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Enron and the Law of the Market

by Fred E. Foldvary

People will learn lessons from the collapse of Enron. Some of these will be the wrong lessons.

Critics of markets claim that the Enron debacle shows how “capitalism” is defective and proclaim that the government should increase the regulation of corporations and financial markets. There does need to be a change in government policy, but not in the direction of greater interference with business.

A market needs to have clear rules about property rights, and this implies a general Law of the Market about telling the truth. What we need is a clearer codification of the Law of the Market, enforcement, and penalties against fraud. Fraud is a type of theft, and theft is a violation of market rules.

Let’s start with the accounting firms that are supposed to audit corporations. The purpose of such audits is to ensure that the company has truthfully and fully accounted for its operations. This implies that the auditor should be impartial and not be swayed by any financial interest in the company.

That was not the case with Enron. Its auditing firm, Arthur Andersen, was also a consultant to Enron. In my judgment, that constituted a potential conflict of interest. If the auditor reported accounting problems, that might reduce its consulting income.

Some argue that the government should prohibit auditing firms from also doing consulting work for the firm it audits. I argue for a noninterventionist policy.

The Law of the Market would require that all statements made by firms be truthful unless the company charter clearly and explicitly states that it might lie. The Law of the Market would also require that external audits of corporations be impartial, with firms having no financial interest in the company or any links other than the auditing, unless it is clearly and explicitly stated in the charter that it might have other business with the auditing firm, or that it might not be audited at all. It should be up to the shareholders to take on risks, but they should know what those risks are regarding company reports.

If the company’s charter states that it may be audited by firms that also have other financial interests in the company, then all shareholders are warned that the audits might be suspect, and that the accounting reports—the balance sheet and income statements—might be misleading. The value of the shares will then be discounted to reflect this.

The Law of the Market would also specify that the accounting reports of a company fully show all assets and liabilities of the firm at current market prices, unless its charter states otherwise. Enron was able to hide liabilities in partnerships, which were not fully disclosed. A firm’s business includes its

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membership in partnerships, and if a firm wishes to hide part of its balance sheet in partnerships, this policy should be clearly stated in its charter for all to see. Then shareholders will be warned, and the value of the stock will be lower to reflect this.

Honest Statements

Likewise, the Law of the Market would require that when the executives or board members of a corporation make public statements about its prospects, these are to be honest, unless the charter lets the company spokesmen lie. If the charter does not state that they may lie, they should be legally required to tell the truth to the best of their knowledge.

It is tragic that many Enron employees put much of their retirement funds in the company's stock. One of the basic principles of personal finance is to diversify your portfolio. "Don't put all your eggs in one basket" is age-old advice many of us learn from our parents.

This should be a financial lesson for everybody. Markets are efficient because the ineffective firms fail and go out of business. Most investors don't know what is going on inside a company. It can look good on the outside but be crumbling on the inside. Even

those working for Enron did not know what was really going on, yet many put most of their retirement funds in the company's stock. A general rule for investing is not to put more than 5 percent of your assets in the stock of any one company.

The Enron problem was not a fault of the market, but a violation of the ethical rules of the market. There will always be those who try to defraud others. That is why we need laws against theft and fraud. The Enron debacle is the fault of government for not having a clear Law of the Market making auditing conflicts illegal unless the company charter states that it would engage in such practices. The Law of the Market need not even be a governmental law, but given that governments enact laws against theft and fraud, this one would clarify the property rights involved. A company should be presumed honest unless its charter states otherwise, in which case the company's basic documents would be honest.

The pure free market does not include force or fraud, but rather consists of voluntary activity. Vague and confusing government laws and regulations provide the illusion of safety, but actually prevent shareholders and employees from recognizing the risks they are taking. Once again, government, not the market, failed. □

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