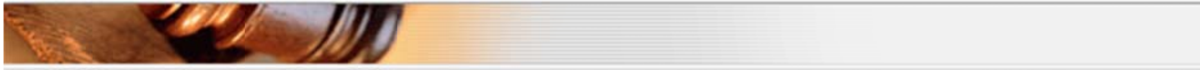

The Fall of Enron - Corporate Governance Lessons

Introduction

The Chapter 11 collapse of the energy company Enron represented, at the time, the largest bankruptcy in U.S. history. Thousands of Enron employees lost not only their jobs, but their life savings in 401(k) and ESOP qualified plans tied to the company's stock. Arthur Andersen, Enron's auditing firm, suffered mortal damage to its reputation and business after admitting to signing off on improper accounting methods that kept billions of dollars in losses and debt from Enron’s balance sheets.

Enron’s implosion, along with similar events within high-profile companies such as WorldCom, Sunbeam, and Global Crossing, has sent shock waves across corporate America. The responsibilities of corporate officers and directors to properly perform corporate governance have been placed under close scrutiny.

As shown by the Sarbanes-Oxley Act of 2002, there has been a renewed nationwide focus on accountability, corporate governance, and compliance management for both public and privately held companies.

What can owners of privately held companies learn from Enron? How can lessons from Enron help you maintain your corporate veil and properly govern your business?

Enron Background

Based in Houston, Texas, Enron resulted from a 1985 merger between InterNorth and Houston Natural Gas. Enron began life as a natural gas pipeline company. As energy markets were deregulated, Enron rapidly evolved from delivering energy to being an energy-related financial trader. Enron traded energy commodities, futures transactions, and other derivatives.

Enron’s Energy Futures Contracts

Enron offered customers long term energy futures contracts. These were agreements to purchase or sell an energy commodity at a defined price at some specified future time. The contracts had durations of 10-20 years, and their resale values would fluctuate based on price fluctuations in the underlying commodity, such as heating oil.

Buyers of energy futures contracts would use them to hedge risk. In other words, the owner of a futures contract for heating oil or natural gas would be protected by knowing that, for the duration of the contract, he or she could purchase or sell his/her heating oil or natural gas for a guaranteed price. Futures contracts increase predictability, and thereby reduce risk.

For Enron to make money with futures contracts, they had to accurately forecast future movements in the energy commodities market. Price fluctuations in this recently-deregulated market were difficult to gauge, which gave Enron wide latitude in setting valuations for its long-term contracts.

Enron took an aggressive approach with valuation in order to maximize reported profits. This included forecasting often unrealistic future prices for the contracts. As a result, many contracts were overvalued, representing a significant risk to the company’s future financial performance.

At some point, the likelihood was that the contracts would underperform the valuation estimates, resulting in significant financial losses to Enron.

SPEs & "Mark-to-Market"

Enron, like many other companies, made use of "special purpose entities" (SPEs). SPEs are business entities such as limited partnerships or LLCs with outside parties. In theory, SPEs are used to separate ownership and control of certain investments from the parent company in order to access capital or hedge risk. Done properly, this is a common and valid technique for managing complex businesses.

In the mid 1990's, Enron began using an accounting technique called "mark-to-market accounting". This included adjusting the values of derivative contracts on Enron's balance sheets to fair market value at the end of a particular quarter. Mark-to-market accounting is supposed to cause a company to book unrealized gains or losses to the income statement of the period, in order to provide a more accurate picture of the company's financial condition.

In Enron's case, the accounting technique coupled with Enron's aggressive futures valuations caused them to considerably overstate earnings.

What Enron Did Wrong

After a few years, Enron's approach to valuing futures contracts and its use of mark-to-market accounting began creating problems for the company. In short, the company had set itself up to fail by how it priced its products and accounted for its financial performance. Unrealized trading gains accounted for more than half of the company's $1.41 billion reported pretax profit for 2000.

During this time, Enron used SPEs and creatively violated corporate governance rules in order to hide its inevitable financial losses from investors.

The details of Enron's dealings and the methods used to obscure its finances are complicated, but the essence is simple: Enron misused SPEs to borrow huge sums of money, while keeping these liabilities off Enron's own financial statements.

Here's how the scheme worked:

- Enron established thousands of SPEs, many in the form of limited partnerships or LLCs, funding them with Enron stock (a questionable practice).
- Once formed, an SPE would borrow large sums of money from an outside source (often investment banks). The SPE would use the money to buy certain futures contracts from the parent company, Enron. This relieved Enron of a liability, and provided a cash infusion that could be booked as a "sale".
- SPEs were used to "park" overvalued futures contracts that were about to drop in value. That way, when the contract dropped in value, the financial impact would be felt by the SPE, not by Enron itself.
- To compensate SPE investors for risk of loss, Enron promised to issue additional shares of its stock. This practice forced Enron into a "rob Peter to pay Paul" cycle that ultimately brought about a collapse.

Lessons to Learn From Enron

Much has been written analyzing the Enron debacle. Enron will serve as a case study for business, accounting, and legal students for years to come.

Our interest is how corporate governance violations of the SPEs contributed to Enron's collapse. Fundamentally, an SPE is just a privately held business, similar to countless LLCs, limited partnerships, and corporations throughout the United States. What corporate governance lessons can we draw from Enron's misuse of SPEs?

There are at least 4 faulty practices that can be illustrated with Enron's SPEs. These provide some useful insights for other business owners:

1. Illegal Hedging

Enron used SPEs to violate securities laws and SEC regulations. There are three basic requirements of a hedge: true independence between the two parties, creditworthiness of the hedging partner, and a diversity of assets backing the hedge. Enron failed disastrously on all three requirements.

2. Mere Instrumentality

Enron's SPEs did not meet the standard of separate business entities; they were a "mere instrumentality" of Enron executives.

Mere instrumentality is defined as two companies with the same officers or directors, sharing employees, office space, finances, or other resources. In cases where a plaintiff can prove mere instrumentality, court judgments can be fulfilled by piercing both the subsidiary's veil and the veil of the parent company (if both are private).

Andrew Fastow, the CFO of Enron, was the sole managing member and general partner of several of the SPEs. In addition, the Fastow-ran entities employed many Enron employees while using Enron's office space.

3. Commingling of Funds

Commingling is defined as "the sharing or pooling of personal and business assets". Taking loans from the business and not formalizing the loan with proper documentation, which would be needed to create an arms-length transaction, can result in veil piercing and personal liability for business conduct.

Andrew Fastow personally provided funding to help get multiple SPEs started. The SPEs would then borrow money and repay Fastow within weeks, paying up to 40% interest. This money usually went directly to Fastow's personal account.

4. Inadequate Capitalization

Perhaps the signature governance violation of the SPEs was undercapitalization. Courts frequently find corporations to be inadequately capitalized when they carry on business with so little assets they are unlikely to be able to pay off their debts. Setting up an entity without adequate capital to meet the business' obligations will often be seen by courts as an unfair attempt to escape personal responsibility for the business debts. This is a pretty succinct summation of how Enron was using SPEs.

Enron funded the SPEs with Enron stock, so when Enron's stock decreased, so did the ability of the SPE to repay Enron. The lack of capital in the SPEs did not stop Enron from using them to hide their losses. Enron constantly

restructured the entities, drafting new contracts to show payment by "note" to Enron. Enron, in turn, recorded the "notes" as revenue. In reality, there was little hope that Enron's investors could ever be made whole.

Conclusion

The Enron collapse was a watershed event in corporate governance. It dramatically highlighted the importance of proper governance and compliance in corporate America. While Enron was a public company, and subject to different requirements and rules than private companies, it still provides many useful lessons for private business owners.

Capitalize your company properly. Avoid commingling business and corporate funds. Ensure your business is a bona fide separate entity, not a "mere instrumentality". And whatever you do, don't use your business entity to violate securities laws. Take heed – the expectations for corporate compliance have risen.

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