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Markets, Morality, and Corporate Governance: A Look Behind the Scandals

High-profile bankruptcies, financial scandals, and accusations of tax-dodging have given Corporate America a black eye. Some of this damage is self-inflicted since some executives – presumably a small minority – are willing to cut corners and engage in unethical behavior. But government policy also has a big impact on corporate governance. Many of the problems afflicting corporate America are the result – at least in part – of misguided government policies. This paper reviews how bankruptcy law, tax law, contracting law, and takeover law can influence corporate behavior. The paper also explains why companies should not use government power as a competitive weapon. Businesses can – and should – engage in spirited rivalry. But the battle should be fought in the private arena, with companies seeking to win the hearts and minds (and dollars) of consumers.

By Daniel J. Mitchell

Introduction

Corporate America has a black eye. Indeed, it has several black eyes. High-profile bankruptcies, financial scandals, and accusations of tax-dodging have been plastered in the headlines. Major companies, including Enron, WorldCom, Arthur Andersen, K-Mart and Stanley Works, have attracted so much adverse publicity that the American people are left with the impression that big corporations are either incompetent operations or criminal enterprises.

Much of the bad news is self-inflicted, for the simple reason that corporate executives suffer from the same foibles as people from other walks of life. The vast majority of managers surely are capable and honest, but events have demonstrated that some – presumably a small minority – are willing to cut corners and engage in unethical behavior. And it is these “bad apples” that are generating headlines and creating negative stereotypes.

But corporate governance issues involve more than just ethics. Some managers do not have the skills and abilities needed to keep their companies competitive. This does not mean they are bad people – or even that they are incompetent. Instead, it is an indication that being second best sometimes is not good enough in the global economy. Too many bad decisions – or even a small handful of really big mistakes – can lead a company to bankruptcy. Sometimes, bad luck plays a role. Even a “superstar” executive presumably would have had a hard time running a profitable typewriter company when the personal computer hit the market.

Government policy also has a big impact on corporate governance. Some Washington policy makers, motivated by either ideology or expediency, have adopted an anti-corporate mindset. There is nothing wrong with casting a jaundiced eye on corporate misdeeds, but lawmakers should be careful not to cast stones in glass houses. Many of the problems afflicting corporate America are the result – at least in part – of misguided government policies.

The tax code, for instance, encourages companies to take on too much debt and to place too much reliance on inherently imprecise forecasts of future earnings. So who should be blamed when companies run into trouble because managers incur too much debt and improperly estimate earnings? Restrictive takeover laws protect incompetent managers from stockholders. So who should get blamed when entrenched managers misallocate company funds? And is it fair to blame corporate executives when companies under-perform thanks to government regulatory policy?

These questions are critically important because legislators have many possible responses to corporate scandals, and not all of them are helpful. Some actions, such as the imposition of heavy penalties on individuals who broke laws and engaged in fraudulent behavior, should be universally applauded. But other policies – such as a reflexive increase in government regulation – probably will exacerbate problems. Ideally, policy makers should seize the opportunity to review whether government policy has contributed to some of the corporate scandals.

This paper analyzes major issues of corporate governance, and the theme that ties together the disparate issues covered herein is that government policy often is the problem rather than the solution. Some of the problems associated with corporate governance issues can be blamed – at least in part – on government policies that discourage good behavior. This is not to suggest, however, that good policy will eliminate bad behavior. It would be implausible to claim that corporate executives are any better or any worse than the general population. The “bad apples” periodically will earn headlines for criminal and/or immoral actions. But the perfect should not be the enemy of the good. If changes in government policy can improve corporate governance and reduce (even if only slightly) bad conduct, policy makers should seize the opportunity.

There is also an important sub-theme that runs through this paper: the importance of punishing the individuals responsible for scandals instead of prosecuting an entire corporation for the personal wrongdoing of a few.

Good Policy Promotes Good Governance

1. Bankruptcy Laws: The Good and the Bad

Economists like to say that capitalism without bankruptcy is like religion without hell. If that is true, corporate America has lots of sinners. Big-name bankruptcies have become depressingly common in recent years. Enron, K-Mart, United Airlines, and U.S. Airways are just a few of the high-profile companies that have been unable to meet their financial obligations. In 2001 alone, 95 big, publicly owned companies filed for Chapter 11 bankruptcy.¹

¹ The Economist, “Bankruptcy in America,” The Economist, September 7, 2002.

The telecommunications industry has been particularly hard hit. WorldCom made headlines with its bankruptcy, losing about \$175 billion of investor value according to one estimate.² But many other firms have gone under, and approximately 500,000 jobs have been lost in the telecom industry.³ Even companies that have kept their heads above water have been hard hit. Lucent has lost 90 percent of its value since January 2001 and AT&T has dropped from \$60 per share in 1999 to \$8 today.⁴

The traditional definition is that bankruptcy is “that system of laws by which an insolvent debtor surrenders his property to a court which distributes the proceed proportionately among his creditors and usually declares the debts discharged.”⁵ There are two main forms of bankruptcy. A Chapter 7 bankruptcy occurs when a company has to close its doors. In a Chapter 11 bankruptcy, by contrast, the company continues to operate while the Bankruptcy Court supervises a series of changes designed to restore profitability.⁶

One of the odder consequences of corporate governance scandals is the accusation that corporate bankruptcy is some sort of financial scam, a gimmick perpetrated by malevolent corporations to avoid paying their bills. But this assertion assumes that shareholders are willing to lose the value of their investments just to reduce costs. WorldCom, for instance, certainly did not want to go bankrupt. Shareholders have no desire to see their stock holdings become worthless and executives have no desire to be perceived as failures. It is absurd to think that either corporate stockholders or corporate managers deliberately choose such a self-destructive strategy. The more realistic assessment is that bankruptcy is a last-ditch option, and that bankruptcy laws have good effects and bad effects.

On the positive side, they give troubled firms like WorldCom a chance to reorganize. Most jobs are preserved, and consumers still have access to the firm’s products. This is because bankruptcy laws are designed to minimize the economic fallout when a company falls into the red. Debts are rescheduled, contracts renegotiated, and unprofitable divisions sold or terminated. These are usually difficult and unpopular steps, but they certainly seem better than the alternative. Without bankruptcy laws, a company with cash-flow problems like WorldCom might have to shut its doors immediately and keep them shut forever. All of its 60,000 jobs would vanish, and the market loses a key competitor and provider of goods and services.

Shareholders and creditors also would experience huge losses if companies couldn’t reorganize. When firms permanently shut down, their only remaining “asset” is the money that can be raised by disposing of property and equipment at fire-sale prices. Shareholders almost certainly wind up losing their entire investment, and creditors -- such as banks and vendors -- are lucky to recover a small fraction of what they’re owed.

Many major companies, including Continental Airlines, Texaco and Southland Corporation (7-Eleven stores), are operating today because bankruptcy laws allowed them to reorganize. Another potential benefit of bankruptcy law is that they preclude an option that is

² Letter to General Services Administration, October 30, 2002.

³ Randolph J. May, “They Just want to Be Free,” *Legal Times*, November 11, 2002.

⁴ Peter Huber, “Telecom Undone – A Cautionary Tale,” *Commentary*, January 2003.

⁵ Reginald Parker, *Creditor Rights and Bankruptcy* (Woodland Hills, CA: Forrest Cool Publications, 1951), p. 19.

⁶ Jeffrey Eisenach, “Pruning the Telecom Deadwood,” *The Washington Times*, November 1, 2002.

even worse – government-funded bailouts. A recent editorial in the Wall Street Journal made precisely this point, explaining:

The other alternative of course, as we've recently seen in the case of the airlines, is government subsidies to keep the enterprise alive. That may be appropriate in extraordinary cases or when the government bears some responsibility for the hard times. But in the end, if a customer won't support an enterprise, why should the taxpayers? ...Some critics of bankruptcy claim that the emergent firms' lower costs constitute a subsidy that is unfair to non-bankrupt firms and that might in turn cause their slide into "serial bankruptcies". But the reluctant losses by creditors are surely not a subsidy but just a recognition of reality. What's the alternative? Automatically liquidate every bankrupt enterprise, regardless of its potential going-concern value?⁷

Bankruptcy law also has a negative side. Some critics argue, for instance, that bankruptcy laws are too easy,⁸ allowing firms to shed debts and emerge with a competitive advantage.⁹ There also is a concern that some state laws and bankruptcy courts are captive to local business interests.¹⁰ Bankruptcy laws may even inadvertently reward financial mismanagement, particularly since firms that file for Chapter 11 bankruptcy protection often retain the old management team.¹¹

Economists point out that bankruptcy laws increase the probability of default and therefore drive up interest rates since lenders must offset the losses caused by lax rules.¹² Another economic argument is that bankruptcy laws prevent the market from quickly re-allocating resources to their best uses. Indeed, the airline industry has been used as an example to explain why it may be better to liquidate failing firms (Chapter 7 bankruptcy) instead of allowing them to re-organize (Chapter 11 bankruptcy):

The airlines would have had to renegotiate their debts; equity holders may have been wiped out, their holding reduced to pennies; the unions would have had to make concessions; and the airlines would have had to come up with a plan, satisfactory to their creditors, that would have led them back to health. Some of the airlines may have been forced to sell to other carriers or other group of investors at rock-bottom prices. But in the end, the airlines industry would have emerged stronger for it. It would have forced a change in the way they do things.¹³

⁷ Lawrence J. White, "Bankruptcy's Great Virtue: Warding Off Federal Bailouts," The Wall Street Journal, January 21, 2003.

⁸ Jeffrey Eisenach, "Pruning the Telecom Deadwood," The Washington Times, November 1, 2002.

⁹ Mark Wigfield, "Church Group Wants FCC to Block WorldCom Reorganization," Dow Jones Business News, October 15, 2002.

¹⁰ The Economist, "Bankruptcy in America," The Economist, September 7, 2002.

¹¹ Austrians and the Private-Property Society: An Interview with Hans-Hermann Hoppe, The Austrian Economics Newsletter, Volume 18, No. 1. Available at http://www.mises.org/journals/aen/aen18_1_1.asp.

¹² Lawrence H. White, "Bankruptcy as an Economic Intervention," Journal of Libertarian Studies, Vol. 1, No. 4, pp. 281-288, Pergamon Press, 1977.

¹³ Christopher Mayer, "The Curative Power of Economic Busts," Ludwig Von Mises Institute, October 22, 2001. Available at <http://www.mises.org/fullstory.asp?control=807>.

Last but not least, bankruptcy critics say the process does not work very well. Lawyers, accountants, financial advisers, PR firms, consultants, and other members of the “restructuring” business charge fees equaling 1-2% of a bankrupt company’s assets.¹⁴ Other assets are lost since executives of failing companies often receive big benefits even though they presided over failing companies.¹⁵ Little wonder, then, that creditors only receive compensation in about 15 percent of cases, though that figure is artificially low since it includes the results of personal bankruptcies¹⁶

In the final analysis, there does not seem to be any evidence that bankruptcy laws contribute to corporate governance problems. There is a stronger argument that the laws – particularly for Chapter 11 – may not be economically efficient. But even this assertion seems overstated since investors clearly understand the “rules of the game.” Indeed, it may even be the case that bankruptcy laws mimic the private contractual arrangements that would exist in the absence of law. In that case, the economic efficiency argument vanishes.¹⁷

Risk-taking and entrepreneurship fuel economic growth -- and this explains why the dark cloud of bankruptcy has a silver lining. Most small businesses fail, but the ones that succeed are America’s chief innovators and job creators. America’s entrepreneurial culture promotes this economic dynamism, partly because it is understood that the ability to succeed goes hand-in-hand with the ability to fail.

To be sure, bankruptcy laws probably can be improved. But bankrupt companies should not be blamed for any problems with bankruptcy laws, and the connection between these laws and corporate governance problems – if it exists at all – is very weak.

Once in bankruptcy, a company’s management has an obligation to make the best of a bad situation. In WorldCom’s case, critics may argue that the process will allow the company to gain a competitive advantage by shedding debt. But that should be interpreted as a reason to reform bankruptcy laws or to encourage more scrutiny by bankruptcy courts. It should not be a reason to single-out WorldCom for discriminatory treatment, or as a justification for government interference in a legitimate Chapter 11 restructuring process.

2. Tax Laws: Incentives Matter, Especially Bad Ones

Tax laws have an enormous impact on corporate behavior. The internal revenue code discourages corporate investment, and the burden on dividends is particularly onerous. Tax laws also penalize firms that make long-term investments. But slower economic growth is not the only casualty. Biases in the tax code hinder good corporate governance by encouraging too much debt and placing too much emphasis on capital gains.¹⁸

¹⁴ The Economist, “Bankruptcy in America,” The Economist, September 7, 2002.

¹⁵ Gray Panthers Press Conference, October 30, 2002.

¹⁶ Lawrence H. White, “Bankruptcy as an Economic Intervention,” Journal of Libertarian Studies, Vol. 1, No. 4, pp. 281-288, Pergamon Press, 1977.

¹⁷ Lawrence H. White, “Bankruptcy as an Economic Intervention,” Journal of Libertarian Studies, Vol. 1, No. 4, pp. 281-288, Pergamon Press, 1977.

¹⁸ For a more thorough discussion of this topic, see Lawrence Whitman, “How the Tax Code Contributed to the Corporate Scandals and Bankruptcies,” Backgrounder #1578, the Heritage Foundation, August 27, 2002. Available at <http://www.heritage.org/Research/Taxes/BG1578.cfm>.

Double Taxation Creates Wrong Incentives

The Internal Revenue Code imposes two layers of tax on corporate income. Companies must pay a 35 percent tax on profits. If the remaining after-tax income is then distributed to shareholders, it is subject to another layer of tax since individuals must include dividends in their taxable income. Depending on an individual's tax rate, the effective tax rate on corporate income can exceed 60 percent. Moreover, companies generally have to overstate their profits thanks to depreciation, foreign tax rules, and the alternative minimum tax. This income can also be hit by capital gains taxes and the death tax, further exacerbating the tax code's bias against investment.¹⁹

Subjecting dividend income to an extra layer of tax creates a bias since equity investment is taxed twice while debt-financed investment is taxed once. This creates the opposite of a level playing field, and the tax bias against equity is so significant that corporate managers have little choice but to over-utilize corporate debt.²⁰ This may be the best choice – given the tax code's perversity, but it comes at a cost. Companies incur large amounts of debt, which makes them vulnerable during an economic downturn since revenues fall while interest costs do not. A neutral tax code, by contrast, would encourage companies to restructure their finances and improve their balance sheets, reducing bankruptcies.

It is impossible to know, of course, whether this policy would have stopped any of the other high-profile bankruptcies that have made headlines in the last two years. It is very safe to say, however, that there will be a significant shift from debt to equity in the future if this reform is enacted. This surely will reduce bankruptcies since the tax code no longer will be encouraging corporations to incur excessive debt.

Eliminating the double-tax on dividends also will have a positive impact on investors' attitudes. Current tax law imposes a heavier tax on dividends (distributed earnings) than on capital gains (retained earnings). If this anti-dividend bias disappears, companies will be more likely to attract investors by offering periodic payments (dividends) instead of promising capital gains. This will improve corporate governance, since firms no longer will feel as much pressure to boost share prices by making unwarranted claims about future revenue. Investors then will be more likely to judge companies by the dividends paid to shareholders.²¹

¹⁹ The Administration proposes to end the double taxation of dividends by allowing individuals to "exclude" dividends from their tax return, while preserving the current 35 percent corporate tax that is imposed on this income. The President's plan recognizes that dividends are after-tax payments and puts an end to the discriminatory and unfair practice of making individuals pay a second layer of tax on this income. Eliminating the double tax on dividend income will increase growth by dramatically lowering the effective tax rate on business equity investment.

²⁰ WorldCom was not the only firm with high debt levels. Other U.S. telecom companies borrowed extensively, including AT&T with \$36 billion of net debt and Verizon with \$58.6 billion of net debt. For more information, see www.worldcom.com/infodesk/forward/thrive/wcomwillthrive.pdf.

²¹ Increasing the capital gains tax would be another way of eliminating the bias between distributed earnings and retained earnings, but this approach would exacerbate the bias between income that is consumed and income that is saved and invested. In other words, the only way to improve corporate governance and boost the economy is to eliminate both the capital gains tax and the double-tax on dividends.

This does not mean, to be sure, that dividend reform will entirely stop managers from overstating revenues and understating costs. But it is surely true that the tax code no longer will perversely encourage overly optimistic (or even dishonest) projections.

3. Government Contracting Restrictions: Why Punish Taxpayers?

Corporate governance concerns are creating an opportunity for some positive reforms, including changes in tax policy. But the desire to make changes is a two-edged sword. Some politicians are trying to punish selected companies for real or imagined misdeeds by denying them the right to bid on government contracts.

If this were to happen, the real victims would be taxpayers. Any effort to undermine open, competitive bidding surely would drive up the cost of government and result in taxpayers paying more and receiving less.

There are two major prongs to this issue. On the legislative front, some lawmakers are trying to block competitive bidding by companies that re-charter in low-tax jurisdictions. These lawmakers, not surprisingly, want to make “inversion” more costly. On the regulatory front, there is an effort to deny companies that have experienced corporate governance problems the right to bid on government contracts.²² This effort does not seem to have a policy goal, and instead seems designed to punish the company for the sins of former executives.

Lawmakers and procurement officials should resist all efforts to undermine the competitive bidding process. Government already is too big, yet it will become an even larger burden if fewer companies are allowed to compete for government contracts. Taxpayers will bear the direct costs, but there also will be economy-wide distortions since additional resources will be drained from the productive sector of the economy.

These anti-competition initiatives also create a terrible precedent. Health-food advocates might want to bar companies from providing food to schools, prisons and the military if they sell fatty food to supermarkets. Antismoking fanatics might want to prohibit tobacco companies from any type of government contracts. And peaceniks might want to bar companies from submitting bids for non-defense contracts if they also happen to produce weapons for the Defense Department.

This does not mean, of course, that contracts should be open to all bidders. An Iraqi company presumably should not be eligible to bid for a defense contract, and it also makes sense to impose restrictions on companies if current employees - particularly executives - have been indicted or convicted. Indeed, former WorldCom executives Scott Sullivan and David Myers were suspended from right to conduct business with the federal government.²³ Needless to say, these sensible rules bear little resemblance to the punitive gestures now being advocated.

²² Tom Schatz, “Pull the Purse Strings on WorldCom: Disgraced Company Shouldn’t Get Government Contracts,” *The Washington Times*, October 8, 2002.

²³ General Services Administration, “GSA Picks up Option on MCI WorldCom Contract,” News Release, November 13, 2002.

Taxpayer Savings

During the 2000 presidential campaign, George W. Bush said that he wanted to "open federal positions involving commercial activities to competition from the private sector wherever possible." The Director of the Office of Management and Budget, Mitch Daniels, has proposed to make President Bush's commitment a reality.²⁴ But the potential benefits may evaporate if the competitive bidding process is crippled. WorldCom, to cite a very relevant example, had \$426 million of government contracts in 2001.²⁵ How much more would those contracts cost, and how much would quality suffer, if the company was barred from bidding?

The campaign against competitive bidding certainly would have an adverse impact on privatization. One study reported that competition for 2,138 contracts helped the Department of Defense save an average of 31 percent. Indeed, the department told Congress in 1996 that taxpayers saved \$1.5 billion because competitive bidding was being used to provide services that previously were in the hands of government.²⁶ And now that President Bush has announced a major plan to facilitate even more private contracting, this issue has become even more important. The impressive track record of competitive bidding will be endangered if critics succeed in imposing myriad restrictions.

Opponents of competitive bidding generally are motivated by self-interest. Indeed, this may explain why unions are active in the issue. They may think that restricting competition and driving up the cost of private sector contractors is an indirect way to expand the government work force - and thus create potential new members. Taxpayers, of course, will get the short end of the stick. They will pay more taxes and get less for their money.

But some critics seem motivated by spite. The Communications Workers of America (CWA), for instance, condemned the decision to extend a government contract with WorldCom, stating it would "subsidize the excesses and abuses of WorldCom executives."²⁷ This is an odd statement since the executives who engaged in the abusive behavior have been terminated. It is an even odder statement considering that the CWA union is trying to harm a company that provides jobs for 60,000 workers.

Other critics are motivated by politics, particularly with regard to the corporate inversion issue. From a political perspective, Democratic lawmakers think that the debate puts Republicans on the defensive, which certainly seems to be the case even though the issue was not effective for the left in the mid-term elections. In the final analysis, though, it seems that some lawmakers are genuinely offended that companies have the ability to escape bad tax law. Indeed, one piece of legislation to bar inversions is often referred to as the "Dred Scott Tax Act" since it assumes that

²⁴ For more information, see http://www.whitehouse.gov/omb/circulars/a076/a76_111402.pdf.

²⁵ Gray Panthers Press Conference, October 30, 2002.

²⁶ Ronald Utt, "Improving Government Performance Through Competitive Contracting," Backgrounder #1452, The Heritage Foundation, June 25, 2001. Available at <http://www.heritage.org/Research/GovernmentReform/BG1452.cfm>.

²⁷ Communications Workers of America, "GSA Decision Rewards WorldCom for its Corporate, Public Abuse," New Release, November 13, 2002.

companies – like runaway slaves in the 1850s – remain property even if they escape to a jurisdiction with better law.²⁸

The Tide Has Turned?

The assault on competitive bidding fortunately has not made much progress. The anti-inversion provision in the final Homeland Security Bill last year was almost completely emasculated. The law states that companies that invert are not eligible for contracts, but also that the law can be voided if denying a contract would hurt the economy, increase taxpayer costs, or compromise national security. Needless to say, any effort to deny the lowest bid from a competent provider will hurt the economy and increase costs.

The left already is trying to plug this “loophole.” The Senate recently approved an amendment that removes the provisions protecting taxpayers and the economy.²⁹ It remains to be seen whether the House of Representatives will approve similar language or whether the amendment will survive a House-Senate conference committee.

Taxpayers also seem to be winning inside the executive branch. The federal government's General Services Administration announced last year that it was extending a WorldCom contract, much to the dismay of the CWA. The union had argued that WorldCom should not be allowed to bid for telecommunications contracts because some of its former executives have been charged with fraud, but they never explained why the company should be penalized since the accused executives have been kicked out and are now being prosecuted by the government.

The bottom line is that companies that make the lowest bid should get government contracts if they satisfy the concomitant requirements for quality and dependability. The process should not be distorted by political correctness, and it should not be tilted for ideological reasons.

4. Anti-takeover laws protect bad managers

Anti-takeover laws are another area where poor public policy could contribute to potential corporate governance problems. As the owners of a corporation, shareholders (acting through Boards of Directors) hire senior managers to operate companies in a profitable manner. But what happens when government policies make it difficult for shareholders to exercise control? Specifically, what if incompetent managers can insulate themselves from oversight?

The consequences almost surely are bad. Without appropriate oversight, managers have less reason to use company money in an efficient manner. This does not mean that all executives would take advantage of the situation, but the incentive structure would allow some managers to inflate their own salaries and reduce their own workloads.³⁰ As two professors explained:

²⁸ For more information, see Daniel J. Mitchell, “Bad Tax Policy: You Can Run...,” *The Washington Times*, May 8, 2002. Available at <http://www.heritage.org/Press/Commentary/ed050202a.cfm>.

²⁹ Leroy Baker, “US Senate Approves Legislation To Deny Corporate Expats Federal Contracts,” *Tax-News.com*, Washington, January 24, 2003. Available at <http://www.tax-news.com/asp/story/story.asp?storyname=10620>.

³⁰ This is not to say managers are inherently bad people. Workers also are less productive in the absence of managerial oversight. The point to be made is that all people work harder and produce more if they feel the pressure of competition.

...some managers ran companies in owners' interests, maximizing production and shareholder returns, others used shareholder funds to buy themselves gold desks, frequent and unnecessary junkets to meetings in warm climes, and secretaries who looked like supermodels but could only type five words per minute.³¹

A key determinant of good corporate governance, therefore, is whether management is accountable to shareholders. Economists refer to this as the "agency problem." In other words, how do financial markets ensure that management has an incentive to efficiently use company money?³² The simple answer is that Boards of Directors are supposed to fire bad managers. And if Boards of Directors fail to exercise their responsibility, shareholders are supposed to replace Directors with ones who will fulfill their oversight role.

The best weapon for shareholders is the hostile takeover.³³ Not surprisingly, incumbent managers do not like hostile takeovers. Creating an unholy alliance with unions, they pressured Congress to enact legislation (the Williams Act of 1968) to insulate managers from shareholder pressure. State governments also got into the act, implementing their own management-protection laws following a spate of hostile-takeovers in the 1980s.³⁴

If policy makers are concerned about improving corporate governance, they should make sure that the owners of corporations – shareholders – have the right to kick out managers that misallocate company resources. Reform of the existing anti-takeover laws, which make the removal of bad managers a difficult undertaking at present, would be a good starting place.

5. When Good Companies Go Bad: Can a Firm be Immoral?

A peculiar aspect of the corporate governance debate is the willingness to attack whole companies as if they were living organisms that made independent decisions.³⁵ Barring extraordinary circumstances, there is no such thing as a bad company. Laws and regulations that target corporations, either individually or collectively, may even undermine good behavior by weakening the notion of individual responsibility.

So is there an approach that will encourage good behavior? Walter Wriston, the former Chairman and CEO of Citicorp/Citibank, has proposed a code of ethics, similar to the Sullivan Principles that helped end South African apartheid. Executives from participating companies would be expected to abide by these principles. As Wriston wrote, "Checks and balances, while

³¹ Dale Steinreich and Rod Oglesby, "Enron, One Year Later," Ludwig Von Mises Institute, December 2, 2002. Available at <http://www.mises.org/fullstory.asp?control=1104>.

³² Dale Steinreich and Rod Oglesby, "Enron, One Year Later," Ludwig Von Mises Institute, December 2, 2002. Available at <http://www.mises.org/fullstory.asp?control=1104>.

³³ This occurs when investors, unhappy that the company is under-performing, buy a controlling bloc of shares, take over the Board of Directors, and replace incumbent managers. Assuming the investors made the right decision, the new management team restores efficiency and share prices rise.

³⁴ Dale Steinreich and Rod Oglesby, "Enron, One Year Later," Ludwig Von Mises Institute, December 2, 2002. Available at <http://www.mises.org/fullstory.asp?control=1104>.

³⁵ While technically not accurate, it is common for people to use phrases such as "Look what Enron did" and "K-Mart today decided." This may seem a trivial concern, but it can become a problem when government officials seek to attack and/or penalize a firm when justice is better served by holding to account the individuals making improper decisions.

useful, do not make good people; it is the other way around, good people produce good organizations.”³⁶

The other alternative is to pass more laws and impose more regulations. But supporters of this approach may not be acting in a realistic fashion. There already are 300 laws covering fraud and corporate crimes.³⁷ Will more laws make a difference, especially if company executives already have decided that obeying the law is not a high priority?³⁸ This is a particularly important question when politically connected firms receive favorable treatment. The Securities and Exchange Commission, for instance, granted a special favor to Enron during the Clinton Administration and the agency failed to enforce existing laws and regulations.³⁹

Government can and should punish wrongdoing. But this is just one part of the answer. Stockholders have the best knowledge and the best incentive to monitor corporate executives. Removing barriers to corporate takeovers may be the highest priority. If this reform was combined with a new ethical code and some long overdue changes in tax policy, it is quite likely that corporate governance scandals would soon become a distant memory.

The Persecution of WorldCom

WorldCom probably has the unwelcome honor of being one of the most vilified companies in America. WorldCom’s list of transgressions bears repeating: The company went bankrupt, setting a record for the largest Chapter 11 in U.S. history. The company admitted to more than \$9 billion of financial mis-statements. Four executives have pleaded guilty to various offenses and others face either investigation or prosecution. This is quite a list of “accomplishments,” easily eclipsing the misdeeds of other firms that “merely” went bankrupt or got caught fudging some numbers.

So what happens now? Current WorldCom executives admit that mistakes were made, but point out that the company is under new management and has had a fresh start. According to the new management team, it would be a miscarriage of justice to persecute the WorldCom of today for the sins of yesterday’s executives.

Critics disagree. They argue that WorldCom got away with a slap on the wrist.⁴⁰ A number of organizations, ranging from left-wing unions⁴¹ to taxpayer groups and conservative think tanks,⁴² argue that WorldCom should be put out of business. Even the United Church of Christ has jumped onto the “shut-down-WorldCom” bandwagon.⁴³

³⁶ Walter B. Wriston, “A Code of Our Own,” *The Wall Street Journal*, January 16, 2003.

³⁷ Walter B. Wriston, “A Code of Our Own,” *The Wall Street Journal*, January 16, 2003.

³⁸ And will more rules lead to better behavior, or will they simply encourage company lawyers to find ways of following the letter of the law while doing the wrong thing?

³⁹ John Berlau, “SEC Won’t Let Sun Shine In,” *Insight*, Jan.21-Feb.3, 2003.

⁴⁰ Citizens Against Government Waste, “Reports: WorldCom May Escape SEC With Slight Punishment,” *PRNewswire*, November 26, 2002.

⁴¹ Gray Panthers Press Conference, October 30, 2002.

⁴² J. Gregory Sidak, “The F.C.C.’s Duty,” *The New York Times*, October 8, 2002.

⁴³ Mark Wigfield, “Church Group Wants FCC to Block WorldCom Reorganization,” *Dow Jones Business News*, October 15, 2002.

WorldCom defenders dismiss these attacks, arguing that these critics are motivated by contributions from WorldCom's competitors that have not been publicly disclosed.⁴⁴ They also point out that these groups appear to have singled WorldCom out for punishment, despite the long and growing list of companies that have encountered similar corporate governance problems.

In fact, much of the WorldCom debate is not really about corporate governance or bankruptcy or accounting irregularities. Instead, it is a proxy for a broader fight over telecommunications policy. Regional bell operating companies such as Verizon and long distance companies like WorldCom have been battling each other for years, and this fight has spilled over into the corporate governance debate.⁴⁵

This paper is about corporate governance, not telecommunications policy. But the two have become tangled. This creates an interesting dilemma, particularly for those people (like the author) who lean more toward the Bell operating companies on issues of telecommunications policy but also have strong feelings on corporate governance and feel that WorldCom critics are misusing the issue.

Fighting Fair

Companies can – and should – engage in spirited rivalry. That is what defines a competitive market. As a general rule, however, the battle should be fought in the private arena, with companies seeking to win the hearts and minds (and dollars) of consumers. In a perfect world, companies would not have to compete in the political arena. Unfortunately, politicians long ago prevented the normal development of a competitive telecommunications market. Instead, they imposed a monopoly structure, complete with heavy regulation.

Lawmakers eventually realized that government-sanctioned monopoly was not the right policy. But this created a very sticky question: What is the best way to deregulate? Today's telecommunications battles exist because of different views on how this deregulation should occur.

This telecommunications policy battle is very contentious, as might be expected when the stakes are high. But as companies wage this fight, they should seek victory based on the merits. If one side or the other can convince lawmakers that genuine competition is advanced by siding with WorldCom or against WorldCom, that is a legitimate outcome.

⁴⁴ Mark Wigfield, "Church Group Wants FCC to Block WorldCom Reorganization," Dow Jones Business News, October 15, 2002.

⁴⁵ The author has no desire to wade into the telecommunications policy debate, but a very brief explanation of the battle is probably necessary. The telecommunications industry historically has been Balkanized by heavy government regulation. Policy makers have been trying to deregulate so that consumers – and the economy – can benefit from competition. The challenge for lawmakers is choosing the best way of opening markets. The bell operating companies want authority to enter the long distance market and the long distance companies want the ability to compete in the local phone market, but neither side is terribly interested in having new competitors. The fight today largely revolves around whether Bell operating companies have to make their local networks available to long distance companies and under what conditions.

It is much less legitimate, however, for one side of a public policy dispute to use tangential issues to gain an advantage. If WorldCom is on the wrong side of an issue, critics should explain why the company is wrong. Trying to drive the company out of business with contracting restrictions and regulatory roadblocks, by contrast, is a misuse of governmental power.

6. Malaise, Despair, and Renewal: One Path to Financial Recovery

Enron's spectacular implosion put corporate misbehavior on the front pages, but it was only the tip of the iceberg. Other major companies also filed for bankruptcy, including Global Crossing, Adelphia, K-Mart, United Airlines, U.S. Airways, and F.A.O. Schwartz.⁴⁶ Questionable financial dealings compounded the bad news, creating the impression that business failures were a sign of fraud. Numerous companies had to revise their books,⁴⁷ and it turned out that some financial statements were improperly manipulated.

To some degree, WorldCom has become the poster child for corporate misdeeds. The company was forced to declare bankruptcy last July, earning the dubious distinction of being the largest company in U.S. history to seek Chapter 11 protection from creditors. Not surprisingly, this was big news. The telecommunications giant still employs 60,000 workers and serves millions of consumers.

But even more importantly, the WorldCom bankruptcy generated headlines because of financial shenanigans. The company now acknowledges that it misrepresented its financial position for three years.⁴⁸ As part of a settlement with the Securities and Exchange Commission, WorldCom admits that it mis-stated its financial position by more than \$9 billion and that it maintained false records in order to mislead investors.⁴⁹

Needless to say, these admissions have had dramatic consequences for the company. Four former WorldCom executives have pleaded guilty to charges of conspiracy and accounting fraud, and the company's former Chief Financial Officer is facing trial on the charges.⁵⁰ The former Chief Executive Officer, Bernie Ebbers, also is being investigated.

Meanwhile, the company faces many other challenges. The most obvious hurdle is the need to regain profitability, a difficult task since most companies that file for Chapter 11 eventually fail.⁵¹ WorldCom also faces political challenges. Certain critics have asked the

⁴⁶ Dale Steinreich and Rod Oglesby, "Enron, One Year Later," Ludwig Von Mises Institute, December 2, 2002. Available at <http://www.mises.org/fullstory.asp?control=1104>.

⁴⁷ Dale Steinreich and Rod Oglesby, "Enron, One Year Later," Ludwig Von Mises Institute, December 2, 2002. Available at <http://www.mises.org/fullstory.asp?control=1104>.

⁴⁸ Deborah Solomon, "WorldCom Reaches Partial Settlement With SEC," The Wall Street Journal, November 27, 2002.

⁴⁹ Seth Schiesel and Simon Romero, "WorldCom Strikes a Deal with SEC," The New York Times, November 27, 2002.

⁵⁰ Mark Wigfield, "Church Group Wants FCC to Block WorldCom Reorganization," Dow Jones Business News, October 15, 2002.

⁵¹ The Economist, "Bankruptcy in America," The Economist, September 7, 2002.

Federal Communications Commission to put the company out of business,⁵² while others argue that WorldCom should lose the right to bid on government contracts.⁵³

Despite all these obstacles, the company is now trying to climb back, within the framework of long-established rules of bankruptcy law. The company has fired those implicated in the accounting scandal, hired a new CEO, instituted new accounting controls, retained new auditors and brought on a new CFO. The entire Board of Directors also has been replaced. WorldCom's creditors and new management hope that these steps – along with better business practices – will allow the company to emerge from bankruptcy in 2003.⁵⁴

Conclusion

Good corporate governance is an essential feature of a well functioning market economy. But corporate managers do not operate in a vacuum. They respond to incentives, and many government policies encourage undesirable behavior. Some politicians think that the answer is more government control and regulation, yet it is not clear why this will help if government is not even able to effectively enforce the laws that already are on the books.

Criminal behavior by executives should be punished, and defenders of the capitalist system have a responsibility and obligation to be the fiercest advocates of effective sanctions against those who violate the law. But this is a second-best strategy, akin to closing the door after the horse has left the barn.

The best response is to fix government policies that are contributing to the problem. The most important changes in this regard are fixing the tax law, and repealing anti-takeover laws.

It is also important to make sure that politicians do not make the problem worse, by agreeing to use the government's regulatory power and contracting rules to penalize specific companies for the misdeeds of individuals. Such actions are sure to result in further harm.

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⁵² Mark Wigfield, "Church Group Wants FCC to Block WorldCom Reorganization," Dow Jones Business News, October 15, 2002.

⁵³ Tom Schatz, "Pull the Purse Strings on WorldCom: Disgraced Company Shouldn't Get Government Contracts," The Washington Times, October 8, 2002.

⁵⁴ Deborah Solomon, "WorldCom Reaches Partial Settlement With SEC," The Wall Street Journal, November 27, 2002.

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