THE ETHICS OF BUSINESS DECISION-MAKING

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Thank you, Linda, and thanks for getting us all together to share our views of the stunning events of recent years and to see what we can learn from them.

I've thought a lot about how best to add the ethical thread to the tapestry we'll weave this afternoon.

I've decided to present the testimony of two people who took a course from me twenty years ago and now bear witness to the recent era of corporate boom and scandal.

First, a word about the ethics course they took in the 1980s, early in the growth of applied ethics offerings in medicine, law, management, and other disciplines—usually co-taught by faculty from the professional field and colleagues in philosophy and religion. My course invited students to explore ethical theory and other literature while tackling real cases, focusing especially on moral dilemmas. The course also challenged students to sharpen their skills of analysis, imagination, and empathy. Students came to distinguish and choose between Utilitarianism and the daunting demand of Immanuel Kant to obey moral laws and duties (keep promises, obey the law, don't lie, cheat or steal). We also probed the theory of social justice so famously but opaquely set forth by John Rawls.[1] Students learned to measure their recommendations for action against the question, "How would that look in the fresh public air of the front page of tomorrow morning's *New York Times*?"

I have distilled this report from the testimony of two people. They can't be here, but they know I am going to speak for them, and they have given me license to disguise their identity and create for you in my own way the essence of their thoughts in this account. Here goes . . . in the melded or intertwined voice of two former students.

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Let me tell you what I see, Professor, as I look around at the corporate train wrecks of recent years:

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1. *See generally* JOHN RAWLS, A THEORY OF JUSTICE (1971).

- Some few people committed crimes. They lied, cheated, defrauded, and in doing so broke the moral laws of all societies. Dennis Kozlowski of Tyco may be one of the clearest examples, or those executives from Adelphia.[2] Criminals. White-collar criminals. Their crimes belong on the same dark page of the history book as those involved in the Olympic scandals, priests who molested children, scoundrels in all walks of life . . . even in academia . . . and in all countries. When we are talking about crime, I have no doubt about ethics and my understanding of limits I welcome the criminal indictment of our Chief Financial Officer (CFO) at Enron, Andrew Fastow.[3] More about him later.

- Some people in powerful positions in systems containing unusual incentives and distortions behaved in risky, selfish ways that did much harm. They invented their own rules, hurt many people, and destroyed some companies. Some did it with their eyes open. They obviously tried to game the system to their own advantage, no matter who else was hurt. Such jungle fighters are surely unethical, morally, if not criminally, culpable. They are visible in the recent history of Enron . . . in high places and among abetting professionals in law, accounting, consulting, and investment banking.

- Some people who served in roles of overall control and trust (boards of directors, the accounting profession, the SEC, and others) responded to parts of the total situation but not the whole and, in retrospect, seemed either distracted or seduced by the overall amazing economic boom of which they were a beneficiary.

- Some played their parts in the larger corporate dramas, well-intentioned folks doing their jobs and feeling ethical about it and believing that smart people in pivotal positions were steering the whole ship in wise and effective ways. They are by far the largest group, and I number myself among them. Let me explain. I need to bear witness.

My career with Enron was (yes, *was*) enormously gratifying and exciting. A great company. It did amazing things around the world.

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2. UNITED STATES SECURITIES AND EXCHANGE COMM., SEC Sues Former Tyco CEO Kozlowski, Two Others for Fraud (2002), *available at* http://www www.sec.gov/news/press/2002-135.htm (last visited Aug. 30, 2003).

3. CNN/MONEY, Ex-Enron exec charged (Oct. 2, 2002), *available at* http://money.cnn.com/2002/10/02/news/companies/fastow.

Redefined the standard for performance in the world of energy. Praise came from all sides. I found the experience heady and often inspiriting. Over a short fifteen-year period, we grew very fast from an asset-based pipeline and power generation business to the top tier of the world's corporations, during a time of transformation of the world's energy markets and the development of the Internet.[4] Our Chairman wrote in our 2000 Annual Report that we see a $3.9 *TRILLION* opportunity for Enron in present markets . . . and new markets (forest products, metals, steel, coal, and air emission credits) that add to a total market opportunity of $4.7 *TRILLION*.[5] Total return to shareholders in 2000 was 89%, while the S&P was negative 9%, and the ten-year return to Enron shareholders was 1,415%, compared to 383% for the S&P 500.[6] There was a thrilling feeling of pride and invincibility that made ethical questions more difficult to ask and to understand.

That profile of Enron in the July 22, 2002 *New Yorker* was pretty accurate. We were indeed "a celebration of talent."[7] Young executives were given their heads, awarded fast, merit-based promotions, and remunerated beyond their dreams. A culture of the "best and the brightest." (*Where have I heard that phrase before?*) And that's the way Enron aggressively recruited in MBA Programs, too. All of that in the climate of the greatest economic expansion and rising tide for everyone in this, the world's most powerful country, destined to bring democracy, justice, and a higher standard of living around the globe. It was easy to be proudly complacent, and anyway I was too busy to think critically beyond my own areas of heady and daunting responsibility. I was proud of our Corporate Code of Ethics too. Have you seen it? Sixty-four pages.[8] We all signed off on it. A great credit to our superb legal division.

And so, I missed some crucial happenings and factors, some huge icebergs in the fog ahead. So did almost everyone else. Let me try to describe them in retrospect.

First, there was the resurgent stock market and its insatiable demand for earnings, earnings, earnings. That produced the ethical error of letting

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4. Among other things Enron became the world's largest web-based E-commerce system. *Enron timeline Jan. 17, 2002*, HOUSTON CHRONICLE.COM, *available at* http://www.chron.com/cs/CDA/story.hts/special/enron/1127125 (last visited Aug. 30, 2003).

5. Enron Annual Report 2000, at 5, *available at* http://www.enron.com/corp/investors/annuals/2000/shareholder_sr.html (last visited Aug. 30, 2003).

6. *Id.* at 4.

7. Malcom Gladwell, *The Talent Myth: Are Smart People Overrated*, THE NEW YORKER July 22, 2002.

8. Kris Axtman & Ron Scherer, *Enron Lapses and Corporate Ethics*, CHRISTIAN SCI. MONITOR Feb. 4, 2002, *available at* http://www.csmonitor.com/2002/0204/p01s01-ussc.html.

the end justify the means. Our CFO was under enormous pressure to maintain our earnings growth and the rise in Enron's stock price, and he obviously cracked under that strain and did some unethical things. The way he surreptitiously moved those partnerships off the Enron books and helped himself and his friends to chunks of Enron assets was blatantly unethical, compounded by his attempt to disguise what happened as if it were a legitimate sale of assets.[9] No doubt he rationalized that he was being wisely utilitarian and that rising tides would cover his immoral behavior.

I must cite the incredible compensation explosion, making lots of people in Enron rich beyond anyone's wildest dream and turning their lives around in exciting, if sometimes wrenching ways. On reflection, I have come to see that the system of compensation was out of real control in many corporations, and I cringe when I read respected critics (some of them insiders) now use adjectives like "greedy," "obscene," and "outrageous" to describe some of the motives and results.[10] But we must face the startling facts, such as the news that the ratio of American executives' compensation to workers' pay mushroomed from 45 to 1 in 1973, to 140 to 1 in 1991, to 500 to 1 in 2000.[11]

I must add my grinding ambivalence about stock options. I know your September 27th panel will treat that issue in depth. I went along with the craze for options, as part of the New Age of infinite prosperity. After all, options were not an expense to the company and not taxable to the recipient at the time of receipt.[12] Even if a company's stock went south, no problem, options were repriced.[13] No one could lose. By 2000, half of my compensation was in the form of those magical options.

Enron Directors also received options.[14] Their annual remuneration rose from about $70,000 in 1988 to about $360,000 in 1999.[15] Ethical

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9. John Cassidy, *The Greed Cycle: How the Financial System Encouraged Corporations to Go Crazy*, THE NEW YORKER, Sept. 23, 2002, at 64.

10. *See* Greg, Ip, *The Economy: New York Fed President Chides CEOs on Hefty Compensation*, WALL ST. J., Sept. 12, 2002, at A2 (citing criticism of large growth in executive compensation by Federal Reserve Chairman Alan Greenspan and New York Federal Reserve Bank President William J. McDonough).

11. KEVIN PHILLIPS, WEALTH AND DEMOCRACY: A POLITICAL HISTORY OF THE AMERICAN RICH (2002).

12. David Cay Johnston, *The Markets: Fast Deadline on Options Repricing*, N.Y. TIMES, Dec. 8, 1998, at C12 (noting that stock options had "become and increasingly popular way to pay executives . . . because no expense is recorded on a company's annual profit-and-loss statement, yet the company gets an income tax deduction").

13. *Id.* (stating that as options became more popular so did the practice of repricing them when a stock price fell, with some companies repricing options "three, four or five times in recent years").

14. Leslie Wayne, *Enron's Collapse: Before Debacle, Enron Leaders Cashed in $1.1 Billion in Shares*, N.Y. TIMES, Jan 13, 2002, at A1.

15. THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE, S. REP. 107-70, at 11, 58–

matter? Yes, it has to be. Can you ethicists work out a definition of obscenity in compensation? Does it come from the lexicon of envy? Or is there a way of defining pay as so excessive that it loses its proportionality, cheats the shareholders and other suppliers of capital and robs other legitimate stakeholders in the revenue/cost balance as well as corrupts the recipient?

Was Oscar Wilde describing (in his wry way) a basic feature of the human condition when he wrote, in *Lady Windermere's Fan*, "I can resist everything except temptation"?[16]

Do you remember, Professor, the quote you read us in the final class of our ethics course? It comes back to me when I find myself cataloguing human foibles. T.S Eliot's *Murder in the Cathedral* etched the battle between Henry II and Thomas Becket, Archbishop of Canterbury, nine centuries ago.[17] Becket's Tempters invited his capitulation, and Thomas responded with these lines: "The last temptation is the greatest treason/To do the right deed for the wrong reason."[18]

The actions and inactions of the accounting profession, for which I have always had high respect. How did their professional ethical code break down? Was it unethical for firms to operate with that conflict of interest so obviously built into the combination of audit, tax, and consulting? Looking back, the answer is, "Yes." Why wasn't it fixed? Firms arrogantly insisted they had firewalls between divisions and had no ethical problem.[19] Congress debated the matter and agreed not to change the rules, amidst the eloquent lobbying of the accounting profession.[20] (Somehow in the case study you should write about this whole complicated drama, and the ethical issues in campaign financing and Congressional behavior need to be included.) In our Enron case, the failure of Arthur Andersen to behave ethically and responsibly became a professional tragedy. At Enron, we were a very important client indeed, and they had made the journey to greatness with us, with bold risks. But then they co-conspired, as far as I can see it, with our feckless CFO, who, under relentless pressure to report expected earnings, engaged in elaborate, criminal deceits that Arthur Andersen had to understand and unethically

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59 (July 8, 2002), *available at* http://news.findlaw.com/hdocs/docs/enron/senpsi70802rpt.pdf.

16. OSCAR WILDE, LADY WINDERMERE'S FAN 12 (Publishers Ltd. 1999) (1892).

17. T.S. ELIOT, MURDER IN THE CATHEDRAL (1935).

18. *Id.* at 44.

19. See David S. Hilzendrath, *Doing a Number on Reforms; Accountants Thwarted Change With Lobbying, Stall-and-Study Tactics*, WASHINGTON POST, Jan. 24, 2002, at E01 (noting that the accounting industry effectively forestalled serious reforms in Congress by exercising political clout and adoption a "plethora of small changes in the industry's system of self-regulation").

20. *Id.*

permit, hoping along with the CFO that continued dramatic growth would conceal all they were doing.

Where was the legal profession, legal counsel? Swept along the surging stream of success and famous profits? How about the Andersen lawyer who purportedly advised the shredding of critical documents?![21] Can't we depend on the legal community to remind us of the rights of stakeholders and the overall ethical need for transparency to shareholders, to Wall Street, and to the wider public?

The Enron Board of Directors, strong and admirable people, far from the stale stereotype of the CEO's friends and cronies, far from that. Independent directors of high esteem. But they blew it. Why? What is the ethical report on the Board? Read the lengthy testimony of Robert Jaedicke, Accounting Professor and former Dean of Stanford Business School, in the Congressional hearing.[22] The essence of his sad witness is that he and his Audit Committee were not informed, were kept in the dark by the conspiring CFO (and almost certainly his CEO boss) and by Arthur Andersen, and even by the estimable McKinsey consulting firm, some of whose partners and principals were omnipresent in Enron.[23] So, tell me, Professor, does ignorance trump ethical responsibility? Surely not. How are we going to fix what's broken in corporate governance, now that the Enron explosion has lit the analytical sky?

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At this point, I asked my former students to tell me what advice they have for professional schools of business and law.

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You know what I respectfully ask the academic community to do? Forgive my boldness, but my Enron training has made me prefer candor to modesty! First, you must write the Enron Case, and of course other such cases, recording the facts, the total situation, as thoroughly and expertly as possible. It won't be one case or even one book. Then, help us to look carefully at all the steps taken so quickly this year by Congress, the SEC, and other regulators as a result of the splashy explosion of the scandal and

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21. Mary Mullally, *The Killer E-Mail*, LEGAL WEEK, June 27, 2002.

22. *The Role of the Board of Directors in Enron's Collapse: Hearing Before the Permanent Subcomm. on Investigations, Senate Comm. on Governmental Affairs*, 107th Cong. (2002) (statement of Dr. Robert K. Jaedicke, former Chairman of the Audit Committee of the Board of Directors of Enron Corp.) available at http://www.senate.gov/~gov_affirs/050702jaedicke.htm (last visited Aug. 30, 2003).

23. *Id.*

the clearing of the path for excellent reforms that were surely long overdue (and had been talked about for decades, in some cases). Are these sound corrections and will they make an enduring difference? Won't there be countervailing developments? And then, expand your focus, gather colleagues from other disciplines, look at other countries, and tell the rest of us how (and if) democratic market capitalism can play a constructive role in making the world in the twenty-first century a better place to live.

In class, you told us we could benefit from rereading Adam Smith, famed Professor of Moral Philosophy at the University of Glasgow and intellectual architect of capitalism.[24] You pointed out that before he wrote *Wealth of Nations*[25], Smith said in *The Theory of Moral Sentiments*, "And hence it is, that to feel much for others and little for ourselves, that to restrain our selfish, and to indulge our benevolent affections, constitutes the perfection of human nature."[26]

24. CAMBRIDGE BIOGRAPHICAL DICTIONARY 1360–61 (1990).

25. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (Edwin Cannan ed., Univ. of Chicago Press 1976) (1776).

26. ADAM SMITH, THE THEORY OF MORAL SENTIMENTS 30 (Published by Anthony Finley 1817) (1759).