Corporate Governance and Special Purpose Vehicles

Understanding the Enron Case
Use and Abuse of Enron’s Own Stock under the Perspective of Swiss Law

Many talk about or refer to the Enron case. Many draw conclusions therefrom. Indeed, the Enron case has started a series of regulatory initiatives as well as an ample discussion on the status of corporate governance abroad and in Switzerland. Few do however really know or – justifiably, considering their complexity – understand what actually occurred.

1. Introduction:
From a Rorschach Test to an Objective Approach

As argued by Professor John Coffee, Jr. [1], «the conventional wisdom is that the Enron debacle reveals basic weaknesses in our contemporary system of corporate governance. In Enron’s case, the firm’s strange failure is becoming a virtual Rorschach test in which each commentator can see evidence confirming what he or she already believed».

This article thus begins by outlining Enron’s history and strategy and then continues by recalling the reasons of Enron’s abrupt downfall. In particular, the article focuses on the use and abuse of Special Purpose Vehicles by Enron [2]. Most importantly, the article explains how Enron, by using SPVs and its own stock, was able to hide operating losses from public view. The discussion then briefly presents the various failures that have caused the fall of Enron and that have originated a strong reaction (and possibly an overreaction) from the regulatory bodies. This paper finally and shortly attempts to understand whether Enron’s use of its own stock would have been possible in a Swiss law perspective.

2. The History of Enron and of its Strategy

2.1 Enron in 1985

In 1985, Enron was the biggest natural gas distribution company operating the largest pipeline in the United States. Enron’s profitability was very much dependent on the price of gas, which in the mid 1980s was deregulated. That was expected to force prices down in the industry and to put pressure on Enron’s stock price. Enron’s shares were priced less than USD 10.

2.2 Enron in 2000

In the early-1990s, Enron created a «gas bank» through which it provided highly flexible contractual arrangements for both buyers and sellers of gas and began offering utilities long-term fixed price contracts. In the mid-1990s it extended its gas trading model to other markets, like electric power, coal, steel, paper and pulp, water, and broadband. To ensure delivery of these contracts and to reduce exposure to fluctuations in spot prices, Enron entered into long-term fixed price arrangements with producers and used financial derivatives, including swaps, forwards and future contracts [3].

Thanks to this innovative strategy, at the end of the year 2000 Enron was the largest and most modern [4] natural gas company in the United States, with a solid domestic dominance and starting to expand its business abroad. In addition, Enron had built a portfolio of gas, electric and communication business, while abandoning part of its traditional business (exploration). By 2000 the company earned significant revenue by serving as a marketer/merchant for the trading of energy (both gas and electricity), by selling broadband communication capacity and by providing outsourcing services to manage energy for customers. It also traded extensively in financial markets in respect of the same products and services.

The market endorsed Enron’s new strategy. On December 31, 2000, Enron’s stock was priced at USD 83.13. Its investors had made a 89% capital gain during the year versus a 9% decrease.
of the S&P 500. Its market capitalization exceeded USD 60 billion; the company’s stock was priced at 70 times earnings and six times book value [5]. Enron had become the seventh largest US firm by market capitalization [6].

2.3 Enron in 2001
In 2001, Enron’s image deteriorated rapidly. It confessed to having committed violations of accounting rules and took a major write-down. Its stock price plummeted. It reluctantly agreed to merge with Dynegy (a smaller energy player) and, following Dynegy’s decision to back out of the merger, Enron was forced to file for bankruptcy on December 2, 2001 [7].

3. Reasons of Enron’s Collapse – Use and Abuse of Special Purpose Vehicles

3.1 The Equity/Debt Dilemma
Enron’s strategy in the late 1990s was in substance to buy an asset and expand it by building a more or less virtual business around it. In carrying out such strategy, however, Enron faced the problem that each investment required large initial capital investments which were not expected to generate significant earnings or cash flow in the short term [8]. Funding the investments consequently involved two alternatives, each of which had its disadvantages. Enron could fund the investments by issuing new equity, but this was unattractive because the earnings in the early years would be insufficient to avoid dilution, i.e. reducing earnings per share. Alternatively Enron could fund the new investment by issuing additional debt, but this would have placed pressure on Enron’s credit ratings which was extremely important to the running of its energy trading business [9].

3.2 The Solution: Off-Balance-Sheet Special Purpose Vehicles (SPVs)
Enron tried to solve this finance dilemma by allegedly looking for outside investors to help finance its investments. These «joint investments» were typically structured as separate entities (joint ventures or, more often, so-called special purpose vehicles, sometimes both) to which Enron and other investors contributed assets or other consideration; the entities could borrow in the credit markets, possibly with guarantees or other credit support from Enron [10].

Enron used SPVs in many aspects of its business: (i) synthetic lease transactions; (ii) sales to SPVs of debt or equity interest owned by Enron; (iii) sales to merchant «hedging» SPVs of Enron stock or of contracts enabling them to receive Enron stock; and (iv) transfers to SPVs of assets, often at below-market value [11].

The objective of Enron was to avoid having to consolidate such SPVs in their entirety into Enron’s balance sheet and to treat them as an investment by Enron, i.e. it was to take advantage of a treatment known as «off-balance-sheet», which would have allowed Enron to present itself more attractively as measured by the ratios favoured by Wall Street analysts and rating agencies [12].

Enron’s «off-balance-sheet» treatment of the SPVs was based on accounting rules which require the fulfilment of two conditions: (i) the independent owner of the SPV must have made a substantive equity investment in the SPV (3 % of the total value of the assets being the minimum acceptable equity requirement), provided that such investment must actually be at risk during the entire term of the transaction; and (ii) the independent owner must have exercised control over the SPV (control being determined not only by reference to majority ownership or day-to-day operation of the SPV, but also to the rights of investors) [13].

According to the testimony of Prof. Partnoy before the US Senate [14], Enron established more than 3000 off-balance sheet subsidiaries and partnerships. Hereinafter are several examples of SPVs and of the transactions for which they were used, which outline their use and abuse by Enron.

3.3 Specific SPVs and Transactions

3.3.1 Chewco [15]
Chewco Investments L.P. is a limited partnership formed in 1997 (as a Delaware limited liability company) and represents probably the first use of an SPV to remove a significant investment from Enron’s financial statements.

Chewco was formed as Enron had to redeem from the California Public Employees Retirement System (CalPERS) an interest in a joint venture entered into in 1993 by CalPERS and Enron, known as the Joint Energy Development Investment Joint Venture (JEDI). Because JEDI was a joint venture over which both CalPERS and Enron had joint control, JEDI was not incorporated into Enron’s balance sheet.

In 1997, Enron wanted to form a new JEDI venture with CalPERS but had reasons to believe that CalPERS would not simultaneously enter into two JEDIs. In order to maintain JEDI as an unconsolidated entity, Enron needed to identify a new limited partner. The solution was Chewco, named after the Star Wars character «Chewbacca».

The solution that was initially found was to have Enron CFO Andrew Fastow investing in and managing Chewco allegedly in a purely private capacity; the argument for his doing so was that outside investors would be attracted by his knowledge of the underlying assets,
and quite obviously lured by his position within the company. However, Enron’s legal counsel pointed out that Fastow’s participation in Chewco would have to be disclosed in the proxy statement because Fastow was a senior officer: Michael Kopper, an employee of Fastow, was therefore made manager instead.

While it is not clear if the «Control» requirement was circumvented (in fact even if Kopper did control Chewco this would not necessarily mean that Enron controlled Chewco as Kopper was not a senior manager of Enron and may therefore not have had sufficient authority thereto), Chewco did certainly not meet the «Equity» requirement as it had practically no equity at all. In fact, although Kopper had made some investment of his own funds (USD 125,000 out of the necessary USD 11.5 million corresponding to the 3% equity) no other outside investor could be found. Instead, Chewco borrowed the required amount from a bank (Barclays), but treated a certain percentage of the loan as equity. However, at least part of the loans provided for by the bank were not at risk as they were guaranteed (indirectly) by Enron.

A very simplified diagram of the Chewco transaction is presented in figure 1 [16].

As outlined in figure 1, the existence of the cash collateral provided for by Chewco to Barclays (amounting to USD 6.6 million) was fatal to Chewco’s compliance with the 3% equity requirement. Even assuming that the Barclays’ funding could properly have been considered «equity» for the purpose of the 3% requirement, such equity was not at risk for the portion that was secured by that cash collateral [17].

In October 2001, Enron, after consultation with its auditor Arthur Andersen, decided that, because the «equity» lent to Chewco by the bank was mostly secured, Chewco (and JEDI) should have never been carried off-balance-sheet.

3.3.2 LJM Partnerships [18]

The objective of the LJM Partnerships was to engage in two types of transactions: (1) to purchase assets from Enron that Enron wanted to take off its books; and (2) so-called «hedging» transactions. Enron entered into more than 20 distinct transactions with two LJM partnerships. These transactions had a significant effect on Enron’s financial statements. Taken together, they resulted in substantial recognition of income and the avoidance of substantial recognition of loss. LJMs were thus vehicles used to accommodate Enron in the management of its reported financial results.

**LJM1**

LJM1 was formed in June 1999. Enron’s CFO, Andrew Fastow, became the sole and managing member of the general partner of LJM1. Fastow raised USD 15 million from two independent limited partners. LJM1 entered, inter alia, into a transaction with Enron for the hedging of Enron’s position in Rhythms NetConnections stock [19].

**LJM2**

In October 1999, Fastow proposed to create a new partnership, LJM2. Again Fastow would serve as general partner through intermediaries. LJM2 was intended to be a much larger private equity fund than LJM1. Fastow said he would raise USD 200 million or more of institutional private equity to create an investment partnership that could readily purchase assets Enron wanted to syndicate. LJM2 was approved in October 1999 and ultimately had approximately 50 limited partners, including entities affiliated with Merrill Lynch, J.P. Morgan, Citigroup, et al. Those investors, including the general partner, made aggregate capital commitments of USD 394 million. The most notable transactions carried out by Enron using LJM2 are referred to as «the Raptors» and are outlined in Section 3.3.4 hereinafter.

3.3.3 Rhythms NetConnections [20]

In March 1998, Enron invested USD 10 million in the stock of Rhythms NetConnections, Inc. («RNC»), an internet service provider. In consideration of its investment, Enron received 5.4 million RNC shares at a price of USD 1.85 per share. RNC went public on April 7, 1999 at an initial public offering price of USD 21 per share. The price had risen to USD 69 by the close of trading that day.

By May 1999, Enron’s investment in RNC was worth approximately USD 300 million, but Enron was prohibited by a lock-up agreement from selling its shares before the end of 1999. Since Enron marked to market its merchant investments like RNC, it was concerned about the volatility of RNC’s stock and wanted therefore to hedge the position. However, due to the size of Enron’s stake, the lack of comparable securities in the market and the relative illiquidity of RNC’s stock, it would have been virtually impossible to hedge RNC commercially.

Enron was also looking for a way to monetize the long forward positions in...
its own shares that it had with an investment bank. Such positions had been created to economically hedge the dilution resulting from Enron’s employee stock option programs and had become significantly more valuable due to an increase in the price of Enron’s stock.

In June 1999, Fastow and another Enron’s senior manager submitted to the Enron Board of Directors a plan to hedge Enron’s RNC investment by taking advantage of the value in the Enron shares covered by the forward contracts.

As outlined in figure 2 [21], the transaction had three principal elements:

(i) Enron restructured the forward contracts used to hedge the options, which released 3.4 million shares of Enron stock. Enron transferred the shares to LJM1, subject to the restriction that part thereof were not to be sold or transferred for four years; Enron received a note of USD 64 million. The shares were discounted by approximately 40% as a result of the restriction.

(ii) LJM1 capitalized LJM Swap Sub L.P. («Swap Sub») by transferring 1.6 million of the Enron shares to Swap Sub, along with 3.75 million in cash (obtained by selling an unrestricted portion of the Enron shares).

(iii) Enron received from Swap Sub a put option on 5.4 million shares of RNC stock at a strike price of USD 56 exercisable in June 2004.

The «hedge» that Enron obtained on its RNC position affected the gains and losses which Enron reported in its income statement but was not, and could not have been, a true economic hedge. In fact, the ability of Swap Sub to perform the obligation on the put depended on the value of the Enron shares it had received from LJM1. Swap Sub also did not have the necessary minimum 3% equity at risk and therefore did not satisfy the SPV requirement for non-consoliation.

Enron decided to liquidate its RNC position and the derivatives with Swap Sub in the first quarter of 2000 based on (1) the expiration of the lock-up on RNC stock; (2) the intervening decline in the value of RNC stock; and (3) the continuing volatility of the RNC position and hedge. The result of the termination of the derivatives with Swap Sub resulted, for various reasons, in a huge windfall profit to Swap Sub, LJM1 and, consequently, to the Enron employees involved therein.

3.3.4 The Raptors [22]

The transactions between Enron and LJM2 that had the greatest impact on Enron’s financial statements involved four SPVs known as the «Raptors». Expanding on the concepts underlying the RNC transaction [23], Enron sought to use the embedded value of its own equity to counteract declines in the value of certain of its merchant investments. Enron was however, as with the RNC hedge, hedging risk with itself.

Through its use of the Raptors Enron was able in 2000 and 2001, to avoid booking losses of approximately USD 1 billion, losses which however had to be reversed in the fall of 2001 (when Enron had to seek bankruptcy protection).

There were two basic types of Raptor transaction: (1) Raptor capitalized with Enron shares; (2) Raptor capitalized with shares of the hedged entity. Both types were set up to engage in «hedging» transactions with Enron and were capitalized by both Enron and LJM2 [24] (as the source of the outside equity). Another requirement all Raptors had to fulfil (set forth in an unwritten agreement between LJM2 and the Raptors) before they could enter into hedging transactions with Enron was that LJM2 had to have received back the entire amount of its investment plus a substantial return [25]. To create the required income for distribution to LJM2, Enron purchased from the Raptor a put option on Enron’s shares.

The derivative transactions between Enron and the Raptor took the form of «total return swaps» on interests in Enron merchant investments – that is, derivatives under which Raptor would receive the amount of any future gains in the value of those investments, but would also have to pay Enron the amount of any future losses.

The diagram of type 1 Raptors, known as Raptor I, II, IV (figure 3) shows that Enron’s underlying risk exposure came from its merchant investment, which it hedged by entering into a total return swap with the Raptor. Although Enron therefore appears to have locked in its return on the merchant investment, the ability of the Raptor to perform on the hedge depended crucially on the performance of the Enron shares. Thus, these Raptors were not hedges in the economic sense of transferring risk to a third party, but rather a mean of absorbing losses with a reserve of Enron shares.
The other type of Raptor, known as Raptor III, was created to hedge a single, large investment in the The New Power Company («TNPC»). Instead of holding Enron stock, Raptor III held the stock of the very company whose stock it was intended to hedge – TNPC. As the diagram (figure 4) shows, if the value of TNPC stock decreased, the vehicle’s obligation to Enron on the hedge would increase in direct proportion. At the same time, its ability to pay Enron would decrease. The result was therefore to magnify, not transfer, the underlying risks.

3.3.5 Other Transactions with LJM Partnerships [28]

In addition to RNC and the Raptors, Enron and the LJM Partnerships engaged in almost twenty additional transactions from September 1999 through July 2001. In these transactions Enron sold assets to a purported third party without much difficulty, which permitted Enron to avoid consolidating the assets and, in some cases, to register a gain. However, virtually all of those sales were most likely not at arm’s length and were not properly accounted for by Enron in its financial statements.

3.3.6 Financial Statements Restatements related to SPVs’ Abuses

On October 16, 2001, Enron announced its first restatement and took a USD 544 million after-tax charge against earnings related to transactions with LJM2. It also announced a reduction of shareholders’ equity amounting to USD 1.2 billion related to transactions with that same entity [29].

On November 8, 2001 Enron announced new restatements of its financial statements for the period from 1997 through 2001 because of accounting errors relating to transactions with LJM1 and Chewco. This restatement was very large and substantially reduced Enron’s reported net income and shareholders’ equity and increased reported debt [30].

Finally, in its Quarterly Report of the third quarter of the year 2001, filed with the SEC through Form 10-Q on November 19, 2001 [31], Enron revealed «hidden» guarantees for an amount of USD 3.9 billion in favour of unconsolidated affiliates, triggered by the loss of a certain investment grade credit rating and the fall of its own stock price [32].

3.4 Conclusions

Special Purpose Vehicles are very common in modern financial markets and many of them generate great economic benefits for the companies that create them and for their stakeholders [33]. Enron however abused the SPVs in order to inflate assets, to understate liabilities, to create false profits and to hide losses [34].

This abuse of the SPVs was worsened by Enron’s particular knowledge of the derivative trading business. In fact, according to its 2000 annual report, Enron had in substance become a derivatives trading firm; it made (or at least reported) billions trading derivatives, but it lost billions on virtually everything else it did, including projects in fibre-optic bandwidth, retail gas and power, water systems, and even technology stocks [35].

Thanks to this very sophisticated know-how, Enron was able to use derivatives and SPVs to manipulate its financial statements in three ways: (i) it hid huge debts incurred to finance unprofitable new business [36]; (ii) it hid speculator losses suffered on technology stocks [37]; and (iii) it inflated the value of other troubled businesses it held by selling a small portion of those assets to SPVs at an inflated price and then registering at a higher price the remaining shares of those assets which it was still holding [38].
However, the combination between the increasing market awareness of Enron’s problems and the stock market’s general decline caused Enron’s stock to fall precipitously even before resignations and accounting restatements further beset the company [39].

At mid October 2001 Enron revealed the first accounting restatement, an equity write-off of USD 1.2 billions, and a 2001 third quarter loss of USD 618 million. On November 8, 2001 Enron revealed LJM and Chewco earnings write-offs [40]. The downward earnings adjustment was significant but the numbers were not sufficient to cause the bankruptcy of Enron. But, as Bratton [41] stated: «The problem went beyond the numbers, which were not large enough to bring down Enron, taken alone. The terms of the transactions showed that Enron had been pumping up its earnings by abusing the SPV device».

This caused a huge credibility drop which was vital for Enron’s business in derivative activity. As Enron’s counter-parties no longer trusted Enron for their derivates transactions, Enron’s business completely evaporated. Enron, as a financial intermediary, was then no longer in a position to sustain its activities and to repay its debts and had to file for Chapter 11. It was, as the former Enron CEO Jeff Skilling later observed, a «classic run on the bank» [42].

4. Enron’s Failures

The collapse of Enron was caused by many internal and external failures. Hereinafter is an overview of those failures which have often been referred to as the cause of new regulations and improvements in corporate governance worldwide.

4.1 Accounting and Regulations

It is now clear that Enron engaged in a range of manipulative accounting transactions. As pointed out by Prof. Schwarcz [43] «(Enron’s) primary motivation was to minimize financial-state-ment losses and volatility, accelerate profits and avoid adding debt to its balance sheet which could have hurt En-

ron’s credit rating and thereby damaged its credibility in the energy trading business».

The central accounting issue is whether or not the «off-balance-sheet» treatment of the SPVs was justified [44]. If in many cases it is obvious that Enron’s accountants misinterpreted the accounting rules, in other cases the decision on the independence of the SPVs for accounting purposes is not so obvious and depends on subjective judgements [45]. In any event, in many cases Enron presented financial statements that apparently complied with accounting rules and were approved by Enron’s auditors.

In addition, thanks to its political influence [46], Enron was able to obtain that energy trading companies be totally excluded from financial or disclosure requirements with respect to portfolios of over-the-counter derivative securi-
ties and was therefore not subject to federal supervision of its hudge deriva-
tive trading activity [47].

4.2 Corporate Governance

On paper Enron had put in place a system of corporate governance that was well respected and appreciated by the market. The Board of Enron was a splendid board, composed of 14 members, with only two insiders. Most of the independent members had relevant business experience. The audit committee was headed by a widely respect-
ed accounting professor and former dean of Stanford Business School and included another respected academic; it had a state-of-the-art charter which gave it direct access to financial, legal and other staff and consultants of the Company as well as to outside account-
ants, lawyers and consultants [48].

Enron had a very sophisticated Code of Ethics which inter alia was meant to avoid conflicts of interest [49]. However, Enron’s managers seemed to have a somewhat casual approach towards compliance with Enron’s corporate go-

vernance, in particular with the prov-
isions of Enron’s Code of Conduct [50]. In general a much debated question between authors is whether or not En-

ron’s corporate governance system was adequate. It is, in any case, a fact that even the rules that were in place were constantly ignored by Enron’s management [51].

4.3 Management Oversight

Even where the corporate governance was observed, the required management oversight was not properly implemented. No one accepted primary responsibility therefor, controls were not executed properly and no one undertook to remedy or to bring to the Board’s attention the apparent structural defects [52].

4.4 Conflicts of Interests

The related-party transactions between Enron and the SPVs were extremely lucrative for Enron’s managers and others individuals related thereto. In exchange for their passive and largely risk-free roles in these transactions, the SPVs and their investors were richly and unduly rewarded [53]. This happened, inter alia, because of a web of con-

licts of interests: There was a lack of se-

paration and independence between the SPVs and Enron personnel and a failure to recognize that the inherent conflict was persistent and unmanage-
able [54].

4.5 Disclosure

Enron’s publicly-filed reports disclosed the existence of the SPVs. However, the disclosures were obtuse, did not communicate the essence of the trans-

actions completely or clearly, and failed to convey the substance of what was going on between Enron and the SPVs [55]. Thanks to this opaque disclosure, Enron was considered by the market as a «faith» stock while, in an efficient market, Enron should have been a «lemon» stock, in accordance with the well known Akerlof’s theories [56]. In good times, Enron was a firm whose CEO, Jeff Skilling, publicly castigated as an «asshole» an analyst who had the temerity to ask a critical question about Enron’s financial reports [57].
According to Schwarz [58], the inadequacy of the disclosure may have two possible explanations. One explanation is that the disclosure was fraudulently minimized in order to avoid revealing the conflicts of interests. The other explanation originates from the observation that Enron’s structured finance transactions were so complex that disclosure was necessarily imperfect and therefore Enron’s investor had to rely on the business judgement of Enron’s management in setting up these structures for Enron’s benefit, which precisely defaulted because of the conflict of interests [59].

4.6 Professional Gatekeepers

The market has discovered that it cannot rely upon the professional gatekeepers (auditors, debt rating agencies [60], securities analysts [61], investment bankers [62], securities attorneys, large institutional investors [63]) whom it has long trusted to filter, verify and assess complicated financial information [64]. While it is true that the gatekeeper is typically paid by the party that it is supposed to watch, its relative credibility should stem from the fact that it is in effect pledging a reputation that it has built up over many years of performing similar services for numerous client. In theory, such reputation would not be sacrificed for a single client and a modest fee [65]. In Enron, however, as in a long list of other cases, the gatekeepers have allowed the company to engage in dubious transactions. As a consequence thereof, investors have discovered that the reputed intermediaries upon whom they relied were conflicted and seemingly sold their interests short [66].

4.7 Incentive Compensation System

As in most other US companies, Enron’s management was heavily compensated using stock options, tied to short-term performance [67]. Stock options are favoured in the US because of their accounting and tax consequences: the grant of stock options is not booked as an expense yet when exercised produces a tax deduction for the firm equal to the difference between the market value of the stock and the exercise price of the option [68]. As a result, their use artificially boosts the EBITDA and therefore – even further – the market value of the shares, in the management’s sole interest. While this form of compensation is theoretically designed to align management’s and shareholders’ interests, it actually achieves the opposite and in most cases motivated management to focus on short-term stock performance rather than creating long-term value [69].

5. Use and Abuse of Enron’s Own Stock

5.1 The Rationale behind Enron’s Use of Its Own Stock

As argued in Section 3.4, Enron’s collapse was most probably caused by the combination of serious reverses in its underlying business, by the attempt to hide those reverses from public view by using SPVs and derivatives and, finally, by the crisis of confidence which arose following the announcement of accounting restatements related to the abuse of SPVs, all being accelerated and aggravated by the unexpectedly bearish stock market.

Enron’s collapse was certainly very much favoured by the deficiencies outlined in Chapter 4., which are since being addressed in various manners by the many regulatory bodies worldwide [70].

However, an additional key «failure» is the fact that Enron used (and indeed abused) its own stock in order to capitalize the SPVs and/or to guarantee the obligations incurred by them. As pointed out by Prof. Bratton [71], Enron’s common stock was used as «a back-up currency importing stability to an otherwise shaky deal structure».

As a matter of fact, both the LJMc Partnerships and the Raptors, the most important and widely used Enron’s SPVs, were an endeavour to use gains in Enron’s stock price and circumvent restriction discounts to avoid reflecting losses on Enron’s income statement. Enron bet on its historically rising stock price and considered remote the risk that it would have to pay on its guarantees [72]. If the stock had continued to rise or at least had remained stable, the debt would have been due at its maturity. At that time, the still-buoyant stock would have provided a painless vehicle for paying off the debt should the value of the affiliate’s assets fall short. If Enron’s stock would have fallen gradually causing the financial institutions to request reimbursement of the debt or the provision of additional guarantees, Enron could have gotten out by issuing more stock. But in case of free fall of the stock – as ultimately occurred – Enron was unable to release itself with a new stock offering and the debt was to tragically accelerate directly against it [73].

In substance, Enron, which under US rules had access to its outstanding stock, tried to place itself on a never ending ascending spiral: an increasing stock price would enable it to keep losses in its investments from public view; which, in turn, would spur further increases in its stock price; which, in turn, would increase its capacity to keep losses in its investments from public view [74]. Enron had discovered a very creative method for using the «embedded» value of its stock and was able to borrow on a virtual basis: it took on contingent obligations secured in the first instance by its own market capitalization, the purpose being to divert Enron of its own assets which were loosing their value. At Enron in the virtual late 1990s, the value to back the deal came not from an inside projection of what the firm could earn, but from what the market was led to believe that the stock would be worth [75].

5.2 A Short Analysis Under the Prospective of Swiss Law

Would Enron’s use and abuse of its own stock have been possible under Swiss Company Law? The answer to this question should obviously influence the debate surrounding the necessary improvements of Swiss rules about corporate governance. It is in fact difficult to believe that Enron would have succeeded to hide its losses from public view for so long with such magnitude would it not have been able to capitalize SPVs.
and/or guarantee their debts by freely disposing of its own stock.

Relevant Swiss Law provisions are contained (i) in the Swiss Criminal Code [76]; (ii) in the legislation on Stock Exchange and Securities Trading [77]; and, most importantly – in this essay’s prospective – (iii) in the Swiss Code of Obligations («SCO»).

The Swiss Code of Obligations does, in particular, regulate the use of a company’s own shares in its articles 659, 659a and 659b wherein a series of restrictions to the use by companies of their own shares are set out. The main limitation is that of Art. 659(1) SCO which provides that a company may acquire its own shares only if (i) freely disposable equity in the amount necessary for this purpose is available and (ii) the total par value of these shares does not exceed 10% [78] of the share capital. In addition, the company is to show a separate reserve in an amount corresponding to the acquisition value of the own shares it holds [79]. Finally, the company shall disclose, in the attachment to its financial statements, all transactions performed on its own shares as well as the number of own shares it holds [80].

These limitations are provided for in particular in order to avoid that the company, by acquiring its own shares, reimburses to its shareholders their capital contribution thereby violating art. 680(2) SCO [81].

Pursuant to art. 659b SCO, the rules provided for by art. 659 and art. 659a SCO apply, mutatis mutandis, to the acquisition of a company’s shares by any subsidiary in which the company holds a majority stake. According to the majority of the Swiss authors who have focused on the question [82], the same rules apply when the company is issuing to a third party a put option on its own shares or a financial derivative that has the same effect.

As has been outlined above [83], most Enron SPV schemes were directly or indirectly based on the – sometimes potential – acquisition by Enron or by its subsidiaries of Enron stock. The fact that derivatives – often sophisticated – were used for that purpose does not affect the very substance of this simple fact, the proportion of which was massive. Quite clearly, this was rendered possible, among other factors, by the different approach of US law in respect of the concept (and especially fixity) of share capital. Indeed, United States securities law do not restrict the number of shares of a particular company which such company or its subsidiaries may hold («own shares»). Moreover, the states which are most popular as a place of incorporation expressly permit issuers to reacquire their shares, without limit [84].

Assuming, arguendo, that Swiss Law would have applied to Enron, the requirements of the Swiss Code of Obligations would have meant that (i) Enron could have acquired its own shares, directly or indirectly through the SPVs, only to the extent that it disposed of freely disposable equity; (ii) all Enron shares held by the SPVs and all shares object of a put option or of a similar financial derivative granted by Enron, would have been added to the number of own shares directly held by Enron and could not have exceeded the total amount of 10% of its share capital; and (iii) Enron would have had to show in its financial statements a reserve for an amount corresponding to the acquisition value (actual or potential) of the shares and of the shares owned by the SPVs [85].

It is therefore most likely that, assuming that the relevant schemes would have been properly understood, under Swiss Law Enron would have been unable to carry out its strategy. Therefore, in addition to the measures addressing the failures discussed in Chapter 4., appropriate rules regarding the use of a company’s own shares appear to be an important tool in order to contribute avoiding the reoccurrence of cases like Enron. This shall include, most importantly, a good understanding of the actual effects resulting from the use of options – whether puts or sometimes calls – or, more generally, of more or less complex financial derivatives. Indeed, the use or abuse of these instruments often leads to the same consequences as those of own shares, when not to much more dramatic outcomes due to their intrinsic leveraging effect.

Notes

2 The starting point to this article is the essay of Steven L. Schwarz, «Enron, and the Use and Abuse of Special Purpose Entities in Corporate Structures», University of Cincinnati Law Review, 2002 Symposium Issue on «Corporate Reorganization and Bankruptcy in the New Millennium» (save where otherwise expressly mentioned, references to Schwarz in this Article refer to this essay).
5 Healy/Palepu, op. cit., p. 2.
7 Healy/Palepu, op. cit., p. 2.
9 Powers Report, p. 36.
11 Powers Report, p. 37; see Section 3.3 for examples of SPVs used by Enron.
12 Powers Report, p. 37; Enron used mark-to-market accounting for its trading business, which requires that assets and liabilities be marked to market values, which in many cases proved to be highly subjective estimates.
14 Testimony of Prof. Frank Partnoy, Hearings before the United States Senate, Committee on Governmental Affairs, January 24, 2002 (the «Partnoy Testimony»), p. 4.
17 Powers Report, p. 52.
18 Powers Report, pp. 68-76.
19 See Section 3.3.3.
20 Powers Report, pp. 77-96.
23 See Section 3.3.3.
24 See Section 3.3.2.
25 This allowed LJM2 effectively to receive a return of its capital (which was immediate) but, from an accounting perspective, leave USD 30 million of capital «at risk» to meet the 3% outside equity requirement for non-consolidation. After LJM2 received its specified return, Enron then was entitled to 100% of any further distributions of Raptor’s earnings.
26 In the Powers Report referred to as Raptor’s LII and IV, the data in the diagram refer to Raptor I («Talon»); Powers Report, p. 101; ISDA Report, p. 22.
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29 Powers Report, p. 2. The shareholders’ equity reduction of USD 1.2 billion was due to the fact that when Enron capitalized the Raptors, it booked the notes issued by the Raptors as assets on its balance sheet and increased its shareholders' equity in a like amount, as one would do when selling newly issued common stock for cash in a public offering. Enron and Andersen then decided that this treatment had to be corrected. (Powers Report, p. 125-126; Bratton, op. cit., p. 38).
30 The amount of the restatements is summarised in the Powers Report, p. 2 and is detailed in Form 8-K filed by Enron with the SEC on November 8, 2001 [http://biz.yahoo.com/e/011119/ene.html].
31 [http://biz.yahoo.com/e/011119/ene.html].
32 Form 8-K, November 19, 2001, Part I, Item 2. Impact of Recent Events (Marlin and Osprey debt obligations).
33 A comprehensive presentation of asset securitization and the company’s efforts to get direct and indirect benefits, in particular by reducing their financing costs, is provided for in: Steven L. Schwartz, «The Alchemy of Asset Securitizations», 1 Stanford Journal of International Securitization, published in: Social Science Research Network, 2002.
34 Partnoy Testimony, p. 5.
35 Partnoy Testimony, p. 30.
36 E.g. the Chewco transaction, see Section 3.3.1.
37 E.g. the RNC stock, see Section 3.3.3 and the transactions performed with the Raptors, see Section 3.3.4.
38 Partnoy Testimony, p. 5ff.
39 Bratton, op. cit., p. 25. The price of the Enron stock declined from USD 83.12 on January 1, 2001 to USD 32.30 on October 17, 2002, the day before the first accounting restatement (see Bratton, op. cit., p.41: Enron: The Course of Events).
40 See Section 3.3.
41 Bratton, op. cit., p. 42.
42 Bratton, op. cit., p. 45.
44 See Section 3.2; The major violations of accounting rules included: (1) failing to reflect the true obligations of Enron on its balance sheet; (2) recording increases in its own stock price as income from joint venture partners; and (3) failing to reflect losses in hedging transactions with SPVs arising from SPV credit problems (Healy/Palepu, op. cit., p. 14).
45 See, inter alia, Schwartz, op. cit., p. 5 «Although Enron, in retrospect, may have misjudged, the culpability of its actions must be assessed ex ante, not ex post».
46 Enron paid USD 2.4 million of political contributions in 2000, more than double the next most generous energy company, and USD 21 million to a dozen or so Washington lobbying firms (Bratton, op. cit., p. 4).
47 Bratton, op. cit., p. 5.
49 Enron Code of Ethics was issued on July, 2000, is composed of 62 pages and includes a specific section for «Conflicts of Interests, Investments, and Outside Business Interests of Officers and Employees» (pp. 57–59).
50 Schwartz, op. cit., p. 4. It appears that the Board was requested and accepted that Enron’s Code of Ethics was suspended in some cases in order to allow a senior executive to perform conflicted transactions (Gordon, op. cit., p. 11).
51 In 2000 Enron’s CEO, Jeff Skilling, publicly praised the employee who started Enron’s online trading operation even though she had been explicitly forbidden to do so. Said an officer present at that meeting: «The moral of the story is: you can break the rules, you can cheat, you can lie, but as long as you make money, it’s all right» (Bratton, op. cit., p. 17).
52 Powers Report, p. 16.
53 Powers Report, p. 16.
54 Powers Report, p. 166.
55 Powers Report, p. 17 and p. 197, the disclousures «failed to achieve a fundamental objective, they did not communicate the essence of the transactions in a sufficiently clear fashion to enable a reader of financial statements to understand what was going on». In fact, Enron represented to investors that it had hedged downside risk in its own illiquid investments through transactions with some of the SPVs. Yet investors were unaware that the SPVs were actually using Enron’s own stock and financial guarantees to carry out these hedges, making them essentially sham transactions (Healy/Palepu, op. cit., p. 14).
57 Bratton, op. cit., p. 6.
58 Schwartz, op. cit., p. 8ff.
59 For a detailed description of this observation and of the analysis that follows refer to the forthcoming article of Steven L. Schwartz, «Rethinking the Disclosure Paradigm in a World of Complexity».
60 The three major credit rating agencies – Moody’s, Standard & Poor’s, and Fitch/IBCA – received substantial, but as yet undisclosed, fees from Enron. Yet just weeks prior to Enron’s bankruptcy filing all three agencies still gave investment grade ratings to Enron’s debt (Partnoy Testimony, p. 17).
61 As late as October 2001, 16 out of the 17 securities analysts covering Enron maintained «buy» or «strong buy» recommendations on its stock right up until virtually the moment of its bankruptcy filings (Coffee, op. cit., p. 9 and note 21). On October 31, 2001 the mean analyst recommendation for Enron was 1.9 out of 5, where 1 is a strong buy and 5 is a sell (Healy/Palepu, op. cit., p. 27 citing First Call).
62 Investment bankers earned more than USD 125 million in underwriting fees from Enron in the period 1998 to 2000. (Healy/Palepu, op. cit., p. 27). Academic research findings show that long-term earnings forecasts and investment recommendations are more optimistic for analysts that work for lead underwriter banks (Healy/Palepu, op. cit., p. 28).
63 At the height of its popularity, large institutional investors owned 60% of Enron’s stock. Notwithstanding various negative voices regarding Enron they began selling only in October 2001, after the company announced its accounting problems (Healy/Palepu, op. cit., p. 22).
64 Coffee, op. cit., p. 5.
65 Even if the prospective Andersen annual fees from Enron reached USD 100 million it has to be considered that Arthur Andersen earned over USD 9 billion in 2001. (Coffee, op. cit., p. 7 and note 15). However, the size of the audit fee itself is likely to have an important impact on local partners in their negotiations with Enron’s management. Enron’s audit fees accounted for roughly 27% of the audit fees of public clients for Arthur Andersen’s Houston office. (Healy/Palepu, op. cit., p. 22).
66 Coffee, op. cit., p. 29.
67 It is estimated that Enron’s officers and directors sold USD 1 billion of Enron stock over the last three years period (Bratton, op. cit., p. 17).
68 Gordon, op. cit., p. 15.
69 Healy/Palepu, op. cit., p. 15ff. At December 31, 2000, Enron had 96 million shares outstanding under stock option plans, almost 13% of common shares outstanding.
70 A detailed outline of the measures adopted or proposed will be the subject matter of a forthcoming essay of Prof. Henry Peter which will be published in: Actes de la journée 2002 du droit bancaire et financier, Geneva, Stämpfli, Berne, 2003.
71 Bratton, op. cit., p. 48.
72 Schwartz, op. cit., p. 2.
73 Bratton, op. cit., p. 49.
74 Powers Report, p. 128.
75 Bratton, op. cit., p. 44. As argued by Schwartz, op. cit., p. 4 «One might even view Enron’s attempt to use the «embedded» value of its own stock, increases which could not be reflected on its balance sheet under generally accepted accounting principles, as ingenious because the stock does create real value for the hedging entities [the SPVs]».
76 Art. 161 and 161bis Swiss Criminal Code.
78 Art. 659(2) provides for an increase of this limit to 20% for registered shares acquired in connection with a restriction of transferability.
79 Art. 659a (2) SCO.
80 Art. 663b (no. 10) SCO.
83 See Section 3.3 with the exception of Chewco.
84 For example, Sec. 161 of the Delaware General Corporation Law expressly permits a corporation formed in that state to acquire, own and hold its own shares, provided that the requirements set forth therein are fulfilled. [http://www.delcode.state.de.us/title1/chapter1.htm#TopOfPage].
85 Peter/Bahar, op. cit., p. 41f.
ZUSAMMENFASSUNG

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Verschiedenartige Einflüsse gemeinsam führten schliesslich zum Zusammenbruch: Ernsthafte Verluste in den angestammten Geschäftsbereichen, untaugliche Verschleierungssuche durch die genannten SPV und Derivate, schliesslich Zwang zur Offenlegung und nachträglichen Korrektur der Rechnungsabschlüsse, mit verheerendem Vertrauensverlust für Enron als Partner im Terminhandel (Gegenpartei risiko). All dies wurde noch verschärft durch die allgemein ungünstige Börsenentwicklung.

Das Fehlverhalten lässt sich wie folgt zusammenfassen:

– Nichtbeachtung der Bußfahrungsregeln;
– keine vollständige und klare Offenlegung der gewählten Konstruktionsarten;
– Vorhandensein, aber Missachtung der Regeln der Corporate Governance;
– mangelhaft gehandhabte Überwachung der Geschäftsleitung und unvollständige Information an den Verwaltungsrat;
– professionelles Versagen der auseinandergehenden Fachleute (Wirtschaftsprüfer, Ratingagenturen, Wertschriftenanalytiker, Investmentbanker, institutionelle Investoren);
– kontraproduktive Entscheidungsmodelle der Geschäftsleitung gestützt auf kurzfristige Erfolgsaussichten;
– gegensätzliche Interessen des Unternehmens und der mitwirkenden, entscheidungsfallenden Privatpersonen.

Die schweizerische Gesetzgebung (insbesondere OR Art. 659, 659a, 659b und 680) dürfte ähnliche Missbräuche mit eigenen Aktien verhindern, wobei indessen auch zugehörige Aktienoptionen und andere Finanzderivate samt ihrer Hebelwirkung zu berücksichtigen sind.