assets.

Second, under highly uncertain conditions, the demand for predictions grows. The gurus of the stock market are charismatic prophets who predict events during periods of great uncertainty that cannot be predicted through *rational* calculation. Whether the prophets are really swindlers can usually be determined only after the fact.³⁰

A Final Round in a Prisoner's Dilemma Game

²⁹ The *regulated* electricity markets provide another example for Panel (1): Tariffs were designed to recover the operating and fixed costs of the power plants (Joskow 2000: 123).

³⁰ Prophecies are well remunerated in the financial markets: Jack Grubman, chief analyst of Salomon Smith Barney, 'was paid handsomely for his efforts, earning an average of \$20 million a year' (*Wall Street Journal*, 16 August 2002, p. A4).

The CEO of Enron, Kenneth L. Lay, earned a total annual income of \$103,559,793 in 2000 (one year before Enron filed for bankruptcy).³¹ The average family income in the United States equaled roughly \$48,950 in 1999 (Mishel et al. 2001: Table 1.1). To simplify the math, we will assume that a family is in a position to earn this income over a period of forty years. Thus, the life income of this family would equal \$1,958,000. This means that in 2000 alone Kenneth L. Lay earned about fifty-three times as much as the average American household would over a lifetime.

If an executive can earn such an income just over a period of a few years (the 'average' American would be happy to earn it even just *once*), it is rational to weigh the consequences of fraudulent bankruptcy against the chance to make such exorbitant sums of money. Often the opportunity costs of bankruptcy are relatively small *for the executive*³² who is playing in the final round of a prisoner's dilemma game, in which the dominant strategy is defection.

(here starts p. 174) In the 1990s, all CEOs of the 500 largest US firms received stock options. In 1992, the value of these options equaled about 25 per cent of an executive's annual income; by 1998, this had risen to 40 per cent (Hall and Murphy 2000: 1). Thus, an ever-growing percentage of executive incomes is determined by stock options. This has at least four consequences, all of which are usually ignored by the advocates of the principal-agent theory.

First, the incentive influencing the behavior of corporate executives is not linked to a continuous (internal) growth of the company, but solely to the share price. The stock market is volatile, and the volatility has increased during the past decade. In boom periods this leads to excessive income increases; in bust periods the stock options lose their incentive effect. Second, the income gap between the 'average' American and top executives has increased dramatically. 'The real wage of the median CEO rose 62.7% during 1989–99, helping the average CEO to earn 107 times more than the typical worker' (Mishel et al. 2001: 5). Third, stock options offer a permanent incentive to falsify balance sheets. Since share prices are influenced by what the company managers publicize in the financial statements, and since executive incomes are significantly dependent on the share price of company stock, then there exists a constant temptation to manipulate the accounting

³¹ *New York Times*, 18 June 2002, p. C1; LeMaistre testified that K. Lay earned \$141m in 2000 (LeMaistre 2002). In the following calculation the lower figure of the *New York Times* is used.

³² The opportunity costs of a (fraudulent) bankruptcy is the loss of reputation in the market for managers. On 26 June 2003 the US Department of Labor sued K. Lay for 'mismanagement of two of Enron's main pension plans'. K. Lay has been sued for 'mismanagement', but not for fraud! Source: www.dol.gov/_sec/media/speeches/20030626_Enron_Lawsuit.htm

books.³³ Fourth, if top executives can successfully earn incomes resembling lottery winnings for a few years, then their commitment to the long-term development of the company becomes secondary. These managers have already earned incomes to secure them for their lifetime.

Side Note: What Are Stock Options?

Since the Enron debacle, many critics have demanded that stock options be defined as 'costs'.³⁴ However, stock options are not costs. A stock option is the right to purchase shares of stock during a defined period at a price that is specified in the option (the 'exercise price'). The actual impact of such options is that they water down the equity value later on.

In October 1999, Kenneth Lay received Enron stock options totaling several hundred thousand. At this point, the price of Enron shares stood at about \$38, which also happened to be the exercise price.³⁵ By 24 January 2000, the share price had risen to \$65. Kenneth Lay sold 143,704 Enron (**here starts p. 175**) shares that day and thereby earned \$9,340,760. Where do shares come from like those that Lay sold? They are *newly issued shares* (capital stock increase). For his options, Lay had to transfer to Enron \$38 for each of the 143,704 shares for a total of \$5,460,752.³⁶ His profit consisted of the difference between the 'exercise price' (\$38) and the stock market price on the day of sale (\$65).

Stock options do not incur costs when they are issued. At this point they are nothing more than a contract between the company and the executive involved. (This is what makes stock options so attractive for newly established companies: they can 'pay' their employees with self-issued paper money.) When the executive exercises the option, meaning when he receives the (new) shares from the company and then sells these on the stock market,

³³ 'Instead of figuring out their sales and subtracting expenses to calculate the profit, [companies] work backward, starting with the profit investors are expecting and manipulate sales and expenses to make sure the numbers come' (*New York Times*, 29 June, 2002, p. B1).

³⁴ Gary S. Becker: 'The value of the options given in any year should be deducted from revenue in that year' (*Business Week*, 5 August 2002).

³⁵ 'One of the most striking facts about executive stock options is that the exercise price of virtually all options is set equal to the current stock price at the grant date' (Hall and Murphy 2000: 1).

³⁶ This is the 'amount of consideration to be received by the issuer for the issuance of shares of its stock' (Kraus 2002: 2–16, § 2.03). Lay did not transfer this amount to Enron, but exchanged 98,062 Enron shares back to his company (on 25 January) to cover this consideration and taxes (*New York Times* 8 August 2002, p. 12). Some managers received this consideration as a company loan; later they saw to it that their company redeemed the loan: 'Former CEO of Tyco, D. Kozlowski, has misappropriated millions of dollars of company money through unapproved and undisclosed loans' (*New York Times*, 12 September 2002, p. C1).

the 'costs' are still hidden. At this point, the share price has risen (that is, the market price of a share is higher than the exercise price) and indicates that the demand for such shares is greater than the supply.

The costs to shareholders become obvious only during a period when the market price is falling. At this point, an increased supply of shares (the supply is increased by the number of exercised options) become available to a weak market, and the shareholders pay for the executive options with a considerable drop in share prices.³⁷ But this need not worry the company executives: they have already sold their shares.³⁸

Lack of Countervailing Powers

Falsified balance sheets and other forms of fraud drove Enron into bankruptcy and destroyed thousands of jobs. Did anyone in the management ranks become suspicious and attempt to warn their superiors? This question (**here starts p. 176**) is particularly poignant in connection with the board of directors, who were responsible for the supervision of Enron's management. Did not one board member closely examine the company's tampered books?

To answer the first question: Sherron Watkins, vice president of corporate development, was one of the few Enron employees who was willing to testify before the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce early in 2002. Before being hired by Enron, Watkins had worked eight years at Arthur Andersen. Therefore, she knew how to prepare balance sheets (and how to manipulate them). Watkins was convinced that the accounting books at Enron were falsified, and she feared for the future of the company. Likewise, she feared for her job and therefore dared not express her concerns outwardly at first. 'I was not comfortable confronting either Mr. Skilling or Mr. Fastow with my concerns. To do so I believed would have been a job terminating move.' On 14 August 2001, she wrote an *anonymous* letter to Kenneth Lay, in which she described several cases of accounting fraud. She summarized her views by stating: '*We're such a crooked company.*' Later on, Lay met Watkins. When Fastow

³⁷ 'The stockholders pay for [stock options] by suffering some dilution in equity values, but the cash or other properties of the enterprise itself are not consumed as they are by the payment of other types of compensation, such as salaries' (Kraus 2002: 2–11, § 1.06).

³⁸ The executive managers at Enron encouraged their company's employees to invest their pension funds in Enron stock, yet the managers did this at a point when they themselves were beginning to sell their own Enron stock on a massive scale (*Wall Street Journal*, 1 March 2002: 'Pension practices used by Enron'). 'Mr. Lay went so far as to tout the stock as a good investment for his own employees—even after he had been warned that a wave of accounting scandals was about to engulf the corporation.' Quote from the indictment of the US Department of Labor: www.dol.gov/_sec/media/speeches/20030626_Enron_Lawsuit.htm

found this out, he is reported to have said: 'He wanted to have me fired. He wanted to seize my computer' (Committee on Energy and Commerce 2002: Part 3).

Further reference is found in the records of the congressional hearings: 'Ms. Watkins is still an Enron employee, and because of this fact has requested a subpoena compelling her testimony today'.³⁹ At the point when a Committee of the House of Representatives was investigating the Enron case, Ms Watkins still appears to have feared she would be fired. For this reason, she requested the Committee to subpoena her in order to force her to testify what she knew.

The hearings throw light on the internal balance of power in US corporations. In only a few firms are trade unions strong enough to be able to protect critical employees from losing their jobs. The fate of the analyst Wu at UBS Paine Webber, who warned clients about Enron, has already been mentioned: 'Wu was fired the same day.' American newspapers have reported a number of similar incidents.⁴⁰ Policies of 'union busting' and 'hire and fire' often deter company employees from exercising their 'voice' option. (**here starts p. 177**) Those who do not want to work in a 'crooked company' quit (exit option), but they don't protest.

To answer the question whether any board members scrutinized the company's books, it is necessary to examine the membership of the board of directors at Enron more closely. In September 2001, the board consisted of the following sixteen members.

- Two medical doctors who had contributed outstandingly to cancer research at the M. D. Anderson Cancer Center in Houston (C. LeMaistre, J. Mendelsohn).
- Two directors dependent on Enron (J. Foy, K. Harrison). Harrison had a cross-interlock with Lay. Harrison was the CEO from Portland General Electric, a complete subsidiary of Enron; Lay, the CEO of Enron, sat on the Board of Directors of Portland General Electric. So Harrison was to monitor Lay and Lay was to monitor Harrison.

³⁹ Senator J. Greenwood (Pennsylvania), Committee on Energy and Commerce (2002: Part 3).

⁴⁰ Bradley P. Farnsworth was Dynegy's chief accounting officer. When he refused 'to "shave" the value of losses in the gas market' he was fired (*New York Times*, 5 August 2002, pp. C1, C*6). When Joseph Mulder alerted his superiors to what he said were serious violations of Securities and Exchange Commission rules, he was fired by Donaldson, Lufkin, & Jenrette. When Owen Cheevers refused to comply with the request of investment bankers at his firm to make his cautionary notes on the radio industry more 'glowing', he was fired by the Bank of Montreal in New York (*New York Times*, 20 June 2002, p. C1). Roy L. Olofson, finance executive at Global Crossing, was fired after he questioned the use of [fraudulent] capacity swaps (*New York Times*, 25 Sept 2002, p.C4).

- A professor for accounting at Stanford University (Robert K. Jaedicke) and the dean of the Anderson School of Business, University of California, Los Angeles (Bruce G. Willison).
- Three directors from businesses outside the United States: R. Chan (Hong Kong), P. Pereira (Rio de Janeiro), J. Wakeham (London).
- An executive manager of the United States Olympic Committee (N. Blake).
- Two directors employed in the energy industry, whose appointments to the board could be questioned as having been a violation of the Clayton Act (R. Belfer, J. Duncan).⁴¹
- In addition, there was a former member of the U.S. Commodity Futures Trading Commission (W. Gramm), the chairman of Tektronix (J. Meyer), and the chairman of Alliance Capital Management (F. Savage).⁴²

C. LeMaistre and J. Mendelsohn are two renowned cancer researchers at the University of Texas (Austin). It is not surprising that they did not see through the technical details of the financial statements. R. Jaedicke is a professor emeritus for *accounting* at the Stanford Graduate School of Business. He was the chairman of the audit committee of Enron (until 2001) (**here starts p. 178**) and therefore presented with the balance sheet for examination and signed approval.

Jaedicke's assertion that he knew 'nothing' about the accounting fraud is hardly credible.⁴³ In order to understand his behavior, we need to analyze more closely the situation in which Jaedicke found himself as an Enron director.

⁴¹ Section 8 of the Clayton Act restricts the use of interlocking directorates by competing corporations (Murray 1984).

⁴² ' . . . 10 of the 15 most recent outside directors had conflicts of interest including contracts with Enron, common bonds to charities, and memberships on the boards of other companies doing business with Enron. Some examples: charities close to some of the directors were supported heavily by Enron and its officers. Two directors had earned more than \$6.5 million in consulting fees from Enron since 1991. One director served on the board of a company that in 1999 signed a \$1 billion energy management agreement with an Enron affiliate.' Permanent Subcommittee on Investigations (2002): Statement of Chairman J. Lieberman, 7 May 2002. One of the charities mentioned by J. Lieberman is the M. D. Anderson Cancer Center (see below).

⁴³ Carl Levin, Senator of Michigan and Chairman of the U.S. Senate Permanent Subcommittee on Investigations (2002: 56), listed a few 'red flags' that the Board Members must have noticed: 'In February 1999, the Board's Audit Committee was told by Arthur Andersen directly that Enron's accounting practices were high risk and pushed the limits.' 'By October 2000, the Board knew that Enron had \$27 billion in assets—almost half of its assets—off its balance sheet.'

In October 2001, Andrew Fastow was questioned during a meeting of the Board of Directors. One of the directors welcomed Fastow by saying: 'We very much appreciate your willingness to visit with us.' Carl Levin, Senator of Michigan, commented on the behavior of the Enron directors by noting: 'You can't get much more deferential and obsequious' (*New York Times*, 8 May 2002, p. C7). Why does a seventy-year-old director act in a 'deferential and obsequious' manner toward a forty-year-old financial executive from Enron, whose financial transactions the director is supposed to be monitoring?

A report published regularly by the Stanford Graduate School of Business makes available information on donations to the school. Roughly 50 per cent of the Business School's expenditures are covered by sponsors. These include, for example, Hewlett, Packard (Foundations) and Pfizer, which have each donated more than \$500,000 and are labeled as 'principal investors'. Goldman and Sachs, Intel, Charles Schwab, and several other companies have donated between \$100,000 and \$499,999. This is followed by a long list of 'lead investors' that have each donated between \$50,000 and \$99,999 and include such firms as Eli Lilly,⁴⁴ Morgan Stanley Dean Witter, and Sun Microsystems. The Business School has 52 'endowed professorships', meaning professors whose positions are financed completely or partially by sponsors for a limited period. 'As dean, Jaedicke became a champion fundraiser. Under his leadership the School received 13 endowed professorships, including the Philip H. Knight deanship, which Jaedicke was first to hold.'⁴⁵

It is *not* being asserted here that the sponsors 'paid' Robert K. Jaedicke to neglect his responsibility as an Enron director to closely examine the company balance sheet. Such an assertion would be absurd. However, the Business School is dependent on corporate donations. If a portion of the sponsors were to cease or even reduce their donations, the Business School (**here starts p. 179**) would no longer be able to function fully. We call this the *colonization* of the scientific system by business. The former dean was well aware of these facts, and they acted like an automatic censor in his head. Jaedicke was forced to think twice about being critical of business practices while sitting on the board of directors at Enron.

Jaedicke was aware that management always knows a great deal more than the directors (information asymmetries).⁴⁶ Outspoken criticism of 'creative accounting' can backfire should it be proven later that such criticism

⁴⁴ Kenneth L. Lay had a seat on the Board of Directors of Eli Lilly.

⁴⁵ Source: Stanford University Graduate School of Business, *Report to Investors* (several years); www.gsb.stanford.edu/news/faqs.html#financials; <http://gobi.stanford.edu/facultybios/bio.asp?ID=187>. The endowed deanship was established in 1985 by Philip H. Knight (MBA '62), president of Nike Corporation.

was unfounded. When information is not fully available, it is risky to criticize a management whose strategies were praised by a Harvard professor as recently as mid-2001 for being the 'hotbed of entrepreneurial activity and an engine of growth' (*Business Week*, 17 December 2001, p. 34). For a seventy-year-old professor emeritus, it no longer pays off to take great risks at that point. Faced with the choice between the 'voice' option and the 'keep quiet' option, he chose the latter. This was all Enron's managers expected from him.

Corruption has become subtle. Senator Levin, who strongly attacked the Enron directors during the hearings,⁴⁷ overlooks the constellation of interests and the dependency that limited the perception and critical faculties of Robert Jaedicke.

In 1874, Collis P. Huntington, the president of Southern Pacific Railways, could bribe the members of the US Congress with a check for \$200,000 and thereby hope that Congress would pass a law benefiting his railway (see below). In 2001, a (clever) company no longer chooses this path. Energy corporations do not bribe elected officials directly in order to block environmental legislation. Instead, they sponsor the research of climatologists who come to the conclusion that global warming is not taking place.

Companies finance universities and research centers and hope that the professors, who are then appointed to the board of directors, will be 'deferential and obsequious' in their behavior. Dr Charles LeMaistre, the former president of the M. D. Anderson Cancer Center (Houston, Texas) was chairman of Enron's Compensation and Management Development Committee for almost seventeen years. When he was president of the M. D. Anderson Cancer Center, Enron donated \$600,000 to this Center (*Wall Street Journal*, 25 September 2002, p. C12). *Honi soit qui mal y pense!*

(here starts p. 180) The composition of the board of directors at Enron also indicates another reason why none of the directors chose to exercise the 'voice' option. In 2001, Enron was one of the ten largest corporations in the United States. As a rule, the boards of directors at these extremely large companies are comprised of executives from other major enterprises and the

⁴⁶ In his testimony, R. Jaedicke repeatedly claimed that 'without full and accurate information, an Audit Committee cannot be effective' (Jaedicke 2002).

⁴⁷ 'You're the board. You're the captain of the ship that went down, and you're denying any responsibility. There were plenty of things you were told and that you knew which should have triggered much stronger action on your part' (*New York Times*, 8 May 2002, p. C7). It has to be taken into account that the Hearings are often used by US senators to enhance their own public relations profile. The statement that the board members are 'the captain of the ship' is nonsense. A director has to make sure that the executive managers meet their fiduciary duties.

banks.⁴⁸ Because they hold positions of *equal* rank, these top executives can be expected to possess the necessary authority and critical judgment. It is therefore striking to find that not one of the directors on the board at Enron was from a firm among Standard and Poor's top-500 rankings or from one of the major banks. This offers another explanation why the Board never posed any (critical) questions to management: 'An unquestioning Board of Directors did nothing' (Committee on Energy and Commerce 2002: Part 3).

In summary, it can be said that corporate governance failed in the case of Enron. There are no institutions in American firms that can protect employees when they attempt to defend themselves against (criminal) manipulation. Even the board of directors failed in the Enron case. In selecting the board members, Enron obviously chose people from whom the company expected little resistance.

In the next section, we will explain in greater detail the colonization of the *political* system by business.

The Opportunity Structure for Corruption: A Market for Law

Collis P. Huntington and David D. Colton were co-owners of the Southern Pacific Railways. In 1874, Huntington wrote to Colton:

Friend Colton: Scott is prepared to pay, or promises to pay, a large amount of money to pass his bill, but I do not think he can pass it, although I think this coming session of Congress will be composed of the hungriest set of men that ever got together . . . I believe with \$200,000 I can pass our bill, but I take it that it is not worth that much to us. (Quoted from Perrow 2002: 146–7)

Thomas Scott was president of the Pennsylvania Railroad, and we can describe the relationship between Scott and Huntington as 'competitors in corruption': 'In a market for special interest legislation, legislation is "sold" by legislators and "bought" by winning coalitions that outbid their rival seekers' (Butler 1985: 130).

In a study on donation practices and lobbying by US firms, Ansolabehere et al. (2002) pose the provocative question: 'Why is there so little money in U.S. politics?' The authors discovered that in 2000 the energy industry only donated \$34m to political candidates and parties, while the Department of Energy distributed more than \$1.7bn in subsidies to energy

⁴⁸ Cf. Windolf (2002: 32–3): Interlocking directorates of the 480 largest US firms in 1997 (Tables 2.1 and 2.2).

(here starts p. 181) companies that year. Thus, a relatively minor investment of capital leads to enormously high rates of profit in the 'market for special interest legislation'. From these findings, the authors conclude that 'exceptionally high average rates of return . . . imply that more firms and industries should enter the political marketplace' (Ansolabehere et al. 2002: 3).

The point here is not to criticize the authors' *data* but the *terms* they use in analyzing the political system. If political institutions are understood to be a 'market for special interest legislation' and elected officials are depicted as the 'salespeople of legislation', the choice of terms makes it appear that the difference between politics and economics does not play a role in this analysis. In this vein, politics is nothing more than a market in which specific commodities (legislation) are offered. This type of 'economic' institutional analysis reduces institutions to strictly market operations.

North (1990) maintains that markets cannot function without institutions. This argument makes sense only if there is a *difference* between the markets and institutions. If this difference is obliterated, what is left is a market that functions as the energy market did in California in 2000.⁴⁹

Corruption has been defined as an exchange between systems that violates the specific code of a system. The practice of selling laws in exchange for money from special interests violates the code of the political system and obliterates the difference between politics and economics. It is questionable whether corruption can be defined at all within the terminological apparatus used by Ansolabehere et al. (2002) in their analysis. It appears as if money is a legitimate medium of exchange in *all* social systems.

Special interest legislation not only violates the code of the political system, it also confronts the courts with a difficult problem: when these laws are later 'interpreted' in judicial rulings, the courts must stick to the wording of the law (in which, as a rule, the 'intention' of the legislators cannot be discerned). 'It is often beyond the capacity of the courts to delve into the legislatures' actual motives when construing pure special interest group legislation' (Macey 1984: 3). Since the courts are not in a position to reconstruct the history of corruption behind the genesis of the law, they are often forced to legitimize special interest legislation in the rulings they hand down.

In conclusion, it can be said that the concept of a 'market for law' violates the fundamental contractual principles of state: 'the rules of order are,

⁴⁹ 'Fat boy', 'death star', and 'get shorty' were the nicknames that Enron traders gave the complex trading strategies they employed (*New York Times*, 8 May 2002, p. C1). Dynegy (one of the largest US energy traders) was also engaging in 'round-trip trades'. On 24 September 2002, it agreed to pay \$3m to settle the accusations of the SEC. The accounting firm for Dynegy was *Arthur Andersen* (*New York Times* 25 September 2002, p. C5).

and must be, selected at a different level and via a different process than the decisions made within those rules . . . ’ (Buchanan 1977: 11). Buchanan (**here starts p. 182**) selects the terms ‘different level’ and ‘different process’ in order to distinguish between politics and economics. In the context discussed here, this passage can be interpreted as a defense of the autonomy of the legal and political system.

Dworkin (1986: 176, 225) makes a similar argument when he emphasizes *integrity* and autonomy as important prerequisites for the ability of the legal system to function:

We have two principles of political integrity: a legislative principle, which asks lawmakers to try to make the total set of laws morally coherent, and an adjudicative principle, which instructs that the law be seen as coherent in that way, so far as possible. . . . According to law as integrity, propositions of law are true if they figure in or follow from the principles of justice, fairness, and procedural due process.

The External Effects of Fraud

Williamson (1985) argues that rational actors do not pursue their interests in the market solely with legal means, but that they also use fraud and guile to pursue their ends when the opportunity arises. Therefore, special institutional and contractual regulations are necessary to protect market actors from fraud and breaches of contract.

Williamson (1985: 64) does *not* assume that *all* market actors are unprincipled opportunists and cheaters: ‘To the contrary, I merely assume that some individuals are opportunistic some of the time and that differential trustworthiness is rarely transparent *ex ante*. As a consequence, *ex ante* screening efforts are made and *ex post* safeguards are created.’

A similar argument was made in connection with the Enron case, namely, that the vast majority of American firms and executive managers are law-abiding. They don’t cheat, they pay their debts, and they fulfill their contractual obligations. The problem lies in an information asymmetry: we do not know *ex ante* which companies breach their contracts and which do not or which use other fraudulent methods and which do not. (Only the cheaters know for sure . . .)

Following the bankruptcy of Enron, the US Congress passed laws with amazing speed to prevent the falsification of balance sheets and fraud in the future. For instance, the Sarbanes-Oxley Act (2002) established a ‘Public

Company Accounting Oversight Board' that is to supervise accounting firms in the future. Section 101 states:

The Board will have five financially-literate members, appointed for five-year terms. Two of the members must be or have been certified public accountants, and the remaining three must not be and cannot have been CPAs [Certified Public (*here starts p. 183*) Accountants]. The Chair may be held by one of the CPA members, provided that he or she has not been engaged as a practicing CPA for five years. The Board's members will serve on a full-time basis.⁵⁰

Additional measures included in this law stipulate that thenceforth every company must change its external accounting firm every five years, that CEOs must add their signatures in authorizing the financial statements of the company, and so on. It was argued that these laws will make the financial markets more efficient in the future. Here it is argued, however, that most of these laws will raise the transaction costs of the financial markets. This point can be illustrated by the following.

Every year, several hundred million passengers are scanned, searched, and interrogated at airports. Here too exists a problem of an extreme information asymmetry. In order to identify (or deter) a dozen individuals who are willing and able to commit a terrorist act, millions of passengers must be searched. We know that these measures are necessary, but it is not very reasonable to maintain that they increase the 'efficiency' of air travel.

The (negative) external effects of fraud and corruption can now be more precisely defined: these are the 'ex ante screenings'⁵¹ and 'ex post safeguards' that are growing in number. The increasing mass of laws, regulations, authorities, and guards incurs transaction costs that are far greater than the immediate damage done by the criminals and defrauders.

The Oversight Board is one example of the 'bureaucratic vicious circle' that Crozier (1963) describes in an analysis of French bureaucracy. When rules are broken, orders disobeyed, and instructions ignored in large organizations, *new* rules and monitoring agents are introduced in order to limit the 'degree of freedom' of the organization's members. The Oversight Board itself, for example, will be monitored by the Securities and Exchange Commission (SEC), thereby creating the following bureaucratic chain of

⁵⁰ The Oversight Board will be financed by assessments on accounting firms and public companies.

⁵¹ The following report illustrates this point: 'The nation's major corporations, facing a tide of public suspicion and investor mistrust, are responding by vetting candidates for top positions as never before, looking into all aspects of their professional and private lives with an intensity usually reserved for major criminal investigations' (*New York Times*, 19 August 2002, p. A1).

supervision: SEC ———> Oversight Board ———> accounting firm ———> (say) Enron. The basic principle behind the measures is to police the police of the police.

Crozier goes on to show that the actors then develop new strategies to circumvent the new rules or to make them ineffective. This, in turn, leads to even more new rules. However, social behavior cannot be controlled completely through rules and regulations. However strict or tight the rules become, there always remains a degree of freedom to make strategic (*here starts p. 184*) decisions (opportunity structure for fraud).⁵² All that is certain is that these regulations will increase the transaction costs of the financial markets.

Obviously, the *intention* of the five-year-rotation rule is to prevent accounting firms from identifying their interests too closely with those of the company they are auditing, that is, to prevent conspiracy between the two. The *unintended consequence* of this rule could become a greater mistrust in the financial markets and possibly a greater risk of fraud. Why? As pointed out above, ‘tacit knowledge’ is gained through direct social relationships. Such knowledge is often important in judging the trustworthiness and reliability of a contractual partner. It is unlikely, however, that from now on accounting firms will incur the costs needed to attain such tacit knowledge about their clients when they know that this knowledge will be worthless in five years at most.⁵³

Conclusions

Fraudulent bankruptcies are almost always the outcome of irresponsible individual decisions, if not criminal behavior. In the case of Enron, a relatively small group of top managers pushed the law to its limit and, in many cases, acted beyond this limit. Nevertheless, the analysis of ‘push’ and ‘pull factors’ and the description of the opportunity structure for fraud presented above has shown that Enron’s managers developed their strategies within the framework of a particular institutional structure and that their strategies could not have been successful without the support of this institutional framework. Enron is an example not only of individual failure, but also—and perhaps even more

⁵² Cf. Largay (2002: 154): ‘I doubt there is a group of standard setters on this earth that can enumerate enough rules to contain those who are intent on circumventing full and fair disclosure.’ James A. Largay III has been the Arthur Andersen & Co. Alumni Professor of Accounting at Lehigh University since 1982. (It must be hard these days to be an Arthur Andersen & Co. Alumni Professor.)

⁵³ The unintended consequence of the signatures (that the CEOs must add in authorizing the financial statements of their companies) will probably be an increase in the premium of the professional liability insurance (which is paid by the company). Cf. C. Parsons (2001).

so—of *institutional* failure. In this concluding section, two questions will be asked. Was Enron so different? How can we interpret the results from a comparative perspective (the varieties-of-capitalism debate)?

Was Enron So Different?

Arthur Andersen compiled a 'risk profile' for 2,500 of its clients. Fifty of these were classified as 'maximum-risk' enterprises, including Enron, and 700 as 'high-risk' ones. This relatively large sample of US corporations enables us to draw the following conclusion. Andersen suspected that 30 per cent (**here starts p. 185**) of its clients belonged to the category of firms which Marshall Field would have characterized as 'not safe'. Enron was only one of many companies that pushed the law to its limits.

Agnew Fastow is considered to be the 'villain' in the Enron drama. It seems that he only 'adjusted' strategies and financial techniques that he learned at the Business School at Northwestern University (which were characterized as a 'hotbed of entrepreneurial activity and an engine of growth') to a 'new territory'. A quick glance at the educational background of the top Enron managers indicates that they were not a small group of desperados but a highly educated team of young professionals, similar to those found in other businesses.

The energy transactions that Enron conducted transgressed the borders of legality (for example, energy from California was exported to Oregon and then re-imported an hour later). However, Enron was not the only company to earn billions in dubious energy transactions. Dynegy (one of the largest US energy traders) was also engaging in such 'round-trip trades'.

In 2000, Kenneth Lay earned about \$140m. This is nothing unusual for a CEO in the United States. The total personal income of John Reed (Citigroup) equaled \$293m. Charles Wang (Computer Associates) earned in the three years between 1998 and 2000 roughly \$682.2m, even though the share price of this company plummeted by 63 per cent during this period. The value of the stock options owned but not yet exercised by Lawrence Ellison (Oracle) was estimated to be \$3.4bn (*Business Week* 16 April 2001, pp. 77–9). Kenneth Lay does not appear to have been unusually greedy compared with his fellow CEOs.

Varieties of Capitalism

Institutional structures vary between countries and, therefore, the opportunity structure for fraud and corruption varies between them. The question to be addressed here is *not* whether a bankruptcy like Enron could have happened

in other countries but whether such cases occur *more frequently* in the United States than in countries with a higher level of market regulation.⁵⁴

Chandler (1990) distinguishes different types of capitalism. The United States is an example of what he calls 'competitive capitalism' while Germany is an example of 'cooperative capitalism'. We believe that the former type can be characterized by Schumpeter's notion of 'creative destruction' while (**here starts p. 186**) the latter type is an example of a coordinated market economy in which a strong institutional structure limits the excesses of pure market competition.

For Schumpeter (1942) the 'spirit' of capitalism lies in the process of 'creative destruction': again and again, that which has just been created is destroyed through market competition. This does not apply to material commodities and production plants alone, but also to institutions and cultural creations. Technical innovations not only create new markets for entrepreneurs but also destroy the income opportunities linked to obsolescent technologies. The many hostile takeovers which restructured the corporate economy of the United States during the 1980s are a prominent example of creative destruction.

Hall and Soskice (2001: 38–9) make a distinction between radical and incremental innovation. Radical innovation 'entails substantial shifts in product lines, the development of entirely new goods, or major changes to the production process', while 'incremental innovation [is] marked by continuous but small-scale improvements to existing product lines and production processes'. Radical innovations are very hard to implement in highly institutionalized markets; they are more successfully introduced into 'liberal market economies', that is, in those countries that have a low level of market regulation. Radical innovations—a notion almost synonymous with creative destruction—are particularly important in fast-moving technology sectors with short-term product cycles.

The history of Enron illustrates a process of creative destruction. The corporation was undoubtedly an innovator in the deregulated energy market. It created new forms of energy trade that have since been adapted to other economic sectors. Only a few years later, though, the company crumbled in a process of criminal destruction.

It was argued above that the *irrational* compulsion of greed is controlled by the institutions of capitalism and is transformed into the *rational* pursuit of gains. The 'spirit of capitalism' expresses itself in the tempered pursuit of profit

⁵⁴ The following example illustrates the point: 'The incarceration rate in the United States in 2000 was 686 per 100,000 population, compared with rates of 105 in Canada, 95 in Germany, and only 45 in Japan' (Uggen and Manza 2002: 778). The question to be answered is not whether there is a country with a zero-crime-rate but why the incarceration rate in the US is about fifteen times higher than in Japan.

within the framework of continuous, rational, capitalist enterprise. If we reinterpret Weber's 'spirit of capitalism' from a comparative perspective, it seems that the puritan ethic can provide only part of the explanation. Perhaps as important is the 'force of traditions' embodied in the institutions of different countries which limit the excesses of creative destruction and of pure market competition.⁵⁵

We complete this conclusion with two observations. First, the less market competition is restrained by institutions—that is, the more economic exchanges are coordinated by pure market competition—the more opportunities there are for the implementation of radical innovations and processes of creative destruction. Yet the comparative advantages of one economic (*here starts p. 187*) system have to be weighed against its specific transaction costs. Enron illustrates the transaction costs of an economic system in which radical innovations do not encounter much resistance. Stagnation and a low level of innovation exemplify the transaction costs of an alternative form of economic organization that Hall and Soskice (2001: 38) have termed the 'coordinated market economy'.

Second, Lindblom (2001) points to the relationship between economic and political institutions. The more economic exchanges are coordinated by the market, the larger, *ceteris paribus*, social inequality is. He argues that extreme forms of social inequality threaten political democracy and prevent citizens from effectively controlling political and economic elites. 'If genuine democracy requires at least a rough equality of political influence or power among citizens in their attempts to control elites, then any significant economic inequality among citizens is an obstruction to democracy' (2001: 236). The side payments made by Enron to political representatives are not only to be condemned as 'corruption' but also as an 'obstruction to democracy'.

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⁵⁵ A more detailed picture of differences in the traditions and institutions of various countries is given in *The Three Worlds of Welfare Capitalism* (Esping-Anderson 1990).

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