Information and decision-making processes leading to corporate failure: Enron and red flags

by

Natasha Sharina Ali

A thesis submitted in conformity with the requirements for the degree of Masters of Information

Faculty of Information
University of Toronto

© Copyright by Natasha Sharina Ali 2011
Abstract
Enron is examined as a critical case study to understand the role of information in the Enron’s Board’s decision-making processes. Three major events in the Enron failure were analyzed in detail using thematic analysis. Three themes were identified regarding the communication and use of information in Enron: interdependency of authority relationships, information control, and decision protocol and policies that shaped the information that management sent to the Board during the approval process. The Board was dependent on advisors to provide approvals first, prior to Board approval. The relationships between advisors and management influenced the information sent to the Board and affected controls used to monitor deals. The Board maintained that they were unaware of red flags, such as warnings related to incomplete disclosures and conflict of interest issues. The Board received information for arrangements which required Board approval but it had limited access to information regarding Enron’s operations.
Acknowledgments

It has been a privilege for me to work on this thesis under the supervision of Dr. Chun Wei Choo. I am deeply grateful for Prof. Choo’s patient guidance and valuable suggestions to improve my work. I am thankful for this fantastic opportunity to learn from him.

I would like to offer my sincere gratitude to my second reader, Dr. Lynne Howarth, for her wonderful advice and kindness. I am most grateful for her important advice for my work.

Throughout my studies at FIS, Dr. Siobhan Stevenson has been a wonderful inspiration for me. I thank her for her encouragement during this writing process.

I would also like to extend my gratitude to Sooin Kim, Faculty Services Librarian at the Bora Laskin Law Library, for her assistance to obtain perhaps one of the most valuable sources that I used for my case study.

Special thanks to my parents, Krishna and Jennifer Ramlochan, for a lifetime of encouragement and love.

My sister Michelle Ramlochan has been a wonderful cheerleader for me throughout my life, and especially during the past year. She inspires me to always do my best.

I would like to thank my mother-in-law Sandra Mohan, for sending wonderful dinners every Sunday so that I could write my thesis without too many interruptions.

Last, but definitely not least, my husband Bari Ali made it possible for me to write this thesis. I thank him for every peaceful moment that I had to research and write it. I appreciate the sacrifices that he makes every day to provide for me, so that I may have a chance to do what I love to do. I have been so blessed to have his support and love over the years.
# Table of Contents

Acknowledgments .......................................................................................................................... iii

Table of Contents ........................................................................................................................... iv

List of Tables ................................................................................................................................ vii

List of Figures .............................................................................................................................. viii

List of Appendices ......................................................................................................................... ix

Introduction ..................................................................................................................................... 1

  1.1 Background to the Study ..................................................................................................... 1

  1.2 Research Statement ........................................................................................................ 2

  1.3 Organization of Thesis ..................................................................................................... 3

  1.4 Red Flags, Information Hierarchy, and the Board ........................................................ 5

2 Literature Review ..................................................................................................................... 18

  2.1 Fiduciary Duties .............................................................................................................. 29

3 Enron ........................................................................................................................................ 35

  3.1 LJM Deals, Fastow’s Compensation Issues and Conflict of Interest Waivers .............. 39

  3.2 Raptors ............................................................................................................................. 41

  3.3 Cashing in the Shares ...................................................................................................... 44

  3.4 Andersen’s Discovery ...................................................................................................... 46

  3.5 Arthur Andersen ............................................................................................................. 47

  3.6 Vinson & Elkins .............................................................................................................. 50

  3.7 The Board of Directors ................................................................................................. 51

4 Research Methods .................................................................................................................... 55

  4.1 Documentary Sources for Data Collection ...................................................................... 60

  4.2 Data Analysis ..................................................................................................................... 72

5 Findings ...................................................................................................................................... 85
5.1 Arthur Andersen

5.2 Vinson & Elkins

5.3 Background on Committees Involved in Enron’s Approval Process

5.4 Red Flags

5.5 Controls

5.6 LJM: Background

5.7 Andrew Fastow: Board’s Decision to Waive Conflict of Interest and Compensation Issues Background

5.8 Raptors: Background

5.9 “Candor” and Disclosure

5.10 Theme 1 – Authority Interdependence

5.11 Interdependency of authority relationships

5.11.1 Theme 1 – Case (i): Raptors

5.11.2 Theme 1 – Case (ii): LJM2

5.11.3 Theme 1 – Case (iii): Andrew Fastow: Board’s Decision to Waive Conflict of Interest and Compensation Issues

5.12 Theme 2 – Information Control

5.12.1 Andersen’s Dual Roles

5.12.2 Theme 2 – Case (i): Raptors

5.12.3 Theme 2 – Case (ii): LJM2

5.12.4 Theme 2 – Case (iii): Andrew Fastow: Compensation Issues and the Board’s Decision to Waive Conflict of Interest

5.13 Theme 3 - Decision protocol and policies shaped the information that management sent to the Board during the approval process

5.13.1 Policies and Board Approval

5.13.2 Theme 3 – Case (i): Raptors

5.13.3 Theme 3 – Case (ii): LJM2

5.13.4 Theme 3 – Case (iii): Andrew Fastow’s Compensation Disclosure Issues
6 Discussion & Conclusion......................................................................................................................... 127

6.1 Summary of Findings......................................................................................................................... 127

6.2 Limitations of the Research ........................................................................................................... 134

6.3 Implications for Future Research.................................................................................................... 136

6.4 Conclusions........................................................................................................................................ 138

6.5 Corporate Governance Reforms: Sarbanes–Oxley Act of 2002 (SOX) and Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) .................................................. 146

6.6 Research Contribution of Study ..................................................................................................... 152

6.7 Overall Conclusions......................................................................................................................... 158

References................................................................................................................................................ 160

Legal References....................................................................................................................................... 166
List of Tables

Table 1: Hamilton & Micklethwait (2006) Definition of Swaps, puts, and collars ...............42

Table 2: Salter’s (2008) Stock sales of Enron executives, October 19, 1998, through November 19, 2001 .............................................................................................................45

Table 3: Enron Case Study Documentary Sources .................................................................61

Table 4: Boyatzis’ Thematic Analysis (1998) shown and adapted for Data Analysis for the flow of information as it was communicated in Enron among groups during the decision-making processes. .................................................................72

Table 5: U.S. Bankruptcy Court (2003), Standing Committees .............................................87

Table 6: Three Case Examples to Illustrate Three Themes in the Findings for this Enron Case Study .................................................................98
List of Figures

Figure 1: Boyatzis, (1998) Original Summary of Stages and Steps in Using Thematic Analysis: Data-Driven Approach (Boyatzis, 1998, p.44). .................................................................76

Figure 2: Boyatzis, (1998) Inductively: Data-Driven Code Design [Original Five Steps in Stage 2] ..............................................................................................................................77

Figure 3: Boyatzis, (1998) Adapted Summary of Stages and Steps in Using Thematic Analysis: Data-Driven Approach .................................................................77
List of Appendices


Appendix B: Red Flags Known to Enron's Board (U.S. Senate, 2002) .............................................. 183

Appendix C: 2001 Proxy Statement for Biographical Data of Enron Board and Executives and Corporate Governance Guidelines for the Board of Directors (U.S. Senate, 2002) .. 184


Appendix E: Capitalization of Raptor special purpose entities (SPE) (Salter, 2008) ................. 195

Appendix F: LJM2 Co-Investment, L.P., Private Placement Memorandum (U.S. Senate, 2002) .......................................................................................................................... 196

Appendix G: Board's request to Fastow for information re: LJM (U.S. Department of Justice, 2003). .................................................................................................................. 201

Appendix H: Restructure of LJM Ownership to Avoid Disclosure (U.S. Department of Justice, 2003) .................................................................................................................. 202

Introduction

Turning and turning in the widening gyre

The falcon cannot hear the falconer

Things fall apart; the centre cannot hold

William Butler Yeats: “The Second Coming” (1921)


1.1 Background to the Study

The financial collapse of Enron was one of the most devastating corporate scandals in U.S. history. At first glance, it appeared that the corruption of a few may have contaminated an entire company and it suddenly spiraled down without warning. The Board of Directors maintained they were not aware of any red flags which led up to Enron’s collapse. The Board of Directors is typically perceived as central to corporate governance, and when Enron’s Board could not hold on to its authority and effectively monitor management’s activities, this may have contributed to Enron’s failure. The Board’s explanation that it was unaware of the red flags leading to Enron’s failure was frequently debated in committee reports and research. At the time it appeared unlikely that these warnings could go unnoticed by the Directors. The unusual use of accounting techniques, debt and risk management contributed to Enron’s downfall: “at Enron the grand ideology of the innovative business justified not only the initial acts of debt shifting, but also allowed for more aggressive and deviant accounting procedures which lead to the ruin of the company” (Zygilopoulos, Fleming & Rothenberg, 2009, p.71).

Yet, a closer examination of the decision-making process reveals several substantial barriers to information flow among the groups at Enron, which may have limited the Board’s ability to detect red flags. By using a process perspective, this research aims to highlight the source of restrictions in the information flow; and by using red flags as examples, to demonstrate the consequences of these information barriers. The role of the Board in the decision-making process, its dependence on other groups for information, and the consequences of the limitations to information access in this organization is the focus of this research.
Enron was the result of a merger of two principal companies, InterNorth Inc and Houston Natural Gas. As described in the Enron Background chapter, (see Chapter 3, p.33) this company evolved into a leading corporation: “In the process, Enron’s revenues grew from $13.5 billion in 1991 to a reported $101 billion ten years later” (Salter, 2008, p.1). Enron’s reputation soared as the company “delivered more than 500 percent total return to shareholders” (Salter 2008, p.1). The severity of Enron’s collapse may be exemplified by its stock price: “At the beginning of 2001, Enron’s market capitalization was $63 billion. One year later its stock was worth only pennies to shareholders” (Salter, 2008, p.1). At its height, Enron was highly reputable and at its lowest: “On December 2, 2001 Enron Corp., the nation's 7th largest corporation and six-time winner of Fortune Magazine's most innovative company award, declared bankruptcy. Enron's shares closed the day at less than a dollar, down from $83.13 just eleven months earlier” (Gillan & Martin, 2007, p.930). The consequences of this corporate failure were exorbitantly high. Enron’s failure resulted in massive job loss and exposed extraordinary cases of greed among executives. Particularly disturbing were examples of executives selling their stocks, aware of Enron’s financial state, in the same period when other employees and investors, unaware of any problems, were losing their life savings and $2 billion in pension plans (Henderson, Gregory Oakes & Smith, 2009, p.469). At the time, Enron was the largest bankruptcy in US history and it prompted significant regulation changes.

1.2 Research Statement

Enron’s organizational structure was comprised of groups that appeared to be inter-dependent and this may have affected its decision-making processes. The Board may not have been the central authority, since management appeared to have substantial control over information. By mapping the information flow of these groups to assess the decision-making process and identify the role of the Board, this research intends to examine the information flow and decision-making process of these groups at Enron. “Red flags” provide examples to highlight major events which led up to this corporate failure, and also to demonstrate several consequences of these decision-making processes. It appears that only specific groups or firm members received particular information, and this may have shaped the decision-making processes at Enron. If the Board is unable to consider complete information, it may affect its authority due to its limited access. In doing so, management becomes increasingly independent as the Board becomes more passive. The information flows of groups in Enron may be described by tracing the red flags which led up
to a specific event, the company’s financial collapse. There is a substantial amount of research dedicated to the structure of the Board; however, this study aims to fill the gap for organizational management research of decision-making from a process perspective.

The research questions for this study include:

1. **How did the organizational structure affect the decision-making process and did weaknesses in this structure contribute to Enron’s failure?**

   Weaknesses in Enron’s organizational structure may have contributed to the failure of this company. A key way to assess these flaws may be to examine the formal authority structure among these groups, in addition to the informal relationships between the groups involved in the decision-making and approval processes.

2. **How did the control of information flow shape the decision-making processes?**

   The Board and other groups at Enron required information relevant to company operations in order to make informed decisions. By identifying the individuals who disseminated this information to groups involved in the decision-making process, it may be possible to identify which groups had more access to information.

3. **How did specific groups have access to information that was withheld from the Board?**

   As stated above, it is important to identify the groups in the decision making process that had access to information regarding Enron’s operations and deals. However, this research question addresses the ways that these specific groups were able to access more relevant information than the Board.

4. **Why did red flags or warnings go unnoticed by the Board of Directors?**

   Enron’s Directors maintain that they were unaware of the red flags leading up to Enron’s collapse. It is valuable to investigate the reasons why Directors were unable to identify these warnings.

### 1.3 Organization of Thesis

The literature review chapter includes corporate governance research and background information for Enron, the Board, advisors and major transactions. A special focus on the Mintzberg, Raisinghani, and Theoret (1976) framework is used to examine the information flow
in groups during the decision-making process at Enron in Appendix A. To illustrate this
decision-making process, an example of Fastow’s Compensation Disclosure Issues is described
via Stages of the Identification, Development, and Selection Phases in the Decision-Making
Process based on Mintzberg, Raisinghani, & Théorêt’s model (1976) in Appendix A of this
thesis. In addition, Fisher’s Model of the Audit profession’s self-regulation through peer review
(Fisher, 2010, p.1524) is included in Appendix A, Figure 2, and adapted in order to map the
information flow among the groups based on this study in Appendix A, Figure 3. The
methodology section (Chapter 4) outlines the case study approach as defined as a “critical case”
(Yin, 2003, p.40) using qualitative and explanatory methodology (Yin, 2003, p.3). Enron is part
of a long line of major corporate collapses and this affects the way Enron may be evaluated as a
case study. Enron is not the first company to fail, but the nature of its collapse may be defined as
critical.

Next, the Data Analysis Chapter describes the data-driven inductive approaches for code
development that was used by applying Boyatzis’ Thematic Analysis. This Data Analysis section
(Chapter 4) is followed by the Findings of this case study, which include three themes regarding
the communication and use of information in Enron: interdependency of authority relationships;
information control; and that decision protocol and policies shaped the information that
management sent to the Board during the approval process. Next, the Discussion chapter
includes a summary of findings, followed by a concluding chapter for this research.

Several sources were used for document analysis (see p.59): Congressional Hearing transcripts,
the Hearing before the Permanent Subcommittee of Investigations of the Committee on
Governmental Affairs United States Senate: The Role of the Directors in Enron’s Collapse
The Final Report of Neal Batson (2003), court appointed examiner, and Appendix D of the Final
Report of Neal Batson (2003) focused on the Roles of Lay, Skilling and Outside Directors, were
especially significant to this case analysis, since these reports described examples of the Board’s
role in the decision-making processes at Enron. Please note that the Appendix D of the Final
Report of Neal Batson is not the same document as the Appendix D of this thesis, which is
Enron Corp. Business Risk Management Process Overview and describes the process and shows
titled Innovation Corrupted was used as a major documentary source in this analysis. Salter
incorporates extensive information based on interviews, transcripts, court documents and reports. The appendices in Salter’s (2008) *Innovation Corrupted* were particularly useful to describe the Raptors entities and cited in this thesis as Appendix E. All appendices from *the Final Report of Neal Batson* and Salter’s (2008) *Innovation Corrupted* are referenced in the text by its original title as stated in its report/monograph. Another important source was Coffee’s (2006) *Gatekeepers: the Professions and Corporate Governance*, which provided extensive information regarding Enron’s auditors, particularly for Arthur Andersen. The Powers Report provided valuable background for these events leading to Enron’s collapse from the Special Investigations Committee of the Board of Directors of Enron Corporation by William C. Powers Jr., Raymond S. Troubh and Herbert S. Winokur Jr.: “Herbert S. Winokur Jr., the only member of the investigation committee to serve on Enron’s board during the time frame in question, did not participate in the portion of the report that evaluates the performance of the directors” (Salter, 2008, p.414). Please note that a Glossary is included in the Powers Report and identified as Appendix A to that report. This is a different document from the **Appendix A of this thesis**. Many of the sources included appendices and cited by its title in this study. A variety of scholarly papers and industry reports were examined to identify and describe the red flags as well as to provide context for deals and transactions related to Board approvals. Trade journals and publications were used to obtain details from the financial press; however, this study principally relies on corporate law and business academic journals, investigative reports, legal testimonies and government reports for source material.

1.4 Red Flags, Information Hierarchy, and the Board

*Chaos umpire sits,*

*And by decision more embroils the fray*  

**Milton, Paradise Lost** bk. 2, 1. 907 (1667)

In absence of a true umpire to watch over this corporate disaster, no group ensured that decisions were made in Enron’s best interest and for its shareholders. Extensive research examines the effects of Enron’s high pressure business culture, for example, issues which concern the overcompensation and rationalization of corrupt practices within the organization (Zyglidopoulos, Fleming & Rothenberg, 2009). Zyglidopoulos, Fleming & Rothenberg refer to the term rationalization as the attempt by individuals “to justify past and future corrupt deeds to
themselves and others” (Zyglidopoulos, Fleming & Rothenberg, 2009, p.65). At Enron, this justification of deeds was not limited to only specific individuals. The organization appeared to be divided into groups with various levels of information access. Without an effective check and balance system in this decision-making process, employees concerned about high risk and unusual accounting practices did not offer any criticism in fear that they may be terminated; and therefore, no one provided any rational feedback regarding the actions of these groups: “Enron, of course, is a good example here of how a corporate culture can build such an overly important and confident image of itself that it borders on delusional” (Zyglidopoulos, Fleming & Rothenberg, 2009, p.69). Warning signs existed in Enron’s complex financial reports and yet few analysts questioned the statements. Jim Chanos raised suspicions concerning Enron, as cited in Jonathan R. Laing’s article and included in the U.S. House of Representatives report, Lessons Learned from Enron’s Collapse: Auditing the Accounting Industry:

From his [Chanos] reading of the opaque footnotes, he realized that Enron was dumping its unused fiber and other physical broadband assets on the partnerships. Moreover, he had shorted a number of fiberoptic-network companies, correctly judging that the industry was going into free fall as a result of gross overcapacity and a collapse in pricing. "Didn't the energy analysts touting Enron ever bother to talk to any of the telecom analysts" (U.S. House of Representatives, 2002, p.12).

Chanos’ statement shows that communication barriers between analysts prevented them from comparing information about their sectors. The energy analysts would have realized that the telecom sector was underperforming (please see Enron background for details, p.37-38) compared to Enron’s projections for this market: “these deals suggested that the value of fibre had increased by 53%, while the open market value had fallen 67% in the same period (Hamilton & Micklethwait, 2006, p.46) If analysts had compared the data, this could have raised a red flag regarding the way that Enron was using Special Purpose Entities (SPEs) and Enron’s broadband investments. If the Board had access to complete information, especially the comparison data for the telecom sector and Enron’s use of partnerships regarding its broadband investments, this would have been a red flag for the Board. However, warnings require identification and action to be valuable.
The Board of Directors is supposed to be central to corporate governance and representative of the shareholders in the decision-making process. Rebeiz (2006) explains that Directors are expected to monitor without micromanaging company executives. Certainly for Enron, the Director positions were part-time commitments (U.S. Senate, 2002). A Board is supposed to review and monitor controls in order to make informed strategic decisions: “the board advises, counsels, and takes an active role in shaping the long-term strategy of the firm, but without infringing on the management’s ability to run the business on a day-to-day basis. The role of the board is to act swiftly and decisively in its oversight role over management, not just in crises but also continuously” (Rebeiz, 2006, p.45-46). Directors are expected to provide a consistent form of governance, regardless of their relationship to the company as Outside Directors or Inside Directors:

Outside directors are not officers of the corporations, whereas inside directors are members of the senior management team. Outside directors could further be classified as dependent - also called gray directors or independent [...] independent directors are outsiders with no linkage to the corporation. (Rebeiz, 2006, p.47)

Based on this statement, Outside Directors could be considered dependent or independent. The important characteristic which differentiates these Directors from others is that they are outside and not part of the management team. Inside Directors may be perceived by others as more knowledgeable as they may have access to more company information. However, this is not case for Enron. The directors used meetings to understand “highly speculative derivative transactions when in fact such a learning process should have taken place prior to the meeting” (Rebeiz, 2006, p.50). As a result, Directors were unable to assess information from “a variety of sources” (Rebeiz, 2006, p.50) and their decision-making processes were restricted: “[Directors are] unable to ask the right questions and unable to request additional materials outside the CEO’s main channels if necessary” (Rebeiz, 2006, p.50). This is pending that there are opportunities for directors to request the clarification of this financial information prior to meetings without the presence of the CEO. The Board issued approvals in highly time sensitive environments and multiple transactions were scheduled for review in short periods of time. The Directors became increasingly overextended, with added pressure to approve decisions based on insufficient information. Directors may not have realized that their approvals were based on incomplete information. In order to know if information is missing, the Board must anticipate specific
information. Since not all Directors understood the transactions, the absence of this information was not detected by the Board.

Enron’s chief executive, Ken Lay, and president, Jeffrey Skilling admitted statements: “they could not understand the accounting data” (Laud & Schepers, 2009, p.368). However, Enron employees who did not understand the accounting transactions avoided asking questions in fear of revealing their lack of knowledge and “under the ‘rank and yank’ system, the bottom 10 per cent were shown the door” (Hamilton & Micklethwait, 2006, p.36). Some members of the Board did not understand the financial details and relied on other Directors and Arthur Anderson, Enron’s auditors, to assess and approve deals.

The Board also depended on Enron’s legal counsel to approve the content in the disclosures for proxy statements and annual reports: “Enron, like all public companies, was required by the federal securities laws to describe its related-party transactions to shareholders and to members of the investing public in several different disclosure documents: the periodic reports filed with the U.S. Securities and Exchange Commission (SEC) on a quarterly and annual basis, and the annual proxy solicitation materials sent to shareholders” (Powers et al., 2002, p. 178). The content in the company materials should comply with SEC regulations and provide complete details of the company’s financial position for its readers; among them industry members and shareholders. Enron’s complex disclosures were challenging for industry analysts to comprehend; and shareholders relied on these analysts to interpret the information and rank the company: “Not all shareholders always read and understand the financial statements and related disclosures. Instead, they tend to rely on the business press and the more knowledgeable industry analysts” (Henderson, Gregory Oakes & Smith, 2009, p.468). Enron’s ambiguous financial statements gradually raised questions from the industry: “the disclosures were so complex that even the business press and industry analysts began to struggle. Not understanding Enron’s complex disclosures, analysts and reporters started questioning management more closely and began doubting the accuracy of Enron’s earnings and financial position” (Henderson, Gregory Oakes & Smith, 2009, p.468). It was not until these debates in the industry prompted the publication of a Wall Street Journal article, Enron CFO’s Partnership Had Millions in Profit, dated October 19, 2001 (U.S. Senate, 2002, p. 378), did the Board follow up for information regarding Andrew Fastow’s compensation details (U.S. Senate, 2002, p. 38). Yet Directors maintained that they were unaware of any red flags. The Directors used this prompt by the Wall
Street Journal article to follow up with Fastow for missing information; but did not consider it a substantial warning. The Board did not have access to the complete information yet to understand the severity of this situation. The fact the information was missing should have prompted the Board to question its omission. This is easier to consider in hindsight; but at the time, the Board only assessed the information it received from various committees, advisors and management.

Corporate governance emphasizes company accountability to shareholders and its responsibility to provide comprehensible financial statements: “We do not need more information, but better and more intelligible information” (Laud & Schepers, 2009, p.368). The implementation of an efficient system of internal controls is important, as the Board must monitor these controls to perform its fiduciary duties and to communicate complete and accurate details to shareholders: “The disclosure of effective/ineffective internal controls provides users of financial statements with an additional piece of information with which to assess the credibility and transparency of the company’s reported accounting information (Lopez, Vandervelde, & Wu, 2009, p.237).

Controls must be functional to be valuable. In the case of Enron, the controls were insufficient and the Board was uninformed about management activities. This lack of information undermined the authority of the Board of Directors. In addition, the Board may have been unaware of the red flags events due to limited information upon which it based its approvals. The information which was communicated to shareholders was approved in the decision-making process by several groups prior to the Board. Since the Board depended on advisors prior to granting its approval, the Board believed that the content was appropriate since it passed the advisors’ approval stage in the decision process. The dilemma for this Board was based in its reliance on experts. The Board’s authority was undermined by its lack of expertise to criticize the information presented to it: “Discerning this fine balancing point between the two competing interests of director accountability and director authority has been a long-standing, although elusive, goal of corporate law” (Nees, 2010, p. 203). Nees examines corporate law and fiduciary duties by assessing the criteria for Board oversight and addresses these accountability and authority issues.

Enron’s Board of Directors state that they were not aware of these “red flags” and a major factor may be due to the Delaware courts’ treatment of fiduciary duties, particularly with respect to red
flags. The legal implications of these red flags and the Board have inspired much debate in corporate governance literature. Definitions and specific details about red flags and related fiduciary duties are discussed in the Literature Review and Findings sections of this thesis. A general background is offered in this introduction with respect to relevant cases, *business judgement rule* and duties of care under the statutes of the State of Delaware, in order to provide context for discussion of these red flag events in the following chapters.

In the U.S. where most publicly held firms are incorporated under the statutes of the State of Delaware for tax reasons, the jurisdiction requires that the board has a dual role to the shareholders: A duty of care, due diligence, and a duty of loyalty using the “*business judgement rule*.” Under this paradigm, management is accountable to the board and the board is answerable to the shareholders. (Rebeiz, 2006, p.45)

A substantial reason for companies to incorporate in Delaware is that it offers firms comparative freedom to decide on company governance practices: “without mandating compulsory detailed rules as to the required composition of the board and its modus of operandi” (Rebeiz, 2006, p.45). Rebeiz states that in response to major corporate failures, the SEC has implemented changes to restrict “the discretion of the individual firms and organized exchanges to formulate their own corporate governance best practices” (Rebeiz, 2006, p.45) and in doing so, “recently enacted regulations have somehow tempered this laissez-faire approach” (Rebeiz, 2006, p.45). Based on the events which occurred in absence of strong corporate governance, effective regulations are long overdue.

Nees considers an important and frequently cited Caremark case of 1996, the establishment of adequate controls and its relationship to Directors’ liability for failure to recognize red flags: “The Delaware Court of Chancery opined that directors could be liable for failed oversight if a plaintiff could show that directors knew or should have known that violations of law were occurring yet failed to take good faith steps to prevent or remedy the situation that proximately caused the complained-of losses” (Nees, 2010, p. 205). The central premise of this case was to establish the liability of this Board regarding several failures, including the lack of operative controls to warn the Board of red flags and respond to this information:

Caremark has been interpreted to condition liability upon the failure to implement reporting and monitoring systems, or once having implemented such systems or controls,
failing to monitor and react to the information compiled from such systems—in other words ignoring "red flags" that should have prompted director action" (Nees, 2010, p. 205).

A potential breach of duty of care is the most applicable of the fiduciary duties to the events which relate to Enron’s Board of Directors. This involves task duties to monitor which is explained in detail in the literature review chapter. As in this Caremark case, Enron’s Board failed to monitor executives by implementing ineffective controls. “In re Caremark, 698 A.2d at 967-70 written in the context of a settlement approval, the Caremark decision evaluated whether directors had breached their duties of care by failing to monitor employees who violated various state and federal laws regarding health care provider payments, resulting in significant criminal and civil fines” (Nees, 2010, p. 205). Nees refers to Caremark to emphasize the use of the business judgement rule in support of the Directors’ decisions which should be made in the best interest of the company. In Delaware courts, unless the Board abuses this judgement, the court recognizes that Board decisions are made in good faith:

In re Caremark, 698 A.2d at 967. “A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation.” The business judgement rule is a recognition of that statutory precept.” (Nees, 2010, p. 204)

Nees explains that based on this rule, the Delaware courts do not criticize the Board’s judgements and presumes that Directors are informed in the decision-making process and “will not be second-guessed” (Nees, 2010, p. 204) “[a]bsent an abuse of discretion, that judgement will be respected by the courts” (Nees, 2010, p. 204). The decision-making process must be examined in order to determine whether abuse of discretion occurred, and to do so without second guessing the actions of the Board may prove to be a challenge. Abuse of discretion may not be evident by evaluating the outcome of a decision. It is important to understand the intention of the decision maker at the time that the decision was made and not only assess it based on the result of the decision. This is the reason to consider the Directors’ duty of good faith when examining the oversight capability of the Board.

Nees outlines three elements which influence Directors’ oversight liability: “(1) the prevalence of exculpatory provisions, (2) Delaware's recent interpretations of the duty of good faith, and (3)
the role of the business judgement rule in shareholder derivative suits” (Nees, 2010, p. 215).

Exculpatory provisions are vital in Delaware Courts for oversight liability: “Exculpatory provisions are statutory opt-in rules that allow a corporation to adopt charter language limiting director liability only to instances involving a breach of the duty of good faith or loyalty, and eliminating liability for a breach arising under the duty of care” (Nees, 2010, p. 204). However, the Enron’s Board of Directors would not have been protected under this exculpation provision as it does not protect Directors in breach of their fiduciary duties of good faith. Typically, Board members would have been protected in Delaware courts, but not if Enron’s Directors demonstrated that they were aware of these red flags. Directors may have been reluctant to place themselves in positions to compromise their best interests or they simply were uninformed of the complete picture and relied heavily on the insight and expertise of advisors.

The second factor contributing to the narrowing of the doctrine for director oversight liability is Delaware’s recent interpretations of the duty of good faith. The cases described in this introduction “examine relationships of duties of good faith and loyalty” (Nees, 2010, p. 222).

As stated, cases which involve fiduciary duties of good faith are most relatable to Enron. The Disney cases were frequently cited cases which dealt with business judgement rule and the Board of Directors. These Disney cases were addressed “in both the Delaware Court of Chancery and the Delaware Supreme Court from 1998 through 2006” (Nees, 2010, p. 222). There were several appeals regarding these Disney cases, however only a few of these cases are highlighted for this study. The first case is the original shareholder complaint which involved the Board of Directors’ decision to terminate, CEO Michael Ovitz at the time “after only fourteen months of service, entitling him to a golden parachute worth approximately $130 million” (Nees, 2010, p. 222). This case was dismissed by “the Delaware Court of Chancery in re Walt Disney Co. Deriv. Litig., 731 A.2d 342, 350, 380 (Del. Ch. 1998)” (Nees, 2010, p. 222). After a series of appeals, Chancellor Chandler’s ruling found “that the director defendants neither breached their fiduciary duties nor committed corporate waste” (Nees, 2010, p. 222) and this Disney case took place “in a thirty-seven-day trial between October 2004 and January 2005. In re Walt Disney Co. Deriv. Litig., 907 A.2d 693, 697 (Del. Ch. 2005)” (Nees, 2010, p. 222). The decision in the final derivative case that ended the series of Disney cases was the appeal “to the Delaware Supreme Court, [as the ruling] affirmed the trial court, thus ending the Disney litigation. In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 75 (Del. 2006)” (Nees, 2010, p. 222).
The Disney cases referred to the Directors fiduciary duties of *good faith*. Especially the derivative litigation case which was “brought against Ovitz, by Michael Eisner [President] and Directors, for breach of fiduciary duties of *good faith* and *loyalty* to shareholders” (Nees, 2010, p. 222-223). This Disney cases provide an excellent parallel to the situation of the Board of Directors at Enron. These cases examine the same conduct duties, as described in the literature review, and the *business judgement rule* which protects the Board from liability. As it was affirmed in the final derivative case, Judge Chandler’s statements did not find this Board of Directors in breach of their fiduciary duties. The process for the Disney decision is as follows:

In re Walt Disney Co. Deriv. Litig., 907 A.2d 693, 697 (Del. Ch. 2005). Chancellor Chandler issued an epic eighty-six-page decision in August 2005, finding that the director defendants neither breached their fiduciary duties nor committed corporate waste. Id. at 697, 779. That decision was appealed to the Delaware Supreme Court, which affirmed the trial court, thus ending the Disney litigation. In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 75 (Del. 2006)” (Nees, 2010, p. 222).

Nees states that the red flags related to Caremark do not address the failed process and focus on the consequences of failed decision-making: “Utilizing a revised doctrinal approach that relies upon well-articulated standards giving life to Caremark's concept of red flags, however, hinges liability upon failed processes, instead of the hindsight-benefited determination of poor business decisions” (Nees, 2010, p. 207). In response, Nees offers an “alternative judicial approach to analyze director oversight liability by articulating a five-pronged, process-oriented test to define "red flags" and, thus, director oversight liability” (Nees, 2010, p.199).

As part of this thesis introduction, the red flags leading up to Enron’s collapse which most relate to the Board in the decision-making processes are examined by using Nees’ process-oriented test. By including contextual details of these events, the aim is to show that the consequences of the event and the intention of the participants may not always fit, since other factors may influence a decision. Nees proposes a “five-factor, process-oriented approach” (Nees, 2010, p. 207) and “identifies red flags triggering a director's duty to act under Caremark” (Nees, 2010, p. 207) as discussed above.

Nees’ approach defines the components of the Board of Directors’ decisions: “The five factors are (1) the potential harm to the company, (2) the time directors had to react, (3) the particular
source of the red flag, (4) the frequency of the red flag, and (5) the availability of relevant information to the directors” (Nees, 2010, p. 207). Nees offers the example of the Board’s responsibilities to consider the first factor regarding potential harm to the company:

By looking to both the magnitude and probability shields directors from liability for petty complaints, insignificant losses, and unlikely risks, and instead focuses a court's attention on the information that should have put a reasonable director on notice that action (i.e., exercise of management duties) was required in order to prevent a substantial and likely loss” (Nees, 2010, p. 240-241).

For Enron, this involves the quality and duration of time that the Board devoted to examine information and prepare for the Board meetings prior to approving arrangements. The second factor involves reaction time. Although the Board discussed issues at meetings, this factor examines its response to information: “Whether or not a board took action and how it executed its oversight duties should be informed by the context in which those managerial decisions took place” (Nees, 2010, p. 240-241). A key indicator of response time is to map the ways that Enron’s Board reacted to information or lack of information. It is important to understand the ways that Directors clarified concerns, if they did not understand details or if the content was unclear to them. The third factor involves assessing the information, its accuracy and authenticity from which it came: “Under this approach, inside reports could be given more weight under some circumstances (e.g., evidence of internal control and auditing problems), and outside sources could be given more weight under other scenarios (e.g., evidence of corporate corruption or selfdealing)” (Nees, 2010, p. 242). For this study, examples focus more on internal controls and instances of auditing problems.

The fourth factor is described as a “conscious failure to act” (Nees, 2010, p. 243-244). Enron’s Board of Directors maintain that they were unaware of the red flags, so based on this assertion, Directors could not experience any repetition of warnings, since they did not notice the first one to disregard it: “knowledge of a risk or problem increases the likelihood that a failure to act in response to it would constitute a "conscious disregard”” (Nees, 2010, p. 243-244). The fifth factor examines the opportunities that the Board had to assess information that should raise a red flag. In corporations warnings are detected by adequate controls. Nees states that such warnings may be identified "as a part of regular reporting and monitoring functions, because the
information was readily available to the board” (Nees, 2010, p. 244). However, this only works if the controls are functional. Enron’s controls were not functional nor were they monitored properly.

Controls are monitored to perform formal checks and balances in the interests of shareholders. Such a system appeared to be absent at Enron. It is important to examine the decision protocols and policies for weaknesses which may have prompted these red flag events which led to Enron’s collapse. This company failure was followed by numerous regulatory changes and efforts to improve corporate governance: “In the United States, the pivotal Sarbanes-Oxley Act (SOX) of 2002 increased reporting requirements, penalties and oversight over audits, financial reports, corporate counsel, senior executives and Boards of Directors” (Snider, 2009, p.183). Although the SOX tightened regulation, it provoked a response by some industry professionals to devise ways to counter the improvements: “Tax lawyers and accountants quickly institutionalize new ways to evade, avoid or nullify the latest set of regulations (McBarnet, 2004; Braithwaite, 2005) – until the next crisis (Snider, 1993; Calavita et al., 1997; Rosoff et al., 2006)” (Snider, 2009, p.183). This demonstrated a chain of events: a firm collapses due to inappropriate financial practices, followed by regulatory changes, which encourages others to design new ways to circumvent the from new governance rules.

For Enron, problematic accounting practices and corporate mismanagement resulted in failure: “Facing pressure from its creditors, litigation (initiated and threatened), and investigations by the SEC and other law enforcement authorities, Enron filed bankruptcy in December 2001” (Henderson, Gregory Oakes & Smith, 2009, p.468). Enron’s collapse resulted in the investigation of companies associated with the firm. Arthur Andersen’s reputation was forever changed after these events. Although the Supreme Court changed its decision three years later, the events ruined Andersen’s once prestigious standing in the industry:

In 2002, Enron’s auditing firm, Arthur Andersen, was found guilty of obstruction of justice when it destroyed thousands of documents related to its work for Enron. As a result of the verdict and loss of credibility, Arthur Andersen, the oldest and one of the largest public accounting firms in the world, was effectively forced out of business and 28,000 individuals lost their jobs. The verdict was overturned in 2005 by the U.S. Supreme Court on the basis of inadequate jury instructions (Andersen Conviction

It is impossible to identify all of the factors that contributed to the collapse of Enron. Barker suggests that “decline can stem from sources such as a weak strategy, a dysfunctional organizational culture, financial mismanagement and other factors. Thus, the fact that decline can and usually result from multiple sources makes perceiving its causes difficult” (Barker, 2005, p. 44). This study attempts to map the information flow of groups in the decision-making process. In doing so, Board decisions are contextualized by “red flags” to assess the role of the Directors in this decision-making process and identify the sources which contributed to this corporate failure.

The Sarbanes-Oxley Act did not stop similar company collapses and massive bankruptcies. A string of corporate failures followed Enron, including Lehman Brothers as the largest in U.S. history, with Enron ranked in sixth place (CNN Money, 2009). Lehman Brothers stock plummeted within in a relatively short period of time, to become the largest corporate failure in US history “Lehman’s stock closed under $4, a decline of nearly 95% from its January 2008 value” (Valukas, 2010, p.2) and filed for bankruptcy and the bailout followed within a few weeks:

LBHI [Lehman Brothers] filed for Chapter 11 bankruptcy protection on September 15, 2008 [...] September 16, 2008, the Primary Fund, a $62 billion money market fund, announced that – because of the loss it suffered on its exposure to Lehman – it had “broken the buck,” [...] On October 3, 2008, Congress passed a $700 billion Troubled Asset Relief Program (“TARP”) rescue package. (Valukas, 2010, p. 11- 14)

The subsequent financial bailout and Wall Street reform issues are beyond the scope of this study; but, it is important to note that large corporate failures occurred after Enron collapsed and these financial disasters led to historic legislative reform. On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act, hereafter referred to in this study as Dodd-Frank. Since Enron’s failure prompted regulatory changes in the form of the Sarbanes-Oxley Act, it may be valuable to assess the way the Dodd-Frank Act aims to improve corporate governance. A brief analysis of regulatory issues from Dodd-Frank applicable to this study is in the Conclusion chapter to show the relationship between the Board of Directors’ role
in the decision-making processes at Enron and current issues which affect regulatory changes for this industry.

This introduction chapter offers a brief summary of Enron’s position in the industry, the role of Enron’s Board of Directors to provide governance, and the perception of Enron’s financial position by industry analysts. This background section is followed by the research statement and organization of this thesis. A general overview of the major areas in the literature review is provided to explain concepts of oversight liability and the ways in which “red flags” relate to fiduciary duties of the Board. In this introductory chapter, leading cases illustrate the relationship between *business judgement rule* and the decision making processes of the Board.

The Enron case was applied to the “five-factor, process-oriented approach” (Nees, 2010, p. 207) based on research by Nees (2010). In doing so, I briefly explained that Boards use internal controls to monitor corporate activity and the importance of using these controls in the Board’s decision-making processes. Corporate governance and decision making processes research are introduced in this chapter, as well as the regulatory responses to the Enron collapse. The following chapter is the Literature Review which examines both corporate governance literature and details regarding the fiduciary duties of the Board.
2 Literature Review

“We have created trouble for ourselves in organizations by confusing control with order.”
Margaret J. Wheatley

In the previous chapter, I offered a brief summary of Enron, representative cases related to issues of business judgement rule and red flags as this term relates to fiduciary duties of the Board. For this literature review chapter, both fiduciary duties and corporate governance literature are examined in more detail to provide context for reader to understand the responsibilities of Directors in corporations.

In corporate governance literature, decision-making studies have examined the ways that companies delegate decision authority using various methods and degrees of formality. In many cases, information is presented only if it requires Board approval. However, in order to effectively understand the Board’s role in the decision-making process, it is essential to identify the source which identifies the responsibilities of the Board and the ways that other responsibilities are delegated by the Board to other groups. The term “red flags” was used in this thesis with respect to its legal context, particularly related to the Fiduciary Duties under Delaware Courts. It was important to understand the ways in which Fiduciary Duties influence the Board’s decision-making processes (Section 2.1) and highlight the conduct duty of good faith and the task duty to make informed business decisions, since these Fiduciary Duties relate to the Board’s identification of red flags.

First, the theories and frameworks used in corporate governance research must be examined to assess the influence of the Board. Corporate governance research includes many options to examine the structure of the Board: “Investors and investigators have typically focused on clear observables such as the separation of chair and CEO, size of the board and prior experience of the directors (Conyon and Peck, 1998)” (Useem & Zelleke, 2006, p. 3). Alternatively, researchers may concentrate on corporate governance regulation and the duration of Board appointments: “A parallel focus has been upon board governance policies, such as anti-takeover mechanisms and staggered board terms (Gompers et al., 2003)” (Useem & Zelleke, 2006, p. 3). In addition to examining the structure of the Board, “a stream of behavioural research has emerged that focuses upon what boards do, supplementing our knowledge of what they look like (for example, Forbes and Milliken 1999; McNulty and Pettigrew 1999; Pettigrew and McNulty
Examining Board responsibilities and the execution of its duties offers an opportunity for the researcher to observe “important board activities that can be underplayed in more structural approaches, such as planning, shaping, and monitoring strategy to influence organizational decision-making” (Maitlis, 2004, p. 1276). Based on this corporate governance literature review, the predominant theories regarding Boards have been agency and managerial hegemony theories: “Agency theory and managerial hegemony theory have been most regularly applied to the analysis of boards and directors” (Pettigrew and McNulty, 1998, p.199).

Pettigrew and McNulty describe the Board’s central role in Agency Theory: “Agency theorists place the board at the heart of corporate governance” (Pettigrew and McNulty, 1998, p.199). In this role, the Board monitors management activities; this is achieved by the implementation of internal controls. In agency theory: “the board is portrayed as an alternative monitoring device that helps to control corporate management (the agents) to further the interests of the principals (the shareholders)” (Pettigrew and McNulty, 1998, p.199). Agency theory views Board involvement in decision-making as vital, since it is the entity that represents the interests of shareholders. As an example, the information in proxy statements and annual reports are essential documents used in the communication process from companies to shareholders. The dissemination of complete and accurate financial information informs shareholders about company operations. The Board role is to monitor this process and verify that the information is correct.

Laud & Schepers (2009) highlighted problematic areas regarding “the limits and failures of reporting, there are two areas of major concern. The first is the systematic failure of the current checks and balances of the financial reporting systems to uncover fraud, misdeeds, high-risk decision-making, or simply weak links in the organization” (Laud & Schepers, 2009, p.373). In order to address the first systematic failure, companies must create functional systems of checks and balances for financial reporting systems by implementing adequate internal controls.

The Board monitors these controls to ensure that the company complies with U.S. Securities and Exchange Commission (SEC) regulations. By the Board monitoring controls effectively, it limits the “spread of stock option misuse, back-dating, off-balance sheet accounting, lack of analyst oversight, suspension of ethical codes, board failure, and so on, are merely symptoms of the
larger issue of systematic accountability and financial-system failure” (Laud & Schepers, 2009, p.373). Laud & Schepers state that “the second major endemic concern is the quantity and extent of personal failures attributable to the professions involved in business reporting” (Laud & Schepers, 2009, p.373). This may involve the examination of issues which concern the ethical conduct for professions for this industry: “Enron’s managers, traders, and executives, as well as external analysts, advisors, lawyers, and bankers, were involved in some form of opportunism” (Laud & Schepers, 2009, p.375).

Pettigrew and McNulty refer to Finkelstein & D’Aveni’s work to demonstrate the way that “agency theory is about power” (Pettigrew and McNulty, 1998, p.200) and the role of the CEO and “the power relationship between the board and corporate management (Finkelstein & D’Aveni, 1994)” (Pettigrew and McNulty, 1998, p.200). Based on this assessment, these relationships involve a fundamental need for power which may be interpreted as the ability to influence the decision-making process. McNulty et al. explore this relationship between power and influence in this organizational environment as: “the ability of an individual or group of individuals to realize intended effects is more likely to be a product of awareness, possession, control and tactics in using contextually pertinent power sources, which may be viewed as the relational or micro aspect (Pettigrew 1973; Pettigrew and McNulty 1995)” (McNulty, et al., 2011, p. 93-94). Based on this statement, perhaps power sources may be influenced by a combination of awareness, possession, control and tactics in information flow. These power sources may be management’s awareness of information, management’s access to information (possession), information control and management’s tactics to conceal, manipulate and disseminate information. Management may use power which derive from information to influence groups (over one another) in the decision-making process: “The relational view of power, defined here as influence, requires analysis of behaviour involved in the exercise of power, as well as one’s structural position or role” (McNulty, et al., 2011, p. 94).

Stiles (2001) referred to Zahra and Pearce (1989) to describe the Board’s central role to direct the organization’s purpose using agency theory. This theory “‘places a premium on a board’s strategic contribution [...] the development of the firm’s strategy and the setting of guidelines for implementation and effective control of the chosen strategy’ (1989, p. 302)” (Stiles, 2001, p.628). Prominent themes within agency theory incorporate factors of strategy, power as influence, and the Board’s central role to monitor the decision-making process. Reviewers of
agency theory are concerned about the emphasis of relationships over other factor: “Eisenhardt (1989); Hirsch, Michaels, and Friedman (1987); and Perrow (1986); to varying degrees, have criticized agency theory for its overstatement of the self-interested qualities of human beings, for its fixation with dyadic relationships, and for its lack of empirical development in organizational settings” (Pettigrew and McNulty, 1998, p.200). It is necessary to consider an approach conducive to the examination of organizational structure and information processes. Another criticism of agency theory involves the behavioural conditions in which the Board of Directors’ knowledge is shaped as “The behaviour of key board members is also likely to be shaped by their backgrounds, values, experience levels, and tactical skill as internal politicians. (Pettigrew and McNulty, 1998, p.200)

The second predominant theory in corporate governance literature is managerial hegemony theory. Pettigrew and McNulty (1998) describe managerial hegemony as “a complementary but longer established analytical position for studying board power relationships” (Pettigrew and McNulty, 1998, p.200). Managerial hegemony theory argues that corporate management is: “full-time, better informed, and more experienced” (Pettigrew and McNulty, 1998, p.200). Boards are depicted as “rather passive [and in a] rubber-stamping role” (Pettigrew and McNulty, 1998, p.200). Essentially, management uses their superior experience to manipulate and control Boards. These Boards are only more empowered due to “shareholder activism (Useem, 1993; 1996) and changes in the legal and regulatory environment” (Pettigrew and McNulty, 1998, p.200). As per managerial hegemony theory, managers may control the Board by their “influence over board composition, the board agenda, [and] information flows” (McNulty, et al., 2011, p. 100). Managers send information to select groups to protect and further their own interests.

Maitlis describes the decision-making process of “the CEO’s approach to information management” (Maitlis, 2004, p. 1297) which “involves gathering, holding, and concealing information, as well as disseminating it to certain key parties at strategically advantageous times” (Maitlis, 2004, p. 1297). Maitlis states that the CEOs with the most influence on the information flow were “those who share information with a member of a dominant coalition, while tightly controlling the timing and amount of information given to the rest of the board” (Maitlis, 2004, p. 1299). This research emphasizes the ways that management used information control in the “setting and manipulating of agendas and decision-making processes, as highlighted by
Lukes (1974) and by Bacharach and Baratz (1962)” (Maitlis, 2004, p. 1299) in order to tightly control the timing and amount of information sent to Enron’s Board.

The research in corporate governance literature which relates to the Board’s influence on decision-making processes appears to shift towards a “jointly contextual and processual” (Pettigrew and McNulty, 1998, p.201) approach from a more structural approach (McNulty & Pettigrew, 1996; Pettigrew, 1992; Pettigrew & McNulty, 1995)” (Pettigrew and McNulty, 1998, p.201). According to Pettigrew (1997) the rationale for processual analysis is “to account for and explain the what, why and how of the links between context, processes and outcomes” (Pettigrew, 1997, p.340). Maitlis states that structural methods may be considered “distant” and researchers may prefer a processual approach (Maitlis, 2004, p. 1279) as it examines several factors which effects the outcome of events and “acknowledges the importance of incorporating the social, political, and economic contexts in which the action has taken place” (Maitlis, 2004, p. 1279). This is applicable to a corporate environment, since these conditions shape the way that groups “influence key organizational decisions” (Maitlis, 2004, p. 1277). Maitlis refers to McNulty and Pettigrew (1999) work regarding ways that the Board influences “both the ideas that form the content of company strategy and the processes through which these ideas evolve” (Maitlis, 2004, p. 1280). Yet, this statement appears to contradict the depiction of a “passive board” (Pettigrew and McNulty, 1998, p.200). Perhaps the Board influences the decision-making process; but it may not be in a positive way. It may depend on the organizational culture of the firm and the role of the Board in the approval process. Maitlis refers to several factors which affect this process, such as the “informal communication between directors, and the history and performance of the company” (Maitlis, 2004, p. 1280). Processual research that maps the influence of the Board in the decision-making process and addresses the ways that Directors shape strategic decisions in firms is valuable, as it may contribute to policy development and corporate governance. Shareholders benefit from a processual approach to corporate governance research, as it investigates barriers to information to improve corporate accountability.

In Stiles’ work, factors of power and control are described as integral to the “managerialist thesis” (Stiles, 2001, p.628). Work by Berle and Means (1932) is summarized by Stiles, in order to explain the relationship between management issues and shareholder control:
[Berle and Means (1932)] thesis of the separation of ownership and control argued that as companies grew and increased their share capital, the proportion of shares held by the largest institutions would decrease (Berle and Means, 1932; Tricker, 1984). As a result, the power of large shareholders to control corporations was diluted. The ensuing weakness of shareholder control means that the discretion afforded to management over the control of the company would increase and since managers are likely to be self-serving, they may pursue objectives of their own choosing (Parkinson, 1993). (Stiles, 2001, p.628)

Stiles claims “the managerialist thesis demonstrates that much depends on the definition of the term ‘control’” (Stiles, 2001, p.628). Based on Stiles’ assessment of this work of management control, management is expected to have a detailed familiarity of company operations: “which gives them an intimate knowledge of the business, putting the board at a disadvantage” (Stiles, 2001, p.628-629). This creates an information hierarchy of groups based on their access to important information about company operations. Management also becomes less dependent on shareholders once managers are able to obtain funds from other sources: “in addition to this specialized knowledge, managers in profitable companies are able to finance investments from retained earnings, thus allowing them to weaken the dependence on shareholders for capital (Mizruchi, 1983). This allowed them to pursue other aims other than profit maximization” (Stiles, 2001, p.628-629). Management becomes more independent due to increased access to important company information and options to obtain funds from sources other than shareholders. Management uses this access to information and financial sources to make strategic decisions to sustain their influential position in this information hierarchy.

In addition to research on factors which increase management independence, there has been substantial work which examines issues regarding the independence of the Board: See Maitlis 2004 for a review (Maitlis, 2004, p. 1278). Maitlis refers to two studies, Fama and Jensen (1983) and Westphal (1998) which examine Board independence, power and decision-making. In the first study, the findings involve management and the Board whereby “management decision-making would be better controlled by more independent boards (Fama and Jensen, 1983)” (Maitlis, 2004, p. 1278). This statement assumes that the Board has control over management’s decision-making process even if the Board dependent; which seems unlikely. It may be interesting to examine if any of groups are independent prior to investigating the rate of control
that one group has over the other. The second study involves power and Board independence: “Westphal (1998) showed that boards can become less powerful when their independence is increased” (Maitlis, 2004, p. 1278). This latter study appears to contradict the former, since power is generally associated with control. These statements raise questions about the role of the Board in the decision-making process, the way that the Board is perceived by management as its formal authority. The Board may try to maintain its independence by the use of formal decision protocols to “balance between delegation and oversight, so seemingly straightforward in principle, that many boards intent on reclaiming sovereignty without micro-managing are searching to get right in practice” (Useem & Zelleke, 2006, p. 6). Decision protocols and calendars do not ensure that the Board is able to identify problematic issues as they occur, if these issues are not included as items on the agenda. Unexpected issues may not be identified as a high priority:

The annual calendar and decision protocol set the broad categories on which meetings will be focused and around which directors retain explicit decision-making control, but many potentially board-worthy issues arise unexpectedly over the course of a year on an irregular schedule [...] choices have to be made as to what to include or omit from the next board meeting’s agenda. (Useem & Zelleke, 2006, p. 8)

For some companies, the Board uses decision protocols to rank issues and delegate them to management or include items on the Board agenda. Certain events may not seem like warnings or red flags as they occur. It depends on whether the Board received information to provide context for the events. Only then, is the Board able to rank it appropriately. However, not all companies use decision protocols; and if used, not all companies use decision protocols in the same way.

Useem & Zelleke (2006) examine the ways that written protocols and calendars are used to allocate decisions by the Board of Directors and/or management. Individuals from 31 companies are interviewed for their study to assess the way that protocols and calendars are used as tools in the decision-making process. The Board’s independence may decrease due to management’s ability to decide which issues should be designated for the Board or for management consideration (Useem & Zelleke, 2006, p. 2). Useem & Zelleke explained that methods differed among companies to decide which issues are reviewed by the Board or management, but this
decision process is still an “essentially private affair – we should expect substantial variation among them” (Useem & Zelleke, 2006, p. 5). Based on Useem & Zelleke’s research, these companies use two formal tools, decision protocols and calendars: “to help ensure that directors have the opportunity to take the decisions that they have retained for themselves and to oversee the decisions they have delegated to management without giving up control of them” (Useem & Zelleke, 2006, p. 6). In theory, the Board may intend to use these documents to sustain control. In practice, it is not possible that all decisions may be recorded and monitored to give the Board this type of control: “Managers of large firms with tens of thousands of employees collectively make dozens of major decisions every day, and their board is incapable of reviewing most of them let alone making them” (Useem & Zelleke, 2006, p. 8).

Typically, the responsibilities for Directors may involve “decision authority over a range of legally required or regulatory matters, from declaring dividends and approving mergers to nominating directors and hiring independent auditors” (Useem & Zelleke, 2006, p. 6). Boards may select which decisions to assign to management if these issues are outside of the scope of the Board’s duties: “retaining a select set of major decisions and exercising oversight over the rest” (Useem & Zelleke, 2006, p. 6). This implies that Directors have more influence on the items that are on the decision protocols and calendars, which may not be the case in all companies. In fact, although the majority of the companies in Useem & Zeleeke’s study follow this model, at least one third does not: “Roughly two-thirds of the companies in our sample have taken additional steps, beyond the annual calendar, to formalise the allocation of decisions between management and the board, with a view to keeping lesser issues within management and bringing greater questions to the board” (Useem & Zelleke, 2006, p. 7). Of the two-thirds that follow this model, it is assumed that the Board of Directors understood the consequences of delegating issues to management. The Board perceives these items as less substantial for it to review. However, if the Board does not have a clear understanding of the context for these issues, it may be a challenge for the Board to prioritize items and select those that require the Board’s attention. The Board tends to depend on advisors to assess the information first and offer guidance regarding which issues should be delegated to management.

Board independence decreases as a result, since it relies on advisors to assess complex transactions prior to the Board choosing which issues to include in the decision protocol. This decision may be part of the Board’s role for some companies. Yet, there are companies that
refrain from the decision protocol completely or the Board is not involved in its creation. There are several ways that companies approach decision protocols:

Other companies, by contrast, maintain a far more limited written guideline, with fewer substantive areas, and some depend instead on a set of standing resolutions by the board rather than a single integrated document. Still others largely rely on informal understandings and discretionary judgements, with few or no written guidelines. (Useem & Zelleke, 2006, p. 7)

By eliminating the formal decision protocol, the Board may not have the opportunity to be involved in a decision-making process to divide the responsibilities between the Board and management. As a result, there is no opportunity for the Board to oversee the decision-making process or fulfill its corporate governance role for oversight, and the Board becomes more passive: “True, some of the issues by legal requirement or regulation must be vetted and approved by the board, such as management’s recommendation for stock dividends and share buybacks. But most of these votes are viewed as formalities, with scant discussion and little dissension” (Useem & Zelleke, 2006, p. 7). As the type of issues that the Board is responsible for approving diminish in importance, it has less influence in the decision-making process: “other issues, such as corporate strategy and multiyear operating plans, by contrast, can draw intense dialogue and sometimes spirited dispute – but many companies require no explicit decision by the board” (Useem & Zelleke, 2006, p. 7). In addition to the value of the items that the Board reviews, it is important to note the consequences of decision-making processes which omit Board approval completely.

This division of decision responsibilities depends on the decision protocols set up by the Board. The language used in these formal documents contributes to the division of duties. The language may be phrased to imply an overall review of the transaction by the Board; but may also include specific phases to indicate that the deal does not require Board approval; perhaps during the restructure phase for a deal. As a result, the information for only specific phases is communicated to the Board by management. Although it is the Board’s responsibility to oversee and monitor the appropriateness of the deal, management still has the opportunity to use and manipulate the content in decision protocols based on clauses in the decision protocol. If the language for these clauses is unclear, the Board may not understand the consequences of the
decision protocol as it acts to limit the information that may be assessed by the Board for specific phases of deals: “The language more often than not asserts which executive decisions must receive board approval, but the language at some companies inverts the allocation of decision rights, stating instead which decisions can be made by management without board approval” (Useem & Zelleke, 2006, p. 7). This process is not used by all companies. It is a challenge for companies to compare the use of language in a good example of a decision protocol since “decision protocols are confidential and private” (Useem & Zelleke, 2006, p. 10) and companies cannot access decision protocols to compare and develop their own (Useem & Zelleke, 2006, p. 10).

Management influences the information that the Board may assess: “the criteria for the choice of what the directors should know vary from company to company, but the essence of most is for the CEO to make his or her own judgement call on what the board should hear” (Useem & Zelleke, 2006, p. 8). For many companies, management selects the issues for the Board’s review and this may be done by the CEO in consultation with legal counsel. According to Useem & Zelleke (2006) the CEO decides and selects an important issue, consults with the General Counsel on whether a given issue is “material”, but in large organizations, “few issues meet this [material] test” (Useem & Zelleke, 2006, p. 8). Management and legal counsel determine whether it is necessary for the Board to be involved in the decision-making process. The Board may not be aware that the issue exists while it is under consideration by management since it has not received information from management about it. Useem & Zelleke describe the significance of the General Counsel’s role in this decision-making process: “as the top legal officer at the firm, the general counsel is responsible for ensuring that the firm complies with governance regulations, including what information should reach directors and investors” (Useem & Zelleke, 2006, p. 8). The information sent to the Board may be based on the General Counsel’s assessment of the “materiality” of an issue. “Materiality” is defined by “an inherently vague standard, but its essence is the magnitude of an issue’s anticipated or potential impact on the company” (Useem & Zelleke, 2006, p. 9). This standard may allow the General Counsel to categorize the “materiality” of an issue in a general way based on its vague criteria. In this decision process, which at this point only consists of management and General Counsel, decision protocols do not offer the Board an opportunity to exercise any substantial governance (Useem & Zelleke, 2006, p. 9) since control of this decision: “remains in the hands of management rather
than the board” (Useem & Zelleke, 2006, p. 9). Appendix C includes biographical details (from Enron’s 2001 Proxy Statement) and Corporate Governance Guidelines for the Board of Directors (U.S. Senate, 2002, p.383-392), in order to provide details of the governance practices and responsibilities of the Board.

Directors require access to complete information prior to Board meetings with enough time to review these details and ask for clarification. Successful management works with the Board in the best interest of the company. It is possible for management to work with Boards to create an agenda, if management asks the Board: “what do you want to know more about?” (Useem & Zelleke, 2006, p.10) and encourages questions related to company operations and issues to shape the agenda. In this example from Useem & Zelleke (2006) research the Board agenda was sent to the Board prior to the meeting for Directors to review and comment on issues which created more efficient information flow and communication processes. The executive appeared confident in the process and he stated that “he lost no sleep about what should go up to directors since it is an active and demanding board [as it is] explicit about what should come to its attention” (Useem & Zelleke, 2006, p.10). This explicit use of information flow supports the Board in an active role in the decision-making process: “The decision-making and involvement literatures highlight the relationship between access to information and involvement in decision processes (for example, Heller et al. 1998; Wall and Lischeron 1977), showing that parties are more likely to influence decisions when they have the relevant information” (Maitlis, 2004, p. 1298-1299). The case reported in Useem & Zelleke (2006) research showed the way management gave the Board sufficient time to review and comment on issues in their study. Therefore, management’s use of time may have been an important factor to control information flow at Enron, if management did not allow the Board sufficient time to review issues and imposed additional time constraints during its review.

The Board of Directors must be diligent about their awareness of company operations and critical of the information presented to them as well as the environment by which it is presented to them. Directors make decisions based on issues that have been delegated to them by management. However, it is the responsibility of the Directors to request and investigate information as well as sufficient time to understand and contextualize these issues as part of their role as fiduciaries.
2.1 Fiduciary Duties

Salter cites Black’s Law Dictionary to define a fiduciary as “one who owes to another the duties of good faith, trust, confidence, and candor” (Salter, 2008, p.157). Seven of the fiduciary duties applicable to this Enron case study are organized into two categories of duties: conduct and task (Salter, 2008, p.159). The four task duties include: “decision-making, disclosure, monitoring, and inquiry” as a framework to organize an assessment of how well Enron’s directors served as agents for shareholders (Salter, 2008, p.159). The three conduct duties consider principles of care, good faith and loyalty (Salter, 2008, 158) with specific reference to Oregon Law, since Enron was incorporated in the State of Oregon (Salter, 2008, 158). In many cases, Oregon courts may apply Delaware Law since it has “the most complete body of corporate law” (Salter, 2008, p.417). The State in which a company is incorporated has a significant influence on the accountability of its Board of Directors, since under Oregon law: “Corporations are free to hold directors blameless for negligent breaches of fiduciary duty. See Oregon Revised Statutes § 60.047(2)(d)” (Salter, 2008, p.419). However, if the Board was aware of issues which compromised the best interest of the company, in other words if the Board was aware of “red flags” – then the Board would not be protected from its failure to investigate these warnings. Salter explains the way that this *exculpation provision* does not protect Directors in breach of their fiduciary duties of good faith:

> *Exculpation provisions* do not protect directors for liability based on acts that they know contravene corporate interests. Because Enron provided its directors with such a clause, they would face legal liability only if their actions can be shown to breach the *good faith* duty. The clause is contained in § A, Article VII of Enron’s Articles of Incorporation. (Salter, 2008, p.419)

Conduct duties related to issues with “partnerships and hedging transactions in good faith” (Salter, 2008, p.422) are highlighted in this study to explain a breach of good faith would result in liability for Directors, as described above. Both the *conduct duty of good faith*, and the *task duty to make informed business decisions*, relate to the Board’s identification of red flags (as indicative of problematic corporate issues) and the Board’s role in these decision-making processes. Salter cites the case, *Gagliardi v. TriFoods Int’l Inc.*, 683 A.2d 1049, to define Duty
of Good Faith as: “Directors must act with an actual intent to promote corporate welfare” (Salter, 2008, p.158). By contrast, if a decision has “no ‘rational business purpose’ – that is, it is ‘so beyond the bounds of reasonable judgement that it seems essentially inexplicable on any [other] ground’ See West Point-Pepperell, Inc. V. J.P. Stevens & Co., at 780” (Salter, 2008, p.422), then this decision was made in bad faith (Salter, 2008, p.422). Salter emphasizes the task of Directors making informed business decisions and highlights “business judgement rule” (Salter, 2008, p.159). Business judgement rule, as per the Business and Commercial Litigation in Federal Courts 2d American Bar Association Section of Litigation, outlines that fiduciaries must act:

To make an informed decision, the director or officer must make a reasonable into the corporation's business and affairs. The director or officer may rely upon information provided by others. The rule does not provide ‘protection for directors who have made an unintelligent or unadvised judgement’ [See:] Smith v. Van Gorkom, 488 A.2d 858, 872, Fed. Sec. L. Rep. (CCH) P 91921, 46 A.L.R.4th 821 (Del. 1985). (Bus & Com Litig Fed Cts § 63:8)

The decisions made by Enron’s Directors were governed by their roles as fiduciaries; because there were legal consequences in doing so. Salter states: “Plaintiffs seeking damages from directors must therefore prove that directors’ decision-making process was grossly negligent or that they acted in bad faith” (Salter, 2008, p.159). Therefore, the decision-making processes of directors are mapped in order to identify breaches to duty of good faith. Research which contributes to the understanding of decision-making processes may be used in corporate governance to build on work related to oversight issues. However, as Salter states in the Enron case: “this conclusion should not be interpreted to mean that there was a legal breach of directors’ fiduciary duties” (Salter, 2008, p.155). This fiduciary duty background is meant to contextualize the frequent debates in articles and committee hearings related to this Board’s fiduciary obligations. In order to assess the Directors’ decisions, it is important to understand the requirements of their fiduciary roles and the legal implications of their actions.

Another pertinent task duty which relates to this Enron case involved the Board of Directors’ duty to monitor: “This duty comprises one-half of the directors’ oversight function. The board’s continuing obligation is to remain attentive to and informed about the corporation’s activities” (Salter, 2008, p.158). The Board has a substantial responsibility to monitor the decision-making:
“top decisions become a defining aspect of corporate governance. In the words of an expert in a court case regarding decisions by the board of Walt Disney Corporation, governance entails at root ‘collective deliberation and decision-making on significant matters that require the board’s attention’ (DeMott, 2004, p. 3)” (Useem & Zelleke, 2006, p. 3). This case deals with the breach of contract fiduciary duties claims brought against the president by shareholders; this was done after the president was paid a $130 million severance package. Hill & McDonnell (2007) examines the importance of access to information regarding Directors’ fiduciary duties and the emphasis is on informed and independent decision-making in “Disney, Good Faith, and Structural Bias”. Hill & McDonnell consider the criteria which constitutes “bad faith” in the decision-making process: “It held that if the plaintiffs succeeded in establishing the facts they had pled, they might be able to demonstrate that the board had acted in bad faith both in negotiating the contract and in not trying to terminate Ovitz for good cause” (Hill & McDonnell, 2007, §62). Salter refers to Judge Chandler’s statement regarding the effect of the Business Judgement Rule in this case:

That the directors made an ‘unintelligent or unadvised judgment,’ by failing to inform themselves of all material information reasonably available to them before making a business decision.’ In re Walt Disney Co. Derivative Litigation, 2005 Del.Ch. Lexis 113 (Del. Ch. 2005.) (Salter, 2008, p.422)

The Board may have acted negligently or it may have had a passive and dependent role in the decision-making process which limited its access to complete information to make an informed decision.

As a response to the major incidents of poor corporate oversight, Boards have been under scrutiny. The development of new law and increased compliance for companies to disclose financial information as per SEC regulations are emphasized in corporate governance research: “Corporate scandals and regulatory reforms in recent years have pressured boards to take a more active role in enterprise decisions (Gandossy and Sonnenfeld, 2004; Lorsch et al., 2005)” (Useem & Zelleke, 2006, p. 2). The Board’s role in the decision-making process is emphasized to monitor internal controls to identify weaknesses in organizational systems. However, corporate governance research addresses the necessity for a group to be in a position to assess any weaknesses in the Board: “Conflicts of interest, inadequate board member skills, and the
inability to diagnose and report risk and assess sustainability require a new and truly external solution set (Gillan and Martin 2007; Savitz and Weber 2006)” (Laud & Schepers, 2009, p.372). Possible solutions were offered via improvements in SEC oversight. Laud & Schepers criticized the implementation of “the multiple internal and external regulatory mechanisms that failed at Enron, but were improved through SOX, can now be argued to have failed again in the recent subprime mortgage debacle, bank failures, and credit crisis” (Laud & Schepers, 2009, p.372). These revisions to the regulations by the SEC were intended to prevent fraud and identify corporate weaknesses which led to corporate failures. Although Laud & Schepers argues that these improvements failed to protect against other corporate failures, this argument does not justify a limitation to the SEC and further regulation development to be used for positive change. The revisions to these regulations are necessary in order to integrate new information. Improved regulations may be used to identify breaches to compliance and promote corporate governance.

“Enron's collapse arose within a system of corporate governance—internal and external to the firm — that failed to discipline Enron's management” (Gillan & Martin, 2007, p.930). A substantial emphasis is on the effectiveness of internal and external controls. This issue is consistently addressed in corporate governance literature in connection with the capability of the Board to fulfill its duty to monitor these controls. It also affects the way auditors assess the financial operations of a company. The function of controls is to gauge the financial health and operations of a company. Incomplete information creates gaps in this assessment, and subsequently, does not relay an accurate picture to external and internal governance groups:

“Enron either circumvented oversight by external monitors, or external monitors were slow to react to warning signs at the firm” (Gillan & Martin, 2007, p.930). These warnings signs are technically referred to as red flags. As described earlier in this chapter, if red flags were ignored by the Board of Directors, this legally implicates these Directors, as they would have failed their duties to inquire about these red flags and be in breach of their fiduciary duties. This is similar to the issue of controls and auditor accountability: “Section 404 of Sarbanes-Oxley requires the auditor to evaluate and report publicly on the adequacy of the corporation’s internal controls. This controversial provision has proven to be an unexpected blessing and major source of new revenue for auditors” (Coffee, 2006, p.367).

Sarbanes-Oxley Act Section 404 (‘Management Assessment of Internal Controls’), 15 U.S.C. §7672, first requires in subsection (a) that management must accept responsibility
‘for establishing and maintaining an adequate internal control structure and procedures for financial reporting’ and then provides in subsection (b) that the outside auditor ‘shall attest to, and report on, the assessment made by the management of the issuer on this issue.’ (Coffee, 2006, p. 183)

Coffee explains the significance of this regulation, particularly for Enron, was that if an auditor established that the controls failed, as in the case of Arthur Andersen, then Section 404 may be used to defend the auditors’ inability to identify fraud (Coffee, 2006, p.367). Both the effectiveness of controls and the Board’s recognition of red flags were consistently debated after the collapse of Enron. The reasons were not simply to state that the warnings were there or that the controls had failed; there was a purpose to these debates to establish culpability and responsibility for Board decisions made that related to these red flag events prior to Enron’s collapse. Corporate governance literature addresses the requirements for the roles of industry members, as well as the structural issues regarding the systems to monitor them.

Companies vary in the ways that management and advisors interact with the Board, and issues related to Board oversight were highlighted frequently in this corporate governance literature. This case study examines the information flow of groups at Enron by using major transactions to exemplify the Board’s decision-making processes: “internal oversight by Enron's board was lacking. The board waived the firm's code of conduct to permit related-party transactions (RPTs) with the firm's Chief Financial Officer (CFO) that placed Enron in economic jeopardy” (Gillan & Martin, 2007, p.930). The way the Board waived the Enron’s code of conduct for Andrew Fastow illustrates several factors discussed in this corporate governance literature: conflict of interest, information control of management, and ineffective monitoring of controls by the Board. Corporate governance researchers examined the relationship between the Board and management, particularly the influence of these groups in the decision-making process.

It appears that there were barriers to information flow created by management over other groups, particularly the Board. Directors were unaware of substantial details regarding company operations. Examples of the Board’s unawareness of important financial details include that “the board was also unaware of the gains the CFO would receive from those transactions” (Gillan & Martin, 2007, p.930). These examples that the Board was not aware of substantial information show that there were limitations to the Board’s access to information in this decision-making
process. Since approvals for financial arrangements should be reviewed and approved by the Board, it is useful to analyze major Enron transactions through a process model, particularly mapping these decisions which involve information flow.

In this literature review I have focused on the scholarly research and government publications that address corporate governance research and fiduciary duties of the Board. Literature that pertains to process research, the framework within which findings are interpreted, is discussed in Appendix A.

Corporate governance research was examined to assess theories and frameworks which involve Boards. Although previous research appeared to focus on the composition and responsibilities of Board members, it was important to understand Board structure in order to appreciate the ways in which policies and protocol may influence relationships between Boards and management. The concept of the division of responsibilities between management and the Board based on decision protocol was most valuable. Significantly, corporate governance research regarding the decision-making processes and information control and the shift towards processual analysis was also examined in this literature review chapter. Important concepts related to the Board’s fiduciary duties, such as exculpation provisions and conduct duties were examined in this Literature Review chapter.

The following chapter provides background for Enron as it is useful to understand the organizational structure of this corporation and details related to major deals. I provide context for these arrangements, in order to prepare the reader to examine the communication of this information among the groups in decision-making processes.
3 Enron

"If I had a world of my own, everything would be nonsense. Nothing would be what it is, because everything would be what it isn't. And contrary wise, what is, it wouldn't be. And what it wouldn't be, it would. You see?"

_Alice in Wonderland_ (1951)

Alice wanted an internship at Enron. This background chapter provides a summary of major events that occurred in this Wonderland; but it is not a comprehensive history and as mentioned in the previous Literature Review chapter, this background chapter does not include all major transactions or deals which contributed to Enron’s collapse. Instead it focuses on details related to the examples that are highlighted in this thesis. There are a number of significant factors during Enron’s early years which helped the company evolve from an “‘old economy’ gas pipeline operator to a ‘new economy’ financial intermediary and market maker” (Salter, 2008, p.1). This chapter offers a general overview for a few key events to prepare for the decision-making process analysis involving the Board. According to Henderson, Oakes and Smith (2009, p.465), the merger of InterNorth Inc and Houston Natural Gas to create Enron in the mid 1980s is summarized below:

- Northern Natural Gas Company, based in Omaha, Nebraska, provided the roots for Enron in 1930.
- The company expanded by building pipelines and acquiring its smaller competitors.
- By 1947, Northern was the largest natural gas supplier in United States with its stock traded on the New York Stock Exchange.
- In the 1970s, Northern helped develop the Alaskan pipeline, which it used for accessing Canadian natural gas reserves.
- The company became InterNorth, Inc. in 1980.
- The company expanded its operations to include oil exploration, chemicals, coal mining, and fuel trading while maintaining its focus on natural gas.
- After acquiring Houston Gas, InterNorth had achieved its goal of becoming the largest U.S. natural gas supplier with control of a 40,000 mile natural gas distribution system.
- InterNorth changed its name to Enron in 1986.
Kenneth Lay was Chairman and CEO and envisioned great opportunities for “oil and gas exploration and production interests” (Hamilton & Micklethwait, 2006, p.35). This period of energy deregulation in the United States meant that “companies were free to choose in which parts to operate in the industry value chain” (Hamilton & Micklethwait, 2006, p.37) and “it was not necessary to be a generator or a transporter in order to market and sell power to the end customer” (Hamilton & Micklethwait, 2006, p.37). Enron was built up “through a series of new ventures and acquisitions, many financed by debt” (Hamilton & Micklethwait, 2006, p.35).

Richard Kinder was COO at this early stage in Enron’s history and was described as “traditional oil and gas man who insisted on rigorous controls...and considered the perfect foil to Lay, the free-market visionary” (Hamilton & Micklethwait, 2006, p.35). Jeffrey Skilling entered the company mid way through the 1980s, and impressed Lay with a suggestion to “take advantage of gas deregulation and establish Enron’s ‘gas bank’” (Hamilton & Micklethwait, 2006, p.35). Enron’s ‘gas bank’ provided funds “for smaller sized gas producers to enable them to invest more in exploration and development and, at the same time, provide Enron with reliable sources of natural gas to feed its system” (Hamilton & Micklethwait, 2006, p.35). In 1990, as Skilling became head of Enron Finance, Andrew Fastow was hired “to develop the company’s gas bank business and to obtain and manage the debt and equity capital to fund its third-party finance business” (Hamilton & Micklethwait, 2006, p.35-36). Fastow became CFO in 1998 and was not a certified public accountant (Hamilton & Micklethwait, 2006, p.36). So this was the beginning of the unfortunate chain of events which led to the downward spiral for Enron: “Richard Kinder resigned on November 26 1996 [...] Skilling became president and COO of Enron [...] Skilling was free to use an ‘asset light’ strategy which involved concentrating on trading and disposing of traditional activities” (Hamilton & Micklethwait, 2006, p.36) and the company changed substantially from regulated utility to Lay’s free-market vision (Hamilton & Micklethwait, 2006, p.35).

Enron hired financial experts to: “‘translate any deal into a mathematical formula’ that could be traded or sold on, often to SPEs set up for that purpose” (Hamilton & Micklethwait, 2006, p.36). However, the reason for Enron’s collapse is not limited to “the use of ‘special purpose entities’ (SPEs) to accelerate profits and hide debt” (Hamilton & Micklethwait, 2006, p.34). Enron’s high pressure business culture involved overcompensation and rationalization of corrupt practices within the organization (Zyglidopoulos, Fleming & Rothenberg, 2009). Performance reviews
consisted of “‘rank and yank’ in which the bottom 10–15% performers would be fired each year, and those just above that threshold knew they were at risk of losing their jobs” (Beenen & Pinto, 2009, p.278). Research examines Enron employees’ financial incentives (Ball, 2009) to participate or be punished (Beenen & Pinto, 2009). Employees jeopardized their employment if they deviated from the norm, and the stigmatization of whistleblowers extended beyond Enron into the financial industry (Beenen & Pinto, 2009). In addition to highly compensated senior employees, Enron employed “200 or so in-house lawyers” (Hamilton & Micklethwait, 2006, p.36) and legal counsel appeared to be unable to stop this consistent high pressure to close “deals and not necessarily worrying about how they were to be managed in the future” (Hamilton & Micklethwait, 2006, p.36).

Enron may have started with “contracts for physical delivery, the trading ultimately extended to gas futures, long-term supply contracts and hedges” (Hamilton & Micklethwait, 2006, p.38). Hedging is defined as “action taken to offset or reduce possible adverse changes in the value of assets or the cost of liabilities currently held or expected to be held at some future date” (Hamilton & Micklethwait, 2006, p.190). Through successful lobbying, Enron received an “exemption from the normal regulatory oversight of derivatives trading from then Chairman of the US Commodities and Futures Trading Commission, Wendy Gramm who eventually became a non-executive Director on Enron’s Board” (Hamilton & Micklethwait, 2006, p.38).

As mentioned, Enron had provided funds “for smaller sized gas producers” (Hamilton & Micklethwait, 2006, p.35) and “provided liquidity by repaying for long-term fixed price gas supplies, with the payment secured on the gas itself and not on the assets of the producer” (Hamilton & Micklethwait, 2006, p.38). Enron accomplished this through the development of ‘volumetric production payments’ (VPPs) (Hamilton & Micklethwait, 2006, p.38). This meant that “Enron had first call on a proportion (usually half) of the gas in the field and had a secure long-term natural gas supplies” (Hamilton & Micklethwait, 2006, p.38). Enron was granted permission by the SEC for VPP contracts to “be treated as ‘merchant assets’ and were allowed to mark these assets to market” (Hamilton & Micklethwait, 2006, p.39). Merchant assets may be defined as “assets purchased for investment purposes but considered to be held for later sale by a company rather than longer-term investment. The asset is generally held at fair value or market value rather than historical cost” (Hamilton & Micklethwait, 2006, p.193). Hamilton & Micklethwait outline the way Enron ‘monetised’ a deal:
A trader would forecast the future price curve for the product, calculate the future cash flows and apply a discount rate to compute the net present value (NVP) which could either be sold to an SPE created for that purpose or kept on Enron’s books as a merchant asset. For some products – for example gas futures – market prices could be obtained from NYMX (the New York Mercantile Exchange) but usually for a limited time horizon, say four years. (Hamilton & Micklethwait, 2006, p.39)

Hamilton & Micklethwait explains that Enron used extended contracts, was the only supplier, so in this way the company was ‘marking to Enron’ (Hamilton & Micklethwait, 2006, p.39). Enron provided a forecast price which was used for its own profit (Hamilton & Micklethwait, 2006, p.39). The emphasis appeared to be to use “forward price curves on commodities...with sketchy data or pricing points” (Hamilton & Micklethwait, 2006, p.40) to “mark up the curve” (Hamilton & Micklethwait, 2006, p.40). Based on a case study example by Hamilton & Micklethwait (2006), the emphasis would be on the last years (6-10) and not the loss years (1-5). Enron’s use of extended contracts and forward price curves on commodities is summarized below as per Hamilton & Micklethwait (2006, p.40):

- Using these curves, Enron would enter into long-term transactions with counter parties (ten years was usual in illiquid markets like bandwidth).
- For Enron, it did not matter if they lost money in years 1-5 of a deal (that is, sold below current market values), as long as they recovered the investment and made a ‘profit’ on years 6-10.
- The reason was because Enron used ‘mark to market’ accounting and would take the *Net Present Value (NPV)* of the ten-year deal on day one, using the sketchy curves [Hamilton & Micklewait] mentioned before as price points for discounting and, therefore, making a ‘profit’.
  - * Net Present Value (NPV): The value of a future income stream discounted – using an appropriate interest rate – to take account of the time value of money.
- The fact that the company was bleeding cash in years 1-5 in exchange for potential gains in years 6-10 was usually not considered in these transactions. The only thing that matter was earnings.

As demonstrated by the use of ‘mark to market’ accounting above, the increased “pressure on Enron to maintain quarterly earnings per share (EPS) growth [particularly during] the time when Enron’s shares outperformed the market in the late 1990s” (Hamilton & Micklethwait, 2006, p.44). Enter Andrew Fastow. This was Fastow’s opportunity to find alternative sources of
funding to bear the risk “through equity participation in separate entities, which in turn, could borrow from third parties (outside lenders)” (Hamilton & Micklethwait, 2006, p.44).

It was imperative that these SPEs not be “consolidated in Enron’s results; otherwise it would defeat the objective” (Hamilton & Micklethwait, 2006, p.44). The deals that most relate to the examples used in this case study involve LJM, Raptors and Fastow’s compensation and conflict of interests. Therefore, some background information is offered here to provide context for those events, but not all phases and restructure details are included here, only a general summary.

3.1 LJM Deals, Fastow’s Compensation Issues and Conflict of Interest Waivers

In order to understand LJM, it is necessary to understand the Rhythms hedge. In March 1998 Enron invested in a private company, Rhythms NetCommunications. According to Salter, Enron made incredible gains on its $10 million investment. The share price increased from $1.85 at the time it was private to $21.00 per share when the company became public at the end of April 1999 (Salter, 2008, p.51). However, management anticipated that this company may not continue to be profitable but Enron could not sell “its Rhythms shares before the end of 1999 owing to a lockup agreement, Skilling wanted to hedge Enron’s investment against a drop in share price” (Salter, 2008, p.51). The situation became further complicated by a “too illiquid market” (Salter, 2008, p.51) to support “normal options trading” (Salter, 2008, p.51) regarding Rhythms. Fastow decides to devise a plan “to serve as a hedging counter-party for Enron” (Salter, 2008, p.51). On June 28, 1999 (Powers, Troubh, & Winokur, 2002, p.150), Fastow took a proposal to the Board that involved “rais[ing] $15 million from two limited partners, through an SPE, which would purchase from Enron certain assets and associated liabilities that the company wished to remove from its balance sheet” (Hamilton & Micklethwait, 2006, p.45). At the time that the Board considered Fastow’s proposal, it thought this was “a specific, already-negotiated transaction, rather than a series of future transactions. This was the Rhythms "hedge."” (Powers, Troubh, & Winokur, 2002, p.150).

At this time, the Board did not know that this transaction would be the first in a series of LJM transactions. According to the Powers Report, the Board understood three major points at the
time of the LJM presentation: “(1) Terms for LJM were fixed, (2) Enron would receive an opinion by PricewaterhouseCoopers [PWC] as to the fairness of the consideration received by Enron, and (3) Fastow would not benefit from changes in the value of Enron stock that Enron contributed to the transaction” (Powers, Troubh, & Winokur, 2002, p.150). The Board did not believe that this was a new transaction; therefore, it did not think it required controls for “already-completed negotiations” (Powers, Troubh, & Winokur, 2002, p.150).

However, there was a clear conflict of interest for Fastow, since “Enron code of ethics prohibited Enron from having any dealings with an officer of the company” (Hamilton & Micklethwait, 2006, p.45). The Board waived this code of ethics for Fastow to proceed with the deal; however, the Board insisted that controls were implemented in order to monitor Fastow’s involvement. Once Fastow had the Board’s approval “LJM1 was formed in June 1999; a Cayman Islands registered SPE, and was named using the initials of Fastow’s wife and two children” (Hamilton & Micklethwait, 2006, p.45).

Encouraged by LJM1, Fastow approached the Board with a larger ambition to “raise $200 million of institutional private equity in order to purchase assets that Enron wanted to syndicate” (Hamilton & Micklethwait, 2006, p.45). LJM2 was created “in October 1999 as a Delaware limited partnership. Merrill Lynch prepared a private placement memorandum for a co-partnership with LJM2, which ultimately had some 50 limited partners” (Hamilton & Micklethwait, 2006, p.45).

Appendix F includes this private placement memo which is discussed in the findings chapter. The major issue is that the memo specified Andrew Fastow, Michael Kopper [his assistant], and Ben Glisan as Principals and the Principals’ ability to access information. Hamilton & Micklethwait describe this statement “highlighted their use of inside information” (Hamilton & Micklethwait, 2006, p.46). The phrase in the private placement memo states the word “access.” In the private placement memo, attached as the fourth page in Appendix F, under the heading Ability to Evaluate Investments with Full Knowledge of the Assets: “The Principals believe that their access to Enron’s information pertaining to potential investments will contribute to superior returns” (U.S. Senate, 2002, p. 275). It appeared that this private placement memo highlighted the advantage of the Principals’ access to inside information, it is not clear whether the term “use of” was included in the document in another context. However, for the purposes of this study, the
significance is that the memo marketed the Principals’ “access” to information, which showed sufficient content in this memo to raise a red flag regarding conflict of interest issues.

Enron’s disclosure in its annual report, also discussed in the Findings chapter, was overly general: “In a note to the 2000 Annual report, on page 48, it simply said: ‘In 2000 and 1999, Enron entered into transactions with limited partnerships (the Related Party) whose general partner’s managing member is a senior officer at Enron’” (Hamilton & Micklethwait, 2006, p.46). The results for the LJM deals are as follows: “at the end of the third and final quarters of 1999, Enron sold interests in seven assets to LJM1 and LJM2. Enron bought back five of the seven assets shortly after the close of the respective financial reporting periods” (Hamilton & Micklethwait, 2006, p.46). The Findings chapter includes an example regarding the problematic lists of deals which were bought back by Enron. “While the LJM partnerships made a profit on every transaction, the transactions generated Enron ‘earnings’ of $229 million in the second half of 1999 (out of a total $570 million for the same period)” (Hamilton & Micklethwait, 2006, p.46). The Findings Chapter refers to examples of Fastow’s Compensation Issues. As per Hamilton & Micklethwait (2006, p.46), a summary of issues related to Fastow’s Earnings from the LJM deals are listed as follows:

- In June 2000: Enron sold $100 million of dark fibre-optic cables to LJM, on which it booked a profit of $67 million.
- In December 2000: LJM sold on cable for $40 million to ‘industry participants’ and the remainder to another Enron-related partnership for $113 million in December.
- Between June and December 2000, these deals suggested that the value of fibre had increased by 53%, while the open market value had fallen 67% in the same period.
- Fastow is reported to have profited to the extent of $45 million from these deals.

These four issues listed above are significant to show the profitability of the LJM deals for Fastow and describe the discrepancy between the market value of fibre versus its suggested value in these deals.

### 3.2 Raptors

Fastow constructed “SPEs known as the Raptors... designed to hedge Enron’s rapidly expanding portfolio of merchant investments and stock holdings by entering into derivatives, including swaps, puts, and collars” (Salter, 2008, p.53). Please see Table 4 for definitions for Swaps, puts, and collars for the Raptors.
Table 1. Hamilton & Micklethwait (2006) Definition of Swaps, puts, and collars for the Raptors

**Swap contracts**

(i) Interest rate swaps – an agreement by which two parties agree to pay each other interest on a notional amount over a defined period but calculated according to different interest bases.

(ii) Currency swaps – an agreement between two parties to sell agreed amounts of specified currencies to each other on a future date at an exchange rate established at the outset.

**Put option**

“A right to sell the stock at a stated price within a given time period. Those who think a stock may go down generally purchase puts” (Canadian Securities Course, 2008, Gls-23).

**Call option**

“The right to buy a specific number of shares at a specified price (the strike price) by a fixed date. The buyer pays a premium to the seller of the call option contract. An investor would buy a call option if the underlying stock price is expected to rise” (Canadian Securities Course, 2008, Gls-5).

Since Fastow designed the Raptors to hedge Enron’s investments, the aim was that “these SPEs would keep fluctuations in the value of these investments off Enron’s balance sheet, which had to be adjusted each quarter under mark-to-mark accounting” (Salter, 2008, p.53) as explained above. These SPEs are extremely complex transactions and it is out of the scope of this study to offer an explanation. This summary offers a few significant points regarding a general understanding of the Raptors entities: “three of the four Raptors were capitalized with Enron stock. The fourth, Raptor III, was capitalized with the stock of a company called New Power, another investment Enron was attempting to hedge” (Salter, 2008, p.53). Second, the intention
for Raptors was to create a structure to keep earnings from these entities “on the books by providing a hedging cushion” (Salter, 2008, p.339-340). Salter (2008) explains this “hedge” as follows: “The espoused purpose of the Raptor structures was to hedge Enron’s merchant investments – such as telecommunications companies – to avoid having to report losses on these marked-to-market assets if their value declined” (Salter, 2008, p.339). The Raptor entities were used to conceal the consequences of these investments if they decreased in value. “Enron’s contracts with the Raptors guaranteed that if the market value of a hedged asset did decline, the Raptors would pay Enron the difference between the previously recorded value and the new lower value” (Salter, 2008, p.339). However, since Raptors were designed to involve Enron stocks, this was not a true “hedge” as “Raptors did not shift the risk to a third party” (Salter, 2008, p.341). Raptors were designed to imply to investors that Enron had financial stability that did not exist since the point was to omit investment losses. “Both the intent and the effect were to reduce, if not eliminate, fluctuations in Enron’s reported net income” (Salter, 2008, p.339).

The Raptors were designed so that Enron’s earnings appeared consistent while the market value of Enron’s investments declined and this manipulation of information is evident throughout the examples that were highlighted in this case study. Raptors, LJM transactions and Fastow’s compensation issues and conflict of interest waivers interconnect. Therefore, these specific examples were chosen to best represent the decision-making processes of the Board at Enron. Appendix E of this study shows the ways that Enron’s stock was used to fund the Raptors and the relationship between the LJM partnerships and the Raptors. These SPEs were created and controlled by Fastow. The structural relationship between LJM, Fastow’s compensation issues and Raptors is summarized as per Salter (2008). The Raptors were used to offset the decline in market value for Enron’s investments and “Fastow testified that the Raptors were designed to help Enron keep earnings on the books by providing a hedging cushion, in case these assets had to be booked at their true lower values” (Salter, 2008, p.339-340). Fastow was aware of specific accounting practices were needed for these SPEs: “Fastow testified that the LJM partnerships and the affiliated Raptors bought and warehoused Enron assets that no one else wanted, and acted as a middleman to allow Enron to receive certain accounting treatments on deals” (Salter, 2008, p.340). Since these assets were undesirable and no one else wanted them, this could have been a red flag, since the Enron’s earnings did not fall despite the falling market value of its investments.
The key point which connects Fastow to the LJM2 and Raptors arrangements is “the LJM2 partnership [was] an equity contributor to the Raptors SPEs – which was controlled by Fastow, who appeared to have a conflict of interest” (Salter, 2008, p.340). “However, it is difficult to claim any foul because Enron’s Board of directors approved this arrangement” (Salter, 2008, p.340). This is a significant factor in these examples and it provides the basis for this case study to examine the decision-making processes of the Board to understand the way information was used to approve such arrangements.

This research investigates the decision-making processes of the Board with specific reference to Raptors and Fastow’s interest in LJM2, and related conflict of interest waivers which were approved by the Board. However, it is important to note that not all phases of the Raptors transactions involved Board approval. Each new Raptor vehicle was approved as follows: “the Finance Committee and the full Board reviewed and approved the formation of Raptor I in May 2000. The Executive Committee approved the formation of Raptor II in June 2000, and the Finance Committee and the full Board approved the formation of Raptor IV in August 2000” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.68-69). The restructuring details for Raptors were not “reviewed and approved by the Board or any of its committees” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.68).

An important detail based on this literature review was that the Raptors were not true hedges: “most important non-legal criticism of the Raptor structures is that Enron’s hedges with them were not real economic hedges at all” (Salter, 2008, p.341). Many sources refer to the Raptors’ hedge arrangements as not true hedges several times, due to the problems of its structure: “Enron’s hedges with three of the Raptors did not shift the risk of loss to a third party, because the only assets the Raptors held had been supplied by Enron itself – its own shares. Essentially, in any payout under the hedging arrangement, regardless of direction, Enron would, in effect, be paying itself” (Salter, 2008, p. 342).

3.3 Cashing in the Shares

On January 1, 2001, the Board appointed Skilling CEO of Enron (Salter, 2008, p.8) and he resigned his CEO position in August 14 2001, as “Lay was cashing in his share options, netting himself more than $100 million in the process (Hamilton & Micklethwait, 2006, p.47). Both Skilling and Lay managed to “reap $173 million and $78 million, respectively, from sales of
stock and exercised options during 2000 and 2001 (they had cashed more gains earlier) before
Enron’s share price tumbled down. Executives sold their Enron stock prior to the decrease in
share price, (see Table 2) for Stock sales of Enron executives, October 19, 1998 through
incurred in exercising the options and selling stock meant that executive net proceeds were lower
[…] and reveals how equity-based pay affected the wealth of Enron’s most senior executives
over a three-year period. Proceeds from stock sales dwarfed cash received as salary and bonus”
(Salter, 2008, p.89). Table 2 shows the Gross Proceeds for Lay, Skilling and Fastow as they were
ranked as Enron’s most senior executives. Table 2 outlines stock sales details in order to
emphasize that equity based pay was a significant source of wealth for executives, particularly
Fastow. In doing so, this information is included as background for the example of Fastow’s
compensation and disclosure issues.

<table>
<thead>
<tr>
<th>Name</th>
<th>Position at Enron</th>
<th>Gross Proceeds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lou Pai</td>
<td>CEO, Enron Energy Services</td>
<td>$270,276,065</td>
</tr>
<tr>
<td><strong>Ken Lay</strong></td>
<td>Chairman, Enron Corp.</td>
<td><strong>$184,494,426</strong></td>
</tr>
<tr>
<td>Rebecca Mark</td>
<td>CEO, Azurix</td>
<td>$82,536,737</td>
</tr>
<tr>
<td>Ken Rice</td>
<td>CEO, Enron Broadband Services</td>
<td>$76,825,145</td>
</tr>
<tr>
<td><strong>Jeffrey Skilling</strong></td>
<td>CEO, Enron Corp.</td>
<td><strong>$70,687,199</strong></td>
</tr>
<tr>
<td>Mark Frevert</td>
<td>CEO, Enron Europe</td>
<td>$54,831,220</td>
</tr>
<tr>
<td>Stan Horton</td>
<td>CEO, Enron Transportation</td>
<td>$47,371,361</td>
</tr>
<tr>
<td>Joe Hirko</td>
<td>CEO, Enron Communications</td>
<td>$35,168,721</td>
</tr>
<tr>
<td>J. Clifford Baxter</td>
<td>Vice-Chairman</td>
<td>$34,734,854</td>
</tr>
<tr>
<td><strong>Andy Fastow</strong></td>
<td>Chief Financial Officer</td>
<td><strong>$33,675,004</strong></td>
</tr>
<tr>
<td>Name</td>
<td>Title</td>
<td>Salary</td>
</tr>
<tr>
<td>--------------------</td>
<td>--------------------------------------</td>
<td>----------------</td>
</tr>
<tr>
<td>Rick Causey</td>
<td>Chief Accounting Officer</td>
<td>$13,386,896</td>
</tr>
<tr>
<td>James Derrick</td>
<td>General Counsel</td>
<td>$12,563,928</td>
</tr>
<tr>
<td>Rick Buy</td>
<td>Chief Risk Officer</td>
<td>$10,656,595</td>
</tr>
<tr>
<td>Mark Koenig</td>
<td>Executive Vice President</td>
<td>$9,110,466</td>
</tr>
<tr>
<td>Cindy Olsen</td>
<td>Executive Vice President</td>
<td>$6,505,870</td>
</tr>
<tr>
<td>Steven Kean</td>
<td>Executive Vice President, Chief of Staff</td>
<td>$5,166,414</td>
</tr>
<tr>
<td>Jeff McMahon</td>
<td>Treasurer</td>
<td>$2,739,226</td>
</tr>
<tr>
<td>Michael McConnell</td>
<td>Executive Vice President</td>
<td>$2,506,311</td>
</tr>
<tr>
<td>Kevin Hannon</td>
<td>President, Enron Broadband Services</td>
<td>Unknown</td>
</tr>
<tr>
<td>Greg Whalley</td>
<td>COO, Enron Corp.</td>
<td>Unknown</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td></td>
<td><strong>$953,236,438</strong></td>
</tr>
</tbody>
</table>


3.4 **Andersen’s Discovery**

Enron’s auditor made the ominous announcement in the third week of October 2001:

Arthur Andersen, Enron’s highly compromised outside auditor, ‘discovered’ several large accounting irregularities related to the off-balance-sheet partnerships. This forced Lay to announce a $544 million charge against earnings, and a 1.2 billion write-down in shareholders’ equity, largely related to the impending closure of the Raptors. (Salter, 2008, p.8-9)

Enron was able to manipulate its financial statements to “inflate its reported earnings from the third quarter of 2000 through the third quarter of 2001 by $1 Billion” (Salter, 2008, p.9). There
were several groups of advisors involved in approval and decision-making processes which led to these events. Although the focus of this research is on the role of the Board, auditors Arthur Andersen and legal counsel Vinson & Elkins are examined for their important roles as the advisors in the decision-making processes.

### 3.5 Arthur Andersen

Andersen was considered one of the top firms and described as “a Big Five accounting firm with revenues over US$9.3 billion, 85,000 employees and worldwide operations” (Cahan, 2010, p.55). The Big Five at the time was Arthur Andersen, Ernst & Young, KPMG, and PricewaterhouseCoopers and Deloitte & Touche (Ball, 2009, p. 297). Arthur Andersen was convicted for “the allegation of destroying documents” (Ball, 2009, p. 288) and Anderson “surrendered its license to practice on August 31” (Ball, 2009, p. 288). Ball notes: “three years later, on May 31, 2005, the conviction was unanimously overturned by the U.S. Supreme Court” (Ball, 2009, p. 288). Since Andersen was intrinsically associated with Enron’s collapse, Andersen’s “clients shed it to avoid that taint, and even the subsequent reversal of its conviction could not restore its once illustrious brand name” (Coffee, 2006, p.4).

Andersen had an exceptionally large stake in its relationship with Enron and profits from its consulting services to the company were highly lucrative: “Enron was Andersen’s largest client, and in 2000, Andersen earned over $50 million in fees from the company (U.S. Senate, 2002, 2002, p.5) and worth approximately “as much as $100 million in revenues per year” (Coffee, 2006, p.5). Coffee reports that Andersen, as a firm, “in its final year before the Enron scandal forced its dissolution, Andersen made revenues of over $9 billion” (Coffee, 2006, p.5).

However, Andersen’s fine reputation was not meant to last. Over a specific period, Tremblay & Gendron examined events which tainted Andersen’s standing in the industry. First, on January 10, 2002, Andersen stated that members of its firm “destroyed Enron documents between October and November 2001 (Piaget and Baumann, 2003)” (Tremblay & Gendron, 2011, p.261). Second, WorldCom failed “in the summer of 2002, another client of Arthur Andersen reinforced the negative stereotyping surrounding the accounting firm’s name” (Tremblay & Gendron, 2011, p.261).
Cahan (2010) summarizes the four major events on a timeline compiled by Chaney and Philipich which may have most “affected Andersen’s reputation” (Cahan, 2010, p.55-56) which related to Enron’s collapse:

- On November 8th 2001: Enron announced further restatements and when Andersen was subpoenaed to turn over documents related to the Enron audit to the US Congress.
- On 12 December 2001: Andersen’s CEO Joe Berardino admitted at a Congressional hearing that Andersen had made errors on the Enron audit.
- On January 10 2002: Andersen announced it had shredded documents related to the Enron audit
- On February 4, 2002: the Enron Board of Directors issued a report that was highly critical of Andersen’s work in the Enron audit and when Andersen established its own Independent Oversight Board to investigate possible problems at the accounting firm

Andersen, like Enron, underwent changes in its structure, which led to Andersen collapse. Prior to the period of Enron’s failure, “Andersen, as in other major firms, was under centralized control which maintained accounting policies and practices by an internal watchdog body known at Andersen as the Professional Standards Group” (Coffee, 2006, p.28). The Professional Standards Group was also led by “Andersen’s founder and his immediate successors” (Coffee, 2006, p. 28) and their aim was to keep firms “from the ‘capture’ of a local, [in this case] Andersen office, or audit partner by a powerful client, with the consequence that risky accounting decisions might be approved that could result in liability being imposed on the firm as a whole” (Coffee, 2006, p.28). All firms were aware of the consequences should such a liability happen to any firm. According to Coffee, in the 1990s, there was an erosion of this “auditor ethic” as a new model emerged as the “auditor salesman” (Coffee, 2006, p.28). As a result, the Professional Standards Group no longer had clout: “Andersen changed its policy so that local partners could overrule the national Professional Standards Group. No other major firm appears to have done so” (Coffee, 2006, p.28). Coffee states that Andersen created a reputation in the market that they were a different type of firm, due to this change in policy, the firm’s
“local partner could make a final decision and did not need the national office’s approval” (Coffee, 2006, p. 28).

Consulting changed the organizational power structure at Andersen and contributed to the loss of power of the Professional Standards Group: “The rise of consulting at Andersen may have caused another internal organizational change that directly contributed to the Enron collapse” (Coffee, 2006, p.28). Andersen understood that Enron would not tolerate any questioning of its accounting practices: “the local Andersen Professional Standards Group representative, Carl Bass, who monitored the Enron account was re-assigned – at the insistence of Enron’s Chief Accounting Officer Rick Causey, who believed Bass might interfere with Enron’s use of SPEs” (Coffee, 2006, p.29). Coffee notes that Causey was a former Andersen partner and this shows “the revolving door relationship that had developed between auditors and their clients across the industry” (Coffee, 2006, p.29). In addition to Bass’s reassignment, in order to cover Bass’s concern over Enron’s accounting practices, “records were falsified... to downplay his objections and present him as concurring generally with the views of Andersen’s Houston office” (Coffee, 2006, p.29). The most significant aspect of these events is Andersen’s initial resistance to Bass’s removal (Coffee, 2006, p.29), which was changed to comply with management. Coffee refers to Kurt Eichenwald’s (2005) work regarding this decision point which “caused Andersen to acquiesce in Bass’s removal was not a fear that Enron would drop Andersen as its auditor, but rather the fear that ‘the deep-pocketed client would shift its consulting business at the drop of a hat, leaving Andersen only the low-paying audit work. That was a risk that the Andersen partners were simply unwilling to take” (Coffee, 2006, p.29). This example suggests management could effectively create the team of Anderson advisors which would not critique Enron’s practices. Eventually, the pressure to sustain both roles of consultant and auditor contributed to Andersen backing down from Enron management when faced with the decision to support Bass’s claims regarding the inappropriate use of accounting practices.

It was clear that Andersen partners did not receive support from the firm to confront management about accounting issues. Instead, at the time, it was reported that Andersen acted in the opposite manner and “gave substantial assistance to Enron's officers who breached their fiduciary duties to Enron by causing it to disseminate materially misleading financial information” (U.S. Bankruptcy Court, 2003, p.46). Three major factors contributed to Andersen’s failure with respect to the SPEs: (i) Andersen consultants provided services to
“design and implement the accounting techniques they used to manipulate Enron's reported financial condition” (U.S. Bankruptcy Court, 2003, p.46). (ii) Andersen failed to stop Enron executives from issuing incomplete disclosures and (iii) Andersen failed to inform the Audit Committee about the consequences of these decisions by management (U.S. Bankruptcy Court, 2003, p.46). The role of Andersen as described by these events is mostly about failure to act and failure to intervene when required to do so. The advisors tended to agree with management rather than assess and critique the information that it they received from management.

3.6 Vinson & Elkins

Enron legal counsel was comprised of “over 250 in-house attorneys and retained hundreds of law firms” (U.S. Bankruptcy Court, 2003, p. 48). Enron’s principal law firm was Vinson & Elkins and Enron compensated this firm as follows: “$18.6 million, $26.6 million, $37.8 million, $42.8 million, and $36.4 million in 1997, 1998, 1999, 2000 and 2001, respectively” (U.S. Bankruptcy Court, 2003, p. 48). As per Batson’s Final Report, Vinson & Elkins represented Enron in “approximately sixty-six SPE transactions, rendering legal opinions to obtain the accounting treatment that it sought for these transactions, Related Party Transactions and advised Enron on certain disclosure matters” (U.S. Bankruptcy Court, 2003, p. 48).

The three major examples in this case study, “LJM2, Raptors Hedging Transactions, and Enron's related party transaction disclosure for the proxy statement filed in 2001 which involve Fastow's interest in LJM” (U.S. Bankruptcy Court, 2003, p. 49), involve Vinson & Elkins as an advisor. The most significant factor is that V&E was aware of the details which concerned Fastow’s interest in the LJM entities, particularly “Fastow wanted to prevent the Enron Board from learning how much he was making from the LJM transactions with Enron” (U.S. Bankruptcy Court, 2003, p. 49).

This study does not include the issue about the Watkins letter because this study aims to focus on major issues directly related to the Board’s decision-making process. There were more significant examples which led to Enron’s collapse and involved decisions made by the Board:

But most criticism of Vinson & Elkins has largely been aimed at their investigation of allegations made by Sharon Watkins, the whistleblower who first called Ken Lay’s attention to Enron’s accounting problems. Whatever one thinks of this investigation, it
was largely a sideshow to the main drama in Enron, and Enron’s collapse by this late point was probably inevitable” (Coffee, 2006, p.32).

Although important, the Watkins letter does not fit the scope of this research. As Coffee states in terms of significance to the role of these attorneys: “from a causal perspective, the more central question is who or what was responsible for the inadequate disclosures that allowed Enron to deceive the market for years?” (Coffee, 2006, p.32) Vinson & Elkins was involved in a substantial advisory role for this decision-making process and these details are examined more closely in the Findings chapter.

3.7 The Board of Directors

The role of Enron’s Board of Directors in the decision-making processes is central to this study: “Outwardly, it appeared to be a well structured and composed board for making judicious decisions, with 13 prominent independent directors led by a chair who was not also CEO (Sonnenfeld, 2002). Yet a look at its inner workings, reconstructed by investigators after the collapse, revealed sub-optimal inner decisions despite arguably favourable outward appearances” (Useem & Zelleke, 2006, p.4). According to Gillan & Martin, (2007, p.934-935), Enron’s Board was comprised of fourteen board members in 2001 and included:

- Only two [...] company executives (Chairman of the Board and former CEO Kenneth L. Lay and President and CEO Jeffrey K. Skilling).
- The remaining 12 outside directors included five CEOs.
- Four academics (including economist Wendy Gramm — former head of the Commodities and Futures Trading Commission.
- Robert Jaedicke — a former Stanford accounting professor.
- A professional investor and a former U.K. politician.
- Three directors were considered affiliated:
  - Belfer (the former president of Belco Oil and Gas which was acquired and became an Enron subsidiary).
  - Wakeham (who also acted as a consultant to Enron on the U.K. utility industry.
  - Winokur (who had business dealings with Enron).
The Standing Committees consisted of Outside Directors: “Enron's audit, compensation, and nominating and governance committees were comprised solely of outside directors, and only one affiliated director (Robert Belfer) served on the finance committee” (Gillan & Martin, 2007, p. 935). The Board size fluctuated in the period which led to Enron’s failure: “Enron's board increased from 13 members during 1996, to a high of 18 in 2000, before shrinking to 14 in 2001” (Gillan & Martin, 2007, p. 937). The Board received generous compensation packages for their services compared to other firms. According to Gillan & Martin (2007, p.937) the following is Enron’s Board Compensation in 2000:

- During 2000, outside board members received average director fees of $79,107 and stock options with an estimated value of $270,000 for an annual package valued at almost $350,000.
- This compares to Enron's peer group average of $104,514, in which no firm paid more than $200,000 to its directors.
- The highest director compensation package for the investment banking sample during 2000 is approximately $155,000 at Lehman.
- By any measure, Enron's directors were handsomely compensated, and this level of compensation raises the specter of whether or not such compensation undermined their monitoring efforts.

Based on the amount of Enron stock which comprised the compensation package, Directors had an interest in Enron’s share price and market performance. Gillan & Martin calculated an approximate amount of their shares ownership “using Enron's January 2001 stock price of $83.13 and the directors' beneficial ownership reported in the 2001 proxy, we estimate that director ownership ranged from $266 thousand to $706 million” (Gillan & Martin, 2007, p. 937). Based on this compensation structure, the Board had a substantial investment in the Enron’s market performance.

According to Batson’s Final Report, Appendix D: “During the period 1997 through the Petition Date, twelve of the Outside Directors sold or otherwise engaged in transactions involving Enron stock from which they received aggregate proceeds of over $217 million” (U.S. Bankruptcy Court, 2003, p.38-39). According to Appendix D of Batson’s Final Report, the evidence was “not sufficient for the Examiner to conclude that any of the Outside Directors engaged in
self-dealing in connection with Enron's transactions or that such financial benefits resulted in the Outside Directors being beholden to Enron's officers or otherwise unable to exercise independent judgment so as to amount to a breach of their duty of loyalty” (U.S. Bankruptcy Court, 2003, p.39).

Based on the Directors biographies and background, the Board certainly had the ability to make knowledgeable decisions, “the board was comprised of directors who arguably had the skills to monitor management, yet they did not” (Gillan & Martin, 2007, p. 940). These Directors may have the skill set, the motivation due to their compensation packages and shares ownership; however, if there were barriers to their access of information for them to make informed decisions, this would have affected their decision-making process regardless of structure changes: “boards require information on which to act, and it is not clear that changing the board structure would have changed the information available to the board, or their actions” (Gillan & Martin, 2007, p. 940). It is clear that the Board had a fiduciary duty to inquire for information that it did not have, pending that it noticed that the information was missing in the first place.

The Directors stated that they not understand the details related to Enron’s stock used as collateral for the hedge. It was evident that these hedges could not be understood without the complete context of the transaction. By contrast to the confusion which arose due to missing information, a similar result of Board confusion was due to the overwhelming amount of information. This example involved the Board not being able to understand the risk of Enron’s stock in Raptors. In the Senate Committee Report, Senator Levin asked the following question multiple times about collateral for the hedge before Winokur would respond:

Did the Board realize that Enron stock was being pledged as collateral for the hedge? [...] If, in fact, the stock price went down and the unrealized gain disappeared, did the Board understand that then Enron would have to—that Enron stock itself would be at risk—not just the gain, but that Enron stock would be at risk, that you were not transferring the entire risk to a third party? Did the Enron Board understand that, or did the Enron Board believe that you were transferring that risk to a third party? (U.S. Senate, 2002, p.76-77)

Winokur replied that he could only answer for himself: "I do not recall that Enron stock specifically was being pledged" (U.S. Senate, 2002, p. 77). This is an example of the Board’s
inability to understand information; and significantly, their inability to ask for clarification, increased the way Directors were dependent on their advisors.

In the third example, the Board decided to approve Fastow’s waiver three times but did not appear to consider the conflict of interest issues which may result from this decision: “The Enron board’s decisions to approve the partnership and suspend the ethics code would come to be a central factor in Enron’s collapse. Yet the outward appearance of the board would not have predicted the injudicious decisions the directors took when they met (Useem, 2003; Deakin and Konzelmann, 2004)” (Useem & Zelleke, 2006, p.4). On paper, the Board of Directors were well qualified and suitable for its role, but the Board was increasingly dependent on its advisors, Andersen and Vinson & Elkins. To complicate matters, management had a substantial influence over the same advisors, and as a result, limited the information and advice communicated to the Board.

This chapter provides background regarding the creation of Enron and its organizational structure. It was important for the reader to understand the implications of energy deregulation and the impact of these changes to Enron. VPP contracts, SPEs and ‘mark to market’ accounting techniques increased pressure for Enron to take on increased risk. Details regarding the LJM deals, Fastow’s compensation issues and the conflict of interest waivers which were approved by the Board were provided in this Enron chapter. The Raptors entities and the concept of a *hedging cushion* (Salter, 2008) was explained to prepare for specific examples related to the use of information between groups in the decision-making processes to approve these SPEs. Stock sales information for Enron executives were included in Table 2 to show how a substantial proportion of equity based pay was used at Enron. Andersen’s accounting inaccuracies and the consequences of these errors explained in this chapter. The structure and compensation of the Advisors, the Board of Directors and the Standing Committees are included in this Enron chapter to prepare for decision-making analysis of these groups, since these factors may have influenced their decisions. The following Research Methods chapter includes the explanation for the use of the Case Study method, the purpose of documentary sources for data collection and the adaptation of Boyatzis’ Thematic Analysis (1998) Inductively Data-Driven Code Design used for Data Analysis.
4 Research Methods

In the previous chapter, I explained particular operations, deals, and arrangements which relate to examples for this Enron case study. In this Research Methods chapter, I examine Case Study methodology, outline my research questions, explain the purpose for the selected documentary sources for data collection, and show Boyatzis’ Thematic Analysis as adapted for *Inductively: Data-Driven Code Design* for this study.

Case Study methodology was used to examine Enron’s information flow and decision-making processes which led to its organizational failure. According to Creswell “case studies are a strategy of inquiry in which the researcher explores in depth a program, event activity, process, or one or more individuals. Cases are bounded by time and activity, and researchers collect detailed information using a variety of data collection procedures over a sustained period of time” (Creswell, 2009, p.13). It was important to assess the causes and effects of the red flags and how these warnings influenced the groups at Enron. The case study method was used to analyze the organizational structure, the decision prompts and communication failures.

Both indirect and direct limitations to information flow were mapped to assess the decision-making processes of the Enron groups. It was important to use a research method to enable the identification process of these barriers and case study methodology suited this purpose to examine the relationships among the decision-making groups at Enron. Vissak (2010, p.371-375) notes that case research may be used to: (a) “discover causal relationships (Hillebrand, Kok, & Biemans, 2001; Jensen & Rodgers, 2001)” (Vissak, 2010, p.371), (b) “understand how and why everything has happened in a certain way (Yin, 1994)” (Vissak, 2010, p.371), and (c) “create thick, interesting, and easily readable descriptions and rich understandings (Dyer & Wilkins, 1991; Eisenhardt & Graebner, 2007; Gummesson, 2006; Otley & Berry, 1998; Patton & Applebaum, 2003) of phenomena in their natural settings (Bensabat et al., 1987; Dubois & Gadde, 2002; Ghauri, 2004; Johnston et al, 1999; Lindgreen, 2001; Perren & Ram, 2004; Yin)” (Vissak, 2010, p.371-372).

The case study method incorporated the criteria above to assess the decision-making processes of groups at Enron. This method was appropriate since it offered the opportunity to investigate and communicate the findings using qualitative and explanatory methods. Statistical, quantitative data may not have revealed similar underlying details. Factors such as the intention to
communicate information among groups were discovered using textual accounts in ways that may not have been found from quantitative data. The case study method also offered the opportunity to illustrate Enron’s corporate culture and the decision-making process environment. However, it was necessary to first review previous research about Enron’s corporate culture to examine decision-making theory and apply it to this environment: “This role of theory development, prior to the conduct of any data collection, is one point of difference between case studies and related methods such as ethnography (Lincoln & Guba, 1985, 1986; Van Maanen, 1988; Van Mannen et al., 1982) and “grounded theory” (Strauss & Corbin, 1988). Typically, these related methods deliberately avoid specifying any theoretical propositions at the outset of an inquiry” (Yin, 2003, p.28). Case study methodology was selected over grounded theory methodology since some research questions were formed during the assessment of previous decision-making theory.

Case study methodology also allows for the analysis of textual accounts from secondary sources and findings may be communicated in a textually descriptive format. In doing so, the examples could be used to describe Enron’s “small world” (Huotari & Chatman, 2001, p.352). “Moreover, case examples can help to bridge the gap between academia and industry (Simon et al., 1996)” (Vissak, 2010, p.372). Therefore, these accounts provided details and depth to the context for the decision-making processes of Enron’s groups. By using case study methodology, this offered the opportunity to provide a perspective into Enron’s organizational culture by examining its information and decision-making processes.

Yin describes the essential parts of case study design in five stages: “For case studies, five components of a research design are especially important: (1) a study’s questions; (2) its propositions, if any; (3) its unit(s) of analysis; (4) the logic linking the data to the propositions; and (5) the criteria for interpreting the findings” (Yin, 2003, p.21). A modified version of Boyatizis’ Thematic Analysis was used to analyze and interpret the data. It is important to note that Boyatizis’ Thematic Analysis is a process which involves the examination of patterns as themes, since a theme is defined as “a pattern found in the information that at the minimum describes and organizes possible observations or at the maximum interprets aspects of the phenomenon” (Boyatzis, 1998, p. 4).
Although the study questions and propositions were formulated, and decision-making theory was reviewed, it was important to allow these statements to evolve through the course of the study.

Yin describes five rationales for case study methods. The first rationale best describes this single case as it “represents the critical case in testing a well-formed theory” (Yin, 2003, p.40) and includes “a clear set of propositions as well as the circumstances within which the propositions are believed to be true” (Yin, 2003, p.40). Enron may be described as a “critical case” since it prompted the SEC to seek ways to “improve the way we oversee our disclosure and financial reporting system” (U.S. Securities & Exchange Commission, 2002). Although all rationales were considered, the first rationale best describes this case study.

The “second rationale for a single case is when the case represents an extreme case or a unique case” (Yin, 2003, p.40). At that point in time, Enron was one of the largest financial collapses: “Enron filed for bankruptcy on December 2, 2001 in what was then the largest bankruptcy in U.S. history” (Coffee, 2006, p.18) so it was a relatively “unique case for this period”. However, to date, Lehman Brothers ranks first and Enron is currently 6th on the list of the largest bankruptcies in United States History: (CNN Money, 2009). It may be argued that other companies on this current hit list have filed for larger bankruptcies; however, Enron’s failure has financial issues in its history which may categorize it as a unique corporate disaster. For this reason, Enron may not be best described as “the representative or typical case” (Yin, 2003, p.41) to apply the third rationale, even though Enron is ranked among a long list of corporate failures.

The “revelatory case,” the fourth rationale, requires that “an investigator has an opportunity to observe and analyze a phenomenon previously inaccessible to scientific investigations” (Yin, 2003, p.42). There have been previous investigations into Enron’s failure, although comparatively, not as much research has been dedicated to specific study of Enron’s decision-making processes. There has been opportunity for researchers to evaluate this information. Yin’s fifth rationale, “longitudinal case” requires observations about the way the company changes over “two or more different points in time” (Yin, 2003, p.42). Enron could have been observed over several periods, defined by occurrences of each of the sixteen red flags. However, it was impossible to include all sixteen red flags in the scope of this study. The best rationale was to approach Enron as a “critical case” for a single study method with a “holistic design” (Yin, 2003, p.43) since there is only one unit of analysis. The aim is to examine the decision-making processes of Enron’s groups. Although there are weaknesses to employing a holistic single case
study design: “since the entire nature of the case study may shift, unbeknownst to the researcher, during the course of the study” (Yin, 2003, p.45). Single case study design has challenges regarding changes to research questions. Although it has been “claimed such flexibility to be a strength of the case study approach, in fact, the largest criticism of case studies is based on this type of shift – in which the implemented research design is no longer appropriate for the research questions being asked” (Yin, 2003, p.45). However, this was not an issue for this study since the initial research questions and propositions did not change dramatically through the course of the study. Instead, these questions served as a guide to discover the way that decision-making processes were shaped by information. Another problem with holistic design is that “the entire case may be conducted at an abstract level, lacking any clear measures or data” (Yin, 2003, p.45). However, this study examines data based on text descriptions of decisions made by these groups with respect to events which involve financial transactions, policies and protocols at Enron. In this manner, there is less risk that generalizations may be made across the entire company. Instead, the study focuses on specific groups and their decision-making processes related to major transactions and arrangements at Enron.

During the first stage, study questions were formulated as “explanatory...such questions deal with operational links needing to be traced over time, rather than mere frequencies or incidence” (Yin, 2003, p.6). Yin referred to Latane & Darley’s work as an example of an explanatory question: “why bystanders fail to report emergencies under certain conditions (Latane & Darley, 1969)” (Yin, 2003, p.6) and this question seemed applicable to this study since it may relate to the inability of groups to report high risk and problematic situations at Enron. An essential element of this research process was to select a research strategy, and this was based on the study questions from the review of decision-making theory: “‘How’ or ‘why’ questions are more explanatory and likely to lead to the use of case studies, histories or experiments as the performed research strategies” (Yin, 2003 p.6). A few study questions were formed prior to data collection. However, these questions evolved over the course of the study since decision-making process and corporate governance research was reviewed at the same time, in order “to develop sharper and more insightful questions about the topic” (Yin, 2003, p.9). Theoretical propositions were formed using the research questions as per Yin’s description of case study research design. In order to compose questions for this case study, it was important to examine research regarding ways that information flow may be mapped in corporate environments. The research of
MacIntosh-Murray & Choo (2002) was used as a guide to create the research questions for this study relating to the identification of patterns and barriers to information flow: “One approach could be to devise an inventory of the risk or hazard information sources and how they are being used in the organization. Questions to consider in mapping the flow of information about adverse events and risks include: What are the patterns of information dissemination? What are the boundaries that impede the flow? What sources are commonly used and by whom?” (MacIntosh-Murray & Choo, 2002, p.247-248).

Four research questions were created to address information flow in the Board’s decision-making process and to contextualize the major red flags leading up to Enron’s failure.

**Why did red flags or warnings go unnoticed by the Board of Directors?**

Groups with the most power and authority at Enron may have limited the opportunities for other members of the organization to act on information. Perhaps the Board did not acknowledge red flags as it was unable to detect problems in these red flag events due to barriers in the information flow created by more powerful groups.

**How did the control of information flow shape the Board’s decision-making processes?**

Red flags are warnings which may occur as events. These red flags events are the outcome of a series of decisions made by individuals or groups. At Enron, these groups made decisions based on their access to information. Groups with control over the information flow would also be able to limit the access to information for others in the firm. Since access to information was required to make decisions at Enron, groups with control over information flow shaped the decision-making process.

**How did the organizational structure affect the decision-making process and did weaknesses in this structure contribute to Enron’s failure?**

Organizations have hierarchies, particularly involving management and decision-making processes. Enron’s organizational structure may have had weaknesses in the systems to regulate its decision-making processes, performance evaluation and risk management policies.

**How did specific groups have access to information that was withheld from the Board?**
Information may have been available to specific groups regarding Enron’s failing operations; but not shared with all members of this organization, including the Board. The barriers to the information flow limited the Directors’ access to information regarding Enron’s operations.

Based on the Enron background research, the Board stated that it was not aware of any red flags; therefore, warnings regarding Enron’s failing operations would not have been known by the Board. Based on this assumption, the Board would have not anticipated that Enron’s stock would plummet to junk status. Executives sold their Enron stock prior to the decrease in share price, please refer to Enron’s Background Chapter for Salter’s (2008) Table 1, *Stock sales of Enron executives, October 19, 1998 through November 19, 2001* (Salter, 2008, p.89). As discussed in the Enron Background Chapter, executives sold their shares in the period leading to Enron’s collapse, although the general consensus was that the company was financially healthy.

As described in the Enron Background chapter, the Board of Directors had a substantial interest in Enron’s stock performance: “Directors ownership ranged from $266 thousand to $706 million” (Gillan & Martin, 2007, p. 937). Although Directors sold stock in the period leading up to Enron’s collapse, no self dealing was found according to the Batson’s Final Report (U.S. Bankruptcy Court, 2003, p.38-39). Please see Enron Background of this thesis on p.48 for Board shares ownership.

The details regarding Enron’s declining financial situation may not have been shared with Directors. In the same period that Lay and Skilling “were strongly promoting Enron’s stock” (Salter, 2008, p. 90) they were also selling their shares which was “nine months leading to Enron’s bankruptcy” (Salter, 2008, p. 90). If Directors had knowledge of Enron’s financial state, they might not have held such substantial share ownership at that time of the company’s collapse.

### 4.1 Documentary Sources for Data Collection

While many are discussed in the literature review, it is important that multiple documentary sources were used to confirm details regarding these events leading up to the Enron’s collapse. Table 3 consists of sources that were used to obtain information regarding decisions made by
Enron’s Board, management, and/or advisors, as well as company data related to transactions, arrangements and deals. These documentary sources were used as follows:

1. Enron’s transactions and arrangement details were compared and confirmed using the sources in Table 3.

2. The information was used to create a rich description of the decision-making scenarios at Enron regarding red flag events. Based on these descriptions, information flow may be mapped to identify barriers in the decision-making process.

3. Sources which do not focus on or include Enron are listed in the References list and are not included in Table 3. These sources were used to provide context for red flag events and address factors which shaped the decision-making process, such as market activity, industry trends, legislation and corporate governance issues leading up to Enron’s collapse. There were sources which provide market, legislative and corporate governance context as well as Enron specific details for this case study; for example, Salter’s (2008) *Innovation Corrupted* and Coffee’s (2006) *Gatekeepers: the Professions and Corporate Governance*. Sources which provide both contextual background and Enron specific details are included in Table 3.

<table>
<thead>
<tr>
<th>Table 3. Enron Case Study Documentary Sources</th>
</tr>
</thead>
</table>


Ball examines whether the Sarbanes-Oxley Act (2002) was an overreaction to corporate failures. This article refers to Enron and examines the political/regulatory reaction to the accounting scandal. This article was selected as it compares both political and market perspectives in the Enron case and provides details concerning Arthur Andersen’s role as Enron’s auditor. Ball suggests that audit fees themselves create conflict of interest (Ball, 2009, p. 284). This conflict of interest may contribute to barriers in information flow and this
may shape the decision-making process. This article was included as a source for its extensive background on the financial reporting practices of the company during this period and it was used to confirm details regarding Arthur Andersen’s background and involvement in the firm’s accounting practices leading to Enron’s collapse.


Although this thesis does not focus on the role of whistleblowers in the Enron case, Beenen & Pinto’s (2009) article provides substantial details related to Enron’s organizational culture from its interview with Sherron Watkins, “the former Enron vice president of accounting, whose memo to late Chairman Ken Lay set in motion events that exposed Enron’s corrupt accounting practices” (Beenan & Pinto, 2009, p. 276). This article was selected since it examined organizational perspectives on corporate corruption. Beenen & Pinto (2009) refer to “Pinto et al., 2008 perspectives of ‘top down’ Organizational Corruption (OC) and ‘bottom up’ Organization of Corrupt Individuals (OCI)” (Beenan & Pinto, 2009, p. 275). The benefit of this article is that it provided useful background and contextual information regarding the ways employees perceived internal controls and relationships with Enron’s auditors and consultants.


After consulting Coffee’s (2008) work, it was apparent that advisor reputation was a significant aspect of this case study since it affected the way that the Board may perceive the advice that it received from auditors and legal counsel. Therefore, it was important to include an article that clearly showed the erosion of Andersen’s reputation in relation to the Enron collapse. This article was useful since Cahan (2010) refers to the list compiled by Chaney and Philipich (2002) which identifies “four dates when news that could have affected Andersen’s reputation was released to the market” (Cahan, 2010, p.55). For this study, it was used to provide a timeline for Andersen’s decisions, for example, to announce the major accounting error or shred documents and to confirm revenue data for Andersen as background information.

Coffee’s (2006) book was an important source for details relating to the decision-making processes of Enron’s auditors, Arthur Andersen and its legal counsel, Vinson & Elkins. It provided an excellent overview of advisors as “gatekeepers” and to confirm details of the decision-making processes for these groups in the context of major deals and arrangements at Enron. Coffee’s book was useful to confirm the involvement of legal counsel regarding Fastow’s Disclaimer Issues and was mostly used to confirm details for Andersen’s auditing responsibilities, consulting conflict of interests and background details of the accounting industry during the time leading up to the collapse. Coffee’s book was also used to confirm details of the Sarbanes-Oxley Act (2002) and the Securities Exchange Commission. Based on Coffee’s (2006) work, Enron’s advisors appeared reluctant to act as gatekeepers. The ways in which auditors perceived their duties may shape their relationships with the Board and management and in turn, this may affect decision-making processes.


Gillan and Martin (2007) examine external and internal oversight failure of corporations and the SEC. This article was selected since it deals with Enron’s failure as well as the regulatory reform response following the firm’s collapse. Gillan and Martin’s (2007) article state that changes to Board composition may not have prevented Enron’s failure, but that the emphasis should be to improve controls in order to detect conflict of interest issues. Gillan and Martin’s (2007) article specifies details about Arthur Andersen’s role as advisors and was a good source to confirm data for Board compensation and structure. This article was valuable for general background information and to confirm company data from other sources.


Chapter three of Hamilton & Micklethwait’s (2006) book is entitled ‘Enron: Paper Profits: Cash Losses’ was selected for its extensive coverage of Enron’s background. This chapter
covers Enron’s creation to its demise and offers details regarding specific transactions, deals and arrangements. Information included details related to major decisions of the groups at Enron and these details were used to confirm data regarding the creation and implementation of SPEs, understanding the meaning and consequences of disclaimers in the Private Placement Memos and Enron’s proxy statements. This source provided definitions for ‘volumeric production payments’ (VPP), mark to market accounting, the consequences of LJM entities and high risk decisions made by Enron’s management and advisors. Notably, this source provided the basis to explore the way the Board was perceived by groups at Enron, and the ways that Board perception affected the decision-making processes of these groups.


Henderson, Gregory Oakes, & Smith (2009) article was selected as it provided excellent background information for Enron. The details in this article contributed to the creation of rich descriptions to provide context for red flag events. This article was used to confirm background data, decisions making processes related to Enron’s disclosures, issues of transparency, Andersen’s role as Enron’s auditor and stock prices leading up to Enron’s collapse. Henderson, Gregory Oakes, & Smith (2009) description of Plato’s cave myth also helped to contextualize Enron’s organizational culture and offered timelines offered for major Enron related events.


Laud & Schepers’ (2009) article included a concept by Shiller (2002 & 2008) that became the basis for this case study’s focus on information flow. This important concept relates to “better information, not more, and simplification, not complexity” (Laud & Schepers, 2009, p. 377). This article was selected since it provided details on corporate reporting, the ways in which internal controls failed at Enron and high risk decision-making among the groups. This article was used to confirm details regarding Enron’s use of SPEs, outlines for the responsibilities of stakeholder groups which included the Board, management, and advisors. This article by Laud & Schepers (2009) describes information flow that involves stakeholders and shows “how
strategy translates into operation” (Laud & Schepers, 2009, p. 378) in a Figure 1 of the article (Laud & Schepers, 2009, p. 379). This article provided a source which showed the information flow and processes of a firm and offered a “Stakeholder-centric Model for Improving Intelligibility” (Laud & Schepers, 2009, p. 378). This alternative model was useful to describe the ways in which decision-making processes may be improved for organizations, which offered “the ideal information flow” for a decision-making process.


The Powers report was issued by the Special Investigations Committee of the Board of Directors of Enron Corporation by William C. Powers Jr., Raymond S. Troubh and Herbert S. Winokur Jr.: “Herbert S. Winokur Jr., the only member of the investigation committee to serve on Enron’s board during the time frame in question, did not participate in the portion of the report that evaluates the performance of the directors” (Salter, 2008, p.414). The Powers Report was created within a few months after Enron’s failure and provided the details of the highly complex transactions and deals at Enron. Although it is important to consider the “partisan interests of their authors” (Salter, 2008, p. 414), the Powers Report is a valuable resource since it is a point in time reference published within a short time after the bankruptcy. The Powers Report was used in this study to create the Enron’s background chapter due to its extensive data related to the creation of SPEs, disclaimers, as well as the oversight of the Board and management in the decision-making processes of these arrangements. The other sources in this study were crossed checked against the Powers Report as well as Batson’s Final Report and its Appendix D for accuracy and to confirm the content in other sources.


Salter’s (2008) Innovation Corrupted was used the first source to be examined and one of the most significant sources in this document analysis. As mentioned above, this source was used to provide details for red flag events, transactions, and arrangements as well as to provide information to create the Enron Background chapter. Salter incorporates extensive information
based on interviews, transcripts, court documents and reports, including the Powers Report, Batson’s Final Report and Appendices, and Government Investigative Reports that were used in this study as well. This source was selected due to its extensive examination of the period leading up to Enron’s collapse. Salter (2008) considers various factors which contributed to Enron’s collapse and this source was particularly useful regarding Fiduciary Duties and the Board’s role in the decision-making processes. Much of the data was used from Salter’s book; therefore, it was important to cross reference this data with other sources, such as Batson’s Report (2003) in order to confirm details and provide some context. This source was excellent to understand SPEs, particularly the creation and restructure of the Raptors’ vehicles and the LJM entities. Salter’s work was also incomparable for clear descriptions of legislation and the ways in which Fiduciary rules related to the red flag events leading to Enron’s collapse. This work also provided references to other valuable sources which influenced Enron’s decision-making processes. Related information such as case law related to business judgement rule and fiduciary duties were found in Salter (2008) as landmark cases and judgements were explained in Salter’s (2008) footnotes. Salter’s (2008) Appendix A is attached to this thesis as it provides an excellent visual model for the ways in which LJM, Raptors and Fastow’s compensation and disclosure issues are related using a clear and informative diagram.


The final report is part of a series of reports by examiner, Neal Batson who was appointed by the New York Bankruptcy Court. There are four parts to the series and “the final 1,117 page volume included a detailed appendix specifically dealing with the behavior of the Enron’s Board of Directors…and cost 90 million in professional fees” (Salter, 2008, p.415). The breadth of these reports covers an enormous scope of Enron events, transactions and arrangements. This thesis focused on Batson’s Final Report since it examined the roles of advisors, management and the Board, provided background regarding the events in the fall of 2001, which was the time the Enron announced major restatements. Other researchers may not have the resources to cover the Enron events in the same way as the Batson’s Reports. The overview chapters which addressed the advisors’ potential liability were particularly useful to
provide context for their decision-making processes. As mentioned, the Batson’s Reports were used to cross check information from Salter’s (2008) Innovation Corrupted and other articles to confirm details regarding transactions and disclosures. The Baton’s reports and Senate Committee Reports “include subpoenaed documents related to an array of board activities, including corporate memos, presentations and board committee minutes. These documents provide a picture of what the board knew and did not know about Enron’s operations” (Salter, 2008, p. 415). By using these reports, it was possible to understand in retrospect, what information the Board did not have access to about Enron’s operations in order to understand how the omission of this information may affect the Director’s decision-making processes.


The Batson’s Reports, specifically Appendix D, was the most important source used in this thesis study. It focuses on the role of the Board of Directors in the decision-making processes at Enron. Furthermore, it includes extensive analysis of evidence regarding the Directors’ breach of fiduciary duties related to duty to make informed business judgements, duty to monitor, duty to inquire and duty of candor. As mentioned in the Fiduciary Duties section of the Literature review chapter, conduct duty of good faith and the task duty to make informed business decisions, relates to the Board’s identification of red flags. The sections in these reports were most valuable since this data could be used to construct and map information flows between the groups that were included in this Appendix D: the Board, advisors and Lay and Skilling (individuals in management). The data was used to create a decision-making process timeline and there were specific references to Board meeting and committee minutes which could be cross checked with the original minutes posted from the U.S. Department of Justice. However, the Batson’s Reports provided the context for the statements that were made in the Board and committee meetings, as did Salter’s (2008) Innovation Corrupted. One of the most important sections in this source examined the consequences for Directors if their decisions do not have rational business purpose: “[directors] are not protected under judicial scrutiny for decisions which lack rational business purpose” (U.S. Bankruptcy Court, Batson’s
Final Report, Appendix D, 2003, p. 154). The Board may be protected by *business judgement rule* but *not* if “the evidence proves that the decision was made in *bad faith*” (U.S. Bankruptcy Court, Batson’s Final Report, Appendix D, 2003, p. 154). Therefore, analyzing Board decisions are significant, since the intention of a decision and business purpose are relevant factors which affect if the decision was made in *bad faith*. This source was used to describe and map information flow in the decision-making process and identify any barriers.


This LJM Legal Review is dated May 22, 2001 and under ASF: Current Proposals clearly states: “Restructure of LJM Ownership to Avoid Disclosure” (Appendix H). This source was used since it was included in the Enron Trial Exhibit and was a good source to support the example of Fastow’s Compensation and Disclaimer Issues.


Related Party Disclosures Memo from Mintz to Fastow dated April 6, 2001 explains the way that the “*where practicable*” language in the Proxy Disclosure Rules allowed Enron’s legal counsel to not provide financial information and Mintz describes this as “*a close call*” on the second page of the attached memo (Please see Appendix I). This source was selected to support the explanation of regarding the SPEs as characterized as open transactions versus closed transactions to justify the omission of information regarding Fastow’s compensation.


The Board’s e-mail to Fastow requesting that he disclose the amount of his interest in LJM. This source was included to demonstrate the gentle manner in which the Board stated that they would appreciate this information from Fastow along with details related to LJM’s
relationship with Enron and names of employees that may have interest in the LJM entities. This source provides a clear example of the correspondence between the Board and management regarding a substantial event which could have been identified as a red flag, since the SEC inquiry prompted the Board to request the information from Fastow. However, at this time, the Board was not aware of the actual amount of Fastow’s investment yet.


This report focused on Andersen’s role and the red flags that were associated with those specific accounting related events leading to Enron’s collapse. This report was selected as it provides context for the financial transactions and accounting practices at Enron. A feature of this report is that it includes perspectives of industry analysts that evaluated Enron’s stock at the time prior to its collapse. Mr. James Chanos provides an account of his decision-making process as he evaluated Enron’s stock and recognized the red flags that the Board maintains that it was not able to see. Mr. Chanos was “president of Kynikos Associates, a New York private investment management company which specializes in short selling... an investment technique that profits in finding fundamentally overvalued securities that are poised to fall in price” (U.S. House of Representatives, 2002, p.71). Chanos mentions various warnings, including “cryptic disclosures” (U.S. House of Representatives, 2002, p.72) and Enron’s apparent denial of loss relating to the California energy crisis (U.S. House of Representatives, 2002, p.73). This report provides context to industry related details which influenced Enron’s deals and transactions. This document was used to confirm data in other sources related to Enron’s accounting practices and industry speculation at that time as reported in the media.


As stated, the U.S. Senate Committee reports are probably the most valuable sources since “they include sworn statements from Enron directors made under pain and penalty of perjury” (Salter, 2008, p.415). The role of the Board of Directors in Enron’s Collapse investigates the
decision-making processes of the Board. Many documents, such as LJM2 Co-Investment, L.P., Private Placement Memorandum (Appendix F), 2001 Proxy Statement for Bio details of Enron Board and Executives and Corporate Governance Guidelines for the Board of Directors (Appendix C), and Enron Corp. Business Risk Management Process Overview (Appendix D of this thesis) were retrieved from this Senate Committee Report. The three major case examples highlighted in this thesis: Fastow’s compensation and disclosure issues, LJM entities and Raptors’ vehicles were highlighted in this Senate Committee Report. This report was a good source of information regarding the Board’s responses to questions regarding their lack of oversight and inability to recognize red flags leading up to Enron’s fall. However, due to tone of this Senate Committee hearing, it appeared that the Board members responded as if they did not know about specific Enron operations and relied on advisors to issue approvals prior to the Board approvals. These statements were used in this study to begin the research process and build on these scenarios by investigating more details about Enron’s transactions and deals. The data in this report was cross checked with Batson’s Final Report (2003) to confirm Enron’s background details and with Salter’s (2008) *Innovation Corrupted* to understand the ways in which the red flags outlined in this Senate Committee report, see Appendix D, related to fiduciary duties of the directors.


Useem & Zelleke’s (2006) article served as an important source for this study. It was used for the Enron Background chapter to confirm details regarding Enron’s operations, transactions and arrangements. However, it also served as an important study for corporate governance in the Research Literature Review chapter. Useem & Zelleke’s (2006) work highlighted the use of protocols and calendars in corporations to determine the responsibilities of the Board and management. This division of responsibilities shapes the way that the Board is able to make decisions and have access to information about the overall operations of its company. This article was selected since it incorporated many key aspects required for this thesis: corporate governance, the formal division of labour which affects the power and influence of the Board and management, and significant data regarding Enron’s transactions. This article was relevant due to its focus on the Board of Directors. A valuable finding from this source
included that other corporate Boards functioned very similar to Enron’s Board in the way that information was controlled by particular groups, prior to the Board’s access to it. Information control may not be exclusive to Enron, and this is demonstrated in this article as Useem & Zelleke’s study involved 31 major companies, all with varying degrees of corporate decision protocols.


Zyglidopoulos, Fleming, & Rothenberg’s (2009) article examines the way that Enron created a corporate culture through “debt shifting” (Zyglidopoulos, Fleming, & Rothenberg, 2009, p.71) and became increasingly delusional (Zyglidopoulos, Fleming, & Rothenberg, 2009, p.69). This article was selected to examine the issue of rationalization as it appeared to be a fundamental part of Enron’s culture. Zyglidopoulos, Fleming, & Rothenberg define rationalization as the ways in which “otherwise normal and law-abiding individuals can engage in acts of corruption” (Zyglidopoulos, Fleming, & Rothenberg, 2009, p.65). Although this case study does not examine individual corruption, it is important to address the ways in which corruption may influence decisions in terms of Enron’s groups in this process. Corruption may take the form of controlling and limiting information, in the form of restricting access to information for specific groups.

These sources were used for triangulation in order confirm the data and establish that specific information from one source could be substantiated by another source. Creswell defines triangulation from several data sources as follows: “Triangulate different data sources of information by examining evidence from the sources and using it to build a coherent justification for themes. If themes are established based on converging several sources of data or perspectives from participants, then this process can be claimed as adding to the validity of the study” (Creswell, 2009, p. 191). Yin states that case studies that are well designed use several sources compared to studies that “relied on only single sources of information (see COSMOS, 1983)” (Yin, 2003, p. 99). Data triangulation addressed “potential problems of construct validity” (Yin, 2003, p.99) since “multiple sources of evidence essentially provide multiple measures of the same phenomenon” (Yin, 2003, p.99).
Data extracted from documents and archives was used to create a case study database, as suggested by Yin, in order to “increase the reliability of the entire case study” (Yin, 2009, p.119). This case study Nvivo 9 database consists of notes from document analysis and examples organized by themes and codes. The details of document analysis were used to establish a “chain of evidence used to increase the overall quality of the case study” (Yin, 2009, p.123).

4.2 Data Analysis

Data Analysis was conducted using Boyatzis’ Thematic Analysis which “is a process to be used with qualitative information. It is not another qualitative method but a process that can be used with most, if not all, qualitative methods and that allows for the translation of qualitative information into quantitative data, if this is desired by the researcher” (Boyatzis, 1998, p.4). In order to categorize the data and perform the analysis, this study used thematic analysis which is defined as “a process for encoding qualitative information” (Boyatzis, 1998, p. 4). According to Boyatzis, there are several reasons to use this process which have “a number of overlapping or alternate purposes. Table 4 shows Boyatsis’ Thematic Analysis (1998) and the way that this Data Analysis was used to examine the flow of information at Enron:

<table>
<thead>
<tr>
<th>It can be used as (1) a way of seeing;</th>
<th>(1) It was used to “see” the way the perspectives of groups were influenced by information.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(2) A way of making sense out of seemingly unrelated material;</td>
<td>(2) It was used for assessing seemingly direct and indirect barriers to information flow and the influence of these limitations in these decision-making process.</td>
</tr>
<tr>
<td>(3) A way of analyzing qualitative information;</td>
<td>(3) It was used to examine texts from multiple documentary sources as qualitative information.</td>
</tr>
</tbody>
</table>
(4) A way of systematically observing a person, an interaction, a group, a situation, an organization, or a culture;

(4) It was used to structure the analysis for these examples of Enron’s decision-making processes, by identifying patterns in the way that these groups used information to respond or not respond to red flags.

5) A way of converting qualitative information into quantitative data

Not Applicable in this Case Study


Adapted Data Analysis Method for Enron Case Study based on Boyatzis (1998)

Boyatzis defines a theme as “a pattern found in the information that at the minimum describes and organizes possible observations or at the maximum interprets aspects of the phenomenon” (Boyatzis, 1998, p. 4). Thematic analysis was used to assess the text and describe Enron’s organizational environment based on the way that information was communicated in the groups. Using these texts, themes were used to organize examples in the data, so that fragments from various documentary sources could be used to confirm details of experiences at Enron. These examples were combined to form an overall picture of the limitations to information flow and the ways that this influenced the decision-making processes.

These themes were observed at manifest and latent levels, as defined by Boyatzis: “manifest level (directly observable in the information) or at the latent level (underlying the phenomenon)” (Boyatzis, 1998, p. 4). Since this study did not count terms or words in the information to define the patterns, the general definition for manifest-content analysis was not applied to the texts in this manner. However, the definition of manifest-level analysis includes the consideration of “the visible or apparent content of something” (Boyatzis, 1998, p. 16). Therefore, this analysis did identify specific references in the texts to decisions made by groups regarding Enron’s transactions. These were explicit examples of decisions since the consequences of these decisions were published in Enron’s financial statements. This study also used latent-content
analysis and looked at the “underlying aspects of the phenomenon under observation. It is more interpretive than manifest-content analysis” (Boyatzis, 1998, p.16). The underlying aspects which allowed for limitations to information flows and the influence on the decision-making process were an important factor in identifying these themes. The benefit of using thematic analysis was that this process allowed the use of “both manifest- and latent-content analysis at the same time” (Boyatzis, 1998, p. 16).

Although decision-making process research was reviewed prior to the study, propositions were not taken from prior research and not “generated deductively” (Boyatzis, 1998, p. vii). Instead, themes were “initially generated inductively from the raw information” (Boyatzis, 1998, p. vii). Since themes were identified in this manner, the research design for data analysis was shaped by this process. A hybrid design was used to omit stages typically used in prior-research-driven approaches, in order to apply a data-driven inductive approach for code development. This approach also favoured the use of pattern recognition “defined as the ability to perceive patterns of themes in seemingly random or previously unorganized information. This is at the heart of conducting thematic analysis” (Boyatzis, 1998, p.32). As per Boyatzis, “if sensing a pattern or ‘occurrence’ can be called seeing, then the encoding of it can be called seeing as” (Boyatzis, 1998, p.4). In this way, the text was assessed for examples that “something important or notable was occurring” (Boyatzis, 1998, p.4). Examples may include the Board’s approvals regarding arrangements related to the “red flag” events which led to Enron’s failure. This information was “classified or described” (Boyatzis, 1998, p.4) in a process which begins with “capturing a codable moment” (Boyatzis, 1998, p.4) Boyatzis states that “seeing as provides us with a link between a new and emergent pattern and any and all patterns that we have observed and considered previously” (Boyatzis, 1998, p.4). In thematic analysis, the researcher has the opportunity to create a code and “encoding requires explicit ‘code.’ This may be a list of themes; a complex model with themes, indicators, and qualifications that are causally related; or something in between these two forms” (Boyatzis, 1998, p. 4).There are several attributes which constitute a good code: “(1) A label; (2) A definition of what the theme concerns (i.e., the characteristic or issue constituting the theme); (3) A description of how to know when the theme occurs (i.e., how to “flag” the theme); (4) A description of any qualifications or exclusions to the identification of the theme; (5) Examples, both positive and negative, to eliminate possible confusion when looking for a theme” (Boyatzis, 1998, p. x-xi).
Boyatzis describes the criteria for a good label: “To be of most utility, the label should be (a) conceptually meaningful to the phenomenon being studied; (b) be clear and concise, communicating the essence of the theme in the fewest words possible; and (c) close to the data” (Boyatzis, 1998, p. 31). Boyatzis suggests “the label should be developed last in the process of writing or creating the code” (Boyatzis, 1998, p. 31). In the first step, information was assessed and selected text was categorized and separated into spreadsheets. For this particular stage to generate the initial set of themes, the texts were selected based on content which described organizational culture and information culture. Organizational Culture is defined as “the norms, routines, and shared understandings and expectations of those who work in a firm - impacts how information flows through the hierarchy…the overall institutional culture, that one learns as one becomes a member of that firm" (Cohan, 2002, p.287). While Information Culture is defined as: “Information culture is manifested in the organization’s values, norms, and practices that have an impact on how information is perceived, created and used” (Choo et al., 2008, p.793). Using this information, a label could be developed to describe emerging patterns in the texts.

Boyatzis refers to three stages when inductively developing a code. **Stage 1** in the original *Inductively: Data-Driven Code Design* was omitted due to the fact that “criterion referencing was not possible” (Boyatzis, 1998, p.45). Based on Boyatzis’ explanation, criterion referencing is the identification of a key independent variable used to anchor the material in a study (Boyatzis, 1998, p.42). Since an independent variable cannot be identified, criterion referencing is not possible. Figure 1 outlines the original **Stage 2** and consists of five steps in the process to inductively develop a code:

**Figure 1. Boyatzis, (1998) Original Summary of Stages and Steps in Using Thematic Analysis: Data-Driven Approach**

**Stage 1 (Omitted in this Study)**

1. Deciding on sampling and design issues

2. Selecting Subsamples

**Stage 2**
Stage 3

1. Applying the code to the remaining raw information

2. Determining validity

3. Interpreting results


This study follows: “the stages and steps of the inductive, data-driven approach, but **without Stage II, Step 3**, the comparing and contrasting of themes across the subsamples. That is, the researcher skips Stage II step 3 in that process” (Boyatzis, 1998, p.52).

**Figure 2. Boyatzis, (1998) Inductively: Data-Driven Code Design [Original Five Steps in Stage 2]**

(a) reducing the raw information

(b) identifying themes within subsamples

(c) **comparing themes across subsamples** (Omitted)

(d) creating a code

(e) determining reliability of the code
The final process consists of two stages and described in Figure 3 below: Adapted Summary of Stages and Steps in Using Thematic Analysis: Data-Driven Approach (Boyatzis, 1998, p.44) and used in this study to develop themes and a code.

**Figure 3. Boyatzis, (1998) Adapted Summary of Stages and Steps in Using Thematic Analysis: Data-Driven Approach**

**Stage 1**

- Step 1: reducing the raw information
- Step 2: identifying themes within subsamples
- Step 3: creating a code
- Step 4: determining reliability of the code

**Stage 2**

- Step 1: Coding the Rest of the Raw Information
- Step 2: Validating the Code Qualitatively

I adapted this model in the following ways: I removed the first stage of Boyatzis’ original model for the Data-Driven approach. Next, I followed the suggestion by Boyatzis to skip **Stage II, Step 3**. This study follows: “the stages and steps of the inductive, data-driven approach, but **without Stage II, Step 3, the comparing and contrasting of themes across the subsamples**. That is, the researcher skips Stage II step 3 in that process” (Boyatzis, 1998, p.52). The first modification was made since it was not possible to execute *criterion referencing* as this study focuses on one
organization (Boyatzis, 1998, p.41). The second modification, as suggested by Boyatzis (Boyatzis, 1998, p.52), was to **skip the original Stage II, Step 3, since there was “no evident or desirable criterion variable”** (Boyatzis, 1998, p.52).

Enron is a single unit of analysis: “In one situation, the study has a single unit of analysis. That is, only one person or organization or family or culture is being studied” (Boyatzis, 1998, p. 52) and this study may investigate “the relationship between aspects of an organization’s culture and its financial performance, the unit of analysis is the organization” (Boyatzis, 1998, p. 62). The unit of coding was phrases from the texts of multiple documentary sources.

Enron, as an entity, was central to the analysis, in keeping the holistic design of this case study methodology. The aim of the study was to describe information flows of groups in Enron, tracing red flags which led up to a specific event, the company’s financial collapse. This fulfills the criteria for which it may not be possible to identify independent or dependent variables, as “there are also times at which the researcher is seeking to describe a person, group, culture, or event. Thematic analysis helps in making that description clearer and in making the themes or code developed potentially useful to other researchers” (Boyatzis, 1998, p. 53).

The final stage is “validating the code – involves two steps: Step 1: *Coding the Rest of the Raw Information*. Step 2: *Validating the Code Statistically or Qualitatively*” (Boyatzis, 1998, p.50). The sentences from the texts were used as the units of coding which is “the most basic segment, or element, of raw data or information that can be assessed in a meaningful way regarding the phenomenon” (Boyatzis, 1998, p. 63). The unit of analysis is the organization, this is in keeping with the rule that “the unit of coding can never be an entity larger than the unit of analysis” (Boyatzis, 1998, p. 63). Documentary sources and reports were used for the case study: “when historical documents are the source material, questions about the unit of coding are the most complex (Holsti, 1968; Winter, 1992)...Winter and Healy (1981) described a method for coding “running text” in which the sentence becomes the unit of coding” (Boyatzis, 1998, p. 64). The sentences extracted from phrases of these sources were used as the units of coding. Based on Table 3.1 in Boyatzis’ Examples of Units of Analysis, Units of Coding, and the Related Phenomenon of Interest, a phenomenon of interest may be defined as ‘**organizational cultural**’ with the organization as the **unit of analysis** and ‘**observed events, such as staff meetings**’ as the **unit of coding** (Boyatzis, 1998, p. 66).
Enron was the unit of analysis and the unit of coding was paragraphs from these texts, for example, the Board’s meeting minutes. Every few sentences required summary, assessment and categorization as a part of the data analysis. Each sentence had to be placed in the context of the event. For example, In Salter’s (2008) *Innovation Corrupted*, Lay is described by Salter as “heavily involved in shaping the Board’s preparatory packets and meeting presentations” (Salter, 2008, p.188). If this case study design only relied on Salter’s source, this phrase above might have been interpreted to view Lay’s involvement in the preparation of information presented to the Board as specific to Enron. It was important to refer to the footnote for this situation and confirm the details in the original source, which was Batson’s Final Report, Appendix D. In doing so, the researcher was able to contextualize Lay’s involvement in Board meetings and his role in developing the Board agendas (U.S. Bankruptcy Court, 2003, p.18-19) with the items on the agenda which involved SPEs. It was helpful to have the content of Lay’s presentation and to confirm the details of the information which was presented by Lay to the Board of Directors. This also established that management was aware of the SPE details in this presentation and if the information was edited, the Board would not have the opportunity to view it at this particular meeting. The examination of a third source related to this specific statement above, provided an additional layer to understand that this process for which a CEO may review the content of Board presentations was not rare. According to Useem & Zelleke’s (2006) management decides on the content that is presented to the Board in many companies, not only Enron: “The criteria for the choice of what the directors should know vary from company to company, but the essence of most is for the CEO to make his or her own judgement call on what the board should hear” Useem & Zelleke, 2006, p.8). The first two sources, Salter’s (2008) source and Batson’s Final Report, Appendix D (2003) source, may imply that management had substantial influence over the content. However, the third source, the article by Useem & Zelleke (2006) showed that management control over information is evident in many companies, not just Enron.

The second source Batson’s Final Report, Appendix D (2003) was used to confirm the statement in Salter’s (2008) first source. However, the third source Useem & Zelleke (2006) was used to show the same example in a broader context. By using triangulation for this case study, units of coding or paragraphs from sources confirmed information and provided context to arrangements and transactions to create a rich description of red flag events.
All of these factors influenced the assessment of these texts and the ways that the themes evolved in the study. These themes, once identified, had to be further evaluated to select those that were distinct. Following Boyatzis, it was important to “visually compare the differentiation on each of [the] samples in relation to the themes in the reliable code. Those themes showing differentiation constitute [the] validated code or validated themes” (Boyatzis, 1998, p.50). At this point in the process, relationships among themes were identified: “The researcher may find him- or herself with a variety of themes that appear to have a relationship with each other” (Boyatzis, 1998, p. 134). In this case, it was during the stages in which the codes were developed and implemented, that these relationships became more evident: “A conceptual or empirical relationship may be predicted by the underlying theory or may become apparent during the code development process” (Boyatzis, 1998, p. 134).

In order to assess these relationships, clustering was used rather than the scaling technique: “The vehicle for reflecting or examining these relationships could be scaling or clustering. Although these two words can be used for similar operations, scaling will mean the combination of two or more coded themes into a single score, whereas clustering will mean the organization of multiple themes into groups” (Boyatzis, 1998, p. 134). Eight subthemes were identified in the first assessment of the data:

1. The Board relied on Anderson, PWC or Vinson & Elkins,
2. Gatekeeping issues of advisors,
3. Misleading information from management,
4. Limitation of information communicated for Board meetings,
5. The Board’s inability to understand information,
6. Decision protocol for approvals,
7. Andrew Fastow’s proxy statement &

After a second review of the data, the eight themes were clustered into three final themes:

Theme 1: Interdependency of authority relationships in Enron;
Theme 2: Information Control;

Theme 3: Decision Protocol and policies shaped the Board’s decision and approval processes.

Boyatzis states the criteria by which clusters may be formed as follows: “(a) related characteristics, (b) identification of an underlying construct, or (c) a causal or developmental hierarchy” (Boyatzis, 1998, p. 137). Related characteristics appeared to be the most applicable and were used to cluster themes for this study.

Boyatzis defines reliability as “consistency of observation, labelling, or interpretation” (Boyatzis, 1998, p. 144), “critical in using thematic analysis” (Boyatzis, 1998, p. 144) and differentiates it from verification “which is a pure, positivistic notion. It affects the potential utility of the code and research findings that result from the use of the code. It affects the potential for replication, extension, and generalizability of the research” (Boyatzis, 1998, p.144). Boyatzis emphasizes the contrast between validity of findings and reliability of judgements, and states that the former exceeds the latter with regards to “coding or processing the raw information” (Boyatzis, 1998, p. 144).

To address interrater reliability which is the “consistency among various viewers is attained when different people observing or reading the information see the same themes in the same information. Interrater reliability is consistency of judgement among multiple observers” (Boyatzis, 1998, p.147), the supervisor for this research was able to confirm that themes were identifiable in the information. As per Boyatzis, reliability and validity are influenced by the “the way the information is recorded and the choice as to what is recorded” (Boyatzis, 1998, p. 147). There was no access to “multiple coders to the raw information” (Boyatzis, 1998, p. 147), instead all of the coding was performed by the researcher independently. Neward refers to the Lincoln and Guba (1985) and Creswell (1994) regarding the term ‘trustworthiness’ defined as a “call for internal validity [is] known as trustworthiness in qualitative inquiry” (Neward, 2010, p.162). Neward refers to Lincoln and Guba (1985) description of ‘trustworthiness’ for when a researcher ensures that the “credibility, transferability, dependability, and confirmability claims are strong, a study’s procedures can be deemed trustworthy” (Neward, 2010, p.162). Neward refers to an “audit trail” (Neward, 2010, p.58-59) which consists of details that were used to compile and analyze the data, for this study this was completed in an Nvivo 9 database. In order
to systematically record these codes, a codebook (Boyatzis, 1998, p. 4) was created, which is defined as “the compilation or integration of a number of codes in a study” (Boyatzis, 1998, p. 4). The three themes that emerged from the data analysis are presented below, using the format suggested by Boyatzis (1998) and discussed earlier.

**Theme 1**

Label - Interdependency of authority relationships in Enron.

Definition – The text describes a chain of approvals and in it, each group depends on another group for information and/or approvals during the decision-making process.

Indicators – Coded text which specifies the ways that the Board, management, and advisors depend on each group for information and approvals prior to issuing their respective approvals.

Differentiation: For the purpose of this examination of the approval process and to reflect the examples in the text, the term “approval” indicates that advisors reviewed the transaction and confirmed that it was “appropriate”. The Board received information from Andersen, V&E, “standing committees” and management to review prior to issuing approvals and to assess Enron operations. Andresen & V&E relied on management for details for any deals and Enron operations. Management relied on Andersen and V&E for accounting and legal strategies to best achieve management’s objectives. However, Andersen and V&E personnel were selected by management in the first place; as a result, these advisors tended to conform and support management’s vision. Management appeared to have the most complete view of Enron operations since management did not need to rely on others for these details.

Exclusion – Not coded if the text specifies policies and decision protocol. This theme focuses on the inter-dependent authority relationships between these groups, and not the protocol or policies that were used to form these relationships, as this text is coded in Theme 3.
**Theme 2**

Label - Information control

Definition – Tactics used by management to control, conceal, and contort information in order to mislead members of the Board.

Indicators – Coded when the text specifies management withholding information from the Board or disclosing information to selective groups. Coded when the text specifies individuals or groups involved in conflict of interest issues. This individual or group may have access to valuable information; however, this information is disclosed to selected individuals in order to mislead others. Or this valuable information may be withheld from an entire group or groups. Coded when the text specifies issues with “controls” which are specific conditions set by the Board to monitor operations.

Differentiation - The individual/group in control of this information has the most complete picture of Enron (management), the groups which receive valuable information becomes a preferred group or groups (advisors), and the group that does not receive this information, is less informed and becomes less relevant in the information hierarchy (the Board). The Board requested specific conditions be in place called “controls” in order to monitor operations. However, these ineffective “controls” limited the information which was communicated to the Board by management.
Theme 3

Label - Decision Protocol and policies shaped the Board’s decision and approval processes.

Definition – Decision processes were shaped by the content, timing and amount of information related to Enron’s decision protocol and policies.

Indicators – Coded when the text specifies the content of information in policy or protocol documents: such as the transparency of the language in proxy statements and disclosures. Coded text describes the timing, such as the scheduling of meeting agendas. Coded when the text specifies the Board received overwhelming amount of information to prepare for meetings. Coded when the text mentions the Board’s fiduciary duties of decision-making and oversight, particularly, the Board monitoring operations and failure to inquire into red flags or warnings.

Differentiation – Text examples regarding content issues relate to the Board’s inability to understand transactions or deals due to insufficient information, incomplete disclosure of transaction details or unclear jargon in financial reports and proxy statements. Examples of timing issues include packed meeting agendas that limited the time for the Board to discuss agenda items. Issues which concern the amount of information include examples of the flood of information which inundated the Board, and influenced the Board’s ability to assess the information required for the decision and approval process. The Board may only be responsible for its actions based on available information. Decision protocols and policies affect the Board’s performance regarding its fiduciary duties, since the Board’s ability to assess warning signs depends on the content, timing and amount of the information.

In this Research methods chapter, three themes emerged from the data analysis as outlined above using the format as per Boyatzis (1998). In the following Findings chapter, these three themes demonstrate the communication and use of information in Enron during the decision-making and approval processes.
5 Findings

The objective of this research was to examine how information flow and control affected the decision-making processes at Enron. The study focused on the roles and interaction of the Board of Directors with management and professional advisory groups. For the Board, it was imperative that it receive complete and accurate information prior to issuing Board approvals. However, based on the study’s findings, management appeared to have significant influence over the content, timing and amount of information reviewed by the Board. Three themes were identified regarding the communication and use of information in Enron: interdependency of authority relationships, information control, and that decision protocol and policies shaped the information that management sent to the Board during the approval process.

The first theme examines the interdependency of authority relationships, describes the chain of approvals, and focuses on the way that information flows between groups in the approval process. The second theme, information control, relates to tactics used by management to control, conceal, and contort information. These strategies included the ways that groups selected information and communicated it to specific groups, as well as examining the misrepresentation of information sent to the Board. The third theme examines the ways that policy and protocol were used to influence the content, timing and amount of information and shaped the decision and approval processes at Enron. All three themes describe an organizational hierarchy based on access to information. The communication of information among groups influenced the perception of authority in the approval and decision-making processes at Enron.

The Board relied on Andersen and Vinson & Elkins for approvals regarding transactions first, before it could issue Board approvals. If the deal did not require Board approval, then the Board may not be involved in the approval process and advisors communicated their approvals to management. However, if a deal required Board approval, then Andersen and/or Vinson & Elkins may have approved the transaction first, prior to the Board’s review of the transaction. It is important to note that the required Board approvals were applicable only to specific transactions as determined by Enron’s Decision Protocol and Policies.
5.1 Arthur Andersen

The Board was dependent on advisors to review and confirm that the transactions were appropriate before the deals advanced to the next level in the approval process. Based on the examples, groups used the term “approval” in this process, particularly with respect to when transactions were reviewed by Enron’s auditors, Arthur Andersen. However, it is not clear if the term “approval” was used in a formal manner and with the appropriate legal definition at Enron. This study was not designed to test for the use of the terms “approval” or “opinion”. Therefore, the terms are documented as they appear in the texts. The Board used the term “opinion” to refer to Andersen’s “financial statement opinion” or PricewaterhouseCoopers [PWC] “fairness opinion”. A significant term “unqualified audit opinion” was used to define the intention of Andersen’s review of specific deals and arrangements. For example, Andersen offered an “unqualified audit opinion” regarding “the required disclosures and related party transactions” (Powers, Troubh, & Winokur, 2002, p.25). The definition of an unqualified audit opinion “states that the financial statements give a “true and fair view” (international) or are “fairly presented” (international and U.S.) in accordance with applicable accounting standards. This is often referred to as a “clean” opinion” (Robinson et al., 2009, p. 15) and considered a good assessment of the information. Since Andersen offered an “unqualified audit opinion” regarding “the required disclosures and related party transactions” (Powers, Troubh, & Winokur, 2002, p.25), the Board believed that Andersen was comfortable with the transactions. If Andersen had offered a “qualified audit opinion,” it would suggest “some limitation or exception to accounting standards” (Robinson et al., 2009, p. 15). In this “qualified audit opinion” process, Andersen would assess the exceptions in Enron’s audit report: “so that the analyst can determine the importance of the exception” (Robinson et al., 2009, p. 15). Alternatively, an “adverse audit opinion” is the least desirable of all three opinions: “an adverse audit opinion occurs when the financial statements materially depart from accounting standards and are not fairly presented” (Robinson et al., 2009, p. 15). Finally, if auditors do not offer an opinion at all, this is referred to as a “disclaimer of opinion” and would potentially raise concerns with regards to the reason for no opinion. Based on the examples, Andersen did offer an “unqualified audit opinion” on transactions and arrangements; thereby, the firm supported these deals to advance to the next stage of the approval process.
5.2 Vinson & Elkins

Vinson & Elkins was Enron’s outside counsel and this firm “provided advice and prepared documentation in connection with many of the transactions” (Powers et al., 2002, p.25) which included the assessment of the “disclosures of related-party transactions in the proxy statements and the footnotes to the financial statements in Enron's periodic SEC filings” (Powers et al., 2002, p.26). Vinson & Elkins advised the groups in this approval process, which included the Audit and Compliance Committee and Enron’s legal in-house counsel. According to the Powers Report, it would have been unfair to hold Vinson & Elkins responsible for the accounting issues, as this was Andersen’s role in this process. By contrast, however, several examples in the findings involve Vinson & Elkins (V&E) mostly with respect to proxy statement disclosures as discussed in theme three.

5.3 Background on Committees Involved in Enron’s Approval Process

As noted in the Enron background chapter, the Board was not the only group to approve transactions in the decision-making process. The approval process consisted of several levels of approvals prior to the Board’s review of this information. Each committee was responsible for review and approval of specific items before this information could be presented to the Board. Out of the five “standing committees” included four that were either required or customary for public companies as listed in Table 5 below:

<table>
<thead>
<tr>
<th>Standing Committees</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit and Compliance</td>
<td>“Overseer of Enron’s financial reporting process, system of internal controls, and corporate compliance process [...] comprised solely of Independent Directors (U.S. Senate, 2002, p.390).”</td>
</tr>
<tr>
<td>Compensation and Management Development</td>
<td>“Establishes and evaluates the compensation of Enron’s senior executives to assure that such individuals are compensated in a manner consistent with the stated”</td>
</tr>
</tbody>
</table>
compensation strategy of Enron, internal equity considerations, competitive practice, and the requirements of applicable regulatory bodies [...] comprised solely of Independent Directors (U.S. Senate, 2002, p.390).

<table>
<thead>
<tr>
<th>Nominating and Corporate Governance</th>
<th>“Reviews criteria for membership on the Board, recommends to the Board candidates for election as Directors” Directors (U.S. Senate, 2002, p.390). Approves for recommendation to the Board:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• the Directors to be selected for membership on Board committees</td>
</tr>
<tr>
<td></td>
<td>• for Lead Director</td>
</tr>
<tr>
<td></td>
<td>“Reviews Director performance [...] comprised solely of Independent Directors (U.S. Senate, 2002, p.390).”</td>
</tr>
</tbody>
</table>

| Executive | “During the intervals between the meetings of the Board, [the Executive Committee] possesses and exercises all the powers of the Board, subject to the limitations imposed on such Committee by Enron’s Bylaws and by the Oregon Business Corporation Act” (U.S. Senate, 2002, p.390). |

| Finance Committee | “Reviews and makes recommendation to the Board and management on matters concerning both current and long-range financial strategy and planning, including without limitation budgets, dividends, equity offerings, debt and other financings, foreign exchange policy, investment policy, and trading limits policy [...] [majority] comprised of Directors who have expertise and experience in economic and financial matters and/or capital markets” (U.S. Senate, 2002, p.390). |
Two main committees, the Finance Committee and the Audit Committee, are the most relevant to this approval process and involve Board members: “Outside Directors most involved with overseeing Enron's SPE transactions were the members of the Finance Committee, [...] responsible for reviewing and approving the company's significant financings and [...] the Audit Committee [responsible for] reviewing Enron's publicly disseminated financial statements” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.35). The Board often relied on the Finance and/or Audit committee approvals first, prior to the issue of Board approvals.

5.4 Red Flags
Neal Batson, the court appointed Examiner, states in Batson’s Final Report: “Although the Outside Directors may be criticized for failing to inquire about aspects of Enron's financing activities that might have led them to knowledge of the Senior Officers' wrongful conduct, the evidence does not support a conclusion that the Outside Directors acted in bad faith or with a conscious disregard for known risks in failing to recognize and respond to red flags” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p. 2). Batson’s Final Report may have found insufficient evidence to show that the Directors breached their fiduciary duty to investigate red flags; but the Senate Committee report compiled a list of red flags or warnings “that signalled the risks Enron was taking, and that should have alerted the Board to probe and then to change course” (U.S. Senate, 2002, p. 4). The Senate Committee described sixteen major incidents as red flags; however, the Directors denied that they were aware of any red flags. It is important to note, that if the Directors admitted that they recognized these red flags, but they did not investigate these warnings, then they would have breached their fiduciary duty specific to their “duty to inquire into circumstances, or ‘red flags,’ indicating that potential problems exist within the corporation” (U.S. Bankruptcy Court Final Report of Neal Batson, 2003, p.32-34). The three themes which emerged from these findings are exemplified by three issues related to
the red flags as cited in the Senate Committee Report: Andrew Fastow’s conflict of interest waivers and compensation disclosure issues, the Raptors restructure and LJM2 operations approval processes.

5.5 Controls

Salter (2008) defines decision control as “the process by which senior executives or a board of directors approves plans and capital investments proposed by operating managers, and monitors the results” (Salter, 2008, p.162). Specific controls were imposed by the Board in order to monitor the progress of transactions and arrangements: “the Board put many controls in place, but the controls were not adequate, and they were not adequately implemented” (Powers et al., 2002, p.148). Controls were supposed to be implemented as safeguards: “to ensure that the LJM2 transactions were done at arm's length and that the compensation Fastow received from LJM2 did not adversely affect his performance for and loyalty to Enron” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.108). According to the Powers Report, the necessity for such controls should have warned the Board against the approval of the waivers (Powers et al., 2002, p.156). The examples which describe Fastow’s compensation issues refer to several controls implemented which concern LJM2. Particularly for theme two, the details in Fastow’s presentation for controls are included to provide background for these arrangements. Salter refers to the Enron Audit Committee Meeting Minutes February 12, 2001, [p.3] to describe Fastow’s presentation of four controls to the Finance Committee regarding LJM2: “(1) LJM senior professionals do not ever negotiate on behalf of [Enron], (2) [Enron] professionals negotiating with LJM report to senior Enron officials separate from Fastow, (3) Numerous groups monitor compliance with procedures and controls and regularly update Fastow and Buy, (4) [Enron] regularly consults with internal and outside counsel regarding disclosure obligations” (Salter, 2008, p.174-175).

Although the Board asked management to implement controls, the Board failed to monitor them: “minimal controls to ensure that the LJM2 transactions were done at arm's length and that the compensation Fastow received from LJM2 did not adversely affect his performance for and loyalty to Enron” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.108). The first control was created to assure the Board that Causey (Chief Accounting Officer) and
Buy (Chief Risk Officer) would review all of the transactions (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.108). Second, the Audit Committee would review and make recommendations for these transactions (U.S. Bankruptcy Court Final Report of Batson: Appendix D, p.108). However, based on this report, no specific responsibility was assigned to any group to monitor these controls. Due to this combination of insufficient controls and reports from the Finance and Audit committees reports which stated that there were no issues with the controls, the Board maintained that they thought that these safeguards were in place from management (Powers et al., 2002, p.154) and “working effectively’’” (U.S. Senate, 2002, p.18).

The Board did not follow up to obtain information that would have indicated issues with these transactions. The Board became less informed about Enron’s operations. Instead of implementing and assessing key factors in the decision control process, such as performance standards or milestones, the Board was unable to accurately assess “the progress of approved hedges, merchant investments, and operating policies” (Salter, 2008, p. 176). This is demonstrated in theme two by the LJM2 transactions, Fastow’s Compensation and Conflict of Interest Issues and the Raptors Vehicles to show the failure of “minimal controls” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.108). The Board was aware that it should implement the controls; but failed to use them in an effective manner.

5.6 LJM: Background

The Senate Committee Report refers to the establishment of the LJM partnerships and the waiver of Fastow’s conflict of interest, as the incidents which placed the Board “up to its neck in dangerous water” (U.S. Senate, 2002, p. 5). Therefore, it is important to describe the Board’s role concerning LJM1’s creation on June 28, 1999: “The Board believed it was addressing a specific, already-negotiated transaction, rather than a series of future transactions. This was the Rhythms "hedge" (Powers et al., 2002, p. 150). Management presented Rhythms as a benefit “by reducing income statement volatility resulting from a large investment that could not be sold” (Powers et al., 2002, p. 150). In addition, management communicated that Rhythms terms were as follows: “The Board understood that (1) the terms were already fixed, (2) Enron would receive an opinion by PricewaterhouseCoopers [PWC] as to the fairness of the consideration received by Enron, and (3) Fastow would not benefit from changes in the value of Enron stock that Enron contributed to
the transaction” (Powers et al., 2002, p. 150). Proposals were adopted by both committees to review the transactions, as well as Fastow’s compensation via quarterly reports, in order to implement and maintain controls (Powers et al., 2002, p.155). The Board considered LJM2 based on available information communicated by management and determined that this was positive for Enron’s interests due to Fastow’s involvement: “The principal stated advantage of Fastow's involvement in LJM2 was that it could then purchase assets that Enron wanted to sell more quickly and with lower transaction costs” (Powers et al., 2002, p. 151).

Initially, the LJM2 proposal appeared to be a positive option and the Board understood that it provided an opportunity for Enron which would work to the advantage of the company with respect to transaction costs: "[the] advantage of Fastow's involvement in LJM2 was that it could then purchase assets that Enron wanted to sell more quickly and with lower transaction costs. This was a legitimate potential advantage of LJM2, and it was proper for the Board to consider it" (Powers et al., 2002, p.151). However, the Board assumed that the risk was justifiable provided sufficient controls were in place.

The controls that were implemented for the LJM partnerships were not successful and the Board’s inability to follow up to monitor these safeguards, may have contributed to the failure of these controls. LJM2 was used to examine the major themes as it involved incidents which concerned issues of information control which excluded the Board of Directors and influenced their decision-making process. The decision-making processes of the Board which involved Fastow’s LJM2 compensation contributed to the risk of “Fastow's conflicting roles as CFO of Enron and as general partner of LJM2” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.108). The LJM transactions appeared to fuel the problematic circumstances of Fastow’s compensation and conflict of interest issues. Therefore, both the LJM partnerships and Fastow’s compensation/conflict of interest issues are both described in these findings, to best exemplify the Board’s decision-making processes.
5.7 Andrew Fastow: Board’s Decision to Waive Conflict of Interest and Compensation Issues Background

Andrew Fastow (CFO) was central to the LJM Deals, he requested the omission of his compensation details in LJM was removed from the proxy statement disclosures, and obtained Board’s approval for conflict of interest waivers to Enron’s code of conduct. There were many references to the Boards’ decision to waive the conflict of interest provision of the Enron code of conduct for Fastow three times. These approvals for Fastow’s waivers were listed in the Senate Committee report as red flags #2, #4, and #8 in Appendix B:

In June 1999, the Board approved at a special meeting and without prior Finance Committee consideration the creation of the LJM partnership, and waived the conflict of interest provision of the Enron code of conduct [...] The Board was to approve a code of conduct waiver for Fastow three times over the next 16 months. (U.S. Senate, 2002, p.4)

The text of this approval was taken from the Minutes of the Special Meeting of the Board of Directors, June 28, 1999 as follows: “Resolved further, that the Board hereby adopts and ratifies the determination by the Company’s conduct of Business Affairs/Investments and Outside Business Interests of Officers and Employees that participation of Andrew S. Fastow as the managing partner/manager of the Partnership will not adversely affect the interests of the company” (U.S. Senate, 2002, p.126). Several warning signs indicated this arrangement may create risks: "First, given Fastow's position as Enron's CFO, LJM2 would create a poor public appearance” (Powers et al., 2002, p.151). According to the interviews in the Powers Report, although the meetings do not include the Board’s debate about the public’s perception of Fastow’s conflict of interest, there was apprehension surrounding this issue, which prompted the Board to adopt controls (Powers et al., 2002, p. 151-153). Industry members became more aware of this conflict of interest after Enron announced their earnings: “During the rising stock market, analysts and investors generally ignored Fastow's dual roles and his conflict of interest, but when doubts were cast on Enron's transactions with LJM1 and LJM2 in connection with Enron's earnings announcement on October 16, 2001, this appearance became a serious problem” (Powers et al., 2002, p. 152).

The second risk was due to Fastow’s compensation from the LJM transactions, it may cause Fastow to prefer his duties which relate to LJM over his responsibilities to Enron. As a result, it
may prompt “transactions to occur on terms unfair to Enron or overly generous to LJM1 and LJM2” (Powers et al., 2002, p.152) and “substantial issues of the process leading to that decision” (Powers et al., 2002, p.187). The Powers report refers to Item 404 of Regulation S-K which requires: “the disclosure ‘where practicable’ of ‘the amount of [Fastow’s] interest in the transactions’ (Powers et al., 2002, p.187). The consensus of people involved in drafting the proxy disclosures was to accommodate the strong desire of Fastow (and others) to avoid disclosure if there was a legitimate basis to do so (Powers et al., 2002, p.187). According to the Powers report, management and advisers were investigating “if there were legitimate ways to avoid disclosing Fastow’s compensation from the related parties” (Powers et al., 2002, p.187) in the proxy disclosures. This example shows that advisors were aware of details which the Board was not, since Fastow’s compensation was not revealed to the Board voluntarily by management.

5.8 Raptors: Background

The Raptors transactions are important examples to show the ways that management communicated information which was misrepresented to the Board. The process relating to the Raptors demonstrates that the Board did not have full information in order to make educated approvals. The Board did not understand the nature of the Raptors transactions, particularly consequences and details of this risk associated with this complex hedge: “The idea of a hedge normally is to contract with an outside party that is prepared – for a price – to take on an investment risk. The outside parties with which Enron hedged – the so-called Raptors partnerships – were funded almost entirely with Enron’s own stock, an unusual arrangement approved by the Board” (Salter, 2008, p.8). In many examples, the Directors stated that Andersen would have reviewed Raptors and they relied on Andersen’s expertise to determine the appropriateness of these transactions. However, the Board claims that they were not aware of the specific financial details, since the restructure of Raptors did not require their approval. The Board did not realize the consequences of this hedge. Ultimately, the details concerning the hedge “meant that if the value of Enron’s investments and its stock fell at the same time, these off-balance-sheet partnerships would be unable to meet their obligations. That is precisely what happened in 2000 and 2001, when two of these hedges were unable to cover Enron’s shortfalls” (Salter, 2008, p.8).
Due to decision protocols, the Board was not involved in the restructure or termination process of these transactions (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p. 68-69). Specific aspects of the Raptors transactions were used to exemplify the major themes, as well as the limitations of the Board to access information from management regarding transactions which did not require the Board’s approval. The Directors did not understand the consequences of these deals to the overall operation of Enron due to their limited knowledge of these transactions. However, limited knowledge should not have prevented the Board to investigate information and become informed of Enron’s operations. The Board has a fiduciary duty to inquire in order to provide complete information to shareholders.

5.9 “Candor” and Disclosure

Companies are required by the SEC to release financial details and dealings through disclosure. This system is governed by principles “known as candor [which] require that directors be honest, accurate, and complete in public and direct communications with shareholders” (Salter, 2008, p.170). I refer to this term as “candor” since I am using it in a specific context related to the treatment of fiduciary duties under Oregon law. When candor is used in this manner, it is “also known as the duty of disclosure” (Salter, 2008, p.158). The reason I have spelled “candor” using the United States form rather than the Canadian form as “candour”, is that I refer to this specific term “candor” by its title as one of the main task fiduciary duties recognized under Oregon law and this term should be stated as it appears under Oregon law. Several documents, including Form 10-K annual and Form 10-Q quarterly reports, as well as proxy statements, are filed to communicate financial information. A Form 10-K annual report is “filed with the Securities and Exchange Commission providing a comprehensive overview of the registrant's business and filed within 90 days after the end of the company's fiscal year” (Powers et al., 2002, Appendix A). A Form 10-Q quarterly report is “filed with the Securities and Exchange Commission for each of the first three fiscal quarters of the company's fiscal year and due within 45 days of the close of the quarter” (Powers Report, Appendix A). According to the Powers Report, a proxy statement is described as “information that the Securities and Exchange Commission requires companies to provide to shareholders before they vote by proxy on company matters” (Powers et al., 2002,
Appendix A). Shareholders rely on this document as “most are not in a position to verify that information” (Salter, 2008, p.169-170).

The Board failed to provide the necessary check and balance to ensure that the information communicated to shareholders is not compromised by inaccurate reports: “There was no systematic procedure in place for ensuring identification of all transactions with related parties that needed to be disclosed in financial statement footnotes or proxy statements” (Powers et al., 2002, p. 183). The SEC standards require that companies disclose clear and accurate information in financial statements. Enron disclosed Fastow’s relationship with LJM to the extent that there “were large transactions with entities in which the CFO had an interest” (Powers et al., 2002, p.178). This disclosure problem stems from the omission of these financial details as it creates an inaccurate snapshot of Fastow’s relationship with LJM and his compensation from these deals: “Fastow was the managing director of LJM2’s general partner, which was entitled to a percentage of any profits in excess of the general partner’s proportion of the total capital contributed to LJM2” (Salter, 2008, p.315). However, Enron did not disclose specific details which described Fastow’s “actual or likely economic benefits from these transactions and, most importantly, never clearly disclosed the purposes behind these transactions or the complete financial statement effects of these complex arrangements” (Powers et al., 2002, p.178). Enron omitted specific details in the 2001 proxy statement for the LJM2 sale. Although the disclosure “refers to a sale by LJM of certain merchant investments to Enron in 2000 for $76 million” (Powers et al., 2002, p.192), according to the Powers report, Enron did not include that these “were buybacks of assets that Enron had sold to LJM2 the year before in what were described (in the prior year's proxy statement) as arm's-length transactions” (Powers et al., 2002, p.192). In reality, the LJM transactions were not created to be executed by unrelated parties. In fact, “based on the terms of the deals, it seems likely that many of them could only have been entered into with related parties” (Powers et al., 2002, p.199). Therefore, it was unlikely that LJM2 could be executed in an “arm’s length” manner: “the accounting literature provides: "Transactions involving related parties cannot be presumed to be carried out on an arm's-length basis, as the requisite conditions of competitive, free-market dealings may not exist” (Powers et al., 2002, p.198).

Furthermore, although the statement described “Enron contributions to the Raptor entities” (Powers et al., 2002, p.192), the proxy statement omits that “$82 million was distributed to LJM
(and therefore to its partners) from Raptors I and II in 2000, even before those entities began
derivative transactions with Enron” (Powers et al., 2002, p.192). In addition, Enron’s 2000 10-K
stated that the purchase details for the Raptors; but did not adequately explain that it placed puts
on its own stock: ‘‘Enron paid $123 million to purchase share-settled options from the [Raptor]
Entities on 21.7 million shares of Enron common stock.’ What it did not disclose, however, was
that Enron purchased puts on Enron stock” (Powers et al., 2002, p.199). A put is defined as “an
option that entitles the option holder to sell to the counter-party a commodity, financial
instrument, or other asset at an exercise or strike price throughout the option term or at a fixed
date in the future (the expiration date)” (Powers et al., 2002, Appendix A). If investors were
aware of the puts, there was a possibility that this information could have raised red flags. It
meant that “Enron had entered into a derivative transaction that was, on its face, predicated on
the assumption that its stock price would decline substantially” (Powers et al., 2002, p.199-200).
In Appendix A of Innovation Corrupted, Salter (2008) describes the Raptor put and the closing
price of Enron’s stock was higher than the strike price at the point in time of the purchase: “the
Raptor put gave Enron the right to require the Raptor 1 SPE (Talon) to purchase 7.2 million
shares of Enron common stock on October 18, 2000, six months after the effective date of the
transaction, at a strike price of $57.50 per share. The closing price of Enron stock was $68 per
share when Enron purchased the put. In an economic sense, the put option was a bet by Enron
that its own stock price would decline substantially” (Salter, 2008, p.346-347). The content in
disclaimers must communicate clear information to shareholders in order to adequately represent
Enron’s operations and arrangements. In doing so, the findings suggest show that the groups at
Enron responsible for the decisions to omit information and the lack of oversight by the Board,
contributed to Enron’s failure due to an ineffective decision-making process.

Three case examples: (i) LJM2, (ii) Fastow’s compensation and conflict of interest issues, and
(iii) the Raptors entities, illustrate the three themes which emerged in the findings. The three
themes are as follows: (i) interdependency of authority relationships, (ii) information control, and
(iii) that decision protocol and policies shaped the information that management sent to the
Board during the approval process.

These case examples are interconnected: “The LJM2 partnership [was] an equity contributor to
the Raptors SPEs – which was controlled by Fastow, who appeared to have a conflict of
interest” (Salter, 2008, p. 340). Conflict of interest issues are represented by Fastow’s role in
LJM2. Fastow’s disclosure issues are shown by the omission of his interest in LJM2 in Enron’s proxy statements. These case examples were selected since each transaction/issue relates to significant red flags (Appendix D) which the Board maintained it did not identify prior to Enron’s collapse. These warnings were indicative of problems in Enron’s accounting practices and operations. LJM2, Fastow’s Conflict of Interest and Disclosure issues, and the Raptors vehicles are used to illustrate the three themes which examine information flow and decision-making processes in this organization. Using Boyatzis’ format as a guide, each theme is examined using the case examples to demonstrate issues of (i) inter-dependence of groups, see p.101 for theme one indicators, (ii) information control, see p.107 for theme two indicators and (iii) protocol and policy used to shape these decision-making processes, see p.112 for theme three indicators. Theme indicators for all three examples were evaluated to code the text from several documentary sources. Each example was then analyzed with supplementary research to provide context to the deals, transactions or arrangements. Table 6 below describes the three case examples and red flags for each case.

**Table 6. Three Case Examples to Illustrate Three Themes in the Findings for this Enron Case Study**

<table>
<thead>
<tr>
<th>Case Example</th>
<th>Red Flags Illustrated by Case Example</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>LJM2 and Fastow’s Conflict of Interest</strong></td>
<td>Red Flags List from (U.S. Senate, 2002, p. 203), included as Appendix D in this study.</td>
</tr>
<tr>
<td>Issues</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The relationship between the LJM entities and Fastow’s code of conduct waivers was that “these approvals allowed Fastow to continue serving as Enron’s CFO while acting as the general partner and leader to the LJM partnerships” (Salter, 2008, p.167). The Board approved three times. Therefore both case examples of LJM and Fastow’s conflict of</td>
</tr>
<tr>
<td></td>
<td>- Red Flag #2, Board approves Fastow’s Code of Conduct waiver for LIMJ</td>
</tr>
<tr>
<td></td>
<td>- Red Flag #4, Board approves second Fastow waiver for LJM2</td>
</tr>
<tr>
<td></td>
<td>- Red Flag #8, Board approves third Fastow waiver for LJM3</td>
</tr>
</tbody>
</table>
interest issues relates to several red flags. This Fastow’s conflict of interest waiver was useful to illustrate Theme 2, since the theme of information control consists of indicators related to conflict of interest and management’s ability to manipulate and shape the information flow at Enron. However, all three case examples were used to demonstrate all of the themes.

**Raptors**

Andersen had made an accounting error regarding promissory notes and resulted in a $1 billion reduction in shareholder equity (Salter, 2008, p.348-349). The Raptors were highly complex transactions and since the Raptors’ restructure phases did not require Board approval, Directors did not receive complete information about these arrangements. Although the Raptors were used to illustrate all three themes, the first theme, regarding the interdependency among groups at Enron, is very important to describe the way that Board members relied on others groups to understand the extensive financial and accounting details incorporated into the Raptors and offer approvals prior to the Board granting its approval. This decreased the Board’s power since it appeared to be more passive in this Raptors related decision-making process. There were substantial debates regarding if the

- Red Flag #16, Finance Committee told of $800 million earnings write-down from Raptors
Raptors had any “rational business purpose” (U.S. Bankruptcy Court, 2003, p.11). Therefore, this Raptors’ example is useful since it addresses the intention and actions of the decision maker to determine if the decision was made in good faith as this affects the decision-making process.

**Fastow’s Disclaimer Disclosure Issues**

The word “practicable” was creatively used by Enron’s legal advisors and provided the basis for omitting Fastow’s interest in LJM from the disclaimers: “The disclosure of Fastow's sale of his interest in LJM1 and LJM2 to Kopper (who resigned so he could buy Fastow's interest in LJM1 and LJM2 in the summer of 2001), Fastow's preference was for Enron to avoid mentioning that the purchaser of these interests was a former Enron employee” (U.S. Bankruptcy Court, 2003, p.98). This example was significant to explore all three themes of this study, but particularly useful in the third theme: (iii) that decision protocol and policies shaped the information that management sent to the Board during the approval process because it showed the ways in which formal protocol and policies within the limits of the law could be manipulated to cater to the interests of management.

- Red Flag #13, Fastow sells interest in LJM to Kopper
5.10 Theme 1 – Authority Interdependence

Label - Interdependency of authority relationships in Enron.

Definition – The text describes a chain of approvals and in it, each group depends on another group for information and/or approvals during the decision-making process.

Indicators – Coded text which specifies the ways that the Board, management, and advisors depend on each group for information and approvals prior to issuing their respective approvals.

Differentiation: For the purpose of this examination of the approval process and to reflect the examples in the text, the term “approval” indicates that advisors reviewed the transaction and confirmed that it was “appropriate”. The Board received information from Andersen, V&E, “standing committees” and management to review prior to issuing approvals and to assess Enron operations. Andresen & V&E relied on management for details for any deals and Enron operations. Management relied on Andersen and V&E for accounting and legal strategies to best achieve management’s objectives. However, Andersen and V&E personnel were selected by management in the first place; as a result, these advisors tended to conform and support management’s vision. Management appeared to have the most complete view of Enron operations since management did not need to rely on others for these details.

Exclusion – Not coded if the text specifies policies and decision protocol. This theme focuses on the inter-dependent authority relationships between these groups, and not the protocol or policies that were used to form these relationships, as this text is coded in Theme 3.

5.11 Interdependency of authority relationships

The decision-making process at Enron was comprised of a chain of approvals. Andersen’s role in particular was vital to the Board’s assessment of information. It is significant that Andersen’s opinions were referred to as “approvals” by the Board. The Board also referred to committee’s opinions as “approvals” during the decision-making process. The Audit and Compliance Committee and the Finance Committee would approve transactions first, and then recommend them to the Board to review and approve.

The Finance committee relied on Andersen’s approvals, in order to recommend committee
approvals to the Board of Directors. These groups were dependent on each other to confirm information and issue approvals so that transactions could be moved to the next level in the decision-making process. However, no particular group effectively monitored this process. Appendix D for this Thesis is *Enron Corp. Business Risk Management Process Overview* and describes the process and shows the interdependence among these groups (U.S. Senate, 2002, p.403). Since all the groups were interdependent; in practice, there were no gatekeepers with substantial power to provide an essential system of check and balance. The Audit Committee relied on Anderson’s approval prior to submitting its recommendations to the Board of Directors. In the same manner as the Finance committee, the Audit committee did not evaluate Andersen’s decision, it merely accepted it as the basis for its own approval: "The minutes do not reflect the extent of any discussion or questioning by the Audit Committee members, but they show that Andersen and management repeatedly led the Audit Committee to believe there were no problems" (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.105). Andersen reassured the committee that they did not have concerns about the financial accounting at Enron. This demonstrates that the relationship between Andersen and management was somewhat closed off to the Board.

Since Board members are supposed to oversee management, the Directors’ authority should be clearly defined in the organization. Yet Winokur’s statement above describes the Board as powerless and without “authority” to obtain the answers from individuals that they are supposed to oversee. The authority of Board was undermined due its limited access to complete information, and this created a cycle. The Board did not follow up on missing information; therefore, it did not receive it. As a result of this, the Board became less informed about the operations of Enron. After which, the Board was perceived as less of an authority in the organization, as it became less relevant to the decision-making process.

### 5.11.1 Theme 1 – Case (i): Raptors

In the Senate Committee report, Blake states: “The first Raptor transaction was brought to the Finance Committee, in May 1, 2000. The minutes reflect the Chief Accounting Officer told us that, ‘Arthur Andersen LLP had spent considerable time analyzing the Talon structure and the governance structure of LJM2 and was comfortable with the proposed transaction’” (U.S.
The Board described Anderson’s views of these transactions as “comfortable” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.104). Anderson would state that it was not necessary to have meetings which did not include management (Appendix, p.105). However, when such meetings with non-management took place, Andersen reported to the Audit committee: “that it had no concerns with Enron’s accounting” (Appendix, p.106). Board members were dependent on Anderson, PWC, and Vinson & Elkins to provide approvals first, in order for the Board to approve transactions and policies at the final stage.

Several references included the Directors’ inability to understand the information that was provided to them. The Board was comprised of several members who did not have the financial background to understand these complex transactions: “Despite the large number of directors, however, the Board did not appear to have sufficient expertise in the kinds of complicated structured financings in which Enron engaged” (U.S. Bankruptcy Court Final Report of Neal Batson, 2003, p. 132). The Board’s inability to understand this information created further dependence of the Board on Arthur Andersen to review and approve transactions.

For example, regarding the issue of the economic risk of Raptor I, in a sworn statement made by Norman P. Blake, Jr., an Outside Director and member of the Finance Committee, Blake states his understanding of the hedge and Andersen’s role reviewing the content which was presented by Glisan at the meeting: “Blake, who was present at the meeting, testified that he understood "[t]hat economic risk was transferred in the transaction. Otherwise, I don't believe Arthur Andersen would have approved it" (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.71). In this statement, Blake refers to this as Andersen’s approval, not Anderson’s opinion. In this case, the Board assumed that because Andersen approved it, the risk would have been transferred; and in keeping with the Board’s practice, it was common to rely on advisors for approvals first. Andersen’s approval confirmed that the transaction was appropriate. In reality, Andersen’s assessments may not have always been suitable: “While other transactions may appear improper, they, too were vetted and approved by Arthur Andersen” (Salter, 2008, p.346).

Anderson “vetted and approved” (Salter, 2008, p.346) several of the Raptors transactions. One of the most significant problems involved Anderson’s accounting error regarding the Raptors, which led “Enron to restate its financial statements and reduce shareholders equity by $1 billion”
As Enron’s share price fell in 2001 and “the Raptors’ credit capacity continued to diminish with the decline” (Salter, 2008, p.348). According to Salter, it became clear that Enron must close the Raptors, “after cross-collateralization, restructuring, and additional Enron shares failed to fix the problem” (Salter, 2008, p.348). As a result, on October 16, 2001, “Enron announced an after-tax charge to earnings of $544 million” (Salter, 2008, p.348) which ultimately meant a reduction in “shareholder equity by $200 million. This amount represents the difference between the fair value of stock and stock contracts that Enron owed the Raptors ($2.1 billion) and the value of Enron’s notes receivable from the Raptors ($1.9 billion)” (Salter, 2008, p.349). As this was taking place, Andersen recognized accounting errors regarding “the notes receivable (promissory notes) Enron had received from the Raptors in exchange for Enron shares” (Salter, 2008, p.348). Unfortunately, as Salter states, the promissory notes were incorrectly recorded as increases not decreases to shareholder equity. This did not comply with GAAP because a promissory note in exchange for Enron’s stock “offsets shareholder equity until the note is paid. The errors required an additional $1 billion reduction in shareholder equity” (Salter, 2008, p.348-349). Since no group raised any questions regarding Enron’s accounting practices, the error was found too late in the process to correct it, and caused substantial reduction in Enron’s equity.

Enron did not tolerate any questions regarding company accounting practices, particularly from members of the Andersen team: “the local Andersen Professional Standards Group representative, Carl Bass, who monitored the Enron account was re-assigned – at the insistence of Enron’s Chief Accounting Officer Rick Causey, who believed Bass might interfere with Enron’s use of SPEs” (Coffee, 2006, p.29). Coffee notes that Causey was a former Andersen partner and this shows “the revolving door relationship that had developed between auditors and their clients across the industry” (Coffee, 2006, p.29). In addition to Bass’s reassignment, in order to cover Bass’s concern over Enron’s accounting practices, “records were falsified... to downplay his objections and present him as concurring generally with the views of Andersen’s Houston office” (Coffee, 2006, p.29). The most significant aspect of these events is Andersen’s initial resistance to Bass’s removal (Coffee, 2006, p.29) and the way Andersen eventually complied with management to maintain its profitable consulting relationship with Enron. Coffee refers to Kurt Eichenwald’s observation that the circumstance which “caused Andersen to acquiesce in Bass’s removal was not a fear that Enron would drop Andersen as its auditor, but
rather the fear that ‘the deep-pocketed client would shift its consulting business at the drop of a hat, leaving Andersen only the low-paying audit work. That was a risk that the Andersen partners were simply unwilling to take” (Coffee, 2006, p.29). This example suggests management could create a team of Anderson advisors to comply, not critique, Enron’s practices.

5.11.2 Theme 1 – Case (ii): LJM2

In the case of LJM2, the Board was confident that if Andersen reviewed the transaction, the Board could approve it: "several Directors stated that they believed Andersen would review the transactions to provide a safeguard. The minutes of the Finance Committee meeting on October 11, 1999 (apparently not attended by representatives of Andersen) identify ‘the review by Arthur Andersen LLP’ as a factor in the Committee's consideration of LJM2” (Powers et al., 2002, p.153). The Board failed to consider any ulterior motives for Andersen’s approvals. The Directors did not seek information about the criteria for which Andersen based the approvals, the relationship between Andersen and management, and the ways that these factors influenced Andersen’s decisions. For specific transactions, such as LJM, the Board should have been aware of Andersen’s audit functions at Enron. Without the information and details of this audit process, it would have been difficult to assess if consultants were providing the best advice for the company (Powers et al., 2002, p.23). Anderson did not raise any concerns to the Board, and in doing so, the Anderson advisors indirectly supported management initiatives.

5.11.3 Theme 1 – Case (iii): Andrew Fastow: Board’s Decision to Waive Conflict of Interest and Compensation Issues

The Board was unaware of the extent of Fastow’s compensation. Many sources refer to the Wall Street Journal article in October 19, 2001 which reported Fastow’s compensation for LJM and was a significant example concerning the issue of the Board’s access and request for information. According to the Powers report, “The Board's review apparently never occurred until October 2001, after newspaper reports focused attention on Fastow's involvement in LJM1 and LJM2” (Powers et al., 2002, p.164). John H. Duncan, former Executive Committee Chair, Board of Directors admitted his concern after the Fortune article appeared as documented in the Senate Committee Report. However, Robert Jaedicke, former Audit and Compliance Committee Chair for Enron, claimed that the article did not prompt him to take action (Senator Committee
Since the Board had not followed up on the information, it did not have Fastow’s compensation details. Senator Levin then asked the Directors if the publication in the *Wall Street Journal* article on October 19, 2001 was the first time the Board heard about Mr. Fastow's millions of profit on LJM. Dr. Charles LeMaistre served on the Enron Board and as Chairman of the Compensation and Management Development Committee responded “yes” (U.S. Senate, 2002, p.38) when questioned about if the Wall Street Journal Article prompted him to return and ask for Fastow’s compensation information. The Board made an inquiry to Mary Joyce, Compensation Officer at Enron regarding Fastow’s compensation but did not receive it (U.S. Senate, 2002, p.68). It was not until the issue was brought to the attention of the Finance committee on October 6th 2000, regarding Fastow’s compensation, that the committee: "then unanimously agreed that the Compensation Committee should review Fastow's compensation from LJM1 and LJM2" (Powers et al., 2002, p.164). This example demonstrates the way that the Board depended on other groups for information, in this case a member of the compensation committee, combined with the Board’s failure to follow up with the request in order to have access to complete information.

Instead, the Board operated in a reactive manner as it waited until the fall of 2001 to act on this issue: “Until October 2001, when *The Wall Street Journal* estimated that Fastow's LJM-related compensation was $7 million. There were never any reports to and almost no actions taken by the Board or its committees regarding Fastow's compensation” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.114). The Board had not received reports on LJM since February 2001 (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.114). LeMaistre and Duncan found out that Fastow’s compensation was $45 million and then the Board discharged Fastow (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.114). In many examples, Directors stated that they did not have the information and they were not aware of this situation. Granted, there were barriers which prevented the Board from access to direct information, as discussed above, as many groups did not volunteer information.

### 5.12 Theme 2 – Information Control

Label - Information control
Definition – Tactics used by management to control, conceal, and contort information in order to mislead members of the Board.

Indicators – Coded when the text specifies management withholding information from the Board or disclosing information to selective groups. Coded when the text specifies individuals or groups involved in conflict of interest issues. This individual or group may have access to valuable information; however, this information is disclosed to selected individuals in order to mislead others. Or this valuable information may be withheld from an entire group or groups. Coded when the text specifies issues with “controls” which are specific conditions set by the Board to monitor operations.

Differentiation - The individual/group in control of this information has the most complete picture of Enron (management), the groups which receive valuable information becomes a preferred group or groups (advisors), and the group that does not receive this information, is less informed and becomes less relevant in the information hierarchy (the Board). The Board requested specific conditions be in place called “controls” in order to monitor operations. However, these ineffective “controls” limited the information which was communicated to the Board by management.

The theme of information control relates to tactics used by management to control, conceal, and contort information. These strategies included selective communication of specific information and the misrepresentation of this information by groups in the decision-making process. Information control may be indirectly used by management by briefing advisors about deals; but excluding Board members. In this manner, management shaped a group hierarchy system which was ranked according to access of information and knowledge of Enron operations.

5.12.1 Andersen’s Dual Roles

Andersen served multiple roles for Enron, which included auditing and consulting responsibilities. The Board depended on Andersen to provide advice for Enron’s accounting practices despite that fact the Board was aware of Andersen’s dual roles. The Board failed to consider management’s influence over Andersen’s judgement in this environment. Directors depended on other members of the Board to decide if Andersen’s multiple roles were problematic: “Chan, testified that he relied on other Audit Committee members Jaedicke, Gramm
and John Duncan to understand whether it was appropriate for Andersen to provide both external
and internal audit functions at Enron (U.S. Bankruptcy Court Final Report of Neal Batson, 2003,
p.134). Andersen’s dual roles had a profound influence on the way the firm prioritized consulting
work over its audit responsibilities: “Arthur Andersen collected audit fees of $25 million but
earned even more for its consulting work” (House of Representatives Report, p.69). Management
compensated Andersen highly for consulting; which gave Andersen incentive to support
management initiatives in order to sustain their lucrative consulting arrangement. The Board
relied on Andersen for approvals concerning transactions. The Board did not question Andersen
and used these approvals for the Board’s decision-making process. However, the relationship
between Andersen and management influenced the information that the Board received from
Andersen, particularly concerning the controls that were established to monitor deals.
Information was concealed, controlled and shaped by the management and disseminated to
specific groups. In this case, both Andersen and management assured the Board that there were
no issues concerning the controls. Yet, in reality Enron’s controls were failing.

Herbert S. Winokur, Jr., the Finance Committee Chairman for the Board of Directors, stated that
the Finance committee received reports that would have assured: “the controls were working and
that there were no concerns raised either by management or our outside auditors” (U.S. Senate,
2002, p.18). Andersen and management met to discuss the effectiveness of these controls. The
text describes that these groups were responsible to update the Audit committee regarding issues:
“Another important responsibility of the Audit Committee was to review with Andersen and
Enron management the adequacy of Enron's internal financial controls and the plan for auditing
those controls, as well as Andersen's judgments about the quality of the company's accounting
Board did not investigate the accuracy or effectiveness of the information from Andersen and
management, as it relied on the Audit Committee for this review. The Board also relied on
information from Andersen to confirm financial transactions made by management. Andersen
was compensated by management for consulting roles. The Board did not consider that Andersen
was paid exorbitant consulting fees by management and Andersen had no incentive to criticise
management. Instead, in multiple sources, the Directors maintained that they were not aware of
red flags that led to these conflict of interest issues. Since Andersen and Management did not
disclose particular information about the effectiveness of controls to the Board, the
interdependence of the relationship between these two groups is clear. Management selectively shared information with Andersen and concealed it from the Board as described in the following three examples which concern the Board’s Decision to Waive Conflict of Interest and Compensation Issues, Raptors, and LJM transactions.

5.12.2 Theme 2 – Case (i): Raptors
Chief Accounting Officer, Rick Causey and Chief Risk Officer, Rick Buy did not inform the Board during the meeting in February 2001, concerning the debt from two specific Raptor vehicles: “the Committees were not told that two of the vehicles then owed Enron approximately $175 million more than they had the capacity to pay. This information was contained in a report that was provided daily to Causey and Buy, but it appears that neither of them brought it to either Committee's attention” (Powers et al., 2002, p.160). Management did not disclose this information to the Board. These transactions, according to the Powers Report, "may or may not have required Board action as a technical matter, it is difficult to understand why matters of such significance and sensitivity at Enron would not have been brought to the attention of the Board. Causey and Buy, among others, were aware of the deficit and restructuring" (Powers et al., 2002, p.160). The Board should have been aware of the Raptors’ complete details in order to gain a full understanding of Enron’s financial operations.

5.12.3 Theme 2 – Case (ii): LJM2
A significant example of management withholding information from the Board involved Enron's Chief Accounting Officer, Rick Causey, and the elimination of LJM transactions from an important list (Salter, 2008, p.175). As a result of this intentional omission of specific transactions (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.112-113), both the Audit and Finance committee “members were not made aware that Enron was repurchasing assets from LJM2” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p. 113). The Board would have had the opportunity to investigate the transactions more closely and request further information if it had been given the complete lists:

General Counsel of Enron’s Global Finance Group, Jordan Mintz “deleted those resale transactions from a draft of the list prior to the Audit and Finance Committee meetings and distributed it internally, with an email attaching "a revised draft of those 'disclosable' LJM transactions for use with the Audit Committee at this month's Board Meeting!" His
email said that he had "reviewed this draft with Rick [Causey] and he is comfortable with it. A copy has also been sent to Andy [Fastow]. (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.112-113)

Management’s control of information enabled them to edit documents in order to withhold specific information. Causey maintains that he did not know that "these lists were incomplete” (Powers et al., 2002, p.159). The omission of the transactions from these lists support a specific form of information control, especially with respect to the “buyback” transactions: “the 1999 list identified eight transactions, when in fact there were ten, and the 2000 list of transactions omitted the "buyback” transactions described earlier. Knowledge of these "buyback” transactions would have raised substantial questions about the nature and purpose of the earlier sales” (Powers et al., 2002, p.159). If the Board had this information, it may have been in the position to ask for details concerning the repurchase of assets for LJM2.

5.12.4 Theme 2 – Case (iii): Andrew Fastow: Compensation Issues and the Board’s Decision to Waive Conflict of Interest

The Board delegated the task of implementing controls to management (Powers et al., 2002, p.165), however, management did not perform this “primary responsibility” (Powers et al., 2002, p.165). Controls are to be used to gauge problems and warn the Board of breaches to compliance. If the Board monitored Fastow’s compensation issues appropriately: “it might have provided a warning if the transactions were on terms too generous to LJM1 or LJM2” (Powers et al., 2002, p.163). In addition, it would have discredited claims that “Fastow would not profit from increases in the price of Enron stock” (Powers et al., 2002, p.163). Fastow claimed in his presentation to the Finance committee on May 2000, that his compensation would be “modest” (Powers et al., 2002, p.163) as it would “commensurate with the approximately three hours per week” (Powers et al., 2002, p.163). One of the primary indicators of information control is the way that management used ineffective controls to manipulate the decision-making process.

Another indicator of information control was there were several incidents of information not shared with the Board, particularly about Fastow’s conflict of interest issues. This example describes an e-mail from Anderson which stated that Benjamin Neuhausen did not think that Board would approve Fastow’s role as general partner of LJM1 due to the conflict of interest issues.
Benjamin Neuhausen, an Andersen technical expert in the Chicago office, wrote: Setting aside the accounting, idea of a venture entity managed by CFO is terrible from a business point of view. "Conflicts of interest galore. Why would any director in his or her right mind ever approve such a scheme? David Duncan, the Enron engagement partner, replied: "[O]n your point 1 (i.e., the whole thing is a bad idea), I really couldn't agree more. Rest assured that I have already communicated and it has been agreed to by Andy that CEO, General [Counsel], and Board discussion and approval will be a requirement, on our part, for acceptance of a venture similar to what we have been discussing. (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.58)

David Duncan assured Benjamin Neuhausen that Board approval would be a requirement. However, as discussed in the first theme, the Board relied on Anderson for approval. By excluding information which may have significantly changed the opinion of both parties, management was able to imply to Andersen that an approval would be obtained by the Board. Yet management withheld Andersen’s e-mail response from the Board. If the Board had been aware of this e-mail from Andersen, it might not have approved waiver. The Board relied on Andersen’s opinion and this emails explicitly stated “conflict of interest galore” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.58). As a result, the Board had incomplete information and approved the waiver. Both the Board and Andersen did not follow up with one another in order to find out if this decision was based on complete information.

5.13 Theme 3 - Decision protocol and policies shaped the information that management sent to the Board during the approval process

Label - Decision Protocol and policies shaped the Board’s decision and approval processes.

Definition – Decision processes were shaped by the content, timing and amount of information related to Enron’s decision protocol and policies.

Indicators – Coded when the text specifies the content of information in policy or protocol documents: such as the transparency of the language in proxy statements and disclosures. Coded
text describes the timing, such as the scheduling of meeting agendas. Coded when the text specifies the Board received overwhelming amount of information to prepare for meetings. Coded when the text mentions the Board’s fiduciary duties of decision-making and oversight, particularly, the Board monitoring operations and failure to inquire into red flags or warnings.

Differentiation – Text examples regarding content issues relate to the Board’s inability to understand transactions or deals due to insufficient information, incomplete disclosure of transaction details or unclear jargon in financial reports and proxy statements. Examples of timing issues include packed meeting agendas that limited the time for the Board to discuss agenda items. Issues which concern the amount of information include examples of the flood of information which inundated the Board, and influenced the Board’s ability to assess the information required for the decision and approval process. The Board may only be responsible for its actions based on available information. Decision protocols and policies affect the Board’s performance regarding its fiduciary duties, since the Board’s ability to assess warning signs depends on the content, timing and amount of the information.

Decision protocols and scheduling influenced the Board’s ability to receive and consider information. The Board may not have received information for transactions that did not require Board approval. The criteria to determine whether a transaction would require the Board’s approval depended on Enron’s policies, for example: “on September 30, 2001, Enron had $4.8 billion of Prepay Transaction debt and $2.1 billion of FAS 140 Transaction debt, it does not appear that the Enron Board approved any of the transactions in which this debt was incurred” (U.S. Bankruptcy Court Final Report of Neal Batson, 2003, p.122). Management may have structured and implemented most transactions without Board approval: “under the Risk Management Policy, Enron or any of its subsidiaries could engage in a virtually unlimited amount of Prepay Transactions, and under the Guaranty Policy, if the Prepay Transactions were executed by a 75% owned subsidiary, the subsidiary's obligations could be guaranteed by Enron, all without obtaining Board approval" (U.S. Bankruptcy Court Final Report of Neal Batson, 2003, p.122).

Scheduling restricted the way that information was sent to Board members to prepare for meetings. As they reviewed complex information and dedicated their time to prepare for these meetings to their best ability: “The number of hours that each Outside Director estimated he or
she spent in a year on all matters related to Enron, including reviewing materials and attending meetings, varied widely, ranging from 100 to over 400 hours per year” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, 37-38). However, the length of time allocated for these meetings were relatively short. The quantity and complexity of topics per meeting created a problematic situation, since the obscure transactions required explanation: “Board meetings typically lasted a total of about four to five hours, and committee meetings were generally not more than ninety minutes each. With the large number of significant agenda topics presented at each meeting, these circumstances raise questions of whether the Outside Directors had sufficient time to discuss and understand the matters fully” (U.S. Bankruptcy Court Final Report of Neal Batson, 2003, p.133). The Board meetings considered and approved major transactions in short, packed schedules which intensified the Board’s dependence on advisor opinions: “These reviews were a significant part of the control structure, and should have been more than just another brief item on the agenda” (Powers et al., 2002, p.162). Management replicated the same types of time compressed conditions for other Board meetings. These compressed agendas appeared to be conducive to quick approvals.

Special meetings were called to assess major transactions several times a year: “During the years 1997 through 2001, Enron's directors met for regularly scheduled meetings five times per year, in February, May, August, October and December” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.35). These special meetings were set up to address specific issues in a concentrated time period: “Typically, these sessions encompassed ten to twelve hours of meetings spanning a two-day period. In addition to the regularly scheduled meetings, the Board and some of the committees held special meetings on an ad hoc basis” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.35-36). Special meetings would be scheduled sporadically and included a variety of committees: “in 2000, the Board held four special meetings, the Compensation Committee held five special meetings, and the Executive Committee held seven such meetings” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.36). The Board did not focus their discussion on a few important or inter-related decisions. The agendas for special meetings included multiple, complex issues to be evaluated in a very short time. In this way, Outside Directors had to make decisions within a time sensitive environment. Salter suggests that overbooking meeting agendas within short time periods was a poor way to consider these transactions appropriately; and therefore the Board’s: "flawed
information gathering system also disabled its decision-making systems” (Salter, 2008, p.165). This added pressure to the Board to assess and approve complex transactions quickly.

5.13.1 Policies and Board Approval

Anderson, PWC, and Vinson & Elkins approved transactions depending on the circumstances and nature of the deal. A transaction may or may not require specific approvals depending on its structure as per Enron policy: “The Enron Board did not approve most of the SPE transactions. There were several policies established by the Enron Board that were relevant to determining whether a transaction could be consummated without Board approval” (U.S. Bankruptcy Court Final Report of Neal Batson, 2003, p. 121). Specific examples of these policies include: “(i) Enron's Risk Management Policy; (ii) Enron's Guaranty Policy; and (iii) Enron's Asset Divestiture Policy. Because of the way in which many of the SPE transactions were structured, these policies effectively permitted Enron's officers to incur a virtually unlimited amount of debt through the SPE transactions, without prior approval of the Enron Board” (U.S. Bankruptcy Court Final Report of Neal Batson, 2003, p. 121-122). The Board may not have been informed about details if it was not required to issue approvals for specific transactions or phases of transactions. However, advisor participation was necessary for these deals: “Without Andersen's certification of Enron's financial statements and various other approvals provided by Andersen, Enron would not have been able to employ those transactions to distort Enron's reported financial condition, results of operations and cash flow” (Batons’ Final Report, p.41). Advisors appear to be more informed than the Board, as demonstrated by Andersen’s ability to approve transactions without the Board: “For example, on September 30, 2001, Enron had $4.8 billion of Prepay Transaction debt and $2.1 billion of FAS 140 Transaction debt. It does not appear that the Enron Board approved any of the transactions in which this debt was incurred” (U.S. Bankruptcy Court Final Report of Neal Batson, 2003, p.121-122).

5.13.2 Theme 3 – Case (i): Raptors

Management used Enron’s policies to determine which transactions required Board approval. In doing so, management sent information to the Board which related to these transactions.
However, it is important to note that not all phases of transactions required Board approval, which limited the content, timing and amount of the information that the Board received from management. An example of the way that the content of Enron’s policy influenced the Board’s approval process is demonstrated by the Board unawareness of the details of the Raptors’ restructure: “Enron restructured the Raptors three times, in November 2000, December 2000 and April 2001. Finally, in September 2001, Enron terminated the four Raptors hedges altogether. As a result of the termination, Enron incurred a pre-tax charge to earnings of $710 million” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p. 68). If there had been a real third party involved in this deal, this incident would have required Board Approval, and the Directors would have known more about the restructure. According the Senate Committee report, Senator Levin asked the Board: "If a real third party had participated in the hedge, would the outcome have been different? And Winokur replies that "a real third party would not have been able, presumably, to restructure itself without Board approval in the way that this happened. We were not told of the restructure" (U.S. Senate, 2002, p.80-81). Information was communicated to the Directors based on the need for approval; and therefore, the Board did not receive complete information.

The Raptors vehicles were presented to the finance committee which assessed and approved the Raptors within a short time frame, while it considered numerous other items on the agenda. Therefore, the timing of the approval process was a significant issue for the Raptors vehicles. Various sources documented that the committees and the Board considered the transactions quickly: “Raptor I was presented to the finance committee on May 1, 2000 and also covered in that ninety-minute meeting were an LJM2 update, an analysis of Enron's credit rating, a plan to monetize $1 billion in investments, a request for approval of $1 Billion in new debt, a review of valuations between Enron Energy Services and Risk Assessment and Control (RAC)” (Salter, 2008, p.166). During this meeting, the finance committee “voted to recommend Raptor I to the full board” (Salter, 2008, p.166). Significantly, in a similar meeting on “the following day, during an almost four-hour meeting, the Board approved a five-part resolution proposed by Director Winokur on behalf of the finance committee, including Raptor 1. The Directors also discussed fourteen other issues, including updates from three other committees and reports on five business units, two international lawsuits and a tax dispute in Argentina" (Salter, 2008, p.166). The approval process for the Raptors took place within a very short time span and with a
large number of items on the agenda; therefore the Board had very little time to consider this information.

In this way, the Board meetings were influenced by protocol and policy. Policy was used by management to shape the meeting agendas. Management determined the number of items to be discussed by the Board and the meeting agenda was overcrowded; in this case there were fourteen agenda issues in addition to the Raptors. Policy was used by management to determine the content of the information, since the information was sent to the Board based on if a transaction required Board approval. Management influenced when the information was sent to the Board for review, which limited the amount of information that the Board had to review prior to and to consider each item during the meeting. Factors such as incomplete content combined with insufficient time, in this case four hours, created a high pressure environment in which the Board made decisions.

As mentioned in theme one, the Board depended on advisors to verify the accuracy of the financial structure of transactions. This factor combined with a short period to assess the financial data, was particularly limiting for the Directors. There was little time to effectively engage in discussion for each issue: “At each of the relevant meetings, the Outside Directors who were present adopted resolutions approving the necessary stock-related components of the transactions” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.69). The Board could have demanded more time to understand the structure and consequences of these transactions; however, this time constraint tactic was used successfully by management.

The Board could have requested information regarding all of the aspects of transactions, from creation to the termination of these SPE vehicles, so that it could make an informed decision. Instead, the Raptor approval process demonstrates the way that the Board was unable to examine pertinent information during the Raptors restructure phase. Therefore, the Board was unable to consider and issue an informed approval regarding the Raptors entities.

5.13.3 Theme 3 – Case (ii): LJM2

The content in policy or protocol documents influenced the approval process as demonstrated by issues relating to the LJM2 Co-Investment, L.P., Private Placement Memorandum, Merrill Lynch
& Co. of October 1999 (U.S. Senate, 2002, p.272). In the Senate Committee report, Senator Levin refers to the issue date for this placement memo: “[was] issued on October 13, 1999, which was just 1 day after the Board approved LJM2. This is a pretty complicated document here that Fastow put out. It was obvious he assumed that you would approve this 1 day before he put it out. He counted on that approval” (U.S. Senate, 2002, p.91). The Senate Committee report included a statement from Senator Levin that implied that the Board was comprised of “good people” (U.S. Senate, 2002, p.91). However, the Board may have been perceived as passive by Enron’s CFO Andrew Fastow, since the LJM2 private placement memo was issued on October 13, 1999 which was just one day after the Board had approved LJM2 (U.S. Senate, 2002, p.91). It is clear that Fastow assumed that the approval would pass within one day: "It looks like Enron’s Chief Financial Officer saw you as a rubber stamp" (U.S. Senate, 2002, p.91) and Fastow counted on the fact that the Board’s decision would not change the outcome that he expected.

The LJM2 Offering Memo involved Senior Officers of Enron, Ben Glisan and Michael J. Kopper as “principals in LJM2” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, 115). Therefore, Glisan, Kopper and Fastow were named as Principals in the Private Placement Memorandum for LJM2 (the "LJM2 Offering Memo") which “focused on how Enron officers' inside knowledge of Enron's investment information would provide a financial benefit to the potential limited partners” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.114-115). On page 3 of the "LJM2 Offering Memo" this document states that Principles were in an “advantageous position” (U.S. Senate, 2002, p. 275) and would have “access to Enron's information pertaining to potential investments will contribute to superior returns” (U.S. Senate, 2002, p. 275). According to U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003 in Batson’s Final Report, only one Board Member, Belfer, received this Private Placement Memorandum for LJM2. Belfer testified that he discarded it and did not read it (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.115). Belfer told the Permanent Subcommittee on Investigations on July 8, 2002, that it “offered him an opportunity to invest with LJM but he did not read it” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.115). Although this memo may not have been communicated to all of the Board members, it was sent to one Director. The claims that Belfer discarded the memo or that the
Board did not know about the memo are important; but for the purposes of this theme, the focus is on the content of the memo and its influence on the approval process.

According to the Senate Committee Report, Herbert S. Winokur Jr. testified that he did not see this memo until the Powers report. The Senate Committee stated that this memo was used to market LJM in the way that implied that the Principals were “outing their inside information in Enron as they are selling the interest in that LJM partnership” (U.S. Senate, 2002, p.64).

Winokur states that the Board was told that Vinson & Elkins had “reviewed the drafts of the documents” (U.S. Senate, 2002, p.64) and that he was not aware that Glison and Kopper were Principals (U.S. Senate, 2002, p.64). Other examples showed that Vinson & Elkins were aware of these details as documented by another source: “at least two in-house lawyers at Enron and two Vinson & Elkins lawyers were aware of this fact” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, 115). Enron allegedly used this memo to convey the benefits of the LJM investment because the Principals involved had access to insider information: “this is the way LJM was being marketed” (U.S. Senate, 2002, p.64). Although this example could be categorized under the second theme of information control, as it deals with an example of conflict of interest, it was not coded in this manner since at least one Director, Belfer, received this information regardless of if Belfer disposed the document. This example demonstrates the way that problematic content was distributed even after legal advisors reviewed the document.

Appendix F is a section of the LJM2 Co-Investment, L.P., Private Placement Memorandum (U.S. Senate, 2002, p.272-276). The Board was not involved in the dissemination of this document and did not have knowledge of its content or the two key Principals for LJM: Glison and Kopper. Yet, in the Senate Committee report, Senator Levin asks Winokur regarding this LJM2 Offering Memo: “after you now have read this, have you ever asked your lawyer, how in heaven’s name could you have approved that?” (U.S. Senate, 2002, p.64). This is the key point for this theme regarding the ways that Decision Protocol and policies shaped the Board’s decision and approval processes: the Board had a fiduciary duty to inquire once it was aware of the content in this memo. This document was a red flag and could have been used as a basis to investigate the LJM transactions. Instead, Winokur replied that the Board relied on “the Chief Risk Officer and the Chief Accounting Officer reviewing each transaction” (U.S. Senate, 2002, p.65). This demonstrates ways that management was able to communicate content, such as in this LJM2 Offering Memo, without the awareness of the Board.
5.13.4 Theme 3 – Case (iii): Andrew Fastow’s Compensation Disclosure Issues

The Board depended on Enron’s legal advisors to vet and confirm the information disclosed in the financial statements provided by management. Legal advisors were aware of the requirements for these disclosures, but used their expertise regarding policy to select the content which furthered the interests of management: “Unfortunately for shareholders, Enron’s vague proxy statements, and the footnotes to its Form 10-K financial statements filed with the SEC on related transactions from 1999 to 2001, fell short of corporate governance ideals” (Salter, 2008, p. 170). The content of these disclaimers were inadequate for several reasons. Salter refers to issues which deal with principles of candor and the Board’s inadequate monitoring of disclaimers for Andrew Fastow’s compensation. Fastow’s compensation disclosure regarding his relationship to LJM2, “a private investment company that primarily acquired and invested in energy and communications endeavours” (Salter, 2008, p.315), exemplifies the way that legal advisors selected information for Enron’s proxy statement with the intention to exclude financial details; thereby failing to communicate complete information to shareholders. The disclosure consisted of a broad description of Fastow’s relationship to LJM and his financial entitlement: “general partner of LJM1 and LJM2, of which Fastow was the managing member, was entitled to a share of the profits in excess of its proportional capital investment in the partnership” (Powers et al., 2002, p.187-188). The statement did not indicate his investments in a quantifiable manner which would provide shareholders with an understanding of how Fastow’s profits from the LJM transactions were calculated “or specify the compensation formula in any more detail” (Powers et al., 2002, p. 184).

According to the Powers report, Item 404 of SEC Regulation S-K is frequently used by companies as a reference for “related party transactions in the non-financial statement portions of SEC filings, including proxy statements and the annual reports on Form 10-K” (Powers et al., 2002, p.179). Legal advisors were aware of the criteria to comply with the SEC rules, policy and protocol. Therefore, Fastow’s compensation disclosure required the following information:

Item 404(a) requires disclosure of, among other things, transactions exceeding $60,000 in which an executive officer of the company has a material interest, ‘naming such person and indicating the person’s relationship to the registrant, the nature of such person’s
interest in the transaction(s), the amount of such transaction(s) and, where practicable, the amount of such person's interest in the transaction(s). (Powers et al., 2002, p.179).

Enron in-house attorney Jordon Mintz used the term “where practicable” to support the decision to omit Fastow’s compensation details from the disclosure. The April 6, 2001 memo from Mintz to Fastow which outlines this explanation is included as Appendix I (U.S. Department of Justice, 2003). It is important to note that Mintz’s ability to use the term “where practicable” to his advantage could only have been successful due to the opportune timing of the LJM transactions: “several LJM2 transactions had not been completed by the time the 2000 proxy statement was issued, Enron, in consultation with Arthur Andersen and Vinson & Elkins, decided that calculating Fastow’s interest was not practicable, and therefore that interest did not need to be disclosed” (Salter, 2008, p. 315). Item 404 of SEC Regulation S-K may have been implemented by the SEC to promote information transparency; but ironically, Enron’s legal advisors used this regulation to conceal details about Fastow’s compensation and interest in LJM2.

As stated by the Powers Report, the amount of Fastow’s compensation and interest was known by the Enron’s legal advisors and they “searched for and embraced a technical rationale to avoid that disclosure” (Powers et al., 2002, p.190). Legal counsel explained that LJM2 was still an “open” transaction and according to Powers, “the majority of transactions between Enron and LJM1 or LJM2 were "open" during the proxy reporting period--that is, the ultimate and final determination of obligations and payments remained uncertain” (Powers et al., 2002, p.188). Enron’s legal advisors decided that Fastow’s earnings did not need to be disclosed and to do so would not be "practicable" (Powers et al., 2002, p.188).

The legal advisors explained that several other “open” transactions were justified in the same manner during the “time the 2001 proxy statement was prepared, although it was acknowledged that some of the transactions had closed in 2000 or early 2001 and the rationale would have little force once most of the transactions closed” (Powers et al., 2002, p.188). Enron’s legal advisors understood that the omission of Fastow’s interest in LJM2 from the 2000 proxy statement was as a result of well placed timing for these transactions. However, legal advisors could only justify a delay to the release of this information. Eventually, these LJM2 transactions closed and required disclosure. At the time, legal counsel assumed that this was a sufficient explanation; however, “the lawyers apparently did little if any investigation into what proportion of the transactions
remained open at the time of the 2001 proxy statement filing” (Powers et al., 2002, p.188). Apparently, it was more than serendipitous timing as a substantial factor in this decision-making process. The approval system that was in place facilitated the way that legal advisors were able to make decisions and approve disclosures but did not reveal complete details about Fastow’s compensation. The legal review agenda for May 22, 2001 clearly states: “Restructure of LJM Ownership to Avoid Disclosure” as Appendix H (U.S. Department of Justice, 2003).

As in the RhythmsNet transaction, Jordon Mintz described the decision to not disclose Fastow’s compensation as a “close call” (Powers et al., 2002, p.190) and "other pertinent (and competing) issues" that Fastow had raised led or contributed to the non-disclosure decision, which was only possible because of a quirk of timing” (Powers et al., 2002, p.190). The timing of these disclosures was a significant factor in the decision-making process. These transactions were favourably “open” for a substantial period of time: “RhythmsNet transaction extended over two proxy filing years” (Powers et al., 2002, p.190). Mintz communicated to Fastow that concerns were raised about this non disclosure issue and that as legal advisors, “[our] knowledge of certain facts was delinked by two separate filings; thus, we have relied on two different arguments for avoiding financial disclosure for you as the LJM1 general partner in 1999 and 2000” (Powers et al., 2002, p.190). Mintz maintained that an alternative explanation for Rhythms was necessary to support the non disclosure decision: “The Rhythms transaction had terminated in early 2000, however, and the lawyers understood that Fastow had received compensation from LJM1 for that transaction. Enron therefore needed a different basis or theory to support the decision not to disclose” (Powers et al., 2002, p.188). Without a different explanation, the legal advisors would not be able to continue the omission of such details. This search by legal advisors to find an option to avoid disclosure represents this third theme best. It demonstrates that Enron’s legal advisors deliberately searched for policy, in this case a phrase in regulation, to support Fastow’s interests. The successful search facilitated the approval for these incomplete disclosures. With no check and balance system to monitor this decision process, the publication of these disclosure exemplifies the ways that decisions were made and approved by advisors without effective Board oversight. Therefore, the decision and approval process was manipulated by clever use of policy by legal advisors to further in the interests of individuals in management.

On January 16th 2001, Jordon Mintz sent an e-mail to a Vinson & Elkin’s partner, Ron Astin and also copied this e-mail to Rex Rogers. Mintz requested advice regarding Fastow's LJM-related
compensation disclosure. Mintz stated in the e-mail that Fastow had expressed concern that Skilling would close the LJM deals if Skilling knew the extent of Fastow’s compensation for the Rhythms deal: "Mintz said: "I spoke, again, with Andy about this earlier today and he believes (perhaps rightly so) that Skilling will shutdown LJM if he knew [sic] how much Andy earned with respect to the Rhythms transaction” (U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.146). From Mintz’s perspective, it was imperative for Enron’s legal counsel to use policy, in this case within the limits of the SEC regulation; to not disclose information which may prompt Skilling to close the LJM deals. This was not for the benefit of shareholders; but for the interests of Fastow.

Significantly, Mintz continues this e-mail and described the way that Fastow dealt with the banks and that his intentions were not to jeopardize Enron: "Andy's point is that he 'out negotiated' the banks in that transaction-not Enron. We need to be 'creative' on this point within the contours of item 404 [of SEC Regulation S-K] so as to avoid any type of stark disclosure, if at all possible”” (footnote 648, U.S. Bankruptcy Court Final Report of Batson: Appendix D, 2003, p.146). In this correspondence, Mintz connects Fastow’s strategy regarding his dealings with potential partners, in this case the banks, and his ability to “out negotiate” with the issue of the disclosures. Mintz understood that as legal advisors, they must work within the restrictions of policy, in this case item 404 of SEC Regulation S-K. However, Mintz’s objective was to be ‘creative’ enough to conceal Fastow’s compensation information.

As a result, legal advisors approved a disclaimer which achieved this objective by justifying the disclosure since it complied with policy at the time of its creation: “the Rhythms transaction had terminated in 2000 ‘pursuant to terms allowed for under the original agreement" entered into in 1999. Because the prior proxy statement had addressed the disclosure requirements relating to the Rhythms transaction, they decided that no financial information regarding what Fastow earned in the transaction had to be disclosed in 2001--notwithstanding that it was now more "practicable" to do so” (Powers et al., 2002, p.188-189). Although it was “practicable” to disclose these details after 2000, Mintz offered a vague explanation for non disclosure based on compliance with the original agreement in 1999 and Enron’s legal advisors were able to omit the specific details.
Based on this example concerning Fastow’s compensation disclosure issues, Enron’s legal advisors were well aware of Fastow’s financial details: “Mintz did warn Fastow that it was highly likely that his compensation from the LJM transactions would have to be disclosed in Enron's 2002 proxy statement. It is unclear to what extent this warning contributed to Fastow's decision to sell his interest in LJM2 in the third quarter of 2001” (Powers et al., 2002, p. 190).

Enron’s legal advisors used their expertise to communicate information to selective individuals; but not the Board. Therefore, the process by which disclaimer decisions were approved and included in proxy statements were made without extensive scrutiny from the Board.

The Powers Report describes the disclosure approval process for Fastow’s compensation as heavily dependent on the legal advisors, whereas accountants were responsible for the preparation of the financial statement footnote disclosures (Powers et al., 2002, p.182). The group of legal advisors which organized this process was “Associate General Counsel Rogers and lawyers working for him, with substantial advice from Vinson & Elkins” (Powers et al., 2002, p.183). The actual proxy statements “originated from the office of Enron associate general counsel Rex Rogers” (Salter, 2008, p.170). There were examples that showed that legal advisors reviewed the proxy statements in a more cursory capacity: “James De James Derrick, Enron's General Counsel, reviewed the final drafts to look for obvious errors” (Powers et al., 2002, p.183) and that Derrick depended on counsel from “his staff, Vinson & Elkins, and Andersen” (Powers et al., 2002, p.183) to confirm the appropriateness of the disclaimers “particularly with respect to related-party transactions” (Powers et al., 2002, p. 183). This raises the question of the involvement of legal counsel in the approval process if the Powers Report states that “the related-party transactions were often extremely complex, the Enron Corp. accountants and lawyers responsible for financial reporting relied heavily on--and generally deferred to—the officers and employees in Enron Global Finance who were closer to the transactions and actually knew the details” (Powers et al., 2002, p.182). The Powers Report states that “lawyers played a more central role in preparing the proxy statements” (Powers et al., 2002, p.182). It is important to differentiate the role of legal counsel regarding proxy statements with that of the financial statement footnote disclosures. The Powers Report states that “accountants took the lead in preparing the financial statement footnote disclosures” (Powers et al., 2002, p.182) and Coffee refers to the Powers Report to describe this minimal role: “according to the Powers Report, Vinson & Elkins claimed ‘that they may not have seen all of the filings in advance. But even
when they review proposed disclosures and objected or otherwise commented, their role was modest” (Coffee, 2006, p.33). It is unclear what amount of final approval power that legal advisors had regarding the final disclosures; but there is evidence that legal counsel advised management about item 404 [of SEC Regulation S-K] and that they acknowledged the need to creatively omit information from the disclosures as described in the findings.

According to Salter, the Board finalized the revised disclaimers using a “cycle of revisions” (Salter, 2008, p.170). The Powers Report describes this cycle or system of revisions as a process by which information was disseminated to multiple parties. The Financial Reporting Group did not draft the disclosures; but as a group, they were supposed to confirm that the “amounts reported in the proxies were supported by the information in the financial statements” (Powers et al., 2002, p.183). Although Enron’s management and the Board reviewed the proxy statement drafts, they appeared to focus on the information which pertained to them: “members of the Board focused particular attention to the disclosures about themselves, and were not directed specifically to the related-party disclosures by Management” (Powers et al., 2002, p.183). The Directors may not have adequately reviewed Fastow’s compensation disclaimers if management did not refer to them. Certainly, the Board was dependent on Enron’s legal advisors for guidance; but this is the same legal counsel that sought out ways to use policy to not disclose this information.

The Powers report also states that the Board delegated the responsibility to review the LJM partnership transactions to Enron’s Chief Accounting Officer, Richard Causey: “Causey should have been in a unique position to bring relative familiarity with the transactions to bear on the disclosures” (Powers et al., 2002, p. 202). The Powers Report found that Causey failed to draw from this expertise to effectively contribute to the disclaimer approval process. The Board also delegated responsibilities to the Audit and Compliance Committee to examine the draft disclosures. However, no group involved in the disclosure approval provided sufficient oversight, including the Board (Powers et al., 2002, p. 202). Individuals involved in the approval process may have been critical of Fastow’s compensation disclosures; however, they may have lacked sufficient power to demand a more detailed account of Fastow’s compensation. Appendix G consists of the October 22, 2001 e-mail to Fastow, regarding the Board request for “a general understanding of the amount of your investment and your return on investment in the LJM entities” (U.S. Department of Justice, 2003).
Granted, there are explanations that involve disclosure for companies to remain competitive. As Salter states “For competitive and other reasons, executives do not want to disclose every last detail about their operations, but they must provide enough information for investors to understand the company’s financial position” (Salter, 2008, p. 314). Enron’s legal advisors strategized the best way to manipulate language for Fastow’s compensation disclosure. They achieved the desired disclaimer within the technical limits of the regulation, and according to policy: “While this decision was ‘calculated to reveal as little as possible’ about Fastow’s external ventures, the guidelines seemingly permit it” (Salter, 2008, p. 315). Enron’s decision process was fundamentally flawed in order for these inadequate disclaimers to be approved and published in its proxy statement.

Without an effective check and balance system in place, the Board failed to supervise the groups involved in this decision-making process: “No one outside of Enron Global Finance, the entity principally responsible for the related-party transactions, exercised significant supervision or control over the disclosure process concerning these transactions” (Powers et al., 2002, p.181). A valid assumption may be that legal advisors may have been the best group to monitor the disclaimers since legal counsel was integral to the process. However, this analysis may be too simple an assessment for Enron’s approval process. Based on the example of Fastow’s compensation disclosures, Enron’s legal advisors assessed the proxy statement requirements and worked within Item 404 of SEC Regulation S-K to use language to limit information in the disclosure. “In this context, disclosure means describing a material event or state of affairs in language that is clear enough to enable the reader to understand its importance and effect” (Salter, 2008, p.170). Salter emphasizes the importance of clarity in the content or language used to communicate this information. In this case, information is communicated via the proxy statement. Enron’s legal advisors decided to support and approve these disclaimers undermines the purpose of the disclosure. By publishing incomplete information, the content fails to provide an accurate picture of company dealings to the shareholders.

Policy and protocol documents, such as the LJM2 Offering Memo, were approved in this decision process without the Board’s involvement. Incomplete disclaimers for Fastow’s compensation details were approved for publication in Enron’s proxy statements. Transactions were restructured and approved without Board involvement, as in the example of the Raptors.
Due to protocol and policies, management was able to use timing to shape the content and amount of information sent by management to the Board to prepare for Board meetings and approve transactions. Based on these examples, management interpreted the language used in policy, such as in memos, proxy statements, and decision protocols, to strategize ways to undermine the purpose of SEC regulations and promote management interests. It appears that policy and protocol was used by management and advisors as tools to influence the content, timing and amount of information which shaped the decision and approval processes at Enron.

This Findings Chapter used three themes: interdependency of authority relationships, information control, and that decision protocol and policies shaped the information that management sent to the Board during the approval process, to show the ways in which information was communicated among groups in the decision-making processes. The Raptors and LJM2 entities, as well as Andrew Fastow’s Compensation Issues and the Board’s Decision to Waive Conflict of Interest were used as examples to illustrate each theme. The following chapter provides the discussion and conclusion for these Findings, limitations and implications for future research. The Conclusions section provides answers to the research questions which were outlined in the Research Methods chapter. This section is followed by commentary on related corporate reforms such as Sarbanes-Oxley Act of 2002 (SOX) and the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010). The final sections are comprised of the research contributions for this study and an overall conclusion for the thesis.
6 Discussion & Conclusion

6.1 Summary of Findings

The previous chapter outlined the Findings for this Enron case study and outlined three themes: interdependency of authority relationships, information control, and that decision protocol and policies shaped the information that management sent to the Board during the approval process, to show the ways in which information was communicated among groups in the decision-making processes. The following chapter provides the discussion and conclusion for these Findings, limitations and implications for future research. Six key findings demonstrate issues related to information flow and the groups in the decision-making processes at Enron.

- Board members were dependent on Anderson, PWC, and Vinson & Elkins to provide approvals first, in order for the Board to approve transactions and policies at the final stage.
- The Board was perceived as less of an authority and less relevant to the decision-making process due to its limited access to information from management and advisors.
- Management shaped a group hierarchy system which was ranked according to access of information and knowledge of Enron operations.
- The relationship between Andersen and management influenced the information that the Board received from Andersen, particularly compromising the controls that were established to monitor deals and conflict of interest issues.
- Legal counsel advised management regarding the best way to use vague terms and language to support their publication of incomplete disclosures in proxy statements.
- The Directors maintained that they did not know of any red flags as they received information related to deals which required their approval but not complete information about Enron’s operations.

Several examples were highlighted in the Findings chapter to describe the decisions making processes of the Board of Directors, management and advisors at Enron. These examples described the ways that information was communicated among groups in the approval processes for the Raptors and LJM2 transactions, as well as for Andrew Fastow’s conflict of interest waivers and compensation issues. Three themes emerged from these findings: interdependency of authority relationships, information control, and that decision protocol and policies shaped the
information that management sent to the Board during the approval process. All three themes describe an organizational hierarchy based on access to information. The communication of information among groups influenced the perception of authority in the approval and decision-making processes at Enron.

Key findings related to the first theme, interdependency of authority relationships, demonstrate the ways that Board members were dependent on advisors to provide approvals first, in order for the Board to approve transactions and policies at the final stage. A problematic issue with the Board’s dependence on Andersen and legal counsel was that these firms had their compensation arranged by management. These advisors had access to information from management which was not disclosed to the Board and these firms used their expertise for management’s best interests. Although attorneys and auditors may be considered gatekeepers by the industry, these advisors did not perform the responsibilities of gatekeepers.

According to Coffee, the term “gatekeeper” may have two meanings. A “gatekeeper” may be “some form of outside or independent watchdog or monitor – someone who screens out flaws or defects or who verifies compliance with standards or procedures” (Coffee, 2006, p.2). From this business perspective, the term gatekeeper is described as “an independent professional who plays one of two distinct roles, which tend to overlap in practice. First the gatekeeper may be a professional who is positioned so as to be able to prevent wrongdoing by withholding necessary cooperation or consent” (Coffee, 2006, p.2). The gatekeeper may deny approval as he or she “closes the gate” (Coffee, 2006, p.2). If “gatekeepers” are defined in this manner, according to Coffee, the Board of Directors may be considered gatekeepers, as the Securities and Exchange Commission certainly is a public gatekeeper” (Coffee, 2006, p.2). Coffee suggests that the first definition may be simplistic, as it limits the meaning to gatekeepers “capacity to veto or withhold consent” (Coffee, 2006, p.2).

The second meaning is preferred over the first, to define the term gatekeeper as: “an agent who acts as a reputational intermediary to assure investors as to the quality of the ‘signal’ sent by the corporate issuer” (Coffee, 2006, p.2). The second definition includes the fundamental characteristics of gatekeepers which Coffee describes as: “repeat players who provide certification or verification services to investors, vouching for someone else who has a greater incentive than they to deceive” (Coffee, 2006, p.2). The emphasis is on reputational capital in the
second meaning, which the gatekeepers develop as they become “repeat players” (Coffee, 2006, p. 2) within the industry and “serve many clients over many years” (Coffee, 2006, p. 2). In this case, Arthur Andersen would be the gatekeepers to “pledge reputational capital” (Coffee, 2006, p. 2) to Enron “thus enabling investors or market to rely on the corporation’s own disclosures or assurances where they otherwise might not” (Coffee, 2006, p. 2). As an auditor, Andersen “certifies that the corporation’s financial statements comply with generally accepted accounting principles” (Coffee, 2006, p. 2). Based on the second definition, Coffee states that “the board of directors typically does not qualify as a gatekeeper because its members typically serve too few corporations to have developed reputational capital as monitors” (Coffee, 2006, p. 3). Therefore, for the purposes of Enron, it is established that the Board of Directors are not gatekeepers. Rather Enron’s advisors, Arthur Andersen, and legal counsel, Vinson & Elkins, had the “reputational capital” as described above prior to Enron’s collapse to be considered gatekeepers. However, based on these findings, these advisors did not perform “gatekeeping” duties to benefit the Board or shareholders. By contrast, these advisors may have been reluctant to assume the duties of gatekeepers. Several examples show that advisors used their expertise to assist management, since advisors considered management as their client.

Although the advisors were involved in the approval process and the Board relied heavily on advisor “approvals” – this did not guarantee that all of the information was assessed by advisors in order to offer the best advice to the Board. The fact that Enron’s Board was dependent on its advisors is not rare for Boards, according to Coffee: “all boards of directors are prisoners of their gatekeepers. No board of directors – no matter how able and well-intentioned its members – can outperform its professional advisors. Only if the board’s agents properly advise and warn it, can the board function efficiently” (Coffee, 2006, p.1). Without advisors to support it, Enron’s Board may have been susceptible to manipulation by management, since the Board was only able to assess the information provided to it. However, the Board’s commitment to performing its fiduciary duties is an important factor to achieve a balance of power in this respect. If there is missing or incomplete information, it is the Board’s duty to inquire in order to obtain complete information. In doing so, the Board is not overpowered by management as it is better informed to ask appropriate questions prior to approving transactions and arrangements. A weakness in this Board was that not all Directors offered informed opinions about issues, as they relied on a few members to understand the information and decide for them. However, in doing so, this Board
was unable to contribute to the decision-making process as a group. If the Board of Directors had different opinions regarding these issues and a debate resulted from conflict among Board members due to disagreements, it might have shown management that the Board was thoroughly examining the information. As a consequence of Board debates, the Directors may have demanded more time to arrive at a consensus. This scenario relates to “cognitive conflict” as it “refers to task-oriented differences in judgment among group members” (Forbes & Milliken, 1999, p. 494). According to Forbes & Milliken, (1999) “the existence of cognitive conflict on the board can serve to remind management of the power and role of the board and of the importance of considering shareholder interests in the formulation of strategy even beyond the boardroom” (Forbes & Milliken, 1999, p. 494). If Enron’s Board of Directors demanded clarification of the information that they received from management and discussed these issues, it may have been possible to demand for more time instead of issuing Board approvals under highly time sensitive conditions.

Additional time related restrictions influenced the Board’s assessment of information and increased the Board’s dependence on advisors: “The board of directors in the United States today is composed of directors who are essentially part-time performers with other demanding responsibilities. So structured, the board is blind, except to the extent that the corporation’s managers or its independent gatekeepers advise it of impending problems” (Coffee, 2006, p.7). The Board may not be in a position to inquire about this information if their advisors do not offer appropriate guidance about issues such as policy and protocol, legal disclosures and financial transactions. It is problematic to hire advisors that are compensated by management to assess information on behalf of a Board. Advisors did not serve both management and the Board.

Without the adequate support of advisors to offer guidance, the authority of the Board was undermined due its limited access to information, and this created a cycle. The Board did not follow up on missing information; therefore, it did not receive it. As a result of this, the Board became less informed about the operations of Enron. After which, the Board was perceived as less of an authority in the organization, as it became less relevant to the decision-making process. This was a major weakness in Enron’s information process. Without effective gatekeepers in this approval process, management was aware that they could limit the communication of information to the Board: “In the absence of independent professionals – auditors, attorneys and analysis – boards will predictably receive a stream of selectively edited information from
corporate managers that presents the incumbent management in the most favourable light possible” (Coffee, 2006, p.7). In doing so, management used information control as to tactics to control, conceal, and contort information. Management selected and communicated information to advisors but excluded Board members. In this manner, management shaped a group hierarchy system which was ranked according to access of information and knowledge of Enron operations.

The relationship between Andersen and management influenced the information that the Board received from Andersen. Several sources emphasized the failure of controls to monitor deals. If an auditor establishes that the controls failed, than this may be used as an explanation for auditors’ inability to discover issues, such as fraud: “If an ongoing fraud is not detected, the auditor can explain that the failure to detect the fraud was attributable either to the client’s weak internal controls or to the conduct of a corrupt manager in overriding those controls. Once again, the profession will predictably seek to define its role guardedly: that is, to evaluate the adequacy of the client’s controls – not to detect fraud” (Coffee, 2006, p.367). Many sources described Enron’s inefficient controls and the Board’s failure to monitor them. Based on this explanation, Andersen could argue that their inability to discover issues in Enron’s accounting was compromised by inefficient controls. It was unlikely that Andersen did not review the financial transactions since many examples describe Andersen’s review and approval for deals. Similarly, all of the legal advisors may not have known the complete details regarding Fastow’s compensation interest in the proxy statement disclosures; but the examples describe specific advice from Enron’s legal counsel to management about this issue. It may be that within the groups of advisors there are selected individuals that are privy to information. Enron’s management may have relied on specific attorneys for advice and used their expertise to further their interests: “The prospect of future liability does concern them [legal counsel] and may lead them to take a more conciliatory approach in negotiations with regulators. But they remain in their own minds the zealous champions of their clients, not gatekeepers. Even when attorneys inadvertently begin to play a significant “gatekeeping” role, the profession at its highest levels becomes hesitant” (Coffee, 2006, p.367). Board depended on lawyers as “gatekeepers” but this assumption is problematic since at Enron, management benefited from the guidance of in-house and outside legal counsel.
There were indicators of conflict of interest issues in all groups at Enron; however, these issues were particularly evident in management. Legal counsel advised management regarding the best way to use vague terms and language to support their publication of incomplete disclosures in proxy statements. By publishing incomplete information, Enron’s management failed to provide an accurate picture of company dealings to the shareholders. The omission of important details undermined the purpose of the disclosures as required by the SEC. The Board relied on legal counsel to approve the proxy statement disclosures used to communicate information to shareholders. In doing so, the Board assumed that legal counsel had performed “gatekeeping duties” to ensure that the information was accurate.

The Board relied on legal counsel to interpret policy which outlined the criteria for this information to be disclosed in the statements. Both the Board and shareholders were dependent on the advisors, namely, legal counsel for accurate information in the proxy statements, and Andersen to ensure the accuracy of information in the financial statements. Enron published incomplete information in proxy and financial statements, and the content for these disclaimers passed the approval process. However, according to Coffee, advisors may not be the final stage of the approval process and “it is increasingly debatable whether the corporate lawyer can either monitor the corporate client to the same extent as in the past or gently dissuade it from illegal or reckless action” (Coffee, 2006, p.194). The combination of Enron’s advisors inability to perform their “gatekeeping” duties and the Board’s inability to monitor the approval process due to its dependence on advisors, illustrates the way that shareholders are indirectly dependent on gatekeepers for information: “Once ownership and control are separated (as they have long been in the United States), both shareholders and the board must depend on gatekeepers for an unbiased flow of information” (Coffee, 2006, p.8).

Based on these findings, it is possible that information control by management negated the Board’s ability to create an effective check and balance system to monitor management: “the lack of transparency surrounding Enron seems attributable less to the gatekeeper that failed and more to the absence of any true gatekeeper in the disclosure process with real responsibility or authority” (Coffee, 2006, p.34). Coffee suggests that management intended to create a system which would not allow for any group to question their practices and that it was “not accidental (as Enron’s management did not want close oversight)” (Coffee, 2006, p.34).
This was due to an ineffective disclosure process which “placed Attorneys on the sidelines, where they could comment but not block or delay an adequate filing, seems a more structural failure that invited abuse. If there is no watchdog, it cannot bark when the thief comes in the night” (Coffee, 2006, p.34). Perhaps the watchdogs were not there, because they were not allowed to be there. Enron management used these advisors to create the illusion of compliance and controls, but by limiting the flow of information, there was no way for any group to question management’s control. Granted, these advisors did not need to accept these roles, in the same way that they did not perform roles as “gatekeepers”.

The major flaws in Enron’s structurally weak approval and decision-making processes include the Board’s increased dependence on its advisors. No group monitored this system for functional controls or was able to oversee management’s decisions. Although, in theory, this would have been the Board’s role, in reality, the absence of a check and balance system gave management the ability to control the flow of information at Enron. Management used policy and protocol to influence the content, timing and amount of information which shaped the decision and approval processes at Enron. Policy and protocol was used to assign which transactions required the Board’s approval. As a result, management sent limited information regarding specific transactions to the Board. The Directors did not obtain complete information about Enron’s operations which could have raised concerns regarding the transactions and prompted investigations into these red flags.

The Directors maintained that they did not recognize any red flags; therefore, they could not investigate any warnings. Batson’s Final Report found that there was insufficient evidence to show that the Directors breached their fiduciary duty to investigate red flags (U.S. Bankruptcy Court Final Report of Neal Batson: Appendix D, 2003, p. 2). If the Board acknowledged red flags and did not investigate these events, then the Board would have breached their fiduciary duty to inquire. If the Directors did not understand the information, it would have been difficult to confirm the validity of the approvals provided by committees or Anderson (Powers et al., 2002, p.23). The Board’s inability to understand the complex financial reports, combined with the barriers to access relevant information, may be the basis for which the Directors were unable to detect these red flags.
By mapping the information flow in the decision-making process, it is possible to identify considerable barriers which influenced the approval processes at Enron. This case study examined the information flow of several groups, with a special focus on the Board from a process perspective. The Board was assessed in this study particularly because it is supposed to be the representative of shareholders interests. It is essential to understand the Board’s role in the decision-making process, particularly for Enron as it had the least authority in the firm’s information hierarchy. Based on these findings, it is clear that information may be controlled, manipulated and timed to further the interests of select members of an organization, in Enron’s case, it was management.

By conducting this research, it was possible to identify the ways that decision protocols and policies were used to shape the Board’s role and access to information. However, by understanding the ways that these formal protocols were used to restrict information, it is also possible to suggest ways to use protocol and policy to improve corporate governance initiatives. The aim is to have sufficient understanding of the examples across a spectrum of organizational management. Process perspective research offers a systematic way of evaluating information flow to improve communications, internal monitoring and information exchange among industry members. Enron was certainly not the first company to fall and it was followed by a string of major corporate failures. However, by analyzing the information and decision failures which led to its collapse, these findings may be used to contextualize regulatory improvements, to assess current legislation and to plan for further changes as necessary to foster confidence in investors and improve corporate governance.

6.2 Limitations of the Research

Limitations for research include the inability to incorporate all 16 ‘red flags’ known to the Enron Board as described in the U.S. Senate Report Role of The Board of Directors in Enron’s Collapse as Exhibit #1 (2002). For reference, a chart is attached that maps the occurrence of each flag with Enron’s corresponding stock price in Appendix D from this U.S. Senate Committee report (U.S. Senate, 2002, p. 203). The Board maintained that they were not aware of these red flags which occurred before the period of Enron’s collapse. This research does not involve direct interviews with the Board; therefore, Board testimonies were drawn from various secondary sources.
At first, the intention was to use the Enron e-mail corpus as a primary source, in order to identify data pertaining to the “red flags” and restriction indicators in the e-mail database in addition to the secondary sources. However, due to time limitations, it was simply beyond the scope of this study to select a sample from these e-mails, identify sender and receivers in the raw data, and code the content. Instead, it was more practical to assess documentary sources to develop a more detailed and rich description of the events. Contextual information would not have been available if the data was taken primarily from e-mail. Specific information may have been sent to specific executives at Enron, but the context may not be indicated by scanning the e-mail content. The large e-mail data set was not a source for this study. All of the data was based on documentary sources.

Limitations of using documentary sources were that some of the data relied on the authors’ reporting and interpretation of events based on their research. Document sources regarding this Enron Case study included: Congressional Hearing transcripts, the Hearing before the Permanent Subcommittee of Investigations of the Committee on Governmental Affairs United States Senate: The Role of the Directors in Enron’s Collapse and Lessons Learned from Enron’s Collapse: Auditing the Accounting Industry. According to Yin, reliance on congressional reports may have weaknesses in terms of validity, “even the “verbatim” transcripts of official U.S. Congress hearings have been deliberately edited – by the congressional staff and others who may have testified – before being printed in final form” (Yin, 2009, p.103). However, these reports were valuable sources for details regarding the treatment of corporate failures from the U.S. government’s perspective and included testimonials from Board members.

Sources were also obtained from The United States Department of Justice as the Enron Trial Exhibits and Press Releases are public. However a limitation in using this website was that the material was sorted using trial dates; therefore, the documents, including meeting minutes required substantial review to identify the content. Once found, meeting minutes required context for the transactions in order to identify the specific phase of the deal. It was essential to cross reference these minutes with documentary sources to identify the point of time for a transaction to determine if a decision had been made and if an approval had been issued at that particular point in time. Therefore, meeting minutes were used as a reference, in support of details found in documentary sources, which presented a limitation. However, it is important to note that these minutes were written and edited by Enron staff, so not all content as discussed in the meetings
may have been documented in this text. Instead, it was best to assess a variety of documents and reports which investigated the Enron case. In this manner, the evidence was substantiated as the same details of an event reoccurred in various sources. Also, testimonies by Board members were used to provide context for the decisions that were made and also valuable commentary regarding various Directors’ intentions and support for their decisions.

Case study design relies on extensive document analysis; however, access to documents was limited to resources available for graduate students. Access limitations included restrictions to material for members of the financial industry. I had access to Nvivo 9 to analyze qualitative data, since this study did not involve quantitative methods. Financial reform acts and legislation were included in the final chapter of the thesis; however, it was not the primary focus of this study. This research examined the process related aspects of corporate failure; therefore, financial material such as balance sheets or detailed analysis of regulation and reforms were out of its scope. Instead a general overview of specific transactions that were referenced in the examples for this thesis was offered in the Enron Background chapter. In the concluding chapter, some general observations were offered regarding portions of the Dodd-Frank Wall Street Reform and Consumer Protection Act which relate to specific examples of decision-making processes in this study. Since the Dodd-Frank Act is relatively new, (July 21, 2010), the limitations involve the constant changes and updates relating to this regulation and it was not possible to incorporate all of the changes and aspects of this new law.

This study had one coder to assess and code a large amount of information from several documentary sources. This study did not use a second coder to compare these categorizations and consequentially, it does not have “intercoder agreement” (Creswell & Plano Clark, 2007, p.135) to increase “reliability” (Creswell & Plano Clark, 2007, p.135) in this particular way. This remains a limitation of the study.

6.3 Implications for Future Research

The examination of the information and decision-making processes of the groups at Enron in this study was defined as a “critical case” (Yin, 2003, p.40) and used a single case study method (Yin, 2003, p.47) since a multiple case study requires “extensive resources and time beyond the means of a single student or independent research investigator” (Yin, 2003, p.47). It was not the intent of this study to analyze another comparable corporation collapse. However, future research
may involve the study of another company failure to compare the decision-making processes of another Board. Perhaps a good example may be to examine Lehman Brothers as a second case. The Lehman Brothers’ bankruptcy is often described as the fall of an investment powerhouse and it has substantial parallels to Enron, particularly Lehman Brothers’ reliance on debt and aggressive decisions by management.

Alternatively, further study may continue with a single case study regarding the decision-making processes at Enron, but with a focus on “an embedded, single-case design” (Yin, 2003, p.43) and examine several embedded units in Enron. Perhaps future research may map the information flow and decision-making processes of management and executives at Enron, in addition to another unit, for example the decision-making processes of its advisors. In this way, there are several units for decision-making process comparison within the same firm.

To code and analyze the data, future research may involve several coders instead of one researcher since: “fatigue can lead to drift (Zhang & Wildemuth, 2009) and the possibility that the coder misses some nuance in the data. As such, this was a limitation for the researcher” (Newhard, 2010, p.171). Using multiple coders for future research is beneficial since it incorporates “intercoder agreement” (Creswell & Plano Clark, 2007, p.135). A detailed codebook may be used to establish a guideline for several coders to assess the data and to code: “Should the researcher have only novice peers available, it may be best to establish study trustworthiness with the many other alternatives available, such as full disclosure of all study details and rich, thick description (Charmaz, 2006; Creswell, 1994, 1998; Lincoln & Guba, 1985; Patton, 1990; Sykes, 1990)” (Newhard, 2010, p.245).

Several sources were used for triangulation in order to address “potential problems of construct validity” (Yin, 2003, p.99). For future research, Enron’s e-mail corpus may provide a good primary source in addition to the multiple secondary sources. In this study, the data was taken from multiple sources of evidence in two categories, as per Yin: “Documentation and Archival records” (Yin, 2003, p.86). Future research may consider using direct interviews as a third source of evidence (Yin, 2003, p.86) although many of the documentary sources, such as investigative reports and hearings, included interviews with the Board.

Future research may include interviews with Board members from another public company to observe the decision-making process of its Board over a fixed period of time and assess the
information flow within the firm. Access to Boards are limited; but if it is possible, it may provide primary source data to map the way the Board monitors, controls, interacts with management. A checklist for Board members regarding “How to be a well informed Board member” could be derived and would be useful in preparing a list of considerations in order to ensure that the Board member is well informed in terms of his/her decision-making.

6.4 Conclusions

I only ask for information – Miss Rosa Dartle

(Dickens, 1850 David Copperfield, p.276)

This research set out to examine four research questions with the intent of examining the information flow among groups in the decision making processes at Enron. In revisiting the findings, weaknesses were identified in Enron’s structure as factors which may have influenced the Board’s decision-making processes. This may be due to the restriction and control of the information flow among the groups in the decision making processes by management and the limited access to relevant information by the Board. These organizational weaknesses based on the Board restricted access to information, may have contributed to the inability of the Directors to recognize the red flags prior to Enron’s collapse.

The four research questions posed in the Introduction and Research Methods chapters are answered as follows:

**How did the organizational structure affect the decision-making process and did weaknesses in this structure contribute to Enron’s failure?**

The outcome of most decisions leading up to Enron’s collapse involved furthering the interests of management. This may be due to the organizational structure of Enron. Management shaped a group hierarchy system which was ranked according to access of information and knowledge of Enron operations. Management used their ability to restrict access to information to other groups, including the Board, to increase their authority in the decision-making process. This is identified as information control and the second theme of this study. **The first weakness in Enron’s structure was that the Board was perceived as less of an authority and less relevant to the decision-making process due to its limited access to information from management and advisors.** The Board should represent the governing entity in an organization. If the Board was
not perceived as the central authority, this weakens the structure so that the power shifts to another, more dominant group, in Enron’s case this group was management.

The fact that Directors maintained that they were not aware of any red flags leading to Enron’s collapse showed that there was no central group to provide an effective check and balance system for Enron. Management created barriers to information flow which prevented the Board from accessing complete details of Enron’s operations. Management was able to control information flow and shape the decision-making processes. The Board could have requested more information to fulfill its fiduciary duty to inquire; however, it would have been difficult for Directors to identify gaps in the information if they did not understand the transactions in the first place. Based on the findings, the Board did not appear to be familiar with details for Enron’s major investments or extensive use of SPEs that contributed to its collapse. As a consequence to their unawareness of Enron’s operations, **Directors became less informed and relied on advisors to determine if deals were appropriate. This was the second weakness in the organizational structure of Enron.** The interdependence of Enron’s groups is the first theme in this study but it may also be categorized as a weakness for this company. Enron lacked an independent governing group to monitor its operations and ensure that decisions were made in the best interest of the company and for its shareholders.

**Based on the outcomes of the decisions that were made, advisors supported management interests more than executing their roles as “gatekeepers” and this was the third weakness in Enron’s organizational structure.** If advisors supported the Board in its governance role, it would have been challenging for management to exert any information control over the Board. Advisors should not be in positions which increase risks of conflict of interest, such as accepting dual roles as both auditor and consultant for a firm. The consultant fees were far more profitable for Andersen compared to their roles as auditors. As Coffee (2006) suggests, Vinson & Elkins seemed reluctant to be gatekeepers. Perhaps these advisors did not anticipate that their role would be considered such a primary source of corporate governance. It may not be realistic to expect advisors to assume “gatekeeping” responsibilities in an organization that perceives the Board as passive. This scenario does not provide advisors with a group with enough autonomy and power to support them as ‘gatekeepers’. Effectively, advisors do not have a strong supervisory group to report to if advisors detect issues. This statement does not imply that
advisors should not have been expected to perform “gatekeeping” duties; but that advisors cannot monitor alone. It appears that based on these findings, Enron’s Directors were devoted to their responsibilities for the most part as a part-time commitment. This is a fourth organizational weakness since Enron’s Board was compensated well compared to the services that were provided to the Board. The Directors were highly paid compared to other companies of their operation and size. Although researchers have argued that Board composition and structure may not have been a factor to prevent Enron’s collapse, as discussed in the literature review, an organizational weakness may be due to the lack of knowledge management of Enron’s Board. Research may focus on the credentials of Directors; however, credentials may not necessarily reflect their ability to incorporate managerial principles, assess and determine the relevance of information from groups in the decision-making process. Directors are responsible for: “reviewing and guiding corporate strategy; formulating major plans of action, risk policies, and annual budgets; setting performance objectives; monitoring financial results; and overseeing major capital expenditures, acquisitions, and divestitures” (Salter, 2008, p.162). A part-time commitment by Enron's Board was not sufficient to effectively execute these tasks, particularly since some Directors did not understand the financial information sent to them and relied on others to contribute informed decisions.

Decision protocols and policies were created at the start of the decision-making processes and used to divide the responsibilities between the Board and management. This is a typical and formal practice used by many companies, where the Board receives information about transactions and arrangements which require Board approval as outlined by decision protocol and/or policy. Management decides whether additional information should be sent to the Board and it not compulsory for management to provide Directors with contextual information for transactions that does not require Board approval, unless the Board requests it. However, in Enron’s case, without complete details, the Board may not be able to recognize the need for any of the omitted information due to the complexity of the accounting practices used at Enron, particularly for SPEs. If the Directors do not understand the criteria for the proper execution of SPEs, it may be difficult for the Board to assess if a deal may not comply with the generally accepted accounting principles (GAAP) at that time. Or it may be difficult for Directors to gauge Enron’s interests in broadband without examining the realistic returns on investments from the telecommunications industry. Instead, the Board was unable to effectively use decision protocol
and policies to divide responsibilities between management and the Board. Based on Enron’s protocol, the Board did not receive information regarding the restructure phases of the Raptors vehicles. The Board may not have been aware of the changes related to Raptors or the consequences of the so called “hedge” since management was not obligated to provide this information to the Board. The Board had an opportunity when the decision protocol document was created to ensure that the most significant transactions required its approval for all stages, and not only its creation and termination. A **fifth and most significant organizational weakness was the Board missed opportunities to assert its authority formally through decision protocol and policy.** By contrast, management used these formal policy and protocol opportunities to manipulate, control and conceal information. Through the use of decision protocol and policies, Board could have regulated these groups to maintain its authority and ensure that the Board was responsible for significant issues and transactions. Once the Board’s responsibilities became less pertinent to Enron’s operations, then there was less need for the Board to issue approvals regarding significant deals, which as a result, required less important information to be sent to the Board, and in the end, the Board became less of an authority in the decision-making process. This unfortunate outcome may have occurred as a result of a combination of the five organizational weaknesses as described above.

**How did the control of information flow shape the decision-making processes?**

As a result of formal policy, the Board may not receive complete details and cannot make an informed decision or may not be able to recognize problems with a deal. In this way, the third theme is illustrated to show the way that decision protocols and policies may shape the information flow and decision-making processes of the groups at Enron. Furthermore, the Board may not understand the information that is presented to them, perhaps due to missing information or the complexity of the financial and accounting practices that were used by Enron. In fact, many Directors were dependent on Enron’s advisors to assess if deals were appropriate first, prior to the Board’s review and approval in the decision-making process. This same group of advisors that the Board depended on for guidance was compensated by Enron; and therefore had a direct interest in a strong relationship with management to maintain their lucrative consulting contracts.

**How did specific groups have access to information that was withheld from the Board?**
Based on the information flow between these groups, management shared information with auditors and legal counsel since management required the expertise of these advisors to further management’s interests. Advisors were sent information by management. However, management restricted the Board’s access to information. In addition to these factors, Enron’s formal protocol and policies determined which transactions and deals were designated for Board approval and related information was sent to Directors, not necessarily complete information regarding all Enron operations.

**Why did red flags or warnings go unnoticed by the Board of Directors?**

As discussed in the research literature, red flags are warnings which may occur as events. These red flag events are outcomes of a series of decisions made by individuals or groups. In terms of red flags, the Board depended on these groups to provide the information that it did not have access to, and to offer expertise for transactions that it did not understand; but it was not the priority of these groups to provide the Board with this information. Therefore, it was possible that the Board was ill informed and did not recognize the red flags prior to the collapse, since it was not able to assess complete information.

Management controlled the flow of information at Enron; based on corporate governance research, this was symptomatic of the way many companies functioned, not just Enron. The findings showed the importance of the relationships between management and Enron’s advisors and the ways in which the content, timing, and amount of information influenced the decision making processes at Enron. Despite the Board’s opportunity to make formal decisions for the design of decision protocols and policies which would enable it to monitor Enron’s operations, management was able to exploit these formal decision protocols and policies to use them to their advantage. Management used these protocols and policies as tools to control the information flow, since these documents stipulated which issues were assessed by the Board or by management.

Legal counsel advised management regarding the best way to use vague terms and language to support their publication of incomplete disclosures in proxy statements. In this way, information which pertained to Board approval was sent to the Board, but management may not have offered information to provide context to the transactions. The relationship between Andersen and
management influenced the information the Board received from Andersen, particularly compromising the controls that were established to monitor deals and conflict of interest issues.

Unlike all Boards, Enron’s Board had the opportunity to be involved in the creation of its decision protocols, so this Board started out with power to delegate to management. Yet since the Board failed to use sufficient controls in order to monitor Enron’s operations, it became increasingly dependent on advisors to interpret information. Management shaped a group hierarchy system which was ranked according to access of information and knowledge of Enron operations. As a result, management was the authority in this informational hierarchy, and the Board became less relevant to the decision-making process due to its limited access to information.

The Board had opportunities to perform their fiduciary duties to monitor and inquire for information. Enron’s Board of Directors appeared to be more concerned about whether their decisions were required for an issue, rather than determining whether or not they had complete information to make an assessment. Based on the sources, Directors usually responded to questions regarding Board approvals by stating that they obtained advisor approval first; therefore, they assumed that the transaction was appropriate to approve. There was no system for a check and balance to verify information or monitor the approval processes. Instead, the Board consistently demonstrated that it was dependent on other groups to validate its Board approvals.

In addition to advisor approvals, the Board relied on various standing committees for approvals and assumed that once it had these approvals, it could consent to deals. The Board did not offer critical reviews of information and it issued approvals in highly time constrained environments. The Board appeared complacent as it became pressured to issue approvals during packed meeting agendas. These factors combined with incomplete or inaccurate information, contributed to the Board’s inability to assess information in a productive manner.

The Board was not aware of the consequences to its approvals since it did not have context for transactions. If the Board sought this information, this implies that that the Board was aware that details were missing. The Board claimed that it did not identify any red flags and it was only aware of specific parts of financial transactions; but if the Board recognized gaps in the
information, it had a fiduciary duty to investigate the information. According to the Powers Report: “The Board cannot be faulted for failing to act on information that was withheld, but it can be faulted for the limited scrutiny it gave to the transactions between Enron and the LJM partnerships” (Powers et al., 2002, p.162). The issues for Board approval were already clearly divided between management and the Board based on decision protocol and policies. However, Fastow’s request regarding the waiver for the code of conduct should have prompted a reaction from the Directors.

It was odd that the Board waived Enron’s code of ethics to facilitate a deal. This action clearly signalled conflict of interest issues. The fact that Fastow requested a waiver to a code of ethics in place to restrict breaches to ethical behaviour, should have been a clear and identifiable red flag: “The Board had agreed to permit Enron to take on the risks of doing business with its CFO, but had done so on the condition that the Audit and Compliance Committee (and later also the Finance Committee) review Enron's transactions with the LJM partnerships” (Powers et al., 2002, p.162). The Board realized that controls were required a condition to approve this waiver. Yet, the Board approved the arrangement without consulting the advisors. This seems counterintuitive since the Board required assessments by standing committees to limit risk; but did not ensure that advisors review this particular arrangement with Fastow prior to approving the waiver. The Senate committee report summarized the Special meeting and directed questions to Winokur and other Board members:

On June 28, 1999, the Board held a special meeting in which all five of you participated either by phone or in person. You approved the creation of LJM1, and for the first time, you waived Enron’s conflict of interest provision in your code of conduct to allow the Chief Financial Officer, Andrew Fastow, to take an ownership interest and act as the general partner of the LJM partnership. (U.S. Senate, 2002, p.59).

LJM1 was created on the same day as the Board waived Fastow’s conflict of interest provision and these approvals were issued without any precedent or advisor review:

None of the experts we have contacted have ever heard of such an arrangement, either. But LJM1 was made after 3 days notice of the proposal, no prior Board discussion with
either Enron management or Andersen, no written legal opinion, no prior Finance Committee review. (U.S. Senate, 2002, p.61).

This decision was unlike any other Board decision. The Board constantly depended on advisors to guide it. It was uncharacteristic for this Board to approve this arrangement without precedent or a formal review by advisors. Fastow was now poised in an advantageous position loaded with conflict of interest. Thus, “in negotiating the sale of assets to LJM, [that] Fastow clearly had a superior bargaining position over Enron personnel because both sides reported to him” (U.S. Senate, 2002, p. 65) even though the Board insists at the time that it was not aware of “people on the Enron side making a decision that reported to Fastow” (U.S. Senate, 2002, p. 65).

The Board failed to anticipate consequences for Fastow’s request to waive the code of conduct provision, not just once but three times. The findings show the contrast between the Directors passive approach in the decision-making, in comparison to the way management exploited their ability to use the expertise of advisors to maintain a dominant position in this information hierarchy. The Board relied on advisors to explain information. Management specified their goals and instructed advisors to find ways to best use law or accounting practices to achieve the desired results. Management achieved this by manipulating content, strategic use of timing, and to control the amount of information accessible by the Board.

By examining the ways that content in policies were interpreted to further the interests of management, either by advisors or Enron executives, it is then possible to address the gaps in regulations and implement changes to strengthen compliance and efficient communication to shareholders. The aim of corporate governance reforms such as the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) is to increase transparency and accountability. For example, if content for disclaimers are vetted appropriately, it may be possible to identify problematic disclosures, as in the case of Fastow’s compensation disclosure issues highlighted in this study. It is more challenging to implement changes and respond to information control as a behavioural issue, which may be derived from human responses to power. By approaching these issues from a process perspective, this research addresses issues of corporate governance by monitoring the information flow in the decision-making processes. If information barriers are recognized in the decision-making process, it
may be used together with regulatory improvements, such as the Dodd-Frank (2010), to support reform to improve information transparency in financial reporting.

6.5 Corporate Governance Reforms: Sarbanes–Oxley Act of 2002 (SOX) and Dodd-Frank Wall Street Reform and Consumer Protection Act (2010)

“There reflects but in no sense determines the moral worth of a society. The values of a reasonably just society will reflect themselves in a reasonably just law”

*The Ages of American Law.* (1977)

(Shapiro, 2006, p.310)

Enron’s failure induced “numerous corporate governance reforms including the Sarbanes–Oxley Act of 2002 (SOX)” (Gillan & Martin, 2007, p.930). As described in the corporate governance literature review, Section 404 of Sarbanes-Oxley specifies the criteria for auditors to assess the internal controls for a company via a formal process of an audit. It recognizes the importance for company controls to be monitored and specifies that auditors are to supply an adverse opinion in the event of potential failure. Coffee includes the text for this auditing standard:

Section 404(b) also gives the PCAOB authority to adopt standards governing this attestation, and it has done so in its Auditing standard No.2 (2004), which requires the auditor to conduct a formal audit (and not simply a review) of the client’s internal controls and to give an adverse opinion if there is more than remote likelihood of material failure. (Coffee, 2006, p. 183-184)

This requirement addresses the need for a more thorough inspection of financial statements and an emphasis on effective controls to provide a means for the Board to assess company operations based on accurate and complete information.

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act. This historic act aims to “promote the financial stability of the United States by improving accountability and transparency in the financial system, to end “too big to fail”, to
protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes” (Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub L No 111-203, 124 Stat 1376). Referred to as “Dodd-Frank,” this Act stipulates compensation committee requirements, including disclosures, for the Board of Directors:

The compensation committee of a company’s board of directors, including director independence requirements and rule on the evaluation, retention, and payment of compensation committee consultants and advisors, as well as additional proxy disclosure requirements. (Addleman, 2010, p.182)

Only a few legislative changes are highlighted which are pertinent to the findings of this case study. The issue of interdependence was examined in this study among groups at Enron. It is essential that compensation is considered a significant factor in the decision-making process; and therefore, requires more than general oversight but specific criteria in “defining independence of all compensation committee members as a condition for listing on a national securities exchange” (Addleman, 2010, p.182). It is important that the intention for reform is supported by the implementation of realistic and achievable goals. Since the ability for companies to list on a national exchange depends on defining compensation committee independence, this demonstrates an important change to address gaps for this issue. The criteria to determine independence for a compensation committee member are outlined as follows: “(1) The source of the member’s compensation, including consulting, advisory, or other fees paid by the company and (2) whether the member is affiliated with the company or any subsidiary or affiliate” (Addleman, 2010, p.182). With respect to Enron, this Dodd Frank requirement addresses the conflict of interest issues in Andersen’s dual roles as both consultants and auditors and disclosure of any relationships, specifying compensation, with management. This independent compensation committee has “sole discretion to retain compensation consultants, independent legal counsel, or other advisors” (Addleman, 2010, p.182). This may provide the check and balance required to monitor the retention of legal advisors. This relates to the retention of outside legal counsel, Vinson & Elkins in the Enron case study. In this way, the compensation of the firm is monitored by an independent compensation committee “SEC-identified factors that could affect the independence of such an advisor” (Addleman, 2010, p.182). In doing so, advisor independence is assessed and supported by reviewing “(a) the other services that the advisor’s
employer provides to the company” (Addleman, 2010, p.182). By identifying other responsibilities, this limits possible conflicts of interest situations.

As in the case of Enron, advisors could act as both consultants and advisors. These roles became increasingly complex particularly with respect to the LJM transactions, when advisors worked on deals that involved management interests on the Enron side of business and also advised the Board. The compensation committee also monitors “(b) the amount of fees received from the company by the advisor’s employer as a percentage of that employer’s total revenue” (Addleman, 2010, p.182). It is important to establish the relationship between the company and the firm that employs the advisor. In Enron’s case, the amount of fees received from Enron by Andersen as a percentage of Andersen’s total revenue. This clause protects against a repeat of the situation that occurred at Andersen. Enron provided lucrative consulting opportunities. Andersen employees feared being reprimanded for challenging Enron’s use of questionable accounting techniques. The fear was the loss of the consulting opportunities, not necessarily their auditing role; as per Bass’ example for Andersen. The compensation committee examines “(c) policies and procedures of the advisor’s employer with respect to conflicts of interest” (Addleman, 2010, p.182). This clearly relates to the Enron case to assess the company’s position on conflict of interest and to ensure that the company follows sufficient compliance protocol, which includes the disclosure of “(d) any relationship between the advisor and any member of the committee” (Addleman, 2010, p.182). This clarifies any individual positions of conflict of interest. One of the most important stipulations for the compensation committee’s examination is “company stock owned by the advisor” (Addleman, 2010, p.183), as it is essential to understand the personal financial stake an advisor has in the company, and these holdings may by sizable enough to raise concerns whether these investments may influence the decision-making process of the advisor. Addleman (2010, p.183) describes the final requirement to disclose any work that involved conflict of interest and the resolution of the situation.

- Proxy or similar solicitation must disclose whether the company’s compensation committee has retained or obtained the advice of a compensation consultant.
  - If the committee has retained a consultant, the proxy statement must also disclose whether the work of the consultant raised any conflict of interest
- If the consultant raised any conflict of interest, there must be disclosure regarding:
  - the nature of the identified conflict
  - how it is being resolved
These conflict of interest situations were not identified as red flags by the Enron Board. This Dodd-Frank requirement emphasizes the significance of compensation influences on conflict of interest issues. An important aspect of this requirement is to disclose if consultants were involved in conflict of interests and the ways in which companies resolved these issues, which addresses several examples shown in this Enron case study regarding Andersen’s consulting practices and issues of conflict of interest.

As of July 2011, based on the SEC changes, companies that do not comply with these requirements will not be able to list on national securities exchanges (Addleman, 2010, p.183). There are exceptions to these requirements, which include “foreign private issuers, limited partnerships, and controlled companies from the independence requirement” (Addleman, 2010, p.183). Companies will have time to “cure defects prior to delisting” (Addleman, 2010, p.183). This should not be a major issue for many companies that are already practicing these controls. The difference that Dodd Frank makes is that “the Act now moves beyond simply disclosure towards independence of compensation consultants and other advisors to the compensation committee, additional work will be required in selecting and retaining advisors” (Addleman, 2010, p.183). For the purposes of this study, the emphasis is on the quality of the information disclosed in communication to the public: “Public companies will, as a result of the Act, be required to include significantly more information in proxy statements and other disclosures regarding the compensation paid to their executives” (Addleman, 2010, p.183). This is directly related to the decision and approval processes of Fastow’s compensation interest in LJM disclosures. It was due to the language in the criteria which governed disclosures that legal advisors were technically able to omit Fastow’s interest. This act clearly specifies that the amount paid to executives must be clearly disclosed in proxy statements; and furthermore, disclosures must show the relationship between this compensation and the company’s financial state:

The relationship between executive compensation actually paid to the executives and the company’s financial performance (this disclosure may include a graphic representation, and should take into account change in stock value, dividends, and other distributions) (Addleman, 2010, p.183-184).
Enron misrepresented its financial state as a company and also paid its executives, advisors and Board high above the average compensation packages. In this way, this Dodd Frank specification offers shareholders the opportunity to review the compensation as compared to the company financial performance.

This section also specifies any **hedging arrangements** and permissions which influences the value of company stock:

> Whether any employee or director (or designee) is permitted to purchase financial instruments designed to hedge or offset decreases in value of the company’s stock that was granted to the employee or director as compensation or that is held directly or indirectly by the employee or director” (Addleman, 2010, p.184).

The hedging arrangements may be directly compared to the Enron case. Although the example of Fastow interest in LJM vehicles and Raptors is a complex and unusual situation, it involved the use of Enron stocks for its “hedge.” In Dodd Frank, this phrase included in the Act is to ensure that all information which involve hedging and company stock are made clear.

A substantial policy relates to the “claw back” provision in the Act: “Public companies now will have an obligation in most instances to recover, or “claw back” some portion of incentive-based compensation for senior executives in the event of a financial restatement” (Addleman, 2010, p.184). As discussed, a financial restatement is indicative of error and in this context it relates “to material non-compliance with any financial reporting requirements under the securities laws” (Addleman, 2010, p.184). In terms of Enron, the major financial restatement was due to Andersen’s accounting error for the Raptors which caused a massive reduction as a result: “mistakes had been made in accounting for the notes receivable from the Raptors in exchange for Enron shares...The errors required an additional $1 billion reduction in shareholder equity” (Salter, p.348-349). This claw back provision addresses the fact that after a major restatement, executives may have already been paid their compensation based on financial information reported prior to the adjustment. Addleman notes that there was a clawback clause prior to Dodd Frank in the Sarbanes-Oxley under Section 304 but Dodd Frank “requires the return of compensation received during a period of three years prior to a restatement rather than the one year provision in Sarbanes-Oxley” (Addleman, 2010, p.185). In addition, the clawback clause for Dodd Frank applies to “executive officers without defining the term; Sarbanes-Oxley Section
304 applies only to the CEO and CFO of an issuer” (Addleman, 2010, p.185). In relation to Enron, the extent of the compensation issues related to many executives and was not limited to the CEO and CFO. Dodd Frank addresses the fact that claw backs may be required for individuals that are not CEOs or CFOs. Addleman explains that under SOX, clawbacks applied to “only restatements caused by ‘misconduct’” (Addleman, 2010, p.185) whereas, Dodd Frank applies to “any restatement as a result of material noncompliance with the financial reporting requirements” (Addleman, 2010, p.185).

Dodd Frank also emphasizes the role of shareholder to submit Board nominees via proxy materials: “The Act gives the SEC rulemaking authority to require that proxy solicitations by an issuer include board nominees submitted by shareholders in any proxy materials” (Addleman, 2010, p.187) and companies must explain if “the same person serve as both chairman of the board and CEO or to have different individuals fill those roles” (Addleman, 2010, p.187). The CEO and the Chairman did not share that role at Enron. However, phrase is valuable for other companies to avoid issues of conflict of interest and also to assert some form of check and balance, so that the Board is in a position to critique management decisions without its leader as CEO. This study did not investigate the whistleblower aspect of Enron’s case, but it is important to note the Dodd Frank’s inclusion for protection of whistleblowers. Perhaps Andersen advisors may have been more likely to have questioned the accounting practices at Enron if they had more protection and support from their own employer. Under Dodd Frank there are incentives and protections under this act:

Whistleblowers are given expanded incentives and protections under the Act. Previously, the SEC had the ability to provide bounties to informants who provided information regarding insider trading violations under certain circumstances. The new provisions are significantly broader. The SEC is directed to pay whistleblowers an award in any judicial or administrative action in which the sanctions, including penalties, disgorgement and interest, exceed $1 million. (Addleman, 2010, p.190)

Under Dodd Frank, there are specific references to compensation to encourage the cooperation of whistleblowers. In the past, this issue stated that whistleblowers will be supported and claim that the SEC has a lump sum relating to the initiative. Dodd Frank incorporates changes to these claims to ensure whistleblower protection is available and stipulates the amount for the
individual. This is a more realistic way to demonstrate the ways in which individuals will be supported by the SEC: Whistleblowers “are entitled to receive reinstatement, two times their back pay, and all litigation expenses if they prevail in any action under this section. The SEC must pass final regulations for the whistle blower provisions by April 2011” (Addleman, 2010, p.191).

Developing research concentrates on the SEC’s aim to increase investor protection, which includes: “An SEC study on the financial literacy of retail investors, methods to increase financial literacy, and methods to increase investor information relevant to decision-making. The SEC’s report on this study is due in two years” (Addleman, 2010, p.196). Overall understanding regarding financial literacy and the ways that this influences decision-making is pertinent to this study of Enron. Based on the Findings, Directors claimed that they did not understand the information that was given to them and that they relied on other Directors and the advisors to assess information to make decisions. This undermines the purpose of the Board. The Board is composed of multiple members to ensure that several Directors are able to offer informed opinions about issues, not rely on a few members to decide for them. Directors are supposed to contribute to the decision-making process as a group.

6.6 Research Contribution of Study

“This is no ordinary apple. It's a magic wishing apple...

One bite and all your dreams will come true”

Snow White (1937)

The simplified interpretation of the Board’s role in Enron’s collapse, serves as a cautionary tale for Directors: to beware of executives, holding out a shiny red apple scented compensation package. An interpretation of this story may involve one theme: that management had strong relationships with advisors and used their expertise to ensure the interests of Enron’s executives. Relationships with management were prioritized by advisors. As clients, management had the most influence over the compensation of these advisors. The Board depended on the same group of advisors for information. A more interesting story may incorporate a second theme, that management strategically used its access and control of information to offer the Board these details in the most time sensitive, high pressure environment to expedite Board approvals. A
story worthy of morality tale status; however, requires a third theme. In this complex and seemingly mythical tale, management disguised its power by allowing the Board to participate in decision protocol and policy creation to determine which issues required Board approval. In this way, it appeared that the Board was in a position to select issues to approve deals, but since the Board did not have complete information, it only had the illusion of power. In the end, a simple and incomplete interpretation of these events may be that the Board accepted the apple, rolled over and took a good long nap so it was not aware of any red flags. However, this over-simplified version omits important factors that influenced the Board’s decisions. In absence of a central and internal corporate governance structure to provide a check and balance system, there may be more opportunities for groups to exercise information control tactics in corporations. It may not be possible for one group to cause such an enormous failure, since “organizational failures always have multiple causes, and focusing only on human error misses the systemic contexts in which the accident occurred and can happen again in the future” (Choo, 2008, p.33). Red flags may occur, but without a truly independent Board, many warnings are identifiable in hindsight. It appears the moral of this Enron story may be for Directors is to ask questions about information which seems too readily available, especially if they are pressured to make a decision.

It may not be possible to eliminate issues of greed in corporations; however, it is possible to improve the organizational structure of corporations. Strengthening corporate governance may decrease the opportunities for information control. Process perspective research may be used to determine if a decision lacks rational business purpose, as it “will not be protected from judicial scrutiny by the business judgment rule” (U.S. Bankruptcy Court, Batson’s Final Report, Appendix D, 2003, p. 154) and the process of that decision may be examined to identify abuse and if the decision was made in bad faith (U.S. Bankruptcy Court, Batson’s Final Report, Appendix D, 2003, p. 154).

Process perspective research related to corporate governance has a practical application in law. This research may highlight the consequences for Directors if they breach their fiduciary duty of good faith. In order to investigate if decisions were appropriately considered, it is important to map the information flow in the decision-making process to identify any barriers that may have hindered the decision-making process. The outcome of decisions is important; but in terms of
corporate law, and in this case Delaware Law, the Board’s intention throughout its decision-making process is a key factor to determine if it breached its fiduciary duties of good faith. In particular, the fiduciary duty of **good faith**, and fiduciary task duty **to make informed business decisions**, both relate to the Board’s identification of red flags. If the Board was able to identify red flags, then the Board would be in breach of its fiduciary duties. For this reason, this research on decision-making from a process perspective is important, as it may contribute to the identification of barriers to sufficient information in corporations, rather than assumptions that groups made decisions in bad faith based on the outcome of the decision. Alternatively, by examining the information flow in Board decision-making processes, it may show that Directors had substantial and complete information but failed to investigate red flags. In this case study, research identified the ways that barriers impeded information flow among groups and restricted the Enron Board’s access to complete information. Consequently, this may have hindered the Board’s ability to identify red flags.

As research contributions, I adapted two models in this study. I adapted Fisher’s Model of the Audit profession’s self-regulation, through peer review (Fisher, 2010, p.1524) in a diagram which showed the Information flow in the Decision Making Process related to Fastow’s Compensation Interest Proxy Statement Disclosures (Appendix A, Figure 3). I adapted Boyatzis’ original model for the Data-Driven approach as I removed the first stage of Boyatzis’ original model for the Data-Driven approach. I skipped Stage II, Step 3 (Boyatzis, 1998, p.52) since “no evident or desirable criterion variable” (Boyatzis, 1998, p.52) could be identified using Boyatzis suggestion. Adapting three of Boyatzis’ models in a hybrid combination may be considered a research contribution. In Boyatzis’ Thematic Analysis, there are specific models for Theory-Driven Approach (Boyatzis, 1998, p.44) Prior-Research-Driven Approach (Boyatzis, 1998, p.44), and Data-Driven Approach (Boyatzis, 1998, p.44). I have used a Hybrid Approach (Boyatzis, 1998, p.44) as it modifies the Data-Driven Inductive Approach where the “criterion-referencing method previously described is not possible” (Boyatzis, 1998, p.52). Boyatzis specifies stages that should be used for each approaches listed above; however, Boyatzis does not specify stages for the Hybrid Approach. Instead, Boyatzis (1998) offers a suggestion to modify the Hybrid model. An example of the model is not offered in the way that the steps for the other approaches are summarized by Boyatzis (Boyatzis, 1998, p.44). The adaptation of Boyatzis’ Thematic Research Model used in this study may be considered a research
contribution since it shows a model that includes the stages and modifications for a Hybrid Approach.

In this concluding chapter, the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) was used to show the ways that current regulatory changes relate to the issues addressed in corporate governance literature and to several events which led up to Enron’s collapse. Enron lacked a group to monitor its activities and ensure accountability to its shareholders. Through the implementation of reforms like the Dodd-Frank, weaknesses in the organizational structure of companies may be addressed in order for information to be transparent and for decision makers to be accountable to stakeholders for their actions. The Dodd-Frank (2010) addresses the requirements for companies to disclose clear information. This thesis highlighted a few items in the Dodd-Frank (2010) such as compensation details, hedging arrangements, and conflict of interest issues. The examples highlighted in this case study, LJM, Raptors and Fastow’s compensation disclosures and conflict of interest issues, show the way that the information related to these arrangements were concealed, manipulated and controlled at Enron, with disastrous consequences. In this way, this case study summarized a few of the statements in the Dodd-Frank (2010) reforms to show the way policies may be used to address weaknesses in organizational structure.

The role and responsibilities of Enron’s Board of Directors is specified in the Corporate Governance Guidelines for the Board of Directors from the Permanent Subcommittee on Investigations - Committee on Government Affairs: Role of The Board of Directors in Enron’s Collapse report (U.S. Senate, 2002, p.385) and attached in this study as Appendix C. In order for the Board to carry out these functions, it must have sufficient access to relevant information. However, this information was communicated between groups in the decision-making process. The Board lacked the knowledge of Enron’s operations to effectively criticize the arrangements that were presented to it for approvals. The Board depended heavily on its advisors and management for clarification of this information, which in turn, placed the Board in an inferior position in Enron’s information hierarchy. Consequently, this influenced the perception of the Board’s authority at Enron.

The first major function of Board was to “ensur[e] legal and ethical conduct by Enron and its officers and employees” (U.S. Senate, 2002, p.385). Since the Board depended on advisors and
executives for information to monitor controls, this appeared to undermine the authority of the Board to ensure that business practices complied with legal and ethical standards.

The second major function for the Board was to “select[...], compensat[e], and evaluat[e] Directors and evaluat[e] Board processes and performance” (U.S. Senate, 2002, p.385). This case study focused primarily on the Board processes. However, the Board did not implement and assess performance standards or milestones to monitor Enron’s operations or investments in a successful manner. Instead, the Board depended on its advisors and Enron executives to assess the appropriateness of the “hedges” and investments that it approved and was unable to monitor the restructure of these SPEs or fully understand the consequences of these arrangements.

The third major function of this Board was to “select[...], compensat[e], and evaluat[e], and when appropriate replac[e] senior executives of Enron and ensur[e] that a succession plan is in place with respect to such senior executives” (U.S. Senate, 2002, p.385). Since the Board did not have complete information to understand Enron’s failed investments and true economic activity, it appeared to be in a dependent position for fundamental information to effectively criticize the compensation and appointments of Enron executives.

The fourth major function of this Board was to “approv[e] Enron corporate strategy” (U.S. Senate, 2002, p.385). Although the Corporate Governance Guidelines request that corporate strategy issues are expected to be brought to the Board for review “in a timely manner” (U.S. Senate, 2002, p.389), there is no specific criteria for this period. It appeared that any sufficient assessment of corporate strategy would depend on knowledge of Enron’s operations. This case study shows that complete information was not communicated to Directors, and influenced their ability to make informed decisions. The third theme which relates to policy and decision protocol is most applicable to the fourth function of the Board. Enron’s corporate strategy Board approvals were based on the ability of the Board to approve specific deals and arrangements. If the decision protocol specified that certain deals and arrangements did not require Board approval, then Directors would not be aware of those details. As a result, there were substantial gaps in the information that the Board used to assess and approve other deals. Therefore, the Board approved deals were affected by other investments that may not have been assessed by the Board. The decision protocols were used to determine which transactions or particular phases of deals required Board approval. Related information for these specified deals was communicated
to the Board. In this way, management was able to control the flow and content of information to the Board since only specific information related to deals which required Board approval was expected by the Board. The Directors may not have anticipated the information that would be sent to them if these details did not relate to transactions which required Board approval. The Directors may not know that information was omitted in the first place since they did not have a complete understanding about Enron’s operations. The Board would have required details to request complete information about these transactions from management. Part of the decision process involved understanding the criteria for appropriate transactions. Since the Directors depended on advisors to determine the suitability of these arrangements, Directors appeared unable to criticize these deals.

Since it was perceived by other groups as passive, the authority of the Board appeared to decrease and its role in the approval process became less influential. The Board’s “approval for major management initiatives” (U.S. Senate, 2002, p.385) is the fifth major function of the Board; yet the Board was described as a “rubber stamp” (U.S. Senate, 2002, p.91) which undermined its role the decision-making process. Finally, the sixth major function of the Board was to “provide general oversight of Enron’s business” (U.S. Senate, 2002, p.385). In absence of a check and balance system to provide the necessary supervision, ensure compliance and oversight, the Board was unable to monitor Enron’s operations. The company lacked efficient controls by which to measure performance and did not have an internal governing body to report issues that was separate from management influence. As a result, this offered management the opportunity to exercise information control over other groups in the decision-making process. Although information control is an important theme in this study, it is important to note that the opportunities for information control may have been limited if the Board was less dependent on its advisors and management in the first place. The most significant findings for this study relates to the opportunities for the Board to shape corporate decision protocols and policies. By examining this Enron case, it was clear that this Board’s authority decreased when it was not involved in the decisions or approvals regarding key transactions. It may be possible to improve the way other companies allocate issues for Board approval by ensuring that Boards have an important role in the decisions for the most significant deals. Through advancement in internal corporate governance, such improvements may limit opportunities for management to impose information control and increase access to information by the Board.
6.7 Overall Conclusions

"Everything has to come to an end, sometime."
L. Frank Baum (The Marvelous Land of Oz)

Approximately 10 years ago, on August 14, 2001, Skilling resigned his CEO position at Enron, Lay cashed out his shares, and the steep and downward spiral of Enron showed as its share price plummeted (Appendix B): “August [2011] marks the 10-year anniversary of the beginning of the end of Enron Corp” (Francis & Kelleher, 2011). Enron declared bankruptcy on Dec. 2, 2001 (Reuters News, 2011). Although this thesis focused on the role of the Board of Directors in the decision-making at Enron, three key executives were significant in the examples for this study. Kenneth L. Lay was a Director since 1985 and Chairman of the Board from 1986 as well as the CEO of Enron from 1986 to 2001 (Appendix C). Jeffrey K. Skilling was a Director from 1997 as well as Chief Operating Officer (COO) from 1997 to 2001. Skilling was President and CEO from February 2001 (Appendix C). Although Andrew Fastow was not part of Enron’s Board, it was vital to describe Fastow’s role regarding issues the Board’s decision to waive Enron’s code of conduct and the financial disclosure issues in Enron’s proxy statements. In terms of Fastow’s liability in the Enron disaster: “Fastow pleaded guilty in January 2004 and agreed to cooperate with the authorities in exchange for a 10-year prison sentence. The term was reduced after he testified against former Enron Chief Executives Kenneth Lay and Jeffrey Skilling” (Reuters News, 2011). At this time, Fastow awaits his release on Dec. 17, 2011 and remains in a “community corrections facility in Houston” (Reuters News, 2011).

Fastow testified against Lay and Skilling and their sentences were substantially higher: “A Houston federal jury in May 2006 found Lay and Skilling guilty of fraud and conspiracy” (Reuters News, 2011). The consequences for Lay and Skilling were quite different. Shortly, before the date of his sentencing, “Lay died in 2006 of a heart attack, three months before his sentencing hearing” (Francis & Kelleher, 2011) and “Skilling was sentenced to 24 years in prison (Reuters News, 2011). In 2010, the U.S. Supreme Court decided to reject “one legal theory behind his conviction, [therefore Skilling] will be resentenced” (Reuters News, 2011).

Regarding the Enron Board, in 2005 “Former Outside Directors of Enron Corp. paid about $13 million to settle investors' claims” (Lublin, 2009). If the Board had identified the red flags and
failed to act, then Board would have been in breach of its fiduciary duties. Enron’s Board maintained that it was not aware of these warnings. The reality is that “liability for Boards and management is extremely rare” (Davidoff, 2011). According to Davidoff, Directors are less likely to be held accountable for poor decision-making and “liable only if they intentionally acted wrongfully [under Delaware Law]” (Davidoff, 2011). Most companies incorporate under Delaware law as it protects Directors under business judgement rule as discussed in the fiduciary section of this study. Delaware law supports Directors pending that their decisions were made in the best interest of the company. There have been “only nine cases where a director was held personally liable for securities fraud in a 26-year period” (Davidoff, 2011). Some critics of increased corporate governance and liability for Boards argue that such reforms may deter individuals from serving as Directors (Davidoff, 2011). Realistically, the risk of liability for Directors as a result of poor oversight is low, since there must be evidence that Directors made their decisions in bad faith.

It is not my intention to defend the Board or to portray the Directors as victims. The Board, management, and advisors were involved in the decision-making processes which led to Enron’s failure. I chose to highlight the Board in the decision-making process, particularly since the Board is supposed to serve a central role in corporate governance. A passive Board is ineffective and does not serve its purpose. Although there were barriers to information flow among groups in decision-making processes which may have limited the Board’s access to information to identify red flags, it was also the Board’s responsibility as fiduciaries to investigate, obtain, and clarify information. It is important to note that I examined these issues to demonstrate the importance of developing corporate governance regulation to address organizational weaknesses. Regulatory improvements to corporate decision protocols and policies may include recording major decisions and monitoring the division of responsibilities between management and the Board. In doing so, Boards become more integral in approval processes for the most important deals. As a result, stronger Board authority may provide the crucial internal check and balance system required to improve corporate accountability. This research has highlighted the deficiencies in information flow and corporate governance that, in the end, destroyed both a company, and the lives of many associated with it. The challenge for decision makers is to act during moments when it may seem much easier to ignore the warnings.
References


Filmsite.org (2011). *Snow White and the Seven Dwarfs* (1937)
http://www.filmsite.org/snow3.html


Reuters News (2011 May 18). Ex-Enron CFO moved to halfway house from prison. Retrieved from Factiva Document LBA0000020110518e75i000wl


Wilson, D., Hickson, D. J., & Miller, S. J. (1999). Decision overreach as a reason for failure: How organizations can overbalance. H. K. Anheier (Ed.), When things go wrong:


Legal References

Am Jur 2d, Corporations s 1475 (Currency Date: July 22, 2010) (WL Can)


Findlaw.com, Minutes of a meeting of the Audit and Compliance Committee of the Board of Directors of Enron Corp. Online: Enron Audit Committee Meeting Minutes February 12, 2001 <http://news.lp.findlaw.com/hdocs/docs/enron/audcomp021201min.pdf>

Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub L No 111-203, 124 Stat 1376

Larimo (1995) and Molloy’s (1995) discussion of the phases in Mintzberg, Raisinghani, & Théorêt’s (1976) model are discussed in this chapter to illuminate the stages of the decision making process. Larimo concentrates on the identification, development, and selection phases regarding Foreign Direct Investments (FDIs) in the decision process of five foreign manufacturing investments made by Finnish firms. Molloy studied the IT effects on specific phases of decision making in four companies. Both researchers refer to descriptions from Mintzberg, Raisinghani, and Theoret (1976) framework, and both of their valuable contributions are appropriate for this study to assess the effects of information flow on groups during the decision making process at Enron.

The terms in the strategic decision making process are defined as the following by Mintzberg, Raisinghani, and Theoret (1976):

A decision as a specific commitment to action (usually a commitment of resources) and a decision process as a set of actions and dynamic factors that begins with the identification of a stimulus for action and ends with the specific commitment to action. Unstructured refers to decision processes that have not been encountered in quite the same form and for which no predetermined and explicit set of ordered responses exists in the organization. And strategic simply means important, in terms of the actions taken the resources committed, or the precedents set (Mintzberg, Raisinghani, & Théorêt, 1976, p.246).

In order to exemplify the Board’s decision making process and map information flow at Enron, the red flag events which relate to Fastow’s compensation and disclosure issues illustrated based on Mintzberg, Raisinghani, & Théorêt’s model. Details regarding the specifics of Fastow’s compensation and disclosure issues are discussed in theme three in the Data analysis chapter. Research by Larimo (1995) and Molloy (1995) were used in order to clarify and provide
explanations for the stages in Mintzberg, Raisinghani, & Théorêt’s model and this helped to apply the example of Fastow’s compensation disclosure issues to the decision making process using Mintzberg, Raisinghani, & Théorêt’s model. This example of Fastow’s compensation disclosure issues was selected since it appeared to be the best example for the final and most important theme, *decision protocol and policies shaped the information that management sent to the Board during the approval process.*

In Mintzberg, Raisinghani, and Theoret (1976) model there are three phases in a strategic decision process: “identification, development and selection” (Mintzberg, Raisinghani, & Théorêt, 1976, p.252). Mintzberg et al., explain that these three phases consist of “seven central ‘routines’” (Mintzberg, Raisinghani, & Théorêt, 1976, p.252).

**Phase 1, Identification**

The two routines in the identification phase are “decision recognition and diagnosis (Mintzberg, Raisinghani, & Théorêt, 1976, p. 252-253). The first routine is decision recognition which “consists of opportunity, problem of crisis recognition, and decision activity evocation” (Larimo, 1995, p.32). Molloy describes decision recognition as when “opportunities, problems and crises are recognized and evoke decisional activity” (Molloy, 1995, p.286). For Enron, one of the examples relates to Fastow’s compensation disclosure. The decision recognition of the groups of advisors and management involved in this decision making process recognized that the company proxy statements required disclosure by a specific deadline. Larimo summarizes the second routine, diagnosis, as when “management seeks to comprehend the stimuli evoked and determine cause-effect relationships for the decision situation, Information need for the evoked situation will be analyzed, and information acquisition and the sources of information planned” (Larimo, 1995, p.32). Molloy describes the diagnosis stage as when “information is gathered to clarify and define the issues” (Molloy, 1995, p.286). For this Enron example, management would request guidance from advisors in this diagnosis stage regarding the information which must be disclosed in the proxy statement which concerned Fastow’s interest in the LJM entities based on the SEC regulations.

**Phase 2, Development**
Larimo describes the two routines, search and design, which constitute this development phase: “Search is evoked to find ready-made solutions for the situation. Mintzberg et al. isolate four types of search behavior that vary from an active searching for alternatives to a passive waiting for unsolicited alternatives” (Larimo, 1995, p.32). Molloy describes this search routine as when the “organization decision makers employ a number of search activities to discover alternative solutions to problems” (Molloy, 1995, p.286). Continuing with this example, Enron’s in-house legal counsel requested advice from Vinson & Elkins lawyers to assess alternative ways to not disclose Fastow’s complete interest in LJM allowable in the parameters of the law. Larimo describes the second design routine in the development phase as when “the firm strives to develop alternatives by itself or it modifies a "ready-made" solution. Because the development phase consists of routines that lead to the development of one or more solutions to the situation, this phase can be regarded as being at the heart of the decision-making process according to Mintzberg et al” (Larimo, 1995, p.32). Molloy describes this design routine as when “ready-made solutions that have been identified are modified to fit the problem or new solutions are designed” (Molloy, 1995, p.286). Legal advisors devised a way to conceal Fastow’s interest in LJM based on the interpretation of a specific phrase in legislature to accommodate the concealment of Fastow’s financial information; details are discussed in the data analysis chapter. This best describes the design routine to show the way that the legal advisors investigated solutions to cater to the needs of management.

**Phase 2, Selection**

Larimo describes the three routines, screening, evaluation-choice, and authorization, which constitutes the selection phase (Larimo, 1995, p.32). The first routine, the screen routine “is evoked when search has generated more ready-made alternatives than can be intensively evaluated. Screening is used to reduce the alternatives to a number that can be stored and later handled by time-constrained decisionmakers” (Larimo, 1995, p.32). Molloy describes the screen routine as “a superficial routine designed to eliminate infeasible alternatives rather than determine what is appropriate” (Molloy, 1995, p.286). Legal advisors could have opted for full disclosure of Fastow’s financial details which would have been the appropriate course of action and fulfilled the reason for the disclosure process. Instead, legal advisors opted to circumvent these requirements by the creative use and interpretation of language to support management’s
interests above offering the complete information disclosure for shareholders. Larimo describes the evaluation-choice routine “to investigate the feasible alternatives and to select a course of action. The largest part of the literature on the strategic decision process has focused on the evaluation-choice routine. According to the findings of Mintzberg et al. this routine seemed to be far less significant in many of the decision process routines than the diagnosis or design routines” (Larimo, 1995, p.32). Molloy explains the evaluation-choice routine as when “an alternative is chosen through a process of judgement, bargaining, and/or analysis” (Molloy, 1995, p.286). Legal advisors went through a decision making process to assess the options regarding Fastow’s compensation disclosures which best benefited Fastow. In doing so, it was not best for shareholders, since information was not complete in the disclosure as a result of this decision. The final routine for the selection phase is authorization, and Larimo described it as “used when the individual making the choice does not have the authority to commit the organization to a course of action” (Larimo, 1995, p.32). Molloy shows that in the authorization routine “when the individual making the decision does not have the authority to commit the organization to a course of action, the decision moves up the organizational hierarchy until it reaches a level at which the necessary authority resides” (Molloy, 1995, p.287). By examining the authorization stage in Enron’s decision making process, the authorization routine does not apply in a typical, structural, manner at Enron. Appendix A offers an example for the way in which the information flow and decision making moved through these groups at Enron for Fastow’s compensation disclosure approval. Fastow requested advice from in-house legal counsel regarding a way to avoid disclosure. These legal advisors requested assistance from Vinson & Elkins to offer an alternative option. Prior to the publication of proxy statements, disclosures must be approved by committees and the Board of Directors. These Directors depended on the same legal advisors and auditors to review the content and offer their approvals. At this point, auditors confirm the appropriateness of the disclaimers. The information flow returns to a passive Board to approve the disclaimers based on the advice of legal counsel. The disclosures are released in the proxy statements. In this case, the Board was the final group to approve the disclosures and is considered the authorization in theory and in formal decision protocol. However, examined closely, management, particularly Fastow, had the most influence over this decision making process. It was Fastow’s interests that were most protected by legal counsel since these advisors perceived management as their client. This example demonstrates
the difference between the authorization of the Board in its formal decision protocol process, in contrast to the reality of management in control of the information flow and ultimately the results of the decision making process: “The decision must follow a tiered route of approval up the hierarchy and perhaps also out to parties in the environment that have the power to block it” (Mintzberg, Raisinghani, & Théorêt, 1976, p.259). Legal advisors had the ability to influence the decisions of the Board of Directors and support the interests of individuals in management, in this case Fastow. To illustrate this decision making process, Fastow’s Compensation Disclosure Issues is described via Stages of the Identification, Development, and Selection Phases in this Appendix A, Table 1 and Figure 1 in the Strategic Decision Making Process based on Mintzberg, Raisinghani, & Théorêt’s model (1976) in Appendix A of this Thesis. In addition, Fisher’s Model for the Audit Profession’s Self-Regulation, Through Peer Review (Fisher, 2010, p.1524) is included in Appendix A, Figure 2 and then adapted to map the information flow among groups at Enron: management, advisors and the Board in this case study in Appendix A, Figure 3.

The three central phases in the strategic decision process in Mintzberg, Raisinghani, & Théorêt’s includes three sets of routines: decision control routines, decision communication routines, and political routines (Mintzberg, Raisinghani, & Théorêt, 1976, p. 260-263). Each routine has a distinct purpose in the decision process. Larimo describes the way that Decision control routines “guide the decision process itself. Faced with a decision situation, not only does the decision-maker execute the steps leading to a solution, but also plans the approach and allocates organizational resources to get there” (Larimo, 1995, p.32). Based on this definition, true decision control routines involve a decision-maker with the autonomy in the organization to plan for both short and long term scenarios. In doing so, the ability to guide the decision process may also be related to the opportunity for the decision maker to control organizational resources, which may include information. Larimo explains that “Decision control activities are difficult to study because they tend to be implicit and informal, taking place in the mind of the decision-maker, and they tend not to leave tangible traces” (Larimo, 1995, p.32). This refers to Mintzberg, Raisinghani, & Théorêt’s claim that “the best trace of the completed process remains in the minds of those people who carried it out” (Mintzberg, Raisinghani, & Théorêt, 1976, p.247). However, evidence of the exact decision process used by the decision maker is unattainable in
this manner, and relying on memory may have disadvantages: “Tapping the memories of the decision makers could introduce two forms of error, distortion and memory failure” (Mintzberg, Raisinghani, & Théorêt, 1976, p.248). It may be possible to use the results of these decisions to trace back to the original options which were presented to the decision maker. For example, in this case, Fastow’s compensation disclosure was published; so therefore, the decision to omit information was documented and the groups in power to make that decision were noted in memo and e-mail correspondence. However, as Larimo explains, the entire decision process is not formally documented in memos and Board meeting minutes. The drafts of the disclosures may not reflect all of the stages of disclosure development. Information may be communicated in ways that did not identify all parties involved in this decision making process, for example, via e-mail correspondence. Certainly all of the factors which influence the decision maker may not be tangible, which include “dynamic factors that influence the decision making process” (Mintzberg, Raisinghani, & Théorêt, 1976, p.263-266) and are addressed later in this chapter.

Larimo describes the purpose of the Decision communication routines to “provide the input and output information necessary for maintaining decision-making” (Larimo, 1995, p.32). Three communication routines (Mintzberg, Raisinghani, & Théorêt, 1976, p. 261) are involved in this information flow process. The first is the exploration routine which “involves the general scanning for information and passive review of unsolicited material” (Larimo, 1995, p.32). The exploration routine may be shown by the assessment of voluminous information sent to the Board of Directors. In this way, the communication of excessive information without clear purpose may be assessed by the Board in a passive manner since specific communication was not requested from management. Rather, information regarding unrelated matters was sent to the Board for review in addition to specific disclaimers that were buried under incomprehensible language. This combined with a short time to review the information may have caused a passive review of information which is mentioned in decision making theory research: “It is more likely that speed in the overreach decisions allowed vital information to be overlooked or insufficiently considered” (Wilson, Hickson, & Miller, 1999, p.45).

The key point is that this act of scanning and passively reviewing the information by the Board was a response to the large amount of general information that engulfed the details which required more attention. Larimo describes the investigation routine as it “involves the focused
search for and research of special purpose information” (Larimo, 1995, p.32-33). The investigation routine may be shown by the way that in-house legal counsel requested specific information from Vinson & Elkins regarding ways to work within the SEC regulations but to also omit details which concerned Fastow’s financial interest in the LJM transactions. Legal advisors investigated ways to best produce solutions to support the decision to omit these financial details. The dissemination of the information is the third communication routine (Mintzberg, Raisinghani, & Théorêt, 1976, p.262). The disclosures for Fastow’s compensation for these LJM transactions omitted specific financial details and this information was disseminated in Enron’s proxy statement to the shareholders. Larimo refers to the way that political activities are described in Mintzberg, Raisinghani, & Théorêt’s framework:

Political activities reflect the influence of individuals who seek to satisfy their personal and institutional needs by the decisions made in an organization. These individuals, who may be inside or outside the organization, are tied to the decision process by their belief that they will be affected by the outcome. Their political activities serve to clarify the power relationships in the organization or they can help to bring about consensus and to mobilize forces for the implementation of decisions. (Larimo, 1995, p.33)

The legal counsel that assisted with the omission of specific information from this disclosure used their legal expertise to benefit individuals in management. Even though shareholders contribute to the existence of the company, they do not have a direct relationship with the company’s advisors. This example demonstrates that the interests of management were the priority for these legal advisors. In-house legal counsel and consultants are compensated by the organization, in this case Enron. Legal advisors have a direct interest in their relationship with management, and their clients’ interests are their priority. The reality is that these processes may not be as systematic and clear as they are defined in theory: “Strategic decision processes are often presented as a steady, undisturbed process. In practice the situation is often quite different. According to the findings of Mintzberg et al. most decision processes were unsteady, disturbed processes” (Larimo, 1995, p.33).
Larimo describes the six dynamic factors in Mintzberg, Raisinghani, & Théorêt’s model which “affect the decision process (p. 263-266)” (Larimo, 1995, p.33) as follows: “(1) interruptions, which were caused by environmental forces; (2) scheduling delays, because managers were severely time-constrained; (3) feedback delays, as the decision-maker awaits the results of the previous action taken; (4) timing delays and speed-ups; where managers may speed up or delay a decision on purpose to take advantage of special circumstances, to await support of better conditions, etc.; (5) comprehension cycles, within one routine or between two routines in order to comprehend the issue; and (6) failure recycling; where the proposed solution is for some reason not accepted” (Larimo, 1995, p.33). These factors may be identified in Fastow’s compensation disclosure regarding the role of the Board of Directors decision to approve the final disclosures. Timing delays and speed-ups may have been used to speed up an approval since the proxy statements were scheduled to be released by a specific deadline and the issue of timing was used to support the omission of information these disclosures. The timing and the criteria details regarding these disclosures are described in the Data Analysis chapter. However, this example of Fastow’s compensation disclosure issues shows the way that legal counsel advised management to successfully use timing to “take advantage of special circumstances” (Larimo, 1995, p.33). This disclosure was approved with omitted financial details which concerned Fastow’s interest in the LJM transactions and is an example of the way a dynamic factor, in this case timing delays and speed-ups, affected the decision process. The result of this Board approval was that Fastow’s details regarding his compensation were not completely disclosed in Enron’s proxy statement.

According to Mintzberg, Raisinghani, & Théorêt: “Faced with no acceptable solution, the decision maker may simply delay until one appears or he may change his criteria so that a solution previously rendered unacceptable becomes acceptable. A more typical finding in our study, however, is that organizations faced with failure in finding or designing an acceptable solution cycle back to the development phase” (Mintzberg, Raisinghani, & Théorêt, 1976, p.266). The groups involved in the decision making process for Fastow’s compensation disclosures did not cycle back to this development phase. Instead, legal advisors used their expertise to manipulate the language so that it technically fit criteria. The proxy statement was published with disclosures which may not have been thoroughly assessed by the Board; however, the content was approved and technically acceptable. The information flow shows that the
decision makers did not cycle back to the development phase. Instead, groups involved in the decision making process ignored the “red flags” which were presented to them during this decision making process regarding Fastow’s compensation disclosures.

Choo’s Process Model of Strategic Decision Making (adapted from Mintzberg et al. 1976, Choo, 2006, p.216) examines the way: “a decision is framed (recognized and diagnosed in the identification phase) and how the alternatives are searched or designed (in the development phase) have major impact on the quality of the decision outcome” (Choo, 2006, p.220). MacIntosh-Murray & Choo suggests the use of the following questions as a guide to map the flow of information in the decision making process:

One approach could be to devise an inventory of the risk or hazard information sources and how they are being used in the organization. Questions to consider in mapping the flow of information about adverse events and risks include: What are the patterns of information dissemination? What are the boundaries that impede the flow? What sources are commonly used and by whom? (MacIntosh-Murray & Choo, 2002, p.247-248)

Based on MacIntosh-Murray & Choo’s questions above, this study may examine the patterns of information dissemination and flow within Enron, the restrictions which impede the information flow, the sources of the “red flag” events, and seek to identify if the groups use and respond to this information related to the “red flags” based on the text from the documentary sources. If identified, the “red flag” events which led up to Enron’s collapse could have signalled to the groups involved in the decision making processes, that they were required to approve arrangements under increased pressure. Based on Mintzberg, Raisinghani, & Théorêt’s framework, these groups assessed decisions which may have been considered at the extreme end of the decision spectrum: “Decisions may be categorized by the stimuli that evoked them along a continuum. At one extreme are opportunity decisions, those initiated on a purely voluntary basis, to improve an already secure situation, such as the introduction of a new product to enlarge an already secure market share. At the other extreme are crisis decisions, where organizations respond to intense pressures” (Mintzberg, Raisinghani, & Théorêt, 1976, p.251). The red flag events could have signalled to these groups that the decisions related to arrangements, such as
Fastow’s compensation disclosure issues, was indicative of a “crisis decision” (Mintzberg, Raisinghani, & Théorêt, 1976, p.251). Fastow’s disclaimer example is symptomatic of an existing problem of organizational structure at Enron, which supported the interests of management over the best interest of the company as a whole. It showed Enron’s negligence to protect the interest of its shareholders and the inability of groups to recognize these red flags, made them even less perceptive to “problem decisions defined as those that fall in between, evoked by milder pressures than crises” (Mintzberg, Raisinghani, & Théorêt, 1976, p.251). If these groups were unable to respond to red flags identified as “high crises” (Mintzberg, Raisinghani, & Théorêt, 1976, p.251), the Board may have missed warnings with milder signals and these “problem decisions” (Mintzberg, Raisinghani, & Théorêt, 1976, p.251) may not have been considered by the Board.

The members that do not have an invested interest in the outcome of the decision or the result does not affect them, may be less motivated to prompt the decision, or “the moment of action” (Mintzberg, Raisinghani, & Théorêt, 1976, p.253). According to Mintzberg et al. this is determined by “the relationship between the cumulative amplitude of stimuli and an action threshold” (Mintzberg, Raisinghani, & Théorêt, 1976, p.253). For the scenario of Fastow’s compensation, a number of the factors identified by Mintzberg, Raisinghani, & Théorêt apply to each stimulus.

1. The first factor involves the source of the stimuli, or “the influence of its source” (Mintzberg, Raisinghani, & Théorêt, 1976, p.253) may be that Fastow asked legal counsel for ways to omit his complete LJM interest from the disclosures. Fastow’s authority prompted advisors to seek information from Vinson & Elkins to accommodate his request.
2. The second factor involves “the interest of the decision maker in it” (Mintzberg, Raisinghani, & Théorêt, 1976, p.253), legal counsel had an interest to provide information to management due to their lucrative compensation arrangements for their services.
3. The third factor consists of “the perceived payoff of taking action” (Mintzberg, Raisinghani, & Théorêt, 1976, p.253) and is demonstrated by the published disclaimers in the proxy statement due to the actions of legal counsel. Enron’s advisors found a way to technically comply with the regulations, omit Fastow’s financial details and obtain official approval from the Board.
4. The fourth factor “the uncertainty associated with it” (Mintzberg, Raisinghani, & Théorêt, 1976, p.253) may not have been as influential a factor since Enron’s legal
advisors were aware that the Board also relied on them for advice. Legal advisors were aware that the information that they provided to the Board would affect its approval.

5. The fifth and final factor was not applicable, since it involved “the perceived probability of successful termination of the decision” (Mintzberg, Raisinghani, & Théorêt, 1976, p.253). This factor was not an option, since Fastow’s compensation disclosure decision involved a clear SEC regulation deadline by which the information had to be published in the company proxy statement.

The groups in the decision making process with the ability to shape and omit this information may be perceived as powerful to an extent. However, as shown by this example using Fastow’s compensation disclosure approvals, by mapping the information flow used by the groups, this revealed the groups with the most independence in this organizational structure. The members with the most autonomy communicated their goals (in this case, Fastow did not want his interest in LJM disclosed), and used the expertise of dependent groups to achieve these goals (legal counsel found a way to omit the information from the disclosure). This ability to influence groups in the decision making process was indicative of the ways that access to information was used as a source of power: “It is argued that while sources of power may be structurally embedded, merely possessing information or expertise does not in itself make a person powerful — rather, power is a phenomenon that is negotiated in relationships through the skills and strategies of interested actors. In contemporary conceptualizations, then, power and influence are seen not so much as what one has, but what one does with what one has (Foucault 1980; Knights and McCabe 1999)” (Maitlis, 2004, p.1280). Based on this premise, the information access of groups influenced their level of independence in Enron’s decision making process.

Figure 1. Source: (Mintzberg, Raisinghani, & Théorêt, 1976, p. 266).
Table 1. Fastow’s Compensation Disclosure Issues Described via Stages of the Identification, Development, and Selection Phases in the Decision Making Process based on Mintzberg, Raisinghani, & Théorêt’s model (1976)

| Decision | Groups of advisors and management that were involved in this decision making process realized that the company proxy statements requires disclosure by a specific deadline |

Appendix A. Figure 1. A General Model of the Strategic Decision Making Process (Mintzberg, Raisinghani, & Theoret, 1976, p.266).
| Diagnosis | Management would request guidance from advisors in this diagnosis stage regarding the information which must be disclosed in the proxy statement concerning Fastow’s interest in the LJM entities based on the SEC regulations |
| Search | Legal counsel requested advice from Vinson & Elkins lawyers to assess alternative ways to not disclose Fastow’s complete interest in LJM allowable in the parameters of the law. |
| Design | Legal advisors devised a way to conceal Fastow’s interest in LJM based on the interpretation of a specific phrase in legislature to accommodate the concealment of Fastow’s financial information |
| Screen routine | Legal advisors could have opted for full disclosure of Fastow’s financial details which would have been the appropriate course of action and fulfilled the reason for the disclosure process. Instead, these legal advisors opted to circumvent these requirements by the creative use and interpretation of language to support management’s interests above information disclosure to shareholders. |
| Evaluation-choice routine | Legal advisors went through a decision making process to assess the options regarding Fastow’s compensation disclosures which best benefited Fastow. In doing so, it was not best for shareholders, since information was not complete in the disclosure as a result of this decision. |
Authorization

This authorization stage demonstrates the barriers to Enron’s decision making process. In reality, authorization did not apply in a typical, structural, manner at Enron. Perhaps in theory but certainly not in practice. This example shows the way in which the information flow and decision making moved through these groups at Enron for Fastow’s compensation disclosure approval. Fastow requested advice from in-house legal counsel regarding a way to avoid disclosure. These legal advisors requested assistance from Vinson & Elkins to offer an alternative option. Prior to the publication of proxy statements, disclosures must be approved by committees and the Board of Directors. These Directors depended on the same legal advisors and auditors to review the content and offer their approvals. At this point, auditors confirm the appropriateness of the disclaimers. The information flow returns to a passive Board to approve the disclaimers based on the advice of legal counsel. The disclosures are released in the proxy statements. In this case, the Board was the final group to approve the disclosures and is considered the authorization in theory and in formal decision protocol. However, examined closely, it is clear that management, particularly Fastow, had the most authorization in practice in this decision making process. It was Fastow’s interests that were most protected by legal counsel since management is perceived by advisors as the client. Therefore, this example demonstrates the difference between the authorization of the Board in its formal decision
protocol process, in contrast to the reality of management in control of the information flow and ultimately the results of the decision making process.

Fisher’s Model: *The Audit Profession’s Self-regulation, through Peer Review* (Fisher, 2010, p.1524) shows negotiation between groups: auditors, management and the Audit Committee. By adapting Fisher’s model, Figure 3 shows the information flow among groups at Enron: management, advisors and the Board in this case study.

![Diagram of Audit Profession’s Self-regulation](image)

Figure 2: Model for the Audit profession’s self-regulation, through peer review (Fisher, 2010, p.1524)
Advisors, “weakened by conflict of interest, with peer review providing no effective counterweight to this influence” (Fisher, 2010, p.1524), request advice from V&E

Passive Board of Directors relies on Advisors

Information exchange to identify options re: omit details from Enron’s disclosure request from Fastow to In-House Legal Advisors

“In this case, Fastow is “biased by conflicting interest” (Fisher, 2010, p.1524) in reporting compensation details for LJM entities in disclosures re: Enron’s Proxy Statements.

Board obtains approvals from legal counsel/advisors

Board Decision to approve content of disclaimers based on advisor support of content

Approval “ends with the specific commitment to action” (Mintzberg, Raisinghani, & Théorêt, 1976, p.246).

Proxy Statement Disclosure released in Proxy statement

Adaptation of Fisher’s Model of the Audit profession’s self-regulation, through peer review (Fisher, 2010, p.1524) used text and labels from Figure 2 to create this diagram to show the Enron example.

Figure 3: Information flow in the Decision Making Process for Fastow’s Compensation Interest Proxy Statement Disclosures
Appendix B

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Audit Committee Told Enron accounting practices “push limits”</td>
</tr>
<tr>
<td>2</td>
<td>Board approves Fastow’s Code of Conduct waiver for LIMJ</td>
</tr>
<tr>
<td>3</td>
<td>Whitewing moved off-balance sheet with $1.5 billion</td>
</tr>
<tr>
<td>4</td>
<td>Board approves second Fastow waiver for LJM2</td>
</tr>
<tr>
<td>5</td>
<td>LJM2 update: “Q419999: 8 days/6deals/$125 million”; 2 billion in funds flow to Enron; board approves Raptor I</td>
</tr>
<tr>
<td>6</td>
<td>Executive Committee approves Raptor II</td>
</tr>
<tr>
<td>7</td>
<td>‘Project Summer’ to sell $6 billion in assets fails; Board approves Raptor III/IV</td>
</tr>
<tr>
<td>8</td>
<td>Board approves third Fastow waiver for LJM3; Board told $27 billion in assets off-balance sheet</td>
</tr>
<tr>
<td>9</td>
<td>Board told total revenues jump from $40 billion in 1999 to $100 billion in 2000; Audit and finance committees review LJM procedures and FY2000 transactions</td>
</tr>
<tr>
<td>10</td>
<td>Fortune article questions Enron’s earnings and accounting</td>
</tr>
<tr>
<td>11</td>
<td>Board told $64% of international asset portfolio ‘troubled’ or ‘not performing’; 45 million Enron shares at risk in Raptors and Whitewing</td>
</tr>
<tr>
<td>12</td>
<td>Board told of $2.3 billion deficit in market value of Enron’s international assets</td>
</tr>
<tr>
<td>13</td>
<td>Fastow sells interest in LJM to Kapper</td>
</tr>
<tr>
<td>14</td>
<td>Skilling resigns; Finance Committee told of $6.6 billion in prepay and FAS 125 transactions</td>
</tr>
<tr>
<td>15</td>
<td>Lay defends use of SPEs in online session with employees</td>
</tr>
<tr>
<td>16</td>
<td>Finance Committee told of $800 million earnings write-down from Raptors; Audit Committee told of closed investigation into the Watkins letter.</td>
</tr>
</tbody>
</table>
ROBERT A. BALFET, 65
Director since 1983
Mr. Balfet's principal occupation is Chairman and Chief Executive Officer of Belfco Oil & Gas Corp., a company formed in 1992. Prior to his resignation in April 1996 from Belfco Petroleum Corporation (“BPC”), a wholly owned subsidiary of Enron, Mr. Balfet served as President and then Chairman of BPC.

NORMAN P. BLAKE, JR., 59
Director since 1992
Mr. Blake is the former Chief Executive Officer and Secretary General of the United States Olympic Committee from December 1998 until November 1999. Mr. Blake served as Chairman, President and Chief Executive Officer of the Forum Hotel Corporation when it merged with the Hilton Hotels Corporation. From November 1989 until May 1990, he served as Chairman, President and Chief Executive Officer of Companies. Mr. Blake is also a director of Owens-Corning Corporation.

RONNIE C. CHAN, 51
Director since 1996
For the past ten years, Mr. Chan has been Chairman of Hong Kong-based companies involved in property development, property investment and hotels. Mr. Chan also co-founded and is a director of various companies within Mingnongmer/Spingfield Group, which invests in and manages private companies in the manufacturing and service businesses, and engages in financial investments. Mr. Chan is also a director of Standard Chartered Bank PLC and Matsuriko, Ltd.

JOHN H. DUNCAN, 73
Director since 1985
Mr. Duncan’s principal occupation has been investments since 1990. Mr. Duncan is also a director of EOTT Energy Corp. (the general partner of EOTT Energy Partners, L.P.), Arurix Corp. and Group 7 Automotive Inc.

WENDI L. GRABB, 56
Director since 1993
Dr. Grab is an economist and Director of the Regulatory Studies Program of the Mercatus Center at George Mason University. From February 1998 until January 1993, Dr. Grab served as Chairman of the Commodity Futures Trading Commission in Washington, D.C. Dr. Grab is also a director of IFP, Inc., State Farm Insurance Co. and Invesco Funds. Dr. Grab was also a director of the Chicago Mercantile Exchange until December 31, 1999.

KEM L. HARRISON, 56
Director since 1997
Mr. Harrison served as Chairman, the Board and Chief Executive Officer of Portland General Electric Company from 1988 to March 1998, at which time he retired from Portland General Electric Company. Additionally, Mr. Harrison served as Chairman of Enron Communications, Inc. from its inception in 1994 through November 1999 and as a Vice Chairman of Enron from July 1997 to July 1999.

ROBERT E. JEDICK, 72
Director since 1995
Dr. Jedick is Professor (Emeritus) of Accounting at the Stanford University Graduate School of Business in Stanford, California. He has been on the Stanford University faculty since 1981 and served as Dean from 1985 until 1990. Dr. Jedick is also a director of California Water Service Company. Dr. Jedick was also a director of GenCorp, Inc. until July 2000 and Boise Cascade Corporation until April 2001.

KENNETH L. LAY, 58
Director since 1985

U.S. Senate Permanent Subcommittee on Investigations
EXHIBIT #46
Mr. Lay has been Chairman of the Board of Enron since 1986. From 1986 until February 12, 2001, Mr. Lay was also the Chief Executive Officer of Enron. Mr. Lay is also a director of Eli Lilly and Company, Compaq Computer Corporation, EOTT Energy Corp. (the general partner of EOTT Energy Partners, L.P.), i2 Technologies, Inc., NewPower Holdings, Inc. and Austin Corp.

CHARLES A. LEHMAN, 77
Director since 1985
Cancer Center in Houston, Texas and now holds the position of President Emeritus.

JOHN MENDOLOSH, 66
Director since 1999
Since July 1996, Dr. Mendoleson has served as President of the University of Texas M.D. Anderson Cancer Center. Prior to 1996, Dr. Mendoleson was Chairman of the Department of Medicine at Memorial Sloan-Kettering Cancer Center in New York. Dr. Mendoleson is also a director of InMune Systems, Inc.

JEROME J. MEYER, 63
Director since 1997
For over eight years, Mr. Meyer served as Chairman and Chief Executive Officer of Tektronix, Inc., an electronics manufacturer located in Wilsonville, Oregon. Currently, Mr. Meyer serves as Chairman and as a director of Tektronix, Inc. He is also a director of Standard Insurance Corp. and Canesapian Communications, Inc.

RAFAEL V. FERNAL PEREIRA, 46
Director since 1999
Mr. Pereira is Executive Vice President of Group Banesa. Mr. Pereira served for over five years as President and Chief Operating Officer of Residencial Financial Group and Managing Director of Group Banesa. Mr. Pereira is also the former President and Chief Executive Officer of the State Bank of Rio de Janeiro.

FRANK SAVAGE, 62
Director since 1999
Since 1993, Mr. Savage has served as Chairman of Alliance Capital Management International (a Martin Corporation, Alliance Capital Management L.P. and Qualcomm Corp.

JEFFREY E. SKILLING, 47
Director since 1997
Since February 2001, Mr. Skilling has served as President and Chief Executive Officer of Enron. Mr. Skilling served as President and Chief Operating Officer of Enron from January 1997 through February 2001. From August 1990 until December 1996, he served as Chairman and Chief Executive Officer of Enron North America Corp. and its predecessor companies. Mr. Skilling is also a director of Aurora Corp. and the Houston Branch of the Federal Reserve Bank of Dallas.

JOHN A. URGHART, 72
Director since 1990
Mr. Urganht serves as Senior Advisor to the Chairman of the Board of Enron. From 1991 to 1996, Mr. Urganht served as a Vice Chairman of Enron. Since August 1981, Mr. Urganht has also been President of John A. Urganht Associates, a management consulting firm in Fairfield, Connecticut. He also serves as a director of TCB Energy, Inc., as well, Inc. and The Heit Group, Inc. and as a board member of and consultant to Catalytic Energy Systems, Inc.

JOHN WAREHAM, 68
Director since 1994
Lord Wehman is a retired former U.K. Secretary of State for Energy and Leader of the House of Commons and Lords. He served as a Member of Parliament from 1974 until his retirement from the House of Commons in April 1992. Prior to his government service, Lord Wehman managed a large private practice as a chartered accountant. He is currently Chairman of the Fraser Complaints Commission in the U.K. and chairman or director of a number of publicly traded U.K. companies. Lord Wehman is also a director of Aurora Corp.

HUBERT S. WINDSOR, JR., 57
Director since 1985
Mr. Windsor is Chairman and Chief Executive Officer of Capricorn Holdings, Inc. (a private investor in and Managing General Partner of Capricorn Investors, L.P., Capricorn Investors II, L.P. and Capricorn Investors III, L.P., partnerships concentrating on investments in restructure situations, organized by Mr. Windsor in 1987, 1994 and 1999, respectively. Since 2000, Mr. Windsor has also served as Nonexecutive Chairman of Austin Corp. Prior to his current appointment, Mr. Windsor was Senior Executive Vice President and a director of Pan Central Corporation, the MFC Group Ltd., Mrs. Fields' Holding Company, Inc., Odd Information Services Group, Inc. and DynCorp.)
Corporate Governance Guidelines
of
The Board of Directors
of
Enron Corp.

The business and affairs of Enron Corp. ("Enron"), an Oregon corporation, are managed under the direction of its Board of Directors (the "Board") in accordance with the provisions of the Oregon Business Corporation Act and Enron's Articles of Incorporation and Bylaws.

In discharging its responsibilities to Enron and to Enron's shareholders, the Board performs the following principal functions:

a) ensuring legal and ethical conduct by Enron and its officers and employees;
(b) selecting, compensating, and evaluating Directors and evaluating Board processes and performance;
(c) selecting, compensating, evaluating, and, when appropriate, replacing senior executives of Enron and ensuring that a succession plan is in place with respect to such senior executives;
(d) approving Enron corporate strategy;
(e) approving major management initiatives; and
(f) providing general oversight of Enron's business.

These activities are performed in cooperation with Enron's Chief Executive Officer and Enron's Chief Operating Officer. The Board also has complete access to other senior management of Enron to ensure that it is supplied with sufficient and adequate information to keep it informed with respect to Enron's business affairs.

Ensuring Legal and Ethical Conduct

The Board approves the Enron Conduct of Business Affairs policy, which imposes on each officer and employee of Enron the duty of conducting the business affairs of Enron in accordance with all applicable laws and in a moral and honest manner. The Audit and Compliance Committee provides reasonable assurance that the provisions of the Enron Conduct of Business Affairs policy are observed.

Criteria to Qualify as an Independent Director

For the purposes of these guidelines, a Director or potential Director is considered to be independent if he or she has been determined by the Nominating and Corporate Governance Committee to be independent after taking into consideration such individual's activities and relationships with
Enron and any and all other factors that such Committee deems relevant to make such determination.

Number of Directors

The Board believes that its appropriate size is approximately 14 -17 but recognizes that, upon the recommendation of the Nominating and Corporate Governance Committee, it may be appropriate from time to time to modify its size in light of then current circumstances.

Criteria for Selection of Director Candidates

The Board selects Director candidates that it believes will enhance the quality of its deliberations and decisions. The Nominating and Corporate Governance Committee is responsible for establishing criteria for Board membership. It includes among the factors it considers in evaluating potential Director candidates the qualities of strength of character, an inquiring and independent mind, practical wisdom, and mature judgment, and it periodically reviews membership criteria with the Board.

Mix of Independent and Non-Independent Directors

The Board believes that Enron’s Chief Executive Officer and Enron’s Chief Operating Officer should usually be members of the Board but that a majority of the Board should be comprised of independent Directors. Accordingly, although the Board believes it may be appropriate from time to time for one or more additional officers of Enron to be elected to the Board, no such officer should expect to be elected to the Board simply by virtue of his or her position with Enron.

Selection of Board Members

The Nominating and Corporate Governance Committee, in consultation with Enron’s Chief Executive Officer, is responsible for identifying and screening potential Director candidates, for determining their independence, and for recommending them to the Board for its approval. Following the Board’s approval of a candidate, the invitation to join the Board is extended to the candidate by Enron’s Chief Executive Officer or by such other Director as the Board may specify.

Orientation of New Directors

Each new Director is oriented in respect of Enron and his or her duties as a Director through a program administered by Enron’s Corporate Secretary. The program includes background briefings by Enron’s Chief Executive Officer, Enron’s Chief Operating Officer, and other senior Enron executives.
Director Compensation

Enron management reports periodically to the Compensation and Management Development Committee on the status of the existing Board compensation program relative to the board of directors compensation programs of those companies that are believed to be comparable to Enron. The Compensation and Management Development Committee is responsible for approving for recommendation to the Board annual retainer fees for Directors and meeting fees for Board and Board committee meetings and for approving the terms and awards of stock compensation for Directors.

Lead Director

The Board, upon recommendation of the Nominating and Corporate Governance Committee, designates one of its independent Directors as the Lead Director. The Lead Director is responsible for chairing all executive sessions of the independent Directors and has such other responsibilities as may be assigned to such Director from time to time by the Board.

Assessment of Director Performance and Board Procedures

The Nominating and Corporate Governance Committee is responsible for conducting, on an annual basis, an assessment of the performance of each Director. Such Committee is also responsible for assessing the effectiveness of the processes used by the Board and for recommending to the Board for its consideration any changes to the responsibilities, organization, and membership of existing standing Board committees and the creation of any new standing Board committees.

Director Attendance at Meetings

Each Director is expected to attend all Board meetings and all Board committee meetings of which the Director is a member. The Board recognizes that from time to time conflicts may arise that prevent one or more Directors from attending a regularly scheduled meeting of the Board or one of its committees and that occasionally Board or Board committee meetings may need to be scheduled on short notice when the participation of every member is not possible. The Board expects, however, that each Director will make a concerted effort to keep his or her absences from Board and Board committee meetings to a minimum.

Director Term and Tenure

Each Director is elected annually and holds office until his or her successor has been elected and qualified or until such Director's earlier death, resignation, or removal. There is no limit on the number of terms for which a Director may be elected.

Each Director is expected to volunteer to retire from the Board effective at the Enron Annual Meeting of Shareholders that follows such Director's
seventy-second birthday. The Board believes that such Director should not necessarily be required to retire from the Board, but, rather, that the Nominating and Corporate Governance Committee should have the opportunity to assess each individual situation and to make a recommendation to the Board with respect to whether such tendered retirement should be accepted. If the tendered retirement is not accepted, the Director in question is expected to re-tender his or her retirement annually effective as of each succeeding Enron Annual Meeting of Shareholders, and the Nominating and Corporate Governance Committee is expected to recommend to the Board annually whether to accept such tendered retirement.

Each Director who retires from or changes the principal position such individual held when he or she was last elected to the Board is expected to volunteer to resign from the Board as of the date of such retirement or change. The Board believes that such Director should not necessarily be required to resign from the Board, but, rather, that the Nominating and Corporate Governance Committee should have the opportunity to assess each individual situation and to make a recommendation to the Board with respect to whether such tendered resignation should be accepted.

Succession Planning

Enron’s Chief Executive Officer is responsible for developing and maintaining a process for advising the Compensation and Management Development Committee and the Board with respect to planning for potential successor Chief Executive Officers and for potential successors to other key senior leadership positions in Enron. Enron’s Chief Executive Officer is expected to review this plan with the Compensation and Management Development Committee and the Board at least annually.

Selection of the Chief Executive Officer

The chair of the Compensation and Management Development Committee recommends to the Board an appropriate process pursuant to which a new Chief Executive Officer will be selected. The Board has no required procedure for executing this responsibility because it believes this decision must be made in the way the Board determines to be in the best interest of Enron relative to the circumstances surrounding each such decision.

The Board customarily combines the role of Chairman of the Board with the role of Chief Executive Officer because it believes this practice generally provides the most efficient and effective leadership model for Enron. The Board recognizes, however, that this decision must be examined in the light of the circumstances surrounding each new selection of a Chief Executive Officer.

Evaluation of the Chief Executive Officer

The chair of the Compensation and Management Development Committee is responsible for leading the independent Directors...
periodically (but at least annually) a review of such Committee's assessment of the performance of Enron's Chief Executive Officer.

Equity Ownership by Directors and By Officers

The Board believes that each Director and each officer of Enron should hold a meaningful equity ownership position in Enron. The Compensation and Management Development Committee is responsible for determining and approving from time to time the appropriate requirements of such equity ownership and any exceptions to such requirements.

Executive Sessions of Independent Directors

Meetings of the independent Directors, chaired by the Lead Director, are held following regularly scheduled Board meetings at least annually and more often if any Director requests such a meeting. In addition, the independent Directors meet in executive session when they review the Compensation and Management Development Committee's evaluation of the performance of Enron's Chief Executive Officer.

Frequency of Board Meetings

The Board regularly meets five times annually, in the months of February, May, August, October, and December. In addition, the Board may hold such other meetings as may be required to enable it to discharge its duties.

Selection of Agenda Items for Board Meetings

The Chairman of the Board establishes the agenda for each Board meeting. Each Director may suggest the inclusion of additional items on the agenda. Each Director may raise for discussion at any regular meeting subjects that are not on the meeting's formal agenda.

Director Materials Distributed in Advance

The Board expects that information that is important to a Director's understanding of the business to be discussed at a Board meeting or at a Board committee meeting will be distributed to such Director sufficiently in advance of such meeting to enable such Director to be properly prepared for such meeting.

Corporate Strategy

Periodically (but at least annually) the Board devotes an extended meeting to reviewing with Enron senior executives the strategic issues and opportunities facing Enron.

The Board expects significant corporate strategy decisions to be brought to it in a timely manner for its consideration, discussion, and approval.
Standing Committees of the Board

The Board has established the standing committees described below. The responsibilities of each committee are set forth below in summary form and are more fully described in the charter of each such committee.

Audit and Compliance Committee

The Audit and Compliance Committee serves as the overseer of Enron's financial reporting process, system of internal controls, and corporate compliance process, and it provides reasonable assurance that Enron conducts its business in conformance with appropriate legal and regulatory standards and requirements. Such Committee annually recommends independent auditors for appointment by the Board, reviews the services to be performed by the independent auditors, and exercises oversight of their duties. The Audit and Compliance Committee is comprised solely of independent Directors.

Compensation and Management Development Committee

The Compensation and Management Development Committee establishes and evaluates the compensation of Enron's senior executives to assure that such individuals are compensated in a manner consistent with the stated compensation strategy of Enron, internal equity considerations, competitive practice, and the requirements of applicable regulatory bodies. Such Committee also oversees Enron's employee benefit programs, its Director compensation program, and its management development and succession planning. The Compensation and Management Development Committee is comprised solely of independent Directors.

Executive Committee

The Executive Committee, during the intervals between the meetings of the Board, possesses and exercises all the powers of the Board, subject to the limitations imposed on such Committee by Enron's Bylaws and by the Oregon Business Corporation Act.

Finance Committee

The Finance Committee reviews and makes recommendations to the Board and management on matters concerning both current and long-range financial strategy and planning, including, without limitation, budgets, dividends, equity offerings, debt and other financings, foreign exchange policy, investment policy, and trading limits policy. A majority of the members of the Finance Committee is comprised of Directors who have expertise and experience in economic and financial matters and/or capital markets.

Nominating and Corporate Governance Committee

The Nominating and Corporate Governance Committee reviews criteria for membership on the Board, recommends to the Board candidates for election as Directors, approves for recommendation to the Board the Directors to be selected for membership on Board committees, approves for recommendation to the Board the independent Director to be selected as the
Lead Director, reviews annual Director performance, reviews and makes recommendations to the Board with respect to proposed revisions to the Board’s Corporate Governance Guidelines, and monitors compliance with such Guidelines. The Nominating and Corporate Governance Committee is comprised solely of independent Directors.

Review of Board Committee Charters: Changes to Board Committees

Each standing Board committee reviews its charter annually and submits to the Board for its approval any changes in the charter that such committee deems appropriate.

The Board, acting upon the recommendation of the Nominating and Corporate Governance Committee, has the discretion to form a new standing Board committee or to disband a current standing Board committee as it deems appropriate.

Board Committee Chairs

Only an independent Director may serve as a chair of a Board committee. The chair of each Board committee reports to the full Board, whenever appropriate, with respect to those matters considered and acted upon by his or her committee.

Selection of Agenda Items for Board Committee Meetings

The chair of each Board committee, in consultation with the appropriate members of Enron management, develops the committee’s agenda.

Each member of a Board committee may suggest the inclusion of additional items on such committee’s agenda. In addition, each member of a Board committee may raise for discussion at any regular meeting of such committee subjects that are not on the meeting’s formal agenda.

Frequency of Board Committee Meetings; Staff Support

Each Board committee chair, in consultation with the members of his or her committee, determines the frequency of the meetings of such committee. Each committee prepares minutes of its meetings.

Enron management assigns one or more officers to provide and coordinate staff support for each committee.

Attendance of Non-Committee Members at Board Committee Meetings

Each Director has the right to attend all Board committee meetings (except executive sessions of the independent Directors, which can be attended only by the independent Directors), irrespective of whether such Director is a member of such committee, but only those Directors who are members of the committee are entitled to vote on matters considered by the committee.

Should a meeting of the Executive Committee be called to consider issues that, in the opinion of Enron’s Chief Executive Officer or Enron’s Chief
Operating Officer, would also merit the time and attention of the Directors who are not members of the Executive Committee, every Director will be notified of such meeting and will be entitled to attend it as a non-voting participant.

Meeting fees in respect of a Board committee meeting are paid only to those attending Directors who are members of such committee.

Each Board committee chair may invite members of Enron management to attend such sessions of the committee meetings as the chair deems appropriate.

**Assignment and Rotation of Board Committee Members**

The Nominating and Corporate Governance Committee, after consultation with the Chairman of the Board and after giving due consideration to the desires of the individual Directors and to the membership criteria of each Board committee, is responsible for recommending to the Board the assignment of Directors to various Board committees and the selection of Board committee chairs.

The Board has no set policy for the regular rotation of committee members or chairs.

**Board Interaction with the Media**

The Board expects any Director who receives from the media a request for comment with respect to an Enron matter to refer such request to Enron's designated media spokesperson, it being the Board's view that only Enron management or the individual so designated by Enron management should express Enron's positions to the media.

**Crisis Management Plan**

Enron management has implemented a crisis management plan to facilitate efficient management of a security related incident (such as a kidnapping, extortion, death threat, hijacking, or hostage taking) affecting a Director, officer or employee of Enron. The Audit and Compliance Committee is responsible for periodically reviewing such plan.
Salter describes this relationship between Enron, Raptors, & LJM2 Partnerships which was “controlled by Fastow, who appeared to have a conflict of interest” (Salter, 2008, p.340). The complete diagram is from Figure A.1, Appendix A (Salter, 2008, p.340).
I. EXECUTIVE SUMMARY

Introduction

LJM2 Co-Investment, L.P., a Delaware limited partnership ("LJM2" or the "Partnership"), is being organized by Andrew S. Fastow, Executive Vice President and Chief Financial Officer of Enron Corp., an Oregon corporation ("Enron"), to make privately negotiated equity and equity-related investments in energy- and communications-related businesses and assets. The Partnership expects that Enron will be the Partnership’s primary source of investment opportunities and that the Partnership will (i) co-invest with Enron or its subsidiaries in new investments in, or acquisitions of, businesses and assets, and (ii) make investments in, or acquire an investment interest from Enron or its subsidiaries relating to, existing assets or businesses owned by Enron or its subsidiaries. It is expected that in connection with the foregoing investments, Enron will retain a significant economic or operating interest in the businesses or assets in which the Partnership invests. The Partnership may also from time to time make investments in businesses or assets where Enron has no involvement.

This is the second such fund formed by Mr. Fastow targeted at investing primarily in companies owned or controlled by Enron. The Partnership’s objective is to generate an annualized internal rate of return ("IRR") in excess of 30% to investors in the Partnership after payment of all Partnership fees and expenses and payment of the carried interest to the General Partner.

Enron, headquartered in Houston, Texas, is one of the largest sellers of natural gas and electricity in deregulated and privatized markets on three continents. Additionally, Enron is the largest provider of energy risk management services in the world and owns the largest natural gas pipeline system in the U.S. Enron is also constructing a 10,000 mile nationwide fiber-optic telecommunications network. Enron is frequently characterized as the agent of change in the rapidly deregulating and privatizing energy markets and has been named the “Most Innovative Company in the World” for four consecutive years by Fortune. Enron currently ranks among the Fortune 100 companies with annual revenues of over $30 billion. Importantly, Enron has made investments of over $7 billion in each of the last two years in a variety of energy-related businesses and currently owns merchant investments of over $10 billion. See—“Overview of Enron.” Under Mr. Fastow’s management, the Partnership expects to have the opportunity to co-invest with Enron in many of Enron’s new investment activities and the opportunity to acquire existing Enron assets on a highly selective basis. This access to deal flow should provide the Partnership with unusually attractive investment opportunities.

The target size of the Partnership is $200 million. The General Partner reserves the right to accept additional commitments in excess of $200 million. The Partnership is expected to generate significant co-investment opportunities for investors in the Partnership because the Partnership will be limited to investing no more than 10% of its committed capital in any one company, and the General Partner expects many of the opportunities the Partnership pursues to require capital in excess of the amount the Partnership is able to provide under this diversification limitation. Co-investment amounts will not be subject to a carried interest.

The General Partner of the Partnership will be LJM2 Capital Partners, LLC, a Delaware limited liability company (the "General Partner"), an entity owned and controlled by one or more of the Principals (as defined below). The Partnership will be managed on a day-to-day basis by a team of
three investment professionals who all currently have senior level finance positions with Enron: Andrew S. Fastow, Michael J. Kopper, and Ben Gilman, Jr. (collectively, the "Principals"). The Principals will continue their current responsibilities with Enron while managing the day-to-day operations of the Partnership. See “Risk Factors – Dependence on Key Personnel” and “Conflicts of Interest – Dual Role of Principals.”

Investment Opportunity

The Principals believe that LJM2 provides investors with an unusually attractive investment opportunity for the following reasons:

Access to Significant Proprietary Deal Flow. Enron has extensive deal origination capability that is derived from approximately 2,000 fully dedicated Enron-employed origination and monitoring professionals located around the world. The deal flow emanating from this origination infrastructure has resulted in Enron making over $7 billion of energy-related investments in each of the last two years and holding merchant investments of over $10 billion. As a result of Enron’s in-house deal sourcing capability as well as its leading market position in most businesses in which it operates, Enron frequently has access to investment opportunities that are not available to other investors. The Partnership expects to benefit from having the opportunity to invest in Enron-generated investment opportunities that would not be available otherwise to outside investors.

Enron’s Investment Record. Enron’s record as a successful investor is reflected in returns it has generated for its shareholders as measured by the appreciation in its common stock, which, from January 1, 1990, through September 30, 1999, has increased 641% (price increase plus assumed reinvestment of dividends), as compared to returns of 383% for the S&P 500 and 141% for the S&P Energy Index for the same period. Furthermore, Enron has successfully managed two institutionally funded private equity partnerships, Joint Energy Development Investments III Limited Partnership (“JEDI III”) and Joint Energy Development Investments II Limited Partnership (“JEDI II”), which have generated (or are estimated to generate, as the case may be) an IRR after payment of fees and expenses of the partnership and payment of a carried interest, if any, to the partnerships’ general partners (each, a “Net IRR”) of 23% and 18%, respectively, compared to targeted IRRs for the partnerships on invested capital before fees, expenses, and carried interest (a “Gross IRR”) of 15% and 20%, respectively. The General Partner believes that a significant portion of this superior performance can be attributed to the quality of investment opportunities sourced by Enron. See “Summary of Investment Experience.”

Enron’s Capabilities to Analyze and Structure Investments and Operate Assets. Over the years, Enron has developed a rigorous process of investment analysis, which employs approximately 130 professionals to varying disciplines such as engineering, research, credit, tax, legal, accounting, insurance, and risk analysis. As LJM2 expects that it primarily will be investing in assets in which Enron has an interest, it should benefit from Enron’s expertise in all areas relating to the investment in and management of energy and communications assets, including the physical and financial risk management of energy assets and extensive
operating capabilities in all aspects of the energy industry and certain aspects of the communications industry.

**The Ability to Evaluate Investments with Full Knowledge of the Assets.** Due to their active involvement in the investment activities of Enron, the Principals will be in an advantageous position to analyze potential investments for LJMJ2. The Principals, as senior financial officers of Enron, will typically be familiar with the investment opportunities LJMJ2 considers. The Principals believe that their access to Enron’s information pertaining to potential investments will contribute to superior returns.

**Speed and Knowledge Advantage of LJMJ2.** LJMJ2 will be positioned to capitalize on Enron’s need to rapidly access outside capital due to the Principals’ familiarity with Enron’s assets and their understanding of Enron’s objectives, which should facilitate LJMJ2’s ability to quickly execute transactions. This ability to act quickly is invaluable to Enron and should enhance the flow of opportunities for LJMJ2.

**Investment and Financial Expertise of Principals.** The Principals are a group of highly talented financial professionals with extensive experience originating and structuring complex transactions. This experience has given the Principals the ability to create innovative financial structures around investments, which should enhance returns to investors in LJMJ2. The Principals have been involved in managing JEDI I and JEDI II.

**The Principals**

The day-to-day activities of the Partnership will be managed by Messrs. Fastow, Kopper, and Gilson. Each of the Principals has spent a significant portion of his professional career in energy and communications investing, structured finance, and risk management (including substantial involvement in the organization, operation, and investment management of each of JEDI I and JEDI II). As a team, the Principals possess specific expertise necessary to maximize the Partnership’s performance.

Andrew S. Fastow, Executive Vice President and Chief Financial Officer of Enron, has been the Chief Financial Officer of Enron since 1997; prior to that, he was a Managing Director and principal financial officer for Enron Capital & Trade Resources Corp. ("ECT"). Enron’s principal merchant and investing subsidiary. In these capacities, he has been involved in structuring and managing many of Enron’s investments. Mr. Fastow has been with Enron for nine years. Michael J. Kopper, Managing Director in Enron’s Global Equity Markets Group, is responsible for Enron’s Global Equity and Structured Finance businesses. He has been with Enron for five years. Ben Gilson, Jr., Vice President in Enron’s Global Equity Markets Group, is primarily responsible for Enron’s structured finance activity. Mr. Gilson has been with Enron for three years. Summary biographies of the Principals are included elsewhere in this Memorandum. See – "Management of the Partnership – Biographies of the Principals."

The Principals will remain employees of Enron and will devote such of their business time and attention as they deem reasonably necessary to manage the affairs of the Partnership, subject to their obligation to devote their business time and attention primarily to the discharge of their

CONFIDENTIAL TREATMENT REQUESTED

By Serving on behalf of its clients
responsibilities as senior financial officers of Enron. The Partnership should also benefit indirectly from time spent by the Principals in evaluating and structuring investments for Enron, as many of these investments may become candidates for investment by the Partnership.
LJM LEGAL REVIEW
(May 22, 2001)

Participants: Jim Derrick
Rob Walls
Rex Rogers
Jordan Mintz

A. Developments since March 7th Legal Review Meeting
1. Proxy/10-K Disclosures
2. Enron Wind
3. Overlapping Employee Duties/Services Agreements Review
4. Deal Approval Changes
5. Investor Relations Feedback
6. Meetings with Causey/Buy

B. Meetings with ASF: Current Proposals
1. Restructure of LJM ownership to avoid disclosure
2. "Fresh look" at Enron/LJM relationship

EXHIBIT 13
MARY DOLING, CSR

GOVERNMENT EXHIBIT
20896
Crim No. H 04-0025

DPOEX00029307

INT7 001885

AB0472 01884
LJM LEGAL REVIEW
(May 22, 2001)

Participants: Jim Derrick
Rob Walls
Rex Rogers
Jordan Mintz

A. Development since March 7th Legal Review Meeting
   1. Proxy/10-K Disclosures
   2. Enron Wind
   3. Overlapping Employee Duties/Services Agreements Review
   4. Deal Approval Changes
   5. Investor Relations Feedback
   6. Meetings with Causey/Buy

B. Meetings with ASF: Current Proposals
   1. Restructure of LJM ownership to avoid disclosure
   2. "Fresh look" at Enron/LJM relationship

- Still uncomfortable with disclosure
- Compensation philosophy
- Why does there need to be an Enr person in LJM? Why is the CEO in it?
Interoffice Memorandum
Confidential Communications Attorney-Client Privilege

To: Andy Fastow
From: Jordan Mintz

Subject: Related-Party Proxy Disclosures

Department: Enron Global Finance-Legal
Date: April 6, 2001

You will recall that in preparing the LJM related-party disclosure for this year's (2000) Proxy, we did not disclose financial information regarding your interest as the ultimate general partner/managing member in either LJM1 or LJM2. The purpose of this memorandum is to explain our reasons for concluding such a disclosure was not required in either 1999 or 2000 and to explain why such rationale(s) may not be applicable in future filings.

Discussion

The Proxy Rules require — among other things — a description of the related party's (i.e., LJM's) interest in transactions entered into with the registrant (i.e., Enron), the nature of such interest, and — "where practicable" — the amount of such person's interest in the transaction(s). It is this last piece of information relating to your financial stake that we have not explicitly disclosed because the Legal Department, in consultation with our outside counsel, has concluded disclosure was not mandated. In both the 1999 and 2000 Proxies we have generally provided as follows: "The general partner is entitled to receive a percentage of the profits of the partnership in excess of the general partner's proportion of the total capital contributed to LJM1/LJM2, depending upon the performance of the investments made by LJM1/LJM2." Thus, it is clear that, at a minimum, there is public disclosure that you, as the general partner in these two investment vehicles, are entitled to receive some level of carried interest.

Our rationale for not disclosing any additional financial information related to your general partner interests varies as between 1999 and 2000 and, in particular, with respect to the RhythmsNet transaction, as follows:

(1) 1999: The "where practicable" language in the Proxy Disclosure Rules gave us the basis for not providing additional financial information in 1999. More specifically, the majority of the transactions entered into in 1999 between Enron and LJM1/LJM2 — and specifically the RhythmsNet hedge — were "open" transactions during the 1999 fiscal year and had not yet settled or liquidated in a fashion that it would be "practicable" to determine what you earned in your general partner capacity. The "open transaction" basis applied to both the RhythmsNet transaction and the newly-executed LJM2-related acquisitions and hedges for 1999.

(2) 2000: We determined it was not practicable to quantify your interest in LJM2 in the most recent Proxy, again, based on the existence of multiple open and
unmatured transactions making it impracticable to compute. The rationale
for not making any additional disclosures relating to the settlement of the
RhythmsNet transaction, however, is somewhat different. In particular, the
RhythmsNet transaction settled in 2000 pursuant to terms allowed for under
the original agreement. At settlement of RhythmsNet, it may have been
practicable to determine your financial interest. However, no further
disclosure was otherwise required of the RhythmsNet transaction in 2000
because settlement occurred under conditions permitted in the original
agreement. Thus, there was no new transaction involving LJM1 and Enron
in the year 2000 required to be disclosed in this year’s proxy; accordingly,
we have concluded that there was no requirement to disclose any financial
information related to what you may have earned in that transaction—
notwithstanding that it was now more practicable to do so.

The decision not to disclose in this instance was a close call; arguably, the more conservative
approach would have been to disclose the amount of your interest. Given other pertinent (and
competing) issues that you and I have discussed at great length, we decided against doing so. It was,
perhaps, fortuitous that the RhythmsNet transaction extended over two proxy filing years and the
specific facts of the particular case allowed us to conclude that a disclosable transaction occurred only
in the year in which financial disclosure was impracticable. Thus, we have relied on two different
arguments for avoiding financial disclosure for you as the LJM1 general partner in both 1999 and then
2000. If, however, the RhythmsNet transaction began and concluded in the same year, it would have
been more difficult to avoid making some additional level of financial disclosure.

Going Forward

This disclosure issue will continue to be a challenge as transactions entered into between Enron and
LJM2 settle and, as such, it becomes "practicable" to quantify and, therefore, be required to disclose
the amount of your financial interest. To that end, we need to continue to be cognizant of this issue as
the year progresses and continue to consider some of the safe-harbors provided under the SEC rules
from having to disclose related party transactions — including the (1) competitive bid and (2) reduction
of general partner control alternatives we have previously discussed. I, of course, will continue to
examine other alternatives, as well.

After you have had a chance to review this summary, I am available to discuss any questions or
comments you may have.

Cc: Jim Derrick
    Rex Rogers
    Ron Astin (Vinson & Elkins)