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Levin's Opening Statement:
The Role of the Board of Directors in Enron's Collapse

On December 2, 2001, the seventh largest corporation in America collapsed. Its stock having plummeted from $80 a share to practically nothing in less than 10 months, the reins of what was once a high-flying company of $100 billion in gross revenues and 20,000 employees was handed over to a federal bankruptcy judge. And, that collapse has rolled like a tidal wave across the corporate board rooms of America, across Wall Street, and across the entire investing community which now includes over half of U.S. households.

With this tidal wave we are all asking two questions: what happened at Enron, and could it happen again. Today we hope to help answer the first question in order to ensure that the answer to the second question will become "no."

One of the key players responsible for overseeing the operations of our publicly-held corporations is the Board of Directors. Directors are charged by law to be the fiduciaries, the trustees, who protect the interests of the corporate shareholders. In that capacity they are supposed to exercise their best business judgment on behalf of those shareholders. They are supposed to be independent, and while they are not expected to be detectives, they are expected to ask tough questions of management, to probe opaque answers, and to display sufficient skill and fortitude to say "no" to transactions that don't look right.

Along with management and the auditors, the Board shares the responsibility to provide to the company's shareholders a financial statement that is a fair representation of the financial position of the company. And as the 2nd Circuit Court of Appeals held in a widely quoted opinion, technical compliance with generally accepted accounting principles may be evidence of acting in good faith, but it is not necessarily conclusive. The "critical test," the court said, is "whether the financial statements as a whole" fairly present the financial picture of a company. Enron's financial statements did not, and the Board's role in that failure is also before us.

Today we have five key members from the Enron Board of Directors to tell us what they knew about the financial condition of Enron, when they knew it, and what they did about it, in other words what role did the Board play in these events.

The Subcommittee has issued over 50 subpoenas for documents to Enron, Arthur Andersen, members of the Enron Board, and officers of Enron. Staff has reviewed almost 300 boxes of documents to date, and has conducted lengthy interviews with 13 current and past Board members. Each Board Member complied with the document subpoenas and willingly appeared for interviews. We appreciate their cooperation and their voluntary appearance today.

We have found that when you pare down the hundreds of incredibly complex financial transactions that were the hallmark of Enron you realize that many were nothing more than smoke and mirrors bookkeeping tricks, designed to artificially inflate earnings rather than achieve economic objectives, to hide losses rather than disclose business failures to the public, to deceive more than inform.

The decisions to engage in these accounting gimmicks and deceptive transactions were fueled by the very human but unadmirable emotions of greed and arrogance. Putting a growth gloss on the balance sheet pumped up the stock price, and the rise in stock price, regardless of the underlying true value of the company, was for many the measure in the 1990's for judging corporate success. The Board that was supposed to be the check on the greed and the arrogance, in fact, wasn't.

Here's how it happened. Enron was in transition from an old line energy company with pipelines and power plants to a high tech global enterprise engaged in energy trading and international investments. It experienced large fluctuations from quarter to quarter in its earnings. Those large fluctuations affected the credit rating Enron received, and the credit rating affected Enron's ability to obtain low-cost financing, attract investment, and increase its stock price. In order to smooth out its earnings and avoid the natural dips, Enron engaged in a variety of complicated transactions that relied on "structured finance," derivatives, and other arrangements that, while legal if done right, are nonetheless designed to massage a company's financial statement to make its financial condition look better than it really is.

While it is not uncommon for a company to use these devices, they are also used somewhat sparingly. Enron, however, made them a high art form and used them aggressively and in some cases improperly. When used extensively and when they become dominant – when they involve billions of dollars – $27 billion in assets at Enron's peak, the real impact of these complex transactions on a financial statement is to cover up reality with a glitzy coat of paint; the financial statement becomes a fiction. And that's what happened at Enron.

Step by step, Enron shifted a larger percentage of its assets into these structured finance arrangements not for any real business purpose, but in order to make Enron look more profitable than it really was. Funds flow and the appearance of funds flow became the Enron mantra in order to keep Enron's credit rating up and its stock price climbing. And the Board of Directors went along with it. In many actions starting in 1997 when the Board first approved Whitewing, through the summer of 2001 just before things fell apart publicly, the Board of Directors went along with management's wishes. The Board relinquished its role of questioner and adopted the role of facilitator. It succumbed to the Enron ether of invincibility, superiority, and gamesmanship in manipulating Enron's financial statements to keep the Enron stock price soaring. This is the company, we are told, that had televisions in its elevators in order for employees to monitor Enron's stock price at all times.

The financial transactions the Board approved were used to make debt look like equity, loans look like sales, poorly performing assets look like money makers and Enron-controlled entities look like legitimate third parties. By the time of the collapse, Enron held almost 50% of its assets off its books. And what started as a useful tool to address specific business problems became a way of life.

As long as Enron's stock price was rising, these elaborate financial structures did what they were designed to do – make Enron's financial condition look better than it was. But once Enron stock started falling, these financial structures collapsed on themselves like a house of cards, revealing at the end that there was no "there" there.

These transactions involved a number of deceptions that pushed the limit of accepted accounting practices and at times exceeded them. And, parenthetically, if it turns out that some of the generally accepted accounting principles allow such deceptions, then those accounting principles need to be changed.

One type of deception Enron used was to report on the company's financial statement the sale of an asset, despite an understanding that Enron would buy it back after the financial statement was filed or despite a hidden guarantee that the entity buying the asset would receive a certain rate of return. Five of the seven assets sold that way to the LJM partnership at the end of the last two quarters of 1999 were bought back by Enron – sometimes within 6 months' time. But those guarantees didn't show on the books as a liability; only the sales showed as funds flow.

Another type of deception made what was essentially a loan look like a sale, so the company's financial statement reflected the transaction as income or cash flow instead of debt.

A third type of deception inflated the value of the assets Enron held for sale. For example, Enron would buy a power plant on day one for $30 million and within a month or so would begin carrying it on Enron's books as an asset worth $45 million. Two weeks ago Enron filed a statement with the SEC declaring that it is going to write down its assets by another $14 to $24 billion, a staggering sum, due to overvaluations on the books and "accounting irregularities."

Another type of deception – the Raptors – used Enron stock to backstop a risk that LJM2 and its investors were supposed to be assuming for Enron, and the risk retained by Enron was not disclosed on the company's financial statements in a meaningful way.

No one on the Enron Board – as these structured financial transactions grew in number, size and frequency, as 50% of Enron's assets were moved off Enron's books – no one said that their fiduciary duty required them to blow the whistle and prevent a deceptive picture of Enron's financial situation from being presented to the public.

During our 13 interviews, the Board Members told us they had not been aware of the depth of Enron's problems or the extent of these structured transactions and accounting gimmicks, and most said they had no inkling that Enron was in troubled waters until mid-October 2001. But look at this chart the Subcommittee staff has put together identifying numerous "red flags" the Board of Directors were presented with from February 1999 on, that signaled the risks Enron was taking and that should have alerted the Board to probe and then change course. The staff has identified well over a dozen of them, but I will highlight just a few:

- In February 1999, the Board's Audit Committee was told by Arthur Andersen directly that Enron's accountin practices were high risk and pushed the limits.
- In June 1999, the Board approved at a special meeting, and without prior Finance Committee consideration, creation of the LJM partnership, and waived the conflict of interest provisions of the Code of Conduct to let th Enron CFO Andy Fastow serve as managing partner of LJM, something no Board Member had ever done or heard of prior to this. The Board was to approve a Code of Conduct waiver for Fastow three times over the ne 16 months.
- In September 1999, the Board approved moving off the Enron balance sheet a $1.5 billion joint venture, Whitewing, established by the Board in December 1997 to get a loan that looked like equity, and used from 19 on to purchase assets Enron wanted to move off its books.
- In May 2000, the Board approved the first Raptor transaction, a vehicle designed to hedge Enron investment by using Enron stock to backstop the hedge, which amounted to Enron hedging with itself.
- By October 2000, the Board knew that Enron had $27 billion in assets – almost half of its assets – off its balance sheet.
- In April 2001, the Enron Board knew that 64% of Enron's assets were troubled or not performing and 45 million Enron shares were at risk in Raptors and Whitewing.

Starting with the creation of Whitewing in 1997 and its deconsolidation in 1999, the Board started to wade into dangerous waters; with the establishment of the LJM partnership and waiver of the code of conduct they were up to their necks; and, with the Board's approval of the Raptors, the Board was swimming way over their heads. In the end Enron drowned in its own debt. As the chart shows, the Board had ample knowledge of the dangerous waters in which Enron was swimming and it didn't do anything about it.

The Board told the Subcommittee staff that because each of Enron's transactions was approved by Enron management – whom they saw as some of the most creative and talented people in the business; by Arthur Andersen, a top auditing firm; by Enron's lawyers and private law firms like Vinson and Elkins, by the credit rating agencies, or by investment bankers who had a significant stake in a lot of these transactions – the Board assumed the transactions were okay. I can see why you might rely on the company auditor or outside attorney. But the Board must exercise independent judgment. The Board is not supposed to be a rubber stamp for auditors or attorneys.

Also, the people the Board relied on were conflicted in their roles involving Enron, and the Board knew it. First, the Board knew that Enron's management handed out bonuses like candy at Halloween. Employees were given huge bonuses for closing deals, and many of these deals proved damaging to Enron. For example, two executives closed a deal on a power project in India which is now a financial disaster and got bonuses in the range of $50 million. The head of one Enron division who was moved out of the company walked away with more than $250 million in the year he was shown the door. The temptation to self enrichment at Enron was overwhelming.

Arthur Andersen was conflicted, because it served Enron as both an auditor and a consultant, and for two years it also served as Enron's internal auditor, essentially auditing its own work. Enron was Andersen's largest client, and in 2000 Andersen earned $52 million in fees from the company. Employees of Andersen routinely crossed over to work for Enron, and an Andersen employee who actually questioned an Enron practice while serving on an audit team was promptly reassigned to another client at Enron's urging.

Relying on outsiders, conflicted or not, does not relieve the Board from the ultimate responsibility to make sure, at the end of the day, that Enron was operating properly and that Enron's financial statement was a fair representation of Enron's financial condition. The Board failed in that responsibility.

The structured debt and guarantees overwhelmed Enron's ability to pay. And that meant bankruptcy for the corporation, huge pension losses for employees, investment losses for stockholders, and business losses for hundreds of smaller companies that did business with Enron, while officers of the corporation walked away with fortunes.

Today we're going to go over the decisions the Board made on a number of these transactions as well as the decisions they made with respect to compensation. We will also look at the interlocking financial relationships some members of the Board had with Enron.

Following the Board, we will hear in a second panel from several experts in the field of corporate governance.