

DYSFUNCTIONAL DEFERENCE AND BOARD COMPOSITION: LESSONS FROM ENRON

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INTRODUCTION

It has been over seven years since the public was first made aware that Enron (or the “Company”) was a troubled firm,¹ ultimately doomed to bankruptcy and much litigation, both civil and criminal. Yet, the Enron debacle continues to fascinate researchers and the general population alike. Over the one-year period from September 3, 2007 to September 3, 2008, the Social Science Research Network has posted seventy-one papers that referenced Enron in their abstracts.² What appears most baffling to many observers, especially those interested in corporate governance, is the inability of Enron’s board of directors to get a handle on the massive fraud that occurred under its watch. For example, Charles M. Elson, director of the Center for Corporate Governance at the University of Delaware, stated in regard to the repeated warning signs that the Enron board received during this time, “[t]hey should have inquired further,” and “[t]hey were unwilling to ask and pursue tough questions.”³ However, for all the research done, a satisfactory explanation has yet to be provided for why the Enron board—once considered one of the best boards of a large publicly held firm⁴ in the

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¹ In March 2001 the wheels started to come off Enron’s wagon when an article in *Fortune* magazine raised questions about Enron’s financial statements. See Bethany McLean, *Is Enron Overpriced?*, FORTUNE, March 5, 2001, at 122; see also S. REP. NO. 107-70, at 12–13 (2002) (discussing the *Fortune* article and subsequent events in 2001 that began to evidence that “not all was well at Enron”).

² See SSRN eLibrary Database Search, <http://papers.ssrn.com/sol3/DisplayAbstractSearch.cfm> (enter “Enron” in the “Search Term(s)” section, then select “Last Year” in the drop menu in the “Options” row) (last visited Sept. 3, 2008) (link). SSRN does not allow searches for exact dates, but does permit searches for abstracts posted within a specified period before the date of the search. See *id.*

³ John A. Byrne, *Commentary: No Excuses for Enron’s Board*, BUS. WK., July 29, 2002, at 50.

⁴ A publicly held firm is an “economic organization in which (i) management and residual claimant status (shareholding) are separable and separated functions; (ii) the residual claims (shares) are held by a number of persons; and (iii) the residual claims are freely transferable and neither entry to nor exit from

United States⁵—failed to detect the fraud that ultimately destroyed the company.

Something was obviously amiss at the top of the Enron pyramid. We assert that it had something very much to do with the composition of the Enron board, despite the largely impressive backgrounds of its individual members. We, of course, are not alone in this opinion, as the fall of Enron has led to enhanced independence requirements for board members.⁶

We certainly endorse the board member independence requirements of the stock exchanges and the enhanced independence guidelines as recommended by proxy advisory companies that have developed as a response to the Enron scandal.⁷ Nevertheless, it is our position that corporate boards of publicly held firms would be better off and less prone to error if other rules or guidance were in place that required or strongly encouraged corporate board nominating committees to select members who were less prone to what we refer to below as “dysfunctional deference.” To implement this critical change, we recommend: (i) limiting the number of former or current executive officers allowed to serve as outside directors; (ii) setting term limits for outside directors; (iii) diversifying the background of outside directors; and (iv) requiring outside directors to spend a minimum amount of time on board business.

I. DYSFUNCTIONAL DEFERENCE

It is easy to assume that two heads are better than one and that small groups will make better decisions than individual decisionmakers. And perhaps, overall, that is correct.⁸ Even so, behavioral scientists have been

the firm is restricted.” Michael P. Dooley, *Two Models of Corporate Governance*, 47 *BUS. LAW.* 461, 463 n.9 (1992).

⁵ See Reed Abelson, *ENRON'S COLLAPSE: THE DIRECTORS; Eyebrows Raised in Hindsight About Outside Ties of Some on the Board*, *N.Y. TIMES*, Nov. 30, 2001, at C6, available at <http://query.nytimes.com/gst/fullpage.html?res=9E0CE4DA153DF933A05752C1A9679C8B63>, (noting that Chief Executive Magazine named Enron as one of the top five corporate boards in 2000) (link).

⁶ As so well put by Professors Blair and Stout, “The notion that responsibility for governing a publicly held corporation ultimately rests in the hands of its directors is a defining feature of American corporate law; indeed, in a sense, an independent board is what makes a public corporation a public corporation.” Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 *VA. L. REV.* 247, 251 (1999). However, having a majority of independent directors that meet objective criteria of independence achieves nothing unless these independent directors also exercise “independence of mind.” See John Roberts, Terry McNulty & Philip Stiles, *Beyond Agency Conceptions of the Work of the Non-Executive Director: Creating Accountability in the Boardroom*, 16 *BRITISH J. MGT.* S5, S19 (2005). This, of course, is easier said than done.

⁷ At least ten of the so called “independent” directors at Enron had conflicts involving consulting or legal work with the Company, or were associated with charitable organizations to which the Company had made significant charitable donations. See Marleen A. O’Connor, *The Enron Board: The Perils of Groupthink*, 71 *U. CIN. L. REV.* 1233, 1264 (2003).

⁸ Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 *VAND. L. REV.* 1, 3 (2002) (“A wealth of experimental data suggests that groups often make better decisions than individuals.”).

saying for years that small deliberative groups are prone to error in their decisionmaking if these groups are made up of a majority of members who are similar in position prior to deliberations. Such groups can fall victim to what is referred to as “group polarization”—the tendency of a small deliberative group with an initial tendency to move in a given direction to move to even more extreme positions in that direction following group deliberations.⁹ The corporate board is no exception to this problem.¹⁰

However, the focus here is not group polarization, but something which we consider to be even more pernicious and error inducing for a corporate board. In regard to several important decisions, the board of Enron exhibited such extreme deference to Company management that there was little or no deliberation preceding some of the board’s most important decisions. We refer to this extreme deference to management that leads to little or no board deliberation prior to a board decision as “dysfunctional deference.”

A. *Enron Revisited*

Even though the vast majority of a corporation’s decisions are made by corporate officers and their subordinates, the ultimate decisionmaking authority rests with the board of directors.¹¹ When a corporate decision has the appearance of impropriety or the potential for personal liability, corporate officers may sometimes choose to return the decision back to the board for approval or ratification. Enron provided us with an excellent example of how a board should not handle such a situation.

In 1999 and 2000, the Enron board approved waivers to the Company’s code of conduct three times. These waivers allowed Enron’s Chief Financial Officer (CFO), Andrew Fastow, to establish and operate the now infamous LJM private equity funds. These funds were set up to acquire Enron assets with the purpose of reducing the size of the Company’s bal-

⁹ Cass R. Sunstein, *Deliberative Trouble? Why Groups Go to Extremes*, 110 YALE L.J. 71, 74 (2000). Professor Sunstein notes that the term “group polarization” is misleading as it can be mistakenly interpreted to mean that group members move toward opposite positions. *Id.* at 85.

¹⁰ See Cass R. Sunstein, *Group Judgments: Statistical Means, Deliberation, and Information Markets*, 80 N.Y.U. L. REV. 962, 1020 (2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=604641 (link).

¹¹ The “heart” of corporate authority lies with the board of directors who have statutory authority to manage the corporation. Delaware corporate law provides that: “The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.” DEL. CODE ANN. tit. 8, § 141(a) (2001). In reality, however, the vast majority of significant corporate decisions made in publicly held firms are shifted downward to senior officers. The law provides for this by allowing the board to relinquish its managerial responsibility and take on more of an oversight function by allowing the corporate board to provide “direction” and not necessarily management and by allowing for the appointment of senior officers: “Every corporation organized under this chapter shall have such officers with such titles and duties as shall be stated in the bylaws or in a resolution of the board of directors which is not inconsistent with the bylaws . . .” DEL. CODE ANN. tit. 8, § 142(a) (2001).

ance sheet.¹² Such an arrangement clearly provided Fastow with immense opportunities to engage in self-dealing transactions at the expense of Enron and its shareholders.¹³ Unfortunately, that is exactly what happened.¹⁴ Ken Lay, Enron's Chief Executive Officer (CEO) at the time the funds were created, was cognizant of the controversial nature of this arrangement, and therefore sought board ratification despite the fact that he had full authority to approve the waiver on his own.¹⁵ That in itself should have led to long and intense board deliberations, yet very little in the way of deliberations were reported prior to board approval, evidencing an incredible and surprising deference to the recommendations of management.¹⁶

B. *The Pathology of Dysfunctional Deference*

Normally, deference by independent board members to the opinion of insiders and executive management is understandable and most likely beneficial to corporate board decisionmaking. Insider board members, such as the CEO, will enter board deliberations with a greater degree of knowledge and understanding regarding the true state of the company than the independent directors. This asymmetric distribution of information should be beneficial to board decisionmaking, assuming board insiders are honest about the pros and cons of a prospective decision with the other board members during deliberations.

However, this deference to board insiders and executive management can also lead to serious errors in decisionmaking if the deference is so pronounced that it stifles deliberation of a corporate board's most controversial decisions. In ratifying the waiver of the Company's code of conduct for Fastow with little discussion, the Enron board members demonstrated deference to the recommendations of management, which should be viewed as dysfunctional and as an act of a board that had been captured by management.

1. *Informational Signals and Social Pressures*—Dysfunctional deference to executive management and their representatives on the board appears to develop in two ways: through *informational signals*, which lead

¹² See S. REP., *supra* note 1, at 7–8. The purpose of establishing these entities was to help maintain the Company's investment grade credit rating based on the criteria established by rating agencies such as Moody's and Standard & Poor's. *Id.* at 7. Interestingly, only two of the funds ever became active, LJM1 and LJM2. *Id.* at 24 n.56.

¹³ See *id.* at 24.

¹⁴ See Exhibit A to Plea Agreement, United States v. Fastow, Cr. No. H-02-0665, (S.D.Tex. Jan. 14, 2004) (statement of Andrew Fastow to "provid[e] a factual background for [his] plea of guilty" to charges of manipulating financial statements and engaging in self-dealing transactions).

¹⁵ S. REP., *supra* note 1, at 25.

¹⁶ While there was no evidence of significant deliberations on the topic of the LJM private equity funds at the three board meetings where they were approved, supposedly there was a vigorous discussion of LJM2 at a board finance committee meeting prior to the approval of LJM2. However, it is not known whether Fastow's conflict of interest, the economics of the transaction itself, or both, was the subject of discussion. See *id.* at 28.

board members “to fail to disclose what they know out of respect for the information publicly announced by others” or through *social pressures*, “which lead people to silence themselves in order to avoid reputational sanctions, such as the disapproval of relevant others.”¹⁷

According to Sunstein and Hastie, “the strength of the informational signal will depend on the number and nature of the people who are giving it.”¹⁸ Applying this to a corporate board, if a board’s members include one or more individuals who are acknowledged to be experts on company operations or have an excellent track record of success, such as inside directors, then the other board members are likely to be very reluctant to challenge their opinions and recommendations. Moreover, people are very uncomfortable being sole dissenters.¹⁹ In this situation, “if all but one person in a deliberating group has said that X is true, then the remaining member is likely to agree X is true, even to the point of ignoring the evidence of his own senses.”²⁰ This phenomenon is somewhat mind-boggling, but the result is that the board may be deprived of key information that potentially could prevent it from making a bad decision.

The strength of the social pressure will depend on the “number and nature of those with the majority position.”²¹ The greater the majority, the greater the social pressure on individual members. Moreover, “if certain group members are leaders or authorities willing and able to impose social sanctions of various sorts, others will be unlikely to defy them publicly.”²²

Given the minimal amount of personal contact between Enron board members it does not appear that significant social pressures were at work. The contact of non-insider board members with Enron and its management was quite limited: the Enron board normally held only five regular meetings per year,²³ and outside of formal board meetings, board members did not have much interaction with each other or with Enron management.²⁴

However, a look into Enron’s history reveals how the board could have been captured by insiders and executive management on the basis of informational signals. By August 2000, Enron was the seventh largest U.S. firm by capitalization. Enron had also been named the most innovative firm in the United States for five years in row by *Fortune Magazine*.²⁵ Obviously,

¹⁷ Cass R. Sunstein & Reid Hastie, *Four Failures of Deliberating Groups 2* (John M. Olin Law & Economics Working Paper No. 401 (2d Series) and Public Law and Legal Theory Working Paper No. 215, Apr. 2008), available at <https://www.law.uchicago.edu/files/401.pdf> (link).

¹⁸ *Id.* at 5.

¹⁹ *See id.*

²⁰ *Id.*

²¹ *Id.* at 6.

²² *Id.*

²³ S. REP., *supra* note 1, at 9.

²⁴ *See id.* at 10.

²⁵ William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. R. 1275, 1276 (2002).

the perception in the minds of board members and the general public alike was that somebody was doing something right at Enron. Moreover, given the limited interaction between board members and management, and with so little expected of board members,²⁶ it was reasonable for outside board members to rely heavily on the opinions of inside board members and executive management.

In addition, the profile of the average Enron independent board member included a stint as a chief executive officer.²⁷ Such a background is conducive to *identifying* with executive management and perhaps viewing his or her role at Enron as making sure not to get in the way of what executive management wanted to do. In the context of executive remuneration, Professors Jensen, Murphy, and Wruck have already utilized this rationale in recommending that the number of active CEOs on a public company's board be limited.²⁸ Indeed, initial statistical evidence has borne this out. While Kaufman, Englander, and Tucci have only found weak statistical evidence that the more CEOs on the board of directors the higher the CEO compensation, they did find a strong statistical association between the number of CEOs on a public company's board compensation committee and the level of CEO pay.²⁹

Finally, the profile of the average board member included many years of service on the Enron board, which—particularly during a long period of time when things are going right at the Company—may induce an outside director to believe that executive management can do no wrong, leading her to become highly deferential to executive management recommendations. For example, if the Enron board had developed over time the perception that Lay, Jeffrey Skilling (former President and Chief Operating Officer), and Fastow were geniuses—or close to it—because they had up to that point an unblemished string of successes, a board just might go along with the controversial idea of allowing the Company's CFO to enter into such a risky conflict of interest transactions.

2. *Informational Cascades*—As in chess, the advantage in small group decisionmaking goes to the player who has the benefit of making the first move. The lack of deliberation regarding the LJM transactions did not

²⁶ Board responsibilities were limited to, basically, five two-day meetings per year plus prep time. S. REP. *supra* note 1, at 9–10.

²⁷ See Enron, Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 (Schedule 14A), at 3–9 (Mar. 21, 2000), available at www.sec.gov/Archives/edgar/data/1024401/0000950129-00-001279.txt (listing the eighteen nominees to be elected by shareholders to the eighteen positions on the board of directors) (link).

²⁸ See Michael C. Jensen, Kevin J. Murphy & Eric G. Wruck, *Remuneration: Where We've Been, How We Got to Here, What are the Problems, and How to Fix Them* 55 (Harvard NOM Working Paper No. 04-28; ECGI-Finance Working Paper No. 44/2004, July 12, 2004), available at <http://ssrn.com/abstract=561305> (link).

²⁹ Allen Kaufman, Ernie Englander & Christopher L. Tucci, *The Managerial Thesis Revised: Independent Directors and the CEO "Directorate"* 34 (July 2006) (unpublished manuscript, on file with the Northwestern University Law Review), available at <http://ssrn.com/abstract=1030845> (link).

mean that board insiders and executive management whom they represented did not get to have their say. Board members were provided management-generated briefing papers prior to the board meeting,³⁰ no doubt recommending or at least leaning in the direction of approving Fastow's participation in the private equity funds. In an assumed state of strong deference to insider and executive management recommendations, this may have caused an *informational cascade*, which was very hard for the outside board members to overcome.³¹ According to Sunstein and Hastie, "a cascade is a process by which people influence one another, so much so that participants ignore their private knowledge and rely instead on the publicly stated judgment of others."³² Interestingly, people are not considered to be acting irrationally when they come under the influence of an informational cascade; they are simply succumbing to the pressure of the signals provided by others in the group.³³ This may have been the effect of the management generated briefing papers. Alternatively, a domino effect may have been created where the acceptance of the management position by some board members (Ken Lay for one) provided a signal to other board members to also accept the position—right or wrong—without receiving any new information, or to ignore or fail to disclose any private information or reservations that may have helped the board move in the direction of disallowing the waivers. In either case, the insiders on the board got to be the leaders in a game of follow the leader with minimal verbal communication.

C. Groupthink

Marlene A. O'Connor has argued that these failures of the Enron board were due to another problem with small group deliberations called "groupthink," which can be described as "a mode of thinking that people engage in when they are deeply involved in a cohesive in-group, when the members' striving for unanimity overrides their motivation to realistically appraise alternative courses of action."³⁴ Thus, too much of a warm and fuzzy feeling between board members can lead a board to make wrong decisions. Yet, the Enron board did not give the appearance of being overly cohesive. As already discussed, the entire Enron board met only five times a year and had

³⁰ S. REP., *supra* note 1, at 27 (written materials on LJM1 were faxed to board members three days prior to meeting). It was typical for management to provide extensive background and briefing materials prior to a board meeting. *Id.* at 9.

³¹ Sunstein & Hastie, *supra* note 17, at 12–13.

³² *Id.* at 12. O'Connor defines a cascade to be "a process whereby an entire group quickly comes to share a view, which may be false, because some people in the group appear to accept the belief." O'Connor, *supra* note 7, at 1240. Or, in the context of game theory, "an information cascade . . . is a situation in which every subsequent actor, based on the observations of others, makes the same choice independent of his/her private signal." Wikipedia, Informational Cascades, http://en.wikipedia.org/wiki/Information_cascade (last visited Sept. 12, 2008) (link).

³³ See Sunstein & Hastie, *supra* note 17, at 12–14; Wikipedia, *supra* note 32.

³⁴ O'Connor, *supra* note 7, at 1238 (internal quotation marks omitted).

very little interaction at other times.³⁵ Furthermore, groupthink focuses on small group decisionmaking occurring at times of high stress.³⁶ However, the key decisions facilitating the fraud at Enron occurred during the time when Enron was doing extremely well, which no doubt minimized the stress of board decisionmaking. Counterbalancing this lack of personal interaction outside the board room was the similarity in career backgrounds, as most of the board members had experience as CEOs of large institutions and very long average tenures on the board.³⁷ Still, it is hard to imagine that this was enough to create an environment where groupthink prevailed. Dysfunctional deference—not groupthink—was the more likely cause of these serious errors in board decisionmaking.

II. RECOMMENDATIONS

Professor William Bratton expressed a very pessimistic outlook for corporate governance based on the Enron story: “Enron, then, reminds us that the monitoring model assures us of little. It gives only a circumstantial guarantee of good governance because it only requires *evidence* of a “conscientious,” well-informed business judgment. The conscientiousness itself is ill-suited to ex post verification.”³⁸ If that is so, then up-front improvements in board composition become that much more important in reducing error in corporate board decisionmaking.

Without requiring all board members to be independent, it is impossible to avoid the informational advantages insiders have in board deliberations and the natural deference to insiders and executive management that this situation creates. However, an all independent board would then be without the insights, knowledge and understanding of those who know the company the best. This would cause more harm than good in board decisionmaking. Alternatively, and ideally, public corporations can work to minimize the negative aspects of a mixed board by tailoring board composition in a way that minimizes dysfunctional deference to insiders and executive management. To this end, based on the lessons of Enron, we recommend the following:

1. *Limit the Number of Former or Current Executive Officers*—Limit the number of outside directors who have been or are CEOs of large institutions—public or private—to less than a majority of outside directors in order to reduce the potential for over identification with insiders and executive management.

2. *Set Term Limits*—Term limits are critical to ensure that outsider board members do not over-identify with insiders and executive management.

³⁵ See S. REP., *supra* note 1, at 9.

³⁶ See O’Connor, *supra* note 7, at 1267.

³⁷ See *id.* at 1263.

³⁸ See Bratton, *supra* note 25, at 1337–38.

3. *Require Knowledge of the Company*—Board nominating committees should select outside directors who have knowledge of the Company’s business or who could potentially learn quickly and with a sufficient depth of understanding. As stated by McNulty and Roberts in their study on the effectiveness of boards, “the exercise of power and influence that comes with the position of non-executive is critically conditioned by their knowledge of the company.”³⁹

4. *Establish Modified Diversification*—Nominate outside directors with diverse backgrounds, but not to the extent that there is potential for prospective board members to become lone dissenters. This would also apply to shareholder nominated directors. Better to have multiple shareholder-nominated directors than just one.

5. *Require Minimum Time Commitments*—It was striking how little time board members—as the most important decisionmakers at Enron—were required to devote to their duties. Although board membership is considered a part-time position, there is a need for a minimum time commitment to ensure that outside board members gain the confidence to deliberate and vote on an issue without total reliance on management recommendations.

While each recommendation is geared toward minimizing the risk of dysfunctional deference, these recommendations are purposely general.⁴⁰ Each publicly held firm is different, requiring a unique, tailored application of these recommendations to fit the needs of each company. Implementation of these recommendations can come through a number of different mechanisms: securities class action or derivative suit settlements, charter or by-law amendments, institutional shareholder engagement, new stock exchange rules, or positions taken by proxy advisory companies. Moreover, empirical analysis has yet to be done that could help to both fine tune these recommendations and propose new ones. For example, statistical analysis that looks at board composition as a function of securities fraud, with the independent variables differentiating between criminal and civil events. All in all, Enron has shown us that dysfunctional deference is something that

³⁹ Roberts, McNulty & Stiles, *supra* note 6, at S19. This recommendation also requires that the company provide a minimum amount of director education in order for the outside director to get up to speed on the operations of the firm. For example, management led orientation programs focusing on company operations.

⁴⁰ Of course, there are many other possible improvements in corporate governance—such as majority voting and annual election of directors—that might reduce the likelihood of a similar debacle in the future. See, e.g., Lucian Arye Bebchuk, John C. Coates IV & Guhan Sabramanian, *The Trouble with Staggered Boards: A Reply to Georgeson’s John Wilcox*, 11 CORP. GOV. ADV. 17 (2003), available at <http://ssrn.com/abstract=384980> (link); Stephen Deane, *Majority Voting in Director Elections: From the Symbolic to the Democratic* (Institutional Shareholder Services Institute for Corporate Governance, White Paper, 2005), available at <http://www.issproxy.com/pdf/MVwhitepaper.pdf> (link). We have limited our recommendations in this Essay to those that we believe would help to minimize dysfunctional deference.

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corporate boards must defend against, with board composition being a viable tool in its prevention.