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LEARNING FROM ENRON

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Abstract

This essay argues that the Enron affair has been misunderstood as a failure of monitoring, with adverse consequences for the drafting of the Sarbanes-Oxley Act and the Higgs report. Where Enron's board failed was in underestimating the risks that were inherent in the company's business plan and failing to implement an effective system of internal control. Enron demonstrates the limits of the monitoring board and points the way to a stewardship model in which the board takes responsibility for ensuring the sustainability of the company's assets over time.

JEL Codes: G38, K22

Key words: Enron, corporate governance, shareholder value, internal control, non-executive directors, monitoring board, stewardship

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1. Introduction: Enron as corporate governance failure

Financial scandals have long been one of the main drivers of change in company law (Lee, 2002). In the case of Enron, the response of lawmakers to the company's collapse in the final months of 2001 was immediate and far-reaching. The Sarbanes-Oxley Act, adopted by the US Congress in the summer of 2002, is the most significant measure of federal securities and corporate law since the New Deal legislation of the 1930s. In many respects, Sarbanes-Oxley is a mirror image of Enron: the company's perceived corporate governance failings are matched virtually point for point in the principal provisions of the Act (see Ribstein, 2003). The guiding assumption of the new law is that Enron's fall was brought about by conflicts of interest on the part of its senior managers and by a lack of oversight on the part of its board and advisers. As a result, the Act imposes rules aimed at enhancing the independence of directors and auditors, with the objective of more precisely aligning managerial behaviour with the interests of shareholders. The same objective underlies UK responses to the corporate scandals, including the recommendations made in the Higgs Review of Non-Executive Directors (Higgs, 2003) for changes to the Combined Code. Higgs and Sarbanes-Oxley, then, are entirely consistent with the idea that, above all others, informed late twentieth century capitalism in the common law world, namely that corporations exist to further the interests of their shareholders.

In this paper we take a closer look at the events surrounding Enron's fall with a view to assessing whether the response that it has elicited is justified. We argue that, while there were serious conflicts of interest at the board and senior management levels in the period running up to the company's bankruptcy, these conflicts were not the principal reason for its fall. More relevant, from a corporate governance point of view, was the failure of Enron's board and management to take responsibility for the risks inherent in the company's business plan, in particular the use of special purpose entities (SPEs) and related forms of so-called 'structured finance'. It was the misuse of these forms of off-balance sheet financing and the need to correct their initial mis-reporting in the company's accounts which destroyed market confidence in Enron; the conflicts of interest which led to the enrichment of certain corporate officers, while egregious, were incidental to the company's failure.

The circumstances of Enron's fall should be seen in a wider context. As its fortunes rose, in particular during the second half of the 1990s, Enron was celebrated in the financial press and in business school case studies because it was seen to embody an agenda for the modernization of the corporation. Enron's managers understood and applied the language of 'core competencies',

‘asset lite’ balance sheets and ‘virtual integration’. Enron was also, famously, the company that claimed above all others to be ‘laser focused on earnings per share’. Its fall inevitably resonates, then, with widely expressed concerns about the effects of the dominance of the ‘shareholder value’ norm in Anglo-American corporate governance (Kennedy, 2000; Mitchell, 2001; Bratton, 2002; Millon, 2003). Yet this aspect of the debate is almost entirely missing from the public policy discourse surrounding Sarbanes-Oxley and Higgs. Is it possible that policy-makers are learning the wrong lesson from Enron?

2. Virtual integration and ‘asset lite’: Enron’s business plan

The business strategy, which Enron’s managers developed in the course of the 1990s, was based on the exploitation of novel forms of risk management in the energy supply chain. Enron began life from the merger of two utility companies in the mid-1980s and, for the next ten years, enjoyed steadily rising profitability as it exploited the opportunities that arose from the deregulation of US energy markets (Fusaro and Miller, 2002). In addition to owning several interstate gas pipelines, Enron ran a natural gas and electricity transmission business and a retail supply arm dealing directly with energy users. When, after 1985, access to gas pipelines was deregulated, Enron developed a gas trading business offering various types of derivatives (forward contracts and options) to its customers.

The emergence of futures markets for gas supply created the possibility of ‘spread’ or ‘basis trading’ which exploited the difference between prices in spot markets and futures markets. Enron’s head start in gas trading enabled it to act as a market maker for parties on either side of the supply chain; it would therefore act as a counterparty to trades on both sides of the exchange, in effect taking its profits in the form of the spread between bid prices and offer prices. By acting for both sides, Enron confined its exposure to the residual risk across the market as a whole, which it was then able to hedge by entering into swaps and similar arrangements with dealers on recognised futures exchanges.

As an energy trader, Enron had a comparative advantage over its rivals from the financial sector: because it owned and operated physical plant, it was in a position to hold energy supplies in its own right as a protection against movements in market prices. As an industry insider it also had an informational advantage in forecasting regional and sectoral shocks. As a result, it could claim to be both a ‘market maker’ (in the sense of supplying liquidity to an existing market) and a ‘creator’ of altogether new types of products, using legal and contractual ‘technologies’ to develop and trade mechanisms of risk management

which had not previously existed. As Jeffrey Skilling, initially the head of Enron's energy trading business and later (briefly) its CEO put it, '[we are] a company that makes markets. We create the market, and once it's created, we make the market' (quoted in Culp and Hanke, 2003: 7).

Enron's business strategy was, as it put it, 'asset lite' [sic] in the sense that it sought to combine the minimum level of ownership and operation of plant, which was necessary to maintain a physical market presence, with the development of ever more sophisticated risk management techniques. Enron was heavily leveraged for much of the 1980s and 1990s as a result of the loans initially taken on at the time of the merger, which created the company. 'Heavy' assets such as pipelines, power stations and reservoirs represented fixed costs and a potential drain on the company's profitability and its capacity to manage debt. Trading derivatives contracts, on the other hand, did not (in theory, at least) involve such a high degree of fixed capital investments. Thus the optimal combination was one in which a relatively small investment in physical assets was combined with an extensive market-making 'overlay'. The 'asset lite' approach implied that, by these means, a higher rate of return could be achieved than through a more traditional asset structure. This meant, in turn, moving from a 'vertically integrated' form of organization to one in which different firms in the supply chain were linked through 'virtual integration' based on the contractual management of risks:

'The fundamental advantage of a virtually integrated system is you need less capital to provide the same reliability...It's very hard to earn a compensatory rate of return on a traditional asset investment... In today's world, you have to bring intellectual content to the product, or you will not earn a fair rate of return ...' (Skilling in *BusinessWeek Online* February 2001, quoted in Bratton, 2002: 1292).

There is an argument for saying that energy derivatives provided markets with much needed liquidity in the period following liberalization (see Culp and Hanke, 2003: 6). However, this must be set against allegations that the company was involved in attempts to manipulate energy prices in a number of states including California, and claims that, from early on in the existence of its energy trading arm, the company's earnings from derivatives were being mis-stated in ways which concealed its true position (for discussion, see Partnoy, 2003: ch. 10). Until such time as evidence from Enron's bankruptcy proceedings or elsewhere may show otherwise, it seems reasonable to accept that Enron's energy trading business was both legitimate and useful. But even on this basis, there were considerable risks for the company.

An 'asset lite' strategy requires a number of preconditions to be met if it is to be successful (Culp and Hanke, 2003: 15):

1. the company must have access to considerable resources of liquid capital if it is to be able to service its obligations as a counterparty to transactions in which it simultaneously services both buyers and sellers in the chain of supply;
2. relatedly, it must enjoy an unblemished reputation with the banks and credit rating agencies on which it ultimately depends for its supply of liquid capital; and
3. in order to maintain its comparative informational advantage as a market maker, it needs to maintain a physical presence in the sectors in which it operates as a trader.

The architects of Enron's strategy were well aware that being able to meet these conditions was the basis for the company's competitive position:

'In Volatile Markets, Everything Changes but Us. When customers do business with Enron, they get our commitment to reliably deliver their product at a predictable price, regardless of market condition. This commitment is possible because of Enron's unrivalled access to markets and liquidity ... Market access and information allow Enron to deliver comprehensive logistical solutions that work in volatile markets or markets undergoing fundamental changes, such as energy and broadband' (Enron Annual Report, 2000, quoted in Bratton, 2002: 1291)

Enron's bankruptcy came about in the autumn of 2001 when each of these conditions, in turn, ceased to hold. In part this can be attributed to its decision to start offering derivatives contracts in markets, such as broadband, which were not only highly volatile, but in which it had no physical presence and no specialized knowledge of the kind which would give it a comparative advantage. But the disappearance of its working credit and the collapse of support from lenders around this time were also linked to the unraveling of accounting devices which it had used to shift heavy and/or volatile assets off its balance sheet. This was the less acceptable side of 'asset lite'.

3. Enron's accounting: 'intelligent gambling'

Enron took advantage of US accounting rules, which enable companies to set up corporate vehicles, so-called special purpose entities or SPEs, to manage assets off balance sheet. In essence, these rules allow companies to engage in a form of risk-spreading. The return on an asset can be maximized, and risk minimized, by transferring it to an SPE, which must at some point repay the debt that it has incurred to the vendor company. An outside investor comes in to supply external capital and share the risk with the vendor, in exchange for which it also gets to share in the high rate of return that the SPE can provide.

It is a basic principle of modern company law and accounting practice that the accounts of parent and subsidiary companies in the same group should be consolidated. Otherwise, it is a fairly simple matter to shift assets between parent and subsidiary in such a way as to give a misleading impression to shareholders of the state of their respective balance sheets. This principle has been recognized for over half a century in developed economies and was introduced as a response to some of the more egregious accounting scandals that accompanied the Great Crash of 1929 and the economic depression of the 1930s (for the UK side of this story, see Lee, 2002).

The rules on SPEs give every appearance of marking a fundamental departure from the principle of consolidation. The US Generally Accepted Accounting Principles (US GAAP) provide that the assets and liabilities of an SPE do not need to appear on the balance sheet of the vendor company which has set it up, as long as two conditions are satisfied: the outside investor must supply at least 3% of the total working capital of the SPE and, in addition, must be in a position to control the disposition of the asset or assets which are transferred to the SPE. The 3% figure was introduced by the SEC in 1991. It was meant to represent the minimum acceptable investment that was compatible with the notion of a genuine transfer of risk of the kind that would occur in the leasing transactions, which at that time represented the most common situation in which SPEs were used. Moreover, the original letter issued by the SEC presented the 3% figure as indicative only: it was thought that 'a greater investment may be necessary depending on the facts and circumstances, including the credit risk associated with the lessee and the market risk factors associated with the leased property' (Partnoy, 2003: 81). However, in the course of the 1990s, meeting the 3% threshold came to be seen as sufficient in itself for complying with US GAAP; today, structured finance transactions using SPEs have a combined annual value of trillions of dollars.

In the course of the 1990s Enron set up several thousand companies which, thanks to the rules of US GAAP on SPEs and so-called ‘equity accounting’, did not count as its subsidiaries and whose accounts therefore did not need to be consolidated with its own. The use of SPEs and equity affiliates enabled Enron to replace potential liabilities (risky or heavy investments with the potential to be a drain on the company) with assets (promissory notes issued to Enron by its own SPEs) and earnings (income streams generated as the SPEs repaid to Enron the debts incurred as a result of the initial asset transfer).

None of this was a problem in practice, and none of it contravened accounting principles or the rules of corporate law, until the late 1990s when the company entered into a series of transactions for which no genuine outside investor could be found. In the case of the SPE known as Chewco, the ‘investment’ was made in the form of a bank loan, which Enron guaranteed. Attempts were made to dress up the loan as an equity holding but, in essence, the bank in question was not putting up any risk capital and so the deal was a sham. Further sets of entities, the LJM and Raptor SPEs, were capitalized through a combination of bank loans and Enron common stock. These SPEs were used to take on extremely volatile investments, including shares in a dotcom company (the ‘Rhythms transaction’), which Enron had booked as assets on its balance sheet using ‘mark to market accounting’. If these assets were to have declined in value, Enron faced a potential loss on its balance sheet. This in turn represented a risk to its credit rating.

The existence of these transactions was disclosed, as required, in Enron’s annual reports, but in a manner which was less than clear and did not avert to the essentially sham nature of the deals. The further details which are now available were first revealed in the Powers report, a several hundred page document produced by a subcommittee of Enron’s own board in the weeks following the company’s bankruptcy. Additional material emerged in several weeks of hearings before Congress and through the publication of a Senate subcommittee report in July 2002 that provided a blow by blow account of alleged failings of Enron’s board (Senate subcommittee, 2002). As bankruptcy proceedings began in New York in the winter of 2002, the court placed several thousand pages of documents relating to the company’s collapse on a website with public access. The extent of disclosure and its focus on what the board knew contrast sharply with the much more limited inquiry carried out by the Financial Services Authority (FSA, 2003) into the near collapse of the leading UK engineering and telecoms company, Marconi, in 2002; we still know little about the circumstances under which the decisions that led to Marconi’s difficulties were reported to and approved by its board (see Plender, 2003: ch. 5, for one of the few informed accounts).

As the Powers report put it (Powers, 2002: 98), ‘the Raptors were designed to make use of forecasted future growth of Enron’s stock price to shield Enron’s income statement from reflecting future losses incurred on merchant investments’ such as the Rhythms shares. However, ‘[t]his strategy of using Enron’s own stock to offset losses runs counter to a basic principle of accounting and financial reporting: except under limited circumstances, a business may not recognize gains due to the increase in the value of its capital stock on its income statement’ (Powers, 2002: 98). Put slightly differently, a company should not be able to present an increase in its share price as additional earnings simply with the aim of generating a further increase in that same share price. However, this was precisely what Enron did in the case of the Raptors, and had been doing for several years; as long ago as 1996, its CFO, Andrew Fastow, had made a virtue of the practice (see Partnoy, 2003: 303).

Enron’s share price, at this point in the late 1990s, was enjoying enormous growth, in large part because of a perception that it was a ‘new economy’ company. Capitalizing the LJM and Raptor SPEs with Enron shares must therefore have seemed a low-risk option. Clearly, it was only low risk as long as the share price continued to rise as it had done for the previous decade. Like all other ‘new economy’ companies, Enron’s shares began to fall from early 2000 as the result of the bursting of the dotcom bubble. There was little or nothing Enron could do about this. But as the share price steadily declined through the spring and summer of 2001, it looked increasingly likely that the LJM and Raptor SPEs would default on their obligations to Enron. To make things even worse, no attempt had been made to take out a separate ‘hedge’ on the deals in question by transacting for a third party to take the risk of default. Essentially this was because the assets concerned (the Rhythms stock and similar financial investments) were simply too ‘large and illiquid’ (in effect, too risk-prone) to be hedged in the normal way (Powers, 2002: 100).

Enron’s fall was probably unavoidable once the sham SPE transactions began to unravel in the autumn of 2001. Chewco was the first SPE to be wound up and the LJM and Raptor transactions then followed. In each case Enron’s auditor, Arthur Andersen, having initially approved the deals, now told the company that they were incompatible with accounting principles. In each case, the balance sheets of the SPEs had to be consolidated with that of the parent company. The result was that earnings going back several years had to be restated and liabilities that had previously been concealed in the SPEs had to be reported on Enron’s balance sheet. The earnings restatements ran into several hundred million dollars and the revaluation of assets and liabilities led to an overall reduction in the company’s worth of several billion dollars.

These restatements and revaluations would not in themselves have bankrupted Enron. Its annual revenues (in the sense of cash flow) at this point were in the tens of billions of dollars and while its pre-tax earnings (in the sense of profits) were much less than this (around \$1.5 billion in the five quarters to the autumn of 2001), even with the Raptor restatements, it would not have ended up reporting a loss. However, the events of autumn 2001 shook market confidence, which had already been undermined by Skilling's unexplained resignation as CEO in August of that year. At the end of October 2001 Moody's Investor Services downgraded Enron's long-term debt, in direct response to the announcement of earnings restatements. Other credit rating agencies followed their example. As Enron's credit status declined (eventually falling below investment grade level), debts automatically fell due and liabilities accumulated under the terms of its loan covenants. The effect, as Skilling later put it, was like that of a 'run on the bank'. This was more than just the result of 'a simple flaw in treasury management' (Plender, 2003: 175); Enron's entire strategy depended upon being able to maintain the confidence of the credit and capital markets. Efforts to save the company through a last-minute line of credit from the investment bank J.P. Morgan, and a planned merger with rival energy trader Dynegy (which was called off as the scale of Enron's debts became clear) failed in November 2001. As a result, the company entered Chapter 11 bankruptcy on 2 December. Its shares, which had once traded at over \$90, then stood at less than \$1 each.

4. Conflicts of interest, risk management and the role of the board

The role of the conflicts of interest that have since been the focus of much attention and debate must be seen against the backdrop of the company's final months. The most serious of the conflicts related to the involvement of Enron corporate officers in setting up and running some of the sham SPEs with which the company dealt. Michael Kopper, a senior employee in the finance section of the company, ran the Chewco SPE through a series of limited partnerships and companies that he controlled; his involvement was not disclosed to the board. Fastow ran the LJM SPEs and was prominently involved in several of the entities used as part of the Raptor transactions, as were a number of more junior Enron employees in accounting and finance positions. Fastow's involvement in the LJM deals was not only disclosed to the board, at a meeting which took place in 1999, but the board approved of his participation, following a recommendation to this effect from the then CEO and Chairman, Ken Lay.

Fastow and Kopper were not members of Enron's board. However, as senior employees and, in Fastow's case, a designated senior officer of the company,

they owed fiduciary duties to Enron. Self-dealing – acting on both sides of the deal – is potentially a breach of the fiduciary duty of loyalty that a director or senior employee owes to the company. However, fiduciary duty laws can, in effect, be waived. In the context of a listed company such as Enron, approval by the board will almost certainly suffice. With a dispersed shareholder base it is impracticable to require shareholder approval in such a case, and corporate law generally does not insist upon it. Fastow's involvement was, however, *disclosed* to shareholders in Enron's annual report for 2000, after the transactions were undertaken but well before the company's difficulties began. While his role in the LJM deal would have been a breach of Enron's own code of ethics had the board not waived it on Lay's advice, the code was not legally binding and the board did, in this event, give its approval.

The Powers Report implies that the board was either misled, or simply not informed, about Kopper's role in Chewco. It also indicates that the board was not informed of the large sums which Fastow, Kopper and others received for managing the SPEs that they set up. Fastow received \$30 million in return for his part in this. It was only in October 2001, when the deals were falling apart, that the board asked and learned about the extent of Fastow's remuneration. Following this, it decided to suspend him from his employment with Enron. It is far from clear that Fastow committed any legal wrong in not notifying the board since the sums in question were not received in his capacity as Enron's CFO. It is, however, difficult to explain why the board made no earlier inquiry on the matter.

The report of the Senate subcommittee was much more critical of Enron's board than the Powers report had been. The subcommittee accused board members of allowing own conflicts of interest to get in the way of their monitoring role. In particular, it argued that nearly all of the non-executive directors were conflicted because they received substantial payments as consultants in addition to their directors' fees. In addition, some members of the board received indirect compensation in the form of gifts made by Enron to their universities and hospitals. Part of the reaction to Enron since its fall has been to regard such connections with suspicion. As we noted above, both the Sarbanes-Oxley Act in the US and the Higgs Review of Non-Executive Directors in the UK went out of their way to stress the need for genuine independence on the part of non-executives.

In the same vein, Arthur Andersen LLP, Enron's auditors, has been blamed for failing to act with the necessary independence in its dealings with Enron. Andersen received fees not just for auditing, but also for consultancy services; and it engaged in regular exchanges of employees with Enron. It earned

substantial fees, tens of millions of dollars, from organizing the SPE transactions, which were to prove most costly to the company. Enron's legal advisers, Vinson and Elkins, were also directly involved in arranging these transactions. The view that Enron and other corporate scandals owed much to the decline in the professional standards of the legal and accounting 'gatekeepers' during the 1990s (Coffee, 2002) is behind several of the new Sarbanes-Oxley provisions, such as those relating to the regular rotation of accounting partners responsible for auditing company accounts.

How should we assess the charge that conflicts of interest brought Enron down? Three different sets of conflicts need to be considered, namely those affecting senior managers, the auditors, and the non-executive directors. The main charge against the senior managers relates to the self-dealing and stratospheric remuneration that accompanied the setting up of the sham SPEs. However, while the sums paid to Fastow and his immediate colleagues for running the SPEs were enormous even by the standards of late 1990s corporate America, the sums diverted did not bankrupt Enron. The real damage was indirect; when the deals set up by Fastow were unraveled, investor and creditor confidence in the company was undermined at a critical time. From this perspective (and with the obvious benefit of hindsight), it could be said that the board made a mistake in waiving the ethics code. However, the earnings restatements that upset the markets were brought about not by Fastow's conflicts of interest but by the quite separate issue of the earnings restatements that followed Andersen's belated decision that the relevant transactions did not comply with US GAAP.

It must also be remembered that much of the news that hurt Enron in 2001 did not involve any breach at all of the 'no conflicts' rule. Members of Enron's senior management team had each profited by tens (sometimes hundreds) of millions of dollars from cashing in share options at a time when the company's share price was falling and its future looked uncertain. The sums raised by these means dwarf even Fastow's \$30 million. When the sales were revealed in the autumn of 2001 there was an outcry and allegations of illegal insider dealing were made, but these have yet to be borne out. On one view, Enron executives were simply doing what many managers in new economy companies did in the late 1990s: they cashed in share options in a falling market before it was too late.

There is also substantial evidence to cast doubt upon the claim that Andersen was prevented from acting by its own conflicts of interest. We know from the report of the Senate Sub-Committee that in 1999, Andersen told Enron's audit committee that the company's accounting practices were 'at the edge' of acceptable practice (Senate subcommittee, 2002: 12). In internal

communications during 2000, Andersen partners characterized Enron as a 'maximum risk' client. Its managers were said to be 'very sophisticated and enter into numerous complex transactions and are often aggressive in structuring transactions to deal with derived financial reporting objectives'. An Andersen lawyer said that it was 'ridiculous' to characterize Enron's accounting practices as 'mainstream' (Senate Subcommittee, 2002: 17-19). Whatever the extent of Andersen's involvement in, and encouragement of, Enron's accounting strategy, it seems that Andersen regarded Enron as an atypical client with the potential to cause harm to the audit firm itself, as proved to be the case.

Nor is it convincing to see the failure of Enron's board as stemming from conflicts of interest on the part of the non-executive directors. Reputationally, the directors had much more to lose from Enron's fall than they could ever gain from consultancy payments and charitable donations. Once evidence of the company's perilous position began to emerge in the autumn of 2001 they were highly active in attempting to resolve the situation, only to find that there was virtually nothing they could do by that stage. Since the bankruptcy, they have had to endure public obloquy and a Senate inquisition; and the possibility of personal liability for breach of the duty of care cannot be ruled out.

The charge against the board is, or should be, a quite different one: Enron's directors failed to make an appropriate assessment of the risks to which the company was exposed. Enron was engaged in what an Andersen partner called 'intelligent gambling' (Senate subcommittee, 2002: 19). The 'asset lite' strategy was a fundamentally precarious one, which depended for its success on a contingent combination of circumstances. Although it was preeminent in the energy trading market, Enron faced growing competition from new entrants. Margins in derivatives and options trading are notoriously tight; to be profitable, Enron had to generate considerable volumes of business. It was far from unsuccessful in this, hence its position as one of the largest US corporations in term of revenues. But earnings were only ever a relatively small proportion of the cash flows generated from the company's trades. It also seems that those profits that were recorded may well have been massaged over a period of years by the use of SPEs (see Partnoy, 2003: 325-330).

Moreover, the misuse of SPEs that triggered the company's downfall were not isolated incidents. The use of off-balance sheet financing had been endemic within Enron for several years and was an integral part of a business strategy, which depended for its success on creating the illusion of earnings growth. The board, while not aware of the degree to which senior managers were enriching themselves, *was* informed not just about the SPE transactions which were later

to lead to the company's downfall; as we have seen, it was also told by Andersen that they 'pushed limits' and were 'at the edge' of acceptability.

In the course of Congressional hearings, and again in reply to the findings of the Senate subcommittee, Enron directors argued that they had been either misled or not informed by senior managers of the essentially sham nature of the SPE deals. Even if important facts were kept from the board, however, this argument for disclaiming responsibility sits uneasily with the board's responsibility for internal control. One of the core principles of Anglo-American corporate governance is that (in the words of the UK Combined Code, para. D2) 'the board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets'. If the board does not put in place the procedures by which it can obtain the information that it needs to make the necessary assessment of business risks, the failure to do so is, in the final analysis, its own. In the UK, the basic obligation in paragraph D2 has been amplified by the Turnbull report (ICAEW, 1999) and, in a significant move, one of the less remarked on provisions of Sarbanes-Oxley, section 404, now requires an annual disclosure stating how the board has fulfilled its responsibility not simply for maintaining an effective internal control structure but also for evaluating its operation.

Enron's board was ultimately responsible not simply for the company's high risk accounting policy but also for a human resources strategy which made it more likely than not that it would never receive the information it needed about the company's accounting practices. In line with what passed (then and since) for conventional wisdom on the need to incentivise employees, Enron operated a version of 'rank and yank' under which a fifth of its employees was regularly demoted or dismissed on the basis of performance rankings drawn up by peers and superiors. Those who stayed the course were well rewarded with stock options and performance-based increments. Under these circumstances it is not surprising that the employees engaged by Andrew Fastow with the task of setting up the Chewco and Raptor SPEs appear to have made no protest about the conflicts of interest to which these transactions gave rise, nor to have complained of the risk they represented to the company's well being. Nor is it a surprise that these particular employees were also extremely well rewarded for their roles in facilitating the relevant transactions.

As it turned out, it is clear that in the absence of an effective channel of communication from the board to the wider organization of the company, both the company's assets and the investments of its shareholders were being put on the line. Moreover, the outcome produced real victims. Those affected were not just the beneficiaries of the mainly public sector pension funds who had

invested heavily in Enron stock, but also the many employees of Enron itself who were even more exposed than the pension funds were to fluctuations in the company's fortunes, thanks in part to a 'pensions blackout' which prevented them from moving their section 401(k) pension plans into alternative investments during the autumn of 2001. Appropriately enough for a would-be virtual corporation, it was these employee-shareholders who came to bear the residual risk of the company's failure; few of them were sufficiently senior in the organization to have had stock option plans of the kind which senior managers were continuing to exercise at the same time as the pensions blackout was in force. The most severe consequences of the failure of internal control were felt by those who had neither voice nor exit available to them.

5. Conclusion: Enron and the limits of the monitoring board

The Enron affair raises a number of fundamental issues concerning the current trajectory of Anglo-American capitalism, in particular the role of deregulation in destabilizing energy markets and financial markets. It calls into the question the conventional wisdom that firms can generate value by unbundling their component parts in favour of a 'virtually integrated' structure, and it points to the costs involved in the use of high-powered performance-based incentives for employees. Above all, it undermines some of the central nostrums of the corporate governance debate for the past decade.

If anything good is to come out of Enron's failure, it lies in the capacity of the regulatory system to draw the right lessons. Here, the omens are not promising. Enron's fall has been widely seen in terms of the inability of its board to effectively monitor what its managers were doing, with conflicts of interest identified as the root cause of this failure. But while there may well have been fraud at Enron, and conflicts of interest, these were not the sole or even the principal reason for the company's collapse. Instead, Enron appears to have been a case of mismanagement of corporate risk. Enron collapsed because of a systemic failure in which the company's business plan and its accounting policy were implicated. The company's managers pursued a strategy of minimizing its fixed costs with the aim of boosting its share price. In the end it was only a short step from being 'asset lite' to using SPEs to manipulate earnings and conceal debts. At the same time, the company's human resource strategy militated against a culture of transparency and trust. Its employees were subjected to a ruthlessly administered system of performance appraisal, which led to demotions and firings for those with low rankings. Treating employees as a readily disposable asset in this way may have been entirely consistent with the goal of creating a 'virtual corporation', but it also served to increase the risk of a

catastrophic failure of information and accountability of the kind that ensued in the autumn of 2001. In this situation, it is likely that no amount of extra monitoring by the board of its senior managers would have made any difference.

It has been said that Enron is ‘an embarrassment’ for the model of the monitoring board on which so much reliance has been placed by corporate governance reformers (Gordon, 2002: 1241). Sarbanes-Oxley and Higgs, in their different ways, aim to strengthen the model by insisting, among other things, on stronger guarantees of independence for non-executive directors. But if the argument put forward here is correct, this strategy is likely to be of limited value and perhaps even counter-productive. Whatever else their failings may have been, Enron’s non-executive directors were as well qualified as almost any group of outsiders could have been to judge the regulatory and business risks which arose from the company’s business. That they failed to do so is testimony to the complexity of the monitoring task. In a deregulated and liberalized market environment, the risks of competitive failure on the part of listed companies are greater than they have ever been. This places non-executives, in particular, in an unenviable position: when companies fail, they will increasingly be held accountable, either through the harm done to reputations or in extreme cases through litigation; but, as outsiders, they will often lack the knowledge and experience to have made a difference to the outcome.

The goal of making the task of non-executives a meaningful one is linked to the wider issue of how to define the objectives of corporate governance. In the end, Enron’s ‘laser focus’ on shareholder value helped neither its board nor, paradoxically, its shareholders. The idea that directors should be stewards of the company’s assets with a view to ensuring its sustainability over time rather than simply the representatives of the shareholders is still, perhaps, regarded as heterodox in corporate governance circles, such is the power of shareholder value. The true lesson of Enron is that until the power of the shareholder value norm is broken, effective reform of corporate governance will be on hold.

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