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A Governance Dilemma at Enron

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To paraphrase Santayana, managers who do not learn from the mistakes of the past are doomed to repeat them. Enron was a colossal failure in corporate governance. Violating the wisdom of recommendations by governance reformers, Ken Lay served as CEO and Chairman of the Board. Board members owned significant shares of Enron stock, earned consulting fees working on Enron projects, and had formed close personal relationships with Ken Lay. Complicated accounting and finance transactions required input or approval by external auditors and lawyers before reaching the Board's agenda.

Below is a business problem and solution that required approval by Enron's board of directors. How would you have responded to this situation if a board member?

Business Problem

The second half of the 1990s saw an abundance of overvalued dot.com IPOs. Investors wanted to obtain stock prior to the official IPO, watch the stock skyrocket through a speculation bubble, and then cash out before the stock price collapsed. Enron hit the jackpot with Rhythms NetConnections, an Internet service provider. Enron purchased 5.4 million pre-IPO shares at $1.85 for a $10 million equity investment. Rhythms NetConnections went public on April 7, 1999. The stock ended its first day of trading at $69 a share. Enron's initial $10 million investment was now worth more than $372 million.

During May 1999, Rhythms NetConnections stock decreased to $56, reducing the value of Enron's investment to $300 million. To help Enron meet its second-quarter goals, Jeff Skilling, Enron's then Chief Operating Officer, wanted to claim the $290 million profit as a part of recurring income before the stock price went lower. But pre-IPO investors had a legal obligation to hold the stock for six months after the public offering before selling it. One possible way around this problem would be for Enron to buy a "put option" from someone who would guarantee purchasing the Rhythms NetConnections stock at the current $56 price when the six-month holding period ended. But most investors assumed that the Rhythms NetConnections stock price would decline, so the cost of buying a put option on the open market was very high.

Not to be deterred, Andy Fastow, Enron's Chief Financial Officer, proposed creating a Special Purpose Entity (SPE) called "LJM1," which could sell Enron a put option at a reasonable price. The put option would obligate LJM1 to purchase the Rhythms NetConnections stock on demand for $56 a share between November 1999 and June 2004. If the stock price went higher than $56, Enron could sell Rhythms NetConnections on the open market and claim the additional profit. If the stock price went below $56, Enron could exercise the put option and force LJM1 to purchase the stock at $56. In both scenarios, Enron came out a winner thanks to Fastow. However, enticing investors to participate in LJM1 would be a hard sell because the hedge was very risky. The key was making LJM1 appealing enough to

attract the 3 percent outsider equity necessary for SPE status. Fastow offered to invest $1 million of
his own money in LJM1, and to serve as managing director, to gain the trust of the investment community.

Managing the Conflict of Interest

There was one major problem with this solution – the "Conflict of Interest" clause in Enron's Code of Ethics prohibited senior executives from having a financial stake in any organization doing business with Enron. As Enron's CFO, Fastow had a legal obligation to buy a hedge from LJM1 at the lowest price possible. As an LJM1 partner, Fastow had a legal obligation to sell a hedge to Enron at the highest price possible.

Fastow, Skilling, Lay and Arthur Andersen, Enron's auditor, developed the following safeguards to offset anyone's concern that the relationship would favor LJM1 because of Fastow's involvement:

- PricewaterhouseCoopers accounting firm would supply an opinion letter certifying the fairness of all transactions between LJM1 and Enron.
- All deals between Enron and LJM1 would be presented to the board for final approval.
- Ken Lay, Enron's CEO and Chairman of the Board, would sign a statement waiving Enron's Code of Ethics for this one particular situation.

The final step in the process required approval by Enron's board of directors. At the June 28, 1999 board meeting—attended by Lay, Skilling, Enron's chief risk officer Rick Buy, and David Duncan of Arthur Andersen—Fastow explained how Enron needed to hedge its Rhythms NetConnections stock, and the only available seller of a put option was LJM1, and outside investors would only invest in LJM1 if Fastow served as its managing partner.

Decision Choice

If you were an Enron board member would you:

1. allow Enron to claim the Rhythms NetConnections profits by exempting Fastow from Enron's Code of Ethics, given the established accounting safeguards; or
2. allow Enron to lose its Rhythms NetConnections profits by refusing to exempt Fastow and, as a result, letting the entire LJM1 plan collapse? Why?

After you have stated what you would do, find out what happened through the next section entitled "Enron Board Decision Epilogue"

- This dilemma is revised from Denis Collins (2006) Behaving Badly: Ethical Lessons from Enron, http://business.edgewood.edu/behavingbadly.

Enron Board Decision Epilogue

Enron's Board of Directors supported the proposed arrangements and exempted Fastow from Enron's Code of Ethics. In so doing, the board overlooked one important detail: by law SPEs required an independent manager. As Enron's CFO, Fastow was not independent. Therefore, LJM1 was not a legitimate SPE and violated Generally Accepted Accounting Principles. LJM1 should have been accounted for as an Enron subsidiary and all of its debt should have been included on Enron's financial
statements. After that announcement and correction was made, investors started dumping Enron stock on the market, contributing to the company's implosion.

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