Was the Primary Cause of Enron Crisis Gatekeeper Failure?

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At the end of 2001, Enron Corporation, one of the world's leading electricity, natural gas, pulp and paper, and communications companies with billions of dollars in revenues, filed for bankruptcy. The collapse of Enron was particularly shocking because its financial statement showed a very positive result which made Enron appear to be healthy and prosperous. The Enron crisis was one of the largest bankruptcies in the world. Enron, which started as a small company, became one of America's largest corporations with billions of dollars in turnover. However, its success was based on counterfeit accounting practices and manipulated profits which led to Enron’s eventual bankruptcy. John C. Coffee, Jr. in his article “It’s About the Gatekeepers, Stupid” (2002) argues that the primary cause of Enron’s collapse was gatekeeper failure (p.256). Coffee especially defined Gatekeepers as “reputational intermediaries who provide verification and certification services to investors” (p. 256). He claimed that Gatekeepers had lost their original objectives as auditors or analysts because of the decline in the risk of being involved in fraud and the 1990s market bubble which made them temporarily irrelevant (p.259). Although Coffee argued that gatekeepers had failed to do their jobs properly because of the decreased in liability of fraud and the market bubble, I will argue that Coffee’s arguments fails.

Coffee essentially explained that there are only three candidates primarily responsible for the Enron crisis. Those candidates are board of directors, gatekeepers, and greed. First, board of directors. In corporations, boards of directors are the entities that know about the overall situation of the corporation. The boards of directors supervise the works of the executive directors such as, approving budgets, creating corporation’s goals, selecting executives, etc. In Coffee’s article, he argued that Enron’s board of directors cannot be the primary cause of the crisis because its boards of directors were outdistanced by the growing pace of Enron as a whole. Enron’s boards of directors are not aware of the decision and not able to perform their duties adequately (Coffee, 2002, p. 256). Enron’s growth was helped by the executive directors’ decisions to create many Special Purpose Entities (SPEs). The purpose of an SPE is to make Enron looked well financially. The money borrowed by SPEs was then transferred to Enron’s cash asset considered as SPEs buying services or products from Enron. Actually, there was no transaction between them. Eventually, the debt of the SPEs kept increasing and it had never been reported on Enron’s financial statement as the debt. In addition, Coffee also claimed that Enron acted differently than other corporations (Coffee, 2002, p. 256), Enron was the only company that created lots of subsidiaries which in this case are SPEs. Enron was a unique corporation, so Enron’s boards of director’s manners must also be different and they should not be considered the same as the other general companies’ board of directors (Coffee, 2002, p. 256). Since Enron’s boards of directors are not aware of Enron’s decisions which caused the crisis; therefore, Enron’s board of directors cannot be the primary cause of the crisis. In essence, ignorance is pleading innocence.

The second candidate that Coffee suggests is gatekeepers. According to Coffee (2002), gatekeepers are mediators that verify and certify some services to investors such as creating and auditing financial statement, evaluating credit rating, assessing businesses prospects, and appraising business transactions (p.256). For gatekeepers, their reputation is very important because corporations look at their credibility before using their services. Therefore, to maintain their credibility as reputational gatekeepers, they are more reluctant to engage in fraud. However, Coffee (2002) argued that experience proved that gatekeepers did engage in managerial fraud in the 1990s (p.257). He explained that there are two reasons for gatekeeper failure in the market. First, the underdeterred gatekeeper. Coffee (2002) claimed that in 1990s, there was a decline in the risk of involving in managerial fraud (p.258). Two bills related to securities frauds (PSLRA and SLUSA) were passed in the 1990s. Those bills reduced the threat of private enforcement on the gatekeepers. In addition, while the liability of doing fraud was declining, the incentives of gatekeepers involving in fraud action were increasing. The gatekeepers, who were supposed to audit a corporation’s financial statement, were then becoming the consultants for the corporation. Coffee (2002) claimed that the benefit of consulting is three times more than the benefit of auditing (p.259). This increased the chance of fraud because the auditors would be more likely to become consultants. For example, if a corporation is about to engage in fraud, and as a consultant, gatekeepers disagree with such actions, then they would be replaced by another auditing and consulting firm. However, since the gatekeepers realized that the risk of involving in such actions is low, they would rather work with the corporation. In addition, the corporation can also bribe the auditing firms by increasing the service fee if they want to involve in such actions. As auditors for their own decision, they do not have to worry about the possibility of getting caught by the law enforcement because they can cover that up. Second, the market bubble. Coffee (2002) argued that in the market bubble, gatekeepers became temporarily irrelevant. They even become a bother for the management because they audit things which sometimes do not attract investors (p.259). He claimed that “gatekeepers are necessary only when investors are cautious and skeptical” (Coffee, 2002, p. 259 - 260). This market bubble led to a possibility of auditors looking for income from consulting, not auditing. The underdeterred gatekeepers and the market bubble have caused the gatekeeper to fail in fulfilling their responsibilities. Therefore, gatekeeper failure might be the primary cause of Enron crisis.

The last candidate that Coffee suggested is greed. He (2002) mentioned that there is a decline in people’s morality (p. 263). Nowadays, people do not care whether their action is right or wrong. They only care about their own benefit from any actions. One thing that declines people’s morality is greed. However, Coffee (2002) argued that greed has never declined and everybody is greedy (p.263). Therefore, greed should not be the primary cause of Enron crisis.

Coffee claimed that there are three candidates for the primary cause of the Enron crisis. They are boards of directors, gatekeepers, and greed. From the three suggested candidates, gatekeeper failure has the highest potential of causing the Enron crisis because the law had changed and gave them easier access to commit managerial fraud. Also, their situation in the market bubble as consultants had given them financial incentives to engage in such actions. Therefore, Coffee argued that gatekeeper failure was the primary cause of the Enron crisis. Although Coffee argued that the gatekeepers had failed to do their jobs correctly and caused the bankruptcy, I will argue that his argument will fail because of two points. First, there should be another entity involved in the Enron crisis. Secondly, boards of directors must have known something about the SPEs, since they were the entities that supervise the executive directors.

Coffee claimed that there are only three candidates for the primary cause of Enron crisis. In fact, there is another entity that might cause the crisis in Enron. Coffee should include executive directors as one of the primary cause of the Enron crisis because executive directors are the entity that knows everything that happens in the corporation. Executive directors manage the corporation resources, and make sure that the corporation will be profitable in the present and future. In addition, they are responsible to the boards of directors and shareholders in ensuring that the corporation is running well financially. In today’s market, if a corporation performed very well, then the executive directors will be rewarded by given high bonuses, compensations, etc. On the other hand, if the corporation is not doing well, then the executive directors will be held responsible and forced to resigned or be replaced. Since the executive directors are responsible for everything that is going on in the corporation, then there are some possibilities that Enron’s executive directors had failed to fulfill its responsibilities to shareholders or boards of directors such as giving bad decision that would just benefit themselves, which eventually caused the crisis to occur. Therefore, Coffee’s argument on the candidates for the primary cause of Enron crisis is false because executive directors should also be considered as one of the primary cause of Enron’s crisis.

The second argument is about the board of directors’ knowledge of the SPEs’ transactions. Boards of directors are the entities that know about everything in the corporation after the executive directors. Since the boards of directors supervise the works of the executive directors, they must have known about the SPEs’ transaction or at least questioned the authenticity of Enron’s financial statement. One of boards of directors’ responsibilities is to approve annual budget of a corporation. In order to approve a budget, reasonable boards of directors would not just sign and approve it without careful consideration. Reasonable boards of directors would question the purpose of the budget and make sure that it was used effectively and efficiently. Hence, boards of directors must have questioned the decisions that were related to corporate budgets. In addition, boards of directors also supervise the executive directors’ jobs to make sure that they are doing the jobs properly. If the executive directors are about to make a big decision, then they must have discussed it with their supervisor, which are the boards of directors. In Enron case, SPEs transactions were not a small decision that could be overlooked by any reasonable boards of directors, these transactions involved hundreds of millions of dollars even probably billions of dollars. No boards of directors in any companies in the world would ever neglect transactions involving such an enormous amount of money. If they did, they must not be the board of directors, but they must be the shareholders. Since SPEs transaction was a very big decision that I think reasonable people would find it impossible to be overlooked by any reasonable boards of directors, Enron’s board of directors must have had knowledge about the SPEs’ transactions and given some kind of approval to the executive directors to proceed with the decision. Therefore, Coffee’s argument that Enron’s boards of directors were unique and should not be considered the same as the general board of directors are wrong because Enron’s board of directors must have realized about the SPEs situation and approved such actions, or they could at least do something to prevent if they disagree with the decision for they were the supervisor of the executive directors.

Coffee’s arguments that gatekeeper failure was the primary cause of the Enron crisis are false because some of his arguments are false. There was other candidate that created such scheme that caused the crisis to occur. That candidate had higher possibility of being the primary cause of Enron crisis. That candidate was the executive directors. Executive directors were the entity that came up with these SPEs ideas which brought Enron to the crisis. Executive directors’ failure caused more devastating result than gatekeeper failure. Therefore, gatekeeper failure was not the primary cause of Enron crisis. In addition, Coffee’s arguments that Enron’s boards of directors were unique and should be considered differently than the general boards of directors are also false. These SPEs transactions were such a big decision that involved the corporation’s future in business. It is impossible that Enron’s boards of directors were so unique that they did not even know about this huge scheme going on in their company. Therefore, Enron’s boards of directors should have known about this scheme and should be considered as part of the causes of Enron crisis as well. In every situation, I think blame should primarily be put on the entity that started the problem or came up with the idea that created the problem, not on the entity that tried to make sure everything is correct.

References

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