Agency Theory, Reasoning and Culture at Enron: In Search of a Solution

Brian W. Kulik

ABSTRACT. Applying evidence from recently available public information on Enron, I defined Enron’s culture as one rooted in agency theory by asserting that Enron’s members were predominantly agency-reasoning individuals. I then identified conditions present at Enron’s collapse: a strong agency culture with collectively non-compliant norms, a munificent rare-failure environment, and new hires with little business ethics training. Turning to four possible antidotes (selection, objectivist integrity, integrity capacity, and stewardship reasoning) to an agency culture under these conditions, I argued that the currently available ethics literature would have made little difference toward averting Enron’s collapse if any of the recommendations from the relevant ethics literature had been implemented. I conclude by identifying new directions for business ethics literature in order to make it more implementable under the conditions identified at Enron. Essentially, we need a way to clearly determine (1) the difference between connivance and commitment, (2) what is meant by balance with regard to the multiple dimensions of ethics and legal theories, and (3) the proper balance between agency and stewardship reasoning.

KEY WORDS: agency theory, Enron, integrity, integrity capacity, organizational culture, stewardship theory, unethical behavior

Introduction

What can a corporate executive do to positively influence organization-wide ethical conduct? The ethics literature is replete with suggestions, including selection and hiring of ethically-oriented employees (Abdolmohammadi et al., 2003), establishing codes of ethics (Gaumnitz and Lere, 2004), promoting an ethical culture (Sims and Brinkmann, 2003), developing employees internally (Becker, 1998; Petrick and Quinn, 2000), and taking a stewardship perspective (Davis et al., 1997). Given the well-known recent corporate scandals, and especially the plethora of now publicly available information that is available from Enron, two critical questions emerge. First, if the suggestions from the literature cited above had been implemented by Enron’s top management team, could Enron’s ethics shortcomings have been avoided and bankruptcy averted? Second, if the answer to the first question is “no,” then in what direction(s) must the relevant ethics literature proceed before suggestion–implementation congruence is obtained?

The case of Enron stands as a unique opportunity to investigate the above critical questions because the widespread interest in identifying Enron’s downfall, and what the business world should do about it, has spawned a number of books and articles. In addition, the previously private information now made public by the company’s bankruptcy proceedings has shed light on Enron’s operations to a depth that is not available from most other companies, public or private. For example, bankruptcy court-appointed examiner Neal Batson’s third interim report (2003) found that six financial institutions had ‘actual knowledge’ of Enron’s wrongful conduct, gave

Brian E. Kulik is a Ph.D. candidate in Management at Washington State University’s School of Business. His work focuses on the prevention of corporate corruption, corporate governance and ethics, teamwork and diversity, and research methods. His research to date has appeared in the Western and National Academy of Management conference proceedings and the journal Organizational Analysis. He earned M.S. degrees from Washington State University and The University of Cincinnati, and M.B.A. from The University of Denver.
'substantial assistance' by aiding in the structuring and funding of Enron's now infamous special-purpose entities, that the amount of money involved was 'material,' and that such disguise harmed other creditors. These findings may help define limits to strategic alliances more clearly and delineate a firm's motivation for the creation of such alliances. In a recent book by Smith and Emshwiller (2003), the Wall Street Journal reporters who first made known some of Enron's impropriety (specifically, special purpose entities, or SPEs, named LJM and LJM2) to the public, chronicled their work before and during Enron's demise. This work may be interesting to researchers in the tactical positioning that companies use in the disclosure of negative information. Finally, a book co-authored by Sherron Watkins (Swartz and Watkins, 2003), former vice president at Enron, details her involvement in Enron since 1993. Their contribution was essentially an exposure of the cultural and climatic conditions within which Enron employees worked. There is a growing consensus on the idea that Enron's culture, rather than the isolated actions of a few individuals, was the key enabling mechanism that allowed the widespread practice of unethical and illegal behavior based on self-interest (Bryce, 2003; Cruver, 2002; Fusaro and Miller, 2002; Mills, 2003; Sims and Brinkmann, 2003; Swartz and Watkins, 2003; Windsor, 2004). However, no attempt has been made to link the characteristics of Enron's culture to a theoretical base that might be used to both test the potential implementability of recommendations to practitioners in the ethics literature and the closeness of Enron's culture to those of other firms.

This paper first establishes a theoretical base which might be used (1) as a means in itself of providing practitioners a way to avert future Enron-like debacles by the identification and generalization of Enron’s culture and (2) as a test of the avertability of Enron’s downfall through some of the ethics literature’s recommendations. To this dual end, I draw a number of parallels between Enron’s culture and agency theory, a theory made popular by lawyers, economists, and finance and management theorists, that attempts to explain the effectiveness of corporate governance in publicly-held corporations. The next section describes the key elements of agency theory and how it is purported to work correctly. Then, Enron’s culture is identified as one centered in the basic tenets of the agency relationship, with parallels drawn between their dysfunctional culture and agency theory’s characteristics. In search of a solution based on recommendations made in the ethics literature, I investigate alternative approaches that an organization’s cultural and ethical base might instead be founded on, but I find limits to their effectiveness in correcting the problems in an agency culture. I conclude by noting that, while enduring companies cannot harbor cultures based purely in agency theory, vital questions must be answered before specific and effective measures can be taken to avert the emergence of a destructive culture such as Enron’s.

Agency theory

Agency theory, as developed primarily by Jensen and Meckling (1976), is a popular tenet in corporate governance today. For example, the ISI Social Science Citation Index finds that Jensen and Meckling’s (1976) work has been cited more than 3,000 times since 1989 and every article in the Academy of Management Review’s 2003 special issue on corporate governance cited Jensen and Meckling (1976; see Daily et al., 2003), and at least one textbook on strategic management (Hitt et al., 2005) structures its chapter on corporate governance around agency theory. Typical of its use in articles concerned with corporate governance, Daily et al. (2003) stated: “Jensen and Meckling (1976) proposed agency theory as an explanation of how the public corporation could exist, given the assumption that managers are self-interested, and a context in which those managers do not bear the full wealth effects of their decisions” (p. 372). Thus, one can hardly avoid discussion of agency theory in any dialogue on corporate governance.

In particular, agency theory states that, in a public corporation, there exists a central problem with regard to shareholders’ interests: top management does not always act to maximize shareholders’ return on investment. With regard to a corporate executive, “agency costs will be generated by the divergence between his interest and those of outside shareholders” (Jensen and Meckling, 1976, p. 313). According to Rediker and Seth (1995), mechanisms used to align the interests of the manager with those of the shareholders take the form of threats (of