

June 20, 2002 12:19 a.m. EDT

CAPITAL

By DAVID WESSEL



FROM THE ARCHIVES: June 20, 2002

Why Boardroom Bad Guys Have Now Emerged en Masse

The 1990s Stock Bubble Magnified Shifts In Business Mores as Watchdogs Napped

Every decade has king-size corporate villains. In the 1970s, Robert Vesco was indicted for looting the Investors Overseas Services mutual funds. In the 1980s, arbitrageur Ivan Boesky and junk-bond inventor Michael Milken went to jail.

But the scope and scale of the corporate transgressions of the late 1990s, now coming to light, exceed anything the U.S. has witnessed since the years preceding the Great Depression.

CAPITAL EXCHANGE

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Enron Corp.'s top executives reaped hundreds of millions as the company collapsed. Arthur Andersen LLP, Enron's auditor, was convicted last week of obstructing justice. **Tyco International** Ltd.'s lionized chief executive is charged with tax evasion and accused of secret pay deals with underlings. Cable giant Adelphia Communications Corp. admitted inflating numbers and making undisclosed loans to its major shareholders. **Xerox** Corp. paid a \$10 million fine for overstating revenues. **Dynegy** and **CMS Energy** Corp. simultaneously bought and sold electricity in transactions with no point other than pumping up trading volumes. **Merrill Lynch & Co.** paid \$100 million to settle New York state charges that analysts misled investors, and other Wall Street firms are now under scrutiny.

"I've never seen anything of this magnitude with companies this large," says Henry McKinnell, 59, chief executive of

pharmaceutical maker **Pfizer** Inc.

Why is so much corporate venality surfacing now? Is there more of it, or is more attention being paid? Did a few executives lose their ethical moorings in the exuberance of the 1990s? Or did a few notorious offenders break rules that many others merely bent? Is the entire system of corporate governance and regulation flawed? Or was the system abused by a few cleverly diabolical executives who deserve, as Treasury Secretary Paul O'Neill puts it, "to hang ... from the very highest branches?"

What's WRONG?

Go to the [Called to Account](#)³ page for more coverage.

See a [chart](#)⁴ of companies whose business practices have been questioned recently.

What's most to blame for the spate of scandals surrounding U.S. corporation? Participate in the [Question of the Day](#)⁵.

The answer, put simply: A stock-market bubble magnified changes in business mores and brought trends that had been building for years to a climax. The victims: the very shareholders the executives were supposed to be serving.

One culprit was stock options, which gave executives huge incentives to boost near-term share prices regardless of long-term consequences. No CEO pay package seemed to strike any board of directors as too big.

These incentives helped turn the widely practiced art of earnings management -- making sure profits meet or barely exceed Wall Street expectations -- into a gross distortion of reality at some companies.

And the institutions that were created to check such abuses failed. The remnants of a professional ethos in accounting, law and securities analysis gave way to getting the maximum revenue per partner. The auditor's signature on a corporate

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For the Business Roundtable's view on corporate governance, see <http://www.brtable.org/issue.cfm/29>

For the Avolio, Gildor, Shleifer paper, see <http://www.kc.frb.org/PUBLICAT/SYMPOS/2001/sym01prg.htm>¹⁰

For Mr. Gipson's thoughtful letter to shareholders, see <http://www.clipperfund.com/qtr302.html>¹¹

For more on Prof. Tedlow, see http://dor.hbs.edu/fi_redirect.jhtml?facInfo=bio&facEId=rtedlow¹²

report didn't testify that the report was an accurate snapshot, says Mr. O'Neill. He says it too often meant only that a company had "cooked the books to generally accepted standards."

The current sordid chapter in the history of American business opened on Aug. 14 last year when Jeffrey Skilling quit as chief executive of Enron Corp., an unmistakable sign that all was not well inside one of the country's most-admired corporations.

Enron is "the private sector's Watergate," says John Coffee, a Columbia University securities-law professor. Although not all politicians were crooks, Watergate bred a virulent cynicism about government among the public, the press and even some politicians. That cynicism persists 30 years after the White House-blessed burglary of the Democratic National Committee's office.

Enron and all that followed threaten to do the same to American business. "I have had a lot of e-mail from shareholders who seem to have gone off the deep end and think all corporate executives are crooks and all accountants are sheep, just as some think all Catholic priests are pedophiles," says mutual-fund manager James Gipson of Clipper Fund. "None of those statements are true."

Measuring the volume of corporate skulduggery precisely is difficult. The SEC opened 570 investigations last year. That's more than in any of the previous 10 years -- but just 10 more than in 1994. More than 150 companies restated their earnings in each of the past three years, an acknowledgment that they had misinformed investors. That's more than triple the levels of the early 1990s, but represents only one of every 100 publicly traded companies.

'A Few Bad Apples' Analysis

One view, a staple of speeches by chief executives and government officials, underscores that only a small fraction of companies and executives stand accused of wrongdoing. It's the "a few bad apples" analysis. Treasury Secretary O'Neill, former chief executive of **Alcoa Inc.**, talks of "a very small number compared to all the enterprises out there."

Pfizer's Mr. McKinnell, who serves as vice chairman of the Business Roundtable's corporate-governance task force, cautions against generalizing from "eight or 10 companies who allegedly behaved in ways that are incomprehensible ... and deserve what they're getting." Securities and Exchange Commission Chairman Harvey Pitt, who has been practicing securities law in and out of government for 35 years, chides business reporters by recalling how the reporting of muckraking journalist Lincoln Steffens created a "crime wave" in the 1890s at a time when the actual number of crimes was falling.

For this camp, the smart response is to punish the miscreants severely and tinker with the parts of the system that are broken, taking care to avoid hasty changes with unintended consequences. "Things aren't as broken as they appear to be," says Mr. McKinnell.

But there's another view: The headline-making cases are symptoms of a broader disease, not exceptions, and a regulatory apparatus that isn't up to the challenge. "A few bad apples? Looks like we've got the whole peck here," says retired federal judge Stanley Sporkin, the SEC's enforcement chief in the 1970s.

"Everybody did this," says economic historian Peter Temin of the Massachusetts Institute of Technology. "The people who got in trouble are those who are most at the edge. Enron didn't get caught. Enron got so far out on the edge that it fell off."

To this camp, the reasonable response is broader legislation and tougher regulation on the scale of the 1930s laws that created the SEC and the modern regulatory regime.

The "irrational exuberance" so famously flagged in 1996 is an essential part of explaining the 1990s. When the man who coined the term, Federal Reserve Chairman Alan Greenspan, talks informally with business and other groups, he says the greediness of human beings didn't increase in the 1990s. What increased, he says, were the number of opportunities to satisfy that greed. The run-up in stock prices meant there was more to grab.

Revelation and outrage always follow the bursting of a bubble. The cycle is immutable. "At any given time there exists an inventory of undiscovered embezzlement," economist John Kenneth Galbraith wrote in "The Great Crash of 1929." "This inventory -- it should perhaps be called the bezzle -- amounts at any moment to many millions of dollars. ... In good times people are relaxed, trusting and money is plentiful. But even though money is plentiful, there are always many people who need more."

Mr. Galbraith continues: "Under these circumstances the rate of embezzlement grows, the rate of discovery falls off, and bezzle increases rapidly. In depression all this is reversed. Money is watched with a narrow, suspicious eye. The man who handles it is assumed to be dishonest until he proves himself otherwise. Audits are penetrating and meticulous. Commercial morality is enormously improved. The bezzle shrinks."

ABOUT DAVID WESSEL

David Wessel, 48, The Wall Street Journal's Washington bureau chief, writes Capital, a weekly look at the economy and the forces shaping living standards around the world. He also appears frequently on CNBC.

David has been with The Wall Street Journal since 1984, first in the Boston bureau and then the Washington bureau, where he was chief economics correspondent. During 1999 and 2000, he was the newspaper's Berlin bureau chief. He also has worked for the Boston Globe, where he shared a Pulitzer Prize for a series of stories on the persistence of racism in Boston, and at the Hartford (Conn.) Courant and Middletown (Conn.) Press.

He is the co-author, with fellow Wall Street Journal reporter Bob Davis, of "Prosperity: The Coming 20-Year Boom and What It Means to You" (Random House/Times Books, 1998), which argued that the next 20 years will be better for the American middle class than the previous 20 years.

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Mr. Gipson, the mutual-fund manager, says, "There is a tendency during boom times for even honest people to shift their moral compasses, and there is a belief that everyone else is doing it. It's when the music stops, if you will and the scrutiny goes up that the over-the-top cases become apparent."

Stock options were supposed to solve a problem of the past: entrenched corporate management that wasn't serving shareholders -- the indictment that corporate raiders made with such ferocity in the 1980s.

Gordon Gekko Speaks

"Today, management has no stake in the company," raider Gordon Gekko says in his speech to shareholders in the 1987 movie "Wall Street." "Where does Mr. Cromwell [the CEO] put his million-dollar salary? Not in Teldar stock. He owns less than 1%. You own the company. That's right, you, the stockholders. You are being royally screwed over by these bureaucrats with their steak luncheons, hunting and fishing trips, their corporate jets and golden parachutes."

The solution, widely embraced in American business, was to use stock options to link executives' and shareholders' interests. It sounded reasonable: Executives would benefit if they managed companies in a way that lifted share prices.

[Perturbed Investors in Europe Hope to Turn Off Bonus Spigot⁶](#)

It didn't work as intended. A soaring stock market rewarded executives not for good strategic management, but for riding the roller coaster. And when the stock price dipped below the exercise price -- essentially making the options worthless -- some companies simply revised the terms or, in Wall Street jargon, "reloaded" them.

Even worse, the incentives to do almost anything to increase the stock price were huge. And the incentives weren't to increase profits and share prices over a decade or two, but rather to increase profits -- never mind if they have to be restated later -- just long enough for executives to cash out, often without ever risking any of their own money to buy shares in the first place.

Stock options, Mr. Pitt says, were "a device that was supposed to align shareholder and manager interests -- and actually 'disaligned' them." Not all executives were swayed, of course, but an ill-designed compensation system pushed them in the wrong direction.

Of course, corporate executives aren't supposed to be monarchs. All sorts of checks and balances have been established during the past century: accountants, lawyers, securities analysts, investment bankers, audit committees, regulators, even the press.

None of the abuses that have been exposed in the past 10 months were committed by chief executives who worked alone to steal shareholders' money. "In every one of these cases," says Mr. Sporkin, the former SEC chief, "you have professional assistance."



This exposes one of the problems that have plagued corporate capitalism since its inception. "When the laws or regulations fail to protect investors, corporate insiders -- whether managers or owners -- tend to expropriate," economists Gene D'Avoilio, Efi Gildor and Andrei Shleifer asserted in a paper they presented at a Federal Reserve Bank of Kansas City conference last summer.

Perhaps the rules were inadequate; that's still being debated. But there is little debate about the failure of the professionals who are supposed to see that rules are obeyed and executives are honest.

The decay of professionalism -- and codes of ethics that distinguished a profession from a job -- intensified in the 1990s, but it didn't begin then. Reflecting on his 23 years in corporate management, Mr. O'Neill recalls a parade of Wall Street professionals who came to his office with plans for "new and exotic" financial maneuvers to reduce his company's tax bill or report debt levels in ways "not clearly prohibited by the tax code or law," but not designed to illuminate corporate operations, either.

"They get," he says, "into an ethical vacuum space."

The shortcomings of accounting firms are now well exposed. The duplicity of some highly paid Wall Street analysts is documented in internal e-mails that are now public. The acquiescence of the lawyers inside Enron and Tyco, as well as the readiness of lawyers to clear increasingly aggressive corporate tax shelters for other companies, is readily apparent.

This disturbing pattern is the biggest reason why the abuses of the 1990s can't easily be dismissed as the fault of a few flawed human beings. "The professional gatekeepers were greatly compromised by finding they could make tremendous profits by deferring to management," says Columbia's Mr. Coffee.

But not one of the instances of egregious abuse of shareholder interest could have occurred if the CEO had simply said, "No!"

The climate made it commonplace. The incentives were perverse. The watchdogs were sleeping. But not every company did it. What distinguishes those that did from those that didn't?

Mr. Gipson, the mutual-fund manager, divides offenders into two classes: the "confirmed crooks" who deliberately and willfully ripped off shareholders, and the "morally marginal who went right up to the line of acceptable behavior" and then "when the line was moved found themselves on the other side."

Treasury Secretary O'Neill makes a similar point: "A little lie leads to ever bigger ones in lots of cases without a recognition on the part of the perpetrator that they ever told a lie, even when it gets grotesque. They say, 'If only I had another 12 months ... ' "

Case Studies

At Harvard Business School, the citadel of corporate management, the faculty uses case studies of heroes and villains in an effort to inoculate students against the temptations they will inevitably confront.

"Maybe," says a member of that faculty, Richard Tedlow, "we ought to think about CEOs and other managers as fully formed human beings, not as people who focus on one variable and who check their personalities at the coat rack. Some of what was going on was people doing exactly what the incentives suggest that they do: Give me a lot of stock options, and I'll make the stock go up.

"But something is missing," he adds. "Life is lived on a slippery slope. It takes a person of character to know what lines you don't cross. That part of the equation of corporate management hasn't had the emphasis it should have had in the last decade or two."

The excesses of the 1920s and the spectacular crash of the stock market in 1929 led to the creation of modern financial regulation, from bank-deposit insurance to the ban on insider trades, in 1933 and 1934. Despite the obvious parallels, this is a different time. The U.S. is not in an economic depression, nor does George W. Bush see himself as Franklin Delano Roosevelt's heir. The debate over how to repair the system is just beginning to take form; this week saw competing legislative and SEC proposals to tighten oversight of accountants.

The nature and dimensions of the reforms depend on factors that aren't knowable. How many more Enrons and Tycos remain unreported? How swiftly will corporations, boards of directors, the New York Stock Exchange, the National Association of Securities Dealers and other self-regulatory organizations move to reassure investors? And, most important of all, how much longer will the stock market languish?

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