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HOW CORPORATE GOVERNANCE AND GLOBALIZATION CAN RUN AFOUL OF THE LAW AND GOOD PRACTICES IN BUSINESS: THE ENRON'S DISGRACEFUL AFFAIR

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ABSTRACT

The purpose of this paper is to set out the Enron's demise into the perspective of Corporate and Global Governance. To accomplish this target, the incremental cash flow model is expanded to give room for governance issues, while a functional introduction to information sets is developed, including bounded rationality, asymmetric information, opportunistic behavior, transaction costs and agency problems. Then, corporate governance is linked to globalization by means of some recent approaches that go beyond a narrow economic mindset to encompass a far-reaching dynamics. Taking advantage of such background, the Enron's story is tracked down over a span of fifteen years since its starting day to its bankruptcy filing. Leading events are explained from corporate and global governance viewpoints, while an in-depth analysis is worked out on Enron's complex game of deception and breach of contracts: the outrageous affiliated limited partnerships, the lavish pay package to its executives, the involvement with global governance through the Indian affair and the Taliban connection. It is for the incremental cash flow model to explain malfeasance with cash flows from assets, and how cash flows to creditors were actually contrived. Furthermore, to highlight how cash flows were swindled from stockholders and, finally, how Enron made wheeling and dealing with cash flows on behalf of its managers.

JEL Classification System: G30, K22, F40.

Key words: corporate governance, global governance, incremental cash flow model, globalization, information sets, good practices.

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INTRODUCTION

In January and February 2002, the author was Visiting Scholar at the Center for Corporate Governance, University of Delaware. In December 2001, Enron filed for Chapter 11 on Bankruptcy Law in the worst case ever known so far. Delaware is the leading state in America as regards corporate law and the Delaware Supreme Court is the beacon of distinctive precedents on corporate governance and law. This was the environment where the decision about writing this paper came to light. From June to September 2002 the author took, this time as a student, the course in Globalization given by Professor Carlos Escude in the Master program in Political Science at the University of Cema. That was the background against which this working paper came to shape and encouragement was found to keep on researching the subject in the near future.

In section 1, we provide a non-conventional definition of corporate governance, grounded on core issues either academics or practitioners currently look upon as topical. Besides, corporate governance makes the most of North's institutional approach that seems more realistic and comprehensive than other alternative points of view.

Section 2 takes advantage of the author's engagement and research in corporate governance for the last four years, introducing the incremental cash flow model to keep track of many sources that nurture conflicts of interest and also to provide with a quantitative method for discussing discretionary behavior and breach of fiduciary contracts.

It is for section 3 to bridge the gap between corporate governance and globalization, a subject that has been pervasive and difficult to cope with, each time globalization was narrowed down to flat economic foundations, what amounts to neglect other powerful dimensions whenever global issues are at stake.

Section 4 introduces a powerful framework that has been successfully employed for the last twenty years in Financial Economics, in a broad attempt of leaving aside many of the assumptions in neoclassic economics that have proved untenable to understand the world and its participants. The section expands on information sets, bounded rationality, asymmetric information, opportunistic behavior, agency problems and transaction costs. These tools of analysis are currently being applied in the realm of Political Science.

Section 5 develops a nurturing case and it will not come as a surprise that Enron itself will stand as the purveyor not only of the story but the lesson as well. An extensive and detailed chronology will highlight the main events in the rise and fall of Enron from 1985 till 2002, while corporate governance remarks will be supplied to each of them. Besides, some particular matters that explain the company demise will be expanded on at length by means of the incremental cash flow model and the tools developed in section 4: namely the special purpose vehicles, managers pay package, the limited partnerships and the role Raptors performed in deceitful corporate practices. Last of all, the Enron's affair will be pictured against a globalization background that leads to unexpected links with global governance and politics.

1.- CORPORATE GOVERNANCE

"Corporate Governance" seems to be a growing concern among academics, practitioners, lawmakers, and company's stakeholders. This is not a striking point because corporate governance has to do with ownership, accountability and control, incomplete contracts and agency problems, performance and incentive design. Since the Berle and Means (1932) well-known book, the concept went a long step further from the separation of ownership and control that led to the first widely accepted meaning of corporate governance. It was after distinctive research underwent by Jensen, Fama, Williamson and Hart, among others, that the subject established itself as a complex field. A comprehensive survey of these efforts can be found in Shleifer and Vishny (1986). On the other hand, an encompassing work in comparative analysis of governance structures from advanced economies is provided by Demirag (1998), while corporate governance in Argentina has been researched by Apreda (2001c).

It doesn't seem easy to define "corporate governance" as it always happens with thriving new fields in which semantics turns out to become loose and tentative. Nonetheless, we can set forth a functional definition that does not attempt to fix a cut and dried meaning, but provide with useful guidelines instead.

*By **Corporate Governance** it is meant the field of learning and practice related with the following subject matter:*

- *Ownership structure*
- *Company's Charter and bylaws*
- *Board of Directors, Trustees, and the allocation of control rights*
- *Managers' fiduciary duties towards owners, and the allocation of decision rights*
- *Creditors protective covenants*
- *Changes in the capital structure*
- *Conflicts of interest between managers, creditors and owners*
- *Accountability to stakeholders*
- *Tight budget constraints and short-termism*
- *Managers' performance and incentives*
- *Information production and disclosure to markets and stakeholders*
- *The role of gatekeepers*
- *National and international corporate law, regulations and law enforcement*

Remarks:

*i) Everybody that is able to hold a claim on the company becomes a **stakeholder**: owners and creditors are the main stakeholders, followed by managers, employees, government (taxes and complaints), suppliers (bonding and trust), customers (quality and conveniences), and communities (labor development and environmental damages).*

*ii) **Gatekeepers** are distinctive organizations that safeguard the interests and rights of different stakeholders: auditing and accountancy firms, investment banks, law firms, market regulators, institutional investors, creditors' trustees, NGOs (non-government organizations acting as watchdogs of corporations, markets, regulators) and credit-rating firms.*

*iii)) **Corporate Governance** seems an unfortunate misnomer because all organizations, by far, display a governance structure of one sort or another. Besides, government organizations exhibit complex governance features.*

For the time being, organizations in general, and corporations in particular, cannot be isolated from their institutional contexts. This linkage, suitably labeled "institutional", has been studied widely for the last thirty years. Being North (1990) a foremost authoritative source, we are going to quote him so as to provide an outline of this distinctive point of view:

"Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange, whether political, social or economic. Institutional change shapes the way societies evolve through time and hence is the key to understanding historical change. [...] Organizations are created with purposive intent in consequence of the opportunity set resulting from the existing set of constraints (institutional ones as well as the traditional ones of economic theory) and in the course of attempts to accomplish their objectives are a major agent of institutional change "

When the study of corporate governance is mapped onto the institutional viewpoint, it can address some core issues at which alternative explanations fall short of expanding on them in an all-inclusive way:

a) What can be said about the ownership and control structure of the firm, its chart and bylaws?
b) Are there multiple voting rights schemes? What is the structure of the Board of Directors?
c) How the firm is to be financed and what are the warranties for financiers to be paid eventually?

d) To what extent the capital structure mirrors the institutions of the country where the company runs its businesses? Does the firm belong to the common law (Anglo-Saxon countries) or the civil law (continental European) tradition?
e) What kinds of conflicts of interest arise among stakeholders and how should they be relieved?
f) How are protected the property rights of creditors and stockholders? How good is the law environment to enforce contracts?

g) To what extent the information provided by the firm to owners and third parties is accurate and reliable? What about the way such production of information is influenced by current accountancy and auditing practices?
h) What are the incentives fostered by formal and informal institutions so that companies become more efficient and reputable?
i) To what extent managers are prevented from plundering owners or creditors?

j) How good are the covenants that the company pledges on behalf of creditors, owners and other stakeholders?
k) To what extent a legal framework holding in a country can be regarded as a competitive advantage for companies willing to invest in that country?
l) Which is the way capital-flows move around within and between national boundaries? What about the regulations in capital markets and the money markets across boundaries? Is there a fiduciary capitalism? *(The claim for a fiduciary capitalism is well developed in Hawley and Williams, 1997)*

m) How to prevent companies and managers from creative accounting, money laundering and self-dealing?
n) Which corporate governance procedures and practices should be enacted so as to avoid rogue states, crony firms, mafia-partnerships and terrorism linkages, from investing in corporations and banks through special purpose vehicles like those that Enron, and so many companies, set up eventually all over the world?
o) Do good practices in corporate governance pay off? Do they enhance the companies' value?

p) What is the relationship between corporate governance and public governance? For last, what about corporate governance and global governance?

2. CORPORATE GOVERNANCE INCREMENTAL CASH FLOW MODEL (ICFM)

As the former section put forth, a manifold set of issues and concerns arise from this field of learning and practice called corporate governance. It seems advisable, therefore, to make use of some information model that enables either academics or practitioners to keep track of governance matters. In Corporate Finance there is an organizing framework grounded on cash flows that certainly comes in handy to this paper's targets, namely, the incremental cash flow model. Furthermore, it has already been applied to corporate governance (Apreda, 1999, 2001b, 2002a). An outline of this approach follows below.

For any company, it holds that its finance providers lay claim to incremental cash flows brought about by assets along a conventional period [t ; t + 1], usually a month or a year, beginning at date " t " and ending at date " t + 1 ". That is,

$$\Delta CF_t\,(assets) = \Delta CF_t\,(creditors) + \Delta CF_t\,(stockholders) \tag{1}$$

In other words, (1) brings forward that debt holders and stockholders have cash flows rights on the residual income of any company.

Cash flows to debt holders are usually split down into the following components:

$$\Delta CF_t\,(creditors) = interest_t + debt\ repayment_t + debt\ repurchase_t - new\ debt\ issues_t \tag{2}$$

while cash flows to be passed onto stockholders exhibit this structure:

$$\Delta CF_t\,(stockholders) = dividends_t + stock\ repurchase_t - new\ stock\ issues_t \tag{3}$$

It can be seen from (2) and (3) that cash flows directed either to creditors or owners are positive (outflows) unless the company finances itself with new issues; in that case, cash flows become negative (inflows, from creditors or stockholders toward the company). Debt and stock buybacks, on the other hand, are positive since former claims are retired and cash flows delivered to claimants.

Cash flows from assets make up the other side of the coin. Breaking down its main components results in

$$\Delta CF_t\,(assets) = \Delta CF_t\,(operations) - \Delta CF_t\,(working\ capital) - \Delta CF_t\,(fixed\ assets) \tag{4}$$

while cash flows from operations are defined

$$\mathbf{D}CF_t\,(operations) = Ebit_t - taxes_t + depreciation_t \tag{5}$$

where $Ebit_t$ stands here for "earnings before interest and taxes", $\mathbf{D}CF_t$ *(working capital)* for additions to working capital, and $\mathbf{D}CF_t$ *(fixed assets)* for incremental capital spending. It must be borne in mind that the ICFM assume that short-term finance is embedded into $\mathbf{D}CF_t$ *(working capital)* since it performs like an incremental current liability, while interest payoffs of short-term debt get their place in $Ebit_t$, as a matter of course.

Although cash flows from operations (5) measure up free resources after meeting taxes and adding depreciation charges (which are not actual outflows), it would be nonsensical to distribute (5) without taking care not only of working capital but capital investment requirements as well. For instance, we must provision for inventories, receivables and payable accounts so as to cater for working capital needs in (4). Also, fixed assets maintenance, the selling of outdated or obsolete machinery, the buying of strategic fixed assets, are all investments that keep the company running or add up to its competitive edge. A general development of this model is to be found in Apreda (2002b).

2.1 Application of the Incremental Cash Flow Model to Corporate Governance Issues

Several corporate governance problems arise whenever some stakeholders claim back cash flows over which they are entitled to but, for some reason, those cash flows are diverted to other group of stakeholders instead, even with guile, greed or intending to expropriate the claimants outright. For that reason, the incremental cash flow model (1) has to be shaped up so as to disclose the prospective sources of conflicts of interest.

$$\mathbf{D}CF_t\,(assets;\,net) = \tag{6}$$

$$= \mathbf{D}CF_t\,(creditors) + \mathbf{D}CF_t\,(stockholders) + \mathbf{D}CF_t\,(managers) + \mathbf{D}CF_t\,(cash\ assets)$$

where

- $\mathbf{D}CF_t$ *(managers)*: this item means "cash flows to be sent to managers through their pay packages",
- $\mathbf{D}CF_t$ *(cash assets)*: this item amounts to "changes expected in cash that would not be required for operations along the period, and also financial assets in the company's investment portfolio".

As these cash flows had been hidden in the left side of (1), this time $\mathbf{D}CF_t$ *(assets; net)* will mean the "remaining cash flows after we leave out both cash flows to managers and cash assets.

It is for (6) to provide a sharp picture of distinctive issues addressed by corporate governance.

3.- GLOBALIZATION AND CORPORATE GOVERNANCE

After the Second World War, people witnessed the rise of a global economy whose main hallmarks were, according to Gilpin (2000), the following ones:

- Open markets
- Unrestricted capital flows
- Pervasive activity and influence from multinational corporations

In this perspective, multinational corporations carried out a decisive bearing in such broad issues as trade levels and location of economic activities. This understanding comes as an upside, because allows an easy embedding of globalization in the field of corporate governance. A downside of this approach consists of a constrained focus on economic development, leaving aside three distinctive features that have been shaping globalization ever since:

a) a market-led globalization that becomes intertwined with political nested interests;

b) an interstate system plus a composite made up of crony capitalism, mafia partnerships and mega-terrorism setting up a world-system that depends on a capitalist world-economy and its security-structure;

c) the growing role of some institutions aiming for a global governance target.

The market-led globalization and the political interests, as Friedman (2000) forcibly argues, is grounded on three wellsprings of conflicting interests:

- The traditional balance between nation-states: at present, it encompasses the United States on the one hand, and the remaining nations on the other.
- Nation-states and global markets: the latter are led by the Electronic Herd (millions of investors and dealers wired by means of communication networks) that gathers in the most important financial centers in the world, places that Friedman called "the Supermarkets".
- Individuals and nation-states: Some individuals can influence markets and nation-states in more powerful ways than any time before, and that is why they are called "Super-empowered Individuals".

Within this standpoint, some corporate governance issues run smoothly, namely global accountability, tight budget constraints for private and government debtors, investment grade ratings, debt collaterals and securitization, short-term pressures, and global portfolio diversification.

A more encompassing approach, however, it has been introduced by Professor Escude (1999, 2002a, 2002b), who stresses the sum and substance of the "Postmodern World-System":

- A capitalist world-economy
- A fragmented security-structure with weapons of mass destruction

Escude points out the structure of the international system as built up by:

- An interstate composite that comprises those states that make the rules, those that takes rules, and "rogue" states that albeit they are not able to spell out rules for themselves, they are ready to reject those coming from the rule-makers.
- A dominant newcomer: the mega terrorism.

The advantages of this frame of reference for corporate governance seem manifold:

i. The states which make the rules are also those that enjoy the best practices in governance of private or public organizations, while states that take the rules exhibit a wide range of achievers, from outstanding to substandard countries (transitional and emergent economies bearing witness to the latter group). However, the rogue states strike as counterexamples of what might be understood by good practices in corporate governance.

ii. Criminal economic activities, first and foremost money laundering, drug dealing, smuggling of high-tech weaponry, and global terrorism, find out their way through special purpose entities allowed by the governance of global companies or the leniency of investment funds in offshore affiliates (Escude-Zavaleta, 2001).

Finally, an institutional point of view has been undertaken by some scholars trailing behind the United Nations global governance targets (Scholte, 2000). They highlight the following matters of concern:

- Globalization conveys the emergence of a sort of post-sovereign governance, because states cannot be sovereign in the traditional sense.
- The rise of supraterritoriality has promoted moves toward multilayered governance, where regulatory competences are more dispersed across manifold substate, state, or suprastate arrangements and agencies.

Remarks:

i) The Commission on Global Governance (United Nations) defines Global Governance as "the sum of the many ways individuals and institutions, public and private, manage their common affairs. It is a continuing process through which conflicting or diverse interests may accommodate, and cooperative action may be taken. It includes formal institutions and regimes empowered to enforce compliance, as well as informal arrangements that people and institutions either have agreed to or perceive to be in their interest. [...] At the global level, governance has been viewed primarily as intergovernmental relationships, but it must now be understood as also involving non-governmental organizations, citizen's movements, multinational corporations, and the global capital market. Interacting with these are global mass media of dramatically enlarged influence."

ii) Among the most important global governance agencies in the world, we can point to the following: IDEA (The International Institute for Democracy and Electoral Assistance) was created by 14 countries; ECOSOC (Economic and Social Council, UN); IMF (International Monetary Fund); The World Bank; The World Trade Organization; The Bank for International Settlements; OECD represents industrial countries; UNESCO (United Nations Educational, Scientific, and Cultural Organization).

In Section 5.5, we are going to resume this issue in connection with Enron's disgraceful story.

4.- UNDERLYING INFORMATION SETS IN THE BEHAVIOUR OF ECONOMIC AND POLITICAL ACTORS

Financial Economics has been developing an approach based in how the economic agents behave on the grounds of asymmetric information, bounded rationality, transaction costs, opportunistic behavior and agency problems. This approach has recently come in handy not only in Macroeconomics (Drazen, 2000) but also in Political Science (Dixit, 1996). Taking advantage of the author's own line of research (Apreda, 2001) applied to corporate governance and financial economics, we are going to outline this point of view to give grounds on this paper's subject.

*By **Information Set** for any economic or political actor " e " at date " t " is meant all the available information he can assess up to that date.*

We denote such set

$$\Omega(t \, ; e)$$

and the fact that past information up to that date is stored in the current information set can be translated by the condition:

$$\Omega(t - j \; ; e) \subseteq \Omega(t \, ; e) \quad ; \qquad j : 1, 2, 3, ...$$

It goes without saying that "economic or political actor"(also agent) stands here for either individuals, groups or organizations.

When an economic actor turns to the cash flow model (1), he is only able to appraise a heap of expectations that are grounded on his information set at date " t ". That is to say, (1) is conditional to the economic actor underlying information set. Formally,

$$E[\, \Delta CF_t \, (assets) \, ; \; \Omega(t \, ; e) \,] = \tag{7}$$

$$= \; E[\, \Delta CF_t \, (creditors) \, ; \Omega(t \, ; e) \,] \; + \; E[\, \Delta CF_t \, (stockholders) \, ; \Omega(t \, ; e) \,]$$

In a world without conflicts of interest, stockholders, creditors and managers would agree on (7) outright. Furthermore, they would likewise assess how cash flows are produced and distributed. Moreover, all of them would pursue their self-interest, which will help each other to attain their own, in a sort of anonymously competitive-cooperative enterprise (the invisible hand in the market). Finally, any of them would regard contracts fully enforceable, costlessly designed and easily monitored. Unfortunately, this environment has invariably being contested through real world settings.

Having said that, what the economic or political agent actually reaches at date " t " is usually an imperfect information set:

$$\Omega(t \, ; e)$$

that conveys five striking features:

- both individuals and organizations get only restrained admittance to any information;
- two or more parties gain access to dissimilar information sets;
- any economic or political agent may be enticed into trespassing relationships, contracts or legal constraints;
- meaningful usage of information sets cannot be achieved unless the related parties endure and go through a great variety of costs embedded in their transactions;
- in many economic or political settings, a special kind of relationship evolves many times into open conflicts of interest between the parties involved, and being nurtured from their own information sets (the parties being referred as "principals" and "agents", the latter committing efforts and skills on behalf of the former, who grants payment and incentives to the latter).

To reach a discerning understanding of these five features, we have to delve into sensible explanations. They will be, namely, bounded rationality, asymmetric information, opportunistic behavior, transaction costs and agency problems. (From here to the end of this section, we are going to profit from an earlier paper where we focused on what we then called " the brokerage of asymmetric information " (Apreda,2001a)).

4.1. Bounded Rationality

As for gaining access to information sets, either time or effort spending seems unavoidable.

Bounded rationality *refers to the manifold costs that arise whenever the economic or political actor looks for, finds out, gather, processes, organizes, evaluates, stores, makes meaningful use of, or trades with information.*

It was Herbert Simon (1947) the first to install this subject as academically relevant, giving rise to the Bounded Rationality Approach. Since models of bounded rationality are grounded on the idea of scarcity, they deal with human cognition like a scarce resource. Furthermore, deliberation about an economic decision is also a costly activity in which the decision maker tries to achieve a balance between the benefits of better decisions and the cost of additional allocation of effort to the decision-making process. (This topic is extensively developed in Conslisk, 1996).

The main concern with bounded rationality lies on the fact that contracts are in practice not only incomplete but costly to be designed, monitored and enforced. In other words, drafted contracts are not able to foresee all the contingencies, courses of actions and their likely consequences.

4.2. Asymmetric Information

Either economic or political actors, as well as their intermediaries, while exchanging goods and services among them, or political actors when dealing with their political transactions, they jointly engage in a twofold process (Apreda, 2001a):

- the actual trade of goods, services, political trade-offs, contracts, financial securities, or derivatives vehicles defined upon underlying real goods and financial securities;
- a virtual exchange of smaller subsets of their information sets so as to bind both parties within the boundaries of their common knowledge.

This process leads to the issue of asymmetric information. In fact, let us suppose that agent "k" (the principal: a company owner for instance) is about to offer a contract to "s" (the agent: a manager for instance). In other words, they exchange compensation granted by "k" for effort, proficiency and a fiduciary role promised by "s". In order to do so, they share information, but only to a certain extent, as it is shown in picture 1. That is to say:

$$\Omega(t ; k) \neq \Omega(t ; s)$$

Although this feature should not prevent counterparts from rounding off their transactions, a new development arises. One of the parties may take advantage of non-shared information on behalf of his own interest to the extent of getting much more from his counterpart than it would have been the case if that private information had been shared. By the way, this environment is at the root of almost every matter in Politics.

Asymmetric Information *refers to the advantage one party can enjoy by having different information than his counterpart, so as to improve either from the trade or the relationship for his own benefit.*

Picture 1 conveys the main idea. Both agents share some information for sure, as we can see in the subset of common knowledge $\Omega(t ; k) \cap \Omega(t ; s)$, but they also have information that remains hidden or non-accessible to each counterpart. In this case, we can point at two subsets that are private information regions: agent "k" keeps non-shared information for himself, and the same can be predicated on the agent "s" likely behavior.

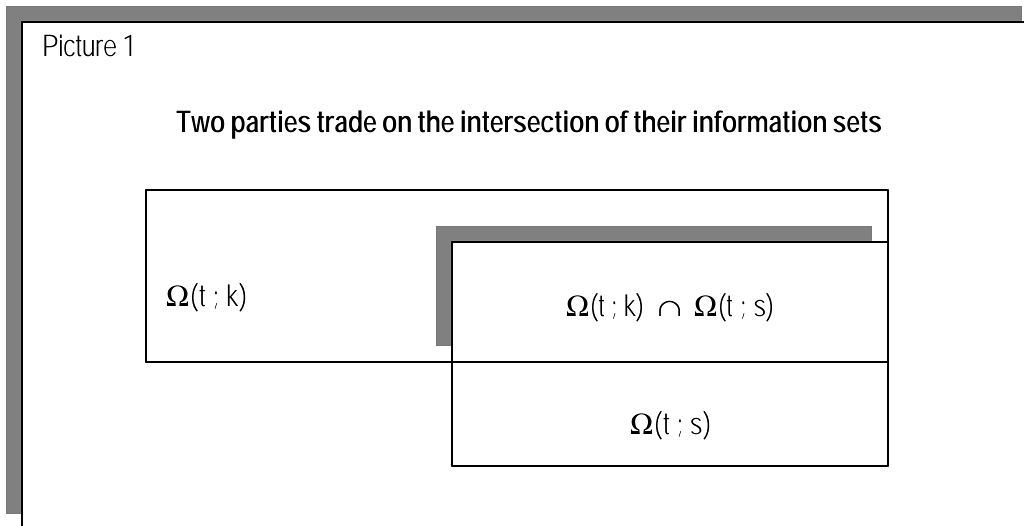
Why would the economic or political actors take profit of non-shared private information, rendering in that way conflict of interests? The answer lies on opportunistic behavior.

4.3. Opportunistic Behavior

It has been a tenet of Economic Analysis that agents behave so as to fulfill their self-interest (Adam Smith, 1777). However, this standpoint falls short of explaining what really takes place in down-to-earth transactions.

But it is when we think that agents perform their goals in a world of future commitments and uncertainty, that the concurrence of self-interest and the likelihood of breaking promises to deliver goods, services, efforts or payments in the future, both lead to ***Opportunistic Behavior****.*

If one party knew something that the other did not, that party might willingly distort, misrepresent or not disclose such information on his own benefit, what actually amounts to self-interest with guile. Opportunistic behavior can follow even without asymmetric information (pilfering and shirking at the workplace being current examples), albeit asymmetric information often seems a driver for opportunism.



In fact, asymmetric information does provide with advantage to its holder, and explains a lot of things about market intermediaries (see, for instance, Demsetz, 1968 or Spulber 1996). Arbitrageurs and speculators, for instance, take profit in markets from their superior information sets, without necessarily impairing counterparts' property rights or fostering conflicts of interest.

This example proves that asymmetric information is not a sufficient condition for opportunism. Smart economic actors playing in the markets grab opportunities and reap the gains of the trade without becoming opportunistic eventually.

To make precise the boundaries between "smart" behavior of well informed economic actors and "opportunistic" behavior, Williamson and others add to the latter a further qualification by means of the phrase "with guile", that is, the use of clever but dishonest behavior in order to deceive other people.

Picture 2 deploys the fact that, if opportunistic behavior were to take place, it would come out of the "private domains" within those information sets that each actor keeps under wraps:

- for the economic or political agent "k", it is the subset $\Omega(t\,;k) \cap \Omega^{C}(t\,;s)$, which reads as " the points in the information set $\Omega(t\,;k)$ not shared by the set $\Omega(t\,;s)$ "
- for the economic or political agent "s", it is the subset $\Omega^{C}(t\,;k) \cap \Omega(t\,;s)$, which reads as " the points in the information set $\Omega(t\,;s)$ not shared by the set $\Omega(t\,;k)$ ".

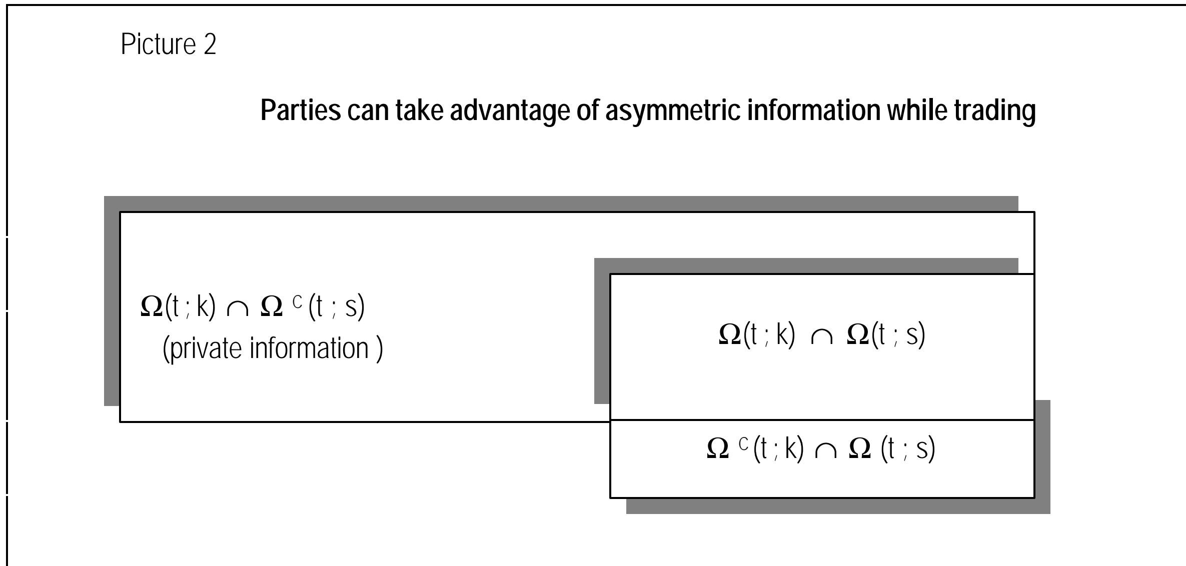
Summing up, the region where most of conflicts of interest arise consists of both information sets excluding their intersection. This amounts to what in Mathematics is called the "symmetric difference set":

$$\Omega(t\,;k)\ \Delta\ \Omega(t\,;s) = [\ \Omega(t\,;k) \cap \Omega^{C}(t\,;s)\ ] \cup [\ \Omega^{C}(t\,;k) \cap \Omega(t\,;s)\ ]$$

Remarks:

i) It can be argued that one party may even perform opportunistically in the intersection of both information sets. Although this event is a likely one, for instance when one party behaves in a stupid way, bounded rationality would rule out this outcome most of the time.

ii) Mathematical foundations for the structure of information sets, based on rings and algebras of sets, can be found in Apreda (2000b).



Generally speaking, we must bear in mind that some of these single and private subsets may convey information not relevant to the transaction. It is what remains of those subsets, however, that nurtures different kinds of knowledge pertaining any trade, as represented in picture 3.

i. Not every piece of information included in the information set of the agent "k" is actually needed for a particular transaction. Hence, we can isolate at date " t " pieces of information not relevant for the trade:

$$\Omega(t\ ;\ k;\ \text{irrelevant to the transaction})$$

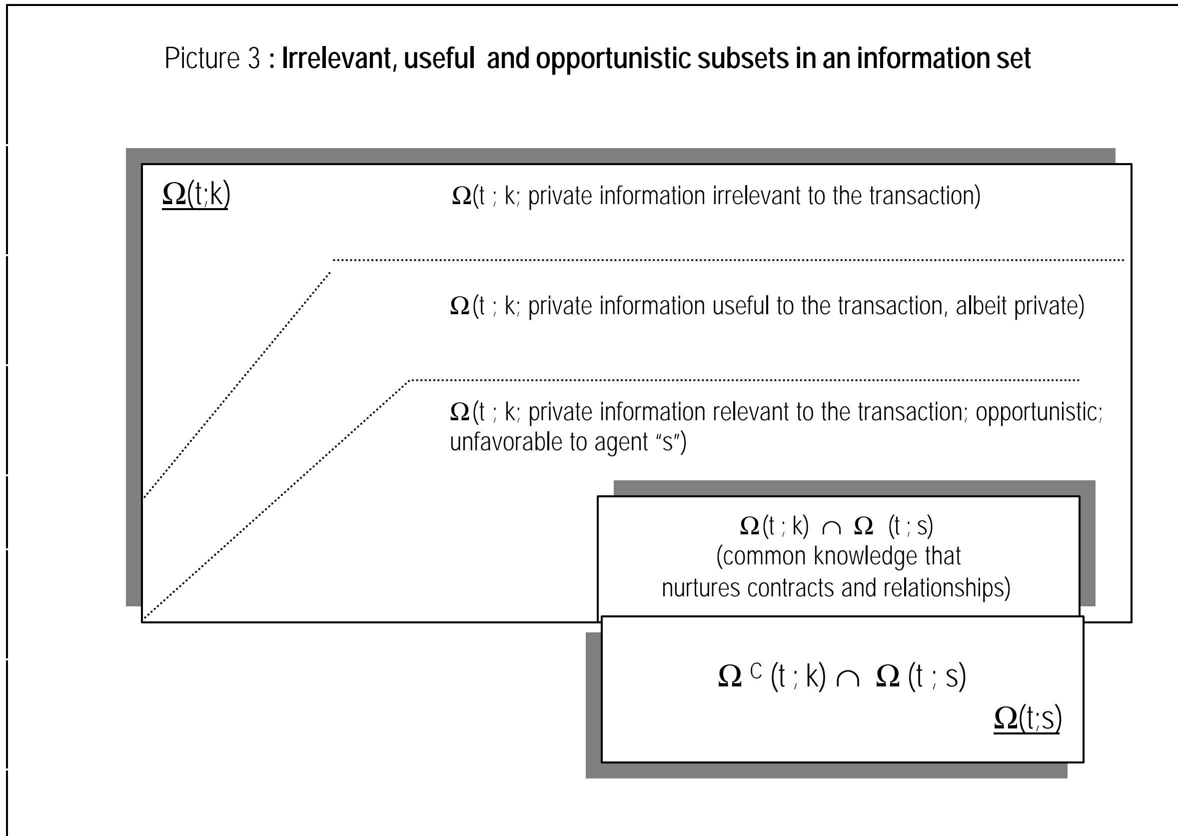
ii. Next, useful information for the party but not harmful towards the counterparts interest (namely, know-how, expertise, professional qualifications, customers and advisers networks, reputation) is found in the subset

$$\Omega(t\ ;\ k;\ \text{useful to the transaction albeit private})$$

iii. Finally, useful information for the party, but the sort of which conveys impairment or damage to the counterpart's interest is included in

$$\Omega(t\ ;\ k;\ \text{relevant to the transaction; opportunistic; unfavorable to agent "s"})$$

There are four types of opportunistic behavior that have deserved a distinctive concern from academics and practitioners dealing with financial markets (and later embraced by macroeconomists and political scientists): hidden action, hidden information, free-rider problems and signaling. By giving a brief summary of each of them, we would like to stress the fact that they are powerful devices to impair or even lessen the quality of information sets, preventing reliable information from spreading over parties, markets, prices and constituencies.



Picture 3 **: Irrelevant, useful and opportunistic subsets in an information set**

a) Hidden Actions

At the root of ***Hidden Actions*** lies the problem of the extent to which actions (efforts, behavior, decision making, performance or tasks to be accomplished) can be observed or monitored. Therefore, there may be an inducement for one party to keep a likely profitable personal agenda, leaving for the counterpart to foot the bill. On the other hand, to cope with hidden action seems of the utmost importance to handle verifiable or measurable variables of performance, that is to say, variables that can be checked by an independent arbitrator. In the context of an agency relationship this sort of asymmetric information paves the way to moral hazard. (Prescott,1999)

b) Hidden Information

At the root of ***Hidden Information*** lies the problem of the extent to which relevant characteristics can be known or screened beforehand by counterparts in any trade. They can be personal or non-personal. By personal characteristics we mean, for instance, biographical features, professional qualifications, past experience track, personal skills, and credibility from each party at trade. By non-personal we point at characteristics found in goods or services rather than in human beings: quality, maintenance, contents, sanitary conditions, compliance with set standards, packaging, after-sales service, consistency between what is promised and it is delivered. Hidden information also means information on some relevant state of nature which can influence the outcome of the relationship between counterparts in any trade or lasting contract. Faced with a set of feasible contracts, non-neutral to risk people will select different contracts; this means self-selection or, from the company's point of view, adverse selection. In the context of an agency relationship this sort of asymmetric information leads to Adverse Selection matters. (Cummings, 2001)

c) Free-riding problems

This sort of problem arises whenever some people would rather profit from information gathered by others than invest in such information on their own; that is to say, they get a ***Free-ride*** on somebody else's effort. Investors who buy or sell only after knowing what dealers with a longstanding reputation are doing, is a good example. If some investors acquire information that tells them which securities are undervalued (overvalued) and they buy (sell) these securities, other investors who have not paid for this information may be able to buy (sell) right along with the well-informed investors, who don't reap all the profits they could have done otherwise. Savvy suggestions on free-riding problems arising in Politics may be found in Buchanan (1975).

d) Signaling

Opportunistic behavior advises the economic agent to hold back private information whenever he can obtain greater utility by keeping it secret. But sometimes, plain opportunistic behavior may encourage the economic or political agent to let the other part know a bit of hidden information, whenever by doing so he will be able to improve his welfare or get better terms in the transaction. A ***Signal*** is some activity or decision by which the agent claims a certain ability or characteristic. For instance, education acts as an important signal for human resources departments in corporations and banks, conveying the message "this person is able of learning, being trained, and brings with him a distinctive professional qualification". Signaling by means of market behavior is well developed in Fremling-Posner (1999).

4.4.- Transaction Costs

The Transaction Costs Approach matches bounded rationality with self-interest-seeking, even to the extent that rules or contracts might be trespassed on with guile. It also recognizes that any time economic or political agents behave opportunistically they may disclose information only to their own advantage, by selecting and distorting it within broad contexts of personal agendas and agency misdeeds. Williamson (1996) defines transaction costs this way:

"The ex~ante costs of drafting, negotiating and safeguarding an agreement and, more especially, the ex~post cost of maladaptation and adjustment that arise when contract execution is misaligned as a result of gaps, errors, omission, and unanticipated disturbances. Also it refers to the costs of running the economic system."

Nevertheless, to regard the economic agent behavior as the main source of transaction costs may be misleading, because institutions and technology have a conclusive say in the ultimate size of transaction costs (North, 1990). Hence, a broader outline should include intermediaries (Spulber, 1999) and also encompass important cost components like trading, information, taxes, financial and microstructure costs (Apreda, 2000a, 2000b). Lastly, transaction-cost politics in an all-inclusive perspective is attempted by Dixit (1996).

4.5. Agency Problems

Agency relationships stand out among the major determinants that shape the structure of any organization and their distribution of decision rights. They consists of the following features:

- there are two parties: a "principal" (one or more) and an agent (one or more);
- the agent commits effort and proficiency so as to work on behalf of the principal's interest;
- the principal promises a compensation and incentives for the agent to fulfill his commitment;
- the relationship is grounded on a contract, either formal or informal.

A wide variety of sources can bring about problems to this kind of relationship, usually labeled ***"agency problems".*** Particular stress must be laid on the following sources:

- Incomplete and costly contracts that arise from bounded rationality and transaction costs.
- Drafting, enforcement and monitoring tasks that are hindered by asymmetric information and opportunistic behavior.
- Ex~post residual agency costs, arising from unexpected agency problems, left out of ex~ante contracts.

Within for-profit organizations, agency problems are rooted in conflicts of interests among owners, managers and creditors that evolve from the normal running of the company to the extent of financial distress (background on this subject in Jensen-Smith, 1985). In the basic setting, we find the shareholders expecting that their agent managers (officers and directors) service the firm's debt and set up a growing residual value for its owners. Creditors, on their own, have lower risks linked to their property rights than owners. Managers have contractual duties to creditors but fiduciary duties toward their principals (where the term fiduciary stands for acting on behalf of the interest of the principal with the same prudence as if agents were promoting their own interests). But if a company became financially distressed and insolvency threatened, managers' fiduciary duties would shift away from value enhancement owed to shareholders, toward preserving value for creditors. In this environment, corporate assets are regarded as a trust fund for the benefit of the creditors.

5.- CASE STUDY: ENRON

Enron's demise in December 2001 brought into light an outrageous counterexample on what good corporate governance stands for. It shook not only the corporate world but the ultimate foundations of capitalism. At the end of the day, this experience conveys a lesson and sets up a strong claim about deep changes in practices, regulations and information production.

As this story evolved through fifteen years, we can find many instances in which Enron was signaling deception and malfeasance albeit the gatekeepers remained stonily lenient, substituting sleaze, political peddling, and greed, for fiduciary duties, accountability and full compliance with the law. The damage this shameful case uncovered goes beyond investors and markets, to threaten core beliefs and values in Democracy, Liberalism and good practices in corporate and public governance.

We are going to review the main events that took place in this narrative, by means of a series of exhibits that will run every other page. Each of them consists of two columns, the first one highlighting the triggers of particular reactions or developments, the second one sorting out their consequences for Enron's corporate governance. Meanwhile, in the opposite page to each exhibit, some distinctive issues will be expanded on so as to understand much better the background within which Enron's case will be remembered as an ill-fated tale of crony capitalism and opportunistic behavior with guile.

5.1. FROM BEING A GAS COMPANY TO BECOMING A DERIVATIVES TRADING ROOM PLUS A HEDGE FUND

In 1990, the Commodity Futures Trading Commission (CFTC) decided to let Enron and a handful of other companies profit from largely unregulated energy-trading businesses. Two years before, Enron had used its political clout to get Congress to exempt it from both CFTC and the Security and Exchange Commission (SEC) regulation and oversight of what had become, in essence, a publicly traded hedge fund making its own highly speculative investments.(The Economist, December, 2002). (***Exhibit 1 and 3***)

Technically, hedging with a third party conveys that if the value of the investment goes down, the outside party will ultimately bear the loss. But Enron exchanged its own stock to a Special Purpose Vehicle (SPV) in exchange for a promissory note. For instance, through options, futures or swaps, the SPV would take on the risk that an internet service provider called Rhythms would see its stock's value going bust, by hedging Rhythms stock.

5.2. SPECIAL PURPOSE VEHICLES (SPVs)

SPVs (also called special purpose entity, SPE) are limited partnerships, and they can be omitted from the company's consolidated financial statements as long as parties independent of the company provide at least 3% of the SPV's capital. The remaining 97% is funded by loans from external lenders. (***Exhibit 7***)

ENRON MAIN EVENTS AND CORPORATE GOVERNANCE ISSUES (Exhibit 1)	
Events	**Corporate Governance Issues**
1985 Merger of Houston Natural Gas with Inter North gave rise to Enron. The deal integrated pipelines systems to create the first nationwide natural gas pipeline system. It begins to work not only in gas, but also in oil and gas exploration, and liquid fuels as well.	**Incremental cash flows from assets: strategical key point** As Enron's profitability was dependent on the price of gas it would take advantage of deregulation in the sector. **Underlying assumption**: Fall in prices would follow. **Year end 1985** *Revenue: $ 10.2 billion (10% international)* *Net Income: $ 125 million (13% international)* *Market Capitalization: $ 2.0 billion* *61 % Debt / Total Capital* *Gas Pipeline: 37,000 miles*
1986: Kenneth **Lay** appointed as CEO and Chairman. He had been chief executive officer of Houston Natural Gas. **1987**: Enron faces an environment of risky swings in prices. **1988**: First overseas office in **England** **1988**: George W. **Bush** elected President of the United States of America	**Incremental cash flows: short-term goals and tight budget constraints** a) Debt reduction (Enron was the outcome of two pipeline merger and did so by increasing its debt burden) b) Operating expenses reduction, scale back other business lines and find growth opportunities. c) Campaign for changes in federal energy rules to allow natural gas to be sold on open markets like any commodity. **New business definitions** Develop services that reduce the risks of price swings. **Underlying rationale** a)To take advantage of England's privatization of power industry and enter unregulated markets to match its business in the regulated pipelines. b) Buy or develop an asset (a pipeline, a power plant) and then expand it by building a wholesale or retail business around the asset.
1989 Jeffrey **Skilling** joins Enron, after being Enron's consultant for a while. Carlos **Menem** is elected President of Argentina	**Off-balance sheet incremental cash flows and short -termism** Skilling builds up the future core business at Enron: a) The company pioneers in the use of management risk products and long-term contracting structures. b) Change Enron from a natural gas supplier into an energy-trading company to serve as intermediary between producers (natural gas and electricity) and end users. c) Cope with pressures on Enron's financial reports and credit ratings arising out of the "underlying rationale".

Enron transferred its own stock to an SPV in exchange for a promissory note and/or cash. The SPV would hedge a particular investment in Enron's balance sheet, by matching it with Enron's stock. If prices were up and up, then Enron would not pay on its guarantees. When Enron's price fell, the SPV's value fell too, triggering the guarantees payment, and worsening Enron's value. When both assets and stock fell, the SPV would be unable to perform its hedge. Finally, the SPV's debt should end up onto Enron's balance sheet.

5.3. LIMITED PARTNERSHIPS HAD A COMMON FLAW: NOT ONE OF THEM WAS TRULY INDEPENDENT FROM ENRON

Let us see some features attached to this financial engineering.

a) SPVs were used to shift poorly performing assets from Enron to these affiliates, that become off-balance sheet items. $27 billion out of $60 billion had been transferred this way by the end of 1999. Many big names in Wall Street were involved, as well pension funds and equity investors. To get assets off its books, a company typically sells them to an SPV, which funds the purchase by borrowing cash from institutional investors. As a sweetener to protect investors, many SPVs incorporated triggers that require the parent company to repay loans or give them Enron's additional securities if its stock feall below a certain price, or in case credit rating agencies downgraded its debt. (see example 1)

b) Enron's engaged at the end of each quarter through lots of deals with SPVs, reversing most of the deals at the beginning of next quarter, always at a profit for the partnerships. In most cases, these mechanisms amounted to lease transactions by which an asset was sold to an SPV and later leased back to Enron, which increased the value of assets while outstripping them for a while from its income statement. Here comes to light the main rationale, because the creative accounting allowed Enron to keep safe and sound its investment grade rating.

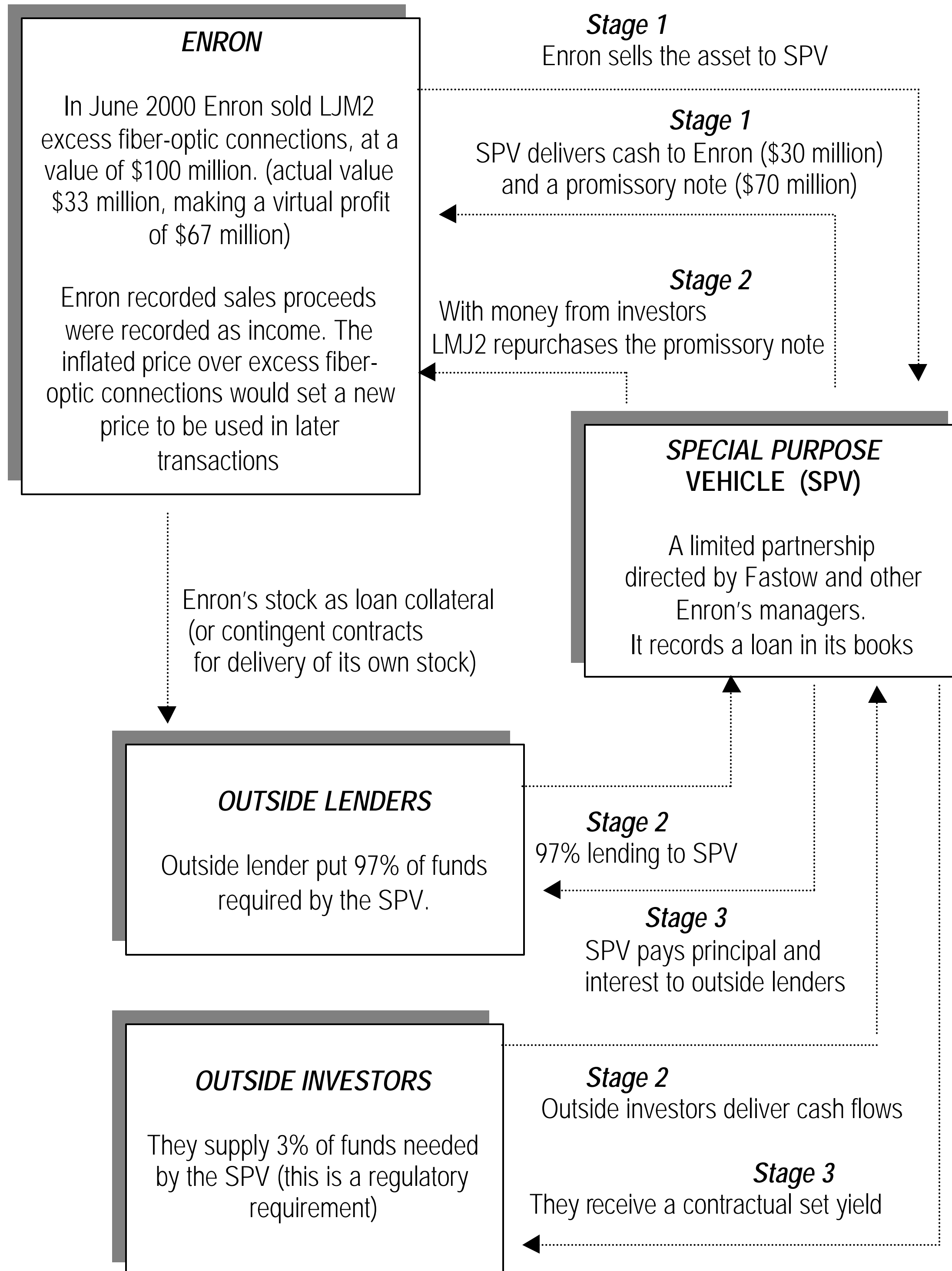
c) When Enron's Energy Service division agreed to supply power to a company at a fixed price, it made optimistic projections that energy prices would fall enough in the future so as to guarantee Enron a healthy profit. On this ground, it could report the expected profit as soon as it signed the contract. The accounting rule required Enron to mark-to-market the value of its energy trades. If the market is active, then you can get prices. When there is no such market, companies must resort to fair values figured out by means of financial valuation models. Enron excelled both at devising model values and keeping them under wraps to market analysts, regulators and institutional investors. (***Exhibit 5***)

d) Blockbuster Deal: Enron set up a partnership called Braveheart, raising $115 million from a bank in exchange for a promise of most of the expected earnings from the deal for some years, as well as other money that would come from outside investors; finally it put some of its own stock at stake. If earnings were not enough for the bank, Enron promised that it would repay the balance to the bank. Afterwards, it reported the whole transaction on a mark-to-market basis, discounting future cash flows to get an up-front income, albeit a virtual one. In this way, it recorded $110 million as flat profit. But prices plummeted and, very soon, Blockbuster left the deal. (***Exhibits 8 and 10***)

ENRON MAIN EVENTS AND CORPORATE GOVERNANCE ISSUES (Exhibit 2)	
Events	**Corporate Governance Issues**
1989 Skilling launches Enron's Gas Bank	**Hidden action and information in the incremental cash flows from assets** a) It is a program under which Enron buys large volumes of gas from producers and resells it to industrial customers on long-term contracts, locking in supplies at fixed prices, stabilizing the US gas market. b) Besides, it offers financing for oil and gas producers.
1991 a) **India:** it faces global changes b) **Argentina:** it launches deep economic changes, privatizations and deregulation.	**Global governance and funding** a) The World Bank suggests India to open up to foreign investment in oil and power plants. b) The World Bank approves loan to privatize Argentina's oil and gas companies.
1992 a) **Bolivia:** a gas privatization program b) **Argentina**: gas business c) **India:** signs with Enron a memorandum of understanding for Dabhol's power project, the largest deal in the country's history (worth $ 30 billion over its lifetime). William J. **Clinton** is elected President of the United States.	**Global governance and funding** a) The wave of deregulation and privatizations makes sense for an expansion of Enron's businesses in emergent economies. The World Bank finances Bolivia privatization program. b) Argentina receives $25 million from OPIC in insurance over next four years to Enron's pipeline, Transportadora de Gas del Sur, which partially acquires. c) In 1992, a World Bank's report highlights adverse financial impact of the Dabhol's project on the Maharashtra State Electricity Board.
1992 a) Enron starts taking disguised loans as hedging for commodities and trading resources. By doing this, it keeps the loans off-balance sheet. b) Funds provided by JPMorgan Chase, Citigroup and Credit Suisse First Boston. c) In practice, Enron also becomes an over the counter derivatives trading firm.	**Opportunistic behavior through investors' deception and creative accounting** a) If Enron had disclosed the money as debt, credit ratings agencies and industry analysts would have known that it was riskier than it seemed to be, hence downgrading the company outright. b) The loans were set up mainly as prepaid swaps, by which banks give an up-front payment forecasted from future expected cash flows, and Enron was to repay for a fixed number of years. (It amounts to a synthetic loan). Another vehicle was a loan to be repaid in two years, contingent on changes in the price of oil. c) Enron recorded these transactions as "assets from price risk management" and "liabilities from price risk management". Although the accounting treatment was done within accounting recommendations for prepaid swaps, procedures became secretive and deceptive.

e) Example 1 provides a simplified diagram to explain how a SPV works when the parental company sold assets to the limited partnership.

EXAMPLE 1: ASSET SALES THROUGH AN SPECIAL PURPOSE ENTITY



ENRON MAIN EVENTS AND CORPORATE GOVERNANCE ISSUES (Exhibit 3)

Events	Corporate Governance Issues
1993 a) **Guatemala:** Puerto Quetzal Power Co. b) **Philippines:** Batangas and Subic Bay Co. c) **Venezuela:** natural gas business d) **Trinidad-Tobago:** projects in oil and gas development.	**Global governance and funding** a) A Guatemalan company was set up by Enron and when an increase in rates up to 100 % was enacted, political crisis ensued and President Serrano fled the country. b) In the Batangas concern, Enron has ownership and receives OPIC $30 million support. c) US Export-Import Bank, Coface (France) and Sace (Italy) provide $290 million for natural gas premises, in which Enron has 50 % of the stake. d) In Trinidad-Tobago, Enron has 95 % ownership and receives $100 million in insurance from OPIC. (Wysham-Vallette, April 2002)
The Federal Energy Regulatory Commission grants Enron an exemption from reporting requirements in electricity contracts.	**Political peddling and sleaze** The Federal agency was chaired by Wendy Gramm, the wife of Senator Phil Gramm, who was a well-known recipient of Enron's political money.
1994 First electricity trade contract	**A new profit center** It is a likely concoction of the Risk Management Division
a) **Dominican Republic:** power stations b) **Colombia:** Promigas pipeline project c) **India:** Dabhol power plant would cost $3 billion. d) **Turkey:** power plant e) **Philippines**: Batangas Power plant.	**Global governance and funding** a) The World Bank invests over $200 million in Power and Pipelines in Dominican Republic. b) The World Bank provides $30 million to Promigas. c) Indian project is financed with $600 million by OPIC and Ex-Im (guarantees and financing). Belgian, Japanese and Indian banks furnished additional financing. The State of Maharashtra gives Enron a guarantee "to indemnify and keep the company against any loss sustained or incurred by the company by reason of the invalidity, illegality or unenforceability of the deal". In a counter-guarantee to Enron, the Republic of India stakes all its assets (including those abroad, save diplomatic or military) as surety for the payments due to Enron. d) Enron owns 50 % of a power plant, and OPIC agrees on a loan up to $295 million. e) OPIC and the Asian Development Bank provide $76 million to Batangas.

5.4. HOW "RAPTORS" PLAYED UP DECEPTION

To hedge its profits, Raptors were created as investment entities, furnished with Enron stock and stock options eventually. Raptors issued promissory notes to pay back and committed to hedge for the value of emerging companies whose stock Enron owned. Money to Raptors came from SPVs, which funded themselves with institutional investors and banks. (***Exhibit 8***) Should the price of emergent companies stock fell, Raptors make it up for the decrease so as to protect SPVs and their creditors. In Enron's books, Raptors performed as an independent speculator providing hedging.

Enron made use of its own equity value to counteract declines in the value of certain of its merchant investments, thus preventing losses from being recorded in its income statement but diluting stockholders value. To accomplish this, Enron entered into derivative transactions with the Raptors, a sort of accounting hedging. If the value of the merchant investment declined, the hedge would increase by an equal amount, and this could prevent the income statement from disclosing any loss. But it was not an actual hedge, with a third party ready to assume the risks of a decline in investments. Instead, Enron and LMJ2 created the raptors, ending up with only an internal risk-hedging architecture, by means of transferring Enron stock (or contracts to receive Enron's stock), to the SPV and at a discount of market price. As long as Enron's stock kept its value, the Raptors could stand ready to pay for the hedging. ***All this procedure goes against accounting principles: a business may not recognize gains due to the increase in the value of its capital stock on its income statement.*** When the value of Enron's merchant investment fell in late 2000 and early 2001, the Raptor's liabilities with Enron grew, but also fell Enron's stock, impairing Raptors to honor the hedging eventually. That's why Enron had to terminate Raptors and disclose in October 2001 more than $500 million charge after taxes, and an amazing shareholder's reduction of equity by $1.2 billion. (***Exhibit 5***)

We are going to outline two kinds of limited partnerships as used by Enron, albeit many details about them remain unclear so far. Besides, Example 2 provides with an exhibit that outlines what was taking place with raptors and SPVs.

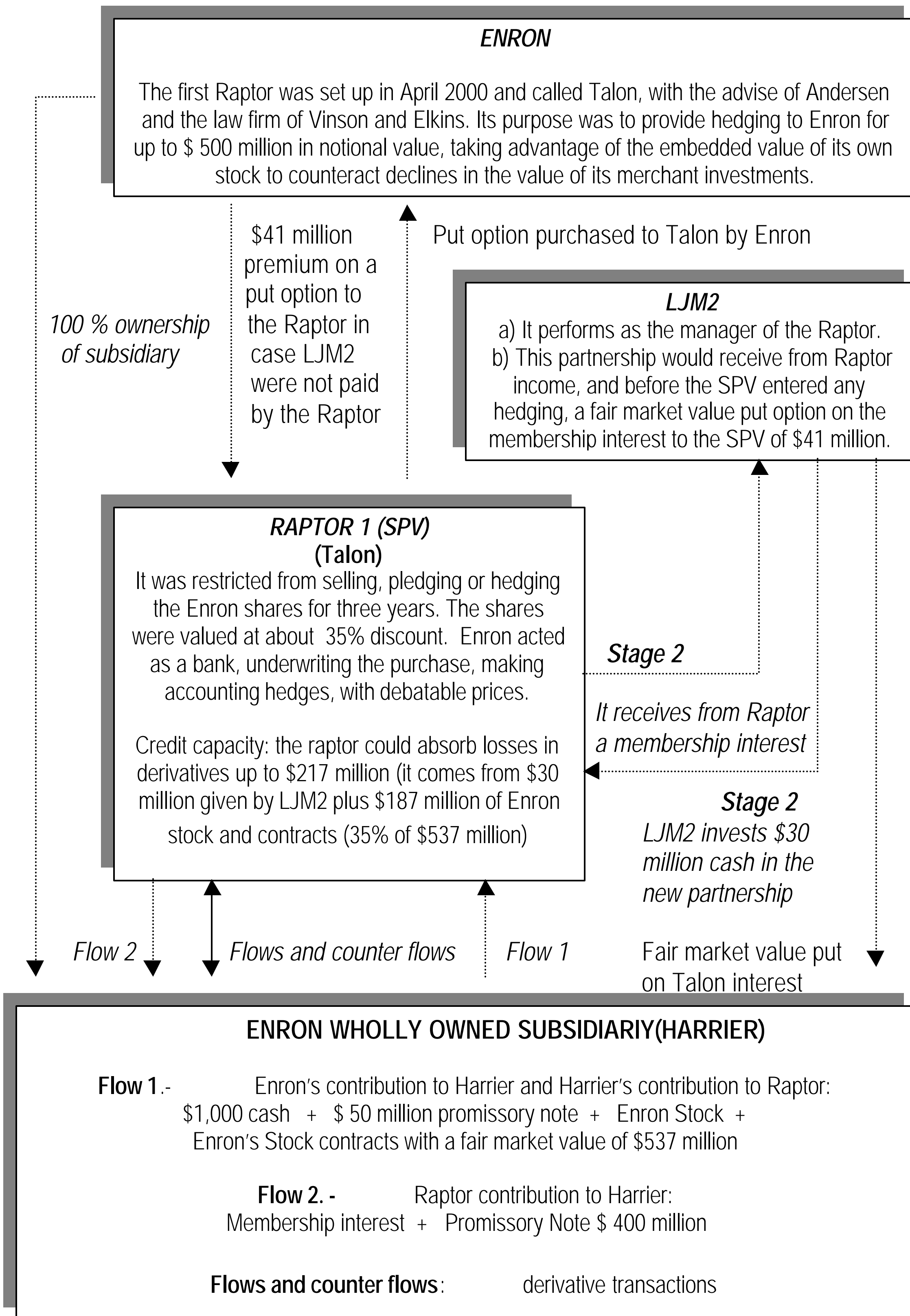
a) *In 1997, Chewco is designed to keep off Enron's balance sheet a distinctive merchant investment, the Joint Energy Development Investment (JEDI).*

From 1993 to 1996 Enron and Calpers (California Public Employees' Retirement System), were partners in a $500 million joint venture investment partnership called Joint Energy Development Investment Limited Partnership (Jedi). Jedi was not consolidated in Enron's financial statement because it was shared with Calpers. In this way, gains and losses were recorded in the income statement, but it did not show Jedi's debts. Calpers put $250 million in cash and Enron in its own stock only.

In November 1997, Chewco came to light in order to allow Calpers to leave the partnership paying $383 million to close the deal. Chewco finances the purchase of Jedi's interests with debt with two banks giving Enron stock as collateral. It did not record the deal in Enron's books, not even complying the rules of non-consolidation in SPVs. AsMr. Fastow was a Senior Executive running Chewco he appointed a close friend of his, Mr. MichaelKopper (director of Enron Global Finance) to lead the project, with an initial personal stake of $125.000, earning more than $2 million as management fees from 1997 to 2000. When in March 2001 Enron repurchased Chewco, Kopper received more than $10 million. (***Exhibit 5***)

ENRON MAIN EVENTS AND CORPORATE GOVERNANCE ISSUES (Exhibit 4)	
Events	**Corporate Governance Issues**
1994 July: **Bolivia-Brazil** pipeline.	**Global governance and funding** Enron won a public bid to partner with YPF Bolivia the construction of the Bolivian side of the pipeline. The incumbent president, Gonzalo de Lozada started negotiations with Enron five months before the date, but only leaving other bidders 13 days before deadline. In December 1994 the contract was signed in New York between Sanchez de Lozada and Enron, utterly illegal under Bolivian law. Enron was allowed to set up an international offshore company dodging Bolivian taxes. In first quarter 2002, a Congress committee began to investigate these deals, and was told by the government that the contract has disappeared. Besides, Enron has committed environmental negligence and likely crimes.
1995 Enron's division in Europe establishes a trading center in **London**. President Carlos **Menem** gets reelection in Argentina. a) **Dominican Republic**: power stations. b) **Turkey**: power plant.	**Wholesale Business** Enron enters the European wholesale markets. **Global governance and funding** a) Enron acquires 50% of World Bank ownership in the power plant. b) OPIC supplies $295 million to Enron's investment.
1996 a) **Argentina**: gas pipeline. b) **Bolivia**: World Bank loan to pipeline. c) **China**: power plant. d) **Colombia**: Promigas plant. e) **Panama**: Bahia Las Minas power plant **California** deregulates the state's power sector.	**Global governance and funding** a) The Argentine southern gas pipeline wholly owned by Enron and the Chinese National Petroleum Corporation. b) Bolivian pipeline runs from Bolivia to Brazil. Enron is a major shareholder to which OPIC will lend further. c) The power plant is run by Enron. The guarantee comes from the World Bank. d) World Bank extension of $35 million to Promigas. e) Enron's plant Las Minas gets guarantee from Export-Import Bank to Bank of Boston for financing sales of gas turbines. (Wysham-Vallette, April 2002)

EXAMPLE 2: A RAPTOR STRUCTURE TO HEDGE ENRON'S MERCHANT TRANSACTIONS



ENRON MAIN EVENTS AND CORPORATE GOVERNANCE ISSUES (Exhibit 5)	
Events	**Corporate Governance Issues**
1996 **India:** construction of Dabhol power plant in India starts, after being signed in 1994 but delayed by political concerns. President William J. **Clinton** gets reelection.	**Global governance and funding** The project amounts to $3 billion and faces domestic political problems and rampant corruption allegations from scratch. OPIC supplies guarantees needed by Enron's in oil and gas field development. Riots and strong criticism tarnishes the company's reputation. In 1995 the State of Maharashtra filed suit in the Bombay High Court seeking cancellation of Dabhol's contract on grounds of fraud, corruption and misrepresentation. In May, the new government signs a counter guarantee on behalf of Enron.
1997 **Jeffrey Skilling appointed as President**. Skilling builds up the Energy Services Division and The New York Mercantile Exchange awards Skilling for Global Vision in Energy.	**Incremental cash flows from assets** Shift from an asset-based pipeline and power generating company to a marketing and logistics company. **Information production and disclosure to markets, regulators and stakeholders** Lou Pai is appointed as divisional CEO and starts using **mark-to-market accountancy** (and reporting virtual profits when the contract was signed, on 10-year assumptions about future energy prices and use, although the money would not come in for years, if ever). This is a debatable information disclosure technique to profit from deregulation of electricity markets. Its mission will consist of providing energy management services to customers.
1997 a) **Brazil** launches the liberalization of its energy markets. b) **Gaza Strip**: power plant . c) **Indonesia**: gas power plant. Scalpers' interest in JEDI bought by Enron.	**Global governance and funding** a) Enron's Bolivia-Brazil project gets $1billion from Japanese, European and multilateral banks. Enron gets the utility Elektro (Sao Paulo), paying $1.3 billion. b) OPIC and World Bank furnish $37 million in a sensitive area. c) Java plant is guaranteed by World Bank in favor of Enron's investments. **Breach of fiduciary duties by the Board of Directors** Full approval of the buy out.

b) LMJ1 and LMJ2: They allowed Enron to increase its financial reports in at least $1 billion.

LJM1, LP, Cayman (June 1999), allowed to create an SPV called Swap Sub that was used as a counterpart for hedging transactions with put options (rights to sell stock) in order to protect Enron's operations with Rhytmus, a privately held internet service provider.

LJM2,LP (October 1999), was used to build up four SPVs as counterparts to hedge transactions with merchant investments. Outside investors put $349 million in LJM2, which invested millions of dollars in the Raptor partnerships, under the promise of at least 30 percent return. (***Exhibit 7***)

Enron lent $1.2 billion of its stock to Raptors partnerships, promising to issue more stock if the value of Raptors' investments fell, thus insuring the solvency of partnerships. Raptors issued promissory notes. Raptors invested in some of Enron's assets, power plants and pipelines. When asset values and stock prices fell, Enron has to provide more of its own stock to keep the partnership solvent. However, issuing the more, the bigger was dilution against former stockholders. From 1999 through June 2001, Enron entered in more than 20 distinct transactions with the LJM partnerships, some of them intended to sell assets, while the remaining ones to hedge transactions.

5.5. A BLESSED CASH COW FOR INSIDERS

Enron devised a complex executive payment package that became a tangled web of fraud and deception in the managers' hands. From a corporate finance point of view, any such package is to be regarded as a portfolio of cash, financial assets and derivatives. The main components in this portfolio, and their monetary weights, for year 2001, were made known in the files to the bankruptcy court (***Exhibit 12***). The information includes packages enjoyed by 144 executives (including Lay, Skilling and Fastow).

Portfolio Component	Qualification	Amount (U$S)
Salary in cash	base salary, cash allowances, benefit payments	26,704,229
Bonus	annual cash incentives on performance	97,343,619
Long Term Incentive	multi-year (3 to 5 years) on key market drivers performance	48,521,928
Deferred Income	stock option or phantom stock arrangements	- 7,992,891
Deferral Payments	due to termination of employment or in-service withdrawals	32,083,396
Loan Advances	promissory notes with option to repay with Enron's stock	83,925,000
Other	severance, consultancy, relocation costs (also abroad)	42,667,589
Expenses	business expenses reimbursement , fees for consultancy	5,235,198
Director Fees	cash payments and value of stock grants to non-executives	1,398,517
Sub Total		**309,886,585**
Exercised Stock Options	value in excess of exercise price, in cash or stock swap	311,764,000
Restricted Stock (RS)	gross fair market value of shares and accrued dividends	130,322,299
RS Deferred	value of restricted stock voluntarily deferred by arrangement	- 7,576,788
Sub Total		**434,509,511**
Total		**744,396,096**

ENRON MAIN EVENTS AND CORPORATE GOVERNANCE ISSUES (Exhibit 6)	
Events	**Corporate Governance Issues**
1998 a) **Brazil**: Elektro and Bolivian pipeline b) **Panama**: it launches the privatization of the power sector. c) **Venezuela**: natural gas extraction d) **Dominican Republican**: privatization of the public sector e) **Argentina**: Enron International Argentina is granted the first power marketer license in that country. Enron acquires Wessex Water in the United Kingdom.	**Global governance and funding** a) OPIC grants $200 million in Elektro, and $200 in the Bolivian pipeline from Santa Cruz de la Sierra to Cuiaba, Matto Grosso, Brazil. Enron's partner is Royal Dutch/Shell Group. b) International Finance Corporation finances the privatization process. Enron purchases 51% of Las Minas. c) OPIC provides $400 million to Enron's facilities. d) The World Bank gives a loan to Dominican Republic to privatize its power sector. Enron gets a large share in the power business, and after taking over, power rates increased up to 50 %. e) The license allows buying and selling electricity. The company can offer physical delivery of energy commodities, financial energy products and risk management service to commercial and industrial customers. The Inter-American Bank provides Enron with $375 million to finance the pipeline system. **Subsidiaries** With this purchase, it grounds the water subsidiary Azurix. It pays $2,2 billion.
1999 **Broadband business** is launched.	**Investment with misleading assumptions** a) "The market for bandwidth intermediation will grow from $30 million in 2000 to $95 billion in 2004" Enron Annual Report. b) Bandwidth Trading: The capabilities as energy merchant would be easily applied to this trading line.
1999 **Enron Online** is formed as a commodity trade Internet site. May: Azurix-**Argentina** gets water and waterwaste concession in Buenos Aires province, for 30 years.	**Online businesses** It quickly becomes the largest in the world, to become the cash cow in the group, but nobody outside the division knew what it was going on. (In 2000 processed more than $335 billion of transactions). **Global governance and political peddling** It pays $438,6 million, and there was strong political criticism. It also invest in water utilities in Brazil and Mexico.

Going deeply into the information, we can see those of top executives Lay, Skilling and Fastow, in contrast with the whole lot of 144 executives. It should be borne in mind that Fastow's main income was coming from the limited partnerships with which he was involved as general manager, and information on that income is still unclear to this date.

Portfolio Component	Kenneth Lay	Jeffrey Skilling	Andrew Fastow	All 144 executives
Salary in cash	1,072,321	1,111,258	440,698	26,704,229
Bonus	7,000,000	5,600,000	1,300,000	97,343,619
Long Term Incentive	3,600,000	1,920,000	1,736,055	48,521,928
Deferred Income	- 300,000	-	- 1,386,055	- 7,992,891
Deferral Payments	202,911	-	-	32,083,396
Loan Advances	81,525,000	-	-	83,925,000
Other	10,359,729	22,122	277,464	42,667,589
Expenses	99,832	29,336	55,921	5,235,198
Director Fees	-	-	-	1,398,517
Sub Total	**103,559,793**	**8,682,716**	**2,424,083**	**309,886,585**
Exercised Stock Options	34,348,384	19,250,000	-	311,764,000
Restricted Stock	14,761,694	6,843,672	1,794,412	130,322,299
Restricted Stock Deferred	-	-	-	- 7,576,788
Sub Total	**49,110,078**	**26,093,672**	**1,794,412**	**434,509,511**
Total	**152,669,871**	**34,776,383**	**4,218,495**	**744,396,096**

Taking advantage of the market's boom in the 1990s, Enron's executives and directors had been selling $1 billion worth of shares since 1998 (***Exhibit 12***)

5.6. THE INCREMENTAL CASH FLOW MODEL AND ENRON'S GOVERNANCE

In section 2 we dealt with the incremental cash flow model, which has turned out to be the customary tool in valuation any time we want to assess the value of companies, investment projects, and financial assets in a ever growing field of applications. Furthermore, it has recently been used to focus on corporate governance issues (Apreda 2001b, 2002a). Now, we are going to draw some understanding of Enron's infringements and misdeeds by means of this cash flow approach.

- Firstly, we need an extension of this model as put forth by (6), allowing for cash flows delivered to managers, and also the company's portfolio on financial assets investment. As regards the manager's side, their particular items follow the details reported by Enron in the bankruptcy files submitted to courts.

ENRON MAIN EVENTS AND CORPORATE GOVERNANCE ISSUES (Exhibit 7)	
Events	**Corporate Governance Issues**
1999 Azurix goes public	**Ownership changes** Azurix goes public on a third of its equity, but shares did not perform as expected.
Enron becomes the largest and most innovative natural gas company in the USA.	It engages in gas, electric and communication businesses. Fortune calls Enron "the America's most innovative company" for the fifth time.
a) **Colombia**: concessions and privatizations plan.	**Global governance, funding and political peddling** a) President Pastrana meets in October with Texas Governor George Bush Jr., and important oil and gas executives, including Enron's, to discuss concessions and privatization in the sector. In December, two congressmen are ousted for alleged bribes from Enron.
b) **Panama**: Bahia Las Minas power plant.	b) World Bank provides guarantees to Enron's investment. The company rises rates and people refuse to pay; power is shut off and rioting ensues. Fraud claims alleged.
c) **Dominican Republic**: power plant	c) Enron gets a large slice in power business, but rises rates so much that riots ensue, and they go on worse after rolling blackouts follow. Eight people killed by riot police.
1999 Enron's CFO, Andrew Fastow, with full approval of the Board, established LJM Cayman LP and LJM 2 Co-Investment LP, two Special Purpose Vehicles (SPV). Fastow becomes general partner.	**Gatekeepers: Board oversight and acquiescence with limited partnerships**: a) The board passed a waiver of the company's conflict of interest rules. b) The stated purpose of these limited partnerships was "to hedge the fluctuating market values of Enron's assets". c) The real purposes were hid speculative losses Enron suffered on technology stocks; huge debts to finance unprofitable new businesses (retail energy services); inflate value of troubled business in fiber-optic bandwidth.
Outside Investors in SPVs: Citicorp, American Home Assurance Company, American International Group, Morgan Stanley, Travelers Insurance.	d) As early as in 1997, the Board received detailed briefing on limited partnerships, approving aggressive accounting actions, including moving debt off the company books.
Head of Risk-Management team at Enron's against SPVs.	**Asymmetric information and lack of accountability** Vince Kaminsky warns that risk hedging with SPVs was bad and dangerous. Skilling transfers him out of the risk-management division "because he was acting like a cop, killing deals". (Behr-Witt, their series at The Washington Post, 07-28-02)

THE INCREMENTAL CASH FLOW MODEL IN CORPORATE GOVERNANCE

1. Incremental Cash Flow Model

$$\Delta CF_t \text{ (assets; net) } =$$

$$= \Delta CF_t \text{ (creditors) } + \Delta CF_t \text{ (stockholders) } + \Delta CF_t \text{ (managers) } + \Delta CF_t \text{ (cash-assets)}$$

2. Cash Flow to Managers

$$\Delta CF_t \text{ (managers) } = (\text{ Salary in cash } + \text{ Performance Bonus } + \text{ Deferred Income } +$$

$$+ \text{ Long Term Incentive } + \text{ Deferral Payments } + \text{ Loan Advances } + \text{ Other } + \text{ Expenses } +$$

$$+ \text{ Director Fees } + \text{ Exercised Stock Options } + \text{ Restricted Stock } + \text{ Restricted Stock Deferred})_t$$

3. Cash Flows kept within Cash-Assets Portfolios

$$\Delta CF_t \text{ (cash-assets) } = \text{ cash not for operations}_t + \text{ short-term financial assets portfolio}_t +$$

$$+ \text{ medium- and long-term financial assets portfolio}_t + \text{ fair present value of derivatives portfolio}_t$$

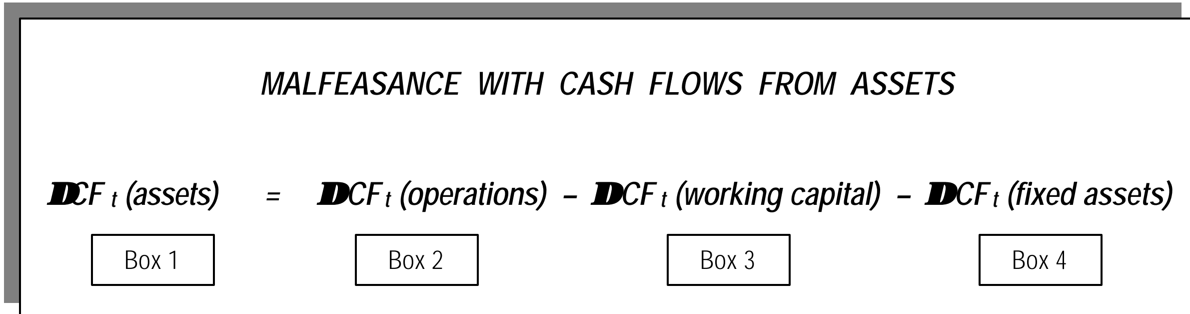
What this set of relationships convey is that managers always enjoy an amazingly wide latitude whenever they have to assess, allocate and hide ex~ante cash flows. On the other hand, bounded rationality and asymmetric information explains how advantageous the managers' side really becomes, preventing investors and stockholders from distinctive and functional information. Moreover, as witnessed by corporate scandals spanning along the last months, regulations appears to be seriously flawed and lenient for the time being. Therefore, deep changes in capital markets oversight, as well as accountancy and law practices, should be enacted outright.

In the case of Enron, managers played what Fuller and Jensen (2002) have recently denoted "the earnings game", by which they tried, by hook or by crook, to keep earnings and value growing, so as to meet the analysts expectations and the investment grade rating. And the only way to perform this game of deception was the outright manipulation of future expected incremental cash flows.

- Secondly, it seems useful to single out the main components shown above to give account of the opportunistic behavior of Enron's managers. This is accomplished throughout four exhibits that feature in more detail how to track down prospective malfeasance by following the sources and uses of future expected changes in cash flows from assets, in contrast with cash flows toward creditors, stockholders, and those funneled into managers hands and cash-assets portfolios.

ENRON MAIN EVENTS AND CORPORATE GOVERNANCE ISSUES (Exhibit 8)	
Events	**Corporate Governance Issues**
1999 CFO's Magazine gave Fastow an "Excellence Award in Capital Structure Management for his pioneering work on unique financing techniques".	**Free-riding, window-dressing, and gatekeepers as partners-in-crime** More than 40 lawyers from Vinson and Elkins played their role in designing, structuring and reporting of various partnerships leading to structured finance methods. (Cunningham, 2002)
2000 April: It is created the first Raptor, an Special Purpose Vehicle (SPV), to help hedging transactions with Enron. Arthur Andersen billed Enron $330.000 for its engagement at designing the SPV. Enron let know that is playing in many fields in profitable ways. Stock appreciation up to 60 %. Highest price Enron's stock: $90 in August. **At Davos, Switzerland, Lay** described Enron executives as "guerrillas fashioning bullets out of ideas".	**Breach of good practices code on conflicts of interest** It will be later found out that Fastow cashed $30 million as partner in SPVs. **Empire building, hidden action and risk transfer with guile** a) Enron Transportation Services: market marketer and merchant for the trading of energy; gas and electricity. (Wholesale) b) Enron Energy Services: it provides outsourcing services to manage energy to customers (Retail) c) Enron Broad Band Services: it sells broadband communication capacity (Wholesale)
2000 a) **Nigeria:** power project b) **Venezuela**: natural gas plant George **Bush Jr**. declared President by the Supreme Court.	**Global governance and funding** a) Nigeria government offers Enron a subsidy to start project. b) Ex-Im Bank sends $65 million so as to help Enron's Venezuelan investment.
2000 Annual revenues reach $100 billion (more than double the year before) mainly because the increase in the trading line of business. The value of the company was nurtured by transmission business (9%), wholesale (52%), retail (39%). **July:** Enron announces a 20-year deal with Blockbuster to deliver broadband services (video on demand to consumers' homes over the Internet).	**Moral hazard, adverse selection and free-riding** **Year end 1999** (Bodily-Brum, 2002) *Revenue: $ 40.1 billion (25% international)* *Net Income: $ 893 million (36% international)* *Market Capitalization: $ 50.5 billion* *48 % Debt / Total Capital* *Gas Pipeline: 32,000 miles*

THE INCREMENTAL CASH FLOW MODEL AND THE ENRON'S CASE (1)



Box 1
Cash Flows from Assets

While this item went on increasing period after period, the company pretended there was value enhancement. Furthermore, an amazing lack of checks and balances by the Board of Directors came as a matter of course.

Box 2
Cash Flows from Operations

Enron designed the SPVs to make up its income from virtual operations, as if it were actually selling goods or services to the market.

Box 4
Cash Flows from Fixed Assets

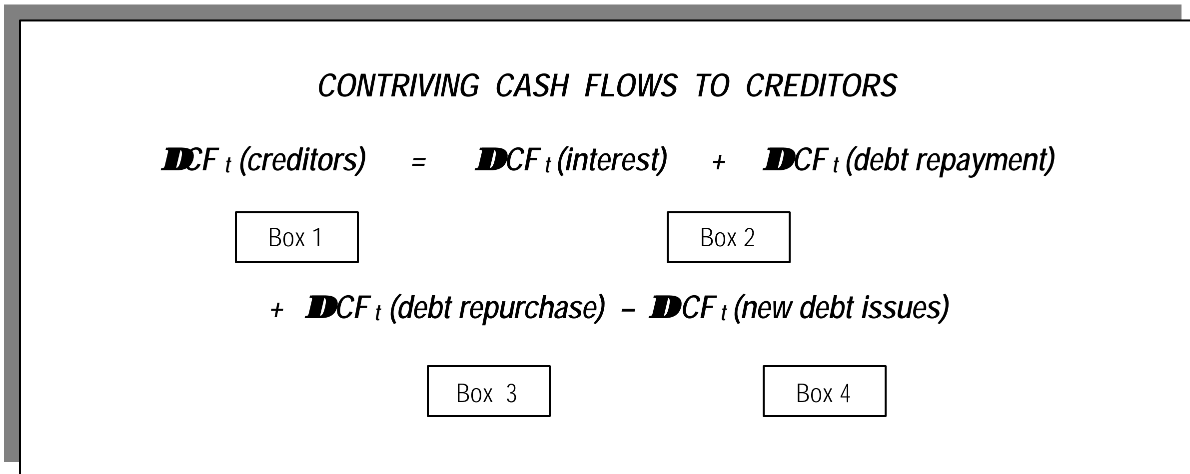
By means of assets sold to limited partnerships close to the end of financial reporting periods, this item furnished more virtual inflows to cash flows from assets.

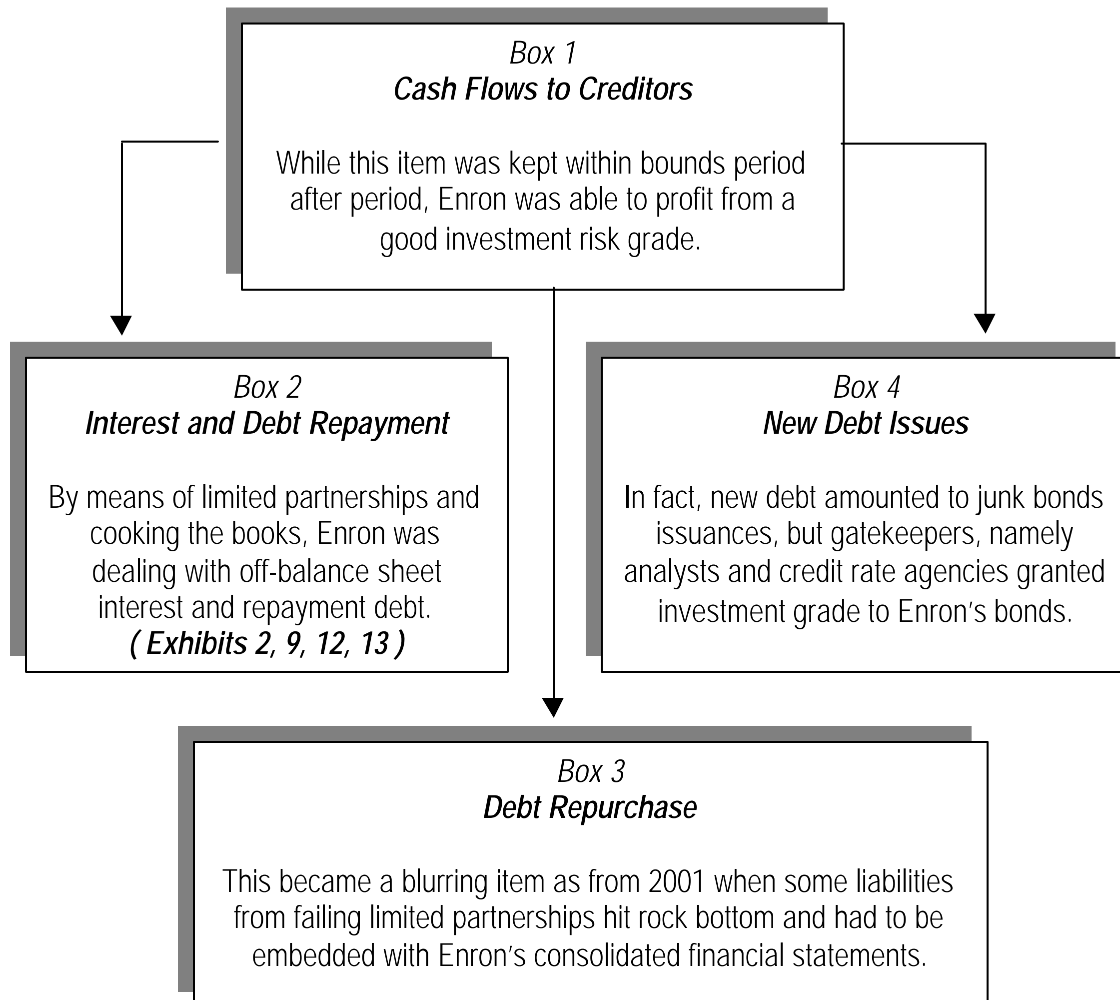
Box 3
Cash Flows from Working Capital

The Risk Management Division, by hedging operations, and taking short-term loans from banks, it kept inflows increasing by hook and by crook.

ENRON MAIN EVENTS AND CORPORATE GOVERNANCE ISSUES (Exhibit 9)	
Events	**Corporate Governance Issues**
2000 Andersen collects $52 million as fees from Enron. (consulting fees: $27 million; audit fees: $25 million)	**Gatekeepers: conflict of interest** For the last ten years, a growing concern in the market and regulators had spread over the issue of audit firms like Andersen that engaged themselves in consultancy roles
Argentina: **Azurix-Buenos Aires investment meets problems.**	**Global governance and funding** Angry population complains bad quality in water supplied by Azurix, and there are increasing financial problems between the government and the company.
August: Citicorp issues Credit-Link Notes from this date to May 2001, amounting to $1.4 billion. (Altman, February 8, 2002, The New York Times)	**Covenants in bonds harmful to stockholders** a) Citigroup offered five year notes to investors under the label of credit-linked notes. They were issued by companies incorporated as trusts. Investors received fixed payments on the notes, and Citigroup invested the proceedings in government and corporate top rate securities. b) It nothing wrong came up, Citigroup returned the principal to investors. Otherwise, even if Enron went bankrupt, they would receive Enron's unsecured debt from Citigroup loans, while Citigroup would keep the highly rated securities instead. In this way, investors should settle their grievances in the courts, directly with Enron.
December: Congress fosters deregulation in derivatives markets.	**Institutional Environment and Governance** After powerful lobbying, big companies in the energy business like Enron get a deregulated status for derivatives, by means of the Commodity Futures Modernization Act, that allowed them to fell into a regulatory black hole.
December: **California power crisis** Clinton's Energy Department bans Enron from trading in California. In January 2001, the day after Inauguration Day, Bush's Energy Department reverses Clinton's order (Palast, The Observer, March 8, 2002). (***Exhibit 10***)	**Hidden action and information, political peddling: Incremental cash flows from assets manipulation** a) It increased artificially demand, by shipping more energy than needed and later selling the excess at a profit. b) Phantom power transfer, being paid to scheduling transmission out of congested lines, without actually moving energy. c) Megawatt laundering, by shipping back to California as imported electricity previously bought in the same state at a profit.

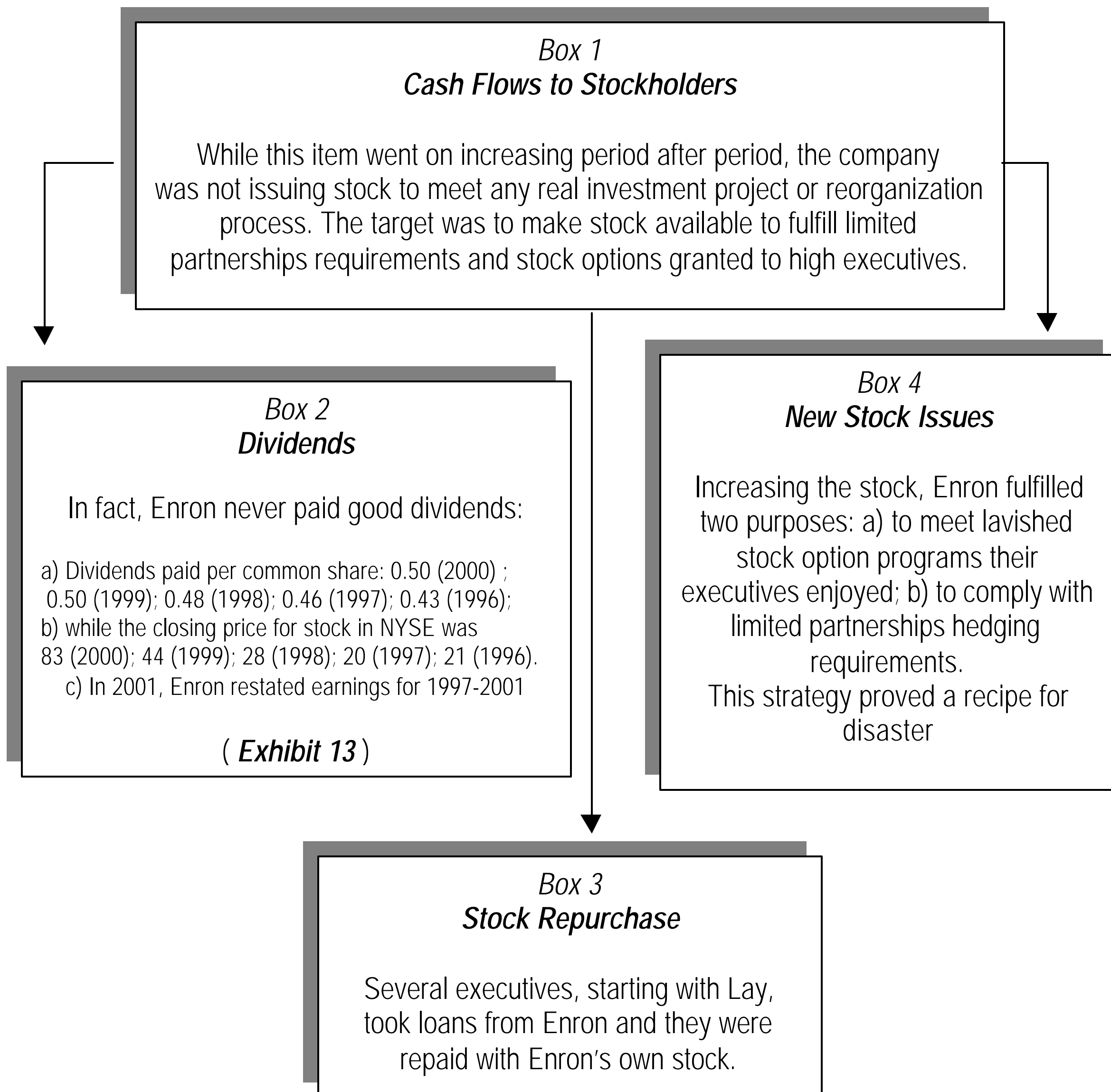
THE INCREMENTAL CASH FLOW MODEL AND THE ENRON'S CASE (2)





ENRON MAIN EVENTS AND CORPORATE GOVERNANCE ISSUES (Exhibit 10)	
Events	**Corporate Governance Issues**
2001 **a)** January: George Bush Jr. is sworn in as President of the United States. b) January: California power crisis c) Pressure on Californian government February: Skilling takes over as CEO while Lay remains as Chairman.	**Public and corporate governance** a) Enron heavily contributed to political campaign: From 1990 to 2002, Enron gave $5,8 millions to candidates, and three quarters of that money went to Republicans. b) Rolling blackouts in California because rates increase by 266%. Enron and other companies blame to power shortages, albeit there is no such thing. c) Governor Davis agrees with power producers to lock in $43 billion in power purchases over twenty years to balance rates and avoid blackouts. (***Exhibit 9***)
2001 **a)** February, March and April: Lay meets with vice-president Cheney, who is alleged to have submitted directions on how to run the energy policy in the country b) Vice-president is also blamed on boosting pending projects in India. March 5: "Included in the $126 a share that Enron says it's worth is a $40 a share (or $35 billion) for broadband. Several of Enron's analysts value broadband at $25 (and congratulate themselves for being conservative)". Adding later that "but for all the attention that's lavished on Enron, the company remains largely impenetrable to outsiders."(Fortune) March: Enron and Blockbuster's deal falls through. Skilling gets the "Number 1 CEO of the United States Award".	**Global governance and political peddling** a) Cheney uncovers the national energy plan after holding at least six meeting with Enron's executives. b) In April, Secretary of State Colin Powell meets India's Foreign Minister Singh, hinting that Dabhol's failure would amount to lose investors confidence. And in June, Cheney raises the issue with Sonia Gandhi, on behalf of Enron. **Gatekeepers failure and breach of fiduciary duties** a) Law firm Vinson and Elkins had not found any wrongdoing for the last ten years. Vinson and Elkins has been one of the most important contributors to both Bush presidential campaigns. (Bodily-Bruner, 2002) b) Arthur Andersen did not warn Enron about any of its dubious accountancy procedures. c) Some market analysts voiced their worries about Enron's partnerships (did they hide debt?) and Fastow's role (did he know Enron's share were overvalued?) (On the role of gatekeepers stands out Coffee (2002))

THE INCREMENTAL CASH FLOW MODEL AND THE ENRON'S CASE (3)



ENRON MAIN EVENTS AND CORPORATE GOVERNANCE ISSUES (Exhibit 11)	
Events	**Corporate Governance Issues**
2001 April: From 1999 to the first quarter of 2001, price risk management grew to $22 billion from $60 billion in assets and liabilities. It received from banks almost $4 billion in loans under the guise of hedging price risk. a) **Nigeria:** Problems with Enron in Lagos plant. b) **Dominican Republic:** political turmoil because of Enron's policies.	**Free-riding problems,** **and lack of checks and balances as well** Since 1997 Enron's stock increased more than 370 % but while Skilling was CEO (six months period) the share price busted (from $80 in January to $43 in August) because failures in the broadband business and international power projects (mainly in India) **Global governance and funding** a) The government accuses the company of secrecy and bad faith in contracts enforcement. The World Bank helps the plant, and also grants a loan to privatize Nigeria's power, telecoms, air transport and water utilities. Enron sells Lagos power plant to AES. b) It is disclosed that power assets were sold at least $1 billion below actual value and the auditor comes to be Arthur Andersen. The government accuses Enron of fraud and blackouts.
2001 June: **Brazil** power plant July: **Fastow** ended his participation in the main SPVs. August and September: Pressure on **India**.	**Global governance and funding** OPIC provides $190 million loan guarantee to Enron's Brazilian power plant. **Global and corporate governance, political peddling** a) In July, Christine Rocca, in charge of Central Asian Affairs, USA Department of State, meets Indian government to discuss Enron investments. b) In August, American ambassador Blackwill holds a meeting with Indian government on behalf of Enron's affairs. Lay writes in Financial Times that India would be cut off of any aid in case the government expropriated Enron's premises. c) In September, the World Bank is asked to express concern over Enron problems in India. On September 9, senior officer at OPIC sends a report to Cheney suggesting some talking points with oncoming meeting with Foreign Minister Singh. (The Washington Post, January 22, 2002)

THE INCREMENTAL CASH FLOW MODEL AND THE ENRON'S CASE (4)

ENRON: WHEELING AND DEALING WITH CASH FLOWS FROM ASSETS, CREDITORS AND STOCKHOLDERS

$$\Delta CF_t \text{(managers)} + \Delta CF_t \text{(cash-assets)} =$$

$$= \Delta CF_t \text{(assets; net)} - \Delta CF_t \text{(stockholders)} - \Delta CF_t \text{(creditors)}$$

Box 1
Cash Flow to Managers

ΔCF_t *(managers) = (Salary in cash + Performance Bonus +*

Deferred Income + Long Term Incentive + Deferral Payments +

Loan Advances + Director Fees + Exercised Stock Options +

Restricted Stock + Restricted Stock Deferred + Other + Expenses)$_t$

To keep the managers on a tight rein, the package not only rewarded managerial skills and performance but also compliance with a company's culture of malfeasance and hiding.

Box 2
Cash Flows kept within Cash Assets Portfolios

ΔCF_t *(cash assets) = short-term financial assets portfolio* $_t$ +

+ cash not-for-operations $_t$ *+ fair present value of derivatives portfolio* $_t$ *+*

+ medium- and long-term financial assets portfolio$_t$

Black holes in capital markets regulation, as well lenient accountancy and law procedures, allow companies to mismanage these items, investing in substandard projects, taking off loans from financial statements, marking-to-market virtual gains, or outright empire building, political peddling and sleaze, (to the extent of buying dustbins for Enron headquarters made of marble, because it signaled a commitment with excellence…)

ENRON MAIN EVENTS AND CORPORATE GOVERNANCE ISSUES (Exhibit 12)	
Events	**Corporate Governance Issues**
August 14: CEO and President of Enron (Jeffrey Skilling) resigns regardless of losing a $19.9 million severance package. **Ken Lay** takes over as CEO while being Chairman**.** August 23: Bond Analyst Scotto, from BNP Paribas, lowered Enron's rating. September 11: Terrorist attack to World Trade Center in New York and Pentagon building in Washington.	**Asymmetric Information and Accountability** Wall Street starts claiming more disclosure of financial statements and performance. **Anti-market behavior** Enron complained about Scotto's report and BNP puts the analyst on family leave and fired him in December
September: **Azurix crumbles**	**Global Governance and Azurix investments** Water utilities in Argentina, Brazil, Mexico and England accused of supplying water dangerous for health, while financial shortcomings come to light. Enron announces it would be selling Azurix investments in those countries. Azurix CEO, Rebecca Mark resigns from Azurix and Enron's Board after selling 1.8 million shares of stock for about $81 million.
September 28: JPMorgan-Chase's Deal Pictured as a hedge to protect against rising prices in natural gas. Enron got $350 million of incremental cash flows. Far from being a hedge, it was a covered loan. JPMorgan argued that the bank had recorded the transaction according to regulations linked with "structured finance". **Leakage about inside sellings**	**Incremental cash flows to creditors and hidden transactions** a) Chase paid Mahonia, an offshore company in Channel Islands, $350 million, to be repaid on March 26, 2002, plus a floating components contingent on natural gas futures contracts. b) Mahonia lends Enron the money, under the same contractual covenants. c) Enron agrees on September 28, to pay Chase $356 million on March 26, 2002, in return for a payment equal to the floating payment owed from Mahonia to the bank. (Enron actually paid to the bank a loan rate of 3.4%) d) It was another transaction intended to increase earnings and hide debts. e) JPMorgan Chase total exposure to Mahonia in this one and former deals amounted to $1.1 billion. (Altman, February 17, 2002, The New York Times) **Conflicts of Interest and Inside Dealings**: Skilling sold shares for $30.6 millions; Ken Lay for $16.1 millions; Lou Pai (former Chairman, Enron Energy Services) for 33.6 millions; Ken Rice (former CEO Enron Broadband) for 14.7 millions.

5.7. THE GLOBAL GOVERNANCE ISSUE

To raise the question whether corporate governance has any linkage with global governance might have been sounded farfetched, to say the least, throughout the Cold War period. But in the called post-modern world (Escude, 2002a, 2002b), not only seems feasible, but necessary.

After the OPEP pushed on oil prices in 1973, a huge cost-structural inflation spread over the world, stirring up a growing concern around the developed countries. The challenge was about finding the means of weakening their dependence from Arabic countries. It did not came as a surprise that some global institutions, mainly the World Bank, were taking big steps toward huge investments in oil and gas. In 1981, President Reagan set up policies requiring, for a country to qualify as a World Bank loan recipient, that it should start privatizing and deregulating the oil, gas and power domestic market. It also included the involvement of officials in the US Commerce Department, State Department, and Energy Department, to advise governments and also meet politicians in the target country. In some cases, these became sound measures to pursue, but utter failures in others. In fact, some companies did extremely well, without blemish and much praise to draw from their involvement, but other multinationals tarnished their reputations, infringed human rights, damaged the environment and endeavored in crony capitalism practices.

This was the environment that Enron took advantage of, becoming global and seeding the roots of its own demise. But this was not the time of "global reach" that many multinational corporations had enjoyed for decades, as those in the oil or the grain business, where the bulk of the task and effort rested on the companies shoulders. Now, ***the globalization in a post-modern world required the joint effort of global governance provided by interstate agencies and the corporate governance afforded by the company itself.***

The process by which interstate institutions masterminded their role can be briefed this way: the World Bank (and soon other agencies) began to issue loans to help privatizations and deregulation in developing countries. In a second stage, bidders from the private sector would apply to purchase the going concerns. Sometimes the bidder became the only owner of the former state-owned company. But in other cases, it would need leverage to round up the whole amount of money to be invested in the privatization. At that juncture, the World Bank would provide with the additional finance. In a third stage, the foreign company that was running the new company, might undertake additional investment projects so as to meet contractual covenants signed when the privatization or deregulation took place, or to enlarge the scope of the business outright. Here, the company was able to apply for more funds, bring new partners or ask interstate agencies for insurance of political risk. (***Exhibits 2, 3, 4, 5, 6 and 11***)

Extensive research (Wysham-Vallette, April, 2002, and Vallette, August, 2002) disclosed that five statements stand out on evidence about the Enron's involvement with overseas operations during more than a decade in almost 30 countries:

- Overseas direct investment would not have been feasible for Enron, unless huge finance and political clout had been provided by interstate agencies.
- The World Bank was the largest creditor of Enron's projects abroad, second to OPIC. From 1992 to 2001, it gave Enron almost $1 billion.

ENRON MAIN EVENTS AND CORPORATE GOVERNANCE ISSUES (Exhibit 13)	
Events	**Corporate Governance Issues**
2001 October 18: The Wall Street Journal matches write-offs with partnerships designed by Enron CFO Andrew Fastow.	**Conflicts of interest** "Vexing conflict-of-interest questions" said the paper, and it added "Enron repurchases 55 million of its shares that it had issued with an investment vehicle ran by Fastow". (WSJ, October 18)
Internal Report requested by the Board of Directors.	**Board of directors audit: The Powers Report** The committee was chaired by W.Powers, who was the dean of the University of Texas Law School and member of Enron's Board. The Report was released in February 2002, with severe indictments on Enron's accountancy procedures.
Prudential's analyst advises to short Enron's stock.	**Gatekeepers Conflict of Interest** But for Prudential, the remaining analysts kept advising to buy Enron's securities.
India: Political involvement with Enron's investment.	**Global and corporate governance** a) Undersecretary Larson meets with economic officials in India government so as to foster November 9 meeting between Bush and the Indian Prime Minister. b) Larson ask OPIC senior investment officer to write down some talk point to be used in November 9 meeting between Indian Prime Minister and President Bush.
November 1: Enron discloses that Citigroup and JPMorgan Chase gave $1 billion	**Incremental cash flows to creditors and off-balance transactions** It was a line of credit to "supplement short-term liability and refinance maturing obligations".
November 8: **Enron restates its own earnings for 1997-2001.**	**Deceitful auditing practices: incremental cash flows model badly applied for more than four years** The main grounds for restating earnings were: a) "Financial statements for these periods and the audit reports relating to the year-end financial statements for 1997 through 2000 should not be relied upon" b) To correct accounting errors c) To consolidate three-off balance sheet entities that Enron and its auditors might have been included d) To disclose Andrew Fastow's involvement with partnerships.
November 9: Indian Prime Minister visits Washington.	**Global and corporate governance** Bush is prevented from dealing with Dahbol issue while meeting with Prime Minister Vajpayee.

- It turned out that through taxpayer's contributions, US government agencies disbursed $3.4 billion in support of Enron's international business. Main financiers were: The US Overseas Private Investment Corporation (OPIC), the Export-Import Bank, and the US Maritime Administration Trade and Development Agency. Besides, it should be added the non-monetary involvement of these agencies in advisory, lobbying, public and institutional support.
- Even if the above-mentioned agencies or the World Bank regarded untenable the project, there were chances for Enron to get money through the Commonwealth Development Corporation (United Kingdom), the European Investment Bank and the Inter-American Development Bank. ($3 billion)
- OPIC gave Enron not only financing but political-risk insurance for foreign projects.

5.7.1. ENRON INVOLVEMENT IN POLITICS THE INDIAN DABHOL POWER PLANT AND THE OIL-TALIBAN ISSUE

Dabhol's investment in India became hazardous for Enron, because the company was in great need, from an early stage, of getting cheap gas to fuel the plant. Firstly, it was thought that liquefied gas from Qatar would come in handy, but later it turned out to be a very expensive energy source for the Indian consumer to foot his electricity bill. Enron owned 65% of Dabhol, the remaining stock were in the hands of Bechtel, General Electric and the Maharashtra State Electricity Board. In May 2001, Dabhol was almost finished, but the construction was halted mainly because a cheap source of natural gas was not available at the time. Moreover, the government faced trouble to meet contractual payments to Enron. (***Exhibit 3 and 5***).

It's worth remembering at this point that in 1996 Unocal (a leader energy resource and project development company) got a contract to build a long oil and gas pipeline to exploit Turkmenistan natural gas fields. It would extend from the Afghanistan-Turkmenistan border, through Afghanistan, crossing the Pakistan border and ending in Multan, Pakistan. To accomplish this huge investment, Unocal signed an agreement with the Taliban government and also their foes, the Northern Alliance for the pipeline to be built across Afghanistan. The project allowed for an extension from Multan to New Delhi. Unocal had the controlling power, but the company was a consortium whose other members were Saudi Arabia's Delta Oil Company, and groups from Japan, Korea, Indonesia, Pakistan and Turkmenistan. On the other hand, Halliburton, a company that had been managed for many years by Vice-president Dick Cheney, would have constructed the pipelines eventually.

To tighten the surprising linkage the first two paragraphs actually conveyed, it must be said that as soon the Soviet Union crumbled and fell down in 1989, the United States started to nurture the idea of controlling the Central Asian oil and gas pipelines, because it was not only cheaper (the Russian charged very highly to let their own pipelines to be used) but would cut down on his dependency from the current Persian-Arabian Gulf sources. Besides, profiting from the new international order, Washington could foster American companies to bid for businesses and deal face to face with new countries that sprout in the Caspian basin after the Soviet Union demise. Between 1991 and 1997, big companies (Unocal, Shell, Texaco, BP Amoco) became involved with the state of Kazakhstan, setting up expected further investments that would amount to $35 billion.

ENRON MAIN EVENTS AND CORPORATE GOVERNANCE ISSUES (Exhibit 14)	
Events	**Corporate Governance Issues**
2001 December 1: The Economist calls Enron "a hedge fund with a pipeline on the side".	**Gatekeepers Leniency:** Moody's Investor Service, Standard and Poor's and Fitch granted "investment grade" to Enron up until a few days before bankruptcy. And failed to highlight discrepancies between reported earnings and retained earnings. Even worse, they did not perform cash flow and debt analysis.
December Sunday 2: **Enron filed for Chapter 11 bankruptcy protection**. Almost $50 billion in assets, the largest bankruptcy in history overriding Texaco's bankruptcy in 1987, with $36 billion in assets. Discretion with Enron's stock-options distribution among high executives mean changes in ownership structure when those options are exercised.	***a) Enron's Estimated Debt (in billions): $40*** *Balance Sheet:* *To Banks $4* *To Bondholders $9* *Off-Balance Sheet Transactions* *To Banks $3* *To Bondholders $17* *Other Debt Instruments $1* ***b) Changes in Ownership Structure 1996-2000*** *1996: $3,723 billion* *1997: $5,618 billion* *1998: $7,048 billion* *1999: $9,750 billion* *2000: $11,470 billion* ***c) Some big stockholder groups losses*** *Retirement Systems of Alabama ($48 million)* *Arizona State Retirement System ($35 million)* *University of California Retirement Plan ($145 million)* *Florida Retirement System ($306 million)* *Employees Retirement System of Georgia ($127 million)* *New York City Pension Funds ($109 million)* *Public Employees Retirement System of Ohio and State Teachers Retirement Systems ($115 million)* *Teachers Retirement System of Texas ($59.7 million)* *State Investment Board of Washington ($69 million)*
December, Monday 3: More than 4000 of Enron's headquarters employees were let go.	**Damage to stakeholders**: Each employee received $4500 severance pay. (Vinod, 2002)
December 5: Wall Street Journal attacks Enron's Culture of Secrecy.	**Culture and Organization Failures:** "A culture of highly questionable financial engineering, misstated earnings and persistent efforts to keep investors in the dark."

As for Enron's involvement with the Caspian basin, it must be born in mind that in November 1996 had got a contract in Uzbekistan to explore gas fields, giving up the project after Gazprom, the Russian pipeline company, overcame the whole project. In February 1999, Enron won a contract to lead a technical research about the feasibility of a trans-Caspian gas pipeline project to be run among Turkmenistan's government, and the American companies Bechtel and General Electric. The study was paid by the US Agency for Trade and Development, under Clinton presidency and it cost $750,000. Enron's advise was to follow an earlier project, through Afghanistan. (***Exhibit 7***)

In August 2001, the Bush government tried to settle down a deal with the Taliban government so as the pipeline project were set into practice. The signature of this contract might have avoided the Enron collapse. At the end of August, negotiations between American officials and Taliban counterparts went sour, mainly because some Taliban demands were not met by the United States (namely to reconstruct Afghanistan's infrastructure and to open the pipeline to local consumption). On September 11, Taliban protected terrorists struck a heavy blow in New York and Washington. On December 31, 2001, Bush appointed Zalmay Khalizad, former Unocal consultant and Taliban defender as special envoy to Afghanistan. In February, he was acting as Special Assistant to the President and National Security Council member on post-Taliban affairs.(Callari, February 8 and 28, 2002) (***Exhibit 10***)

According to a highly reviewed article published in Albion Monitor, February 28, 2002, it could be likely that Enron's CEO Ken Lay would have enjoyed the inside track with the American negotiations with the Talibans representatives in August 2001, and regarded the whole deal as the bail-out that so badly needed Enron for the time being. Failure with the Taliban option led Enron's CEO to trust in the American pressure on India government that could have allowed him to resell Dabhol in $2.3 billion, as an alternative solution. In fact, in August, Lay writes in the Financial Times that India would be cut off of any aid in case the government expropriated Enron's premises. To add insult to injury, on September 14, 2001, Lay threatened Indian Prime Minister in a letter where he said that $2.3 billion price "was reasonable because they Enron had a legal claim of up to $5 billion". (***Exhibit 3 and 11***)

Filing for bankruptcy on December 2, 2001, Enron's top executives knew that their company was at the end of the road, while their game was over.

ENRON MAIN EVENTS AND CORPORATE GOVERNANCE ISSUES (Exhibit 15)	
Events	**Corporate Governance Issues**
2002 **Enron's Aftershocks** January: Blow-whistlers	a) Sherron Watkins warned Lay in August 2001 about accounting malfeasance within Enron. ("I am incredibly nervous that we will implode in a wave of scandals) b) Maureen Castaneda disclosed that shredding of compromising files began after Thanksgiving in Houston headquarters.
January: Amalgamated Bank, a union bank which manages pension funds, filed a suit against Enron executives	**Incentives and Inside Information** The bank alleged that the last four years Enron's executives and directors earned $600 million selling the company's shares they have received as incentives under the guise of stock options.
January: Allegations of misdoing and blame	**The Gatekeepers**: **SEC**: it lacked will and resources to research in the Enron files submitted **Securities Analysts**: they relied on SEC files and were slow to warn investors to sell. They were in most cases inside traders. **Andersen**: failed to audit according to law, accountancy principles and fiduciary duties. Destroyed core information with guile.
a) **Mozambique's** steel factory project given up b) **Bolivia-Brazil:** Cuiaba Pipeline.	**Global Governance and Funding** a) Enron had planned to invest $1.1 billion in the project to build up a natural-fueled factory to produce steel slabs. It was the only confirmed shareholder in the project. b) OPIC cancels any additional loan to the Cuiaba natural gas pipeline.
February: The Power Report to the Board is released.	**Accountability and Gatekeepers** "In virtually all of the transactions Enron's accounting treatment was determined with the extensive participating and structuring advice from Andersen, which reported to the Board". (The Power Report) As time goes by, some scholars regard the gatekeepers failure at the root of Enron's malfeasance. Investors and employees found out that reputational intermediaries breached their fiduciary contract towards them. (Coffee, Understanding Enron: It's about the Gatekeepers, Stupid, Columbia Law School, 2002)
New CEO appointed to cope with the reorganization of the firm.	**Reorganization under the Bankruptcy Law** Stephen Cooper is appointed CEO at Enron to proceed with the company's reorganization. He had spent more than 25 years restructuring and rehabilitating troubled businesses.

6.- CONCLUSIONS

To the extent that a company becomes global, its corporate governance must keep up with this stage. At that point the company will run around with financial suprastate agencies, governments, politics and crony capitalism practices as well. To the extent that a company gets involved with the most innovative trends in the markets, a strong pressure from analysts, investment banks and credit rating agencies will corner the company's managers to perform only for the short term and in pursuit of their personal agendas. Opportunistic behavior might provide with an ill-advised response to that global reach and sustainable growth stubborn demand. This is why corporate governance cannot be left on the sidelines.

By taking advantage of the incremental cash flow model, this paper expanded on distinctive corporate governance issues that went wrong with Enron. By developing the main features of economic and political actors when they handle their information sets, it is possible to understand the pervading influence that bounded rationality, asymmetric information, opportunistic behavior, transaction costs and agency problems carry on the daily running of any business.

When linking corporate governance with global governance, complex and dangerous matters arise. In the Enron's tale, sleaze and political peddling were the vehicles chosen to back the managers ' pretense that the company was going to excel forever. Global agencies disbursed millions of dollars to enable Enron to expand all over the world in unsuccessful projects in contempt of law. At last, employees, pension funds, institutional investors, banks, emergent countries communities and their governments, all of them were unfairly called to foot the bill.

The main lesson to draw from this narrative, lies on the accountability problem. Whereas Enron will have to face the music in several courts of justice, this disgraceful tale of malfeasance uncovered the ultimate actors that should be blamed for: the gatekeepers. They neglected their fiduciary role and damaged the credibility of many institutions and practices either in corporate or global governance. To raise the standards in accountability remains an unsettled issue and the task to address in the future on behalf of corporate life, democracy and stakeholders.

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