BATES WHITE
ECONOMIC CONSULTING

Enron Creditors Recovery Corp.

CASE STUDY

Client

ENRON CREDITORS RECOVERY CORP.

Industry

ENERGY

Once a darling of Wall Street, Enron's spectacular collapse in late 2001 was the result of substantial off-balance-sheet borrowing, imprudent investments, questionable accounting—and financial fraud. According to Enron's Bankruptcy Examiner, Enron insiders perpetrated a massive financial fraud, primarily through a series of complex structured finance transactions with Enron's numerous investment banks. These transactions, often conceived by the investment banks, were designed to disguise Enron's true financial condition from rating agencies, regulators, creditors, and investors. For example, in one group of transactions called "prepays," Enron borrowed hundreds of millions of dollars from its investment banks, but disguised the borrowing as cash flow from operations through a complex circular flow of commodity futures contracts with the banks.

In 2004, Enron Creditors Recovery Corp. (ECRC) sued many of Enron's former investment banks, alleging that they aided and abetted Enron's insiders' breach of their fiduciary duties and perpetrated a massive financial fraud on Enron's creditors. Counsel for ECRC retained Bates White Partner and Stanford University Professor Douglas Bernheim to analyze issues of causation, forseeability, damages, and apportionment. Working closely with Bates White staff, Dr. Bernheim developed a theory of causation and damages focused on the effect of the fraudulently reported transactions on Enron's investment grade credit rating. According to Dr. Bernheim's theory, if the true economic substance of the transactions had been disclosed, more likely than not, Enron would have been downgraded below investment grade well before November 2001. The loss of an investment grade rating would have triggered massive collateral obligations associated with Enron's commodity trading operations and would have forced Enron to confront its problems earlier—through bankruptcy or otherwise—thus saving Enron's creditors and the estate billions of dollars in further losses. According to Dr. Bernheim's theory, by delaying the market's discovery of Enron's true financial condition, the fraudulently reported transactions directly caused the substantial incremental losses sustained by Enron's creditors and the estate.

To test his theory, Dr. Bernheim directed Bates White staff to undertake a series of complex financial, statistical, and economic analyses. Specifically, Dr. Bernheim directed Bates White staff to perform the following tasks:

- Review each of the 85 challenged transactions to determine the true economic substance and measure the effect of the fraudulent disclosure on the key financial metrics routinely monitored by the credit rating agencies.

- Analyze contemporaneous financial data and credit ratings for thousands of U.S. companies to develop statistical models to predict downgrades as a function of companies' observable financial characteristics.

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- Employ statistical models of downgrade to predict the date by which, more likely than not, Enron would have been downgraded below investment grade if the fraudulently reported transactions had been properly disclosed.

- Determine Enron's overall deficiency balance—i.e., the amount by which Enron's total obligations exceeded its total assets—for each quarter from 1998 through 2001, as well as Enron's final deficiency balance as a result of the bankruptcy process. This substantial exercise required valuation of Enron's numerous business units through time, including its complex trading and international operations.

Dr. Bernheim then determined total damages by calculating the difference between Enron's deficiency balance at the predicted date of downgrade below investment grade and the final deficiency balance.

To apportion the total damages among the fraudulently reported transactions, Dr. Bernheim calculated the "causal contribution" of each transaction to the harm suffered by the estate as a function of: (1) the increased likelihood of downgrade below investment grade associated with the transaction and (2) the incremental losses that could have been avoided if Enron had faced its issues at an earlier date. Thus, according to Dr. Bernheim's principled approach, fraudulently reported transactions received shares of total damages in proportion to the expected losses that could have been avoided if the transaction had been properly disclosed.

Dr. Bernheim also theorized that the consequences of the financial fraud would have been reasonably foreseeable to those with knowledge of the true purpose of the fraudulently reported transactions. According to Dr. Bernheim, companies' financial disclosures are carefully regulated to ensure that "market monitors"—e.g., credit rating agencies, analysts, etc.—provide effective discipline to poorly performing companies. In contrast, Enron's fraudulently reported transactions were specifically designed to disguise Enron's true financial condition from the market monitors. Dr. Bernheim concluded that it was reasonably foreseeable that helping Enron's insiders avoid market discipline would likely lead to imprudent risktaking and mounting losses.

Working closely with Bates White staff, Dr. Bernheim prepared lengthy affirmative and rebuttal reports detailing his methodologies, provided two days of deposition testimony, and coordinated with counsel to prepare for trial. Ultimately, all defendants settled before trial, but ECRC's total recoveries from its investment banks surpassed $6 billion in cash payments and foregone bankruptcy claims.