

What Happened to Enron? Why Does It Matter?

Chapter Objectives

After reading this chapter you should be able to

Understand what bankruptcy is and why bankruptcy laws are useful.

Understand the causes and effects of the K-Mart, Global Crossing, and Enron bankruptcies of 2001 and 2002.

See that the accounting practice related bankruptcies of 2002 are potentially more problematic to financial markets because of the deception involved.

In the aftermath of September 11, 2001, attacks on New York City's World Trade Center buildings and the recession of 2001, the Enron Corporation declared bankruptcy. Enron, the United States's seventh largest

Bankruptcy: A legal status entered into when a company or individual cannot pay its debt.

Creditors : The people or institutions to which a company or individual owes money.

corporation in terms of revenue declared **bankruptcy** owing more than \$5 billion and lacking the ability to pay the interest on that debt. Companies or individuals declare bankruptcy when they lack the necessary funds to pay their **creditors**. While K-Mart and

Global Crossing also declared bankruptcy during the same period of time, the Enron bankruptcy made far more news. Why? K-Mart served many more customers, and Global Crossing was more in debt (\$12 billion), but Enron's demise was potentially far more damaging.

As it describes Enron's problems and actions, this chapter will discuss what bankruptcy is, what characterizes bankruptcy laws in the U.S., why a well-functioning capitalist system requires bankruptcy laws, how the major bankruptcies of 2001 and 2002 differ, and it will discuss why Enron's troubles were not unique.

Bankruptcy

Corporations raise money in two ways: by selling shares of stock and by borrowing money directly or borrowing it by selling bonds. Shares of stock are called equities; borrowing money or selling bonds puts a company into debt. So, corporations raise money either with equity or with debt. Money raised through equity markets results from a company selling shares of stock. (See the Stock Market chapter) Corporations can borrow directly from banks and other lending institutions or they can sell bonds in the open market. The primary difference between these methods of raising money is that bondholders are promised a specific return on their money and must be paid before anyone else if a company goes under; whereas stockholders are promised a share of dividends and are the last to be paid.

When a corporation cannot pay its creditors it must either renegotiate the repayment schedule that it has with its creditors or it must declare bankruptcy. When a

company declares bankruptcy, it has two choices: It can try to reorganize and go forward or it can simply give up. The former, called Chapter 11 bankruptcy, protects companies from their creditors so as to give the company time to get its financial affairs back on track. The latter, called Chapter 13 bankruptcy, lets the company sell off its assets in an orderly fashion so as to preserve as much value as possible for the last-in-line stock holders. Nearly every case of corporate bankruptcy you hear on the news is of the Chapter 11 variety.

When a company declares bankruptcy a judge is appointed to oversee its financial affairs. Such major financial decisions as the sale of assets must first be approved by the judge.

Why Capitalism Needs Bankruptcy Laws

While, on the surface, it may seem strange that the ability to avoid debts would be viewed as a “good” thing, under capitalism bankruptcy laws actually aid economic efficiency. Without the ability to seek protection of your creditors, even a temporary inability to pay your debts would make it so that any one of them could foreclose on the business. This could reduce or even eliminate the business’s ability to turn things around, and it would happen because, while it would be in the collective interest of the creditors for the company to get back on its feet, it would be in their individual interest to be the first in line to get their money back.

Suppose, for example, that a company owes money to three different banks. Suppose, too, that the company has insufficient funds to pay these creditors this year but that, given the chance, it can probably make enough money over the next few years to

pay them what it owes. Further suppose that if the company sells its assets it can only pay what it owes to two of the three banks. Without the protection of Chapter 11 bankruptcy, it would be in the interests of each of the banks individually to foreclose because each would not want to be the one bank that wasn't paid. In an apparent contradiction, it might easily also be in the banks' interests for the company to be allowed to continue without anyone foreclosing. Bankruptcy laws enable firms to continue under judicial supervision and afford all concerned the hope that they will pay off their debts.

The 2001-2002 Bankruptcies

The K-Mart and Global Crossing Cases

When K-Mart and Global Crossing filed for Chapter 11 bankruptcy in 2002, economists found the reasons to be familiar and not all that troubling. K-Mart, in the middle of a discount store sandwich with Wal-Mart and Target, went bankrupt because it was not able to discount as deeply as Wal-Mart, nor was it able to market to upscale consumers as effectively as Target. Global Crossing took a gigantic gamble borrowing billions to string fiber-optic cable under the oceans, connecting Europe, Asia and North America with internet-friendly broadband connections.

Bankruptcies like these do not trouble economists in the ways in the ways they appear to disturb people in the press, bankers, and shareholders. Economists hold that when companies get out-competed it's right that they lose money. Further, when they do it long enough, they should go out of business. They maintain that capitalism only works when the promise of profit is countered by the threat of bankruptcy. Incompetence and risky business decisions that turn out badly must have consequences and in the cases of K-Mart and Global Crossing this is exactly what has happened. K-Mart suffered from

management and marketing strategies that were not up to those of the competition.

Global Crossing operated on the premise that intercontinental bandwidth would be a hot commodity, and it used debt to finance its decision. AT&T, which is in the same market and raised their money with sales of stock and reinvested profits, also made little money in this market. It survived because their losses resulted only in disappointing earnings to stockholders. Global Crossing, on the other hand, could not generate enough profit to pay the interest on its \$12 billion in debt.

Both K-Mart and Global Crossing declared bankruptcy, even though, on the books they possessed more in assets than they owed their creditors. K-Mart had \$16 billion in assets and \$2 billion in debts while Global Crossing had \$22 billion in assets and \$12 billion in debts. There were two problems though: the assets were listed at book value rather than market value and the assets were not such that they were producing revenue.

Two examples may illustrate the problem. When K-Mart builds a store and outfits it with the K-Mart logo and colors, it may cost \$10 million but there is no one who will pay \$10 million for it after it is built. Similarly, it may have cost Global Crossing \$20 billion to lay fiber-optic cable from one end of the ocean to another but that by no means suggests that anyone will buy it from Global Crossing for that amount of money.

To illustrate further the circumstance in which there are many assets and no revenue from those assets with which to pay creditors, suppose someone is worth \$5 billion and borrows \$10 billion to buy gold coins. The person has an asset worth \$10 billion but has no revenue coming in to pay the interest on the debt. Now suppose the person takes those coins and drops them one by one in the ocean between New York and

London. Our hypothetical person now has \$15 billion in assets on his or her books but the coins that are apparently worth \$10 billion may actually be worth next to nothing. There is genuinely \$10 billion worth of debt with no revenue in sight to pay for the interest that is accruing on it.

What Happened in the Enron Case

Usually it is not that difficult to say what a business does. Wal-Mart, for example, is a discount retailer, GM makes cars, State Farm sells insurance. To get a handle on what went on in the Enron case you have to understand Enron's actual business activities. What does Enron do to make money? It is an energy trading company. It buys electricity, oil, natural gas, gasoline and other energy sources from producers, with the intent of reselling it to industrial companies and utilities. It makes money by "buying low and selling high." It did this rather well for several years during the 1990s. Later it started getting into sideline businesses such as the buying and selling of bandwidth for the internet.

"Buying low and selling high" is always good business practice, but it is hard to sustain because economic profit always induces entry, (i.e., new competition) especially when there are few barriers. Enron had few competitors in this industry in the early 1990s, but when other companies saw that profits were achievable in this arena, they jumped in. With no barriers against getting into the arena Dynegy Inc., Reliant Energy, El Paso Energy, Duke Energy North American, and Calpine Corp. joined the competition, and they raided Enron for valued employees who knew the game. Had this been the end of the story then there would not have been much of one. It would have been the typical

“company has idea, milks it for as long as it can, and then settles in for a run of normal profits.”

What happened with Enron was that its management wanted to keep things going and its executives were paid almost exclusively in stock and stock options. One

Principal-agent problem:

The problem that occurs when the owner of an asset and the manager of that asset are different and have different preferences.

of the classic problems in corporate capitalism is called the **principal-agent problem**, a problem that occurs when the owners of the company (the shareholders) are motivated by long-term profitability for the company and the managers are motivated by monetary gain for themselves. When Chief Executive Officers (CEO's) are paid high salaries they may avoid potentially lucrative business avenues that might be accompanied by some level of risk. The problem is that the agent, in this case the CEO, is not making decisions consistent with the principals', in this case the stockholders', wishes. The primary concern in this example of the principal-agent problem is that salaried CEO's will avoid risking their jobs and will error on the side of caution.

For years it has been taken on faith that the best way for stockholders to get the CEO to do their bidding was to tie the CEO's compensation to stock performance. One version of this has the CEO paid only in stock. Thus, when stock prices are low the CEO is paid less than when the stock price is high.

An extreme version of this scheme is in place when management is paid in stock options. Stock options are authorizations that allow those who hold them to buy a specific number of shares of stock at the price stated on the option. They are enormously

valuable when the stock price is above the option price but have no value when the underlying stock price is below the option price. Enron's compensation package for its managers was a combination of stocks and options.

Enron's management compensation was thus tied to stock performance, and in the eyes of Enron shareholders, this was good. Their perception was that management decisions that affected the company in good ways were rewarded while those that affected the company in bad ways were punished. It unfortunately also put management in a position such that if it could deceive the *markets* into thinking that it was doing better than it actually was, then management could enrich itself. This is not new. This is the primary reason why accounting firms exist. They are supposed to guard against such deception by going over the corporate financial statements of the companies they audit so as to certify to the public that when a company says it earned \$1 billion, they it actually did.

Enron's deception took the form of high-debt, off-the-books, gambles. Enron created several subsidiaries, named, for whatever reason, for "Star Wars" characters, and it saddled each with millions in debt. Each subsidiary had a high-risk, high-return niche market. None of this would be interesting except for the fact that the debt of these firms was secured by assets of the larger corporation. That in turn would not be interesting except that this debt was deceptively noted in Enron financial statements.

Enron would state that it was owed money by other companies, it would report this as an asset but would not mention that it was also a debt. Even more troubling, the smaller subsidiaries would borrow from banks to pay Enron the interest, thus raising

Enron's reported profits. In the final analysis, Enron was overstating its profits by \$1.2 billion and its assets by even more.

When the whole thing collapsed in the Fall of 2001 there were two fatally wounded companies: Enron and its accounting firm Arthur Andersen. Andersen had certified Enron's books to be accurate when they demonstrably were not. It had participated in the creation of the subsidiaries and had gone along with the attempt to cover things up by issuing a reminder to employees working on the Enron account to shred "unneeded" documents. Though this "reminder" was technically a simple restatement of company policy, everyone at Andersen who worked on the Enron case knew that it meant to shred the evidence. Why would an accounting firm participate in such fraud? It again boils down to the principal-agent problem. The lead accountant in any firm wants to please his or her clients. The clients pay the firms millions in fees per year for which the lead accountants are handsomely rewarded. The **principal**, the accounting firm, must trust the action of its **agent**, the lead accountant. Their interests are sometimes at odds because the accounting firm is worthless without a reputation for honesty. That reputation was effectively sold by the lead accountant without Andersen's knowledge or consent. The upshot of all this is that Andersen may well be destroyed by the actions of its lead accountant in the Enron case.

Why The Enron Case Matters More Than the Others

The K-Mart and Global Crossing cases really do not have much influence on the economy as a whole, but the Enron debacle is an ominous sign of a systemic problem.

Economically speaking, K-Mart's loss is Wal-Mart's and Target's gain. Global Crossing rolled the dice and it came up "snake-eyes." The risk associated with buying Global Crossing stock was pretty well understood, and if international bandwidth markets had taken off, Global Crossing stockholders would have made a fortune. Because they did not, and because the firm was very much in debt, the stockholders were left with nearly worthless stock. Enron stockholders were simply lied to. Investors must be able to rely on the veracity of financial statements

Investors take calculated risks. They assemble the information and make decisions based on that information. The area of uncertainty that investors expect is that of the return to be received from their investments. Some companies make a profit and others do not. They seek to avoid the uncertainty over the veracity of financial reports by insisting on independent audits. If accounting firms aid the company's deceptive tactics rather than uncover them, then investors are left with two areas of uncertainty: (1) will the company make money? and (2) will the financial statements tell me the truth? The additional uncertainty about the accuracy of audits raises the required rate of return on stocks and results in inhibiting some profitable business avenues.

As a direct result of problems evidenced by Enron and Andersen, other companies began to reveal their own "overstatements" of profits. One-by-one Xerox, WorldCom and other corporate giants came out with earnings "corrections." As a result, investors continued to lose confidence through the summer of 2002 and stock values dropped an additional 20% from levels that were already 20% to 60% below the levels of March, 2000.

Summary

The bankruptcies of 2001 and 2002 highlight some important economic lessons with regard to investing. This chapter defined what bankruptcy is, showed why bankruptcy laws are useful in a capitalist economy, and discussed the issues and consequences of the K-Mart, Global Crossing, and Enron bankruptcies. It showed why the first two were as a consequence of normal economic factors but that the Enron debacle was more about the corruption of normal business practices. It showed why such corruption could lead to specific, adverse economic consequences.

Key Terms

Bankruptcy

Creditors

Principal-agent problem