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Dumb and Dumber No More -Up the Revolution!

In January, we wrote "Dumb and Dumber" to express our concern that the indicted former executives from the high fliers of the 90's would be able to escape criminal punishment in their forthcoming trials by pleading they were totally fooled by their own accountants. Despite the "dumb" defense, Bernie Ebbers was convicted in Federal Court on all counts. What's going on here? Are juries getting smarter? Analysts whose predictions or suppositions fail are obliged to review the basis of their prior conclusions. Is this a watershed for white-collar crime? What might it portend for the trials of the others—and perhaps for future cases of alleged corporate malfeasance? Finally, what explains this apparent shift in the attitudes of Everyman toward the beneficiaries of corporate crime?

Our first assumption was that the trials would feature the "dumb" defense---asserting that the principal didn't realize or "know" that the books were being cooked? That is what transpired. The prosecution referred to this tactic as the "Aw shucks" defense that portrayed Ebbers as an "accounting ignoramus." In the Ebbers trial, the key witness for the prosecution, Scott Sullivan, the former CFO of Worldcom, was cast as an accounting genius. Yet, he too suffered lapses of credibility to the jurors. In spite of these portrayals, defense efforts to impugn Sullivan's credibility were not convincing and neither was Ebbers testimony on his own behalf. Yet, at the end of the day, the jury concluded that even if **Ebbers did not initiate the fraudulent accounting process**, he "ought to have known" that the numbers really didn't add up. Guilty!

If the Wall Street Journal's account is to be believed, it was not Ebbers' own testimony that undermined him. The jury still had to sort out which man told the better story and Sullivan's testimony was not entirely believable. The majority of the jury believed he was guilty and minority holdouts were won over only on the last day of deliberations. Apparently, trying to judge between the two, plausibility won out over exactitude.

This basis of conviction may not stand well with some legal theorists, but it is just this kind of reasoning that is essential (and commonly used) by investors. That may be one of the signal implications of the trial. Investors are supposed to be suspicious of self-serving presentations---otherwise they can easily become victims of implausible outcomes. From a capital markets point of view, distinguishing between **plausible** outcomes and **perfect** outcomes is the mark of a sagacious investor. If there is an antidote to "irrational exuberance," it is that in a world of events, there are good outcomes and bad outcomes that cross every company's path. A healthy dose of skepticism is essential for any market to work well. It may not be an entirely satisfactory basis of judging a criminal act, but in this case 'it was close enough for government work.' It may turn out that an Ebbers appeal will succeed because our judicial system works more on absolutes than averages, whereas for skeptical investors, averages and rates of change are far more important. The Ebbers' case suggests that "learning" is ubiquitous—if not always timely. We will have to see if the decision is overturned.

There is another lesson from this trial worth noting. The efficacy of "public companies" for "entrepreneurs" could well be altered significantly. In fact, we believe that it has already been altered. Access to public capital markets was always a driver of corporate behavior, particularly in the immediate decades following World War II. To go public was to get access to scarce capital and to avoid to some degree the suspicious attitudes of commercial bankers in providing long-term credit. As public markets grew, even merchant banking, long a principal source of risk capital, diminished in importance. Shareholder capitalism was "efficient," and the cost of capital went down. In the 1980's, public capital markets took on a different function as they came to be used to unseat old managements seen as not providing adequate shareholder value. The "junk bond" was the lever that allowed at least some shareholders to take control of businesses that could be run better with more talented managers. Shareholder value became the war cry of those who proclaimed that performance driven management was required to unharness capital assets not providing sufficient returns.

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This gain in the effectiveness of shareholder capitalism also had a downside, however, because it exposed corporate managers to two conflicting objectives. First, it made them highly sensitive to smoothing earnings vicissitudes that reflected real events. Why? Markets were willing to pay for increased certainty of outcomes. Higher multiples went along with higher predictability. As we have learned, however, that is not always a good thing for a market. Smoothing earnings was often the beginning of a long downhill slide that ended in actual fraud. There are many ways to produce smooth earning, but the more the multiple on one's stock becomes the target of corporate strategy, the greater the temptation to manipulate earnings. Now, add the notion that managerial incentives had to be geared to measured performance. This has all too often proved to be a toxic brew. Where did we get it wrong?

The second part of the story is that earnings predictability and the doctrine of shareholder value became entwined in such a way to motivate outright fraud in the pursuit of personal gain by managers. The unfortunate part of this story is that the market did not quickly rectify this path of abuse. In fact, a certain division of responsibility impeded the efforts of some to get behind the numbers. Capital market participants were often able to draw less than efficacious lines separating their responsibility for producing "good numbers." This is a kind of market failure that in our view relates to how liability for accounting accuracy and accounting sensibility is parceled out among capital market participants. All too often it became a litany of "it's not my responsibility."

Instead, government has now re-entered perhaps even intrusively---applying strong sanctions on corporate misbehavior. Investors may initially be pleased by this, but in the long run, government regulation may have rather untoward implications for risk-taking. Were government merely to enforce the law, government intrusion might not be so bad. However, with the numerous scandals that have been exposed, government has been motivated not only to enforce the existing public law on public corporations, but to *de facto* the scope of government regulation. Government or the fear of prosecution is now being used to construct large hurdles for corporate management to leap. The mere threat to "go after" a suspected miscreant has meant that markets are not going to be self-regulating and they may deter risk-taking for fear that prosecutors can view future corporate failures as willful efforts to defraud investors. This would be a kind of *post hoc ergo propter hoc* type of reasoning that appears to have significant political appeal. If managers are going to be subject to political threat whenever there is a 'failure,' safer paths will be chosen. Sarbanes Oxley is probably not the end of this story. But, in the end, risk taking is what productivity growth is all about.

In our view, there has been and will continue to be a retreat from the public market by entrepreneurs who wish to take chances. If the public market demands the end of volatility of earnings, and the growth of the economy requires continual "creative destruction," what will be the outcome? It has to mean that more and more real entrepreneurship will be found in those parts of the capital market that are distinctly not public. What this can mean is that entrepreneurs who fully expect that they should take risks and that outcomes might not be smooth will move to less public sources of capital. That is not in itself so bad. We see it happening ever more frequently as Hedge Funds take on the roles of private equity providers, merger and acquisition activity and corporate reorganization. But a government intent on regulation will try to enclose the private domain with rules designed for public markets. The real danger is that public regulators will now wish to "protect" the public from hedge funds, making even that source of capital more expensive.

There is a certain kind of irony that that the attempt to "protect" the public can result in driving much of the public out of the public capital market. What has been a remarkable return of the small investor to public capital markets could be reversed. History proves that it is but a short step for government to extend protection into prohibition.

There are real issues here that need thoughtful treatment. Driving shareholder value seems to be part of the

solution to the "agency" issue that has so often troubled the separation of owners and their managers. The very nature of complex enterprise dictates that professional management is essential, even in ostensibly private companies. The notion of pay for performance is also essential for rewarding improved outcomes. What is lacking are appropriate metrics for connecting these two, essential drivers.

"Short term-ism" was the appellation that was often thrown at American capitalism. Managers didn't focus on building long term value, but only short term profits. The counter-example was often thought to be Japan. But, as we now know, corporate governance issues also deeply troubled the Japanese economy, and it can even be argued that managerial performance in Japan is often inferior and essentially just as likely to create corporate malfeasance. What this ought to tell us is that the distinction between various "varieties" of capitalism may be largely fictitious. It ought to tell us that the Agency problem is hardly yet solved and the search for better performance metrics must still go on. For public capital markets, it may be necessary to change some of the current institutional arrangements that deal with "responsibility."

For example, in the U.S., for many years, auditors were hired by the managements of public companies and the auditing was built around the notion that auditors observe the "process," but do not verify the company's own internal numbers. Next, underwriters in the public capital markets created a prospectus for new issues of debt and equity, but drew a distinction between what they as underwriters assumed to be true given both the company's numbers and what the auditors' reports disclosed about the "process." To tie all these themes together, we have seen the "dumb defense" that asserts a right of a manager to claim that he too is "not responsible." If it is not the manager's responsibility, if it is not the auditor's responsibility, if it is not the securities dealer's responsibility, then it is caveat emptor—save the government who will now become the 'good housekeeping' seal for investors. Is that the best we can do?

Current securities legislation and enforcement has been invited into the breach because capital market participants have become performance driven as well while responsibility for the metrics of performance has been passed around like the Queen of Spades in a Hearts game. No one wants to be stuck with the ultimate responsibility.

And so it goes…Corporate directors seek insurance to cover their liabilities. Managers seek insurance to cover theirs. Investment banks want insurance in the event any hint of scandal touches their activity. The latest turn of events in this capital market melodrama is that the insurance industry's capability to provide liability cover and to provide new techniques to smooth earnings is now under question.

Despite impressive press coverage on these events, the latest revelations of enhanced managerial performance has created ever more doubt on how the Game is played and raises profound questions on how it should be played? Once down the regulatory highway, all bets are off. It is time for investors to do some serious thinking about how they want the game to be played and how they pay their umpires?

The original Dumb and Dumber from January is printed below

"Investors should watch with great interest the trials of Ebbers, Kozlowski and Swartz, Lay and Scruchy, to name the most vilified, as prosecutors attempt to punish corporate America for its crimes against shareholders. Unfortunately, justice for shareholders may not be forthcoming for a very simple reason. The alleged perpetrators of corporate malfeasance were too dumb to understand their own accounting systems. Should you doubt that, note that the preferred defense of these alleged corporate villains is that they didn't know any better. Who says this is not a 'kinder America?' How can we punish 'dumb and dumber?' Should

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stupidity a crime? Maybe the test should be whether the CEO at the time of his action knew "right from wrong?"

Since 1843, when Daniel McNaughton was acquitted for the crime of murdering the secretary of the British Prime Minister on the grounds that he could not at the time distinguish between right and wrong, many accused have escaped criminal punishment by 'reason of insanity.' Attorneys for the accused corporate malfeasants appear to be heading down an analogous, time-tested path. They will defend their clients by claiming that the clients were victims of their own accounting and managerial underlings who had been cooking the books. Apparently, much like their own shareholders, these accused corporate executives were deceived. As in the McNaughton rule, attorneys for the accused will attempt to show that at the time, the corporate executives were unable to distinguish the frauds concocted by their accountants. Accounting today is too arcane of a science. It's about time that a kinder society not only provides for the insane, but also for the dumb.

Should we be upset at such an outcome? Probably not, since many outrages to conventional justice are permitted through some version of a "victim" theory! Never mind that the same mind that ostensibly lay behind a very rapid rise in their share prices, virtually unlimited access to capital markets for unwise corporate expansion and astounding, if not utterly defensible, compensation for "performance," could still be judged too dumb to understand the complexity of the corporate books. Reasonable juries will probably sympathize with the complexities these corporate executives had to face in understanding modern-day accounting. Jurymen, who often cannot understand their own tax returns, must surely be sympathetic to 'good men' who admit all too willingly that they too were victims of accounting complexity. To put it bluntly, much as McNaughton's defense argued that at the time of his crime, McNaughton did not possess sufficient mental competence to know right from wrong, these executives can appeal to the public's aversion to complexity and claim they too were victimized by underlings who cooked very complex books. Who has not been a victim of a complex financial statement, a complex loan contract or a complex warranty statement? If you doubt this, consider the lack of objection by the Board Members of these same companies?

Sarbanes-Oxley (SOX, in the current vernacular) attempted to address the issue of cooking the books, responding, no doubt to the public's call that it had been victimized by unscrupulous corporate executives. Who better than the Congress revels in waving the bloody flag of corporate crime and the benefits of re-election by assuaging gored shareholders? Unwitting shareholder must feel somewhat relieved when the do-good Congress forgives their erroneous stockpickng as mere victims of executive inspired corporate fraud? "Doing Good," is the modern day equivalent of Patriotism. Should you doubt the efficacy of Congressional watchdogs, perhaps it is well to recall Samuel Johnson's oft-quoted remark that "patriotism is the last refuge of a scoundrel." Read "Doing Good" as modern day patriotism and the good Doctor is "right on!"

The quite intelligent sponsors of corporate accounting reform are known for their sharp wit and perspicacity. Who better to wave the flag of 'doing good' than the esteemed Senator (and lawyer) from Maryland, who hones his barbs on none other than Greenspan? If you judge intelligence by the manner in which he spars with the Chairman, you have to be impressed. Why shouldn't the public trust such a purveyor of the public good? A careful consideration of the defense tactics of these on-trial defendants suggests that Senator Sarbanes may actually be hoisted on his own petard. He missed the most obvious defense they would offer. What he should have required is a very simple statement by the CEO and the CFO---namely, "I, ________________, hereby certify that I understand our corporate financial records!" Signed at the time of the alleged offense, Stupidity could not be allowed as a defense!

If you agree that we should require nothing less from the leaders of public companies, perhaps a similar oath from the Congress with regard to the Budget might be in order. But that is an essay all of its own.

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Of course, one could argue that miscreants swore they understood accounting complexity when they didn't. Should they be punished if they just made a mistake? The counter to this defense is much like that of a driver who runs through a stop sign he claimed not to see. It doesn't matter! However, a self-assertion that the corporate executive does understand complex accounting raises the question of why we should not require "intelligence" as a pre-requisite of all important posts of leadership. The reader is right to next inquire if such a criterion should be applied to the makers of law in this country, namely the Congress. Just how much a difference this could make can be inferred from the remark that Richard Nixon once made. Replace "I am not a crook," with I am not a stupid man" and history would have changed, correct?

Seems to me that a movement to end stupidity in public life should have broad support. Let the trials begin!

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