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COMMENT: CORPORATE GOVERNANCE EVENTS: LEGAL RULES, BUSINESS ENVIRONMENT AND CORPORATE CULTURE

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Commissioner Campos has focused our attention on what might be termed corporate governance events. Such events may be seen as episodes involving the failure of a company's corporate governance process to address behaviors that may involve undesirable, unethical or even fraudulent actions or activities. Understanding corporate governance events requires attention to the actual behaviors underlying such events both in terms of affirmative acts as well as acts of omission, which in turn highlights the importance of education as one tool to avert such events. Corporate governance events also entail recognition of two distinguishable features of the settings in which they take place. The first is broader and relates to the general business environment in which such events occur. The second is more particular and concerns the specific corporate cultural context where such events unfold.

The episodes, often grouped within the rubric of corporate governance events, are by no means identical. A Google search for corporate governance events reveals a familiar list of names: Enron, WorldCom, Conseco, Global Crossing and Tyco, and more recently Fannie Mae, Freddie Mac, Computer Associates and Disney. Such episodes are also not limited to the United States, and a number of companies based in Europe could be added to the above list, including ABB, Vivendi, Parmalat and Shell. Although not identical, one commonality in a large majority of these cases relates to questionable, and in

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some cases even fraudulent, accounting practices. The fact that accounting practices tie many of these episodes together is in large part a result of the business environment of the late 1990s in which these and other companies operated.

Corporate governance events from the late 1990s onwards have taken place in the context of a changing business environment in which intangibles such as information technology were increasingly important forces. In fact, during the latter half of the twentieth century a transition has been apparent to what might be characterized as an intangibles paradigm in which intangibles have been more and more pervasive in business worldview and practice.[1] This increase in intangibles has been attributed to a number of factors, including increased global competition and deregulation in the latter half of the twentieth century, particularly in the 1980s and 1990s.[2] These factors, combined with an upsurge in information and communication technologies (ICTs), have contributed to the rise of intangibles.[3] The rising prevalence of intangibles has in many respects presented challenges to existing accounting and legal disclosure standards.

The corporate behaviors manifested in corporate governance events must be evaluated within the context of this changing business environment. This business environment is important because it reflects to some extent changing rules of the game that were an important background element to corporate governance events. As Commissioner Campos has noted, new rules of the game often also present new opportunities for fraud. This new paradigm has put pressure on existing standards and rules, as is evident in accounting, for example. As a result, the intangibles paradigm also can make transparency more difficult to achieve; it can make measurement and verification of accounting numbers more difficult, and it can challenge the ability of companies to make adequate and accurate disclosures.[4]

The most obvious response to such corporate episodes would be to change the rules that may have either failed to prevent or facilitated their occurrence. This is an approach that is currently being applied. As a result, one important consequence of the post-Enron regulatory era has been changes in governance rules. For example, the Sarbanes-Oxley Act of 2002[5] and other rules with respect to accounting

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[1] Olufunmilayo B. Arewa, *Breaking Through the Intangibles Haze: Measuring and (Mis)Representing Economic Reality under the Intangibles Paradigm*, 45-56 (January 25, 2005) (unpublished manuscript on file with author).

[2] BARUCH LEV, INTANGIBLES, MANAGEMENT, MEASUREMENT, AND REPORTING 9 (Brookings Institution Press 2001).

[3] *Id.*

[4] Arewa, *supra* note 1, at 56-65.

[5] Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 7201-7266 (West Supp. 2002) [hereinafter,

treatment of special purpose entities (SPEs),[6] which increased the minimum third-party interest from 3 percent to 10 percent to avoid consolidation of the SPE, are two specific rule changes that came about subsequent to and no doubt at least partly as a result of the corporate governance events that occurred in and after the late 1990s. Although it may be early to determine the effectiveness of these rule changes, as Commissioner Campos has observed, rules really can influence behavior. As a result, changes in rules that might lead to greater board independence, separation of the CEO from the chairman, which is still under discussion in the U.S. and which remains more typical in Britain than the U.S., and changes in the composition of audit committees can make a difference in behavior. Further, such rule changes may have an influence on outcomes with respect to potential corporate governance events.

Although rule changes have the potential to influence behavior, two points should be noted about the rule changes adopted in the post-Enron context. In the first place, these rules do not and likely cannot by their nature directly address many of the issues that arise from the business context of the intangibles paradigm within which these corporate events occurred. In addition, such rules do not necessarily touch upon issues of internal corporate cultural context. Corporations often have discernible cultural styles and practices that form a foundation that may encourage or discount particular types of behaviors. One example of corporate culture influencing behavior is Enron, where what might be described as an aggressive, assertive and largely unreflective corporate culture contributed to and facilitated fraud.[7]

Sarbanes-Oxley].

[6] *See* FINANCIAL ACCOUNTING STANDARDS, Emerging Issues Task Force Issue 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions* (Financial Accounting Research System CD-Rom, current through 1984) (setting 3 percent as the minimum third-party interest in an SPE to avoid consolidation of the SPE); *see also* Bala G. Dharan, *Financial Engineering with Special Purpose Entities, in* ENRON AND BEYOND: TECHNICAL ANALYSIS OF THE ACCOUNTING, CORPORATE GOVERNANCE, AND SECURITIES ISSUES 103, 114-116 (Julia K. Brazelton & Janice L. Ammons eds., CCH Incorporated 2002) (discussing changing consolidation rules for SPEs and noting that the 3 percent rule was an ad-hoc solution intended as a short term band-aid that subsequently became standard practice); Jalal Soroosh & Jack T. Ciesielski, *Accounting for Special Purpose Entities Revised: FASB Interpretation 46(R),* THE CPA J., July 2004 at 30-37, *available at* http://www.nysscpa.org/cpajournal/2004/704/essentials/p30.htm (examining the response of the Financial Accounting Standards Board to the development of sophisticated SPE transactions); FINANCIAL ACCOUNTING STANDARDS BOARD, Interpretation No. 46(R) (Dec. 2003).

[7] BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON (Portfolio 2003). *See also* Ronald R. Simms, & Johannes Brinkmann, *Enron Ethics (Or: Culture Matters More Than Codes)*, 45 J. BUS. ETHICS 243 (2003) (discussing role of Enron corporate culture on the ethics of its employees).

Such cultural factors play a role in the behaviors manifested in corporate governance events. Moreover, differences in cultural context highlight the fact that similar rules may apply differently in varied business environments and in the context of different internal processes and relationships that are in part a product of corporate culture.

Assessing corporate governance events reveals that behaviors often matter and that particular corporate responses to the changing general business environment may depend on multiple interrelated factors, many relating to what might be identified as features of corporate culture, including the relationships and actions of the board of directors within and with respect to the broader corporate culture. The unhealthy distance mentioned by Commissioner Campos is relevant here. This gap is characterized by an unhealthy distance between members of the board of directors and business decisions of the public companies on whose boards they serve.

This unhealthy distance is partly a result of corporate cultural context, but it is also a function of education, which is a related aspect of this context. Good corporate governance is at least partially a learned behavior. As a result, good corporate governance and best practices may need to be relearned and revisited in different business environments and corporate cultural contexts.

The development of best practices can be considered in the context of the intangibles paradigm. Under the intangibles paradigm, companies may relate to and use accounting in a different way. The widespread and pervasive nature of intangibles and ICTs in the intangibles paradigm business practice has clearly posed challenges for both accounting rules and legal disclosure requirements.[8] As a result, in the case of software companies, recognition of revenue may pose new challenges to existing regulatory frameworks. These challenges may be a reflection of both business environment and aspects of corporate culture.

Business environment may influence accounting decisions by virtue of the fact that existing rules may need to be adapted to the particular business environments such as those associated with the intangibles paradigm. At the same time, corporate culture may also be relevant in shaping how particular companies confront the challenges that a particular business environment may pose. As a result, different companies may respond quite differently to such challenges. In the case of accounting revenues of a software company, the extent to which a particular corporate culture fosters flexibility in confronting questions that result from changes in the general business environ-

[8] Arewa, *supra* note 1, at 56-65.

ment can be important. Furthermore, this highlights the need to incorporate ongoing learning and reeducation in the face of new business environments and challenges as a desirable core feature of corporate culture.

The challenges that new business environments pose for legal and accounting rules are thus partly an issue of education and ensuring the broadest possible range of education as to the types of fraud and the types of misrepresentations that might occur in this new environment as well as taking practical steps to prevent activities and practices that might lead to corporate governance events. Such education should extend to actors within corporations as well as their gatekeepers and regulators. Such education must also be informed by the realities of the corporate cultures within which corporate governance events take place and should also seek to influence behavioral outcomes.

In many respects, Enron has been a watershed from the perspective of both legal and accounting issues. Prior to Enron, the consequences of corporate governance failure did not represent a clear and present danger to many actors in corporate contexts. For many, business failure was a much closer and pertinent concept, and intuitive understanding of the concept of business failure thus came rather easily to most actors within corporate contexts. In contrast, the concept of a business failing or ceasing to exist on account of corporate governance problems or failure was a much more distant reality. As Commissioner Campos has mentioned, however, executives being led off in handcuffs contributed enormously to the ability of many to understand the potential consequences of corporate governance failure and likely has had a significant deterrence effect.

The post-Enron era represents an important opportunity for education and relearning in the context of changing business environments and varied corporate milieus. Understanding corporate governance events thus can be transformed into a question of how to encourage private enforcement of best practices by educating diverse groups and constituencies within corporate contexts as to what constitutes best practices within changing business environments as well as within the context of different corporate cultures.[9]

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[9] *See* Denton Collins, Austin L. Reitenga & Juan Manuel Sanchez-Cuevas, *Managerial Consequences of Earnings Restatements* (October 2004), *available at* http://business.utsa.edu/departments/ acc/arc/papers/CR_Draft.pdf (looking at penalties given to managers connected to earnings restatements); Hemang Desai, Chris E. Hogan & Michael S. Wilkins, *The Reputational Penalty for Aggressive Accounting: Earnings Restatements and Management Turnover* (August 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=471842 (noting the importance of private penalties and enforcement of GAAP rules).

Such education requires a continuing effort that reflects Commissioner Campos's discussion of ethical education within corporate contexts. Such education should focus on integrity and honesty and the importance of good business practices in general as well as specific issues that might arise from consideration of the relevant business environment and applicable cultural context. As part of this education process, the distinction between structures and rules such as Sarbanes-Oxley, which are often very important, and actual behavior, must be noted. Any education effort must focus on helping actors within corporate contexts understand that behavior as might be reflected in both questions asked and those not asked. Such questions should be seen as important ways to assess and evaluate the impact and application of pertinent rules. Furthermore, how individuals who might be members of management or the board of directors actually operate within the broader corporate culture is also very important.

Consequently, whether a company is run by an imperial CEO, how the board relates to this CEO, whether the board questions a CEO, as well as a myriad of other factors, are all issues of corporate cultural context and behavior that have an impact and that must be considered within the context of how to best effectuate a system of rules given existing corporate culture and the general business environment. For that reason, in addition to considering relevant rules and focusing on actual behaviors, continuing education about corporate practices should reflect an understanding of the significance of broader environmental and contextual factors.