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Case Study

Enron: The Good, The Bad, and The Really Ugly

Denis Collins

Enron. The name conjures up images of everything wrong with corporate America. And for good reason. The poster child of the “New Economy” and a darling of Wall Street, Enron’s stock price soared through the 1990s, enriching millions of investors. If you bought the stock in

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August 1999 and sold it one year later, you more than doubled your money. For five consecutive years, Enron won *Fortune* magazine's award for being the nation's most innovative company. In 2000, with revenue climbing to \$100 billion, *Fortune* named Enron America's best-managed company; it was ranked #7 on the Fortune 500 list. One year later Enron imploded into bankruptcy. Twenty thousand people lost their jobs and pensions, and hundreds of thousands lost their investment.

Enron's demise can be attributed to a wide range of diverse factors, including the personalities of key decision-makers, the organizational culture, economic and political trends, and the nature of capitalism. The same deadly ingredients can destroy any organization, if owners and managers are not careful.

THE BEGINNING

Exposed in late 2001, Enron's fraudulent accounting techniques can be traced back to the early 1990s when Enron adopted aggressive accounting measures for calculating revenue. At the time, the company was trying to financially grow out of the heavy debt incurred following the 1985 merger of the two natural gas pipeline companies that became Enron. Minneapolis investor Irwin "The Liquidator" Jacobs had set his sights on raiding Omaha's financially troubled InterNorth natural gas company. The hostile takeover was averted when Ken Lay, the CEO of the much smaller Houston Natural Gas (HNG), agreed to sell his company to InterNorth for \$2.4 billion. Lay and other HNG shareholders were paid \$70 a share for stock selling at \$47. The combined InterNorth/HNG entity had a daunting \$4.3 billion debt to manage, leading Jacobs to withdraw his initial offer.

Lay soon impressed a majority of InterNorth/HNG's board of directors with

his astute responsiveness to the Reagan Administration's deregulation policies. Just six months later, the board promoted Lay to CEO, making him the fifth-highest-paid chief executive in the United States. The combined corporate entity was renamed Enron, and Lay moved its headquarters from Omaha to his adopted city, Houston.

KEN LAY'S RAGS TO RICHES

Becoming Enron's CEO was a dream come true for Ken Lay, the ambitious forty-two-year-old son of an ordained Southern Baptist preacher. Born in 1942, Lay grew up in rural poverty as a Missouri farm boy, living without indoor plumbing until the age of eleven. He received a scholarship to attend the University of Missouri, where he earned a master's degree in economics, and later became a senior economist for a Houston oil company. Being of draft age during the Vietnam War, Lay enlisted in the Navy and was assigned to conduct economic analyses at the Pentagon, work that he leveraged into a doctoral degree in economics in 1970 from the University of Houston.

After completing his military career, Lay served as a chief aide to the Federal Power Commission and Deputy Undersecretary of Energy in the Department of the Interior, where he specialized in deregulation policies. His work led to a job as vice-president of governmental affairs at Florida Gas, where he was promoted to president within two years. Through hard work and the right connections, Lay advanced from childhood poverty, when he felt lucky to have lunch meat to eat on Thanksgiving, to becoming president of a regulated monopoly before the age of forty, with an annual salary of \$268,000, equivalent to more than \$700,000 in 2006 dollars. A few years later he became CEO of Enron.

SKILLING'S GAS BANK TO THE RESCUE

Enron, which had dug a deep financial hole to avoid Jacobs's hostile takeover attempt, reported losses of \$14 million in 1986, and almost defaulted on its debt payments. Lay relied heavily on McKinsey and Company, the world's most prestigious consulting firm, to help him manage Enron's operational problems. He was very impressed with one particular McKinsey consultant—Jeffrey Skilling.

Whereas Lay's "rags-to-riches" story appropriately earned him the Horatio Alger Award, Skilling had always been a master of the universe. While still in high school, Skilling had saved an amazing \$15,000—equivalent to \$81,000 in today's money—working as a production manager for a cable television station. He invested all of it in the stock market, and lost it when a bull market turned bear. Despite losing a small fortune, Skilling was hooked on the intellectual excitement of trying to outsmart other stock market investors in predicting a company's future performance. He went on to earn a finance degree from Southern Methodist University and an MBA from Harvard.

With the collapse of communism in 1989, Lay and Skilling understood that the world would eventually become one transparent global market. The first companies to take advantage of the new political and economic landscapes would jump to the head of the Fortune 500 list. They predicted that natural gas would play a more prominent role in the nation's future energy portfolio, and Enron owned the largest natural gas pipeline in the United States.

But the natural gas industry was a mess. Public utilities purchased natural gas every thirty days on the highly unpredictable spot market, making accurate long-term budgeting for suppliers and customers nearly impossible.

Skilling's genius was to create a Gas Bank, where natural gas producers could sell their reserves to Enron, which would then sell them to customers under long-term contracts. Enron would take on the price fluctuation risk for both producers and consumers. Lay hired Skilling in August 1990 to be the CEO of Enron's new Gas Bank Division. In addition to a \$275,000 salary and a \$950,000 loan, Skilling negotiated for a \$10 million cash bonus when the division grew to a valuation of \$200 million, and \$17 million more when the Gas Bank reached a valuation of \$400 million.

Skilling focused on reaching those financial goals. A mere four months after taking the job, he struck gold with his first long-term deal, a \$1.3 billion contract to sell natural gas to the New York Power Authority for the next twenty-three years. By the end of 1990, Enron had become the nation's largest natural gas company with \$13.2 billion in revenue, a 40% increase from the previous year. The thirty-six-year-old Skilling became an instant corporate hero.

Lay, who didn't like personal conflict, particularly with someone as headstrong and successful as Skilling, gave Skilling plenty of latitude to run his division as he saw fit. Skilling changed Enron's corporate culture from a southern, conservative, good-old-boy system in a highly regulated industry to a very competitive "survival-of-the-fittest" system by attracting the brightest students graduating from the nation's elite MBA programs, tasking them to exploit new market opportunities. The "Skillingites" he employed tended to be extremely intelligent, creative, competitive, single-minded MBAs willing to work eighty-hour weeks. Dangling lucrative stock options and pay for performance bonuses, Skilling offered them an opportunity to become multi-millionaires by the age of forty, just as he did.

MARK-TO-MARKET ACCOUNTING

By mid-1991, the Gas Bank division had long-term contracts with more than 35 natural gas producers and 50 users, generating tremendous financial value for Enron. But it didn't look that way to the outsiders Skilling wanted to impress because Enron's traditional pipeline accounting system only recognized revenue when received. Skilling wanted this changed so that his division's financial statements would reflect the almost guaranteed long-term future revenue streams from public utilities, entities that state governments would not allow to fail.

He looked to the financial industry for an alternative accounting method because his Gas Bank division traded energy in much the same way that brokerage firms traded capital. He found what he was looking for in mark-to-market accounting. Financial institutions calculated the value of their stock portfolios by marking the stock against the current market price, not the original purchase price. By applying the same accounting logic to his Gas Bank division, Enron could claim the current economic value of its almost guaranteed long-term contracts with public utilities.

The Securities and Exchange Commission (SEC) rejected Skilling's initial request to do so, in part because trading companies rely on the market system, an external independent source, to determine the value of their assets, whereas Enron employees would be determining the long-term value of Gas Bank assets, making the valuation more prone to abuse. Skilling insisted such manipulation could be prevented through rigorous auditor oversight, and Enron employed one of the most prestigious auditing firms in the world, Arthur Andersen. With strong support from Arthur Andersen and Enron's board of directors, the SEC approved Enron's use of mark-to-market accounting for the first quarter of 1992. Skilling retroactively applied mark-to-market account-

ing for the recently completed 1991 fiscal year, which favorably impacted executive bonuses.

ANDY FASTOW AND SPECIAL PURPOSE ENTITIES

Enron still had a lot of debt. Skilling hired Andy Fastow, an expert on cutting-edge finance activities and husband to the heir of a Houston fortune, to do something about the company's debt problems. Fastow, who had majored in economics and Chinese at Tufts University and earned an MBA from Northwestern, quickly became Skilling's confidant. He even named his first son "Jeff" in honor of his new mentor. Fastow, who was loud, vulgar, obnoxious, and prone to temper tantrums, fit in well with the boys-will-be-boys culture being developed by Skilling. Fastow also shared an important attribute with both Lay and Skilling—a propensity for financial risk-taking.

Fastow quickly became an expert on Special Purpose Entities (SPEs), "off-balance-sheet" arrangements that protect company assets from risky business projects. A wide variety of companies, including airlines and large manufacturers, use SPEs to finance the purchase of assets, such as an airplane or new technology. Accounting-wise, an SPE is treated as a separate business entity rather than a subsidiary. If an SPE fails, the sponsoring company's assets are legally protected from the SPE's creditors. According to accounting standards, SPE status can be declared if the business entity meets two important criteria: (1) an independent owner maintains at least a 3% equity investment that remains at risk at all times, and (2) the independent owner exercises managerial control of the SPE.

With some creativity, Fastow constructed SPEs that generated large financial benefits for both Enron and the SPE. He funded SPEs with as much as 97% Enron stock, the highest

amount legally allowed, thus requiring no cash from Enron. As Enron's stock increased, so did the economic value of the SPE, making the SPE more attractive to outside investors. Fastow then used the SPEs to add revenue to, and decrease liabilities from, Enron's financial statement. By purchasing an asset *for* Enron's use, the debt associated with the purchase would appear on the SPE's, not Enron's, balance sheet. By purchasing an asset *from* Enron, the SPE would help inflate Enron's revenue and remove the purchased asset's debt from Enron's balance sheet.

Why would an SPE's outside investors agree to this arrangement? These transactions significantly improved Enron's financial statements, which attracted the attention of Wall Street investors, who then drove Enron's stock price to higher levels. Because an SPE's financial foundation was primarily based on Enron stock, SPE outside investors earned very favorable return-on-investments whenever Enron's stock price increased. The win-win relationship between Enron and the SPE would continue for as long as Enron's stock price continued to increase in value. Fastow quickly became one of Skilling's favorite employees.

INTERNATIONAL EXPANSION AND REBECCA MARK

Enron's International Operations Division, under Rebecca Mark's leadership, rivaled the Gas Bank's growth potential. During Mark's ascendancy, Enron negotiated a contract to construct the world's largest cogeneration plant, one that would supply 3 to 4% of Great Britain's electricity needs. Mark, an attractive woman who frequently exploited her good looks in the macho work of international development, possessed a missionary's zeal to provide developing nations in South America and Asia with the energy required for industrialization. She hired well-known high level dignitaries, such as

former Secretaries of State James Baker and Henry Kissinger, to open international doors.

Entering new markets requires substantial start-up costs. To attract high quality managers, executive bonuses were based on the economic value of a deal, not profits. For instance, Mark and her executive team skillfully negotiated a \$2.9 billion contract to build a power plant in Dabhol, India that would meet the region's increasing energy needs. The deal was justified based on future revenue projections from the sale of energy. The executives were not expected to return their bonuses when, several years later, the agreement collapsed due to local political problems.

Unfortunately for Enron, Mark was typically out-negotiated. When Argentina privatized its water system, Mark's winning bid of \$438.6 million exceeded the next highest bid by \$288 million. Even worse, the agreement did not include the water company's main office building, a major oversight by Enron's negotiating team. Yet what turned out to be a terrible financial deal for Enron benefited Marx and her management team, whose bonuses were linked to the price of the winning bid.

MANAGING CASH FLOW PROBLEMS

Enron faced several major financial hurdles as its debt kept growing. Skilling's use of mark-to-market accounting techniques made it more difficult to achieve new annual revenue targets. Wall Street analysts continually increased revenue expectations based on the amount of reported revenue. Each year Skilling's division had to exceed its inflated revenue calculations by 15%. This created a cash flow problem because a substantial amount of the Gas Bank's reported revenue was projected, not actual. Skilling considered the cash crunch to be a short-term problem and turned to his protégé, Andy Fastow, to pull him out of the cash hole. Fastow found a complex way to obtain loans

from an investment banker that could be recorded as cash on Enron's financial statements through an intricate web of SPEs.

Lay, impressed with the Gas Bank's annual 20% growth rate, promoted Skilling to Chief Operating Officer (COO) for the entire company, a step away from succeeding Lay as Enron's CEO. With his power extended to other divisions, Skilling inserted loyalists in key executive positions throughout the company. He promoted Fastow to vice-president of Treasury and Business Funding, with a goal of raising \$20 billion a year in capital. Everyone at Enron who needed capital would have to cooperate with Fastow's growing staff.

Skilling challenged his executive team to apply the successful Gas Bank business model to other operational areas. The plan was simple: find an untapped area of business, buy some assets, don't worry about initial costs, get the revenue numbers up, and control 20% of the market. Soon, sales volume would more than make up for the initial sunk costs. Skilling went on a buying spree, purchasing assets in other industries, such as electricity, paper and coal. Enron then created ways to trade key commodities between potential buyers and sellers within these industries, with Enron getting a small percentage of each transaction.

VIOLATING ACCOUNTING REGULATIONS

Skilling began with the electricity industry due to its similarities to the natural gas industry. Enron focused on California because the state was on the verge of deregulating electricity. The first major problem Fastow had to deal with was what to do with an asset Enron already owned in the state, which would lose its tax advantage if Enron became a major player in the California electricity market. Fastow created an SPE called RADR to purchase the asset from Enron in a way that protected the tax advantage.

Outside investors had profited quite nicely from Fastow-structured SPEs. Fastow now wanted to have some of the economic rewards that RADR would likely generate. However, Enron's Code of Ethics prohibited senior executives from having a financial stake in any organization doing business with Enron. The potential conflict of interest seemed obvious: would Fastow represent Enron's interest by selling an asset to RADR for the highest possible price, or represent RADR's interest by buying an asset from Enron at the lowest possible price?

Enron's Code of Ethics prohibited only senior executives, not their assistants. Looking to exploit the loophole, Fastow initially considered making his assistant and protégé, Michael Kopper, serve as the RADR's outside investor. Fearing that the link would be too obvious, Fastow created "Friends of Enron" to serve as RADR's outside investor. The investment group was led by Bill Dodson, Kopper's domestic partner, who borrowed \$419,000 from Fastow's wife to create the group. Kopper funneled RADR's profits back to Fastow by writing "gift" checks to the Fastow family in amounts just under the IRS minimum required for tax reporting and other schemes.

This network of relationships, hidden from Arthur Andersen auditors, violated company policy and Generally Accepted Accounting Principles (GAAP). Next, Fastow created an even more problematic SPE called Chewco that was ultimately 99% funded by Enron, a clear violation of accounting rules and regulations. Fastow named Kopper as Chewco's managing director, and gave his wife Lea an administrative position with an annual salary of \$54,000.

CONQUERING THE CHECKS AND BALANCES

Fastow, as well as Skilling, managed his way around every check and balance established by Enron and federal authorities.

Internally, Enron's risk assessment and control (RAC) department was responsible for calculating the economic impact of Fastow's deals, ensuring their fairness from Enron's perspective. However, Fastow and Skilling controlled Enron's semiannual 360 degree performance evaluation process. One negative performance evaluation submitted by a Skillingite could undo a host of favorable comments submitted on behalf of an RAC employee. Not cooperating with Fastow could end one's career at Enron.

Externally, outside auditors and lawyers have professional obligations to protect shareholder interests. However, Arthur Andersen and Vinson & Elkins, Enron's law firm, earned substantial consulting fees from Enron. Disagreeing with Fastow could threaten future consulting assignments. The relationships among the SPEs and Enron had become so complex, and Fastow's presentations about them so misleading, that only someone dedicated to finding a known fraud in the web of relationships would be able to unravel the illegality.

In addition, many Enron accountants were former Arthur Andersen employees. Richard Causey, Enron's Chief Accounting Officer, was a former Andersen auditor. In early 1997, David Duncan, a relatively young partner at thirty-eight years old, had worked with Causey on one of Fastow's first SPEs, and became Andersen's lead auditor on the \$40 million Enron account. Duncan would be reviewing his former trusted colleague's work. Furthermore, Duncan's annual bonus and advancement within Arthur Andersen depended on his increasing client fees by 20%. Critically questioning Enron's accounting transactions and financial arrangements could mean career suicide, something Fastow and Skilling pointed out to Duncan and his subordinates.

Lastly, members of the board of directors, who owned significant amounts of stock in Enron, have a fiduciary duty to represent

shareholder interests. However, several board members earned consulting fees from Enron, which made it difficult for them to confront Lay or Skilling about potential improprieties. In addition, they considered Lay and Skilling to be their friends and respected them as colleagues.

At each level of checks and balances, an assumption was made that questionable or illegal SPE arrangements would be detected by the next level. Those holding authority at each successive level assumed that Fastow's deals were legitimate because the previous level had not objected to them. The board of directors, which has ultimate responsibility, signed off on the questionable transactions under the assumption that they had the approval of Enron's RAC department, Andersen auditors, and Vinson & Elkins lawyers.

THE BOOM YEARS

Throughout 1998, Enron's stock price steadily climbed 48%, to \$57.10 a share. Lay promised to double employees' annual salary in Enron shares of stock if the company continued to hit its performance targets. With everyone's attention fixated on Enron's stock price momentum, Skilling went on a buying spree funded by Enron stock, acquiring 41 companies. He also invested \$1 billion to jump-start broadband activities, sending a strong message to employees: Enron's future success would be grounded in trading commodities and Internet expansion, not brick-and-mortar pipelines. Skilling promoted Fastow to Chief Financial Officer (CFO) and removed Mark as CEO of Enron's financially overextended International Division. Fastow hid her many financial failures with a web of SPEs; again, these SPEs were funded primarily with Enron stock.

On April 7, 1999, Enron hit the Initial Public Offering (IPO) jackpot with its investment in Rhythms NetConnections, an Internet

service provider. Enron's 5.4 million pre-IPO shares, worth \$10 million at the beginning of the day, skyrocketed in value to \$372 million by the end of the day. When the investment value declined to \$300 million a month later, Skilling wanted to claim the \$290 million profit before the stock price declined further. But pre-IPO investors had a legal obligation to hold the stock for six months after the public offering before selling it.

Fastow found a way around this rule by creating an SPE called "LJM1" (named after his wife Lea and sons Jeff and Matthew) to purchase a "put option" from Enron that would lock in the profit. Among LJM1's outside investors were some of the largest investment banks doing business with Enron. When investors questioned how LJM1 would profit from such transactions, Fastow noted that they should trust him; not only would he be directing the fund, he would also be one of the investors, with Enron's permission.

Fastow and Skilling convinced Enron's Board of Directors to waive the company's Code of Ethics so that Fastow could invest \$1 million in LJM1 and serve as its director. This was a clear violation of GAAP because LJM1 was being managed by Enron's CFO rather than an independent manager. Fastow was now negotiating on both sides of the table. He favored LJM1 and scolded Enron employees if they negotiated too hard. After all, Fastow argued, LJM1 was helping Enron get debt off its financial statements. When Enron's treasurer complained to Skilling about Fastow's strong-armed negotiating tactics, Skilling re-signed the treasurer.

Even though Fastow favored LJM1 in the negotiations, the results were still so beneficial for Enron that Skilling granted Fastow permission to create LJM2 to serve a similar purpose. The professional staff of LJM2 included Fastow's protégé's Michael Kopper and Ben Glisan, both of whom were on the Enron payroll. During the last eleven days of 1999,

Fastow orchestrated seven deals between Enron and the LJMs that provided Enron with badly needed cash and helped different business units meet quarterly projection targets.

Fastow's schemes included an illegal arrangement, wherein Merrill Lynch investment bankers created a company called Ebarge to temporarily purchase three electricity-generating power barges off the coast of Nigeria that Enron owned. Enron claimed a \$12 million profit from the sale, with the understanding that it would purchase the barges back within six months at a price favorable to Ebarge. The parking of an asset with a guaranteed buy-back was a clear violation of GAAP rules. Another complicated set of maneuvers involved an SPE called Southampton Place. In less than two months, the Fastow Family Foundation and Kopper's domestic partner each received \$4.5 million for their \$25,000 investment, and an Enron lawyer and Ben Glisan, Enron's new treasurer, each received \$1 million for their \$5,800 investment.

Fastow had become everyone's savior. His creative financing of Enron's mergers and acquisitions were widely acclaimed in the media and earned him *CFO Magazine's* 1999 CFO Excellence Award. That year, Enron succeeded General Electric as the winner of *Fortune* magazine's best-managed company in America.

TROUBLES IN PARADISE

The year 2000 was a wild roller coaster ride for Enron. The dot.com bubble burst in April 2000 and the Internet bull market soon came to a screeching halt. As a result, by mid-year, Enron's new broadband division surpassed its projected \$100 million in annual losses and raised its projected loss expectation to \$500 million.

Enron's financial statements were saved by a California heat wave and traders who

manipulated the electricity market to the detriment of rate-payers. Enron relied on creative accounting techniques to prevent disgruntled electricity consumers and California politicians from determining how much the company profited from the state's turmoil. Skilling and Causey created "Schedule C," an account that did not appear on Enron's balance sheet, to hide \$1 billion in profits from its California business that they could use to offset any future losses and to help other business units meet their quarterly targets.

The announcement of a twenty-year partnership with Dallas-based Blockbuster to provide videos on demand through the Internet helped boost Enron's stock price to \$90.56 a share by late August. Consumers would be able to choose from a library of the most recently released movie videos from the comfort of their homes. However, the companies were not even close to developing the necessary cost-effective technology. Given a stock split, Enron stock purchased for \$40 when Skilling became COO in March 1997 was now worth \$181. Rebecca Mark was finally pushed out of Enron for her many failures, and cashed out \$82.5 million in stock options. Causey sold a more modest \$10 million in stock and Skilling sold more than \$7 million in stock options.

Skilling, a hero in the financial press, was now poised to take on Lay's CEO duties and steer the course of Enron's future in 2001. As 2000 came to a close, Enron rose to #7 on the Fortune 500 list with \$100 billion in revenue, a 150% increase from the previous year, and \$1.3 billion in reported profits.

SKILLING'S REIGN AS ENRON CEO

On February 12, 2001, Ken Lay stepped aside and named Skilling, at age forty-eight, CEO of Enron. Lay wanted to gradually retire and, if all went well, Skilling would replace Lay as chairman of the board at the end of the year.

Skilling predicted that Enron's stock would climb to \$126 during his first year as CEO.

Things started to unravel; Enron's stock went down, not up. With Enron trading assets in so many markets, a handful of stock market analysts had compared Enron's financial performance to investment banks, rather than energy companies, and concluded that either the investment banks were significantly undervalued or Enron was significantly overvalued. During an analyst conference call, Skilling cursed at a short-seller who questioned Enron's lack of financial transparency. Soon the broadband market collapsed, as did Enron's partnership with Blockbuster. Enron's international businesses were failing and the company was being blamed for California's electricity problems. Meanwhile, Lay was purchasing a \$41 million state-of-the-art corporate jet for Enron, and construction continued on Enron's new \$300 million office building in downtown Houston.

Skilling's dream job was turning into a nightmare. His biggest headache was Fastow's network of more than one thousand SPEs. As the financial value of Enron's stock continued to decline, so did the financial value of the SPEs funded mostly with Enron stock. After references to LJM appeared in the media, Skilling told Fastow that his dual role as CFO of Enron and managing director of SPEs doing business with Enron had to end. Fastow chose to stay with Enron and sold his financial interests in the LJMs to his protégé Kopper, who quit Enron to manage them.

Despite these financial problems, Enron announced \$50 billion in revenue for the second quarter of 2001. Yet, the very next day, Skilling, struggling with depression, told an astonished Ken Lay he wanted to resign. Ken Rice, Skilling's good friend and former broadband CEO, prepared for Skilling's resignation by selling 772,000 shares for a \$28 million profit.

On Monday, August 13, Skilling notified Enron's board of directors that he was resigning due to "family matters." As a sign of good

faith to the company, Skilling repaid a \$2 million loan and forfeited \$20 million in severance pay. Lay informed stunned reporters that he would temporarily return as CEO. The board of directors rewarded Lay with what he needed most, a \$10 million bonus and more stock options to help pay margin calls on Enron's declining stock price. While recommending that employees buy Enron stock, Lay sold 78,500 shares for a \$2.1 million profit and Skilling sold \$37 million of stock options over the next month.

\$7 BILLION IN HIDDEN LOSSES

Following Skilling's resignation, a suspicious Sherron Watkins, an Enron vice-president and former Arthur Andersen accountant, submitted an anonymous one-page letter to Lay highlighting some of Fastow's accounting manipulations. When Lay avoided addressing her concerns at an all-employee meeting, she admitted authorship of the letter and met with him directly. Lay hired Vinson & Elkins to investigate Watkins' claims. Fastow demanded that the disloyal Watkins be fired immediately and confiscated her laptop. Enron's lawyers recommended against firing Watkins because the resultant legal fight would be played out in the media, to the detriment of Enron's already ailing stock price.

Lay learned more about the inner workings of Enron during the last two weeks of August than he had his previous fifteen years as CEO. The most urgent problem was financial—what to do about \$7 billion in losses hidden by overvalued assets and SPE balance sheets. Officially, Enron had a debt of \$12.8 billion, but the actual total was nearly three times that amount, around \$35 billion.

Then another unexpected catastrophe occurred. On September 11, 2001, a terrorist attack on the World Trade Center and the Pentagon killed more than three thousand

civilians. The stock market halted trading, and analysts predicted a negative effect on all stocks. The credit market tightened at the worst time possible, just when people were beginning to question Enron's creditworthiness.

Arthur Andersen was already under a cease and desist order from the SEC for its role in a \$1.7 billion accounting fraud uncovered at Waste Management. In June 2001, prior to Skilling's resignation, the SEC threatened to disbar Andersen from practicing public accounting if the company knowingly approved fraudulent accounting again. Just a few months later, Andersen realized that it had been fraudulently certifying the books of another client—Enron.

Duncan, the Arthur Andersen engagement team's lead auditor, informed Fastow and Causey that some of Enron's SPEs violated GAAP and, as a result, Enron would have to restate earnings going back several years by \$1 billion. In addition, Enron would have to restate its third quarter earnings by another \$1.2 billion, to reflect an accounting mistake in calculating shareholder equity that had been made the previous year. Fastow, fearing an SEC investigation, ordered Kopper to destroy his laptop and any office or home computer files that contained damaging information about the LJM's.

Lay and Causey continued to keep Andersen auditors in the dark about billions of dollars in hidden losses. Although Duncan was demanding at least \$1 billion in write-offs, Lay knew that there was another \$6 billion in hidden losses that Andersen had not yet uncovered. Lay now faced a decision that would directly impact Enron's 20,000 employees—how honest should he be with stockholders? With the collapse of the dot.com market compounded by a recession and the World Trade Center tragedy, Wall Street analysts predicted Enron would announce \$2 billion in losses for the third quarter of 2001. Lay sought counsel from his executive team, which felt confident that Enron could

reasonably explain losses totaling \$1.2 billion. Enron's stock price would decline further, but the company wouldn't be destroyed, which would probably happen if \$7 billion in losses were unexpectedly announced. This would give Enron another three months to improve operating revenues before acknowledging the additional hidden losses.

THE FALL OUT

Early Tuesday morning, October 16, 2001, Lay announced third quarter operating losses of \$618 million and a total of \$1.01 billion in non-recurring write-offs. The next day, a disgruntled group of shareholders filed a class-action lawsuit against Enron for insider trading. Worse yet, the *Wall Street Journal* published the first of a series of articles about Fastow's SPE arrangements. Anticipating a formal investigation by the SEC, Duncan activated Arthur Andersen's documentation retention and destruction policy. On October 23, Andersen employees in the Houston office were directed to start destroying all extraneous documents, emails, and computer files related to the Enron audit. The policy was also invoked in Andersen's Chicago, Portland, and London offices.

When questioned by Enron board members upset with the *Wall Street Journal* exposés, Fastow admitted that he had earned \$45 million from the two LJM SPEs. This was in addition to the \$33.6 million of Enron stock he previously had sold and \$3 million in bonuses. Enron's leading banks refused to lend any more money as long as Fastow remained CFO. As Enron's stock further declined, the board instructed Lay to fire Fastow in order to restore investor confidence. Unfortunately, Enron employees who had overloaded their pension plans with Enron stock were unable to sell their holdings because their accounts had been temporarily frozen until a long planned changeover in pension plan administrators was completed.

Warren Buffet, General Electric, Royal Dutch Shell, GE Capital, the Carlyle Group, and a Saudi prince all refused overtures from Lay to bail out Enron. Pressured by Arthur Andersen, Enron announced in early November that, between 1997 and 2001, income had been overstated by \$586 million due to accounting errors related to recording SPE transactions. Profits in 1997, Skilling's first year as COO, had been \$9 million rather than the reported \$105 million.

Enron was now losing \$2 billion a week and lawsuits from employees and creditors were beginning to pile up. Its stock price, which had been \$90 a year ago, was down to \$8.40. Then Dynegy, a much smaller energy competitor located in Houston that had copied some of Enron's best strategies, announced its intentions to acquire the company for \$9 billion. Enron had been saved!

But when Enron's credit rating was downgraded to just one level above junk bond status, an SPE collapsed and Enron had two weeks to pay back the \$690 million the SPE had borrowed on behalf of Enron. The extent of Enron's new financial problems caught Dynegy executives and stockholders by surprise.

On November 28, credit agencies admitted the obvious—Enron was unable to pay its debts. Dynegy immediately pulled out of merger negotiations. The value of Enron's stock dropped to 61 cents, as trading volume soared to 345 million shares, compared to the 4 million shares traded on a normal day. The stock of a company that, a mere six weeks earlier, had reported annual sales of \$130 billion and assets worth \$62 billion, was now worthless.

Lay, who had risen from rural poverty to the top of the corporate ladder, was now relegated to meeting with bankruptcy lawyers. On December 2, having no cash left to pay bills, Enron temporarily closed its doors to reorganize. The following day, 4,000 Enron employees received termination notices. Most of them were given thirty minutes to pack their personal possessions and leave the building.

A month later, Enron was delisted from the New York Stock Exchange, and Lay submitted his resignation. All that remained of Enron were the lawyers there to settle legal claims.

More than four years later, at a joint jury trial, Lay was convicted on six counts of fraud and conspiracy and Skilling on nineteen counts of fraud, conspiracy, and insider trading. Six weeks after the verdict, Lay died of a heart attack while awaiting sentencing. Skilling was sentenced on October 24, 2006 to a twenty-four year term in

prison. Causey pled guilty to fraud and Kopper pled guilty to two counts of conspiracy. As of October 2006, thirteen other Enron employees have pled guilty, and three have been convicted. After being indicted on 98 counts of fraud, conspiracy, insider trading, money laundering, and other criminal conduct, the wheeling and dealing Fastow pled guilty to two counts of conspiracy. He received a reduced sentence of six years in jail for providing evidence against Lay, Skilling, and other defendants.
