THE ENRON BOARD: THE PERILS OF GROUPTHINK

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> One Enron director could have made a difference.
> —William Patterson, AFL-CIO[1]

INTRODUCTION

The Enron debacle is one of the United States' most disastrous business failures.[2] One of the striking features of Enron's collapse was the firm's abrupt and dramatic transformation from what appeared to be a very prosperous company to a bankrupt enterprise in less than three months. Wall Street uniformly portrayed Enron as a successful corporation that had transitioned from an old-economy energy company to a high-tech global enterprise. Specifically, from 1998 to 2000, Enron's gross revenues rose from $31 billion to more than $100 billion, making it the seventh largest company by market capitalization of the Fortune 500.[3] In October 2001, however, Enron shocked Wall Street by revealing a $544 million charge to earnings and a $1.2 billion reduction of shareholder equity. Investor confidence plummeted when the media reported that the charge and write-down stemmed from transactions with partnerships that Enron's Chief Financial Officer controlled.[4] One month later, market faith collapsed when Enron

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[1] Matthew Benjamin, *Cardboard Board*, U.S. NEWS & W. RPT., Apr. 18, 2002, at 28, 30.

[2] For a detailed history and examination of the causes of the fall of Enron, see, *e.g.*, William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002). For other articles on the corporate governance aspects of Enron, see SAMUEL BODILY & ROBERT F. BRUNER, ENRON, 2001 (Graduate School of Business Administration, University of Virginia 2002); Lawrence Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows* (Boston College Working Paper 2002); Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233 (2002); Faith Stevelman Kahn, *Bombing Markets, Subverting the Rule of Law: Enron, Financial Fraud, and September 11, 2001*, 76 TUL. L. REV. 1579 (2002); Panel Discussion: *Enron: What Went Wrong?*, 8 FORD. J. CORP. & FIN. L. S1 (2002).

[3] *See, e.g.*, Bethany McLean, *Why Enron Went Bust*, FORTUNE, Dec. 24, 2001, at 32.

[4] For a detailed description of how these related-party transactions worked, see *Bratton*, *supra* note 2; Kurt Eichenwald, *Deal at Enron Gave Insiders Fast Fortunes*, N.Y. TIMES, Feb. 5, 2002, at A1.

In brief, Enron used many Special Purpose Entities (SPEs), through which the transferor transfers an asset to the SPE in exchange for payment other than SPE equity. The SPE usually raises the money to pay for the asset through outside borrowing or providing the transferor with its own note. Firms using SPEs are not required to consolidate these entities on their financial statements providing that (1) an outside acknowledged that the transactions with the related-party partnerships allowed Enron to inflate its earnings for the last five years and keep billions of dollars of contingent liabilities off its balance sheet.[5] The decline in Enron's stock price caused credit rating agencies to downgrade their assessments of Enron. Within weeks, this crisis of confidence led Enron to file bankruptcy.[6] As a result of Enron's collapse, thousands of employees lost their jobs and retirement savings,[7] while shareholders lost billions of dollars.

This article concentrates on the Enron Board's role in the scandal for three reasons. First, although Enron was one of numerous recent corporate meltdowns,[8] it captured the public's attention in a unique

investor funds at least three percent of the SPE's equity (2) the transferor does not "control" the SPE, and (3) the transferor gives an opinion concerning the "bankruptcy remote" status of SPE. In one case, Chewco, Enron could not find a three percent equity investor to replace CalPERS. This led Jeffrey Skilling, the CEO at Enron for the first six months of 2001, to use a hidden loan by Enron to fund the Chewco equity. In the fall of 2001, Enron recognized that Chewco did not qualify for nonconsolidation, decreasing Enron's earnings by $405 million and raising its liabilities by $628 million. To solve the equity problem that arose in Chewco, Fastow set up two related-party partnerships, LJM1 and LJM2, to serve as the three percent outside equity investor in SPEs set up by Enron. Many of the transactions with these related-party partnerships were used to manipulate Enron's reported earnings.

Many firms frequently use SPEs as vehicles for off-balance sheet securitization of financial assets such as accounts receivables. Thus, we need to take caution in any reform of these vehicles post-Enron. *See, e.g.*, Steven L. Schwarcz, *Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, 70 U. CIN. L. REV. 1309 (2002).

[5] On November 8, Enron issued restated earnings disclosing that "financial statements for these periods and the audit reports relating to the year-end financial statements for 1997 through 2000 should not be relied upon." BODILY & BRUNNER, *supra* note 2, at 39. Enron reveal that the restatement was necessary to correct accounting errors connected with the $1.2 billion write down in shareholder's equity and to consolidate three off-balance sheet entities. *Id.*

On November 19, Enron filed its third quarter earnings report with the SEC; three items shocked Wall Street as well as Dynegy, a possible merger partner. First, Enron owed $690 million to a partnership as a result of Enron's lower credit rating. Second, Enron had less funds than forecasted. Third, Enron would owe $3.9 billion from other partnerships if its credit rating fell further. Enron warned that fourth-quarter earnings would be less than expected. On November 28, rating agencies downgraded Enron to "junk status" and the deal was off with Dynegy. *Id.*

[6] *See, e.g.*, Wendy Zellner & Stephanie Anderson Forest, *The Fall of Enron*, BUS. WK., Dec. 17, 2001, at 33.

[7] On October 17, 2001, Enron management locked down its 401(k) plan for employees, which had been sixty percent invested in Enron stock. Despite the fact that employees were not allowed to sell the declining Enron stock, officers and directors are accused of unloading $1 billion over a three-year period. *See, e.g.*, Reed Abelson, *Enron Board Comes Under A Storm of Criticism*, N.Y. TIMES, Dec. 16, 2001, at BU4; Leslie Wayne, *Before Debacle, Enron Insiders Cashed in $1.1 Billion in Shares*, N.Y. TIMES, Jan. 13, 2002, at A1.

[8] Other scandals, such as Waste Management, Sunbeam, and Cendant, preceded Enron and others followed, such as *Global Crossing, Audits & Bubbles*, THE WASHINGTON POST, Feb. 3, 2002, at B.06 [hereinafter *Audits & Bubbles*] (bankrupt after booking long-term contracts as revenue immediately); Tyco, *see, e.g.*, Ellen Simon, *Tyco's Directors Could Sue Ex-CEO*, THE STAR-LEDGER, July 7, 2002 (former CEO Dennis Kozlowski accused of using company money to buy paintings, a New York apartment, and a house; directors accused of acting like "lapdogs."); George Mannes, *Adelphia Filing Details Intricate Financial Web, at* www.TheStreet.com (May 24, 2002) (directors unaware of related-party transactions); WorldCom, reports on new scandal, the WorldCom's fraud—the largest in corporate history, dealt with a simple accounting

way.[9] That is, Enron serves as a "perfect storm"[10] metaphor that the checks and balances in the American system of corporate governance are not working the way they should. Second, although other corporate watchdogs failed in Enron, the board serves as the primary protection in the corporate governance system.[11] Analysis of the Enron Board's role, however, has implications to understand the lack of diligence by other corporate gatekeepers such as analysts,[12] auditors,[13] outside counsel, institutional investors,[14] credit rating agencies,[15] journalists, investment bankers, and regulators. Finally, subsequent investigations of the Enron Board provide detailed documentation about the specifics of the Enron Board's decision making processes, providing a rare glimpse into actual boardroom dynamics.[16] These accounts suggest that

issue; they capitalized S3.8 billion in expenses. The fraud later turned out to be S7.1 billion. *See, e.g.*, Elisabeth Douglass et al., *Global Crossing Hurt by Board's Cronyism*, LOS ANGELES TIMES, Feb. 24, 2002, at C1 (board compromised by cronysim and chronic instability; in last three years thirty directors on board ranging from eight to seventeen members).

[9] For perceptive discussion of the public's sustained outrage over Enron, see Cheryl Wade, *Comparisons Between Enron and Other Types of Misconduct: Compliance with Law and Ethical Decision Making as the Best Form of Public Relations*, 1 SEATTLE J. SOC. JUS. 97 (2002) (comparing public reaction to Enron to corporate misdeeds involving harms from tobacco, the Ford/Firestone controversy, and racial discrimination at Texaco).

[10] Many commentators have used this phrase to refer to the proliferation of corporate scandals. *See, e.g.*, John A. Byrne et al., *How to Fix Corporate Governance*, BUS. WK., May 6, 2002, at 68.

[11] Congressional hearings reported: "[Enron] represents a colossal failure of virtually every mechanism that is supposed to provide checks and balances on which the integrity of our capital markets depend. And in that system, the board of directors is supposed to provide the first line of defense by overseeing the conduct of management." *Financial Collapse of Enron Corporation: Hearing Before the Subcomm. on Oversight & Investigations of the Comm. on Energy & Commerce*, 107th Cong. 7 (2002), *available at* http://energycommerce.house.gov/107/action/107-88.pdf. [hereinafter *Enron Hearings*].

[12] For criticism of the role of analysts in pumping up Enron's stock prices, see, *e.g.*, Joseph Fuller & Michael C. Jensen, *Just Say No to Wall Street* (Harvard Business School Working paper 2002), available at http://ssrn.com; Leslie Wayne, *Congress' Scrutiny Shifts to Wall Street and Its Enron Role*, N.Y. TIMES, Feb. 19, 2002, at A1.

[13] *See, e.g.*, Sean M. O'Connor, *The Inevitability of Enron and the Impossibility of "Auditor Independence" Under the Current Audit System* (Working Paper 2002), available at http://ssrn.com; Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight Into Securities Fraud Litigation*, 95 NW. U. L. REV. 133 (2000).

[14] Diana B. Henriques, *CalPERS Knew of Problem But Kept Silent*, N.Y. TIMES, Feb. 5, 2002, at 1. CalPERS board's also had conflicts of interest—five members of the board owned stock also owned by CalPERS and received political campaign contributions from companies in which they invested. Sharon L. Crenson & Martha Mendoza, *Problems at Pension Fund Giant*, MARKET NEWS INT'L, July 18, 2002.

[15] *See, e.g.*, Patrick Caragata, *Protecting Public Confidence in the Market Place*, 10 BOARDROOM, July/August 2002, at 1 (through Oct. 2001, Goldman Sachs, CSFB, UBS Warburg, and Salomon Smith Barney rated Enron a "strong buy"; Merrill Lynch rated Enron "buy.").

[16] We know little about what actually goes on in boardrooms because minutes of board meetings are not publicly available. DEL. CODE. ANN. tit. 8, § 220 (shareholders can inspect corporate records if they show proper purpose). In the future, institutional shareholders may use these types of statutes to make directors more accountable.

Thus, I use Enron for this case study because of information available in the Powers Report, congressional hearings, and the Senate Report. *See infra* note 17. Congress is currently evaluating the boards of other scandals.

a significant factor contributing to Enron's demise was the Enron Board's approval of and failure to monitor the related-party transactions.[17] Although the Enron Board's waivers of the company's ethics code to allow these deals were unusual events, the Enron Board's actions serve as a case study of boardroom politics that may influence other corporate boards to varying degrees.[18]

This article responds to a question many commentators have debated in the aftermath of Enron: How could the Board let it happen? Why was the Enron Board fooled by the emperor's new clothes? The Enron Board consisted of experienced and intelligent people.[19] The Enron

[17] *See, e.g.*, WILLIAM POWERS JR., BOARD OF DIRECTORS OF ENRON, REPORT OF THE SPECIAL INVESTIGATIVE COMMITTEE OF ENRON (Feb. 1, 2002) [hereinafter POWERS REPORT], *available at* http://news.findlaw.com/hdocs/docs/enron/sicreport; SENATE GOVERNMENTAL AFFAIRS COMMITTEE, THE ROLE OF THE ENRON BOARD IN THE COLLAPSE OF ENRON CORPORATION 1 (May 7, 2002); U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE (Report 107-70, July 8, 2002) [hereinafter SENATE REPORT].

William Bratton provides a subtle and complex account of the fall of Enron that includes the related-party transactions in conjunction with three factors. Bratton, *supra* note 2. First, Bratton explains that the Enron SPEs involved funding with Enron's own stock in return for debt instruments of the SPEs. The proper accounting treatment required an increase in shareholders' equity as the notes were paid. Enron, however, booked the notes issued by the SPEs as assets on its balance sheet and increased its shareholders' equity immediately. This improper accounting led Enron to reduce shareholders' equity by $1.2 billion. *Id.*

Second, Enron's "asset-light strategy" involved forming SPEs with Enron's own stock as a fall back. Specifically, Enron used LJM-related SPEs as counterparties in equity swaps, so that if the stock Enron held in its merchant portfolio decreased, the SPEs would have to pay Enron. When Enron's stock price fell, Enron was issuing its own common to cover its income statement loss. Bratton notes: "This one may not do under the most basic rules of accounting, indeed, under the most basic rules of capitalism." *Id.* Enron executives concealed this series of transactions from Board. *Id.*

Third, as Enron's stock declined beginning October, 2001, contract contingencies began to trigger $4 billion of off balance sheet debt. Enron did not disclose this debt until November, 19, 2001; this led to credit agencies downgrading Enron. *Id.*

In summarizing the fall of Enron, Bratton explains: "Had Enron suffered no reverses in its basic business and no crisis of confidence, the contingencies respecting the $4 billion of obligations that pushed Enron into Chapter 11 might never have occurred. . . . We can pare down the account by coupling the crisis of confidence and the hidden $4 billion of obligations as primary causes." *Id.*

[18] *See, e.g.*, Benjamin, *supra* note 1 (Ken Bertsch of TIAA-CREF stating that Enron suggests boards may still serve as rubber stamps); Ralph Whitworth, *Self-Governance in the Wake of Enron: What Must Change*, DIRECTORS' MONTHLY, July 2002, at 13-14 (same).

[19] The Enron Board consisted of fourteen directors; Robert Belfer (since 1983); Norman Blake (since 1993); Ronnie Chan (since 1996); John Duncan (since 1985); Wendy Gramm (since 1993); Robert Jaedicke (since 1985); Kenneth Lay (since 1985); Charles Lemistre (since 1985); John Mendelson (since 1999); Paul Perraz Pereira (since 1995); Frank Savage (since 1999); Jeffrey Skilling (since 1997); John Wakeham (since 1994); Herbert Winokur (since 1985). Enron Proxy Statement (Mar. 27, 2001), *available at* http://edgar-online.com. Ken Lay was Board chairman and CEO; Jeffrey Skilling was a board member from 1997 until August 2001 when he resigned from Enron. The Enron Board consisted of one Asian American woman, one Hispanic man, one Asian man, and one African American man. The Enron directors had impressive qualifications: former chairperson of the executive committee of Gulf & Western, Industries; former chair person of the U.S. Commodity Futures Trading Commission; former Secretary of State for Energy of the United Kingdom; Professor of Accounting and former Dean of the Stanford

directors followed many of the best practices for good corporate governance, achieving acclaim as one of the five best boards in corporate America.[20] In addition, corporate commentators hailed the landmark decision of *Smith v. Van Gorkom*[21] as requiring independent directors to ask management hard questions.[22] So why did the Enron Board neglect to make these inquiries despite the presence of significant red flags? Why were these sophisticated, bright directors duped by such objectively defective proposals? Have the best practices of corporate governance been more myth than reality?

To understand the Enron Board's role in the firm's demise, this article examines the literature from social psychology on small group decision making.[23] In the last few years, corporate governance scholars have turned away from the dominance of neoclassical economics toward social psychology to focus on how cognitive imperfections such as ego and self-deception distort decision making. Although social psychology depends on laboratory studies that may not fully approximate real world settings,[24] this research offers a much more realistic approach than the rational actor model for evaluating the role of directors. Social psychology shows that groups are generally better than individuals in making many of the types of decisions made by boards. This research also reveals, however, that groups can suffer from behavioral defects similar to those that affect individuals. While human frailties are magnified in groups, groups can also succumb to their own distinct patterns of cognitive faults.[25]

Using the lens of social psychology, this article seeks to shed light on the debate about whether the recent corporate scandals involve only 'a few bad apples' or whether corporate governance is 'rotten to the core.'[26] Without empirical data, we cannot know whether either

Business School. Enron Proxy Statement (2000), *available at* www.edgar-online.com.

[20] Thomas R. Horton, *Groupthink in the Boardroom*, SOME THINGS CONSIDERED 9, Winter, 2002.

[21] 488 A.2d 858 (Del. 1985) (directors breached due care by approving decision to sell company in a two-hour meeting, held on short notice, relying only on oral report from CEO and failing to ask questions). For a recent symposium on this case see, *Symposium: Van Gorkom and the Corporate Board: Problem, Solution, or Placebo?*, 96 NW. U. L. REV. 447 (2002).

[22] *See, e.g.*, Lynne Stout, *In Praise of Procedure: An Economic and Behavioral Defense of* Smith v. Van Gorkom *and the Business Judgment Rule*, 96 NW. L. REV. 675, 690 (2002).

[23] The behavioral law and economics movement relies on much of the literature in social psychology. For a general overview of behavioral law and economics, see BEHAVIORAL LAW AND ECONOMICS (Cass R. Sunstein ed., 2000); Donald Langevoort, *Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Overview*, 51 VAND. L. REV. 1499 (1998); Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998).

[24] *See, e.g.*, Jennifer Arlen, *The Future of Behavioral Economics of Law*, S. VAND. L. REV. 1765 (1998).

[25] Donald C. Langevoort, *Taking Myths Seriously: An Essay for Lawyers*, 74 CHG.-KENT L. REV. 1569, 1577 (2000) [hereinafter Langevoort, *Myths*] (noting the relationship is controversial).

[26] *See* Cover, *The Crisis in Corporate Governance*, BUS. WEEK, May 6, 2002, http://www.

position has validity. In the absence of statistical evidence, this article surmises that both explanations are inadequate. On the one hand, we should not accept the story that there are only "a few bad apples," given the proliferation of corporate meltdowns and the widespread knowledge required within many of the corporations for the problems to occur. On the other hand, we need to resist the cynical view that most corporate actors are corrupt. Although the scandals appear to involve some greedy, deceptive individuals, we should not generalize their motivations to others in the corporate governance system.

Social psychology teaches that people are fallible. Specifically, good corporate actors can make bad decisions when placed in certain situations. They can do so without guilt, however, because self-serving biases allow them to rationalize their behavior to maintain self-esteem.[27] Societal and corporate norms foster this rationalization process so that corporate actors can continue to think of themselves as honorable people. This perspective explains why many boards have learned to go through the motions of good corporate procedures, but nevertheless continue to fail to challenge managers when necessary. Although actors falling under the influences of cognitive defects may be less morally blameworthy than first appears, behavioral biases should not serve as a legal defense for poor behavior. This would allow genuinely corrupt actors to assert disingenuous defenses that courts would not be able to distinguish from those involving honest, good faith behavior. Rather, an understanding of cognitive biases is useful in evaluating the potential of corporate governance reforms to change the dysfunctional norms present in some boardrooms. Specifically, effective reform requires not only implementing new procedures, but also eliminating the behavioral barriers that jeopardize their effectiveness.

This article uses social psychology to build a case study for how the Enron Board may have been affected by a significant impediment to group deliberation called "groupthink." As this article explains in more detail below, Irving Janis, the creator of this theory, described groupthink 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 actions."[28] According to Janis, groupthink causes members

businessweek.com/magazine/toc/02_18/B3781govern.htm; Cover, *Wall Street: How Corrupt is it?*, BUS. WEEK, May 13, 2002, http://www.businessweek.com/magazine/toc/02_19/B3782magazine.htm.

[27] For an overview of issues pertaining to corporate morality, see, *e.g.*, Donald C. Langervoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997) [hereinafter Langevoort, *Illusions*].

[28] IRVING JANIS, VICTIMS OF GROUPTHINK 78 (1978) [hereinafter JANIS, VICTIMS]. For other

of a group to unconsciously generate shared illusions of superiority that hinder critical reflection and reality testing.[29] For these reasons, groupthink leads groups to make faulty judgments. With an understanding of groupthink, we can see that the Enron Board did not prevent the Enron debacle because of psychological processes that lead cohesive boards to avoid seriously scrutinizing managerial policy. Thus, examination of the cognitive factors surrounding the Enron Board's decision making is significant because such human foibles may affect other corporate boards.[30]

Part I provides background by reviewing the role of the board of directors in light of the social psychology literature on group decision making. This Part details how several of the requirements needed to obtain the optimal benefits from peer group decision making are not present in some boardrooms. Specifically, despite reforms to include more independent directors on corporate boards, CEOs retain much influence over board decision making. Even in the absence of this dominance, however, information constraints diminish director's ability to perform their monitoring role. Specifically, social psychology warns that even the most honest, hard-working, independent directors may inevitably lack the psychological objectivity necessary to scrutinize managerial policy. With this perspective, Part I analyzes how rising stock prices may create a more difficult situation for corporate governance to address (and are thus potentially more dangerous) than

literature on groupthink see, *e.g.*, IRVING JANIS, GROUPTHINK (1982); IRVING JANIS, GROUPTHINK: PSYCHOLOGICAL STUDIES OF POLICY DECISIONS AND FIASCOES (1982); Irving Janis & Leon Mann, *Decision-Making Context, in Decision Making* (1977); Won-Woo Park, *A Review of Research on Groupthink*, 3 J. OF BEH. DECISION MAKING 203 (1987); Jeanne Longley & Dean G. Pruitt, *Groupthink: A Critique of Janis's Theory*, in 1 REV. OF PERSONALITY AND SOC. PSYCHOL. 74 (1980); R. Aldag & S. Fuller, *Beyond Fiasco: A Reappraisal of the Groupthink Phenomenon and a New Model of Group Decision Processes*, 3 PSYCHOL. BULL. 113 (1993); Richard Cline, *Detecting Groupthink: Methods for Observing the Illusion of Unanimity*, 2 COMM. Q. 38 (1990); Ronald Sims, *Linking Groupthink to Unethical Behavior in Organizations*, 11 J. BUS. ETHICS 651 (1992); Peter Tetlock et al., *Assessing Political Group Dynamics: A Test of the Groupthink Model*, 3 J. PERSONALITY & SOC. PSYCHOL. 63 (1992); Matt Turner et al., *Threat, Cohesion, and Group Effectiveness: Testing a Social Identity Maintenance Perspective on Groupthink*, 5 J. PERSONALITY & SOC. PSYCHOL. 63 (1992); Christopher Neck & Gregory Moorhead, *Groupthink Remodeled: The Importance of Leadership, Time Pressure, and Methodical Decision-Making Procedures*, 48 HUM. REL. 537 (1995).

[29] JANIS, VICTIMS, *supra* note 28, at 68.

[30] Several corporate scholars have noted that groupthink is prevalent in boardrooms. *See, e.g.*, James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 J.L. & CONTEMP. PROBS. 82, 99 (Summer 1985); Jayne Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. REV. 1135 (1991). As one corporate governance commentator remarks: "It's always been interesting to me that you take these intelligent, accomplished, honorable people, and somehow you put them around a boardroom table and their IQ points drop 50 percent and their spines fly out the room." *All Things Considered, Nell Minow Discusses How Companies Can Restore Investor Confidence* (NPR radio broadcast, July 2, 2002).

declining stock prices. Indeed, the recent corporate scandals suggest that a bubble stock market may lull boards into a false sense of security.

Although this article focuses on the problem of groupthink, Part II examines two related, but distinct, negative aspects of group decision making called "polarization" and "cascades." Polarization refers to the strong tendency of like-minded people deliberating in groups to move toward extreme consequences.[31] Specifically, polarization shows that groups make riskier decisions than those made by individuals acting alone. A cascade involves 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. While polarization and cascades are helpful in developing a fuller account of board deliberations, this article maintains that groupthink may more accurately reflect the social dynamics of the Enron Board's failure to properly monitor the related-party transactions. Each of these theories, however, is a form of "group-mindlessness," that is, a process whereby persons adjust their behavior in response to their impressions of other group members. Thus, polarization, cascades, and groupthink may have each contributed to the Enron Board's decisions regarding the related-party transactions. Social psychology emphasizes that when several factors come together, they can multiply group biases so that the effect is much greater than simply adding the factors together.[32]

Part III presents the case study of how groupthink by Enron's board contributed to dramatically negative business consequences. In applying the groupthink theory, this Part analyzes evidence about the Enron's board's deliberations found in the Report Prepared by the U.S. Senate Permanent Subcommittee on Investigations (Senate Report),[33] Enron's Special Committee (Powers Report),[34] and congressional hearings. These investigations reveal that the Enron directors "were as surprised as anyone by the company's collapse."[35] Indeed, it appears that the Enron Board was one of the last to know about the firm's problems.[36] Likewise, in many other business failures, executives explain that they

[31] For discussion of polarization in the corporate law literature, see, *e.g.*, John C. Coffee, Jr., *No Soul to Damn: No Body to Kick: An Unscandalized Inquiry Into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 395 (1981). Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 J. CORP. L. 1 (1996) [hereinafter Dallas, *Relational*]; Cass Sunstein, *Deliberative Trouble? Why Groups Go to Extremes*, 110 YALE L.J. 71 (2000).

[32] Cox & Munsinger, *supra* note 30, at 104.

[33] SENATE REPORT, *supra* note 17.

[34] POWERS REPORT, *supra* note 17.

[35] SENATE REPORT, *supra* note 17, at 12.

[36] RALPH NADER ET AL., TAMING THE GIANT CORPORATION 17 (1976) (compare the board to "cuckold" who are "often the last to know when the dominant partner-management-has done something illicit.").

could not comprehend how they could let it happen; that is, they felt swept along in disregarding warning signs and believing irrational predictions. Groupthink explains how and why this happens.

Part IV discusses the reforms recently passed by the New York Stock Exchange (NYSE) to improve board decision making in terms of their potential to prevent groupthink.[37] This Part is skeptical that these reforms will end the era of laxity when directors fail to ask hard questions.[38] While these reforms empower directors with better tools for decision making, they do not go far enough. In the end, we need directors who are bold and courageous enough to say that the emperor has no clothes. To facilitate this behavior, this Part proposes two reforms based on the literature aimed at preventing groupthink. First, Part IV recommends establishing and rotating the role of the devil's advocate on the board. The devil's advocate role formalizes the right to challenge managers in a manner that does not undermine the independent directors' collegial relationships with corporate insiders. This reform provides independent directors with the "power to act," but it does not assure that they have the "will to act."[39] To assure more directors have the "will to act," the second proposal seeks to increase diversity on corporate boards by appointing directors with "outsider values." By increasing diversity, this reform reduces the existing homogeneity that can lead to groupthink.[40] In this regard, several institutional investors promote diversity on boards to foster divergent thinking that may contribute to board effectiveness and ultimately shareholder value. Of course, formalizing the role of the devil's advocate and increasing diversity on the board are not cure-alls for the various cognitive biases that influence directors. Admittedly, there is no simple solution. Even with these reforms, time and informational constraints will continue to limit what we can expect from boards. Along with the NYSE reforms, however, the implementation of these two methods to prevent groupthink may play a significant role in reducing the conformity pressures that inhibit candid discussion in the boardroom.

In Part V concludes that the proliferation of recent corporate scandals should lead corporate law professors to engage in critical self-reflection

[37] Report of the New York Stock Exchange Corporate Accountability and Listing Standards Committee, approved August 1, 2002; set for approval by the SEC on September 6, 2002.

[38] Jean Strouse, *Capitalism Depends on Character*, N.Y. TIMES, July 7, 2002, at 9.

[39] *See, e.g.*, Shannon Turnbull, *Crumbling Corporate Governance Myths*, 704 J. OF CORP. DIRS. ASS'N OF AUSTL. 5 (2002), *available at* http://www.thecorporatelibrary.com/special/turnbull/turnbull10.html (distinguish the power to act" verus the "will to act").

[40] I use the term "diversity" broadly to mean gender, race, class, ethnicity, age, national origin, sexual orientation, and socio-economic background.

about how and what we teach in our business courses. As professors, we influence the ways students perceive the corporate world and their lives as corporate attorneys. We need to find a way to get past the prevailing cynical accounts of corporate governance and overcome the public disillusionment with corporate actors. On the one hand, we should not provide students with a picture of human behavior as solely self-interested because this dark view can become a self-fulfilling prophecy.[41] On the other hand, we do not want to foster blind faith in corporate actors, either. Rather, we should encourage "cautious trust," a perspective that is both realistic and idealistic at the same time.[42] To achieve these goals, Part V calls on corporate law professors to emphasize corporate morality in teaching their courses. To include ethics in business courses, this Part recommends that we teach students about social psychology so that they can recognize and avoid the various cognitive biases present in corporate cultures. This perspective is important for corporate attorneys to fulfill their new obligations to report corporate wrongdoing to the board under the Sarbanes-Oxley Act.[43] Specifically, unless transaction lawyers overcome cognitive limits, they will fail to appreciate red flags indicating potential corporate wrongdoing. Part V urges that an effective teaching tool to convey the essence of these behavioral traps is to tell morality stories such as the one offered by the tale of the Enron Board.

I. SOCIAL PSYCHOLOGY AND THE MONITORING FUNCTION OF CORPORATE BOARDS

A. Small Group Decision Making and Boards

Corporate boards serve three roles. First, their most important function is to monitor firm performance to prevent managerial self-dealing and shirking.[44] Second, board members provide advice and guidance to senior managers in making major policy decisions.[45] Finally, the board serves a relational function, whereby board memberships provide links to various corporate stakeholders.[46]

[41] *See, e.g.*, Jeffrey Rachlinski & Cynthia Farina, *Cognitive Psychology and Optimal Government Design*, 87 CORN. L. REV. 549, 554 (2002).

[42] Jerry L. Mashaw, *Deconstructing Debate, Reconstructing Law*, 87 CORN. L. REV. 682 (2002).

[43] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, sec. 307, 116 Stat. 745, 784.

[44] *See, e.g.*, MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 140-48 (1976).

[45] *See, e.g.*, JAY W. LORSCH & ELIZABETH MCIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS (1989).

[46] Dallas, *Relational*, *supra* note 31, at 1-3.

Recently, corporate law scholars have turned to the literature in social psychology on small group decision making to evaluate the deliberative processes of boards. This literature provides support for the requirement in corporate statutes that the board meet as a collective body because groups make better decisions than individuals in evaluative assignments.[47] For these tasks, groups provide more reliable decisions, generate fewer errors, and uncover more mistakes than individuals.[48] To explain these results, social psychologists theorize that groups curb individual weaknesses by offering different perspectives, arousing greater attention to the issues, and correcting random errors among members.[49] Thus, these studies provide support for the board's role in overseeing managers' plans.[50]

Social psychology offers evidence that changing the processes used in group decision making can improve the outcome.[51] Specifically, studies indicate that groups make better decisions when: (1) the group consists of equal status peers, (2) the group has nondirective leadership, (3) members feel free to ask questions, and (4) members have assigned roles in small task groups. To promote better decision making by boards, institutional shareholders have pushed for various reforms for over a decade.[52] For example, boards size has decreased[53] and many boards have committees of independent directors that focus on auditing, nominating directors, and compensation. This comports with the findings discussed above that small task groups and assigned evaluative roles allow groups to make better decisions. Current boardroom practices, however, fail in a critical respect. Specifically, the next section examines how many boards do not consist of equal status peers who have impartial leadership because the CEO dominates the board.[54]

[47] STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS (2002) (reviewing studies where groups outperform individuals for problems with one clear answer, logical problem-solving, complex problem involving over twenty variables, and complex decisions making under condiiions of high uncertainty).

[48] *See, e.g.*, *id.*, at 10; Robert J. Haft, *Business Decisions by the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1 (1981); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 782 (2001).

[49] *See, e.g.*, Haft, *supra* note 48, at 10.

[50] BAINBRIDGE, *supra* note 47, at 210.

[51] Barnard, *supra* note 30, at 1170.

[52] For an overview, *see, e.g.*, ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE (1995).

[53] *See, e.g.*, Theodore Eisenberg & Stefan Sundgren, *Larger Board Size, Decreasing Firm Value, and Increasing Firm Insolvency*, 48 J. FIN. ECON. 35 (1998). *But see*, BAINBRIDGE, *supra* note 47, at 42-43 (finding studies inconclusive and arguing large board size may be better). As a result of these reforms, the average size for corporate boards is eleven directors. *See* Korn/Ferry's *New Study Tracks 25 Years of Change in America's Corporate Boardrooms*, BUS. WIRE, Sept. 24, 1998.

[54] *See, e.g.*, Cox & Munsinger, *supra* note 30, at 92; Lynne L. Dallas, *Proposals for Reform of Corporate*

B. Factors Impeding Peer Group Decision Making on Boards

CEO-dominated boards may fail to monitor managers in the shareholders' best interests because independent directors may be beholden to the CEO in six ways.[55] First, devising a definition of "independence" that ensures that directors criticize management when necessary is not feasible. Most definitions of independence include the absence of employment, family relationships, and consulting contracts with the company. The goal of these definitions is to remove financial ties other than stock ownership.[56] With respect to stock ownership, corporate governance scholars suggest that firms provide director compensation in stock, rather than the current practice of using stock options.[57] Stock options allow directors to benefit on the upside when the stock price increases, but not to experience the pain caused when the stock price falls. To assure that directors share in the downside, some corporate governance experts suggest that directors hold the stock for the tenure of their terms. Other commentators go further and argue that directors should not be paid in stock because it contributes to short-term thinking and ties directors to only one corporate stakeholder to the detriment of other stakeholders, especially employees.[58] The social psychology literature on small group decision making confirms these views about director stock ownership; that is, groups do not obtain the benefits of peer group decision making if members receive contingent compensation based on short-term stock prices.[59]

Second, another factor that reduces independence is that many directors receive side payments in the form of corporate philanthropy to their pet charities[60] and consulting contracts.[61] As a matter of human

Boards of Directors: The Dual Board and Board Ombudsperson, 54 WASH & LEE L. REV. 91, 93 (1997) [hereinafter Dallas, *Ombudsperson*].

[55] Alan Greenspan, Speech at Stern School of Business (NYU, Mar. 26, 2002). A leading article that first espoused this notion is Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village*, 95 HARV. L. REV. 597 (1982).

[56] Charles M. Elson, *Director Compensation and the Management-Captured Board: The History of a Symptom and a Cure*, 50 SMU L. REV. 127 (1996).

[57] Charles Elson, *The Bad Board Booby Trap*, DIRECTORS MONTHLY, Mar. 2001.

[58] Marleen A. O'Connor, Union Pension Power and the Shareholder Revolution (1999) (unpublished article prepared for The Second National Heartland Labor-Capital Conference (Apr. 29-30, 1999), *available at* http://www.heartlandnetwork.org/conference4_99/downloads/OConnor.pdf).

[59] Haft, *supra* note 48, at 12-13.

[60] *See, e.g.*, Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. REV. 579 (1997); Symposium, *Corporate Philanthropy*, 28 STETSON L. REV. 1 2000; Symposium, *Corporate Philanthropy, Law, Culture, Education, and Politics*, 41 N.Y.L. SCH. L. REV. 753 (1997).

[61] *See generally*, Benjamin, *supra* note 1 (Former SEC Chairperson Arthur Levitt states: "A whole panoply of seductions bind the interest of the board members to the CEO rather than to shareholders.").

nature, such financial ties can redirect loyalty away from shareholders and toward managers.[62] Jeff Gordon explains that managers can use such side payments to threaten directors with "low visibility sanctions" if they do not concur with the CEO's wishes.[63] This is in contrast to the "high visibility sanction" of not renominating a dissenting director to the board. Because low visibility sanctions do not appear on analysts' radar screens,[64] Gordon surmises that these side payments may undercut director independence to an even greater extent than the threat of dismissal from the board.

The third factor that diminishes the equal peer status of boards is when the CEO serves as the chairperson of the board; this is the case in three out of the four largest corporations.[65] Through this position, the CEO establishes the agenda at board meetings and controls the quantity and timing of the information presented to other directors at meetings. Social psychology warns that members of a group tend to conform their opinions to what they perceive the leader of the group wants to hear.[66]

Fourth, despite nominating committees that consist entirely of independent directors, these committees are sympathetic to the CEO's views about the "right type of person" to serve as a director.[67] Indeed, many independent directors on the nominating committees consist of current and former CEOs who may favor maintaining a system that benefits them. Social psychology indicates that the independent directors are likely to feel strong loyalty to their appointer.[68] In looking for directors who will "fit in," nominating committees usually seek people who have accommodating demeanors and avoid those who are irritable and overly opinionated.[69] In this regard, the usual nominations are the CEO's social or business acquaintances—leading to the clubby nature of boards. As a result of this cronyism, corporate boards are quite homogeneous, consisting mostly of white males, in their mid-fifties, who are predominately Protestant and Republican.[70] Social psychologists explain that the common background and social ties among group members can gradually lead to an in-group bias.

[62] *Id.*

[63] Gordon, *supra* note 2, at 12.

[64] *Id.*

[65] Benjamin, *supra* note 1.

[66] Haft, *supra* note 48, at 13.

[67] *See, e.g.*, Cox & Munsinger, *supra* note 30, at 98; Langevoort, *Human Nature*, *supra* note 48, at 780.

[68] Haft, *supra* note 48, at 10.

[69] Langevoort, *Human Nature*, *supra* note 48, at 782.

[70] *See, e.g.*, James D. Westphal & Edward J. Zajac, *Who Shall Govern? CEO/Board Power, Demographic Similarity, and New Director Selection*, 40 ADMIN. SCI. Q. 60 (1995).

Specifically, the cultural cohesiveness on corporate boards can stifle directors' willingness to dissent.[71]

Fifth, many independent directors serve for long terms—over twenty years.[72] On the upside, long terms for directors foster collegiality that promotes the notion of "fictive friendship" among directors. To a certain degree, cohesiveness is essential to promote good working relationships among board members. On the downside, the presence of such "fictive friendships" on the board creates social norms that make it inappropriate for the independent directors to challenge their "friends."[73] Specifically, these continuing relationships can lead to too much conformity among group members, which decreases their willingness to engage in critical analysis.[74]

Finally, although many compensation committees consist of independent directors, CEOs still retain considerable leverage over this issue. Here again, part of the problem stems from stacking the compensation committee with current and former CEOs who have a vested interest in perpetuating the status quo. Although compensation committees rely on outside consultants, many CEOs still select the consulting firm and have leverage over its opinions by providing other consulting opportunities.[75] Indeed, some compensation committee members publicly have stated that they are influenced by the CEO.[76] The CEO's domination leads some boards to allot more time and energy to compensation issues, rather than to assuring the integrity of the company's financial reporting system.[77]

Thus, while institutional shareholders have achieved some success in pushing for reforms, these efforts fall far below those needed to achieve peer group decision making. Perhaps this is why empirical evaluation shows that implemented reforms do not correlate with improved financial performance.[78] For example, although many institutional

[71] Cox & Munsinger, *supra* note 30, at 92.

[72] *Id.* at 98.

[73] *Cf.* Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 654-55 (1996) [hereinafter Langevoort, *Selling Hope*] (discussing "fictive friendships" between brokers and investors).

[74] Haft, *supra* note 48, at 9.

[75] *See, e.g.*, Uma V. Sridharan, *CEO Influence and Executive Compensation*, 31 FIN. REV. 51 (1996) (more influence CEO has over the board, the higher the CEO pay).

[76] *See, e.g.*, Todd Perry & Marc Zenner, *CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?*, 35 WAKE FOREST L. REV. 123, 135-36 (2000); Carol J. Loomis, *This Stuff is Wrong*, FORTUNE, June 25, 2001, at 72.

[77] Byrne et al., *supra* note 10, at 68 (Oracle, compensation committee met twenty-four times; entire board met five times).

[78] *See, e.g.*, Bernard Black, *Shareholder Activism and Corporate Governance in the United States*, CORP. GOV. ADVISOR 14 (Jan./Feb. 1999) ("One could hardly say that institutional investor activism is a bad thing. But the best reading of the currently available evidence is that institutional investors activism does not

shareholders assume that independent directors will increase firm value, no empirical evidence supports this position, and some evidence points the other way.[79] The existing statistical studies may not capture the nature of the shareholder revolution for two reasons. First, despite the lack of data showing that shareholder proposals alone improve the bottom line, shareholders use governance practices as important factors in evaluating the quality of management. Second, even though the actual number of shareholder proposals that change governance practices are low, managers are not likely to seek to install defensive tactics through the articles of incorporation because they know that shareholders will veto such measures.[80]

C. The Business Judgment Rule: Increasing Directors' Duties

The business judgment rule protects directors from liability for decisions made without fraud or self-dealing. The reason behind the business judgment rule is that courts should not judge board decisions with hindsight bias. Hindsight bias causes people to evaluate events as being easily foreseeable.[81] The business judgment rule encourages risk-taking by managers, which benefits shareholders holding diversified portfolios. Thus, courts dismiss shareholder suits for breach of the duty of care by applying the business judgment rule if they can find "any rational business purpose" for the decision. The theory is that free markets will weed out those firms making too many bad decisions, rather than having a court play this role. Social psychology also lends support to the business judgment rule because external review of group decision making would harm the interpersonal relationships among board members that are necessary for boards to function.[82] This threat to cohesiveness also offers a rationale as to why corporate law does not distinguish among directors for liability purposes.

After *Smith v. Van Gorkom*,[83] boards use more rigorous decision making procedures in order to avoid liability for breach of the duty of due care.

significantly affect firm performance, and cannot substitute for the discipline provided by an active market for corporate control.").

[79] *See, e.g.*, Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999). This evidence may indicate that inside directors play an important role in strategic decision making. April Klein, *Firm Performance and Board Committee Structure*, 41 J.L. & ECON. 195 (1992).

[80] *See* Black, *supra* note 78, at 16.

[81] *See, e.g.*, Jeffrey Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571 (1998).

[82] BAINBRIDGE, *supra* note 47, at 49 ("every man for himself" phenomenon).

[83] 488 A.2d 858 (Del. 1985).

As a result of these ritualized procedures, it is generally noted that directors take their duties more seriously by working harder preparing for and participating at meetings. By requiring directors to ask questions, *Van Gorkom* reduces directors' "costs of confrontation" by allowing them to "sugarcoat" their questions by appealing to the law as the reason for their inquiries, rather than distrust of management.[84]

Another case increasing the responsibilities of directors is *In re Caremark.* While this case does not require directors to implement compliance programs to monitor firms, many boards have implemented these procedures. Examined through the lens of the business judgment rule, good faith attempts by the board to monitor management are sufficient. The *Caremark* opinion explicitly states a high threshold for directors' liability: "Only a sustained or systematic failure . . . to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability." Thus, lack of good faith is not demonstrated by a single instance of faulty monitoring, but rather through prolonged neglect. By imposing this duty, fiduciary law also reduces the directors' "costs of confrontation" by allowing them to implement compliance programs in a manner that does not undermine collegiality among independent directors and managers.

Courts give directors the benefit of the business judgment rule only when there is an absence of self-dealing. In cases of conflict-of-interest transactions, the interested fiduciary has the burden of proving that the transaction is "fair," which means that the terms are similar to those obtained in an arm's-length deal. In Delaware, prior approval or ratification by disinterested directors or disinterested shareholders provides the interested directors with the benefit of the business judgment rule. Thus, the plaintiff needs to prove that the transaction amounts to "waste," i.e., no quid pro quo. Other states, however, take a different approach and shift the burden of proving the unfairness of the transaction to the plaintiff when the interested director obtains disinterested director or shareholder approval.

Social psychology offers a partial explanation for these rules. With regard to conflict-of-interest transactions presented to the board for prior approval, the social dynamics of the boardroom make it uncomfortable for disinterested directors to deny a colleague access to a proposed project. Independent directors may be biased toward endorsement of these deals because voting "no" is akin to saying "I do

[84] Stout, *supra* note 22, at 690.

not trust you" to the manager proposing the deal. It is even more difficult, however, for disinterested directors to refuse to ratify a completed project because lack of approval subjects the interested director to serious risks of shareholder litigation. Given that directors pursuing conflict-of-interest transactions may rely on the mutual trust of fellow board members to approve deals that favor the director, social psychology supports the need for courts to scrutinize these business decisions for fairness.

Cases such as *Van Gorkom* and *Caremark* increased the proliferation of good corporate governance practices in boardrooms, but these reforms have not succeeded in overcoming the dysfunctional norms of many boardrooms. In other words, some independent directors may be motivated by the desire to get along and gain approval of those to whom they feel accountable—senior managers, not shareholders. Specifically, board members know that renomination to the board depends on "appropriate performance," which means they need to conform their behavior to the "cult of politeness." While it is appropriate to give weight to senior executives' views, this is qualitatively different than the CEO's domination of the board. Under current boardroom norms, directors' criticism of the CEO signals disloyalty or "no confidence" in the CEO. Given time and information constraints, independent directors may seek to fulfill their board duties by making satisfactory, rather than optimal decisions. In other words, given the human nature to prefer the "least effort" solution, independent directors who lead hectic, overloaded lives may take the easy road when faced with complex decisions and simply smile and nod during board meetings. Another reason for this behavior is that if directors say "no" to managers, they face the immediate risk of jeopardizing their "friendship" with managers, which may lead to the loss of side payments. Going along with managers' policies may hurt shareholders, who the directors have probably never met, but these negative consequences often occur later. Given this "time delay trap," independent directors, like most human actors, may choose short-run gratification. These behavioral tendencies cause boards to rarely (1) vote other than unanimously on issues of importance to the CEO, (2) seek information outside the communication channels provided by the CEO, and (3) discuss issues of accountability or the premises upon which the board operates. As a result, board meetings tend to resemble "endless pep rallies," rather than necessary conversations about corporate strategies.

D. *Bubble Governance and the Dangers of Tournaments*

1. Independent Directors' Schemas

Even if directors were financially independent of managers, doubt remains about how well they can perform their monitoring role because they have limited information and meet only a few times a year. Given these constraints, psychological weaknesses may impair independent directors' abilities to perform their monitoring function in a vigilant manner. Specifically, questions exist about how "cognitively independent" directors are from managers' views and perceptions. To explain, we need to consider the perspective of the independent director in deciding whether to join a board. In making this initial decision, the director needs to assess whether to trust the senior executives of the firm. Given that most independent directors are successful people with demanding schedules, an individual director may seek to minimize the time and information required to evaluate this complex decision. Thus, the independent director may use initial impressions as short cuts to form mental roadmaps about the corporation.[85] Social psychology refers to this process as using a heuristic device known as a "schema."[86] The director may develop an overall favorable impression or schema of top management when she does not see any surface problems in the firm, but perceives that the senior executives have impressive track records and other respected gatekeepers associate with the corporation.[87] In addition, since the CEO effectively appoints the director, social psychology suggests that an individual tends to develop favorable views of others who can promote her goals.[88]

Once an independent director makes the commitment to trust senior managers, the director may be reluctant to change this initial impression despite warning signs. This is because people tend to interpret new information in a manner to confirm the status quo.[89] Specifically, once people have made some voluntary commitment to a person or course of behavior, there is a strong subconscious need to maintain consistency in the face of subsequent events in order to continue to justify the original commitment to themselves and others.[90] Social psychologists refer to

[85] *See, e.g.*, ELLIOT ARONSON, THE SOCIAL ANIMAL 136-37 (6th ed. 1992).

[86] Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry into Lawyers' Responsibility for Clients' Fraud*, 46 VAND. L. REV. 75, 98 (1993) [hereinafter Langevoort, *Where*].

[87] *Id.*

[88] Langevoort, *Where*, *supra* note 86, at 99.

[89] ARONSON, *supra* note 85, at 118.

[90] *Id.* at 202-03.

this as "cognitive conservatism."[91] Social psychology explains that when people face information that indicates that their initial decision was wrong, they may rationalize it away or ignore it. This is the well-accepted notion of "cognitive dissonance," that is, the tendency to reduce psychological inconsistencies.[92] The tendency for "cognitive dissonance" is likely to be strong when a person's commitment is made public, such as that of an independent director's decision to join a board.[93]

Although an independent director's schema evolves throughout her term on the board, this schema remains substantially derived from the insiders' perspectives.[94] In this way, inside directors, particularly the CEO, have considerable influence in setting the tone within the boardroom.[95] In addition, as the next section details, the CEO plays a primary role in establishing the corporate culture. Corporate cultures may influence directors because they are dependent upon insiders' views of the firm.[96] In this way, independent directors may lose their outsider perspective, that is, their "cognitive independence," by falling prey to the cognitive influences permeating the corporate belief system.[97] Importantly, the independent director may not receive sufficient warnings from the other corporate gatekeepers to change this favorable schema. Specifically, outside lawyers, accountants, and consultants undergo similar processes in developing schemas of a particular firm.[98] Thus, these corporate watchdogs may also adopt the corporation's biases because they are also dependent upon much "derivative information-gathering" from insiders.[99]

Directors' lack of psychological independence poses particular problems when the firm's stock price is rising. It is much easier for directors to ask questions when the stock price is dropping. Thus, good corporate governance practices serve as a "floor"—if the company performs poorly, it is more likely that the board will dismiss the CEO.[100] When the firm's financial statements indicate success, directors may be

[91] Langevoort, *Where*, *supra* note 86, at 100.

[92] *See, e.g.*, *id.* at 103.

[93] *Id.* at 102-03.

[94] Donald C. Langevoort, *The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior*, 63 BROOK. L. REV. 629, 637 (1997) [hereinafter Langevoort, *Epistemology*].

[95] *See, e.g.*, Dallas, *Relational*, *supra* note 31, at 5 (discussing the two-process theory of influence; group members experience conformity pressures due to normative and informational social influences).

[96] Langevoort, *Epistemology*, *supra* note 94 at 639.

[97] *Id.* at 643.

[98] *See* Prentice, *supra* note 13; Langevoort, *Epistemology*, *supra* note 94.

[99] Langevoort, *Human Nature*, *supra* note 48, at 813.

[100] *Directors' Monthly*, 23 CORP. GOV. REV. 1 (Jan. 1999) (Ken West, TIAA-CREF).

reluctant to question managers about details.[101] Thus, rising stock prices may cause directors to be less diligent, posing serious problems for corporate governance in a bubble stock market.

2. Superstars and Loss Framing

To examine how senior executives influence corporate cultures, this section examines the economic literature on compensation and promotion practices. Many large firms in competitive environments structure internal labor markets through promotion processes whereby employees' success depends upon their relative positions in competition with their colleagues.[102] As an example, Enron used the "rank and yank" system whereby workers evaluated each other; those falling at the bottom of the curve were fired, while those at the top were given large bonuses. Many firms use similar practices to establish what is in essence a tournament—a key determinate of a corporation's culture.[103] At Enron, the tournament structure led to a "gladiator"[104] or survival-of-the-fittest corporate culture where employees attempted to defeat not

[101] Evidence shows that boards with a majority of independent directors have a higher chance of removing a CEO for poor results, but are less likely to remove the CEO if the firm's stock price is above average. Michael S. Weisbach, *Outside Directors and CEO Tumover*, 20 J. FIN. ECON. 431 (1988).

[102] *See, e.g.*, Donald C. Langevoort, *Ego, Human Behavior and Law*, 81 VA. L. REV. 853 (1995) [hereinafter Langevoort, *Ego*] ("I think stock price obsession is more a symptom than a disease," thus not give tournament survivors more freedom to manage). For an overview of toumaments, see, *e.g.*, MARC GALANTER & THOMAS PALAY, TOURNAMENT OF LAWYERS: THE TRANSFORMATION OF THE BIG LAW FIRM (1991). *See, e.g.*, David B. Wilkins & G. Mitu Gulati, *Reconceiving the Tournament of Lawyers: Tracking, Seeding, and Information control in the Internal Labor Markets of Elite Law Firms*, 84 VA. L. REV. 1581 (1998) [hereinafter Wilkins & Gulati, *Tracking*]; David B. Wilkins & G. Mitu Gulati, *Why Are There So Few Black Lawyers in Corporate Law Firms? An Institutional Analysis*, 84 CAL. L. REV. 493 (1996). These tournaments can lead to second-generation discrimination against minorities and women. *See infra* notes 473-81.

The economic model of tournament theory explains why firms do not reward workers for their current productivity. Instead, many large firms, including large law firms, provide an implicit promise for employees to compete with their colleagues for promotions to positions with higher pay and security. Importantly, these firms do not promote every qualified worker, but only a pre-set number based on relative performance. Tournament theorists explain that when the costs of monitoring workers is high, firms can avoid these expenses by simply putting workers in competition with each other and promoting the best performers. Thus, workers compete in a "multiround" tournament, which includes practices such as tracking, seeding, and information control typically found in sporting events and other kinds of formal competitions. Donald C. Langevoort, *The Organizational Psychology of Hyper-Competition: Corporate Irresponsibility and the Lessons of Enron*, GEO. WASH. L. REV. (forthcoming) [hereinafter Langevoort, *Hyper-Competition*] (on file with University of Cincinnati Law Review).

[103] *See, e.g.*, Kimberly D. Krawiec, *Accounting for Greed: Unraveling the Mystery of the Rogue Trader*, 79 ORE. L. REV. 301, 330 (2000). Under this peer-review process, a group of twenty employees voted unanimously to judge Enron employees. The top five percent ranked superior received bonuses sixty-six percent higher (and much larger stock option grants) than those ranked excellent, the next thirty percent.

[104] William Bratton used this term to refer to Enron's corporate culture during his talk at Tulane Law School in April, 2002.

just outsiders, but each other.[105] Although managers used the rhetoric of "team building," the Enron tournament promoted the notion of the star player.

Under a tournament structure, an employee who excels, or a "superstar," is generally rewarded with less supervision and oversight.[106] Yet, to retain her status, the superstar must continuously outdo herself and others. In such a competitive environment, the constant "what have you done for me lately?" stress may lead the superstar to worry that she may lose her status.[107] Social psychologists explain that when people perceive that they may lose existing benefits, they may take greater risks to keep the benefit than they would to obtain it in the first place. This is called a "loss frame." Under a loss frame, superstars may take greater risks to maintain their current status and their long-run concerns for their reputation diminish. This willingness to take greater risks to prevent the loss of superstar status can lead to a vicious cycle where the superstar continually takes larger risks to maintain her status.

In addition, Donald Langevoort writes how superstars tend to be "high-ego" or "high-mach" employees who may suffer from an overconfidence bias.[108] Due to this overconfidence, such "high-mach" types are slow to recognize problems as attributable to their mistakes. Self-serving biases may allow the superstar to see failure as an incident of bad luck, but success as proof of superior talents.[109] In extreme cases where the superstar is engaged in serial decision making, this overconfidence may lead to serious problems. Specifically, rather than change course when a long-term project begins to fail, executives may take greater risks and throw even more good money after bad in the hope that their luck will change. This cognitive bias is known as the "optimism-commitment whipsaw."[110]

With this perspective, we can see how executives who achieve success may get caught in "encore trap" because maintaining their superstar status depends on meeting or exceeding analysts' predictions about next quarters' earnings.[111] Successful executives reveal that they continue to

[105] McLean, *supra* note 3.

[106] Krawiec, *supra* note 103, at 312 (superstar has less supervision thus can the superstar's take larger risks).

[107] *See* Amos Tuersky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCI. 453, 454 (1981).

[108] Langevoort, *Hyper-Competition*, *supra* note 102 ("ultimate tournament survivor is a hard core narcissist").

[109] MAX BAZERMAN,JUDGMENT IN MANAGERIAL DECISION MAKING 96 (3d ed. 1994).

[110] Barry Staw, *The Escalation of Commitment to a Course of Action*, 6 ACAD. MGMT. REV. 577, 580 (1981).

[111] THOMAS R. HORTON, THE CEO PARADOX: THE PRIVILEGE AND ACCOUNTABILITY OF LEADERSHIP 66 (2001).

work hard long after making their millions. After they attain a certain amount of wealth, the additional compensation does not affect everyday life and the money itself means little.[112] Rather, the main motivation for superstars is the excitement of "the game" and the chance to test oneself as a "major player."[113] The level of compensation is merely a way to "keep score" as a measure of one's winnings.[114] One corporate governance commentator noted that this mentality leads to the concept of the "trophy wife."[115] In this way, the company's stock price goes deeply to its executives' sense of identity and self-worth.[116] The recent scandals suggest that some CEOs sought to retain their status by "hyping [their] way to stock market stardom."[117] That is, these executives manipulated accounting rules through complex financial maneuvers to create "virtual wealth"—paper profits that do not contribute to real productivity gains in the long-term.

To further understand how tournaments may foster pathological behavior, we can analyze how corporate cultures contribute to executives rationalizing away ethical violations. Specifically, Langevoort emphasizes that tournament structures may defeat firms' attempts to implement compliance programs to ensure ethical behavior.[118] Employees may rationalize cutting corners because the corporate culture is perceived as unfair. Langevoort offers two factors contributing to this perception. First, exorbitant CEO pay may lead employees to believe that senior executives sanction self-serving behavior.[119] Specifically, the CEO sets the tone for ethical behavior at the firm. An employee may feel that if the CEO uses his power in a self-serving manner, it is acceptable for the employee to do the same. Second, employees may feel the tournament is not fair because its demands are too stringent. An employee may come to view her corporation's efforts to foster an ethical climate as insincere given the dog-eat-dog pressures to perform internally from the tournament and externally from the stock market.[120] Such competitive pressures may lead employees to rationalize overly aggressive actions in a manner that allows them to think that they

[112] *Id.* at 330.

[113] Krawiec, *supra* note 103, at 314.

[114] AL DUNLAP, MEAN BUSINESS 98 (1997).

[115] HORTON, *supra* note 111, at 66.

[116] Donald Langevoort, The Organizational Psychology of Hyper-competition: Corporate Irresponsibility and the Lessons of Enron (Working Paper 2002) [hereinafter Langevoort, Hyper-competition].

[117] *Audits & Bubbles*, *supra* note 8, at b.06.

[118] Donald C. Langevoort, *Monitoring: The Behavioral Economics of Inducing Agents' Compliance With Legal Rules* (Working Paper 2002), *available at* http://ssrn.com [hereinafter Langevoort, *Monitoring*].

[119] *Id.*

[120] *Id.*

behaved honorably, or should be blameless for the consequences of their decisions. Facilitating these rationalizations, Langevoort explains that firms using tournaments infuse their corporate cultures with military and sports rhetoric to simultaneously inculcate competitiveness and loyalty.[121] Such metaphors allow employees to see questionable moral conduct as merely the type of combative action needed to win the "war" or the "game."[122] Thus, these metaphors can aid employees in making rationalizations by viewing corporate ethics codes in a cynical way to avoid guilt.

This explanation of how corporate cultures promote processes whereby corporate actors rationalize away unethical actions does not mean that such actors should necessarily be let off the hook for bad behavior. Rather, the goal is to shed light on the powerful dynamics that flow from tournaments and the corporate cultures they create. This Part emphasizes doubt about how "independent" directors remain because they are subject to "contagious biases"[123] of the prevailing corporate belief system. To explore these issues further, the next Part focuses on two cognitive biases that may impede board decision making: polarization and cascades. As mentioned previously, these two theories overlap in some respects with the groupthink theory discussed in Part III. Thus, Part II serves as a prelude to a fuller account of the Enron Board's deliberations that follows in Part III.

II. POLARIZATION AND SOCIAL CASCADES

Polarization and social cascades raise serious problems for board deliberation.[124] Polarization refers to how group deliberation pushes a group, and its individual members, toward increased risk-taking.[125] Prior to social psychologists examining group decision making, the generally accepted belief was that groups move toward the center of the members' positions held prior to group discussion.[126] Empirical evidence, first produced by J.A.F. Stoner in 1962, shows that groups have a strong tendency to take extreme positions. Specifically, Stoner

[121] Langevoort, *Myths*, *supra* note 25, at 1592.

[122] *Id.*

[123] *Id.* at 647.

[124] Corporate governance scholars have recognized the problems relating to pclarization. *See, e.g.*, Dallas, *Ombudsperson*, *supra* note 54, at 107. Stephen Bainbridge, however, states that the tendency for groups to make riskier decisions than individuals benefits shareholders who hold diversified portfolios. BAINBRIDGE, *supra* note 47, at 156.

[125] Note, that the "risky shift" does not result when groups make certain types of decisions such as whether one should marry or travel with a medical condition. Sunstein, *supra* note 31.

[126] *Id.*

asked several groups to make unanimous choices between safe and risky decisions, including a low-return, high-security stock or a high-return, lower security stock. The members of the group made initial decisions individually and then discussed their choices in a group. Twelve out of the thirteen groups chose the riskier alternatives. Importantly, after group deliberations, individual's private opinions also changed to favor the riskier positions.[127] In explaining why polarization occurs, an individual's need for conformity does not provide a complete answer because group members do not converge on the mean result of their individual opinions.[128] Instead, two factors account for polarization. First, when groups consist of like-minded members, the argument pool becomes limited and "persuasive arguments"[129] based on rhetoric currently favored in the culture become significant.[130] Second, social influence comes into play because people like to maintain certain self-perceptions.[131] For example, if an individual likes to think of herself as more risk prone than average, she may shift her position to favor even more risk after hearing other members in the group espouse risky positions. Thus, when like-minded members of a group favor risk, then group deliberations can produce quite extreme decisions due to polarization.[132]

The polarization story may offer help in explaining the Enron Board's role in the fall of Enron. Specifically, the Enron CEOs, Jeffrey Skilling and later Ken Lay, may have acted as "polarization entrepreneurs" by creating enclaves of like-minded people to monitor them on the Board. The Enron Board probably shared a limited argument pool—hearing many arguments in favor of taking risks and few counter positions. In this regard, arguments for increased risk-taking to produce shareholder value in the new economy may have had a rhetorical advantage in pushing the Enron Board to approve the related-party transactions. In addition, given the strong risk-taking norm present in the Enron culture, individual board members may have wanted to hold themselves out to others as people who are not afraid to take risk. Thus, individual board members may have shifted their initial positions to take even greater risks upon hearing the views of other Enron Board members.

Related to the polarization concept is the theory of cascades, which can also lead groups to take extreme positions. As a result of cascades,

[127] *Id.*

[128] *Id.*

[129] *Id.*

[130] For example, cultural norms make it hard to argue for reducing sentences for drug crimes. *Id.*

[131] *Id.*

[132] *Id.* ("enclaves of people, inclined to risky business practices, might move sharply in that direction as a consequence of internal deliberations.").

groups end up with a shared perception—which may not be true—because other people seem to hold a particular view. The distinctive feature of cascades is a snowballing effect. Specifically, as members of a group with low thresholds start to favor a position, members with higher thresholds come to share this view in a cascade-like process, reaching a "tipping" point where group consensus forms.[133] Similar to polarization, cascades occur for informational and reputational reasons. In the case of an informational cascade, group members who lack information rely on the opinions of others in making up their own minds. In contrast, reputational cascades occur because members may publicly take a stand or remain silent in order to maintain their reputations with other members of the group, although their private perceptions may vary.[134] Cascades differ from polarization because cascades can occur without group deliberation. In addition, polarization can result from each group member reaching an extreme position independently, rather than through a cascade-like process.

The cascade effect may have played a role in influencing the Enron directors. Specifically, as one director spoke in favor of approving the related-party transactions, other directors may have joined for informational reasons, because they did not know what to think or for reputational reasons, to maintain the esteem of the other board members.

These two negative aspects of group decision making—polarization and cascades—are important to our understanding of interactions in the boardroom. This article maintains, however, that groupthink, which is related, but distinct from polarization and cascades, provides a more descriptive account of the Enron Board's role in Enron's collapse. As noted previously, however, groupthink encompasses the same ideas as polarization and cascades, thus each of these biases may have been present in the Enron boardroom.

III. THE ENRON BOARD AND GROUPTHINK THEORY

A. The Groupthink Phenomenon

In the 1970s, Irving Janis developed the groupthink theory by examining how small, high-level groups of government officials used faulty decision making procedures that resulted in fiascoes in U.S. policy. Specifically, in formulating this theory, Janis examined how

[133] *Id.* at 77 ("where a rivulet ends up as a flood.").

[134] *Id.*

various groups of Presidential advisors interacted in making strategic decisions, such as those leading to the attack at the Bay of Pigs, the unpreparedness of the U.S. for the attack on Pearl Harbor, the escalation of the Vietnam War, and the Watergate cover-up.[135] Analyzing the social dynamics of these groups of advisors, Janis produced case studies to show how cohesive groups can make serious miscalculations about both the practical and moral consequences of their decisions.[136]

Janis emphasized that under the influence of groupthink, groups believe that their goals are based on ethical principles and they stop questioning the morality of their behavior. This tendency may foster overoptimism, lack of vigilance, and sloganistic thinking about out-groups. At the same time, groupthink causes members to ignore negative information by viewing messengers of bad news as people who "don't get it." As a result, Janis explained that group members engage in self-censorship to repress dissent: "When groupthink tendencies become dominant, the members try to avoid saying anything that might disturb the smooth surface unanimity that enables the members to feel confident that their policies are correct and bound to succeed."[137] In addition, a group suffering from groupthink tends to arrive at a decision before realistically appraising the available courses of action.

Janis was a firm believer that good procedures lead to better decisions. Groupthink causes a deterioration in the quality of group deliberation, thus the probability of the group reaching a successful decision diminishes. Groupthink usually produces faulty decisions, but Janis noted that groupthink is helpful in making routine decisions because it saves time. In addition, groupthink does not necessarily lead to disasters because some groups under this influence may fortuitously avoid negative results.[138] Interestingly, within the same group, groupthink can occur in making one decision, but not another. As an example, Janis referred to how groupthink influenced President Kennedy's inner circle of advisors in formulating strategic plans leading to the Bay of Pigs, whereas the members avoided the same errors when deliberating during the Cuban Missile Crisis.[139]

Of course, just because a group decision fails does not mean that it was the result of groupthink or any other type of defective decision

[135] JANIS, VICTIMS, *supra* note 28, at 25.

[136] *Id.*

[137] *Id.* at 37.

[138] *Id.*

[139] JANIS, VICTIMS, *supra* note 28, at 14.

making.[140] Bad decisions result from other common causes of human error as well, such as information overload, fatigue, prejudice, ignorance, and bickering, as well as various individual and group behavioral biases. Beyond these types of errors, however, groupthink can affect cohesive groups in a way that they develop a strong concurrence-seeking tendency suppressing critical inquiry.

Although Janis's groupthink theory is well-accepted in the field of social psychology, empirical tests have produced mixed results as to the theory's validity.[141] The nature of some of the predicates for groupthink make Janis's hypotheses difficult to test in controlled laboratory settings. Specifically, cohesiveness is the most important condition for groupthink to occur, but because of its elusive and multifaceted nature, cohesiveness is difficult to replicate in studies. Researchers, however, have developed several case studies to support the basic notions of groupthink.[142] Yet, much more empirical and theoretical work is needed to clarify the groupthink theory, especially the relationships between the variables.

When Janis first developed the groupthink theory, it struck a responsive chord because of the tendency for spectacular failures to captivate the public's attention. Many are intrigued by Janis's intentional use of the Orwellian sounding term "groupthink," which echoes notions of "doublethink" from the novel *1984*. (Indeed, doublethink seems to apply to boards because some directors are "more equal" than others. In addition, we use the term "election" to describe how directors obtain board seats.) As a result of the popularity of the concept of groupthink, some people use the term loosely and indiscriminately, as an expression to explain any type of bad decision made by a group. This lack of analysis appears in some newspaper accounts about Enron that refer to the result as a product of groupthink without much evaluation.[143] Before applying the groupthink label, however, Janis cautioned that one must carefully look for three antecedent conditions and eight symptoms. This Part examines the three antecedent conditions: (1) a cohesive group, (2) structural faults in decision making, and (3) situational context. Then, this Part discusses the eight symptoms of groupthink: (1) sense of invincibility, (2) belief in inherent morality of goals, (3) collective rationalization, (4) stereotyping

[140] *Id.* at 11.

[141] *See, e.g.*, Marceline B.R. Koorn et al., *Managing Group Decision making Processes: Individual Versus Collective Accountability and Groupthink*, 2 INT'L J. CONFLICT MGMT. 91 (1991).

[142] *See generally* Park, *supra* note 28.

[143] A few newspaper accounts of Enron mention groupthink in passing without further explanation. *See, e.g.*, Carl Franklin, *Beware of the Ostrich Factor*, SUNDAY BUS., Jan. 13, 2002; Allan Sloan, *Who Killed Enron?*, NEWSWEEK, Jan. 21, 2002, at 20; Jeffrey Sonnenfeld, *How Go-Along Boards Jam Up Firms*, *The Forum*, USA TODAY, Feb. 6, 2002, at A13.

of out-groups, (5) appearance of unanimity, (6) self-censorship, (7) pressure on dissenters, and (8) self-appointed mind-guards.[144] These symptoms overlap in some respects and reflect three categories: (1) the first two symptoms stem from overconfidence, (2) the next two symptoms reflect the biased way members perceive issues, and (3) the last four represent pressures for conformity.

As this Part discusses the various components of the groupthink theory, it applies these factors to the Enron Board's decision making regarding the related-party transactions. In building a case study of groupthink, Janis warns that major fiascoes resulting from apparent errors of judgment invite controversies about what happened and why. For this reason, Janis emphasized that, for each antecedent factor and symptom, a case study should construct a solid foundation by examining contemporary and retrospective reports by the group members themselves. Following this guidance, this Part relies primarily on the Enron directors' statements in the Powers Report, the Senate Report,[145] and congressional hearings (subsequent investigations).[146] Janis noted, however, that where such direct evidence does not exist, case studies may appropriately make inferential leaps by using other sources of information. Accordingly, for many of the antecedent conditions and symptoms of groupthink, this Enron case study relies on general boardroom norms and journalists' accounts of Enron to bolster the direct proof. This Part also uses this indirect evidence to supply support for three symptoms (sense of invulnerability, pressure on dissenters, and self-appointed mind guards), where firsthand proof is not available at this time. Although direct proof does not exist for these symptoms, Janis emphasized that case studies do not need to include all eight symptoms. In developing a case study, Janis stressed the need to look at broader social and cultural forces to understand group dynamics. For this reason, this case study seeks to evaluate how the "new-economy" myth and a bubble stock market may have affected the Enron Board's decision making. Researchers explaining the groupthink theory also

[144] *See generally*, JANIS, GROUPTHINK, *supra* note 28. Past studies have veered away from the original groupthink model to suggest that additional factors are needed to explain why groupthink occurs within small groups. Some of the variables that have been suggested to complement Janis's original framework are group polarization, individual dominance, group cognitions, and time pressure on group decision making.

[145] During April 2002, the Subcommittee staff interviewed thirteen past and present Enron Board members, none of whom had previously been interviewed: Robert A. Belfer, Blake, Chan, Duncan, Gramm, Jaedicke, LeMasitre, Mendelsohn, Perira, Savage, Wakeham, Walker, Winokur; all appeared voluntarily and represented by the same counsel. SENATE REPORT, *supra* note 17, at 2-3.

[146] The POWERS REPORT reflected information gathered from the interviews of Enron directors; during congressional hearings, five Enron directors testified; and the Senate Report contains information gathered from other directors. *See* POWERS REPORT, *supra* note 17.

incorporate other behavioral tendencies in case studies of groupthink. As mentioned previously, groupthink is related to other insights about group dynamics, such as polarization and cascades. This Part explores how these parallel theories, as well as individual behavioral biases, are complementary to groupthink and may reinforce groupthink tendencies. Thus, where applicable, this Part explores other social-psychological phenomena that may overlap or blend into the groupthink phenomenon.

B. Antecedent Conditions of Groupthink

1. Cohesiveness

a. Theory

The first, and most important, antecedent condition of groupthink is cohesiveness. Janis described cohesiveness as involving a "we-feeling" that produces a "warm clubby atmosphere."[147] What was striking about Janis's groupthink theory is that he showed how too much cohesiveness in groups can have a detrimental impact on decision making. By fostering an environment of camaraderie, Janis explained that cohesiveness may cause a group to avoid facing hard questions in order to avoid conflict so that the group quickly reaches a consensus.

At the outset, it is important to note that cohesiveness is one of the most studied, yet controversial, topics in social psychology. Importantly, groupthink can develop when groups are only moderately cohesive.[148] A generally accepted principle is that cohesiveness stems from all the forces motivating members to stay in the group. Cohesiveness may arise because the members have strong affective ties. As an example, Janis pointed to the off-duty socializing of the military officers before the attack on Pearl Harbor.[149] Affective ties, however, are not necessary for groupthink to occur. Rather, cohesiveness of the group may flow from functional ties. As an example, Janis noted that the inner circle of Nixon

[147] JANIS, VICTIMS, *supra* note 28, at 142. Janis further explains: "[T]he more amiability and esprit de corps among the members of a policy making in-group, the greater the danger that independent critical thinking will be replaced by groupthink, which is likely to result in irrational actions directed against outgroups." *Id.*

[148] *Id.* at 197 ("If the group is moderately or highly cohesive; I tentatively suggest that every executive who participates in group decision is ostensibly susceptible to groupthink.").

[149] *Id.* at 257.

advisors had much internal competition, but were bound together through loyalty to Nixon.[150]

In discussing functional ties, Janis emphasized that three factors contribute to cohesiveness because they provide incentives for members to remain in the group. First, cohesiveness arises when members share a sense of belonging to a powerful, protective group. Second, homogeneity of the members' social backgrounds, ideologies, and cultural backgrounds promotes cohesiveness.[151] Finally, cohesiveness develops when members have significant admiration for the group leader and the group has achieved success in the past. Through attachment to a high-prestige group, members satisfy the human need to verify their self-worth.[152]

General boardroom norms indicate that many boards of Fortune 500 companies have a high level of cohesiveness for two reasons.[153] Directors note that the identity of other board members is the most important factor in joining a board. Not only do directors enjoy associating with other successful people,[154] directors provide each other with access to key informal and social networks that promote career advancement.[155] Indeed, many commentators state that boards remain "good ole boys clubs" where insider bargains are struck. In addition, boards are high status groups described as "elite private clubs with a rubber stamp."[156] The enhanced self-esteem derived from being singled out for membership in a select group motivates many directors to join boards.[157] Thus, both (1) the motives and rewards that encourage directors to serve on boards, and (2) the process used to select independent directors interact to form cohesive groups.

[150] *Id.* at 211-13.

[151] *See, e.g., id.* at 259; Cox & Munsinger, *supra* note 30, at 105.

[152] Cox & Munsinger, *supra* note 30, at 98.

[153] *See, e.g.,* Dallas, *Relational, supra* note 31, at 6. *But see,* Martin Lipton & Jay Lorsch, *A Modest Proposal for Improved Corporate Governance,* 48 BUS. LAW. 59, 65 (1992) (directors very busy and spend little time together; thus, "most boards are not a cohesive group able to work well together toward a common purpose.").

[154] Cox & Munsinger, *supra* note 30, at 94.

[155] When asked why he accepted a directorship, one director quickly responded "Vanity." Edmond Warner, *The Inside View: Time to Declaw An Old Pet,* THE GUARDIAN, Mar. 9, 2002, at 1.24. As Lynne Dallas explains: "Corporate boards are groups characterized by their ability to provide valuable benefits to their members; . . . Board members are primarily motivated to serve on boards because of the identity of other board members." Lynne Dallas, *Ombudsperson, supra* note 54, at 109; *see also* Barry Baysinger & Robert E. Hokisson, *The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy,* 15 ACAD. MGMT. REV. 72, 72-73 (1990).

[156] *See, e.g.,* Langevoort, *Human Nature, supra* note 48, at 79.

[157] Cox & Munsinger, *supra* note 30, at 99.

b. Application to Enron

Direct evidence of the Enron Board's cohesiveness is found in the Senate Report and congressional hearings. The Senate Report stated, "Enron Board members uniformly described internal board relations as harmonious."[158] One Enron director went so far as to testify during congressional hearings: "Personally, I believe while we may have initially just been a collection of individuals, we have now evolved into a very cohesive and collegial group."[159] The Senate Report noted that the Enron directors characterized their working relationship with Enron management as "good."[160] Specifically, the Enron directors indicated they had possessed great respect for senior Enron officers, trusting their integrity and competence.[161]

This cohesiveness among the Enron directors does not appear to stem from affective ties. Specifically, although some of the directors had close personal relationships with the CEO, Ken Lay,[162] the Senate Report stated that the directors had "very little interaction or communication" outside Enron Board meetings.[163] Rather, the Enron Board's cohesiveness flowed from three factors: (1) a high degree of homogeneity among the Enron Board members, (2) financial incentives for the Enron Board to bond together, and (3) a corporate culture that promoted loyalty to the Enron senior executives.

First, the common backgrounds as well as the long terms of the Enron directors were conducive to producing a clubby atmosphere in the Enron Boardroom. The board members had similar social, educational, and career backgrounds of the power elite in corporate America.[164] In addition, many of the independent directors served for extensive terms (over twenty years),[165] setting the stage to develop cohesiveness from attachments to the group itself.

Second, several types of financial incentives may have promoted a sense of solidarity among Enron Board members and a strong affiliation to the group itself. Enron Board members were among the most highly compensated directors in the world; most of this compensation consisted of Enron stock options.[166] As a result, some board members were large

[158] SENATE REPORT, *supra* note 17, at 8.

[159] *Enron Hearings*, *supra* note 11, at 21.

[160] SENATE REPORT, *supra* note 17, at 8.

[161] *Id.*

[162] *Id.*

[163] *Id.* at 10.

[164] Enron Proxy Statement, 2000, *supra* note 19.

[165] *See supra* note 19.

[166] SENATE REPORT, *supra* note 17, at 11 (The total cash and equity compensation of Enron Board

stockholders of Enron[167]—many making hundreds of thousands of dollars, and a few making more than a million dollars in sales of Enron stock.[168] In addition, ten of the fifteen most recent independent directors had conflicts stemming from side payments.[169] Several Enron directors had conflicts of interest involving donations by Enron or Enron executives to several of the directors' pet charities.[170] Other conflicts resulted from consulting or legal work that Enron had with directors or their firms.[171] Note, the Audit Committee members received these types of side payments, which may have clouded their judgments.[172]

Finally, media reports noted the "cult-like" atmosphere at Enron.[173] Specifically, Enron employees reported being "fanatically loyal" to the CEOs, Jeffrey Skilling and later Ken Lay.[174] One Enron employee asserted: "[E]very time Skilling spoke, I'd believe everything he'd say."[175] In describing this loyalty, one former Enron executive went so far as to analogize Enron to the Taliban.[176] This intense allegiance to Enron managers within the Enron corporate culture may have permeated the boardroom.

Thus, direct evidence, as well as boardroom norms and journalists' accounts, indicate that the most important antecedent condition for groupthink—cohesiveness—may have existed among the Enron directors. Analysis of the other two antecedent factors reveals that they may have also been present in the Enron Board's decision making.

members in 2000 was valued by Enron at about $350,000 or more than twice the national average of $138,000.).

[167] Sonnenfeld, *supra* note 143, at A13 (directors were large shareholders; Robert Belfer, $2 billion as Enron investor; holding more shares than any other individual, Enron director's Frank Savage's firm, Alliance Capital was Enron's firm's largest shareholder with 43 million shares).

[168] *Enron Hearings*, *supra* note 11, at 8.

[169] *Id.*

[170] *See, e.g.*, Daniel Kadlec et al., *Power Failure*, 158 BUS. SOURCE ELITE 68 (Dec. 10, 2001) (John Mendelsohn, President of a cancer clinic given about $600,000 by Enron and CEO Lay; Charles LeMaistre ran the cancer clinic now headed by Mendelsohn for eighteen years.).

[171] *Id.* Lord John Wakeham, a former parliamentarian in England, received $72,000 in Enron consulting fees in 2000. *Id.* John Urquhart, a former General Electric executive and Enron Board member until May 2001, made nearly $200,000 a year consulting for Enron. John Barber's oil and gas firm did more than $30 million in business with Enron in 2000. *Id.*

[172] Wendy Gramm is Director of the Mercatus Center; Enron has given the Mercatus Center $50,000. *See, e.g.*, Joanne S. Lubin, *Inside, Outside Enron, Audit Committee is Scrutinized*, WALL ST. J., Feb. 1, 2002, at C1; Ronald E. Berenbein, *The Enron Ethics Breakdown*, THE CONFERENCE BOARD, 15 Exec. Act., Feb 2002. For John Mendelson's conflict, see *id.*

[173] Joe Stephens & Peter Behr, *Enron's Culture Fed its Demise*, WASH. POST, Jan. 27, 2002, at A01.

[174] *Id.*

[175] *Id.*

[176] *Id.*

2. Structural Faults in the Organization

a. Theory

The second antecedent condition for groupthink to develop concerns structural faults in the group's decision making processes. These structural faults may involve (1) inadequate decision making procedures, and (2) a lack of impartial leadership.[177] With respect to inadequate decision making procedures, Janis emphasized that an important impediment to groups' decision making is the reliance on faulty information given by outside experts. In some instances, where different groups rely on each other for information, Janis noted the possibility of collective groupthink by interlocking groups. In examining the United States' lack of precautions for the attack on Pearl Harbor, Janis discussed how the Navy, Army, and War Council each demonstrated groupthink inclinations that magnified these same tendencies by the other groups. Specifically, under the influence of groupthink, members suppressed their personal doubts. Thus, the interlocking groups reciprocally indulged in the withholding of information, intensifying each group's inclination toward groupthink.[178] In this way, a circular form of social learning took place whereby each of these groups discounted the negative information it possessed, because the other groups failed to show apprehension.[179]

Janis stated that impartial leadership also leads to structural faults. Leaders are impartial when they strongly state their own views at the beginning of meetings and discourage dissent.

b. Application to Enron

In reviewing the Enron Board's actions, four structural faults stand out for emphasis. First, as noted at the beginning of this article, other corporate gatekeepers failed to detect the problems at Enron, such as analysts, auditors, outside counsel, lead lenders, institutional investors, credit rating agencies, journalists, investment bankers, and regulators. With respect to this widespread breakdown of corporate checks and balances, collective groupthink may have influenced these interlocking

[177] JANIS, VICTIMS, *supra* note 28, at 183. Janis argued that this groupthink conditions infers "the leader does not feel constrained by any organizational tradition to avoid pushing for his own preferred policies." Closed leaders do not encourage divergent opinions from group members, do not emphasize the importance of reaching a wise decision, and states his or her opinion at the outset of the meeting. *Id.*

[178] *Id.* at 100.

[179] Langevoort, *Where*, *supra* note 86, at 107.

groups. Specifically, each of the corporate watchdogs in the Enron scandal may have downplayed red flags and avoided greater vigilance because the other groups appeared to maintain positive schemas of Enron.

Second, the Enron Board relied on the involvement of Enron's outside auditor, Arthur Andersen.[180] The Senate Report revealed that Arthur Andersen (and Enron mangers) were aware of problems for months and withheld this information from the Enron Board.[181] In addition, Andersen had a conflict of interest in advising Enron on structuring the related-party transactions because Enron was Andersen's largest client and Andersen employees routinely went to work for Enron.[182] Andersen also obtained significant consulting fees from Enron and served as Enron's internal auditor for two years. During congressional hearings, the Enron directors stated that these potential conflicts by the outside auditor did not cause apprehension. This lack of concern is understandable, given that the prevailing norm among directors at the time accepted auditor conflicts as routine by the oligopoly of the then-existing Big Five accounting firms. When questioned about the evidence of Enron's "high risk" accounting, the Enron directors emphasized that Enron's auditor had given the company a clean audit opinion each year. In addition, the Audit Committee relied on the fact that they offered Andersen personnel an opportunity to present information to them without management present.[183] The Enron directors reported that they could not recall occasions when Andersen disclosed reservations about particular transactions or accounting practices at Enron.[184] Revealing an important aspect of the Enron corporate culture, an Enron employee stated: "[A]nyone who questioned suspect deals quickly learned to accept assurances of outside lawyers and accountants."[185]

Third, structural faults existed in how Enron employees negotiated the related-party transactions with Fastow, Enron's CFO (the managing partner of the general partners of the limited partnerships investing the special purpose entities set up to transact with Enron). Specifically, contrary to the Enron Board's request for compliance controls, Enron employees working on the related-party deals reported to Fastow and sat next to Enron workers negotiating on Enron's behalf. The Powers

[180] POWERS REPORT, *supra* note 17, at 167 n.3.

[181] SENATE REPORT, *supra* note 17, at 15-20.

[182] *Id.* at 24.

[183] *Id.* at 10.

[184] *Id.* at 14.

[185] McLean, *supra* note 3, at 33.

Report found that in at least thirteen instances, Fastow pressured Enron employees to obtain better terms for his partnerships.[186] According to the Powers Report, "[s]imply put, there was little of separation and independence required to enable Enron employees to negotiate effectively against LJM2."[187] With respect to the Enron Board's control procedures to review the related-party transactions, the Powers Report notes that in many instances, "officers interpreted their roles very narrowly . . . [and] [n]o one in Management stepped forward to address the issues as they arose, or to bring the apparent problems to the Board's attention."[188]

Finally, congressional hearings indicated that the Enron Board lacked impartial leadership. As with most boards, the CEO, Ken Lay, appointed many of the Enron directors[189] and served as chairperson of the Enron Board.[190] In addition, the Enron Board did not have a practice of meeting without Enron management present.[191] The Senate Report noted that Lay and Skilling usually attended Executive, Finance, and Audit Committee meetings, as well as full Board meetings. Lay also attended many Compensation Committee meetings; one indication of Lay's influence on the Enron Board is the level of his compensation, which was quite high, even by current standards.[192]

3. Situational Context

a. Theory

The final antecedent condition for groupthink focuses on the group's need to make consequential policy decisions during a time of high stress.[193] Janis emphasized that groupthink is a problem for high-level decision makers making important, as opposed to routine, decisions. Janis found that this condition occurs when a group needs to formulate policies that contradict prevailing ethical standards, including individual member's own moral codes. When faced with the sacrifice of moral values, group members recognize that they risk threats of social

[186] POWERS REPORT, *supra* note 17, at 67-69.

[187] *Id.* at 67.

[188] *Id.* at 10.

[189] Joseph Nocera, *System Failure*, FORTUNE, June 20, 2002, at 62, 72.

[190] Enron Form 10k (Spring 2001) *available at* http://www.edgar-online.com.

[191] SENATE REPORT, *supra* note 17, at 10.

[192] Lay received $141 million in 2000—ten times the average of CEO compensation of the top 200 CEOs. *Enron Hearings*, *supra* note 11, at 18-19. In fairness, the average CEO compensation for the top ten companies was $169 million. *Id.*

[193] JANIS, VICTIMS, *supra* note 28, at 86.

condemnation as well as self-disapproval. In this difficult situation, each member may encounter personal feelings of shame and guilt, which lower self-esteem. To block these negative emotions, each member will turn to the others in the group for rationalizations to avert the potential loss of honor. Thus, Janis explained that groupthink is a defensive mode for coping with decisional stress. In particular, Janis emphasized that the role of threatened self-esteem pushes members of the group toward quick consensus as a form of social support.

To promote this rationalization process, Janis stated that the group may become a source of moral consolation that nurtures the shared belief that "we are a wise and good group." That is, members turn to group concurrence to ease anxieties aroused from violating ethical standards.[194] This may lead the members to view group consensus as the criterion for judging the efficacy, as well as the morality, of the group's decision. For these reasons, members avoid raising ethical concerns that imply that this "fine group of ours, with its humanitarianism and its high-minded principles, might be capable of adopting a course of action that is inhumane and immoral."[195] In addition, members seek to reassure themselves with the idea that "you can't make an omelet without breaking some eggs."[196] In this way, Janis explained that cohesiveness causes "hardhearted actions by soft-headed groups." As an example, Janis explains how Nixon's advisors became dependent upon the group to maintain their morale during the Watergate cover-up.[197]

b. Application to Enron

The subsequent investigations provide several examples that the antecedent factor of situational context may have been present in the Enron Board's deliberations. Specifically, the Enron Board waived the company's ethics code three times within sixteen months to allow the CFO to serve as general partner of the entities that Enron used as conduits for much of its highly complicated and controversial financial maneuvering.[198] These waivers by the Enron Board were unusual events. During congressional hearings, the Enron directors could not identify a precedent for the waivers, stating that they were "unaware of any company that had its CFO running a private equity fund on the

[194] *Id.* at 203.

[195] *Id.* at 20.

[196] *Id.* at 203.

[197] JANIS, GROUPTHINK, *supra* note 28, at 210-11.

[198] *Id.* at 27.

side."[199] In addition, corporate governance experts testified that they never heard of a public company ratifying a similar proposal.[200] Indeed, one former CEO commented, "In my wildest dreams, I can't imagine how a director can sit there and approve that."[201] That CEO stated that not only would he have voted against the transaction, he would have resigned the next day if the board approved it. In addition, an internal memo at Arthur Anderson noted, "Why would any director in his or her right mind ever approve such a scheme?"[202] Nevertheless, the Senate Report notes, "[Enron] Board approval proved easy to obtain" with few questions asked.[203]

The Enron directors testified that they made the decisions to waive the ethics code for two reasons. First, although the Enron Board members realized that significant risks were present regardless of what decision they made, they felt the benefits outweighed the costs. On the one hand, the Enron Board noted the advantages flowing to Enron because Fastow's expertise could lead to efficiencies in structuring deals between Enron and the related-party partnerships.[204] On the other hand, Enron directors recognized the disadvantage stemming from the risk of public criticism for approving the related-party transactions.[205]

Second, the Enron Board members testified that they had established controls to mitigate the conflicts.[206] In response, the Powers Report chastised the board: "At bottom, however, the need for such an extensive set of controls said something fundamental about the wisdom of permitting the CFO to take on this conflict of interest."[207]

Thus, the Enron Board may have believed it was necessary "to break some eggs" by waiving Enron's ethics code to allow the related-party transactions to assure Enron's continued success. In sum, the antecedent factors of groupthink—cohesiveness, structural faults, and situational context—appear to have been present in the Enron Boardroom. Next, this Part examines how the Enron Board demonstrated the symptoms of groupthink.

[199] *Enron Hearings*, *supra* note 11.

[200] *Id.* at at 6.

[201] *Id.*

[202] SENATE REPORT, *supra* note 17, at 25-26.

[203] *Id.* at 28.

[204] POWERS REPORT, *supra* note 17, at 67.

[205] *Id.* at 151 (risks arising from Fastow's conflict of interest could create a poor public appearance).

[206] POWERS REPORT, *supra* note 17, at 29.

[207] *Id.* at 68.

C. Symptoms of Groupthink

1. Illusion of Invulnerability

a. Theory

The first symptom of groupthink is the group's feeling of invincibility, which creates overconfidence and leads to excessive risk-taking. Specifically, group members may come to believe that they can do no wrong, particularly when the group is powerful and has achieved past success. Essentially, the idea is, if the leader and everyone else in the group decides that the plan is appropriate, then the plan is bound to succeed, even if it is quite risky, because luck is on the group's side.[208] As an example, Janis referred to the sense of "unlimited confidence" Kennedy's advisors had in planning the Bay of Pigs invasion. Janis noted that the advisors had tremendous faith in Kennedy because "[e]verything had broken right for him. Everyone around him thought he had the Midas touch and would not lose."[209] This "buoyant optimism" centered on the promise of bold, new ideas and the "euphoria of the new day." Thus, Janis summarized the attitude as "everything is going to work out all right because we are a special group."[210]

In general, individuals tend to be overly optimistic about (1) risky events that they have little control over, and (2) their own talents and abilities.[211] Indeed, successful people can become so overconfident that they resist evaluating the boundaries to their power and the losses that may arise if their luck does not hold.[212] This cognitive bias is known as the "winner's curse."[213] Within groups, successful individuals can spread this bias to others through a process called "emotional contagion." Indeed, this bias may be so contagious that it leads to a type of "group narcissism."[214] This tendency for excessive optimism is present in many corporate cultures because it relieves stress[215] and fosters a "can do" atmosphere. Such optimism can turn into a self-fulfilling prophecy because it promotes higher morale and aggressiveness among

[208] JANIS, VICTIMS, *supra* note 28, at 36.

[209] *Id.*

[210] *Id.* at 132; *see also* Langevoort, *Illusions*, *supra* note 27, at 143-45.

[211] BAZERMAN, *supra* note 109, at 95.

[212] JANIS, VICTIMS, *supra* note 28, at 37.

[213] *See, e.g.*, RICHARD H. THALER, THE WINNER'S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE (1992).

[214] Langevoort, *Myths*, *supra* note 25, at 1578.

[215] *See* Langevoort, *Hyper-Competition*, *supra* note 102.

employees.[216] This theory is used to explain how executives' overly-optimistic views of their firms' future lead to large takeover premiums.[217]

This ego-centric bias, however, has a dark side when it causes organizational members to ignore indications that point toward limits to their competence. Specifically, the illusion of invincibility affects a person's perceptions pertaining to risk-assessment. In general, powerful psychological influences are necessary to overcome the risk-aversion most individuals have. Motivated by financial incentives and loss framing, however, individuals, as well as groups may turn to rationalizations that allow them to view large risks as reasonable.[218] Bolstered by overconfidence, groups may underestimate the severity of risk posed by their decisions. In this way, groupthink has important similarities to polarization, discussed in Part II.

b. Application to Enron

Examination of direct sources revealed no evidence that the Enron directors felt invincible. Such bald-faced statements of superiority by individuals are rare, even among high-ego types. During congressional hearings, however, one senator stated: "The [Enron] Board . . . succumbed to the Enron ether of invincibility, superiority and gamesmanship in manipulating Enron's financial statements to keep the Enron stock price soaring."[219]

The direct evidence, however, does indicate that the Enron directors approved of Enron's overall strategic plans, which were extraordinarily ambitious. Enron's "asset-light" policy required an intense focus on Enron's credit rating, cash flow, and debt burden. To accomplish these objectives, the Enron directors supported management's methods of using complicated transactions with convoluted financing and accounting structures.[220] Although the Enron directors denied it, the Powers Report criticized Enron for engaging in "significant transactions that were apparently designed to accomplish favorable financial statement results, not to achieve bona fide economic objectives to transfer risk."[221]

[216] *Id.*

[217] Matthew Hayward & Donald C. Hambrick, *Explaining the Premiums Paid for Large Acquisitions: Evidence of CEO Hubris*, 42 AMIND. SCI. Q. 103, 120 (1998).

[218] Langevoort, *Selling Hope*, *supra* note 73, at 641.

[219] *Enron Hearings*, *supra* note 11, at 2; SENATE REPORT, *supra* note 17, at 8.

[220] SENATE REPORT, *supra* note 17, at 8.

[221] POWERS REPORT, *supra* note 17, at 4.

Providing indirect support that the Enron Board displayed the symptom of invincibility, journalists' accounts reflect that the Enron corporate culture was well-known for its high level of hubris. Specifically, four factors indicate that an illusion of invulnerability permeated the Enron corporate culture and may have influenced the Enron Board's decision making. First, Enron compiled an extra-ordinary track record. For example, Fortune magazine voted Enron as the most innovative company for five years running.[222] Skilling once boasted "Enron has reported 20 straight quarters of increasing income. There's not a trading company in the world that has that kind of consistency."[223] Thus, the Enron culture promoted the belief that its employees' conquests stemmed from talent, rather than luck.[224]

Second, this impressive performance led to a superstar culture of "we're above everyone else"[225] at Enron. As evidence, Enron described itself as "the world's leading company."[226] Indeed, the culture of arrogance was so extreme that Skilling once told a group of utility executives: "I'm going to eat your lunch."[227]

Third, the Enron culture promoted the idea that Enron was "untouchable."[228] This sense of untouchability arose from Enron's position as one of corporate America's top political contributors.[229] Prior to Enron's fall, these political investments appeared to reap large benefits for Enron. For example, Enron was the largest contributor of George W. Bush's career and President Bush referred to Lay as "Kenny Boy."[230] As evidence of Enron's political influence, Lay was the only energy executive to advise Vice President Dick Cheney in framing the Administration's energy policy.[231] Most importantly, Enron received an exemption of its trading activities from federal regulation.[232] Thus, the Enron culture promoted the concept that Enron had purchased vast political power.

[222] Patrap Chatterjee, *Enron: Pulling the Plug on the Global Power Broker*, CORPWATCH, Dec. 13, 2002.

[223] McLean, *supra* note 3, at 32.

[224] Langevoort, *Hyper-competition*, *supra* note 116, at 8.

[225] BODILY & BRUNNER, *supra* note 2, at 48.

[226] McLean, *supra* note 3, at 28.

[227] *Id.*

[228] Rick Bragg, *Enron's Collapse: Workers*, N.Y. TIMES, Jan. 20, 2002, at 1.

[229] Enron spent $10.2 million between 1997 and 2000. *See, e.g.*, Albert R. Hunt, *A Scandal Centerpiece: Enron's Political Connections*, WALL ST. J., Jan. 17, 2001, at A15.

[230] In running for governor, Bush received $774,000 from Enron managers and $312,000 from Enron, see *e.g.*, Chatterjee, *supra* note 222, at 28; Howard Fineman & Michael Isikoff, *Lights Out: Enron's Failed Power Play*, NEWSWEEK, Jan. 21, 2002, at 15.

[231] *See, e.g.*, Stephen Labaton, *Enron's Collapse: The Lobbying*, N.Y. TIMES, Jan. 19, 2002, at 1.

[232] The Commodity Futures Modernization Act included an exemption for energy trading companies. *See, e.g.*, Bratton, *supra* note 2.

Fourth, Enron's culture of hubris encouraged breaking the rules and taking extreme risks.[233] One reporter noted, "The common theme is hubris, an overweening pride, which led people to believe they can handle increasingly exotic risk without danger."[234] This over-optimism, however, also had a dark side. Through the "rank and yank" tournament structure, the Enron culture placed intense pressure upon employees to improve Enron's glowing track record.[235] This competitive atmosphere may have provided Enron employees with the rationalization that aggressive tactics were merely part of the game.[236] In describing the Enron culture, an Enron officer stated, "You can break the rules, you can cheat, you can lie, but as long as you make money, it's all right."[237] As an example, one Enron employee received a promotion after violating company policy in making an investment that turned out to be successful.[238] As one reporter summed up the corporate culture:

> [B]ut what made Enron successful—innovation and daring—got the company into trouble when it decided in its arrogance that it could "financialize" almost anything. Feeling it could do no wrong, the company too often pursued unprofitable markets, obscured the costs and stiff-armed anyone who asked for an explanation.[239]

The Enron culture of invincibility may have infected the Enron Board, which had been hailed as one of the five best corporate boards.[240] It is human nature for directors to allow such praise to cloud their judgments, especially when their corporation has a track record as glowing as Enron's. This is true especially in light of the time constraints on the Enron Board; as is typical of most boards, the Enron Board met five times a year in regular meetings and occasionally in special meetings.[241] The Finance Committee and the Audit and Compliance Committee each met for one to two hours before the board

[233] Bill Mann, *Enron as Icarus*, THE MOTLEY FOOL, Nov. 30, 2001, at 19.

[234] *Id.* ("It bred a culture of breathtaking arrogance that Enron could do the impossible.").

[235] *See, e.g.*, Stephens & Behr, *supra* note 173, at A01.

[236] Langevoort, *Selling Hope*, *supra* note 73, at 664 ("experience the happy confluence of higher share price and lower moral anxiety").

[237] *Id.*

[238] Stephens & Behr, *supra* note 173, at A01.

[239] *Id.*

[240] Horton, *supra* note 20, at 9.

[241] *See e.g.*, SENATE REPORT, *supra* note 17, at 9. The Board normally held five regular meetings during the year, with additional special meetings as needed. Board meetings usually lasted two days, with the first day devoted to Committee meetings and a board dinner and the second day devoted to a meeting of the full Board. *Id.*

meeting.[242] Enron directors varied in how much time they spent reading the materials and preparing for Board meetings, with the reported preparation time for each meeting ranging between two hours and two days.[243] Given these constraints, many Enron Board members probably relied on the objective evidence of Enron's rising stock price to simplify and reduce to manageable proportions the many complex factors involved in approving the related-party transactions. Simply put, Enron's high stock prices generated a culture of optimism and the Enron Board may have felt it should not interfere with Enron's extraordinary achievements.

2. Belief in Inherent Morality of the Group

a. Theory

Another symptom of groupthink, related to the first symptom of invincibility, is a belief in the group's inherent morality.[244] One social scientist explains, "The feeling is that we are good guys and our decisions are in everyone's best interests. We are doing this to benefit everyone."[245]

b. Application to Enron

The Powers Report and congressional hearings provide direct support for the view that the Enron Board demonstrated this symptom. Before reviewing this evidence, this section provides background by examining two aspects of the Enron corporate culture: (1) the belief that the Enron strategy would improve the world, and (2) society's view of top Enron executives as heroes.

First, Enron set out to enhance societal welfare by reducing the role of government and changing the nature of markets.[246] Specifically, Enron inculcated the belief that it was leading a revolution that would change the world. Indeed, Enron's former CEO Jeffrey Skilling not only stated, "[W]e're the good guys,"[247] he went so far as to say,

[242] POWERS REPORT, *supra* note 17, at 158 n.3.

[243] SENATE REPORT, *supra* note 17, at 9.

[244] JANIS, VICTIMS, *supra* note 28, at 88.

[245] *Id.* at 178.

[246] *See, e.g.*, *Fallen Idols*, ECONOMIST, May 4, 2002, at 11; Mann, *supra* note 233; Kadlec et al., *supra* note 170, at 68; Sloan, *supra* note 143, at 19.

[247] *OnLine Extra: Q & A with Enron's Skilling*, BUS. WK. ONLINE, Feb. 12, 2001.

"[W]e're on the side of the angels."[248] Both Skilling and Lay were true believers that deregulation was the key to improving society. Analysts reported that conferences with Enron executives had the flavor of revival meetings where the Enron executives' pitch rested on a "near-fundamentalist faith in the self-regulating efficiency of the market."[249] One journalist described Enron as an "evangelical cult," with Ken Lay as its "messiah."[250] Another newspaper account stated that Skilling was like a "religious zealot who couldn't stop repeating his favorite mantra as the solution to all the world's problems."[251]

Enron's deregulation strategy was part of its portrayal as a new-economy maverick. Pushing the view that Enron was making business history, Skilling stated, "[t]here's only been a couple of times in history when these costs of interaction have radically changed. One was the railroads, and then the telephone and the telegraph."[252] Skilling claimed there were no limits to its "asset-light" strategy[253] to reduce Enron's dependence on hard assets so that Enron would serve as a market intermediary, trading everything from water futures to weather contracts.[254] Enron cast its competition as "stick-in-the-mud"[255] companies that didn't "get it." Skilling once stated, "These big companies will topple over from their own weight."[256]

This account of the Enron corporate culture sheds light on the direct evidence. Congressional hearings noted that the Enron Board needed to "exercise heightened vigilance when a company is pursuing unfamiliar or new territory.[257] These hearings indicated, "It appears that the [Enron] board of directors continued to perform its duties as if Enron were still an old-line conservative energy company, at a time when it appears they should have been far more probing, given Enron's metamorphosis into an energy trading company."[258] This is easy to say in hindsight. The sense of mission generated by the idea that Enron was leading a revolution may have provided Enron Board members with rationalizations to allow the related-party transactions to proceed. In

[248] *Id.*

[249] Bethany McLean, *Is Enron Overpriced?*, FORTUNE, Mar. 5, 2001, at 32.

[250] Pratap Chatterjee, *Enron: Pulling the Plug on the Global Power Broker*, CORPWATCH, Dec. 13, 2001.

[251] *Id.*

[252] Jerry Useem, *And Then, Just When You Thought the "New Economy" Was Dead*, BUS. 2.0 (Aug. 2001), www.business2.com.

[253] *See* Bill Bratton's description of Enron as a "virtual corporation." Bratton, *supra* note 2, at 1280.

[254] For an innovative discussion on virtual corporations, see Claire Moore Dickerson, *Spinning Out of Control: The Virtual Organization and Conflicting Governance Vectors*, 59 U. PITT. L. REV. 759 (1998).

[255] *The History of Enron* (NPR radio broadcast, Jan. 22, 2002).

[256] McLean, *supra* note 3, at 34.

[257] *Enron Hearings*, *supra* note 11, at 5.

[258] *Id.* at 6.

addition, the popularity of "new era economics" in the financial press served as a short cut justification for many sophisticated people in making business decisions in the bubble economy.[259] Specifically, the dot com boom started a cultural change in the outside financial community that supported and encouraged the distortion of basic business values by using new financial metrics.[260] The Senate Report indicated that the Enron Board may have been influenced by this "new era" thinking. One Enron director stated, "I think all of us understood that these [were] highly structured, new kinds of transactions . . . [that would allow Enron] to be at the beginning of these transactions . . . ."[261] Another Enron director echoed these sentiments, stating these transactions were "relatively new" and had "not been done by many companies in the world."[262] Given the time and information constraints on the board, some Enron directors may have believed that the new economy propelled Enron's success. Such framing may have reduced the cognitive complexity involved in evaluating the complex financial structures used to build Enron's house of cards.[263]

Second, American culture portrayed the CEOs of Enron, Skilling and then Lay, as modern day heroes.[264] In times of economic transition, business executives become "larger-than-life leaders" because they are the engines of social change as they push through the massive transformations that society periodically undertakes.[265] At the beginning of the 1900s, Andrew Carnegie, John D. Rockefeller, and Henry Ford became legends. In the past few years, the shareholder value mantra made Wall Street heroes out of financial wizards who could do magic

[259] Langevoort, *Human Nature*, *supra* note 48; *see generally*, Langevoort, *Myths*, *supra* note 25 (people unconsciously impose an order on their environment through myths that serve as "anxiety buffers").

[260] *See, e.g.*, Tim Race, *Ashamed to Be an Executive*, N.Y. TIMES, July 1, 2002.

[261] SENATE REPORT, *supra* note 17, at 19-20.

[262] *Id.* at 20.

[263] Thus, in describing Enron, one commentator noted: "It looked like the quintessential instance of bubble governance: a pliant board, lulled into false sense of security by a rising stock price, a successful management team and a stable of high-profile advisors." Andrew Hill, *Enron's Demise Has Taken the Shine Off Boardroom Tables*, FIN. TIMES, May 30, 2002, at 22.

[264] *See, e.g.*, Jennifer G. Hill, *Deconstructing Sunbeam—Contemporary Issues in Corporate Governance*, 67 U. CIN. L. REV. 1099 (1999) ("the cult of the charismatic CEO continues to have a powerful, but potentially dangerous hold on U.S. commercial psyche . . ."); Michael Maccoby, *Narcissistic Leaders: The Incredible Pros, The Inevitable Cons*, 78 HARV. BUS. REV. 69 (2002) (superstars such as Bill Gates and Jack Welch, "the world's business personalities are increasingly seen as the makers and shapers of our public and personal agendas."). The Enron debacle and other scandals seem to have ended the era of CEO as heroes. A more significant contributor to the fall of executives as gods was the action of firefighters and police officers on September 11, 2002. As one journalist noted: "It is difficult not to contrast the professionalism of modestly paid firefighters and police doing their duty on September 11 with the secretive and squirrelly behavior of six and seven figure CEOs who failed at their duty with Enron." Bruce Nussbaum, *Can You Trust Anybody Anymore?*, BUS. WK., 31, 31, Jan. 28, 2002.

[265] Maccoby, *supra* note 264, at 70.

with share prices.[266] Enron was "laser focused"[267] on shareholder value at a time when many people viewed higher, short-term stock prices as an unequivocal virtue.[268] Indeed, Enron had televisions in its elevators to allow employees to monitor stock prices at all times.[269] As a result of Enron's success, the financial and popular press lionized Enron executives.[270] Kenneth Lay achieved icon status as part of the elite corporate royalty. Viewing themselves as "revolutionaries" that lived the rule of "creative destruction," some Enron executives went so far as to describe themselves as being like Gandhi and Martin Luther King.[271] Thus, journalists described the senior Enron managers as "self-proclaimed masters of the universe."[272]

This background sets the stage to review the direct evidence. The Powers Report and congressional hearings reveal that the Enron Board relied on the Enron managers' reputations in making the decisions to approve and monitor the related-party transactions. Significantly, one director testified that the Enron Board approved the deals because Enron executives were "some of the most creative and talented people in business."[273] One Enron director stated, "We truly believed we had hired some of the best and brightest in the industry. National independent publications lauded the Enron officers for their intelligence, leadership, and creativity."[274] Perhaps the Enron Board believed the CEO-worship hype and approved the related-party transactions in the

[266] *Id.*; *see generally*, MARJORIE KELLY: THE DIVINE RIGHT OF CAPITAL: DETHRONING THE CORPORATE ARISTOCRACY (2002) (shareholder worship of CEOs who inflated stock prices).

[267] Enron Annual Report 2000, at 2 *available at* http://www.enron.com/corp/investors/annuals/2000/ar2000.pdf.

[268] Maccoby, *supra* note 264, at 70. Commentators noted:

> As stock options became an increasing part of executive compensation, and managers who made great fortunes on options became the stuff of legends, the preservation or enhancement of short-term stock value became a personal (and damaging) priority for many a CEO and CFO. High share prices and earnings multiples stoked already amply endowed managerial egos.

Fuller & Jensen *supra* note 12, at 2; *see also* Jeremy Kahn, *Accounting in Wonderland; Down the Rabbit Hole with G.E.'s Books*, FORTUNE, Mar. 19, 2001, at 37.

[269] *Enron Hearings*, *supra* note 11, at 2.

[270] *See, e.g.*, *Fallen Idols*, ECONOMIST, May 4, 2002, at 11.

[271] Bill Mann, *Enron as Icarus*, THE MOTLEY FOOL, Nov. 30, 2001, at 19; *see generally* Maccoby, *supra* note 264, at 70 (Consider how an executive at Oracle describes CEO Larry Ellison: "The difference between God and Larry is that God does not think he is Larry.").

[272] Peter Coy & Emily Thornton, *Enron: Running on Empty*, BUS. WK, Dec. 10, 2001 at 80. In the past, Al Dunlap, a.k.a. "Chainsaw Al" or "Rambo in pinstripes" was also viewed as a hero. *Exit Bad Guy*, ECONOMIST, June 20, 1998, at 70. Dunlap's accounting gimmickry at Sunbeam lead to his demise as he attempted to repeat his success at Scott Paper. John A. Byrne, *How Al Dunlap Self-Destructed: The Inside Story of What Drove Sunbeams, Board to Act*, BUS. WK,, July 6, 1998, at 58.

[273] *Enron Hearings*, *supra* note 11, at 4.

[274] *Id.* at 2.

belief that such decisions were warranted to allow the heroes of Enron to continue making business history.

3. Collective Rationalization

a. Theory

Another symptom of groupthink is the group's efforts to rationalize away red flags that would otherwise lead members to revise their positions.[275] This symptom of collective rationalization demonstrates a mindset of "hear no evil, see no evil, speak no evil." As discussed previously, social psychology explains that red flags indicate the need for change and that it is human nature to preserve the status quo in order to reduce stress under the "illusion of normalcy."[276] That is, groups can interpret negative data in a way that supports the maintenance of previously agreed upon policies through "cognitive conservatism."[277]

Given sunk costs and serial decision making, groups suffering from illusions of invulnerability may engage in what Janis called the "irrational escalation of commitment." This is the so-called "optimism-commitment whipsaw" discussed previously, whereby decision makers ignore red flags as instances of bad luck and intensify their efforts in the hope that their luck will change. To avoid the potential loss of self-esteem from facing up to the situation, groups suffering from this bias may not only stay their course, but also increase their level of commitment by throwing even more resources at the problem.[278] As an example, Janis pointed to the Johnson administration's failure to recognize that the United States was failing in its attempt to win the Vietnam War.[279] Instead, through a series of decisions, Johnson's advisors responded by continuing to escalate the United States' commitment by employing more troops and resources.

[275] JANIS, VICTIMS, *supra* note 28, at 45. Individuals can also suffer from a similar phenomenon. Donald Langevoort explains: "When people voluntarily commit themselves to a certain position, attitude or belief, the subsequent discovery of information that indicates harmful consequences flowing from that commitment directly threatens their self-concept as good, worthwhile individuals. Thus, cognitive processes will work to suppress such information if at all possible." Langevoort, *Where*, *supra* note 86, at 102-03; *see also* Langevoort, *Human Nature*, *supra* note 48, at 826 (path dependence leads people to throw good money after bad); Langevoort, *Illusions*, *supra* note 27, at 143 (self-serving beliefs—"people naturally see what they want to see").

[276] Langevoort, *Myths*, *supra* note 25, at 1575.

[277] JANIS, VICTIMS, *supra* note 28, at 45.

[278] Langevoort, *Selling Hope*, *supra* note 73, at 645.

[279] JANIS, VICTIMS, *supra* note 28, at 97.

As discussed previously, independent directors often make decisions to trust the CEO of the company in deciding to accept a board seat. This initial determination to rely on the CEO, however, creates the possibility of cognitive dissonance because facing up to negative information may lead to an ego-threatening realization that the independent director originally had poor judgment. This cognitive dissonance may lead the independent directors to be less diligent in their monitoring role in the three ways. First, independent directors are likely to accept managers' explanations at face value without making an effort to otherwise investigate the accuracy of these statements.[280] Second, directors may subconsciously choose to forego seeking information that indicates that the initial choice to join the board was a bad decision. Thus, independent directors may not take the time to comb through the preparation materials prior to board meetings to look for proof that managers are failing. Finally, independent directors may fail to heed warning signs that suggest that such trust should not continue.[281] Post-commitment, these independent directors may tend to dismiss suspicious information by relying on the other independent directors who appear not to worry. This fosters an unfortunate cycle when the other independent directors share the same biases.

In addition, Langevoort explains the concept of "motivated influence," which may play a role in independent director's perceptions.[282] Discovering a red flag would put the director in the unpleasant position of having to question the integrity of a "friend." Rather than risk destroying the managers' trust, independent directors may give managers the benefit of the doubt and favor an interpretation that avoids negative inferences. Once such rationalizations occur, the independent may not notice a red flag.[283] Perceiving some evidence of problems, independent directors may honestly, but mistakenly believe that these are minor setbacks, drawing on collective myths of invulnerability derived from the salience of past achievements.

It may take quite a long time for a board that has rationalized away red flags to recognize that a strong possibility of failure is imminent. By the time reality hits, the "commitment-whipsaw" bias tends to reduce the time interval of the failure and increase the acuteness of the firm's collapse.[284] In other words, when the board finally perceives how bright

[280] Prentice, *supra* note 13, at 163 (auditors accept client's explanations).

[281] Langevoort, *Selling Hope*, *supra* note 73, at 693.

[282] Langevoort, *Monitoring*, *supra* note 118.

[283] *Id.*

[284] Langevoort, *Epistemology*, *supra* note 94, at 645.

red the flags actually are, the firm may be very deep in the Big Muddy. Social psychologists call this the "last-period problem."[285]

b. Application to Enron

The Senate Report indicates several examples of different types of collective rationalizations used by the Enron Board to ignore red flags. Before reviewing these collective rationalizations, it is important to note that the Senate Report included thirteen red flags over two years that the Enron Board should have seen.[286] This led one senator to state: "[T]he board had ample knowledge of the dangerous waters in which Enron was swimming, and it didn't do anything about it."[287] Perhaps this is too easy to say in hindsight. Social psychology provides a more subtle, nuanced account of the Enron Board's failure to respond to red flags. Fastow and other Enron managers may have shrewdly framed the Enron Board's decisions in a manner that the directors perceived Enron's situation in a loss frame,[288] that is, Fastow may have emphasized that without these related-party deals, Enron could lose its superstar status. Given the salience of Enron's stellar track record, the optimism-commitment may have led the Enron Board to continue to grant waivers of the ethics code despite indications that they needed to change course. Despite warnings over this two year period, the Enron directors continued to grant waivers of the firm's ethics code to allow additional related-party transactions—three waivers of the ethics code within two years—providing evidence of the so-called "optimism-commitment whipsaw."

This section reviews six of the red flags discussed in the Senate Report in historical sequence and suggests reasons why the Enron directors may have ignored this mounting evidence about the related-party transactions. First, the Enron directors downplayed their role in congressional hearings. Specifically, several Enron directors refused to admit that they "waived" the Enron code of conduct, but rather referred to the action as "ratification of the Office of the Chairman."[289] This

[285] *Id.*

[286] POWERS REPORT, *supra* note 17, at 148 ("The Board was denied important information that might have led it to take action, but the Board also did not fully appreciate the significance of some of the specific information that came before it."); *Enron Hearings*, *supra* note 11, at 3 (staff identified over a dozen red flags).

[287] *Enron Hearings*, *supra* note 11, at 30.

[288] *Cf.* Prentice, *supra* note 13, at 156 (citing studies where half of the auditors were decided by management's frame).

[289] SENATE REPORT, *supra* note 17, at 25 n.59 (In the case of the LJM partnerships, Lay approved waiving the code of conduct prohibition for Fastow, but also asked the Enron Board to ratify his decision,

statement indicates that the Enron Board members rationalized away the degree of their responsibility for the decisions.

Second, the Enron Board encountered a warning signal during the outside auditors' presentation on the second related-party deal. Specifically, Arthur Andersen reported to the Enron Board that the most significant hazard of the transaction was "accounting risk."[290] Anderson ranked the different risk factors with "H" for high, "M" for medium and "L" for low.[291] Anderson highlighted that one of the major risks of the deal was that authorities would challenge the accounting treatment used, giving the factor an "H". The Enron Board failed to inquire what this conspicuous signal entailed. During congressional hearings, an Enron director said that he viewed the "H" for "high risk" accounting as really meaning an "I" for "important"[292]—providing evidence of the nature of the rationalization used to minimize the negative implications of this information.

Third, although Audit Committee monitoring was a critical control for the related-party transactions, the Powers Report found that the Audit Committee treated this issue by "cursory reviews," as "brief items on the agenda,"[293] which lasted only ten to fifteen minutes. No Enron Board member recalled asking to review the documents for the related-party transactions, such as the private placement memorandum or other marketing materials used to attract investors to the limited partnerships.[294] The subsequent investigations fault the Enron Board for failing to ask probing questions despite obvious risks and warning signals. For example, the Audit Committee did not question whether the Enron managers followed the control procedures and whether these mechanisms achieved the goal of protecting Enron against transactions that were overly generous to Fastow. These actions suggest that the Enron Board engaged in "see no evil" rationalization. That is, if the Enron directors scrutinized the deals in greater detail, such behavior would have served as a "relationship-threatening act of defiance" that human nature tends to avoid.[295] One Enron Board member testified that he received the memorandum in the mail, offering him the opportunity to invest in one of the deals, but he threw it away without reading it.[296]

even though Board concurrence was not explicitly required by company rules.).

[290] POWERS REPORT, *supra* note 17, at 158.

[291] SENATE REPORT, *supra* note 17, at 16.

[292] *Enron Hearings*, *supra* note 11, at 14, 23, 53.

[293] POWERS REPORT, *supra* note 17, at 162.

[294] SENATE REPORT, *supra* note 17, at 16. (would have learned two other senior Enron financial officers who worked for Fastow participated in LJM2, although they did not seek a waiver of the ethics code).

[295] Langevoort, *Selling Hope*, *supra* note 73, at 683.

[296] SENATE REPORT, *supra* note 17, at 28.

The Enron director may have avoided reading the docu-ment because he did not want to look for indications that his original decision to approve these deals was made poorly.

Fourth, the Enron Board failed to see Skilling's abrupt departure for "personal reasons" in August, 2001—after only six months of serving as CEO, but three months before the beginning of Enron's abrupt decline —as a red flag.[297] Journalists reported after Enron's demise that the resignation was "bizarre" because Skilling gave up a $19.9 million severance package and $2 million loan forgiveness.[298] During congressional hearings, the Enron directors stated that they did not view this event as a danger signal. Yet, it is important to recognize that the other corporate watchdogs also failed to recognize this red flag. After Skilling left, Ken Lay stepped back into the role of CEO, and reported that there were "[a]bsolutely no accounting issues, no trading issues, no reserve issues, no previously unknown problem issues,"[299] behind Skilling's departure. Lay had such credibility on Wall Street that most people believed him.[300] In the aftermath of Enron, one reporter stated, "What's astonishing is that even in the face of this dramatic—and largely inexplicable—event, people were still willing to take Enron at its word."[301] Thus, the Enron Board may have engaged in the type of "hear no evil" collective rationalization with respect to Skilling's resignation.

Fifth, during congressional testimony, the Enron directors stated that they left the board meeting in early October 2001 (the beginning of Enron's quick, downward spiral), believing that Enron was "still on track,"[302] even though the Enron Board learned about an anonymous employee letter warning of company problems. The outside counsel, Vinson & Elkins, indicated that their preliminary study of the employee's concerns did not deserve additional inquiry. Relying on this presentation, the Enron directors did not ask to review the original letter, or the Vinson & Elkins report on the parameters of the investigation until Enron began to collapse.[303] Social psychology explains that to ask for such documentation would indicate a lack of trust, not only in the outside counsel, but also in the CEO. Again, this suggests that the Enron Board failed to heed this red flag using the "hear no evil" collective rationalization.

[297] *Id.* at 12.

[298] *Id.* at 31.

[299] POWERS REPORT, *supra* note 17, at 97.

[300] Alex Berenson, *Enron's Collapse: The Chairman*, N.Y. TIMES, Jan. 23, 2002, at 16.

[301] BODILY & BRUNNER, *supra* note 2.

[302] SENATE REPORT, *supra* note 17, at 12.

[303] *Id.* at 48.

Finally, at this same meeting, the Enron directors learned about an $800 million earnings charge from the termination of one of the related-party deals, known as Raptors. During congressional testimony, the Enron directors testified they were not concerned about the termination of this deal because it was a "one-time event." This "one-time" rationalization is commonly used to trivialize problems as being insignificant because they will not reoccur.[304]

During this October 2001 meeting, the Enron Board later testified that Lay told them of the $800 million charge to terminate Raptors, but not the $ 1.2 billion equity write-down. The Enron directors learned about the write-down by reading a *Wall Street Journal* article following Lay's disclosure to financial analysts on October 17th.[305] Several directors reported that this was the event that made them realize that Enron was in trouble, or recognition of the "last period problem." By this time however, it was too late because Enron was deep in the Big Muddy, beginning its intense and abrupt downward cycle, lasting only three months before Enron filed for bankruptcy.

The subsequent investigations provide direct evidence that the Enron Board may have been swept away by a "see no evil" norm in approving the related-party transactions.[306] The Enron directors were probably unaware of how much they were relying on shared rationalizations in order to appraise these highly risky ventures as safe.

4. Out-Group Stereotypes

a. Theory

The fourth symptom of groupthink is the group's stereotyping of rivals, which can apply to outsiders as well as to members of the group itself. Through such negative stereotyping, the group fosters the belief "either you are with us or against us." Janis explained that this

[304] Langevoort, *Epistemology*, *supra* note 94, at 643.

[305] SENATE REPORT, *supra* note 17, at 48.

[306] In addition, journalists' accounts reveal that many others within Enron and outside Enron show evidence of collective rationalization. Specifically, an atmosphere of "puffery," and "winking" arose surrounding Enron and within Enron. With respect to analyzing the financial disclosures for the related-party transactions, analysts seemed to bury their heads in the sand. Specifically, analysts accepted statements that the details of these deals were "confidential" because Enron "did not want information to get into the market." BODILY & BRUNNER, *supra* note 2, at 38 ("[it was] Enron culture that contained the seeds of its collapse, a culture of highly questionable financial engineering, misstated earnings and persistent efforts to keep investors in the dark."); McLean, *supra* note 3, at 38 ("Enron's aggressive culture, which had been as asset during the company's transformation, became a liability as questions about Enron's credibility increased.").

stereotyping process causes cohesive groups to view those opposing the decision, either within the group or outside the group, as weak-minded for "not getting it."[307]

Within the group, deviants face intense social disapproval and may become outcasts. As an example, Janis discussed how this stereotyping behavior was used by the inner circle of President Kennedy's advisors in planning the Bay of Pigs fiasco.[308] Some members of this group represented the military and supported the use of force through bold, brutal rhetoric. In addition, the military members insinuated that Kennedy's supporters were soft-headed idealists. Afterward, some members stated that they failed to voice disapproval of the decision to invade Cuba during these planning sessions because they feared seeming "unvirile" or "unmasculine" in front of the military advisors.[309]

Viewed in a similar light, we can see why intelligent, experienced directors who monitor firms on a part-time basis may be unwilling to challenge management's business acumen. Most people, but particularly professionals, do not want to risk embarrassment by displaying their ignorance in public.[310] This leads some individuals to subconsciously avoid such humiliation by pretending to understand the complicated issues at hand; they concur, but in reality they are relying on the trust in their "friends."[311] Thus, independent directors may try to avoid appearing unsophisticated in the presence of management when discussing complex financial matters. Shrewd CEOs and senior managers may manipulate this cognitive weakness by using tough rhetoric to pressure independent directors to act like they "get it" and accept dubious proposals.[312]

b. Application to Enron

Subsequent investigations contain evidence that this stereotyping symptom may have influenced the Enron Board. In order to place this information in context, this section reviews journalists' accounts of

[307] JANIS, VICTIMS, *supra* note 28, at 230. With respect to experts advising the group, members may stereotype these experts as slowing down decision making tasks. For example, Ronald Sims notes that group leaders may disparage an accountant by making sport of fastidiousness as "fussiness." Sims, *supra* note 28, at 27. Perhaps this explains, in part, Arthur Andersen's role. In addition, the old accounting rules were said to be ill-equipped to measure the new economy companies.

[308] JANIS, VICTIMS, *supra* note 28, at 14.

[309] *Id.* at 41.

[310] Langevoort, *Selling Hope*, *supra* note 73, at 656.

[311] *Id.* at 653.

[312] *Id.* at 657.

Enron's reputation for publicly humiliating those who asked too many questions, from the outside financial community and within Enron itself.

Externally, Enron had a "we're smarter than you guys" attitude toward analysts.[313] Specifically, one analyst reported, "When you question them in detail, they get offended."[314] For example, when an analyst questioned Skilling, he replied: "Our business is not a black box. It's very simple to model. People who raise questions are people who have not gone through it in detail. We have explicit answers, but people want to throw rocks at us."[315] Thus, until its downfall, Enron denied that its financial statements were complicated; anyone who couldn't understand its business just didn't "get it."[316] Skilling also had a reputation of taking more extreme measures if the questioner persisted. For example, when the first reporter began to ask how Enron really made its money, Skilling told her the questions were "unethical" and hung up the phone.[317] In another instance, when Enron executives distributed the firm's balance sheet, but not the income statement during an analysts' meeting, one analyst asked to see the missing financial statement. Skilling responded by calling this analyst an "asshole;" no one asked any more questions after that exchange.[318] As one analyst summed up the situation, "[Enron] had Wall Street beaten into submission."[319]

Internally, Enron had a reputation for stereotyping its employees that stemmed from the "rank and yank" tournament structure. As one Enron employee stated: "If you didn't act like a light bulb came on pretty quick, Skilling would dismiss you."[320] Thus, Enron employees reported: "[Y]ou either got with the system or you were out the door."[321] Another worker noted: "One day, you are viewed with favor, and the next day you are not. You know who is in the in-crowd and who is not. You want to continue to be liked in that organization. You do everything you can do to keep that."[322]

[313] Zellner & Forest, *supra* note 6, at 30.

[314] Kadlec et al., *supra* note 170, at 68.

[315] McLean, *supra* note 3, at 33.

[316] *Id.*

[317] *Id.* at 33; Felicity Barringer, *10 Months Ago, Questions on Enron Came and Went With Little Notice*, N.Y. TIMES, Jan. 28, 2002, at A11.

[318] *Special Report, Enron, The Amazing Disintegrating Firm*, ECONOMIST, Dec. 8, 2001, at 61.

[319] John Byrne, *At Enron, The Environment Was Ripe for Abuse*, BUS. WK., Feb. 25, 2002.

[320] *Id.*

[321] Rick Bragg, *Enron's Collapse: Workers*, N.Y. TIMES, Jan. 20, 2002, at 1.

[322] Stephens & Behr, *supra* note 173, at A01. Thus, managers worried about their advancing age in a culture which had many young upstarts. Skilling was made CFO at the age of thirty-six. Older executives feared their superiors would see them as too conservative, pushing they to demonstrate extreme risk-taking. *Id.*

Given this corporate culture of stereotyping rivals, we can turn to the Powers Report for evidence of this symptom in the Enron boardroom. The Powers Report stated:

> The Board authorized the Rhythms transactions and three of the Raptor transactions. It appears that many of its members did not understand those transactions—the economic rationale, the consequences, and the risks. Nor does it appear that they reacted to warning signs in those transactions as they were presented, including the statement to the Finance Committee in May 2000 that the proposed Raptor transaction raised a risk of "accounting scrutiny." . . . As complex as the transactions were, the existence of Fastow's conflict of interest demanded that the Board gain a better understanding of the LJM transactions that came before it, and ensure (whether through one of its committees or through use of outside consultants) that they were fair to Enron.[323]

The Powers Report also noted that the Raptor deal was "an extremely complex transaction, presented to the [Enron Board] by advocates who conveyed confidence and assurance that the proposal was in Enron's best interests, and that it was in compliance with legal and accounting rules."[324] Thus, we see hints that the Enron Board members may have faced pressure to put up a front during these meetings, acting as if they "got it." In addition, Enron's culture of negative stereotyping may have affected the Enron Board's willingness to inquire about the complicated related-party transactions for fear of being seen as afraid of risk. That is, the Enron directors may not have wanted to appear "soft" on risk-taking or like "old-time dinosaurs" who could not adapt to "new economy" thinking. If a board member did have the courage to raise issues, they may have quickly backed down upon meeting the type of rebuff the Enron management gave to people who asked too many questions.

5. Illusion of Uniformity

a. Theory

Under this symptom of groupthink, the appearance of a group consensus pressures members to accept decisions.[325] Of course, a certain degree of concurrence seeking is necessary for any group to reach a

[323] POWERS REPORT, *supra* note 17, at 23.

[324] *Id.* at 166.

[325] JANIS, VICTIMS, *supra* note 28, at 83.

decision. Janis, however, distinguished the type of concurrence seeking in groupthink as being extreme and premature. Similar to the cascade phenomenon discussed previously, once a sufficient number of members of the group appear to favor a proposal, others sense "which way the wind is blowing" and adopt the same view.[326] Group leaders can pressure this type of quick concurrence, by simply stating, "it appears the group has reached a consensus." Such a comment may lead to self-censorship by group members for fear of "rocking the boat." This self-censorship increases the illusion that silence means consent.[327] In extreme cases, this tendency can lead to situations that many in the organization know are problems, but are afraid to discuss openly. Management theorists refer to such topics as "moose issues."

b. Application to Enron

With respect to the symptom of the appearance of unanimity, the Senate Report noted, "[Enron Board members] said that Board votes were generally unanimous and could recall only two instances over the course of many years involving dissenting votes."[328] Thus, the subsequent investigations revealed no indication that the Enron directors challenged management, even though some directors lost millions of dollars from their investments in Enron stock.[329] In addition, the Powers Report stated:

> [T]here's no question that virtually everyone, from the Board of Directors on down, understood that the company was seeking to offset its investment losses with its own stock. That is not the way it is supposed to work. Real earnings are supposed to be compared to real losses. . . As a result of these transactions, Enron improperly inflated its reported earnings for a 15-month period—from the third quarter of 2000 through the third quarter of 2001—by more than $1 billion. This means that more than 70 percent of Enron's reported earnings for this period were not real.[330]

This comment implied that the financial manipulation relating to the related-party deals developed into a "moose" issue within Enron. Other

[326] Haft, *supra* note 48, at 37-38.

[327] JANIS, VICTIMS, *supra* note 28, at 167.

[328] SENATE REPORT, *supra* note 17, at 8.

[329] Robert Belfer, the largest Enron shareholder, lost S600-S700 million and his family lost S 2 billion. Carrie Johnson, *Enron Director Robert Belfer Gave Away Millions*, LINCOLN J. STAR, May 9, 2002, at 3.

[330] Testimony of William C. Powers, Jr., Chairperson of the Special Investigative Committee of the Board of Directors of Enron Corporation, Before the Committee on Financial Services, United States House of Representatives, Feb. 4, 2002, at 4.

indications support the proposition that the Enron Board may have also been influenced by the Enron culture, which showed strong signs of the illusion of uniformity. For example, one Enron executive remarked, "You had to keep drinking the Enron water"; while another stated you had to "drink the Kool-Aid."[331] As a telling indicator of the symptom of unanimity, an Enron employee from the Enron Energy Services division (EES) reported, "EES knowingly misrepresented EES' earnings . . . . This is common knowledge among all the EES employees, and is actually joked about. . . . Enron must investigate all these going ons."[332]

6. Self-Censorship

a. Theory

The sixth symptom of groupthink is self-censorship by members of the group.[333] This symptom demonstrates the members' psychological need for excessive concurrence seeking. Specifically, members may remain silent even if they disagree, or they may soft-pedal their disagreements when the group appears to favor a decision. Group members conform to the group opinion rather than suffering the costs of being the lone objector and "sticking out like a sore thumb."[334] Simply put, if everyone else in the group is against you, the easiest approach is to "put up and shut up."[335] Thus, members may publicly agree, or remain silent even when they privately disagree. In essence, they "go along to get along." This symptom points to the pressures for conformity in boardrooms. With boards, this pressure may flow from the hierarchical relationship directors have with the CEO. An individual director may comply with a decision as a form of obedience to her appointer.

b. Application to Enron

The subsequent investigations provided evidence of two instances that the Enron Board may have engaged in self-censorship. In addition, journalists' accounts of Enron's corporate culture support the inference that this symptom appeared in the boardroom.

[331] Stephens & Behr, *supra* note 173, at A1.

[332] *Id.*

[333] JANIS, VICTIMS, *supra* note 28, at 34.

[334] Candice Predergast, *A Theory of "Yes Men"*, 83 AM. ECON. REV. 757, 769 (1993) (tell supervisors what they want to hear).

[335] Sims, *supra* note 28, at 134.

First, the most dramatic indication that the Enron directors engaged in self-censorship comes from the Audit Committee's failure to ask how much money Fastow and other executives made from the related-party transactions. For the first year, the Enron Board relied on Skilling to review the amount of income and asked no questions. In October, 2000, after learning about the multiple, high dollar transactions the related-party partnerships had with Enron, the Finance Committee asked the Compensation Committee to conduct a one-time review of Fastow's earnings from these deals. This led an Enron director to ask a senior compensation officer to provide data on all Section 16(b) officers; the director did not tell the officer that he wanted information about Fastow "to avoid office gossip."[336] After failing to receive the information after requesting it twice, the director let the matter drop.[337] Thus, one year later, despite the Finance Committees directive, the Compensation Committee failed to learn about Fastow's significant levels of compensation from the related-party transactions.[338]

The Enron Board found out about the large benefits Fastow reaped at Enron's expense by reading the newspaper. After Enron's October 2001 disclosure, journalists investigated the related-party deals and reported that Fastow earned $30 million. This led an Enron director to have Enron's general counsel draft specific questions to ask Fastow about this matter. The Enron Board sent a written memorandum to Fastow, which began with the deferential phrase "we very much appreciate your willingness to visit with us."[339] During congressional testimony, an Enron director noted that in the meeting following this letter, Fastow admitted receiving $45 million, but never provided information about his partnerships' rates of return to the Enron Board. The Enron Board, however, placed Fastow on leave after this conversation.[340]

When asked during the congressional hearings why the Enron directors did not pursue the issue about Fastow's compensation more assertively, some directors reported that they felt such questions were "inappropriate" or "intrusive."[341] In response, the Powers Report stated that this "reticence" was unreasonable given that the Enron Board merely had asked for Fastow's tax returns.[342] Such reluctance, however, may have arisen from the "fictive friendships" that arise in boardrooms;

[336] SENATE REPORT, *supra* note 17, at 35.

[337] *Id.*

[338] *Id.*

[339] *Id.* at 36.

[340] *Id.*

[341] POWERS REPORT, *supra* note 17, at 173.

[342] *Id.*

social norms do not allow one to inquire into a "friend's" financial situation. In addition, congressional hearings criticized the Enron Board for being "obsequious" in questioning Fastow after the media brought Fastow's compensation to the Enron Board's attention.[343] The Enron directors' courtesy toward Fastow, being shocked after reading the newspapers, may indicate extreme self-censorship by Enron Board members.

These indications that the Enron Board engaged in self-censorship are bolstered by the "kill the messenger" norm present within the Enron culture. Specifically, journalists' accounts provide three examples of how Enron employees knew that conveying negative news could destroy their careers because co-workers would jeopardize their reviews under the "rank and yank" system. First, one Enron employee remarked, "You don't object to anything, the whole culture at the vice-president level and above just became a yes-man culture."[344] Second, an employee reported, "People perpetuated the myth that there were never any mistakes. It was astounding to me."[345] Finally, an Enron employee stated that under the "rank and yank" tournament, "[p]eople went from being geniuses to idiots overnight."[346] Thus, direct evidence, as well as the Enron corporate culture, indicate that the Enron directors may have engaged in self-censorship.

7. Direct Pressure on Dissenters

a. Theory

Under this symptom of groupthink, members use common forms of social pressure against individuals who question the group's judgment in order to ease their own anxiety and guilt about the merits of a dubious decision.[347] Because each member wants to stay in the group, the others have sanctioning power over deviants. For example, group members place direct pressure on a dissenter by labeling the person as "not a good team player."[348] Additionally, the group leader can downplay criticism through power statements such as, "I'm sure that the dissenter isn't trying to upset the apple cart."[349] More extreme pressure

[343] *Enron Hearings*, *supra* note 11, at 64-65.

[344] Byrne, *supra* note 319, at 45.

[345] McLean, *supra* note 3, at 362.

[346] BODILY & BRUNNER, *supra* note 2, at 48.

[347] JANIS, VICTIMS, *supra* note 28, at 39-40.

[348] JANIS, VICTIMS, *supra* note 28, at 56.

[349] Sims, *supra* note 28, at 87.

on dissenters can produce a culture of fear that leads to the classic corporate "yes man."[350]

As an example, Janis discussed how the inner circle of President Johnson's Administration pressured dissenters who questioned the escalation of the Vietnam War.[351] During these sessions, members described the dissenter as losing his "effectiveness," as a "has been" who would ultimately face banishment from power. The inner circle of the Johnson Administration allowed some disagreement, but only if it was presented in a detached manner by using humor. But, even in these instances, the good-natured objector had to accept collegial jokes made as his expense. For example, the inner circle of the Johnson Administration commonly referred to one disagreeing member as "Mr. Stop the Bombing."[352] Janis emphasized that the weak presence of this subdued criticism served to facilitate the group's rationalization, that after accepting and appraising opposing views, the process they used in making their decisions was sound.[353]

b. Application to Enron

Although no direct evidence exists at this time that Enron managers pressured the independent directors, the subsequent investigations reveal two indications of this type of pressure on others.[354] First, the Powers Report detailed how Fastow attempted to coerce Enron workers who dealt with the related-party partnerships to gain better terms for himself.[355] One Enron employee complained to Skilling in March of 2000, stating that he received a smaller bonus after disagreeing with Fastow about a matter pertaining to the related-party partnerships.[356] In general, Enron employees described Fastow as a "prickly, even vindictive man, prone to attacking those he didn't like in Enron's group performance reviews."[357] Specifically, an Enron employee stated, "[Fastow] was such a cut-throat bastard that he would use it against you

[350] This raises the classic issue related to whistleblowers; why don't people blow the whistle more often or sooner? Is it pressure from pressure of colleagues or the fear of losing money from their stock options? One answer to the dilemma may be to allow whistle blowers to sell short.

[351] JANIS, VICTIMS, *supra* note 28, at 99.

[352] *Id.* at 115.

[353] *Id.* at 12.

[354] In other cases, journalists reported that an analysts who expressed apprehension about Enron was fired from his brokerage firm. In another situation, the media indicated that Fastow tried to have a lawyer fired for negotiating too hard for Enron. Tom Hamburger & John Emshwiller, *Enron Officials Sought Lawyer's Dismissal Over Negotiations with Outside Partnership*, WALL ST. J., Feb. 6, 2002, at A3.

[355] POWERS REPORT, *supra* note 17, at 166.

[356] *Id.*

[357] Zellner & Forest, *supra* note 6, at 30.

. . . . He could filibuster and hold up the group for days, because every decision had to be unanimous."[358] Second, congressional testimony indicated that Arthur Andersen may have faced coercion from Enron managers to approve the related-party transaction.[359] The Senate Report notes that Andersen marked its risk analysis of Enron as a client as "maximum" because "management pressures were very significant."[360] At Enron's request, an Andersen employee on an audit team faced reassignment after asking too many questions.[361]

With regard to pressure on the Enron Board, Fastow made several presentations to the Enron Board to get the related-party transactions approved. Thus, Fastow's reputation for manipulating the "rank and yank" system may have influenced the Enron directors.[362] Although subsequent investigations do not reveal that Enron Board caved in to managerial pressure, perhaps there was no need for this type of action because the directors did not express any objections in the first place.

8. Self-Appointed Mindguards

a. Theory

The last symptom of groupthink is the emergence of self-appointed mindguards, that is, members who take it upon themselves to protect the group from adverse information.[363] The mindguard performs the role of "thought homogenizer" by informing others in the group that the leader is not open to criticism or by running to the leader to act as a "mole" any time a member shows signs of dissent.

b. Application to Enron

With respect to self-appointed mindguards on the Enron Board, the subsequent investigations do not provide any direct signs that an individual Enron Board member or Enron manager performed this role. The Senate Report, however, noted that Fastow was so confident that the Enron Board would approve the second waiver of the ethics code, that he completed much of the negotiations for the transaction prior to

[358] *Id.*

[359] *Enron Hearings*, *supra* note 11, at 25.

[360] SENATE REPORT, *supra* note 17, at 18.

[361] *Enron Hearings*, *supra* note 11, at 4.

[362] John Schwartz, *As Enron Purged Its Ranks, Dissent Was Swept Away*, N.Y. TIMES, Feb. 4, 2002, at C1.

[363] JANIS, VICTIMS, *supra* note 28, at 78.

asking the Enron Board for approval.[364] Similar to the symptoms of direct pressure on dissenters, the presence of Enron managers during the board meetings approving the related-party deals, may have served as self-appointed mindguards. In addition, perhaps no such mindguards were needed because the Enron Board quickly approved these deals.

In sum, this Part reveals that the Enron Board's actions fit a specific pattern of concurrence seeking behavior in face-to-face groups, when the "we-feeling" of solidarity is running high. Thus, group processes may have been subtly at work, preventing the members of the Enron Board from debating the real issues posed and from carefully appraising its serious risks. Perhaps some Enron directors did not realize that other directors shared their negative opinions, and these directors did not wish to provoke conflict with the CEO. This case study of the Enron Board shows that groupthink is an error that can diminish abilities of some of the most intelligent people in our society—the prestigious, independent directors of publicly-held corporations. Without empirical evaluation, we cannot know the extent to which groupthink is a problem for boards in general. This case study, however, suggests that many boards may be susceptible to this phenomenon under certain conditions. In addition, the Enron debacle raises questions about how well our corporate governance system monitors "superstar" performance by executives motivated by stock options to play "the numbers game"[365] in a bull market[366] dominated by "irrational exuberance."[367]

The purpose of this Enron case study is to expand the awareness of groupthink and the other biases that impair directors' cognitive abilities to monitor managers. The next Part examines recent reform efforts in terms of their chances of reducing the probability of groupthink and other biases arising in boardrooms.

[364] SENATE REPORT, *supra* note 17, at 28.

[365] *See, e.g.*, Arthur Levitt, The Numbers Game, *at* http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt. In addition, Former SEC Chairperson Arthur Levitt warned:

> Increasingly, I have become concerned that the motivation to meet Wall Street earnings expectations may be overriding common sense business practices. Too many corporate managers, auditors and analysts are participants in a game of nods and winks . . . As a result, I fear that we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting. Managing may be giving way to manipulation; Integrity may be losing out to illusion.

SEC Chairman Arthur Levitt, *Concerned That Quality of Corporate Financial Reporting is Eroding, Announces Action Plan to Remedy Problem* (SEC News Release), *at* 1998 WL 779351 (SEC).

[366] For an in depth critique of the dangers of shareholder value maximization, see LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT (2001).

[367] ROBERT SCHILLER, IRRATIONAL EXUBERANCE (1999) (discussing how shareholder engage in herd behavior to push up stock prices).

IV. REFORMING CORPORATE BOARDS TO PREVENT GROUPTHINK

As lawmakers and regulators contemplate reforming corporate boards to prevent the next Enron from happening, it is easy to be skeptical about such efforts for two reasons. First, suspicion stems from corporate lobbyists' efforts, such as the Business Roundtable,[368] and from self-regulatory arbitrage between the NYSE and NASDAQ,[369] that prevents much needed reforms from taking place—such as expensing stock options.[370] Second, for the reforms that succeed in passing, apprehension arises because social psychology suggests that it is difficult to change norms.[371] Indeed, one of the main lessons of Enron is that boardroom dynamics are difficult to prescribe because structural solutions are easily subverted, negating the impact on substance.[372] Thus, reforms in the wake of Enron may result in corporate lawyers leaving behind even more extensive paper trails to document compliance with hollow rituals. Undoubtedly, some independent directors will fail to take the spirit of the NYSE Rules to heart. This is because of the human tendency for independent directors to use ego-protecting and stress-reducing techniques to view the corporate scandals as attributable to bad luck or character flaws that do not affect them.[373] Thus, suffering from self-serving biases, these directors may view these reforms as necessary for other directors who lack diligence. These directors may view the reforms as not applicable to their own situations because they perceive themselves as performing their duties in an above-average manner.[374]

Effective corporate boards require independent directors who can overcome the cognitive biases prevalent within corporate cultures that prevent them from performing their monitoring role effectively. This

[368] Arianna Huffington, *My What Big Teeth You Have*, SALON, July, 2002, http//archive.salon.com/news/col/huff/2002/07/11/businessroundtable/index_np.html.

[369] The NASDAQ rules are considered less stringent than the NYSE rules and the NASDAQ has been accused of self-regulatory arbitrage in that companies may delist from the more stringent rules of the NYSE and list with NASDAQ. The NASDAQ rules emphasize independence of the audit committee and also requires shareholder approval for equity-based compensation.

[370] *See, e.g.*, Amy Borrus & Paula Dwyer, *To Expense or Not to Expense*, BUS. WK., July 29, 2002, at 44. Although a few companies are signaling their use of good corporate governance practices by treating stock options as expenses voluntarily. Mary Deibel, *Restoring Trust in Corporate America*, SAN DIEGO UNION TRIB., July 21, 2002 (Coca-Cola, The Washington Post, and Bank One).

[371] *See* Jeffrey J. Rachlinski, *The "New" Law and Psychology: A Reply to Critics, Skeptics, and Cautious Supporters*, 85 CORNELL L. REV. 739 (2000).

[372] Statement of Nell Minow, Corporate Accountability and Listing Standards, NYSE, Apr. 15, 2002.

[373] Langevoort, *Where*, *supra* note 86, at 112-113.

[374] Robert Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. L. REV. 133, 153 (2000).

Part concludes that although many of the changes in corporate governance are useful, these structural reforms may not go far enough because good governance does not stem from procedures alone. Rather, transformation of the powerful psychological forces operating within boardrooms is necessary so that directors do not tune out at board meetings, dulled by repetition of the same old scripted gatherings.

In seeking to change boardroom dynamics, this Part turns to the social psychology literature on preventing groupthink to discuss two reform proposals: (1) formalizing the role of devil's advocate,[375] and (2) increasing diversity on corporate boards.[376] Before reviewing these proposals to prevent groupthink, this Part first discusses the Enron director's potential liability under state law for breach of the fiduciary duty of due care. This Part then examines the recently enacted New York Stock Exchange proposals for boardroom reforms (NYSE Rules)[377] with regard to their potential to curb cognitive biases that influence independent directors.

A. Shareholder Suits Against Enron Directors for Breach of the Duty of Due Care

The Senate Report criticized the Enron Board, stating that "[t]he failure of any Enron Board member to accept any degree of personal responsibility for Enron's collapse is a telling indicator of the Board's failure to recognize its fiduciary obligations."[378] Groupthink theory provides an explanation for this behavior. Specifically, groupthink literature explains that "de-individualization" through group processes results in individuals becoming less self-aware, and more inclined to go along with group decision. Rather than taking personal responsibility for their own actions, de-individualized people view responsibility as diffused, or distributed to the group as a whole. This leads individual group members to feel that they bear no individual responsibility for the consequences of the group's decisions. Thus, social psychology provides

[375] I have found two other corporate scholars advocating this proposal. Barnard, *supra* note 30, at 1170; Haft, *supra* note 48, at 7.

[376] For another corporate scholarship law advocating this position, see Steven Ramirez, *Diversity and the Boardroom*, 6 STAN. J.L. BUS. & FIN. 85 (2000).

[377] Report of the New York Stock Exchange Corporate Accountability and Listing Standards Committee (June 6, 2002); New York Stock Exchange Corporate Accountability and Listing Standards Committee, June 6, 2002. The NYSE approved these rules on August 1, 2002 and the SEC is scheduled to make a decision on September 6, 2002. The Business Roundtable decision in 1988 found that the SEC cannot initiate changes on the exchanges. For an overview, see Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 60 WASH. UNIV. L.Q. 565 (1991). The exchanges, however, can submit such reforms to the SEC for approval. If the SEC could initiate such changes it could prevent the regulatory arbitrage between the NYSE and NASDAQ.

[378] SENATE REPORT, *supra* note 17, at 49.

an explanation for why the Enron directors did not appear to have guilt, despite the fact that their lack of vigilance led to so much harm.

In reviewing the Enron directors' liability for breach of the duty of due care, it is important to note that Langevoort explains that "ego" in particular "frustrates law's attempt to channel behavior in particular directors . . . . We cannot expect people to respond fully to legal rules that ask them to modify their actions upon spotting danger signs, when perceiving such signs would provoke the stress of an ego threat."[379] Langevoort maintains that cognitive biases void the good faith standard of most of its legal meaning. Specifically, Langevoort states that "good faith, honesty of views means little if ego makes it easy to believe it with utmost sincerity in the wisdom and efficacy of ones' own actions however self serving."[380] As stated previously, however, the Enron case study in Part III does not seek to let the Enron Board off the hook legally by providing the rather lame excuse of groupthink for two reasons. First, to do so would allow truly pathological boards to try to fake this defense. Second, social psychology warns that people, including judges and jurors, are poor judges of whether someone is telling the truth.[381]

Shareholder litigation against the Enron Board depends on whether shareholders can rebut the strong presumption of the business judgment rule. If they can, a court must determine whether the Enron directors acted with due care under *Smith v. Van Gorkom*[382] and fulfilled their duties under *In re Caremark.*[383] Specifically, a court first needs to evaluate whether to apply the business judgment rule, and if it does not, whether the Enron Board breached its duty by waiving Enron's ethics code to allow the related-party transactions to go forward. Then, judicial consideration turns to whether the Enron Board failed in its fiduciary obligations to monitor these deals.

With respect to the initial decision to approve the related-party transactions,[384] the most important factor that a court needs to evaluate is the minimal amount of time that the Enron Board took to make this a highly unusual type of decision. For the first waiver, the entire board

[379] Langevoort, *Ego, supra* note 102, at 856.

[380] *Id.* at 876.

[381] Hal R. Arkes & Cindy A. Schipani, *Medical Malpractice v. the Business Judgment Rule: Differences in Hindsight Bias*, 73 OR. L. REV. 587, 588 (1994).

[382] 488 A.2d 858 (Del. 1985). Bratton notes that Enron is an Oregon corporation, but that Delaware law will be persuasive. Bratton, *supra* note 2.

[383] 698 A.2d 959 (Del. Ch. 1996).

[384] In approving the related-party transactions, William Bratton states: "there was no prima facie breach of fiduciary duty bound up in the Fastow deal at the time the Enron Board approved it." Bratton, *supra* note 2; *But see* Joann S. Lublin & John R. Emshwiller, *Enron Board's Actions Raise Liability Questions*, WALL ST. J., Jan. 17, 2002, at C1 (suggesting liability may be possible).

meeting lasted one hour, yet the Enron Board considered several other weighty issues besides the ethics code waiver to allow the LJM1 proposal to go forward.[385] On the other hand, there is evidence pointing toward application of the business judgment rule. Specifically, the Enron Board members received written materials three days before the special meeting. Although the Enron directors stated that they relied on a fairness opinion from a reputable investment bank for the deal as dictated by *Smith v. Van Gorkom*,[386] this opinion was not obtained until two months after the Enron Board's approval. The Enron Board followed similar practices in approving the second waiver as well.[387]

Next, a court needs to evaluate whether the Enron Board's monitoring of the transactions complied with the requirements of *In re Caremark*. A court may find that the Enron directors failed to satisfy *Caremark* duties because the Audit Committee's reviews only lasted a few minutes and the Enron Board failed to heed red flags—such as "high risk" accounting practices. On the other hand, a court may give the Enron directors the benefit of the doubt because the outside auditor did not voice explicit disapproval about particular transactions or accounting practices at Enron.[388] Although it is hard to predict the outcome of shareholder litigation against the Enron directors in light of the available evidence to date, the political dynamics of the public's outrage over Enron and the support from the highly critical Senate Report may increase the Enron shareholders' chances of success.[389] This article counsels, however, that judges need to be careful not to evaluate the Enron directors' actions too harshly in the light of post-bubble hindsight. In addition, the court needs to recognize that most

[385] Other matters included resolutions authorizing a major stock split, an increase in the shares in the company's stock compensation plan, the purchase of a new corporate jet, and an investment in a Middle Eastern power plant and Mr. Lay also discussed a reorganization underway at Enron. SENATE REPORT, *supra* note 17, at 24.

[386] *Id.* at 27.

[387] In approving the second waiver of the ethics code to allow LJM2, the Finance committee of the Enron Board did review the transaction, after what the Chairperson of the Finance Committee described as "a vigorous discussion." Then, the entire Enron Board approved it. POWERS REPORT, *supra* note 17, at 75-76.

[388] Viewed in this light, a court may stress the time limitations faced by the Enron Board, and find it reasonable for the directors to rely on the reports from outside accountants and legal counsel in approving and monitoring the highly technical related-party transactions.

[389] *See, e.g.*, Adam Zagorin, *Enron's Board Games*, 160 BUS. SOURCE ELITE 16, July 15, 2002. On the other hand, the Enron directors' lawyers criticized the Senate Report for using "very selective use of the evidence" and "an unfair and unwarranted characterization of facts to reach a predetermined outcome." Kathryn Kranhold & Michael Schroeder, *Questioning the Books: Enron Directors Are Faulted in Senate Report*, ASIAN WALL ST. J., July 9, 2002, at A4 (quoting lawyer for former Enron directors). The directors' lawyer also stated: "Senate is setting a far higher standard for directors than is normally understood." *Id.*; *see also, Enron Board: We Were Mislead*, CNNMONEY, May 7, 2002.

independent directors are successful individuals who have hectic and stressful schedules; such people need to rely on others for advice in fulfilling their complicated and multiple duties in their part-time positions as directors.

Whether or not the state law action by shareholders against the Enron directors and officers is successful, courts may play a useful role in shaming the Enron directors for poor decisions. Corporate governance scholars have emphasized that Delaware cases provide morality stories designed to shame directors into vigilant monitoring.[390] Social psychology, however, warns that these shaming tactics have difficult cognitive hurdles to overcome. Specifically, this scholarship suggests that shaming may be an ineffective tool because independent directors may not recognize the wrongfulness of their behavior because cognitive processes minimize the effect of ego-threatening information.[391]

Whether change stems from shaming or other reasons, the proliferation of corporate scandals may lead to changes in some boardrooms.[392] As directors engage in self-evaluation post-Enron, journalists suggest that directors are attending more board meetings and asking more questions. In addition, director search firms report that they are looking for "independent thinkers,"[393] but that it is more difficult to persuade directors to accept board seats.[394] Such signs show that independent directors may have learned the post-Enron lesson that it is not acceptable to simply nod in approval and later claim "I didn't know," or "I didn't understand," or "no one told me." To ensure that such actions are not transitory responses, the next section reviews how the recently adopted NYSE Rules[395] seek to ensure the independence of the board from managerial domination.

[390] On the role of shaming, see Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997); David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PENN. L. REV. 1811 (2001).

[391] Langevoort, *Ego*, *supra* note 102, at 856.

[392] NAT'L ASS'N OF CORP, DIRS., RECOMMENDATIONS TO CONGRESS (2002), http://www.nacdonline.org/nacd/enron_recommendations.asp.

[393] Post-Enron Boards are taking steps to find more independent thinkers; Mike McNamee et al., *Turn Up the Heat on Board Cronyism, Mr. Grasso*, BUS. WK., Apr. 22, 2002, at 36 (Korn/Ferry International, a director recruiter reports that searches for candidate up thirty percent and "no one wants lapdogs.").

[394] Emily Thornton & Louis Lavelle, *It's Getting Tough to Fill a Boardroom*, BUS. WK., July 29, 2002, at 80.

[395] Report of the New York Stock Exchange Corporate Accountability and Listing Standards Committee 6 (June 6, 2002), *at* http://www.myse.com/abouthome.html/query=/about/report.html [hereinafter NYSE Rules].

B. Corporate Governance Proposals to Reform the Board

1. The NYSE Exchange Rules

a. New Definition of Director Independence

The NYSE Rules require that independent directors must comprise a majority of the board.[396] This provision will not lead to much change because currently seventy-five percent of publicly-held companies have more than a majority of independent directors.[397] The NYSE Rules also formulate a tighter definition of independence for board members and require increased disclosure of this independence.[398] In determining whether a director is independent, the NYSE Rules require boards to review whether each director has "any material relationship with the company, either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company."[399] The NYSE Rules do not provide a general definition of a "material relationship," but make a per se conclusion in several instances that require a five year cooling-off period. This cooling-off period applies to directors who were employees of the company, or of its independent auditor, and for directors who are or were employees of any company whose compensation committee includes an executive officer of the enterprise making the independence inquiry, and for the immediate family members of these individuals.

The NYSE Rules eliminate some of the types of financial connections that can impair directors' independence. Yet, the NYSE Rules do not affirmatively prohibit some side payments to directors, such as charitable contributions and consulting contracts. As noted previously, CEOs can use these side payments to sanction dissenting directors in a manner that is beyond analysts' radar screens. The NYSE Rules provide that directors' fees must be the sole compensation that audit committee members receive,[400] but do not extend this broad prohibition to other directors. Thus, this standard is less stringent than those

[396] The prior NYSE Rules only required at least three independent directors and that the audit committee consist of at least three independent directors. For criticism of this proposal see, Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards* (Working Paper 2002), *available at* http://ssrn.com (one size does not fit all).

[397] NAT'L ASS'N OF CORP, DIRS., PUBLIC COMPANY CORPORATE GOVERNANCE SURVEY 2001-2002, http://www.nacdonline.org/publications/ (based on 5,000 proxies).

[398] NYSE Rules, *supra* note 395, at 6-7.

[399] *Id.* at 6.

[400] In addition, the NYSE Rules provide that the chair and voting methods of the audit committee cannot hold more than 20 percent of the company's stock. *See supra* note 377.

adopted by many institutional shareholders that try to ensure that independent directors' compensation is only from payment as a director. Importantly, as discussed previously, even if reforms removed these financial ties to management, directors may remain "psychologically dependent" upon managers.

b. Empowering Independent Directors: Outside Meetings and Lead Director

The NYSE Rules seek to empower outside directors by requiring them to meet at regularly scheduled meetings without management and to publicly designate a lead director to chair these sessions. The NYSE Rules recognize that these requirements allow greater and more frank discussion of management.[401] By compelling such regular meetings, the NYSE Rules seek to reduce the independent directors' "costs of confrontation," by "preventing any negative inference from . . . calling such executive sessions."[402]

Thus, the NYSE Rules attempt to create structures that allow independent directors to voice their opinions freely and frequently outside the presence of management. This provision does not, however, address the aversion of independent directors to confront management face-to-face by asking tough questions. Thus, independent directors may find it easy to criticize managers behind closed doors, but still melt when sitting in front of corporate executives.

The NYSE Rules' use of the lead director position differs from many shareholder proposals calling for lead directors in two ways. First, under the NYSE Rules the lead director is only responsible for conducting the outside meetings, but the NYSE Rules do not require the lead director to perform this role during full board meetings.[403] In addition, the lead director under the NYSE Rules is not accountable to the board for succession planning, a critical issue for good corporate governance practices. In this way, the NYSE Rules do not entirely avoid an important antecedent condition of groupthink, the lack of impartial leadership.

[401] NYSE Rules, *supra* note 395, at 8.

[402] *Id.*

[403] Most calls for lead directors make this director responsible for calling board meetings, setting the agenda, leading discussions, and calling in outside experts. *See, e.g.*, Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59, 70 (1992); Gayle Mattson, *The Effective Lead Director*, 23 THE CORP. BOARD 1 (July/Aug. 2002). Directors favor (seventy-two percent) having a lead director according to a recent survey by McKinsey & Co. FIN. TIMES, May 28, 2002.

c. Empowering Committees

The NYSE Rules require companies to have an audit committee, a nominating or corporate governance committee, and a compensation committee, each comprised solely of independent directors. This reform enhances board decision making by assigning evaluative roles to small groups. The NYSE Rules seek to reduce the boards' dependence upon managers for information by allowing these committees to control the hiring of outside consultants. By reducing independent directors' reliance on insiders for information, this requirement reduces the structural faults in decision making, an antecedent condition of groupthink.

The NYSE Rules require each listing firm's audit committee to review more information on the auditor's independence. In addition, the NYSE Rules expand the audit committee's review of financial information by mandating quarterly meetings with management, internal auditors, and independent auditors. The NYSE Rules also require listing firms to have a nominating or corporate governance committee that includes oversight of evaluation processes for senior managers. By requiring these types of reviews, the NYSE Rules reduce the independent directors' "costs of confrontation" that impair collegiality at the board level.

Importantly, the NYSE Rules require shareholder approval of equity-based compensation for managers to serve as a check over the CEO's influence over compensation committees. While this reform may help to curb executive compensation where institutional shareholders play an active role, this reform falls below that suggested by corporate governance leaders. Many commentators assert that corporations should treat stock options as expenses. Others go further to suggest the elimination of executive compensation in either stock or stock options because this leads managers to take a short-term view that ignores constituents other than shareholders.

d. Director Evaluation

The NYSE Rules require that these three committees have written charters and conduct annual self-assessments. By requiring periodic reviews, these provisions help to prevent "loss framing" by ensuring that change is part of the psychological mix of these committees. Literature on small group decision making, however, warns against such selfevaluations because it can undo the peerage of the group.[404] Specifically, this scholarship suggests that peer groups punish individual loafing by subtle pressure, rendering such formal evaluation unnecessary.[405]

2. Institutional Shareholders' Agenda Post-Enron

The NYSE Rules are fairly standard reforms that have been espoused by institutional shareholders for many years. Such reforms may help in changing boardroom dynamics somewhat, but the most important reforms, such as allowing shareholders to nominate directors,[406] have not received adequate attention. This is the most important reform needed to change the CEO-dominated board. This article asserts that the NYSE should allow shareholders to nominate board candidates on managers' proxy statements to allow true corporate democracy. For other reforms, the institutional shareholders need to continue to push corporations to internalize the evolving best practices in corporate governance. Such reforms should be left to institutional shareholders to implement a case-by-case basis because command-and-control legislation is inadequate given that "one size does not fit all."[407] However, in many cases when shareholders' resolutions pass, management frequently ignores them. Given that Delaware courts may hold that binding bylaw amendments are invalid,[408] the NYSE Rules should require that shareholder proposals that pass for three years become binding.

[404] Haft, *supra* note 48, at 20 (relying on Oliver Williamson's position that evaluation among individuals in groups creates a hierarchy rather than a peer group).

[405] *Id.*

[406] Using shareholder nomination committees or institutional investor associations to nominate board members would go much further in fostering fundamental changes in boardroom dynamics. *See, e.g.*, Ronald J. Gilson & Reineer Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991). As an alternative, when a shareholder proposal gets a majority vote and is still rejected by the directors, in the next proxy the shareholders should have the option to nominate one director candidate. At other times, shareholders who hold at least five percent of the stock should have the right to nominate a single director for inclusion in the company's proxy materials. Statement of Nell Minow, *supra* note 372; Damon Silvers, Associate General Counsel, AFL-CIO, Presentation to the New York Stock Exchange Special Committee on Corporate Accountability and Listing Standards, May 23, 2002, A6-7 (Shareholders with ten percent of the shares should have access to management's proxy statement to nominate candidates. Allow shareholders with five percent to have access to the proxy statement for shareholder proposals that the SEC currently deems to constitute ordinary business.).

[407] Bainbridge, *supra* note 396.

[408] *See, e.g.*, John C. Coates, IV & Bradley C. Faris, *Second-Generation Shareholder Bylaws: Post-Quickturn Alternatives*, 56 BUS. LAW. 1323 (2001).

a. Banning Related-Party Transactions for Senior Executives

Shareholder proposals should forbid related-party transactions for the senior officers of publicly-held corporations, or at least require shareholder approval for such transactions. This proposal would deny a manipulative manager the ability to place undue pressure upon the "fictive friendships" on the board that make it difficult to vote against these transactions.

b. Separating the Positions of CEO and Board Chair

The benefits of group deliberation exist only if the board consists of an equal-status peer group. Although the NYSE Rules require a lead director to chair outside meetings, this is a second-best solution. Separating the position of CEO from the Chairperson of the board would reduce the CEO's influence over the board, thereby creating impartial leadership, which would reduce the possibility of groupthink.[409]

In a recent study by McKinsey & Co. of 180 U.S. directors representing 500 companies, more than two-thirds favored separating the CEO position from that of Chairperson of the board. Such reforms may be difficult because CEOs resist giving up this power, although this practice is followed in the U.K.[410] Of course, even in cases where shareholders succeed in separating the CEO and board chairperson positions,[411] the CEO can still wield much power.

c. Term Limits

Currently, only five percent of large, publicly-held companies use terms limits for directorships.[412] On the one hand, an advantage of term limits is that they prevent the type of cohesiveness on boards that leads to groupthink. On the other hand, term limits poses two disadvantages.

[409] For commentary favoring this view, see, *e.g.*, JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 194-85 (1989); MONKS & MINOW, *supra note* 52, at 185-86. *But see* James A. Brickley et al., *Leadership Structure: Separating the CEO and Chairman of the Board*, 3 J. CORP. FIN. 189 (1997) (lose efficiency in separating CEO and Chairperson).

[410] Brickley et al., *supra* note 409, at 189.

[411] *See e.g.*, Jared Sandberg, *Questioning the Book—Congress Begins WorldCom—An Already Tarnished Board Also Faces Tough Questions Over Accounting Fiasco,* WALL ST. J., June 28, 2002, at A3 (CEO Ebbers gave chief executives of the companies he wanted to acquire the Chairperson position; but it was only "ceremonial.").

[412] The Conference Board reports that only five percent of companies have term limits. Carolyn Kay Brancato & D. Jeanne Patterson, *Board Diversity in U.S. Corporations*, CONFERENCE BOARD REPORT 12 (1999).

First, term limits prevent long-term relationships from developing; such relationships foster moral behavior because people care about how others perceive them. Second, term limits may not be efficient in some cases where directors need time to acquire human capital to perform their roles properly. For these reasons, institutional shareholders are best positioned to balance the benefits of substantial expertise on boards against the costs of groupthink on a firm-by-firm basis.

C. Suggested Reform Proposals to Prevent Groupthink

To aid independent directors in avoiding the various cognitive biases that permeate corporate boardrooms, this section considers two reform proposals from the literature on preventing groupthink. First, boards should assign a different director at each meeting to serve as a formal devil's advocate.[413] Second, boards should seek greater diversity of director candidates. Both reforms attempt to reduce conformity pressures on boardrooms and foster critical analysis of managers' policies.

1. Rotating the Position of Devil's Advocate

Janis, the originator of groupthink, suggested that one of the most important methods to prevent groupthink is to formalize the role of the devil's advocate and rotate this position among group members at each meeting.[414] Janis noted that this technique may stimulate more open discussion on controversial issues when the group consists of people with different status and power, such as that existing on corporate boards. Specifically, the devil's advocate role gives each member "an unambiguous assignment to present his arguments as cleverly and convincingly as he can, like a good lawyer, challenging the testimony of those advocating the majority position."[415] Thus, Janis suggested that the devil's advocate serve as a discussion leader for the group, who does not express his own views, but rather encourages questions and protects any emerging minority. In order to prevent too much confrontation stemming from this role, Janis emphasized that the devil's advocate should not be rude or strident in pressing for alternative points of view. Rather, Janis emphasized that the most effective performers would be "truly devilish" by raising questions in a conventional, low-key style,

[413] I want to thank Adam Winkler for encouraging me to emphasize this reform proposal.

[414] JANIS, VICTIMS, *supra* note 28, at 267.

[415] *Id.* at 215.

such as "haven't we perhaps overlooked . . .? shouldn't we give some thought to . . .?"[416]

Frank discussion can be confrontational and many people have a natural tendency to shy away from interpersonal conflict. Through formalizing the role of the devil's advocate, however, this proposal provides a defense mechanism for independent directors who are reluctant to challenge the "culture of politeness" in corporate boardroom in three ways. First, this proposal seeks to change director's self-perception; that is, a director who has this assignment does not perform well if she does not ask hard questions. Thus, this proposal allows independent directors to discuss topics that were formally considered taboo. Second, the devil's advocate role reduces the independent directors' fears about sounding self-righteous. Finally, when the devil's advocate does not understand an issue, she can seek clarification on behalf of the other directors. In this way, the devil's advocate does not suffer any humiliation for admitting that she does not "get it."[417]

Rotating the position among different directors at every meeting may prevent "domestication of the devil."[418] By requiring each director to assume this rule, it is less likely that managers can label a questioning director as a disloyal team member who should be shut out of the loop. In addition, publishing the rotation schedule for the devil's advocate would allow other directors to channel questions about upcoming sensitive issues to that person in advance.

Laboratory tests on the use of the devil's advocate highlight certain advantages and disadvantages from using this technique. On the positive side, these studies confirm that the devil's advocate role improves group performance.[419] Specifically, laboratory studies find that groups using a devil's advocate generate better assumptions and recommendations than groups employing unstructured debates. On the negative side, these studies reveal that the devil's advocate has three drawbacks. First, this technique increases the amount of time that groups take to make decisions.[420] Second, some studies confirm that the

[416] *Id.* at 268.

[417] I thank Claire Moore Dickerson for pointing out this important advantage of the devil's advocate role.

[418] JANIS, VICTIMS, *supra* note 28, at 268.

[419] *See, e.g.*, Dan N. Stone, et al., *Formalized Dissent and Cognitive Complexity in Group Processes and Performance*, 25 DECISION SCI. 243 (1994). The devil's advocate role is often compared to the use of dialectic inquiry, another method to formalize dissent. Under the dialectic inquiry method, proponents of a plan and a counterplan engage in a structured debate to highlight the reasonableness of the assumptions underlying each plan. *Id.* at 245.

[420] *Id.* at 245.

devil's advocate role can become a mere formality that does not produce authentic dissent.[421] Finally, laboratory explorations show that the devil's advocate may increase tension within the group, which may impair the ability of groups to work together in the future.[422] These studies indicate that the effectiveness of this reform may depend on how the first director fulfills her role because it may set the norm for other directors to follow. To avoid these drawbacks, director training programs should use role playing to demonstrate how to effectively use the devil's advocate role to avoid groupthink in the boardroom. In addition, these training programs should teach independent directors about other cognitive biases to raise awareness of red flags that may indicate poor performance by managers.

2. Diversity on the Board

One of the main lessons of the groupthink theory is that social homogeneity on corporate boards harms critical deliberation. Social scientists posit that the best way to avoid groupthink is to prevent enclaves of like-minded people from making group decisions. Thus, this scholarship suggests that reform proposals should discourage groupthink by promoting more diversity on boards in terms of gender, race, class, ethnicity, age, national origin, sexual orientation, and socio-economic background, as well as expertise and temperament.[423] Specifically, studies on social psychology indicate that diversity may promote more independent thinking on boards because diversity directors may hold "outsider values." That is, diversity may enhance board effectiveness because different life experiences may lead to different perceptions of social reality.[424] Although directors who add various types of diversity can achieve the goal of preventing groupthink, this Part concentrates on including more women on corporate boards, but also discusses the need

[421] Charlan Nemeth, et al., *Devils' Advocate Versus Authentic Dissent: Stimulating Quantity and Quality*, 31 EUR. J. SOC. PSYCHOL. 707 (2001).

[422] David M. Schweiger et al., *Experiential Effects of Dialectical Inquiry, Devil's Advocacy, and Consensus Approaches to Strategic Decision Making*, 32 ACAD. MGMT. J. 745 (1989).

[423] With respect to the Enron Board, thirteen of the fourteen members were men; three of the men appear to be minorities (Hispanic, African American, and Asian). The one Asian woman on the board shared the same socio-economic background. *Supra* note 19.

As management scholars explore the role of emotions in corporate life, they are beginning to study issues concerning different temperament. *See, e.g.*, Sigal Barsade et al., *To Your Heart's Content: A Model of Affective Diversity in Top Management Teams*, 45 ADM. SCI. Q. 802 (2000).

[424] *See, e.g.*, Patricia Hill Collins, *Learning From the Outsider Within: The Sociological Significance of Black Feminist Thought*, 33 SOC. PROBS. (Dec. 1986).

for more minority candidates when the research on women board members applies.

In the past, shareholder activists viewed promoting diversity on boards as a corporate social responsibility issue. Increasingly, Enron and September 11th have facilitated the process of convergence, whereby corporate social responsibility issues "cross over" to become corporate governance practices.[425] Diversity has been the leading crossover issue, supported by CalPERS,[426] TIAA-CREF,[427] and the Council of Institutional Investors, Lens, and the NACD.[428] Shareholder proposals calling on companies to increase racial and gender diversity on their boards have received the highest levels of approval among the social policy resolutions—nearly nineteen percent.[429] Given the demand for more "independent thinkers" on boards and the decline in the pool of traditional candidates as they become more reluctant to accept board positions,[430] nominating committees may look to a more diverse group of candidates to serve as directors.

Indeed, the recent scandals may provide an opportunity for women because some firms seek to restore investor confidence by appointing more women to the board for two reasons. First, sensing they are not one of the "good ole boys," women may perceive wrongdoing more easily and may be more willing to speak out when necessary.[431] Second, a common perception is that women generally have a moral authority that they may bring to the board service to encourage more ethical conduct. Studies in social psychology offer some support for the view that adding more women to the board may offset some behavioral biases in existing boards that are predominately male. Overall, women are less affected than men by the over-optimism bias that leads to excessive risk-

[425] Carolyn Brancato suggests that institutional shareholders are intervening a new stage of activism to consider issues previously thought of as promoting corporate social responsibility. CAROLYN KAY BRANCATO, INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE 87 (1997). For example, CalPERS recently pulled its investments from several Asian countries based on poor labor practices based on labor standards. *Post-Enron Observations on Corporate Governance*, CORP GOV NEWS, May 2002.

[426] CALPERS, DOMESTIC PROXY VOTING GUIDELINES (1999), http://www.calpers-governance.org/principles/domestic/voting/page01.asp.

[427] TIAA-CREF, POLICY STATEMENT ON CORPORATE GOVERNANCE.

[428] NAT'L ASS'N OF CORP. DIRS., CORPORATE GOVERNANCE SURVEY, http://www.thecorporatelibrary.com/docs/tiaa-cref%20policy%20stmnt%20on%20corp%20gov.html(last visited June 11, 2003).

[429] Meg Voorhes, *Social Proposals Get New Levels of Support*, CORP. SOC. ISSUES RPTR., May 2002, at 1-3 (diversity proposal at EMC received thirty-two percent shareholder vote).

[430] *See, e.g.*, Susan Stellin *Executive Life*; *Directors Ponder New Tougher Roles*, N.Y. TIMES, June 30, 2002 at 3-16; *see also*, *The Fading Appeal of the Boardroom*, ECONOMIST, Feb. 10, 2002.

[431] *See, e.g.*, Kelly Pate, *Corporate Woes Spell Opportunity for Women*, DEN. POST, Aug. 2, 2002, at C-01; Mary Williams Walsh, *Preparing A Corps For Women For Corporate Social Responsibility*, N.Y. TIMES, Aug. 13, 2002, at C-1.

taking.[432] In addition, studies indicate that business women may have a higher degree of moral development than male executives.[433] Thus, Post-Enron, the traditional "old boys' network" may give way to searching beyond the power elite to include others with different views.

a. Promoting Directors With "Outsider Values" on Corporate Boards

A recent Conference Board report maintains that diversity on boards enhances shareholder value because the additional experience and knowledge bases brought about such diversity contributes to profit generation.[434] Although statistical data does not exist for showing that the presence of diversity on boards increases firm performance, the Conference Board found it noteworthy that the top Fortune ten companies in terms of profitability all have a woman on their boards, and eight out of these ten have more than one woman on their boards.[435] In the past, three economic considerations pushed senior managers to widen their horizons about the types of people who provide the "right fit" on corporate boards. First, some corporations consider the notion of "market reciprocity"; if women make up half the consumer base of a corporation, then that corporation's board should have proportional representation.[436] Second, corporate boards recognize that cultural diversity is important in the global economy to attract business from other parts of the globe. Finally, some firms place women and minorities on their boards for a less virtuous reason, as a method to mitigate against discrimination litigation.[437]

Competing empirical results, as well as corresponding theoretical arguments, exist with regard to the influence of diversity on group performance. Some research indicates some negative aspects from introducing diversity into group decision making. These studies show that heterogeneity creates distance between group members, which makes interpersonal relations based on trust less likely. Offering a more hopeful view, some studies have found that initially homogeneous groups had higher quality processes than heterogeneous groups, but over time heterogeneous groups adapt to acquire processes at or above

[432] In other words, the commonly held view by women that men have "big egos" has empirical support from social psychology studies. *See supra* notes 108-10 and accompanying text.

[433] Prentice, *supra* note 13, at 194 n.351 (female accountants score higher).

[434] CAROLYN KAY BRANCATO & D. JEANNE PATTERSON, BOARD DIVERSITY IN U.S. CORPORATIONS: BEST PRACTICES FOR BROADENING THE PROFILE OF CORPORATE BOARDS 12 (1999).

[435] *Id.* at 8.

[436] *Id.*

[437] *Id.* at 9.

the level of homogeneous groups.[438] Going through this adjustment process may be worthwhile because some research shows that heterogeneity enhances the breadth of perspective, cognitive resources, and general problem-solving ability of group decision making. No clear consensus exists on how heterogeneity influences group performance, and thus more research is needed to explore this important issue. Specifically, this topic has many implications for corporate governance beyond the boardroom. Firms have shifted their organizational structures away from individual responsibility toward focusing on teams of employees. For this reason, much more research is needed in light of globalization and changing demographics of the workforce.[439]

Empirical studies evaluating the gender composition of small groups found that mixed-gender groups have a higher tendency to avoid groupthink, whereas groups composed of one gender have a higher probability of succumbing to this phenomenon.[440] Evaluation of mixed-gender groups posits that such groups also have different interaction styles than groups composed of a single gender. Specifically, groups made up of all men or all women have extreme positions on several stereotypic, gender-related variables. These findings show that women in small groups perform socio-emotional roles and men behave consistently with task-oriented roles.[441]

In the 1970s, Rosabeth Moss Kanter surmised that gender influences are proportional to the gender composition of the group.[442] Subsequent studies of small groups support this proposition. Specifically, gender and race do not affect group decision making unless the percentage of women and minorities in the group rises above the critical level of twenty percent. Thus, having one woman or minority candidate on an average board consisting of eleven people may not produce the efficiency benefits of diversity. One sole woman director sums up these findings by describing her boardroom experience: "[I]t's like going into a [men's] locker room where everybody all of a sudden shuts up."[443]

Studies of the "small world of the corporate elite"[444] in corporate America are pessimistic about the progress made so far in promoting

[438] John Oetzel, *Explaining Individual Communication Process in Homogeneous and Heterogeneous Groups Through Individualism*, 25 HUMAN COMM. RES. 202 (1998).

[439] Symposium, *Issue on Group Diversity*, EUROPEAN J. WORK AND ORG. PSYCHOL. (1997).

[440] Marceline B.R. Kroon et al., *Group Versus Individual Decision Making: Effects of Accountability and Gender on Groupthink*, 23 SMALL GROUP RESEARCH 427 (1992).

[441] *Id.* at 30.

[442] ROSABETH MOSS KANTER, MEN AND WOMEN OF THE CORPORATION 102 (1977).

[443] 2001 CATALYST CENSUS OF WOMEN BOARD DIRECTORS 22 [hereinafter CATALYST REPORT].

[444] Min Yoo et al., *The Small World of the Corporate Elite*, 27 DIRECTORSHIP 4 (Nov. 2001) (4.6 degrees of separation between directors for Fortune 1000 corporations; 3.7 degrees between each board).

outsider values on corporate boards.[445] This cynicism stems from the fact that directors who represent diversity on corporate boards share the same values as the old, homogeneous group.[446] Perhaps, directors representing diversity learn to assure incumbent boards that they will "fit in" and not cause trouble. In this way, some corporate scholars warn that the power elite creates an illusion of diversity by selecting women and minorities who share the same ideologies of the existing CEOs.[447] Arguably, increasing the number of women and minorities above the twenty percent level may change these social dynamics to allow diversity directors to feel comfortable in sharing outsider values.

Although homogeneity on the board can lead to too much cohesiveness, some level of collegiality is desirable because it promotes a well-functioning board. In the past, corporate governance scholars have argued against having constituency directors or cumulative voting because it increases confrontation in boardrooms.[448] In addition, corporate governance scholars have cautioned that too many independent directors on a board may weaken the trust needed among the CEO and board members, which is conducive to giving the CEO advice about strategic planning.[449] Viewed in this light, a possible argument against diversity is that heterogeneity on boards may lead to too much confrontation in the boardroom. However, in light of Enron, corporate boards should worry less about a new director's ability to "fit in" and more about whether the candidate will think independently, speak out on difficult subjects, and provide diverse perspectives for tactical and strategic decisions. Social psychology literature on preventing groupthink also offers a rebuttal to the American perspective that views the German board structure, which provides employees with membership, as inefficient due to heterogeneity.[450] Given the potential drawback of heterogeneity, however, this article maintains that director training programs should focus on diversity training[451] to overcome the potential biases directors may have in working with people who are

[445] *Id.* at 192.

[446] *Id.* at 6.

[447] RICHARED L. ZWEIGENHAFT & G. WILLIAM DOMHOFF, DIVERSITY IN THE POWER ELITE: HAVE WOMEN AND MINORITIES REACHED THE TOP? 192 (1998).

[448] Haft, *supra* note 48, at 23-24.

[449] Langevoort, *Human Nature*, *supra* note 48, at 813 (citing James D. Westphal, *Collaboration in the Boardroom: Behavioral and Performance Consequences of CEO-Board Social Ties*, 42 ACAD. MGMT. J. 7 (1999)).

[450] HENRY HASSMANN, WORKER OWNERSHIP (1999). For comparative research using the groupthink concept see Theo Postma & HanVanEes, On the Functions of Supervisory Boards in the Netherlands (Working Paper 2002) (Cooperation leads to higher potential for groupthink).

[451] Langevoort, *Human Nature*, *supra* note 48, at 800.

"different." The next section focuses on the glass ceiling problem preventing women from obtaining more board seats.

b. Promoting More Women on Corporate Boards

The 2001 Catalyst Census of Women Board Directors reports that in the United States the percentage of women on boards is 12.4 percent, up from 11.7 percent in 2000 and 11.2 percent in 1999.[452] Eighty-seven percent of Fortune 500 companies have at least one woman on their boards, up from eighty-six percent in 2000 and eighty-four percent in 1999. Thirty-five percent have one or more African-American directors (male or female) and eleven percent have one or more Hispanic board members (male or female).[453] Women of color hold 2.6 percent of the board seats of Fortune 500 companies.[454] This report found that women directors are not as likely as men to serve on the important committees of boards such as auditing, nominating, and compensation committees.[455] Women directors, however, are more likely to serve on corporate social responsibility committees.[456] While the percentage of women on boards has increased recently, progress is slow. At the current rate, the percentage of women in top leadership positions will not exceed the critical level of 25 percent until 2020.

Why do we have so few women on corporate boards? CEOs generally state that they have a hard time identifying female candidates.[457] In response, the Conference Board suggests that nominating committees need to look beyond the CEOs of Fortune 1000 companies because currently there are only eleven female CEOs of these firms. Using a broader perspective, many qualified women are "in the pipeline" to be selected for board service.

i. Women Managers

Women now make up fifty percent of managerial and specialized professional positions in organizations in the United States. Studies of top executives reveal that women scored higher than men in many

[452] CATALYST REPORT, supra note 443, at 1.

[453] BRANCATO & PATTERSON, *supra* note 434, at 14.

[454] CATALYST REPORT, supra note 443, at 1.

[455] Diana Bilimorai & Sandy Dristin Piderity, *Board Committee Membership: Effects of Sex-Based Bias*, 37 ACAD. MGMT. 1453 (1994).

[456] BRANCATO & PATTERSON, *supra* note 434, at 30.

[457] Diana Bilimoria, *Women Directors: The Quiet Discrimination*, 16 THE CORP. BOARD 10 (July 17, 1995).

indices of leadership, including those related to the bottom line.[458] Women excelled in interpersonal skills commonly associated with feminine styles of management that are increasingly recognized as important in today's organizations, which stress customer service. Specifically, women managers performed better than men on giving feedback, rewarding and motivating individuals and teams, and acting with integrity. Women also scored higher than men on maintaining productivity, producing quality work, meeting project deadlines, generating new ideas, and moving projects forward.[459] Despite these findings, surveys show that senior managers (eighty-one percent men) viewed actions such as focusing on results and taking charge as positive indications for men, but as negative factors for women. This gender difference stems from societal and organizational norms about leadership. Specifically, corporate rhetoric espouses that leaders should focus on team-building, but the notion of the senior manager as an emotionally restrained, command-and-control type still prevails.

In analyzing gender differences in organizations, Catalyst reports that these differences arise because corporate environments were designed by and for men and presumably geared toward their behavior and responsive to their needs.[460] In a Catalyst survey of Fortune 1000 CEOs, eighty-two percent of the male CEOs responding to survey points to the lack of experience as holding women back and sixty-four percent of these male CEOs believe that women have not been in the pipeline long enough to hold board positions.[461] Many executives, however, tend to disagree with this "pipeline" argument; these executives suggest that male stereotyping (fifty-two percent women and twenty-five percent men) and exclusion from informal networks (forty-nine percent women and fifteen percent men) are the reasons why women have not broken through the glass ceiling.[462] Interestingly, while senior executives perceived the need for organizations to change to include women (seventy-six percent women and eighty percent men), more women than men think they also need to share responsibility in

[458] Deborah M. Merrill-Sands & Deborah M. Kolb, *Women as Leaders: The Paradox of Success*, 9 CGO INSIGHTS, Apr. 2001, http://www.simmons.edu/gsm/cgo/insights_9.pdf.

[459] *Id.*

[460] DEBRA MEYERSON & JOYCE FLETCHER, DISAPPEARING ACTS 129 (1999).

[461] CATALYST, WOMEN IN CORPORATE LEADERSHIP: PROGRESS AND PROSPECTS 36 (1996). This is the first large-scale research study of women who have made it to senior management in the largest companies. This study reports that seventy-two percent of these women are married; sixty-four percent have children; eighty-seven percent are part of career couples; married women contribute an average of sixty-eight percent of their household income; and three-quarters provide over half of the total household income, making them the primary "breadwinners" of the family.

[462] *Id.* at 39.

adapting to corporate cultures (seventy-three percent women and sixty-one percent men).[463]

To understand these gender norms in more detail, the next section discusses literature on second-generation discrimination in the workplace. Although a detailed examination of this topic is beyond the scope of this article, this section outlines how tournament structures may operate to exclude women.

ii. Second Generation Discrimination: Tournaments and Gladiator Corporate Cultures

Scholars studying gender and race discrimination state that organizations have eradicated most blatant types of discrimination, but subtle forms still prevail.[464] This type of gender discrimination stems from norms that appear gender-neutral on their face, but operate to hurt women.[465]

In another article,[466] this author considers how tournaments structures lead to "gladiator" corporate cultures that tend to exclude women. Specifically, tournaments foster winner-take-all combat, reflecting a distinctly male view of the world. As a result of global competitive pressures, tournaments have led to longer working hours in the United States. American employees now work more hours than employees in any other advanced industrialized country, including Japan.[467] Thus, under the pressures of the tournament, successful workers give up on a balanced life and resort to total obsession with the rewards from work. Joan William, a leading work and family scholar, documents that eighty-five percent of woman are mothers, but ninety-three percent of mothers work less than fifty hours a week during their key career building years.[468] In addition, mothers who seek alternative work arrangements are frequently branded as "unprofessional" for lacking sufficient commitment to their firms. Thus, tournaments and gladiator corporate

[463] *Id.*

[464] Susan Sturm, *Second Generation Employment Discrimination*, 101 COLUM. L. REV. 458 (2001).

[465] In one example, an organization concerned about high turnover of women and difficulty in recruiting women found that some of the problems arose because the corporate culture had a norm of allowing people to call meetings on an informal basis at any time. This norm operated to the detriment of women, but men also found the norm disruptive. Identifying this issue and changing the norm benefited all employees in the organization and thus improved organizational effectiveness. *Id.* at 472.

[466] Marleen A. O'Connor, *Sustainable Corporate Governance and Flexible Labor Markets: Recognizing the Family as A Corporate Stakeholder* (forthcoming) (copy on file with University of Cincinnati Law Review).

[467] Joan Williams, *The Family-Hostile Corporation*, GEO. WASH. L. REV. (forthcoming).

[468] *Id.*

cultures naturally tend to exclude employees, especially mothers, concerned with the well-being of their children.

Moving beyond the ideology of the corporate gladiator stemming from the tournament structure will not be easy for two reasons. First, scholars studying tournament structures report that a firm may use gender and race as factors in their decision making about employee promotion without hurting the bottom line.[469] When firms invest scarce training and mentoring resources in average men as opposed to average women, they can do so without impeding the firm's ability to produce the small number of high quality senior executives that it needs to succeed in the future. Thus, these scholars suggest that firms may engage in second-generation discrimination against women and minorities, but may not lose out to other firms that have similar practices in the competitive marketplace.

Second, many workers, especially men, may not work these long hours just for the money. Joan Williams surmises that the incentive to stay in the tournament stems from ego, that is, the need to feel one is a "major player."[470] This points to the need not only to change tournament structures, but also the norms that drive employees to engage in these survival-of-the-fittest competitions to the detriment of all else life has to offer.

Scholars seeking to prevent this subtle form of gender discrimination emphasize that command-and-control legislation will not work because each organization develops its own corporate culture with distinct norms. Instead, scholars, such as Susan Sturm, recommend that firms hire intermediaries such as Catalyst to investigate the norms prevalent within their corporate cultures that operate to the disadvantage of women and minorities. Such organizations have the expertise to question employees to find out about these workplace norms and to suggest changes aimed at eliminating subtle discriminatory forces.[471] As a reform proposal, this article suggests that institutional shareholders encourage corporations to consider using such intermediaries as part of their overall efforts to promote diversity on their boards. In this regard, Catalyst offers a hopeful note by reporting that it cannot determine which comes first, but corporations with many women executives and board members tend to have progressive work and family programs.[472]

[469] *See, e.g.*, Wilkins & Gulati, *supra* note 102, at 1584.

[470] Williams, *supra* note 467; *see also*, Marc Galanter & Thomas Palay, *Large Law Firm Misery, It's the Tournament, Not the Money*, 52 VAND. L. REV. 953 (1999).

[471] Sturm, *supra* note 464, at 464.

[472] BRANCATO & PATTERSON, *supra* note 434, at 8.

In sum, this Part suggests two methods to prevent groupthink in boardrooms: formalizing the role of the devil's advocate and increasing diversity on boards. The next Part considers how corporate law teachers need to adjust their teaching post-Enron to incorporate perspectives from business ethics and social psychology.

V. CONCLUSION: CORPORATE SCANDALS AND THE ROLE OF CORPORATE LAW PROFESSORS[473]

> Our schools of business must be principled teachers of right and wrong, and not surrender to moral confusion and relativism.
> —President George W. Bush[474]

Heeding President Bush's call, business school professors have engaged in a debate about the need to emphasize business ethics in their courses to prevent future corporate scandals.[475] As a result, accounting education is undergoing major revisions and other business school professors are rethinking their approaches.[476] While many business professors favor introducing more ethical content in their teaching, others state that they have no personal responsibility to teach morality. Some business school professors go so far as to rationalize that the problem is really a legal one. Thus, they seek to shift the blame to law school professors. This article asserts that law school professors share this responsibility with business school professors. The corporate law academy, however, shows little sign of serious discussion about such issues post-Enron. Such a debate is crucial, however, for corporate lawyers to fulfill their obligations to report wrongdoing to the board under the recently enacted Sarbanes-Oxley Act.[477] Thus, this article calls on fellow corporate law professors to rethink how we teach business courses, especially the basic course in business associations.

Specifically, we need to ask whether the theories we advocate are justifiable in light of the proliferation of corporate scandals. Do we teach fiduciary law as a mere contractual term void of moral content? Do we promote cynical theories of motivation for corporate actors that treat economic rewards as the only goal? Have we fostered a self-

[473] I also call this part "My Jerry Maguire mission statement." I was inspired to write this conclusion after watching the movie.

[474] Remarks by the President on Corporate Responsibility, www.whitehouse.gov/news/releases.

[475] *See* Michael Lissack's website "Business Schools and Ethics" for comments, at http://isce/edu/wwwboard/wwwboard.html (last visited Aug. 12, 2003).

[476] *See, e.g.*, Laurie Winslow, *Accountants, Students Discuss Accounting Fraud at Tulsa, Okla., Conference*, KRTBN: TULSA WORLD., Oct. 5, 2002.

[477] *See supra* note 43.

destructive era of selfishness and greed, where business lawyers see ethics as an unwanted invasion into corporate life? Do we preach unfettered capitalism and sinister views of government regulation? Do we emphasize techniques of financial manipulation to promote short-term stock prices at the expense of making long-term investments for real productivity gains? By failing to criticize the status quo within corporate governance scholarship and at our own law schools, do we inadvertently provide role models for our students to act like good corporate "yes men?" That is, does our professional behavior signal that it is safer to "bow to authority," rather than jeopardize one's career through "rocking the boat by making waves?"

Corporate law professors need to focus more on teaching business ethics because this aspect of corporate law has not been emphasized in the last decade. Instead, law and economics has dominated corporate law discourse with the myth that human beings are only motivated by self-interest.[478] The dissonance between the language of law and economics and the reality of human nature has had a distorting impact on both lawyering and the legal process. In contrast, for the past fifteen years, Progressive Corporate Law (PCL) scholars have opposed the hegemony of the neoclassical law and economics movement by emphasizing that corporate actors should focus on serving the public interest rather than just shareholder value. Specifically, PCL scholars advocated the need to view corporate executives as moral beings, rather than just rational, economic actors who narrowly focus on short-term stock prices.[479] Mainstream scholars rejected and marginalized the ideas of the PCL movement to the point that some espoused "the end of corporate law."[480] As proof of their victory, these scholars emphasize that the U.S. model of corporate governance is sweeping the globe.

[478] Donald C. Langevoort, *Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review*, 51 VAND. L. REV. 1499, 1526 (1998) ("central rhetorical construct of rational man evokes an image of an institutionally controlled world; or the image of the rational actor as the ideal type reflects the ego-centric self-image of lawyers?").

[479] *See generally*, PROGRESSIVE CORPORATE LAW (Lawrence E. Mitchell ed., 1993).

[480] *See, e.g.*, Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 441 (2001); *see also* ROBERT HAMILTON, THE LAW OF CORPORATIONS IN A NUTSHELL 72 (5th ed. 2000) (As this is written at the end of the Twentieth Century, it seems that the social responsibility debate has ended. Laissez faire and the goal of profit maximization appear to have carried the day); Stephen M. Bainbridge, *Book Review: Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORN. L. REV. 856 (1997). For criticism of this view, see Margaret Blair, *Post-Enron Reflections on Comparative Corporate Governance*, J. OF INTERDISC. ECON. (forthcoming 2002) (Enron causes loss of confidence U.S. corporate governance leads to long-term economic development); Kent Greenfield, *September 11 and the End of History For Corporate Law*, 76 TUL. L. REV. 1409 (2002); William W. Bratton, *Never Trust a Corporation*, 70 GEO. WASH. L. REV. 876, 876 (2002) ("[T]he norm of shareholder value maximization was carried forth to the world as America's greatest gift to global economy since mass production itself.").

Unfortunately, the "dark side of shareholder value"[481] is beginning to appear as well, as we witness corporate scandals similar to Enron proliferating around the world.[482]

It is easy to dismiss these observations as appearing naive in light of the widespread cynicism about corporate ethics. After all, Enron itself had a detailed ethics code. And many remain skeptical after President Bush's call for "a new era of integrity in corporate America"[483] because his past business practices raise questions of unethical dealings.[484] Social psychology, however, warns that relentless cynicism about corporate governance may turn to a self-fulfilling prophecy. The recent corporate scandals will lead many academics and practitioners to jump on the "corporate morality" band wagon, but this author maintains that we need to keep a steady focus on this crucial issue, rather than let it drop when stock prices rise.

Unfortunately, a cynical model of the corporate actor has dominated the thinking about the nature of the fiduciary duties owed by corporate actors over the last twenty years. Recent scholarship on fiduciary law stresses enforcement through threats from shareholder suits or reputational sanctions. This presents a rather sterile view of fiduciary duty because it supports the idea that "honesty is the best policy" as an appeal to self-interest. Instead, we need to emphasize the value of fidelity for its own sake. To stress only obtaining economic rewards and avoiding negative sanctions from being "a good fiduciary" denies us the sense of intrinsic satisfaction we can receive from honorable behavior. Displacing rational self-interest, some legal scholars assert that the prime motivation for human action is the quest for meaning to fulfill moral obligations.[485] Thus, we need to focus more on positive emotions as motivations for behavior in corporate life. Specifically, corporate law scholars need to celebrate the joy, excitement, and flow of everyday worklife in communicating the basic doctrines of corporate governance to their students.

The current reforms of boardroom processes stress empowering independent directors to act on their ethical impulses. We should be

[481] Bratton, *supra* note 2.

[482] *See, e.g.*, Claire Dickerson, *The Ozymandius Effect Applied to Executive Behavior: Are We Shocked-Shocked!* (Working Paper for the 3rd Annual Workshop on Corporations and Capitalism, Osgoode Law School, Sept. 2002); Jean Eaglesham & Nikki Tait, *UK-Style Enron 'Is Possible'*, FIN. TIMES, May 27, 2002.

[483] *See* Remarks by the President, *supra* note 474. Bush's ten point plan to increase corporate accountability includes a doubling of prison sentences for financial fraud, increased funding for the SEC, etc.

[484] *See, e.g.*, Paul Krugman, *Steps to Wealth*, N.Y. TIMES, July 1, 2002, at A-17 (hard to talk about "character" as "questions about Harken Energy pile up").

[485] Edward L. Rubin, *Public Choice, Phenomenology, and the Meaning of the Modern State: Keep the Bathwater, But Throw Out the Baby*, 87 CORN. L. REV. 309 (2002).

careful about placing too much emphasis upon the procedural aspects of corporate governance, however, because it may send a counterproductive message that focuses on decorum, rather than actual propriety itself. In order for these reforms to succeed, much still depends on whether an individual director's conscience dictates appropriate behavior.

Although behavioral law and economics has done much to expand our thinking about the complexity of human actors, we still have much work to do concerning how we can teach fiduciary law in a manner that promotes ethical conduct in corporate life. We know that rules and process controls cannot cover every situation that arises for corporate fiduciaries. In seeking to fill in the gaps and make sense of a situation, a fiduciary will feel stress and anxiety. To avoid these negative feelings, executives will search for rationalizations to continue to think of themselves as just and honorable people. Corporate cultural norms can provide these rationalizations so that executives can engage in questionable conduct without feeling guilt. Thus, developing corporate reforms for board decision making involves not only articulating goals and procedures, but also confronting the various cognitive biases that influence individuals and groups, which jeopardize their effectiveness.

How can we overcome the cynicism about reform procedures that leads to such rationalizations? We should focus not only on structural issues, but also on individual integrity, because it takes character to have the courage to tell the emperor he has no clothes. A fiduciary must resolve many issues through the exercise of sensitive internal dialogue. The director may ask, "Am I the type of person who seeks to benefit from the inherent uncertainty involved in reviewing the transaction?" Or, "Am I the type of fiduciary who resists temptation and chooses the common good?" A director struggling with her conscience turns to fiduciary norms for guidance about what is "right." At this point, fiduciary norms affect directors' value choices by removing a source of rationalization for questionable conduct.

For these reasons, corporate law professors need to revive the moral tradition of fiduciary law that has been lost to the narrow, value-free economic analysis of fiduciary duty.[486] These rhetorical differences play an important role in constituting our moral and social worlds. Specifically, the way we talk about fiduciary obligation is crucial because the most distinguishing characteristic of fiduciary law is its operation as a system of moral education that promotes and reinforces trust and

[486] Marleen A. O'Connor, *How Should We Talk About Fiduciary Duty? Directors' Conflict-of-Interest Transactions*, 61 GEO. WASH. L. REV. 954 (1993).

honesty in commercial transactions. The sermon-like style of fiduciary rhetoric captivates our moral consciousness and contributes to an understanding of fiduciary obligation in ways that reason alone cannot. In its true essence, fiduciary duty seeks to embody a complex value system that penetrates everyday life by appealing to our ears and hearts. This moral appeal offers an experience, an invitation for reflection. In this way, fiduciary rhetoric seeks to intrude into the psyches of fiduciaries to create feelings of guilt for violation of duty and feelings of honor for upholding the tradition. This language encourages readers to internalize the message, to change their ways of thinking and being. In this way, fiduciary discourse has a complex psychological appeal that speaks to our better side to desire noble aspirations, while simultaneously reprimanding our other side by instilling fear of fiduciary breach.

How can we, as corporate governance teachers, ensure that future corporate executives and business lawyers receive ethical training? Currently, corporate law casebooks do not offer much in terms of teaching about ethics and corporate social responsibility.[487] Reciting Justice Cardozo's "punctilio of an honor the most sensitive" and discussing grand theories of business ethics leads some students to give you cynical stares, while others go to sleep. How do we convey ethical lessons about corporate morality to young, ambitious students in a way that captures their minds and hearts and in a manner that they can use in practicing corporate law?

Rather than just using aspirational language to inspire good business lawyers, Langevoort emphasizes that we need to equip students with lessons from social psychology.[488] We need to emphasize that, although deliberate wrongdoing exists, in many cases cognitive biases operating within corporate cultures may lead individuals to have good faith misperceptions of problems. Social psychology suggests that to the extent that corporate cultures place individuals in certain situations, good people will make bad decisions, but they can do so without guilt through rationalizations.

Offering guidance on how to communicate the literature in social psychology to students, Langevoort suggests examining the role of myths or storytelling in educating business lawyers.[489] Langevoort emphasizes

[487] For criticism of these current modes of teaching corporate law, see Lynn P. Q. Johnson, *The Social Responsibility of Law Professors*, 76 TUL. L. REV. 1483 (2002); Theresa Maynard, *Law Matters, Lawyers Matter*, 76 TUL. L. REV 1501 (2002); Kent Greenfeld, *There's A Forest in Those Trees: Teaching About the Role of Corporations in Society*, 34 GA. L. REV. 1011 (2000); Kellye Y. Testy, *Adding Value(s) To Corporate Law: An Agenda for Reform*, 34 GA. L. REV. 1025, 1042 (2000) (questioning whether outside directors really provide "outsider" perspectives).

[488] Langevoort, *Epistemology*, *supra* note 94, at 630.

[489] Langevoort, *Myths*, *supra* note 25, at 1568.

that it is necessary to provide a "good story to overcome the more dysfunctional forms of myth and rationalization that put such a hard protective coating over the pursuit of self-interest."[490] Specifically, teaching fiduciary duty caselaw as morality stories has the capacity to influence students' affective responses.[491] This is important because fiduciary duty must be heartfelt. In this way, students can see the issues in more depth, emotionally as well as intellectually. Thus, corporate law professors need to explore the use of metaphors, stories, myths, language, and rituals to communicate the guiding values of business ethics.

This case study of the Enron directors' role in the scandal aims to serve as a story that allows students to see how honest, smart individuals can succumb to cognitive biases prevailing in corporate cultures. More importantly, perhaps students and lawyers will use this case study as a parable to tell themselves and their clients to avoid these behavioral defects in the first place.

[490] *Id.* at 1369.

[491] Edward Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1047 (1997).