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THOUGHT CONTAGIONS

Enronic Cleansing: Be Warned

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I alienated some friends and clients when I e-mailed a *TrendMacro Live!* note warning of a dangerous new phase of the **Enron** scandal. Everyone is understandably eager to round up the bad guys and hang 'em high. So I'm not making myself very popular by warning that our posse is turning into a murderous lynch mob

No – it's worse than a lynch mob. An over-zealous fervor to wipe out even the most slightly suspicious corporate behavior threatens to become the business equivalent of ethnic cleansing – call it "Enronic cleansing." When that happens, the good have as much to fear as the evil. And it *is* beginning to happen, and it *is* going to be murder on the stock market. Be warned!

Before you start thinking that I have too much sympathy for the devil, be sure you understand that I'm all in favor of vigorous prosecution of fraud and corruption of the type that appears to have been endemic within **Kenneth Lay's** Enron. And I'm all for shining a harsh light on the dark complexities of a corporate labyrinth like **Dennis Kozlowski's Tyco International**. And I think it's great when alert analysts throw stones at a financial house of mirrors like **Lou Gerstner's IBM**. Those are legitimate and worthwhile – if difficult – corrective processes that fall somewhere between law enforcement and tough love.

But the attacks this week in the ***New York Post*** against **Cisco's CEO John Chambers** and its **Vice Chairman Donald Valentine** are an entirely different matter. They draw spurious parallels between Cisco's business practices and Enron's, based on erroneous characterizations of what are only apparent similarities. And in the process they impugn legitimate business practices that are universal across virtually every important technology company in America – practices that have been at the heart of decades of innovation, job formation, and wealth creation.

I'll explain what these practices are – and how the *Post* is falsely portraying them – in a moment. But first, be warned: these practices are so widespread that if they were to be characterized as criminal, then every CEO, board member, and senior executive in Silicon Valley would end up in jail. It will be the genocide of the US technology industry – Enronic cleansing. That's why, as the *Post's* attacks have continued throughout this week, technology stocks have taken a drubbing. At this moment, no one knows how far it might go.

On Monday, in the first of two stories, the *Post* focuses on partnerships set up by Valentine's venture capital firm, **Sequoia Capital**, which various Cisco acquisitions were "funneled through." Now everyone knows that Enron's executives set up partnerships with colorful names like **Raptor**, apparently both to get liabilities and losses off Enron's books, and at the same time to enrich themselves with multimillion dollar fees. The story's implication is simple – no, simplistic – Enron had partnerships, and Enron is bad. Cisco has partnerships, so Cisco must be bad.

But the Sequoia partnerships are *not* creatures of Cisco at all, the way Raptor *et al* were creatures of Enron. Another *Post* article today simply lies about this, calling them "partnership investments set up by Cisco." These partnerships are independent venture capital funds set up

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and operated not by Cisco, but by Sequoia Capital, one of the most successful and respected venture capital firm in history. They are pools of capital put up primarily by plain-vanilla institutional investors like pension funds, charitable foundations and university endowments – and by VCs themselves, such as Donald Valentine. They make investments in hundreds of small companies, and the venture capitalists who act as general partners of these funds almost always sit on the boards of these companies in order to keep a watchful eye on their investments, and nurture the young companies along. When one of these companies hits the big time and goes public, the VC usually stays on the board – just as Valentine is on Cisco's board, and just as VCs are on the board of almost any technology company you would care to name, and a lot of non-technology companies too. Visit the Sequoia website, and you'll see the list of the hundreds of great companies they have helped to create: Cisco, **Oracle**, **LSI Logic**, **Yahoo!**, **PayPal**, **Cypress Semiconductor**, **nVidia** – the names just go on and on. These funds are no Raptor.

As the founder of Sequoia, Valentine has an interest in the success of all of Sequoia's funds. And John Chambers has an interest in one of them, too, as an investor. And therein lies the issue: Cisco acquired a company, **Monterey Networks**, that was one of many investments held in the Sequoia fund in which Chambers was an investor. Thus both Valentine and Chambers were in a position of conflict of interest: with their Cisco hats on, they would want the Sequoia fund to *sell* the company at the *lowest* price – but with their Sequoia fund hats on, they would want Cisco to *buy* the company at the *highest* price.

Sounds bad at first – and that's the way the *Post* wants it to sound – but think about it a minute before you line up Chambers and Valentine and order the firing squad to shoot. Conflicts can be good. It's in Cisco's best interests to have Valentine and Chambers involved in an innovation incubator that can give them a first look at interesting new technologies and companies. And it's in the Sequoia fund's interest to have smart businessmen like Valentine and Chambers who can help young companies with their wisdom, experience, and network of contacts. It's win-win, provided that everyone plays by a few simple rules to keep the conflicts under control.

The rules are simple, effective, well-known and time-tested. Parties with conflicts disclose their conflicted relationships, and recuse themselves from voting on whether or not the deal gets done. Chambers and Valentine both disclosed their connections to the Sequoia funds (although the *Post* makes a big fuss about what appears to be a simple error in the exact name of the Sequoia fund listed in SEC filings). Valentine abstained from voting on the Monterey deal; Chambers apparently did not, but his financial interest in it was quite small – about $10,000 – and he donated that to charity, according to the *Post*.

For the Enronic cleansing mob that the *Post* is trying to get together, the fact that Valentine and Chambers seem to have played by the rules doesn't matter. For the *Post*, small errors in disclosure are as bad as no disclosure at all. Making $10,000 and giving it to charity makes Chambers no less greedy than if he'd made $10 million and bought a yacht with it. And recusal from voting just earns the *Post's* sneers, as though abstention means they were loafing on the job as directors.

In a follow-up story yesterday, the *Post* claims that two other Cisco directors, **Carol Bartz** and **John Morgridge**, and other Cisco executives who are not board members, also held stakes in Sequoia funds – or as the *Post* puts it, "lucrative Sequoia partnerships that did deals with Cisco." What deals? No deals are named. Apparently the assertion that these partnerships were "lucrative" is enough to prove that something must have been crooked (although the *Post* actually doesn't even prove that they *were* lucrative).

And in the same story, the *Post* suggests that there are inconsistencies in how their partnership holdings have been disclosed over time. But there's not the slightest proof offered that this matters, or that any more disclosure than occurred was legally required. No matter. When it's time for Enronic cleansing, if you forget to fill in every little box on an **SEC** form and file it neatly in triplicate, it's off to the gas chamber with you. You're obviously a crook, and your company is obviously "the next Enron."

I live in Silicon Valley, and I count among my friends many venture capitalists and technology company executives. I can tell you for sure that all the venture capitalists sit on public company boards, and that all the executives participate in venture capital funds. These interrelationships are the pride and glory of Silicon Valley, and the key source of its "regional advantage." They fuel the virtuous cycle of risk-taking, innovation, and knowledge sharing. They are held together by trust and integrity, and controlled by rules and procedures that are universally understood and subject to the world's finest corporate legal scrutiny.

But after Enron, trust and integrity, rules and procedures, and scrutiny by experts are all presumed to be worth nothing. And that means that no conflicts can be permitted at all, because they are presumed to inevitably to lead to abuse. That means that the potential to commit a crime is as bad as the crime itself. So if you have the potential, you are guilty. Well, that means there are an awful lot of guilty people. And I really don't know who is going to run all those technology companies when all those guilty people are thrown in jail – newspaper reporters, maybe?

Or suppose, instead, that we have an amnesty. We won't throw them in jail, but we'll say that from now on, no company can make an acquisition if any board member or executive has the slightest interest in the acquired company. Why stop at acquisitions? Let's say that no company can even do business with another company in which a board member or executive has an interest. But we can't have a company's opportunities cut off like that, so we'll have to say that no executive or board member can ever invest in a venture capital fund… which means that no VC will ever be able to sit on a corporate board… which means that no VC will ever make another investment, because he can't protect it.

So be warned. There's no place this can go that is good. And the charges leveled by the *Post* against Cisco are a template for going after just about every technology company in America. I'm sure at this very moment busy beavers in newsrooms all over America are downloading SEC filings like mad to dig up dirt on Oracle, **Intel**, **Microsoft**, **AOL Time Warner**… you name it. There will be more stories. And when there are enough of them, one of them might even turn out to be true.

The NASDAQ may go to zero, but at least we'll be Enronically clean. TM