CORPORATE GOVERNANCE PRACTICES IN EUROPE: ANTIDOTE TO ENRON?

Karin S. Thorburn*

INTRODUCTION

The collapse of Enron uncovered fundamental deficiencies in the governance practices of U.S. corporations. This paper discusses whether corporate governance systems in the United Kingdom and Germany suffer from similar weaknesses. The discussion focuses in particular on accounting practices, board effectiveness, and executive compensation.

U.K. accounting rules place greater demands on companies to consolidate off-balance sheet liabilities. Such consolidation would have made Enron's problems more transparent to the board and outside investors. Mandatory consolidation also mitigates problems with lack of auditor independence. Such problems were common in both the United Kingdom and the United States prior to the recent legislative reforms.

In Germany, the supervisory boards of large corporations are to a great extent controlled by banks and employees. Since these constituencies have fixed claims on firms' future cash flow, they tend to favor a low-risk investment strategy. It is possible that such boards would have rejected Enron's highly leveraged investment strategy. On the other hand, boards favoring low-risk investment strategies also risk passing up valuable business opportunities that are key to corporate profitability and growth.

Finally, much has been said about the potential pitfalls of high-powered executive compensation packages (stock-options and bonus) in the United States. It is true that executive compensation in Europe generally provides lower incentives to take risks. This may alleviate some concerns with excessive managerial focus on short-term earnings and stock price development. On the other hand, there is also a risk that the structure of European executive compensation packages provides too few incentives to maximize shareholder wealth.

The discussion begins with a basic characterization of a corporate governance system, then proceeds with an overview of central corporate governance practices in the United Kingdom and Germany and how they differ from those in the United States. This discussion provides a basis for evaluating some of the key governance reason for the collapse of Enron, discussed in Part III along with an analysis of whether governance practices

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* Associate Professor of Business Administration and Associate Director, Center for Corporate Governance, Tuck School of Business, Dartmouth College; PhD 1998, Stockholm School of Economics; BEc 1987, Stockholm School of Economics. This paper is an expansion of the author's remarks at Vermont Law School's Corporate Responsibility Symposium held on September 27, 2002.

in Europe are likely to provide an effective and/or desirable antidote to cases like Enron. Finally, Part IV reviews some of the recent reform initiatives in the United States and in Europe.

I. CORPORATE GOVERNANCE AND INVESTOR PROTECTION

It is well known that outside investors in large corporations find it too costly to closely monitor management. The resulting separation of ownership and control gives rise to an agency problem that Adam Smith recognized more than two centuries ago.

> The directors of [joint stock] companies, however, being managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance [as owners] . . . . Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.[1]

The problem for outside investors is that managers have access to sophisticated expropriation techniques. For example, they may sell the firm's output or assets at below-market prices to another company in which they are beneficial owners, dilute shareholder rights through targeted security issues, or receive excessive compensation.[2]

Moreover, outside investors are generally more vulnerable to expropriation practices than are other stakeholders. The reason is that management continuously develops personal relationships with employees, customers, and suppliers. This is in contrast to outside investors, who remain useful to the company only at the few discrete points in time when the company needs outside capital. For this reason, the focus of corporate governance is fundamentally on investor protection. At the most basic level, the key governance question concerns how outside investors can make sure that corporate insiders maximize firm value and return profits to investors. A corporate governance system is the collective set of forces constraining the incentives and opportunities of corporate insiders to expropriate outside investors.

Countries with developed capital markets offer investor protection through an elaborate system of corporate, bankruptcy, securities, and

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1. ADAM SMITH, AN INQUIRY INTO THE CAUSES AND NATURE OF THE WEALTH OF NATIONS 264–65 (Edwin Cannan ed., Univ. Chi. Press 1976) (1776).

2. *See generally* Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997) (analyzing different models of corporate control and how managers can control investments).

takeover laws. Key shareholder rights include the right to receive pro-rata dividends, to appoint the firm's board of directors, and to vote on major corporate investment decisions such as mergers. However, voting rights associated with equity ownership may be expensive to exercise. For example, in some countries, proxy voting is ruled out, requiring shareholders to show up in person to vote.[3] Small, diversified stockholders quickly realize that attending shareholder meetings is not worth the effort (the free-rider problem).[4]

Because large owners have incentives to actively monitor management, concentrated ownership generally improves shareholder rights enforcement. Nevertheless, the interest of large shareholders may conflict with the interests of minority stockholders and creditors. Thus, the presence of a large shareholder is not an unqualified blessing for other outside investors.

Creditor rights include the power to seize collateral, to uphold the seniority of loans, and to force a bankruptcy proceeding when the company fails to service its debts. Since default on a debt contract is a straightforward event that can be verified in court, legal protection of creditors is typically more effective than that of shareholders. Creditor rights are governed primarily by bankruptcy and insolvency law and vary with the degree of control rights allocated to shareholders and management in formal reorganization procedures.[5]

Outside investors depend on reliable information about the firm's performance to enforce their rights. Disclosure and accounting rules provide for accuracy and depth of the firm's financial statements. To verify

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3. In many countries, including Japan, Germany, Italy, Spain, Netherlands, Sweden, Denmark, and Finland, the company law or commercial code does not allow shareholders to mail their proxy vote to the firm. Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1130–31 (1998).

4. Standard finance theory suggests that investors hold diversified portfolios. *See, e.g.*, HARRY M. MARKOWITZ, PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENTS (Yale Univ. Press 1970) (1959). A consequence of diversified holdings is that the investor has a relatively small dollar amount invested in each stock. As a result, it does not pay for these investors to incur expenses in order to monitor and evaluate how the firm is run. Such investors instead tend to free-ride on the monitoring efforts of large investors. Thus, if the firm does not have large investors in its ownership base, little monitoring will take place. For a recent survey of ownership structure, see Clifford G. Holderness, *A Survey of Blockholders and Corporate Control*, 9 FRBNY ECON. POL'Y REV. 51 (Apr. 2003), *available at* http://www.ny.frb.org/research/epr/03v09n1/0304hold.pdf (last visited Oct. 14, 2003).

5. For general discussions of creditor rights and bankruptcy law across countries, see Rafael La Porta & Florencio Lopez-de-Silanes, *Creditor Protection and Bankruptcy Law Reform*, *in* RESOLUTION OF FINANCIAL DISTRESS: AN INTERNATIONAL PERSPECTIVE ON THE DESIGN OF BANKRUPTCY LAWS 65-90 (Stijn Claessens et al. eds., 2001); Stijn Claessens & Leora F. Klapper, *Bankruptcy Around the World: Explanations of Its Relative Use* (2002) (World Bank Policy Research Working Paper 2865), *available at* http://wbln0018.worldbank.org/html/FinancialSectorWeb.nsf/(attachmentweb)/wps2865/$FILE/wps2865.pdf (last visited Nov. 11, 2003).

the accuracy of the financial reporting, listed companies are required to have their financial statements certified by an independent accountant.[6]

The enforcement of regulations and laws is just as important as their content. A first-rate governance system requires that regulators and courts, as well as market participants, strictly uphold laws and contracts. Thus, the legal and regulatory system complements the effectiveness of market forces in restricting expropriation of corporate insiders.

There are several important market forces that help reduce agency costs. For example, an active market for corporate control limits agency cost through the threat of managerial displacement in a hostile takeover. Also, a well-functioning managerial labor market disciplines top executives concerned with their future career opportunities. Moreover, firms requiring new outside capital must "dress up" for the capital market by presenting evidence of adequate internal control systems. There is a great variation across countries in terms of the effectiveness of these market forces

The corporate board is the most important internal control system. Research indicates that the best boards are relatively small, have independent directors, require financial literacy, and rely on stock-based compensation of directors.[7] Furthermore, an effective internal control system effectively aligns managerial and shareholder interests through stock-based executive compensation. Pay-for-performance schemes such as options and bonus plans also help alleviate agency costs and promote stock-market confidence.[8]

II. CORPORATE GOVERNANCE IN EUROPE

Europe represents a wide range of corporate governance practices. Countries such as France, Switzerland, Austria, Belgium, Hungary, and much of northern Europe evolved their governance systems along Roman-Germanic, rather than Anglo-American lines. The following comments are restricted to the corporate governance structures of the United Kingdom and Germany.

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6. In the United States, the Securities Act of 1933, 15 U.S.C. §§ 77(g) & 77aa, Schedule A, ¶ 25 (2000), and the Securities Exchange Act of 1934, 15 U.S.C. § 78m (2000), require an annual audit of the financial statements for firms issuing securities to the public.

7. For a survey on board composition, see, for example, Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, 9 FRBNY ECON. POL'Y REV. 7 (Apr. 2003), *available at* http://www.ny.frb.org/research/epr/03v09n1/0304herm.pdf (last visited Nov. 11, 2003).

8. For a review of the executive compensation literature, see Kevin J. Murphy, *Executive Compensation* 26–43 (1998) (working paper, Univ. So. Cal.), *available at* http://www.marshall.usc.edu/fbe/ wp_pdf/98-13.pdf (last visited Nov. 11, 2003).

A. The Anglo-American Governance System

1. Market Based (Contractarian) Financial System

The United States and the United Kingdom share the common-law legal tradition with its market-based (contractarian) corporate environment.[9] Market-based economies are characterized by highly developed public equity and debt markets. Banks play a relatively minor role in the financing of large firms. To illustrate, in 1999, the ratios of stock market capitalization to gross domestic product (GDP) was 225% in the United Kingdom and 152% in the United States, the highest such ratios in the world.[10] These market-based economies are also characterized by an active market for corporate control.

2. Shareholder and Creditor Rights

The Anglo-American system provides comparatively strong protection of shareholder rights, including proxy voting by mail and strong enforcement of insider trading rules.[11] In the United States, shareholders may sue directors for violations of fiduciary duty through class action.[12] Class action lawsuits help resolve the free-rider problem among dispersed shareholders. By coordinating actions and allocating costs across a dispersed group of shareholders, a class action represents a real threat to corporate insiders expropriating outside investors.

Creditors, and in particular secured lenders, are comparatively well protected in the United Kingdom. The U.K. insolvency procedures are strictly creditor-oriented.[13] This contrasts with the United States, where the Chapter 11 bankruptcy procedure provides extensive control rights to management.[14] The question of what constitutes the optimal bankruptcy

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9. *See* Michael Bradley et al., *The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads*, 62 LAW & CONTEMP. PROBS. 9, 35–40 (1999) (discussing the contractarian view of the firm). Other countries with an Anglo-American legal tradition include Canada, Australia, and New Zealand. *Id.* at 51.

10. Raghuram G. Rajan & Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the Twentieth Century*, 69 J. FIN. ECON. 5, 15 tbl. 3 (2003).

11. For further discussion of the legal protection of investor rights, see Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

12. FED. R. CIV. P. 23.1; *see generally* Yeon-Koo Che, *Equilibrium Formation of Class Action Suits*, 62 J. PUB. ECON. 339 (1996) (analyzing class action suits); Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233 (2002) (discussing the benefits as well as the limits in enforcing corporate law).

13. For a description of U.K. insolvency procedures, see Julian R. Franks et al., *A Comparison of US, UK, and German Insolvency Codes*, 25 FIN. MGMT. 86 (1996).

14. *See, e.g.*, Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747, 748–52 (1989) (discussing managerial control rights under Chapter 11 of

system in a market-based economy is, however, a largely unresolved issue.[15]

3. Equity Ownership Structure

While equity ownership is generally highly dispersed in both the United Kingdom and the United States, the distribution of share ownership differs. In the United Kingdom, institutions hold two-thirds of the equity in listed companies,[16] compared to nearly 50% institutional share ownership in the United States.[17] In the United Kingdom, institutional ownership is concentrated. The twenty-five largest institutions jointly own an equity majority in many firms, and geographical proximity facilitates coordination.[18] On the other hand, direct individual ownership of shares is much higher in the United States than in the United Kingdom.[19] In either system, institutional owners have taken a more active governance role over the past decade.

4. Board of Directors

In the Anglo-American tradition, the board's primary fiduciary responsibility is to its shareholders. In the United States, boards tend to have a majority of outside, non-executive directors. However, the chief executive officer (CEO) is typically chairman of the board. Since the chairman controls the board's agenda, this gives the CEO substantial power over U.S. boards. In contrast, while most U.K. boards have a non-executive chairman, they often have a majority of inside directors who are company officers.[20] "[O]nly 42 percent of all directors are outsiders, and 9 percent of the largest U.K. companies have no outside directors at all."[21] Depending on one's view of the importance of separating the roles of CEO and board

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the U.S. Bankruptcy Code).

15. For analyses of alternative bankruptcy systems, see B. Espen Eckbo & Karin S. Thorburn, *Control Benefits and CEO Discipline in Automatic Bankruptcy Auctions*, 69 J. FIN. ECON. 227 (2003); Karin S. Thorburn, *Bankruptcy Auctions: Costs, Debt Recovery, and Firm Survival*, 58 J. FIN. ECON. 337 (2000); B. Espen Eckbo & Karin S. Thorburn, *Overbidding vs. Fire-sales in Automatic Bankruptcy Auctions* (2002) (working paper, Dartmouth College).

16. ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 303 (1995).

17. Bradley et al., *supra* note 9, at 18.

18. *See* Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2002 (1994); Deborah A. DeMott, *The Figure in the Landscape: A Comparative Sketch of Directors' Self-Interested Transactions*, 62 LAW & CONTEMP. PROBS. 243, 247 (1999).

19. DeMott, *supra* note 18, at 247.

20. MONKS & MINOW, *supra* note 16, at 303.

21. *Id.*

chairmanship, one could argue that U.S. boards are likely to be more effective representatives of shareholders than boards in the United Kingdom.

Reflecting the different ownership and board structures, the legal principles for dealing with director conflict of interest differ somewhat across the two countries. The U.K. Companies Act requires shareholder approval of certain transactions that are well within the discretion of financially disinterested directors in the United States.[22] Shareholder approval is required for a range of transactions between the company and (a firm represented by) one of its directors. Such transactions include purchases and sales of assets, and defenses to hostile takeover bids.[23] The concentrated institutional ownership allows U.K. institutions to often exert their influence in private discussions with management prior to the shareholder vote.[24]

In the United States, a board has significant discretion over transactions where directors or company officers have a conflict of interest.[25] Specifically, the disinterested directors who lack a financial interest in the transaction can make decisions that bind the company.[26] As long as the disinterested directors act in good faith with due loyalty and care, the business judgment rule protects a board's decisions.[27] Thus, in the United States, shareholders appear to have fewer rights vis-à-vis the board than in the United Kingdom.

5. Executive Compensation

Executive compensation practices vary significantly across the two countries. In the United States, particularly since the mid 1990s, top executive compensation is largely stock based.[28] Executive pay in Europe generally is at a lower absolute level and contains less stock-based

22. DeMott, *supra* note 18, at 250–57 (contrasting the U.S. and U.K. laws dealing with transactions involving interested directors). DeMott notes that section 330 of Part X of the U.K. Companies Act 1985 prohibits certain transactions such as loans to directors. *Id.* at 252. Such transactions were under the board's discretion in the United States prior to the 2002 Sarbanes–Oxley Act. Sarbanes-Oxley Act of 2002 § 402, 15 U.S.C.S. 78m(k) (Supp. 2003).

23. Sections 320–322 of Part X of the Companies Act 1985 mandates shareholder approval for directors' purchases and sales of non-cash assets. DeMott, *supra* note 18, at 254. The City Code on Takeovers and Mergers requires shareholder approval for board actions that may obstruct an outstanding or imminent bid. *Id.* at 263 & n.95 (citing City Code, General Principle 7 & Rule 21).

24. *See supra* Part II.A.3.

25. DeMott, *supra* note 18, at 250–57, 262.

26. *Id.* at 251–53.

27. *Id.*

28. Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. & ECON. 3, 4 (2002).

incentives. Towers Perrin estimates that a CEO of a medium-sized U.K. industrial company in 2001 earned about one-third of a comparable U.S. CEO.[29] Moreover, fixed salary constituted 43% of a typical U.K. CEO's total compensation, while it only made up 28% of the compensation of a comparable U.S. CEO.[30]

6. Accounting Practices

Accounting standards are high in both countries, but differ somewhat in their emphasis. The U.K. system is principles-based.[31] That is, the auditor is required to issue an opinion confirming that the financial statements present a true and fair view of the company's state of affairs. This is in contrast to the rules-based U.S. system. In the United States, the auditor primarily certifies the compliance of the firm's financial statements with a set of highly technical rules.[32]

B. The German System

1. Bank-Based (Communitarian) System

Germany emphasizes the role of the corporation in society, and thus takes a communitarian view of the firm. Public debt and equity markets are small and banks are the dominating source of debt financing, for both large and small firms. Germany has less than 800 listed companies, compared to nearly 3,000 firms listed in the United Kingdom[33] and more than 9,000 firms listed on the three major stock exchanges in the United States.[34] The stock market capitalization in Germany in 1999 was only two-thirds of GDP.[35] Until recently, there were almost no transactions in the market for corporate control.

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29. *See* TOWERS PERRIN, WORLDWIDE TOTAL REMUNERATION 2001–2002, at 20 dia. 5, *available at* http://www.towers.com/towers/webcache/towers/United_States/publications/Reports/2001_02_WorldwideRemun/WWTR_2001_English.pdf (last visited Nov. 11, 2003).

30. *Id.*

31. *See, e.g.*, Robert Bruce, *FASB Ready for Accounting Revolution*, FIN. TIMES (FT.COM) May 26, 2002, *available at* 2002 WL 19894182.

32. Under the Sarbanes-Oxley Act of 2002, the U.S. system becomes increasingly principles-based. *See, e.g.*, Sarbanes-Oxley Act of 2002, §§ 302, 401, 15 U.S.C.S. §§ 7241, 7261 (Supp. 2003) (governing corporate responsibility for financial reporting and financial disclosures).

33. Julian Franks & Colin Mayer, *Ownership and Control of German Corporations*, 14 REV. FIN. STUD. 943, 944 (2001).

34. Bradley et al., *supra* note 9, at 52.

35. Rajan & Zingales, *supra* note 10, at 15 tbl. 3.

2. Shareholder and Creditor rights

Minority shareholders have few legal rights against management or dominant shareholders in Germany. In contrast, creditors and especially secured lenders are relatively well protected. Compared to the United Kingdom, outside investors have a generally weaker standing under German civil law. Anti-takeover devices remain common in corporate by-laws.[36] German takeover law allows management to take defensive measures against takeovers, including poison pills and voting-right limitations.[37] "Until recently, Germany had no insider trading laws."[38]

3. Equity Ownership Structure

Perhaps in response to poor investor protection, German corporate ownership structure differs significantly from that of Anglo-American firms. In Germany, ownership is concentrated and firms are often controlled by corporate insiders.[39] Corporate ownership typically takes the form of "complex webs of holdings and pyramids of intercorporate holdings."[40] Around 40% of shares are owned by other German corporations and another 14% by banks.[41] Moreover, a substantial portion of the equity is in bearer form, deposited with a bank. Since German law allows banks to vote these bearer shares by proxy, "banks directly or indirectly control a large portion of the equity."[42] Many company charters restrict non-bank shareholders from voting more than 5 to 10 percent of the total equity, regardless of the number of shares that they own.[43] As a result, German banks are a dominating force in German corporate governance.

4. Board of Directors

Under German corporate law, firms have a social responsibility towards the workers and the community at large.[44] Shareholders are viewed

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36. MONKS & MINOW, *supra* note 16, at 290.

37. *See, e.g.*, *Germany Steps up Fight Against EU Reform of Takeover Law*, HANDELSBLATT, Feb. 27, 2002.

38. Bradley et al., *supra* note 9, at 56.

39. For a detailed description of ownership structure and control of German firms, see Franks & Mayer, *supra* note 33.

40. *Id.* at 944.

41. Bradley et al., *supra* note 9, at 53.

42. *Id.* at 54.

43. *Id.*

44. *See id.* at 52 (discussing the German Corporate Governance System).

as only one constituency among many.[45] The law even authorizes the government to dissolve companies if it concludes that the firm's activities somehow endanger public welfare.[46] There are inherent conflicts of interest between different stakeholders. For example, stakeholders that have fixed claims on the firm's cash flow, such as employees, banks, and suppliers, tend to favor low-risk corporate investments. Since these stakeholders have real influence on the German corporation, the result is inefficient corporate investments, as well as low growth and equity capitalization.[47] In fact, over the period from 1974 to 1993, the annual real after-tax rate of return to the corporate sector averaged 7.4% in Germany compared to 9.1% in the United States.[48]

German corporate law specifies that firms with more than 500 employees must have two governing boards: a supervisory board and a management board.[49] The supervisory board performs a strategic oversight role and appoints the management board.[50] Moreover, firms with more than 2,000 employees are required to fill half of the supervisory board seats with company employees (the other half is elected by shareholders).[51] The chairman, who is typically from the shareholder side, has a tie-breaking vote.[52] The management board consists of the firm's top officers.[53] It is responsible for the day-to-day management of the firm and has generally substantial autonomy.[54] The management board reports to the supervisory board and overlapping membership between the two boards is prohibited.[55]

The German two-tier board structure is generally viewed as bureaucratic and hampered by internal conflicts of interest between shareholders, banks, and employees. From the point of outside investors, the board is unlikely to provide much protection of equity holders. Moreover, employee representatives are likely to oppose key supervisory board decisions such as

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45. *Id.*

46. *Id.*

47. *See, e.g.*, Dennis E. Logue & James K. Seward, *Anatomy of a Governance Transformation: The Case of Daimler-Benz*, 62 LAW & CONTEMP. PROBS. 87 (1999); *see also* Bradley et al., *supra* note 9, 41–47 (discussing the impact of the communitarian model on corporate decision making).

48. MCKINSEY GLOBAL INST., *Executive Summary*, exhibit 2, in CAPITAL PRODUCTIVITY (1996), *available at* http://www.mckinsey.com/knowledge/mgi/reports/pdfs/capital_productivity/executive_summary.pdf (last visited Nov. 11, 2003).

49. Bradley et al., *supra* note 9, at 52.

50. *Id.* at 52–53

51. *Id.* at 53

52. *Id.*

53. *Id.*

54. MONKS & MINOW, *supra* note 16, at 288.

55. Bradley et al., *supra* note 9, at 52–53.

downsizing and plant closings. The result may be inaction followed by lower firm value.[56]

5. Executive Compensation and Accounting Practices

Executive compensation usually takes the form of fixed salaries and bonuses.[57] Stocks and stock options are a rare component of most compensation packages.[58] In contrast to the United States, the quality of disclosure of dividend payouts and profits is poor.[59] German firms extensively use reserve accounts that hide profits in good years and are drawn upon in bad years to smooth earnings.[60] The lower accounting transparency complicates shareholder lawsuits in particular, and reduces investor protection in general.

III. THE ENRON DEBACLE

In October of 2001, Enron restated $1.2 billion of earnings and filed for bankruptcy shortly thereafter. In the following year, accounting irregularities were revealed at several other large companies, such as WorldCom, Global Crossing, Tyco, Adelphia, and Xerox. There are common threads among all these firms, including a lack of board oversight, auditor conflict of interest, and high-powered executive compensation systems. This Part focuses on the collapse of Enron and discusses whether governance practices in the United Kingdom and Germany would have made the Enron crisis less likely to happen.[61]

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56. Michael Jensen provides an extensive discussion of the disadvantages of having multiple constituencies directly represented in the board of directors. Michael C. Jensen, *Value Maximisation, Stakeholder Theory, and the Corporate Objective Function*, 7 EURO. FIN. MGMT. 297, 304–08 (2001). In the contractarian model, the interests of special constituencies are protected by their respective contractual arrangements. The only remaining constituency whose interest is not necessarily protected by contracts is the residual claimants, i.e. shareholders. *Id.*

57. Bradley et al., *supra* note 9, at 53.

58. *Id.*

59. *Id.* at 55.

60. *Id.* at 56.

61. For descriptions of Enron's collapse, see DOUGLAS M. BRANSON, ENRON—WHEN ALL SYSTEMS FAIL: CREATIVE DESTRUCTION OR ROADMAP TO CORPORATE GOVERNANCE REFORM? (2002) (working paper); STUART L. GILLAN & JOHN D. MARTIN, FINANCIAL ENGINEERING, CORPORATE GOVERNANCE, AND THE COLLAPSE OF ENRON (2002) (Univ. of Delaware, Center for Corporate Governance, Working Paper).

A. Enron's Collapse

Enron operated power plants and electric distribution companies. During the 1990s, the company supported a rapid expansion of its energy trading operations. Enron shifted its core business into the trading of energy commodities and financial securities based on those commodities. However, increasing competition eroded trading margins. To raise cash to finance growth, the company embarked on an aggressive strategy of off-balance sheet financing through special purpose entities (SPEs). By the year 2000, Enron had transferred significant assets and debt obligations off its balance sheet through these SPEs.[62]

SPEs allow the parent company to raise capital independently of the parent's existing liabilities. This lowers the overall cost of capital for the parent. Thus, SPEs are an important and useful financing vehicle for many firms. However, precisely because these financing arrangements do not show up on the parent company's balance sheet, SPE financing reduces transparency. The lower transparency makes it more difficult for outside investors—and, as it turns out, the board—to judge the overall credit risk of the parent company.

To qualify as an SPE, it is required that outside investors contribute a minimum of 3% of the SPE assets' value in the form of equity.[63] With 3% equity, there is scope for high leverage. In fact, leverage was typically greater in the SPE than in the parent company. Enron further added to the credit risk by issuing loan guarantees in the SPEs that were a function of Enron's stock price. This effectively converted some of Enron's stock price volatility into credit risk. While there is in principle nothing wrong with this financing arrangement, it certainly required minute attention to the impact of stock price changes on the likelihood of default. The Enron board did not seem to actively manage this risk.

Aggressive accounting compounded the negative effects of the board's lack of risk management. The accounting was aggressive in the sense that asset values were systematically overstated relative to a fair value assessment. This overstatement was particularly serious because Enron booked changes in asset values as earnings. Thus, the positive estimation error in the asset value transferred into excessive earnings statements. Again, the board did not seem to grasp this particular consequence of Enron's internal accounting valuation process. The result was literally a house of cards that

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62. "By 1999, Enron reported $33.381 billion of assets on its balance sheet and had an additional $26.993 billion syndicated in off-balance sheet SPEs." GILLAN & MARTIN, *supra* note 61, at 11.

63. GILLAN & MARTIN, *supra* note 61, at app. C.

would collapse if some event were to cause the stock market to significantly reduce the stock price.[64]

Such an event was the detection that Enron's board had allowed its chief financial officer (CFO), Andrew Fastow, to enter into a significant conflict of interest with the SPEs. Specifically, Fastow was put in charge of managing some major SPEs, which involved negotiating asset transfers and financing terms with himself as Enron's CFO.[65] When this became news, the market scrutinized the governance structure of Enron and concluded that there was a major structural problem. Consequently, Enron's stock price started to fall, and the house of cards started to collapse. Compounding the crisis, it also became evident that Enron had violated even the minimum three percent equity requirements in some of their SPEs. This error exposed the board and top management to charges of accounting fraud because they should have consolidated those SPEs into Enron's balance sheet.[66]

B. Lack of Board Oversight

Enron's board of directors failed along several dimensions: it waived its own conflict-of-interest guidelines to allow corporate insiders to run the SPEs; it ignored warnings about aggressive accounting practices; it failed to detect the technical violation of the three-percent rule for outside equity in the SPEs; and it condoned what seems like excessive executive compensation policies.[67]

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64. Through the SPEs, Enron's senior executives entered into a variety of hedging strategies aimed at managing the level and volatility of earnings. However, it is not clear that Enron's board was fully aware of or understood those hedging strategies. *See* GILLAN & MARTIN, *supra* note 61, 14–18, for details on Enron's earnings hedge transactions.

65. Fastow was induced to accept this dual role in part through a $45 million fee from the LJM partnerships. *Id.* at 26. For details, see PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., 2D SESS., THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE, S. REP. NO. 107-70, at 34–38 (2002), *available at* http://www.senate.gov/~gov_affairs/070902enronboardreport.pdf (last visited Nov. 23, 2003) [hereinafter SENATE SUBCOMMITTEE REPORT].

66. The violation of the three-percent rule may indicate a deeper problem with the dual role played by Fastow. The violation came about because Enron guaranteed, backed up with its own assets, part of the three percent equity that was supposed to be independent. One interpretation is that Fastow had difficulty raising the full three percent in outside equity, perhaps due to outside investor concern with the quality of the SPE assets. Because it was in Fastow's interest to close the deal (and cash in the management fee), he appears to have been willing to compromise the formal legal requirement, putting Enron at risk of legal repercussions (accounting fraud).

67. For example, the board approved cash bonus payments of $750 million to Enron executives based on year 2000 performance, when the firm's net income totaled $975 million. SENATE SUBCOMMITTEE REPORT, *supra* note 65, at 54. For additional details on the failures of Enron's Board of Directors, see generally *id.*; WILLIAM C. POWERS, JR. ET AL., SPECIAL INVESTIGATIVE COMMITTEE OF

These failures of Enron's board happened despite a board structure that appears to satisfy most formal requirements for independence. Eighty-five percent of directors were corporate outsiders. Most of these outsiders had relevant business experience, including accounting and senior management experience. The audit, compensation, and nominating committees consisted of independent directors only. The audit committee had a state-of-the-art charter, giving it the power to retain accounting, financial, and legal advice. All directors owned large amounts of Enron stock and most received options as part of their director compensation packages.

So what went wrong? Two factors may have played a role. First, as indicated above, Enron's financial structure was complex and opaque, with the result that the directors did not acquire sufficient knowledge about the company's overall credit risk. However independent, well intentioned, and honorable, directors who do not make the effort to fully understand the company's credit risk are failing in their duties to shareholders.[68]

Second, it is possible that the star quality of Enron's top management further intimidated the board. Several years in a row, Enron was ranked in the top of *Fortune*'s list of "most admired" companies. The founder and chairman, Kenneth Lay, was a superstar celebrity. Enron's outside directors never met in executive sessions without the insiders present. The chairman and/or the CEO usually attended subcommittee meetings, effectively blocking independent board discussions.

If these two factors, financial illiteracy and star culture intimidation, indeed are at the source of the board's failure, then there is every reason to expect similar failures to occur in the European governance environment.

While boards in the United Kingdom typically have a non-executive chairman, the large proportion of inside directors makes U.K. boards more likely to vote with management. Moreover, while requiring shareholder approval of transactions involving director conflict of interest looks good on paper, the widely dispersed ownership structure in the United Kingdom makes it likely that shareholders will vote with management by default.[69]

THE BOARD OF DIRECTORS OF ENRON CORP., REPORT OF INVESTIGATION (2002) [hereinafter POWERS REPORT], *available at* http://news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf (last visited Nov. 23, 2003).

68. The Senate Subcommittee, as well as Enron's board of directors' own investigative report, concluded that Enron's board of directors failed in its oversight duties. SENATE SUBCOMMITTEE REPORT, *supra* note 65, at 59; POWERS REPORT, *supra* note 67, at 148. *See also* Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 UNIV. CHI. L. REV. 1233, 1241–45 (2002) (discussing "Board-Centered Corporate Governance" and the failures of Enron's board).

69. Small shareholders lack economic incentives to spend resources to monitor management.

Thus, as indicated above, it is unlikely that U.K. boards would have presented more of an antidote to the Enron debacle.

As for Germany, it is possible that the labor and bank constituencies on the board would have objected to Enron's high-risk business strategy. However, relying on highly risk-averse constituencies to dictate business strategy may amount to throwing the baby out with the bath water: they would probably not have supported the creation of the new Enron in the first place. That is hardly a recipe for economic growth.

C. Lack of Auditor Independence

Publicly traded firms are required to have independent accountants certify their financial statements.[70] Investors rely on auditors, as well as securities analysts, debt rating agencies, and investment banks, to verify and assess the complicated financial information companies report. The system works only if these gatekeepers maintain independence from the firms they supervise. Enron's auditor Arthur Andersen should have warned the board more extensively about the company's aggressive accounting practices. The auditor failed to do so. It is possible that the auditors were too close to management and unduly influenced by their consulting contracts.

It is now widely accepted that the cross-selling of high-margin consulting services to audit clients compromises auditor independence. Firms discharging their auditors are required to justify this action to the SEC.[71] This may prompt an embarrassing inquiry into the firm, strengthening the auditor's hand. However, no disclosure is required if a firm terminates consulting services in retaliation for a negative audit opinion. Thus, the combination of auditing and consulting services increases a firm's power over its auditors.[72]

With respect to auditor independence, the European system does not appear to offer any greater protection of investors than in the United States. It is common for audit firms in Europe to sell consulting services to their

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70. Securities Act of 1933, 15 U.S.C. §§ 77(g), 77aa, Schedule A, ¶ 25 (2000); Securities Exchange Act of 1934, 15 U.S.C. § 78m (2000).

71. *See* Sean M. O'Connor, *The Inevitability of Enron and the Impossibility of "Auditor Independence" under the Current Audit System* 3 n.14 (2002) (working paper, Univ. of Pittsburg School of Law). The SEC requires listed companies to file an 8-K form within fifteen days of the resignation or dismissal of its auditor. SEC *Form 8-K* (Current Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934), *available at* http://www.sec.gov/about/forms/form8-k.pdf (last visited Aug. 12, 2003). This is not the case for the termination of regular consultation services.

72. Enron paid $52 million to Andersen in 2000, of which only $25 million was for the audit (Anderson's CEO argued that another $14 million was connected to the audit). Anderson even performed audits of transactions that the audit firm itself had advised. *See, e.g.*, GILLAN & MARTIN, *supra* note 61, at 27–28.

audit clients. However, the more principles-based accounting rules in the United Kingdom place greater demands on companies to consolidate off-balance sheet liabilities.[73] Such consolidation would have made Enron's problems more transparent to the board and outside investors at a much earlier point in time. Mandatory consolidation also mitigates problems with lack of auditor independence.

This benefit of the U.K. accounting system is not present in Germany. The German accounting system provides little transparency and clarity, impeding the ability of outside investors to get a fair picture of the firm's financial situation.[74]

D. Executive Compensation

The compensation of Enron's senior executives was closely linked to shareholder value. Top management had aggressive bonus plans and large option grants with short and accelerated vesting schedules. For example, some stock option programs had performance vesting features that cut the vesting period if the firm reached its earnings target. For the most senior executives, approximately 70% of total compensation was a function of earnings or the stock price.[75]

As indicated above, it is widely accepted that linking executive compensation to stock price performance is important to induce management to think like shareholders and act so as to maximize shareholder wealth. However, there is also a controversy concerning whether high-powered stock-based compensation contracts induce management to place excessive emphasis on short-term earnings and short-term movements in the stock price. For example, it has been argued that the internal pressure on Enron to overstate earnings was a result of the executive compensation system.[76] There is currently no resolution of this issue in the academic literature.

What we do know, however, is that compensation packages in the United Kingdom and Germany are to a much lesser extent based on a firm's stock price.[77] Thus, top executive compensation in Europe generally provides less incentive to take risk than the typical high-powered compensation package in the United States. This may alleviate concerns with

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73. *See, e.g.*, *Percy's Bet—UK Can Avoid Enronitis*, LLOYD'S LIST INTERNATIONAL (August 8, 2002).

74. *See* Bradley et al., *supra* note 9, at 55–56 (discussing the lack of regulation and disclosure of corporate activities in Germany).

75. GILLAN & MARTIN, *supra* note 61, at 30.

76. *See, e.g.*, GILLAN & MARTIN, *supra* note 61, at 29–33.

77. *See supra* Part II.A.5.

excessive managerial focus on short-term earnings and stock price development. On the other hand, there is also a risk that the structure of European executive compensation packages provides too few incentives to maximize shareholder wealth. In sum, it is difficult to judge at this point whether European compensation systems would have provided an effective Enron antidote.

IV. RECENT REFORM INITIATIVES

The Enron crisis triggered a major corporate governance reform in the United States, resulting in the Sarbanes-Oxley Act of 2002.[78] The Act attempts to restore investor confidence and protect investors through oversight and deterrence measures to prevent fraud.[79] The U.S. corporate governance reform also prompted regulatory initiatives overseas. The European Union has recently intensified its efforts to improve corporate governance and transparency practices.[80] Key reform proposals last year include new regulation on auditor independence, takeovers, and prospectuses.[81]

A. Board Oversight

The Sarbanes-Oxley Act has several provisions that strengthen the power of corporate boards vis-à-vis management. These provisions include requirements to adopt a code of ethics for senior financial officers and to staff the audit committee with financially literate independent directors.[82] Directors face increased liability to shareholder lawsuits.[83] Moreover, the board may hire its own outside advisers at the company's expense.[84]

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78. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745–810 (codified in scattered sections of the United States Code).

79. *See, e.g.*, *The Sarbanes-Oxley Act of 2002*, COOLEY ALERT!, Aug. 2002, at 1.

80. Klaus J. Hopt, *Modern Company and Capital Market Problems Improving European Corporate Governance After Enron* 3 (2002) (ECGI Working Paper Series in Law, No. 05/2002).

81. *See* Tim King & Victor Smart, *Europe Talks Tough on Governance*, THE BUSINESS (July 14, 2002).

82. Sarbanes-Oxley Act of 2002 §§ 301, 406, 407, 15 U.S.C.S. §§ 78j-1, 7264, 7265 (Supp. 2003).

83. *See, e.g.*, Rob Norton, *Corporate Reform: The Heat Is On*, CORP. BOARD MEMBER, Jan./Feb. 2003, 28, at 33–35, *available at* http://www.boardmember.com/issues (last visited Nov. 23, 2003).

84. Sarbanes-Oxley Act of 2002 § 301, U.S.C.S § 78j-1(m)(5) (Supp. 2003); *see also* Julie Connelly, *Independent Experts Emerge as the Board's Best Friend*, CORP. BOARD MEMBER, Jan./Feb. 2003, 38, at 38–43, *available at* http://www. boardmember.com/issues (last visited Nov. 23, 2003).

The U.K. government recently led an initiative to strengthen the role of non-executive directors and widen the pool of potential candidates.[85] The effort to increase the number of independent directors is an important step in promoting efficient board monitoring.

In February 2002, Germany passed the Cromme Code.[86] While compliance with the Cromme Code is voluntary, companies must declare whether they comply with the various provisions and explain reasons for non-compliance.[87] Provisions of the code restrict directors from holding more than five directorships and encourage immediate disclosure of purchases and sales of company stock.[88] Also, anti-takeover measures must be approved by a shareholder vote.[89]

The European commission is negotiating a new takeover code, aimed at facilitating company takeovers in Europe.[90] The directive is controversial, partly because of a clause effectively eliminating differential voting rights.[91] The Commission further introduced new regulation for stock exchange listing requirements.[92] In essence, the directive establishes that a prospectus is valid throughout Europe once it has been approved in a member country. The United Kingdom is opposing the proposal, arguing that it sets a common standard below the strict U.K. disclosure and director requirements.

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85. *See, e.g.*, Jill Treanor, *Higgs' Boardroom Revolution—Review Outlines Plans to Widen Corporate Pool and Avoid Sleaze*, THE GUARDIAN, Jan. 21, 2003.

86. *See* Commission of the German Corporate Governance Code, *at* http://www.corporate-governance-code.de/ (noting that the Transparency and Disclosure Law was adopted February 26, 2002) (last visited Nov. 23, 2003). [Editor's note: The website provides an English translation of the Deutscher Corporate Governance Kodex, also referred to as the Cromme Code, as amended May 21, 2003.] *See also* Tony Barber, *Shareholder Democracy Gets a Bigger Say*, FIN. TIMES, May 15, 2002, at P1, *available at* 2003 WL 20300150.

87. Deutscher Corporate Governance Kodex §§ 1, 3.10 (2003).

88. *Id.* §§ 5.4.3, 6.6.

89. *Id.* § 3.7.

90. Press Release, Eur. Comm'n, Background, Proposal for a Directive on Takeover Bids Frequently Asked Questions, Memo/02/201 (Oct. 2, 2002), *available at* http://europa.eu.int/rapid/start/cgi/guesten.ksh (last visited Nov. 30, 2003).

91. *See, e.g.*, Commission Proposal for a Directive of the European Parliament and of the Council on Takeovers Bids, Art. 11 (Oct. 2, 2002), *available at* http://europa.eu.int/eur-lex/en/com/pdf/2002/com2002_0534en01.pdf (last visited Nov. 30, 2003); *Companies and MEPs Heap More Criticism on Proposed Takeover Rules*, EUR. REP. Feb. 1, 2003, *available at* 2003 WL 10438919; *Ministers Still Divided over Takeover Directive*, EUR. REP. Mar. 5, 2003, *available at* 2003 WL 10439449.

92. Commission Amended Proposal for a Directive of the European Parliament and of the Council on the Prospectus to Be Published When Securities Are Offered to the Public or Admitted to Trading (Aug. 9, 2002), *available at* http://europa.eu.int/eur-lex/en/com/pdf/2002/com2002_0460en01.pdf.

B. Auditor independence

The U.S. Sarbanes-Oxley Act contains a number of provisions that improve financial disclosure, expand the responsibilities of the audit committee, and increase auditor independence.[93] For example, all material off-balance sheet transactions (such as Enron's SPEs) must be disclosed.[94] Moreover, the CEO and CFO are required to certify that the financial statements give a fair and complete view of the firm's financial situation.[95] Auditors will report directly to the audit committee and audit partners must rotate every five years.[96] The Act further mandates the creation of a public accounting oversight board.[97]

In the United Kingdom, the government recently proposed new measures that increase auditor independence.[98] Large firms must disclose information about the non-audit services that they buy from their auditors, and audit partners must rotate every five years and wait two years to join a client firm.[99]

Beginning in 2005, companies listed on exchanges in the European Union must adopt International Accounting Standards (IAS)[100] and the European Commission has proposed a directive requiring quarterly financial reporting.[101] IAS is considered stronger than the current accounting standards in many European countries, including Germany. However, European regulators generally have less enforcement powers and fewer resources than their U.S. counterparts.

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93. *See generally* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745–810 (codified in scattered sections of the United States Code).

94. Sarbanes-Oxley Act of 2002 § 401, 15 U.S.C.S. §§ 78m(j), 7261(c) (Supp. 2003).

95. Sarbanes-Oxley Act of 2002 § 906, 18 U.S.C.S. § 1350 (Supp. 2003).

96. Sarbanes-Oxley Act of 2002 §§ 203, 204, 15 U.S.C.S. § 78j-1(j), (k) (Supp. 2003).

97. Sarbanes-Oxley Act of 2002 § 101, 15 U.S.C.S. § 7211 (Supp. 2003).

98. *See, e.g.*, *DTI—Hewitt Acts to Strengthen Defenses against Business Malpractice*, GOVERNMENT NEWS NETWORK (Jan. 29, 2003); Kit Bingham, *New Boards to Oversee the Integrity of Auditors*, FINANCIAL NEWS (Feb. 2, 2003).

99. *See DTI*, *supra* note 98; Bingham, *supra* note 98.

100. *See, e.g.*, Press Release, Eur. Comm'n, Agreement on International Accounting Standards Will Help Investors and Boost Business in E.U., IP/02/827 (June 7, 2002); Press Release, Eur. Comm'n, Financial Reporting: Commission Proposes Requirement for Listed Companies to Use International Accounting Standards by 2005, IP/01/200 (Feb. 13, 2001); Press Release, Eur. Comm'n, Financial Reporting: The IAS Regulation—Frequently Asked Questions, MEMO/01/40 (Feb. 13, 2001). Press releases are available at http://europa.eu.int/rapid/start/cgi/guesten.ksh (last visited Nov. 30, 2003).

101. For details on quarterly reporting, see Press Release, Eur. Comm'n, Proposal for a Directive on Transparency Requirements for Listed Companies Frequently Asked Questions, MEMO/03/68 (Mar. 26, 2003), *available at* http://europa.eu.int/rapid/start/cgi/guesten.ksh (last visited Nov. 30, 2003).

C. Executive Compensation

In the United States, the Sarbanes-Oxley Act prohibits personal loans to executive officers and directors.[102] Moreover, if a company must restate its financial statement as a result of misconduct, the CEO and CFO have to repay bonuses and profits that resulted from the erroneous financial statements.[103] In the United Kingdom, a new regulation was passed in August 2002 requiring a shareholder vote to approve executive compensation packages.[104] The German Cromme Code also requires disclosure of executive compensation packages.[105] Also, reform initiatives in the European Union suggest that directors' pay should be disclosed.[106] Overall, the recent governance crises and the regulatory reform initiatives are likely to change the executive compensation structures in both the United States and Europe.

CONCLUSIONS

The Enron collapse uncovered fundamental deficiencies in the U.S. corporate governance system. These weaknesses include lack of board oversight and auditor independence. It appears that the corporate governance practices in the U.K. and Germany suffer from similar flaws, and it seems unlikely that they would have prevented the Enron crisis.

German firms are to a great extent controlled by banks and employees. These constituencies tend to favor a low-risk investment strategy. It is possible that such boards would have rejected the high-risk business strategy of Enron. At the same time, boards favoring low-risk investment strategies may pass up valuable business opportunities that are central to corporate profitability and growth. Boards in the U.K. are dominated by corporate insiders and thus unlikely to be independent from management.

U.K. accounting rules require companies to consolidate off-balance sheet liabilities with their own financial statements. Such consolidation would have made Enron's high-risk financial structure more transparent to investors. Also, mandatory consolidation may mitigate problems with lack

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102. Sarbanes-Oxley Act of 2002 § 402; 15 U.S.C.S. § 78m(k) (Supp. 2003).

103. Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C.S. § 7243(a) (Supp. 2003).

104. Directors' Remuneration Report Regulations 2002 (SI 2002 No.1986), *available at* http://www.hmso.gov.uk/si/si2002/20021986.htm. The new regulations provide for a new Schedule 7A of the U.K. Companies Act 1985.

105. Deutscher Corporate Governance Kodex § 4.2.4 (2003).

106. Commission Amended proposal for a Directive on Prospectuses, *supra* note 92, at 52; *see also* Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on Insider Dealing and Market Manipulation (Market Abuse), 2003 O.J. (L96) 16.

of auditor independence. Before regulatory reform, it was common practice for accounting firms to sell profitable consulting services to their audit clients. In Germany, in contrast, accounting transparency is poor.

Top executives in the U.S. tend to have high-powered compensation packages, emphasizing stock-options and bonuses. In Europe, executive compensation is less sensitive to the stock price and therefore generally provides lower incentives to take risks. While this may alleviate concerns for excessive managerial focus on earnings, there is also a risk that the European executive compensation practices provide too few incentives to maximize shareholder wealth.

Overall, it appears as if the weaknesses that were exposed in U.S. corporate governance practices to a large extent are inherent also in the European governance systems.