People draw different lessons from Enron’s meteoric rise and spectacular fall.¹ Some conservatives called it a triumph of capitalism, proof that “the system” works (because no one in the Bush Administration moved to “bail out” Enron).² Some Republicans claimed that the seeds of disorder were sown in the Clinton Administration. Liberals excoriated the “crony capitalism” of Ken Lay’s friendship with George W. Bush and the tepid response of federal regulators to the California

¹ The lessons I draw owe a particularly large debt to Robert Prentice of the University of Texas. There is a considerable body of work on Enron. Among the best accounts are Dirk J. Barreverd, The Enron Collapse: Creative Accounting, Wrong Economics, or Criminal Acts? (2002); Peter C. Fusaro & Ross M. Miller, What Went Wrong at Enron: Everyone’s Guide to the Largest Bankruptcy in U.S. History (2002); Richard J. Schroth & A. Larry Elliott, How Companies Lie: Why Enron is Just the Tip of the Iceberg (2002).

² Larry Lindsey, the top White House economist, described the Enron affair as a “tribute to American capitalism,” and Treasury Secretary Paul O’Neill declared, “Companies come and go. It’s part of the genius of capitalism.”
energy crisis; crony capitalism has been cited, as well, in Enron’s undue influence in setting U.S. energy policy through Vice President Cheney’s energy task force. In short, people tend to view the Enron debacle through their own ideological filters and reinforce pre-existing beliefs.

This illustrates “confirmation bias,” our tendency to process information in a way that fits our preexisting viewpoints. It reminds me of the paperweight on my former employer’s desk that said, “I’ve made up my mind—don’t confuse me with the facts!” At business schools, Enron is often taken as evidence by those who teach business law and ethics that the curriculum needs more emphasis on both law and ethics. As a teacher of both law and ethics, I would certainly concur (further evidence that confirmation bias is alive and well). It is not clear what universities or business schools should do to create a greater awareness of and commitment to ethical behaviors; striving for an answer should, however, be something that Oakland University embraces.

My purpose in this article is not to lay down such a program, but to draw from Enron’s example some basic truths about organizations and ethics. One such truth, it seems to me, is that many “pro-market” champions are particularly prone to confirmation bias and have made assumptions at odds with reality. Viewing Enron as evidence of the efficiency and efficacy of “the market” is a view that is long on ideology and short on facts. Moreover, Enron’s example should give us all cause to reconsider the U.S. corporate model as it evolved from World War II through the end of the century. While the law persistently tried to put limits on what managers could do to manipulate employees, shareholders, and directors, insiders typically held the upper hand. In the field of law and ethics, such problems are grouped under the phrase “corporate governance.” At the same time, many scholars and commentators found the U.S. model of corporate governance a kind of “gold standard” for the rest of the world to follow—a marvel of efficiency, even where generous stock options and astronomical executive pay seemed excessive. That the Enron
debacle has not put an end to such notions is itself a marvel, a “triumph” of the confirmation bias.

To be blunt, and factual: Enron’s top management was an equal opportunity liar—dishonest with employees, shareholders, auditors, and even the Board of Directors. Sadly, this behavior was not exclusive to Enron, as a host of other corporate scandals has shown. Re-thinking corporate governance requires us to look at the legal architecture of large organizations and ask how such dysfunctions can claim such a prominent place in a “free market” that supposedly optimizes resource allocations in a modern capitalistic society.

Law and Economics vs. Reality

For at least twenty years, law and economics has been the dominant interdisciplinary approach for public policy perspectives on the legal system.\(^3\) Its principal promoters have gained considerable influence, and the theory that free markets will efficiently allocate resources without government interference has become an article of faith. One basic principle of law and economics analysis is that people will behave rationally. This axiom leads us to conclude that companies will fully and honestly disclose all relevant financial information because companies that do so can raise capital more cheaply.\(^4\) This assumption leads them to conclude that we should assume auditors will always be


\(^4\) See, e.g., Stephen Choi, Regulating Investors Not Issuers: A Market-Based Proposal, 88 Cal. L. Rev. 279 (2000). Choi’s essential notion is that because it is rational for companies and other players in the financial markets to disclose fully and fairly and because sophisticated investors can and do bargain for the amount of risk they are willing to bear regarding fraud and carelessness, the financial markets should be fully deregulated. Id. at 282-83.
honest because acting honestly is the only rational way for auditors to act; their reputation for honesty is their most valuable asset.\textsuperscript{5} Taken to the extreme, this “logic” would hold that Enron scandal could not have happened, for it would be totally irrational for Skilling and Fastow and other Enron executives to mislead, commit fraud, risk criminal indictment, and/or risk the end of Enron as a company.

But a growing stream of research roots us right back to reality. Behavioral decision research begun years ago by Amos Tversky and Daniel Kahneman (generally known as the “heuristics and biases” literature) points out that most people make many decisions that are affected by various heuristics (mental short-cuts) and biases (mental tunnels) that lead them to results that are often far from optimal. Quite a few heuristics and biases are evident among Enron executives and the Arthur Andersen accounting firm, as well as members of Congress, the accounting industry generally, and the bankers and investment analysts who touted Enron even when “rational analysts” would have pulled the plug. The heuristics and biases literature undermines standard assumptions about “rational man” (“homo economicus”) that the law and economics approach idealizes as part of its sanctification of “the market.”

First, people almost never have complete and perfectly accurate information, or the perfect capacity to process that information rationally. Second, people often display rational ignorance—they will deliberately choose to make decisions based on far less than full information. Third, people are prone to the confirmation bias. Fourth, most people (unlike homo economicus) are subject to cognitive dissonance; once they are committed to a certain position or belief, they will unconsciously suppress information that undermines that position.

\textsuperscript{5} See, e.g., Melder v. Morris, 27 F.3d 1097, 1103 (5th Cir. 1994) (“[Accounting firms—as with all rational economic actors—seek to maximize their profits . . . . [Therefore,] it seems extremely unlikely that [defendant audit firm] was willing to put its professional reputation on the line by conducting fraudulent auditing work for .”).
or belief. Fifth, most people have a tendency to remember things as they wish to remember them, and to be overconfident in the accuracy of their recollections.

Sixth, people tend to overestimate their own knowledge and ability to make accurate judgments. Seventh, the answers that people find are subject to “framing effects.” Answers are affected by how problems are framed. Thus, by properly framing their presentation, sophisticated fraudsters have more luck fooling auditors. Eighth, people tend to judge probabilities anecdotally rather than statistically; people looking for a new car will often rely more on the salient example of a friend who had bad experiences with a particular brand than on a statistically reliable, comprehensive survey of new model cars in a consumer magazine.

Ninth, people’s judgments are affected by the “anchoring and adjustment” heuristic; if an auditor starts with their clients’ numbers, for example, their judgment is anchored on those numbers and they tend not to correct adequately for new information. Tenth, the self-serving bias means, among other things, that people’s judgments, including judgments of fairness, tend to be influenced by their self-interest. Even if people are trying to be fair, what seems fair to them is inevitably influenced by what is in their own best interests. Thus, the more consulting revenue an accounting firm gains from a client, the more difficult it is for that firm to perform an objective audit.

Eleventh, people’s judgments tend to be influenced by sunk costs; economists will say it is irrational to allow sunk costs to influence judgments, but people do so every day. Twelfth, people have difficulty appreciating the long-range implications of decisions. Therefore, they tend to value immediate over delayed gratification. Thirteenth, people have bounded willpower. Even when they appreciate the long-range implications of activities such as smoking or drinking, people often lack the willpower to refrain from those activities.

This list is far from complete, but it demonstrates that (for example) while corporate officers and company audi-
tors are not always irrational, it is irrational to assume that they would always be rational. If individuals fail to act rationally, then the organizations they inhabit will tend to act irrationally as well. This judgment is consistent with landmark observations about corporate ethical behavior, such as Robert Jackall’s *Moral Mazes*. Writing some twenty years ago, Jackall found that corporations functioned as badly as many government bureaucracies, and that large organizations tended to be places where individuals could hide the consequences of their actions, where success is determined by luck, fealty to the “king,” milking a division and leaving before long-term realities caught up. Success was primarily determined by such factors as appearance, self-control, and patron power, rather than merit. In short, we should not assume that in large organizations, managers will look after the best interest of the owners (shareholders) to maximize the long-term good of the company.

**Enron’s Demise:**

*A Non-Economic Analysis*

According to the worldview of economics and law, regulation of Enron and the accounting profession was not necessary because Enron (like other rational actors) would voluntarily act honestly in order to reduce long-term costs of raising capital, its officers would not derail promising individual careers by engaging in financial fraud, and accounting firms would rationally understand that they could not prosper where their word could not be trusted by market participants.

But these views are demonstrably false in the Enron—Arthur Andersen debacle. Demonstrating this becomes important precisely because we might be inclined to regard it as exceptional or aberrant, where in reality (if heuristics and bias literature is correct) it is neither. There are lessons to be drawn from this sorry tale for any large organization.

The self-serving bias in particular served Enron poorly.
In Brian Cruver’s *Anatomy of Greed: The Unshredded Truth From an Enron Insider*, we find many examples. Enron dealt in commodities and derivative structures\(^6\) that were too unusual to have a reliable market price. So when Enron employees set monetary values on proposed deals, this affected the numbers that were “booked.” But bonuses were paid based on how high these numbers were, so of course (even assuming a modicum of good faith) the numbers were set artificially high.

The behavioral phenomenon of overconfidence is also apparent. Throughout the organization, employees believed they were the best and brightest;\(^7\) the hubris of officers such as Skilling and Fastow clearly played a role in the company’s downfall.

As Robert Jackall noted in *Moral Mazes*, various behavioral factors push companies toward overconfidence. Professor Donald C. Langevoort argues that (a) due to natural concerns about raises, promotions, and terminations within the corporate structure, good news flows to the top more quickly than bad news; (b) corporate cultures often operate to cause managers to misperceive risks and to harbor unrealistically optimistic beliefs about the corporation’s prospects; (c) heuristics, such as cognitive conservatism and decision simplification, coupled with groupthink, encourage corporate management

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\(^6\) Derivatives include any type of security whose market value is directly related to (derived from) another traded security, fixed-income instrument, currency, interest rate, or stock-market index. They are popular with small speculators who trade hybrid stocks that change in value based on an underlying index like the S&P 500. Derivatives can also hedge risk. An automotive company denomining its foreign sales in a local currency like the Mexican peso could use them to hedge against a crisis like the 1994 peso devaluation.

\(^7\) See Malcolm Gladwell, *The Talent Myth*, NEW YORKER, July 7, 2002. Gladwell observes that Enron assumed “that an organization’s intelligence is simply a function of the intelligence of its employees. They believe in stars, because they don’t believe in systems.” *Id.* Meaningful ranking was especially difficult at Enron, where “star talent” was given wide discretion to create new initiatives, and feedback on actual performance (rather than perceived “talent”) was all but impossible. *Id.* [I would observe that this fits with the ideology that systems and regulations are not necessary, because individuals will act “rationally” in “the market.”]
groups to underestimate risk and otherwise unrealistically view the firm’s competitive environment; (d) for various reasons, optimists tend to be hired and to advance faster through corporate ranks, and the resulting overoptimism coupled with the human being’s natural illusion of control leads to a “can do” culture that ignores reality; (e) once executives commit to a course of action, which they often do based on sketchy, preliminary information, it is psychologically difficult for them to change course; (f) self-serving inferences causing company managers to see what they wish to see are pervasive in business; and (g) all factors can coalesce to cause upper level managers to place a recklessly positive spin on information they receive from lower levels.8

This systematic tendency toward overoptimism was especially strong at Enron due to the fact that potential bonuses were literally “unlimited,” and Enron adopted an aggressive employee review system—a semiannual weeding out known as the “rank and yank.” Every six months 15% of employees were to be given unsatisfactory ratings that largely doomed their careers at Enron. These behavioral factors led to a very simple situation where, despite its well-known RICE (Respect, Integrity, Communication, and Excellence) code of ethics, the real rule was an unwritten one: no bad news.

The problem of sub goal pursuit permeated Enron. Because of sub goal pursuit, individual units of Enron tackled huge, risky projects and a number of them—a large power plant in Dabhol, India, a large power plant in South America, a large water business (Azurix) in England—went under, helping drag Enron down. The risk profiles of the individual units did not match the optimal risk profile for Enron itself.

Cognitive dissonance also played a major role in Enron’s demise. Enron proclaimed itself the best corporation in the world. Ken Lay repeatedly told critics that they “just didn’t get

it.” With those beliefs firmly held and repeatedly expressed, it became extremely difficult for Enron employees to process contrary information.

We know now that Enron was pulling these profits out of thin air, but no Enron employee would want to believe this; when Enron’s top management kept telling them nothing was wrong, they believed it because it was already part of a well-entrenched belief system. In addition to cognitive dissonance, part of the problem was anchor and adjustment—employees’ beliefs were anchored on the vision of Enron as an invincible corporate giant and new information would tend not to be processed in such a way as to move employees sufficiently far from that belief. Even stock analysts whose beliefs were anchored on Enron as a success had great difficulty adjusting as negative news continued to stream in.

This account leaves out the directors, the auditors, the lawyers, the bankers, and the Congress. (I will return to them shortly.) But the point is made: the worldview and assumptions of law and economics are demonstrably misleading. Assuming that managers and directors are optimizing shareholder returns, and the corporations are competing and producing in a system that effectively channels self-interest into the greater good for society is an assumption that is blind to behavioral realities.

**Law and Economics Versus Business Ethics**

Not only is the worldview of law and economics misleading, it carries a normative aspect that our students may imbibe, largely by osmosis. If our basic premise in business school or in law schools is that humans are creatures whose purpose is to maximize personal “utility” (primarily reduced to monetary units), then there is an implicit message that this is the way that humans “should” act. Many students assume that if we all just try to maximize our own “utilities,” the invisible (and magic!)
hand of the market will make everything right; that is, the market will somehow allocate resources in a way that is optimal morally and politically. If we teach our students, explicitly or implicitly, to value their personal well-being—narrowly defined in terms of monetary gains or status—then market principles suggest that ethics and morality may be traded-off for goods that are more utility-maximizing.

At Enron, money was the \textit{only} yardstick. Ethics had little or no place in anyone’s decisional calculus. This mindset started at the top with Kenneth Lay, who once said: “I don’t want to be rich, I want to be world-class rich.” With the rank and yank process, those who didn’t “make their numbers” were demoted and destroyed, and those who did make their numbers received bonuses so fabulous that Houston luxury car dealers knew to come to Enron to exhibit their wares every bonus period.

Enron demonstrates that individuals will find it difficult to do the right thing when “the right thing” is not among the options that the institution favors. A theory known as social proof provides that we all tend to take our cues for proper behavior from those around us. Social proof helps account for the success of laugh tracks on TV shows, mass suicides, and the tendency of bystanders not to help a person in peril when others seem unconcerned. Social proof causes securities analysts to initiate or abandon coverage of certain firms, so it is no wonder that it affects the actions of employees who are hired into a corrupt corporate culture. Again, if we unwittingly teach our students that the market will somehow sort all self-interested material striving into a greater collective good, then we undermine their respect for non-material values.

If we unwittingly teach that winning is everything, and that winning is measured monetarily, then we are not serving the greater good that is Detroit, Michigan, this nation, or the world. Any system, any organization, will surely reap what it has sown. Enron did. Doug Shuler, an organizational behavior professor at Rice University who worked at Enron for six months, described it as a “swagger place.” “Can you make the
deal?” was the operative question at all times. John Olson, veteran energy industry analyst, notes that there were plenty of smart people, just an absence of “wise people, or people who could say ‘this is enough.’”

There was, of course, the RICE code of ethics. But it seems to have been one of those “3– P” codes that wind up sitting on shelves—Print, Post, and Pray that something is actually going to happen. In fact, the Enron Board twice suspended the code in 1999 to allow outside partnerships to be led by a top Enron executive who stood to gain financially from them.10

Any business ethics professor can tell you that what executives reward is far more important than what they or a code of ethics says. If your manager wants only good news, then you will never give him or her bad news. Killing the messenger is a common syndrome in corporate America. Consider the story of James Alexander at Enron, who was deliberately marginalized after bringing problems to Ken Lay’s attention.11 When Sherron Watkins sent Ken Lay a letter warning him about Enron’s accounting practices, Andrew Fastow tried to fire her.12

**Corporate Governance and Regulation—the lack of checks and balances**

There was a breakdown of basic corporate governance at Enron. Unfortunately, many of the shortcomings noted below are true not only of Enron, but of many other companies.

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10 From a Vinson and Elkins report, prepared for Enron.

11 John Schwartz, *An Enron Unit Chief Warned, and was Rebuffed*, N.Y. TIMES, Feb. 20, 2002.

THE BOARD OF DIRECTORS—

The Board of Directors did not closely question management. James D. Cox, authority on corporate law and accounting at Duke University Law School, noted that Enron’s board, “. . . like other companies that have gotten into trouble, was composed of people interested in solidifying relationships rather than meaningful review and oversight.” It is still true that “most board members are willing dupes of management.”13 Three of the six directors on the auditing committee were executives at firms in Hong Kong, London, and Rio, making effective oversight on audits somewhat unlikely.

The directors approved stock options, presumably to help align the interests of management with that of shareholders. But it didn’t work out that way, perhaps predictably. Enron’s stock options are a case study in how option awards grew so large that they distorted business and ethical judgment, encouraging some executives to do anything to report strong earnings every quarter so that the stock price will rise. The Enron Board stood by while top executives cashed out more than $1 billion in company stock during the last two years of Enron’s existence.14

The directors were also compromised by material inducements. The Enron Board’s independence was compromised by the lavish material inducements that members accepted from the company. One director received hundreds of thousands of dollars in consulting fees. Another who headed a cancer institute received more than $1 million in Enron donations.15

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13 Bennis, supra note 12.
14 Bennis, supra note 12.
15 Cleaning up the boardroom, editorial, N.Y. TIMES, Mar. 8, 2002.
**ENRON LAWYERS —**

Lay people (not Ken Lay’s people) often deride lawyers for being sleazy, for being “guns for hire.” Lawyering was supposed to be a profession, partly (at least) motivated by a desire to serve the public interest. But big money has a way of offering temptations that smart people cannot resist. Vinson and Elkins made lots of money in helping to set up the partnerships that concealed the true financial state of the company. Smart lawyers are hired to creatively test the edges of what is legal, and make plausible arguments why their clients have acted “in accordance with the law.” But it is usually the letter of the law that is complied with rather than the spirit of the law.

**AUDITORS —**

Arthur Andersen had multiple and potentially conflicting roles; there were no concerted alarms about improper financial statements. Perhaps the biggest failure was reviewing a financial product they did not understand, and failure to be aggressive in questioning management. Enron pressured Arthur Andersen to muzzle an internal critic last year when he challenged too many of the company’s accounting practices. Carl Bass, an Andersen partner, was removed from his post on the firm’s prestigious Professional Standards Group when Enron complained in March 2001 that he was being too critical. Thus, it was not forthright for Andersen to claim, as they did initially, that wrongdoing was confined to the Houston office of Anderson. The job of auditors is to ask tough questions; states have professional standards for lawyers, doctors, and accountants: the reason is to protect the public interest.
BANKS –

Citigroup, J.P. Morgan, and Credit Suisse First Boston made loans disguised as hedges. “JP Morgan Chase and Citigroup provided billions to Enron while also stage-managing its huge investment deals around the world and arranging a fire-sale buyout by Dynergy that failed. Instead of demanding more prudent management, these banks lent additional billions during Enron’s final days. Instead of warning other banks about the rising dangers, Chase and Citi led the happy talk. Both have syndicated many billions in bank loans to other commercial banks—a rich fee-generating business that allows them to pass the risks on to others. . .”

THE INVESTMENT COMMUNITY—

The investment community set up the earnings-management game in which executives who “managed earnings” were rewarded with high stock prices, favorable ratings from stock analysts, glowing news articles, and huge personal profits from stock options that have value only if the shares go up. In terms of earnings management, Enron stood tall but is hardly alone. In the euphoria surrounding the NASDAQ bubble, there was big money to be made telling shareholders what they wanted to be told.

Conclusion: Systems, Laws, and Values Do Matter

Economist and New York Times columnist Paul Krugman notes that capitalism as we know it depends on a set of insti-

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tions—many of them provided by the government—that limit the potential for insider abuse. These institutions include modern accounting rules, independent auditors, securities and financial market regulation, and prohibitions against insider trading. Investors must be reasonably sure that reported profits are real, that executives won’t use their positions to enrich themselves at the expense of stockholders and employees, and that when insiders do abuse their positions their actions will be discovered and punished.

If Congress is unhappy with a FASB standard, it can pass a law directing the SEC to ignore it. From 1991 to 1994, Congress prevented FASB from issuing a standard that would have forced companies to take a charge against earnings when they issue employee stock options. Arthur Levitt, former head of the SEC under Clinton, has complained long and loud about this reality. Few accountants will deny that FASB was unable to close accounting loopholes as rapidly as Enron and Andersen created them. But Congress has not allowed even a modest tweaking. “Congressional involvement in financial standard-setting has been pure politics, fueled by a system of campaign financing that distorts the pursuit of the nation’s legislative agenda.”

Earlier, I noted that the top economist in the Bush Administration described the Enron affair as a “tribute to American capitalism.” But Enron’s rise and fall is not a triumph of capitalism; it is, rather, a story of market manipulation gone unchecked. To quote Alan Greenspan: “modern market forces must be coupled with advanced financial regulatory systems, a sophisticated legal architecture, and a culture supportive of the rule of law.”

Thus, we should be wary of reifying “the market” or the present realities of corporate governance (insiders operating for their own self-interest, or those of their sub-groups, manip-

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19 *Id.*

ulating Boards, employees, auditors, and other constituencies) or assuming that market participants are rational actors in the way that law and economics would have us assume. Enron demonstrates not the exception that proves the rule, but demonstrates, instead, the rule of exceptional self-interest governed by heuristics and biases. We could call it self-interest on steroids.

Nationally, any systematic reform must take human nature, organizational realities, and the market ideals of transparency and honest competition into account. Whether public or private, profit or non-profit, organizational ethics requires that systems be put in place to ensure that all parts of the organization are well-informed, that negative feedback is allowed to temper over-optimism, that quality is measured by something more than numbers, that sub goals within the organization do not overcome the overall mission, and that quality includes ongoing ethics conversations about what is valuable and worthy of the organization’s mission.