ABSTRACT

This case provides students an overview of the demise of the Enron Corporation, one of the precipitating events for a new era of regulation. In the 1990's, Enron was the subject of many articles and studies touting its quick rise as a firm successfully transitioning from a hard assets firm to a financial services powerhouse, a paradigm of the "new economy". The demise of Enron was even swifter, accomplished in a matter of months in the latter part of 2001. A brief overview of Enron's rise is given in the case, as well as a description of leadership, culture, financial operations, and stakeholder analysis. A Supplement is provided with the case for those who wish to pursue at greater depth the financial issues surrounding Enron's collapse.

This case was intended for use in MBA courses on social issues in business, or business ethics. It might also be very useful in courses on financial or accounting ethics, as well as human resource management. Undergraduate students in advanced accounting or finance courses might find the case useful in discussing ethical obligations of their respective professions. These comments are directed at those teaching either social issues or some aspect of business ethics.

On the Side of the Angels

On the day he was elected CEO, Enron's president, Jeffrey Skilling, was pictured on the front cover of the February 12, 2001 edition of BusinessWeek dressed in a black turtleneck and holding an electrified orb in his right hand, appearing more sorcerer than executive. Enron was busy mastering the deregulated energy markets, and he was leading the charge. Skilling defended Enron's activities in these markets, particularly the California market, saying:

We're on the side of angels. We're taking on the entrenched monopolies. In every business we've been in, we're the good guys.¹

By August, 2001, the charge would be over and Skilling would resign after only six months as CEO. In September 2000, Enron's stock price was in the $85-90 region; by November 2001 it was down to less than a dollar. In January 2002, John Clifford Baxter, an Enron executive, died, an apparent suicide. Timothy Belden, an Enron trader in the California markets, would plead guilty to conspiracy to manipulate markets in the California energy market² and another,
John Forney, would be arrested for conspiracy and wire fraud in the same California market. The angels, it seems, had come back to earth.

From Pipelines to Commodity Trader

In June 1984, the board of Houston Natural Gas (HNG), a natural gas distribution firm, hired Kenneth Lay as Chair and CEO, wooing him away from his position as president and COO of Transco Energy Company. His first task was to defend HNG from a takeover bid by The Coastal Corp. He did this by refocusing HNG on its core business. In a 1990 speech, Lay characterized his leadership during that time as follows:

In carrying out that assignment, between June 1984 and January 1985, $632 million of non-natural gas operations were sold and $1.2 billion of natural gas operations were purchased. As one director was heard to quip at the time, the Board gave me unlimited authority, and I exceeded it.

Lay further expanded HNG with the creation of Enron in 1986, merging HNG and InterNorth, a natural gas pipeline company. Through this merger and a series of transactions, Enron became a natural gas and oil company. The name Enron was coined by combining the prefix of the word energy and the ending for the common chemical word for inert gas. Lay, the architect of the merger and Enron’s first CEO, appeared to be one of the few individuals who recognized the opportunities offered by deregulation in the U.S. and privatization abroad. By the early 1990s, Enron had an interest in a 4,100 mile pipeline in Argentina, and was starting its power marketing business worldwide.

In 1994, Fortune ranked Enron first in a new category, pipelines, and 39th overall as one of ‘America’s Most Admired Companies’. By 1996 Enron had climbed to 22nd overall. In the 1990s, Enron was busy expanding its business structure into other areas, such as energy generation, broadband, and financial markets, yet Enron maintained its dominance of the pipeline industry’s ranking and was ranked in the top 20 firms overall through February 2001. In that year, Fortune named Enron the most innovative firm in the U.S. for the second year in a row. It first won the category in 1997. From 1994 to 2001 the firm steadily climbed in Fortune’s ‘America’s Most Admired Company’ list. Its stock price rose as dramatically: on December 31, 1996, Enron’s stock listed at 21 7/16 (adjusted for a 1999 split), and in December 31, 2000, its price was 83 1/8. (Figure 1) In the entry foyer, a huge banner was placed, reading “World’s Leading Company.”

Throughout 2001, as Enron’s stock declined, so did its rankings. From 2001 to 2002 Enron’s score fell from 8.29 to 3.9, and from first to last in its industry. Enron was ranked 523 (of 530) in wise use of corporate assets and quality of management and 521 in fiscal soundness.
“Get it done. Get it done now. Reap the rewards”

Lay built a management team, not of gas and energy people, but primarily of MBAs. Rebecca Mark, an energy professional who rose from part-time trader to President of Enron International and Azurix Water, characterized Enron employees as “aggressive, well compensated traders.”9 One executive in the energy industry noted that, in the later years, it was often difficult for other energy companies to do business with Enron, because they “were just a bunch of MBAs, with no idea of the real energy business.”10 The culture was a mix of Texas and Wall Street, centered in Houston with the drive of a trading floor.

Enron had developed over the years from an oil and gas exploration and pipeline company to a derivatives trading company. In its office tower, the executive offices on the seventh floor overlooked the sixth floor, an expansive derivatives trading operation.11

Enron’s management saw creativity and human capital as the real resource behind its future growth. In the 1999 Annual Report Letter to Shareholders, Lay wrote:

Creativity is a fragile commodity. Put a creative person in a bureaucratic atmosphere, and the creative output will die. We support employees with the most innovative culture possible, where people are measured not by how many mistakes they make, but how often they try.12

In April 2002 Lay described Enron’s culture:

One of our greatest successes at Enron was creating a culture, an environment, where people could try to achieve their God-given potential. But certainly I wanted it to be a highly moral and highly ethical environment. I have done the best job I can of following that every where I have been.13

Lay insisted on ethics at Enron. Every employee received a copy of the Code of Ethics, and with it a memo from Lay dated July 1, 2000 that read in part:

As officers and employees of Enron Corp. ... we are responsible for conducting the business affairs of the Company in accordance with all applicable laws and in a moral and honest manner. ... An employee shall not conduct himself or herself in a manner, which directly or indirectly would be detrimental to the best interests of the Company or in a manner, which would bring the employee financial gain separately derived as a direct consequence of his or her employment with the Company. ... We want to be proud of Enron and to know that it enjoys a reputation for fairness and honesty that is respected. ... Let’s keep that reputation high. (emphasis in original)7
Skilling put his own mark on Enron's culture. Extravagance was celebrated. At one meeting, Mark rode onto the stage with another executive on a Harley. At another, an adult elephant was brought in. One executive showed up for an employee gathering with a tractor-trailer full of expensive sports cars. The floors on the parking garage were marked by words selected to remind employees of valued attributes: bold, innovative, smart, united, ambitious, accomplished, resourceful, creative, confident, adventurous, adaptable, and undaunted.7

Recruitment took place both in long, intense interviews, and visits to topless bars and strip clubs.7 Once an individual passed an initial interview, he or she was invited to a "Super Saturday" session of interviews. This amounted to eight 50-minute interviews. Each interviewer would rank the candidate on between five to eight categories, and the ratings would be compiled. Offers would go out within a few days, and candidates that turned down the job offer would be offered signing bonuses or other financial inducements.14

Central to Enron's human resource policy was Skilling's Peer Review Committee (PRC), or what became known as the "rank and yank" process.7 Every six months, each person would choose five individuals (four plus the immediate supervisor) to provide feedback on his or her performance. Others who desired could also contribute unsolicited feedback. This feedback went to the PRC's ratings meeting where employees were rated on a scale from 1 (excellent) to 5 (worst performing). The PRC took place behind closed doors, but in plain sight, since interior walls on the trading floors were glass. The picture of the individual being discussed would appear on a slide show, visible to all on the floor, while management discussed the evaluations. The PRC was a forced ranking system, where 15 percent of those reviewed had to receive 5's. These would then be "redeployed", meaning they had to search for a job in the organization or find themselves unemployed.

One employee noted that there were two realities of life on the Enron floors: stock price and the PRC.14 Nothing else mattered. Michael J. Miller, a manager in Enron's failed high-speed Internet service venture described the atmosphere as "Get it done. Get it done now. Reap the rewards." An acrylic paperweight from the legal department stated its mission as "To provide prompt and first-rate legal service to Enron on a proactive and cost-effective basis."15 Below that was "Translation: we do big, complex and risky deals without blowing up Enron." Employees that survived were rewarded for earnings that could be quickly booked, regardless of the long-term consequences. For instance, two of the Enron executives who closed the deal on the doomed Dabhol power project in India received bonuses in the range of $50 million just for closing the deal.16

Similar to many other companies in the dot-com boom of the 1990s, Enron offered a high reward structure for its employees. In 1999, Fortune ranked Enron as one of the 25 best companies to work in America, and second in employee talent. More than 2000 Enron employees were millionaires. Employees received free laptops and hand-held devices, expensive ergonomic chairs and lunches at Houston's finest restaurants. The
company distributed Waterford crystal gifts for Secretaries' Day. Enron's Board of Directors was also well compensated. Chosen by management, Enron directors received cash and stock worth $300,000 a year.\textsuperscript{16}

Rewards extended beyond the workday. For a family picnic Enron rented the 85-acre Astroworld theme park. The 2001 Christmas party with a budget of $1.5 million was to be held at Enron Field, Houston's new sports stadium. "Appearances were very important," said Jeff Gray, a former Enron economist. "It was important for employees to believe the hype just as it was important for analysts to believe it."\textsuperscript{17} In London, Enron's well-paid executives submitted sealed email bids for 18 parking places. One executive paid $6,250 to use an optimal space for one year.\textsuperscript{18} However, many employees felt that they deserved the perks because working at Enron required 12-hour workdays and endless travel.

Change was constant as businesses came and went. Enron units were often reorganized, perhaps 3 to 4 times a year. The continual reshuffling taxed the accounting staff. When a unit was reorganized it received a new cost code but the old codes were not immediately deleted. This provided an opportunity for charging purchases to the old cost code.\textsuperscript{17}

On the trading floor, there were stories of the men rating women as potential models on a calendar. When one of the "candidates" would walk onto the floor, someone would yell the name of the month to alert others of her presence.\textsuperscript{17} At Enron like many high-risk, high reward companies gambling was prevalent. A former Enron International executive described the annual NCAA basketball tournament pool as reaching almost $90,000.\textsuperscript{17} At times employees celebrated their trading wins or deals at local strip clubs. In 1999 Enron informed employees to avoid using their company credit cards at the clubs, listing the clubs in a memo under their discreet billing names.\textsuperscript{18}

This culture spilled out of the doors and into Enron's relationships with others, particularly its analysts. On one occasion, Fastow was asked by a Citigroup banker about a group of equations on the whiteboard in the conference room next to his office. The banker wanted to know if Fastow understood the equations. Fastow replied, "I pulled them out of a book to intimidate people."\textsuperscript{18}

Analysts who listened to the quarterly earnings-report conference calls would be derided if they had questions about the details. The most notorious incident occurred during the April 17, 2001 conference call. Skilling had finished presenting the numbers and was responding to questions when Richard Grubman, a managing director of Highlands Capital Management, asked about Enron's balance sheet and cash-flow statement after earnings. Enron had failed to provide either. When Grubman commented that Enron was the only financial institution that never provided such statements for these calls, Skilling shot back, "Well, thank you very much. We appreciate that, asshole."\textsuperscript{7}
Enron and the Capital Markets

Prior to his employment at Enron, Skilling served as consultant to Enron for McKinsey & Co. In 1989, Enron launched GasBank at Skilling’s urging for the purpose of hedging risk for natural gas producers and wholesale suppliers. Both parties could arrange forward contracts (contracts to purchase or sell commodities at a future date at set prices, and Enron would sell financial derivative contracts to sell the risk of the forward contracts to other interested investors. In 1990, Enron became a market maker, a financial clearinghouse, for natural gas, selling swaps and futures on the New York Mercantile Exchange. In that same year, Lay hired Skilling as CEO of Enron Gas Services, and Skilling hired Fastow to serve as Chief Financial Officer (CFO). EGS was ultimately renamed Enron Capital and Trade Resources (ECT).

Through a process known as “asset securitization”, ECT provided financial and risk management services for Enron and its trading partners. This process involves selling the rights to future cash flow streams. Originating corporations, such as mortgage companies, would take their risky investments and sell them to another financial institution, such as an investment bank. The investment bank, in turn, would take a number of such investments, bundle them together, “strip” (or separate) the investment cash flows by level of risk, and put the result into securities they would then sell. In the case of mortgage-backed securities, investment banks might offer two securities, one based on the principal and the second on the interest payments. Each would have a different yield, based on the level of risk. Asset securitization is attractive to the originating corporation on two counts: it eliminates risk of default by selling the risk to the investment bank, and lowers cost of capital by providing immediate cash inflow.

ECT fulfilled two functions. First, it provided asset securitization services for Enron’s natural gas and oil entities, making those entities much more profitable. Secondly, it moved Enron further toward Lay’s vision of Enron as a trading floor, a market maker, for a variety of commodities. With the attainment of risk management and capital flow-through, Enron could in principle trade anything. Through the 1990’s, Enron was rapidly becoming a commodities market based in Houston. Even weather risk was commoditized and traded. This was supplemented with what Skilling would term “asset-lite”: the hard assets Enron originally controlled in such deals would be sold, in many cases to special-purpose entities (SPEs) that were created by Enron.

Two Critical Elements: Mark-to-Market and the SPEs

Enron funded its growth as a financial services firm by using very sophisticated financial practices, mark-to-market accounting and SPEs. Originally termed mark-to-model, the mark-to-market accounting method was intended to assist investors in obtaining some reference point in valuing a security. A model was constructed using a number of assumptions, and the security was then valued using that model. In reality, these prices were generated by computers, not by market process. However, some Wall Street bankers, and later Enron executives, would often term prices obtained through this process as mark-to-market, not mark-to-model. Enron relied on this procedure to

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establish prices (sometimes unrealistically high) in certain of its commodities (e.g., weather) where the markets were new and there were no reference prices.\textsuperscript{11}

The second mechanism Enron used was the creation of special purpose entities (SPEs). SPEs are financial devices designed to give companies greater flexibility in finance and risk management. While an SPE can take a variety of forms (corporation, partnership or trust), the essence is the same: the SPE allows a corporation to segregate financial activity from its corporate balance sheet. A well-established high-tech firm, for example, might want to engage in developing the next generation of devices, but hesitate because even small setbacks in risky R&D efforts could damage its stock price. By setting up an SPE for research into new technology, the firm could safely do innovative research and simultaneously segregate all the risk into its SPE. There are two requirements for SPEs to be legitimate: first, there must be a 3 percent outside equity position; and second, the outside capital must clearly be at risk.

Fastow set up a number of SPEs for Enron. Among the more famous were partnerships named Chewco, JEDI, LJ M1 and LJ M2, and four investments named Raptors. The first SPE created was named the Joint Energy Development Investment (JEDI), a $500 million partnership between Enron and the California Public Employees Retirement System (CalPERS) in 1993. This partnership would continue until 1997, when CalPERS sold its position to Chewco, another SPE created specifically by Enron to purchase the CalPERS shares in JEDI. Enron hoped that this buyout would then encourage CalPERS to invest in JEDI II, a proposed $1 billion venture.

Enron encountered financial problems that SPEs (many failing the legitimacy criteria) would be used to solve. Enron had built itself into its commodities swap mechanism. It was not simply brokering the contract, but actually buying and selling natural gas. This required a high credit rating. High default risk on Enron’s part would ruin the swap business. SPEs provided Enron the opportunity to continually move debt from its balance sheet, keeping its high credit rating and its swap business.

The “Friends of Enron”

As Enron expanded the use of SPEs, new investors were required to satisfy the SEC requirement of 3 percent outside equity investment. Accordingly, Fastow and Michael Kopper (managing director, Enron Global Finance, and a direct report to Fastow) established a group called the “Friends of Enron”. These “Friends” were actually relatives or friends of Enron’s executives. Fastow and Kopper funneled monies through these people to finance the purportedly outside equity in the SPEs.
The Web of SPEs

Enron’s need for a high credit rating drove the creation of even more SPEs to keep debt off the balance sheet. Over time, Enron engaged in deals with over 3,000 off-balance-sheet subsidiaries and partnerships. The thinning margins in each maturing market meant decreasing profits, but profits were necessary to continue Enron’s trading mechanism. The only way to continue was to create more profits, and that meant opening new commodity markets, exploiting them quickly, and then creating newer markets. The SPEs were critical to this strategy, keeping debt from the books and providing capital. Enron’s stock price soared dramatically, unburdened by the debt that was accumulating in the SPEs.

Enron began trading wholesale electricity in 1994, with the beginning of deregulation in the U.S. electricity markets. These trades provided some capital for Enron, but also exaggerated the internal problems. Enron did not have the cash required to acquire generating capacity, though it stated in its 1998 Annual Report that it had indeed done so. In fact, Fastow had created yet another SPE to finance the “acquisition”, again adding minimal assets to Enron’s balance sheet and shielding Enron from the debt.

The SPEs presented Enron with the opportunity to disguise debt and loss as revenue, but they did not necessarily result in cash flow. Enron would establish an SPE by issuing Enron stock to collateralize the SPE, and then engage other entities such as banks to invest in the SPE. Enron would then “sell” the SPE the deal that it had set up the SPE to handle in return for either cash or a promissory note, which Enron would then book as revenue. In one case, it was a forward contract on shares of an internet company in which Enron had invested. Another case was “dark fiber”, i.e., fiber optic cable that was already laid but as yet unusable. In both cases, Enron had a “make whole” contract with the SPE, insuring that the SPE would not lose money. However, even as the dot-com bubble burst, the shares in the internet company declined, and the value of the dark fiber likewise dropped, Enron was able to shield its balance sheet from these losses.

Constructed on Enron stock as they were, these SPE arrangements contained triggers, i.e., valuation points where these deals would need infusions of either more Enron stock or other collateral. For example, in an SPE named Osprey, if Enron’s stock fell below $59.78, Enron was obligated to either issue new stock (either directly to Osprey or in a private placement) or provide cash sufficient to bring the value of Osprey up to cover its debt obligations. In another instance, Enron’s stock price decline forced restructuring of four SPEs named Raptor I, II, III, and IV in December 2000, and then requiring an additional infusion of stock in the first quarter of 2001 to shore up their falling credit capacity. By the end of the restructuring, Raptors II and IV owed an additional $260 million to Enron.

In examining the various Raptor transactions, Stuart Zisman, an attorney for Enron North America, wrote (emphasis added in the Powers Report):
Our original understanding of this transaction was that all types of assets/securities would be introduced into this structure (including both those that are viewed favorably and those that are viewed as being poor investments). As it turns out, we have discovered a majority of the investments being introduced into the Raptor structure are bad ones. This is disconcerting [because] ... it might lead one to believe that the financial books at Enron are being "cooked" in order to eliminate a drag on earnings that would otherwise occur under fair value accounting...²⁰

The Investment Bank Connection

Enron’s need for a high credit rating influenced its relationships with investment banks as well. In return for its business, Enron sought short-term deals that allowed it to disguise loans as sales revenue, and in turn unload (for brief periods of time) unprofitable entities from Enron’s balance sheet. Between 1992 and 2001, Enron borrowed $8 billion from Citigroup and J.P. Morgan Chase & Co. in transactions that had the appearance of gas trades rather than loans, understating Enron’s debt by $4 billion, and overstating its $3.2 billion cash flow from operations by 50 percent.²¹ An independent bank examiner, Neal Batson, found that Enron had recorded profit of $1.4 billion through similar transactions with six investment banks.²²

The Enron Control System

Our philosophy is not to stand in the way of our employees, so we don’t insist on hierarchical approval. We do, however, keep a keen eye on how prudent they are, and rigorously evaluate and control the risk involved in each of our activities.¹²

The Enron culture was not without its system of checks and balances, particularly in the financial dealings. The Board turned to those checks and balances when approving the deals with the SPEs, as well as Fastow’s role in the various SPEs. It was the task of Risk Assessment and Control (RAC) to examine each deal and perform due diligence. RAC had the responsibility to oversee and approve all deals in which Enron engaged, over 400 each year. Each deal was accompanied by a Deal Approval Sheet (DASH) assembled by the business unit responsible for the deal. Each DASH had a description of the deal, origination information, economic data, a cash-flow model (sources and uses of cash and the deal’s internal value), risk components, financial approval sheet, and authorization page.⁷ Corporate policy required approval from the relevant business unit, legal department, RAC, and senior management. Many of the DASH forms for the various SPEs had incomplete authorizations. In particular, Skilling’s signature is blank on many of the DASH forms associated with the LJM deals.²⁰

As the number of deals with LJM increased, a separate LJM approval sheet was added as a control procedure. This approval sheet was printed with check marks already in the boxes. No third-party documentation was required to substantiate claims made on the document. Conclusions were used as questions ("Was this transaction done strictly
on an arm's-length basis?"), while others revealed low standards ("Was Enron advised by any third party that this transaction was not fair, from a financial perspective, to Enron?").

There were twenty deals between Enron and LJM1 and LJM2. In setting up the LJM entities, the Board had waived Enron's Code of Ethics and allowed Fastow to be named general partner, with a $1 million investment in LJM1 alone. When Fastow presented the option of creating the LJM entities to the Board, he portrayed them as alternative purchasers for Enron assets, providing perhaps better valuations for assets Enron was in the process of selling. In fact, as the quote from Zisman earlier hints at, there were no alternative buyers for most of what was sold to the SPEs.

The Board made two critical assumptions. First, it assumed that, since the operational results of each division were at stake, each division would therefore aggressively market assets. Second, it assumed that Andersen's counsel on the LJM deals would be independent. The Board relied on the reviews by Richard Causey (Chief Accounting Officer) and Richard Buy (Chief Risk Officer) as a first level of control. In addition, the Audit and Finance committees of the Board were assigned the task of reviewing all transactions from the previous year. The Board also required Skilling to review and approve all LJM transactions, as well as to review Fastow's economic interest in Enron and LJM.

Skilling, first as COO and later CEO, did not sign many of the DASH forms associated with the LJM transactions. No evidence exists that Skilling knew how much money Fastow was making through LJM. Skilling, in one note, simply said that Fastow's first duty was to Enron because he received more compensation through salary and options than he might be making through LJM.

Neither stockholders nor analysts found it easy to monitor Enron's overall performance. Information on the financial dealings, particularly those with the SPEs, was difficult to find. The information on the SPE deals was disclosed either through proxy statements or in footnotes on the 10-Ks and 10-Qs. This lack of disclosure was contrary to existing standards. Accounting standards demand that sufficient information be provided so that the effects of transactions on the financial statements can be determined. At one level, there should have been enough information for management to assert the related-party transactions were at least comparable with those that would have taken place with unrelated parties. Second, details were often omitted. In the 2000 10-K, Enron stated, "Enron paid $123 million to purchase share-settled options from the [Raptor] entities on 21.7 million shares of Enron common stock." What Enron had actually purchased were put options, thereby betting that its stock would decline.

**It Comes Undone**

Six months after taking the reins as CEO, Skilling abruptly resigned. He had assumed the position of CEO of Enron on February 12, 2001, and he resigned effective August 14, 2001. His fifteen years at Enron were over, but Enron would haunt him long after,
through lawsuits and investigations. Skilling cited "personal reasons" as the cause, but there was widespread speculation that more was behind it.

| Table 1 |
| Enron Corp. and Subsidiaries 2000 Consolidated Income Statement |
| (in millions) |
| Non-derivative revenues | 93,557 | 34,774 | 27,215 |
| Non-derivative expenses | 94,517 | 34,761 | 26,381 |
| Non-derivatives gross margin | -960 | 13 | 834 |
| Gain (loss) from derivatives | 7,232 | 5,338 | 4,045 |
| Other expenses | -4,319 | -4,549 | -3,501 |
| Operating income | 1,953 | 802 | 1,378 |

Source: Testimony of Frank Partnoy
In Hearings before the United States Senate Committee on Governmental Affairs
January 24, 2002.

Table 1 provides a quick glance at Enron's profit and loss from 1998 to 2000. The declining gross margin indicates that Enron's non-derivatives business was losing money. Any profitability was coming from Enron's derivatives business. In fact, the amount of money Enron was making in this area was roughly equivalent to the annual net revenue of Goldman Sachs, Inc. In his testimony, Partnoy analyzed these profits thusly:

The size and scope of Enron's derivatives trading operations remain unclear. Enron reported gains from derivatives of $7.2 billion in 2000, and reported notional amounts of derivative contracts as of December 31, 2000, of only $21.6 billion. Either Enron was generating 33 percent annual returns from derivatives (indicating that the underlying contracts were very risky), or Enron actually had large positions and reduced the notional values of its outstanding derivatives contracts at year-end for cosmetic purposes. Neither conclusion appears in Enron's financial statements.

In the Raptor restructurings at the end of 2000 and beginning of 2001, a series of promissory notes from the Raptors had been recorded as increases in shareholders' equity, eventually totaling $1 billion. In August 2001, Andersen accountants declared that Raptors I, II, and IV were improperly accounted for, and revisions were required. It was decided to record the correction in its third quarter filings, and on November 8, 2001, Lay announced a $1.2 billion reduction to shareholders' equity, with the additional
$200 million write-down resulting from a difference in contracts between the Raptors and Enron. In addition to the $1.2 billion write-down in shareholders' equity, Enron consolidated the SPEs back to 1997. Hence, the balance sheets of Chewco, JEDI, and LJM were now part of Enron's balance sheet. Over the course of the four years, these adjustments reduced Enron's income by $591 million, and increased its debt by just less than $2.6 billion. And some feared that the restatements were insufficient.

In the midst of this restructuring, a lawsuit was filed on October 22, 2001, by Milberg Weiss Bershad Hynes & Lerach, LLP. This was a class-action suit on behalf of Enron shareholders, and disclosed as part of its filing the names and amounts of stock sold by Enron insiders, both senior management and directors (Table 2).

Table 2
Senior Management and Board of Director Members Accused of Insider Trading

<table>
<thead>
<tr>
<th>Senior Management and Board Members</th>
<th>Proceeds from Enron Stock Traded Between October 1998 and November 2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>J. Clifford Baxter(a)</td>
<td>$34,734,854</td>
</tr>
<tr>
<td>Robert A. Belfer(b)</td>
<td>$111,941,200</td>
</tr>
<tr>
<td>Norman P. Blake Jr.(b)</td>
<td>$1,705,328</td>
</tr>
<tr>
<td>Richard B. Buy(a)</td>
<td>$10,656,595</td>
</tr>
<tr>
<td>Richard A. Causey(a)</td>
<td>$13,386,896</td>
</tr>
<tr>
<td>James V. Derrick Jr.(a)</td>
<td>$12,563,928</td>
</tr>
<tr>
<td>John H. Duncan(b)</td>
<td>$2,009,700</td>
</tr>
<tr>
<td>Andrew S. Fastow(a)</td>
<td>$33,675,004</td>
</tr>
<tr>
<td>Mark A. Frevert(a)</td>
<td>$54,831,220</td>
</tr>
<tr>
<td>Wendy L. Gramm(b)</td>
<td>$278,892</td>
</tr>
<tr>
<td>Kevin P. Hannon(a)</td>
<td>&quot;Unknown but substantial&quot;</td>
</tr>
<tr>
<td>Ken L. Harrison(a)</td>
<td>$75,416,636</td>
</tr>
<tr>
<td>Joseph M. Hirko(a)</td>
<td>$35,168,721</td>
</tr>
<tr>
<td>Stanley C. Horton(a)</td>
<td>$47,371,361</td>
</tr>
<tr>
<td>Robert K. Jaedicke(b)</td>
<td>$841,438</td>
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<tr>
<td>Steven J. Kean(a)</td>
<td>$5,166,414</td>
</tr>
<tr>
<td>Mark E. Koenig(a)</td>
<td>$9,110,466</td>
</tr>
<tr>
<td>Kenneth L. Lay(a, b)</td>
<td>$184,494,426</td>
</tr>
<tr>
<td>Rebecca P. Mark(a, b)</td>
<td>$82,536,737</td>
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<td>Michael S. McConnell(a)</td>
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<tr>
<td>Jeffrey McMahon(a)</td>
<td>$2,739,226</td>
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<tr>
<td>Cindy K. Olson(a)</td>
<td>$6,505,870</td>
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<tr>
<td>Lou L. Pai(a)</td>
<td>$270,276,065</td>
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<tr>
<td>Kenneth D. Rice(a)</td>
<td>$76,825,145</td>
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<tr>
<td>Jeffrey K. Skilling(a, b)</td>
<td>$70,687,199</td>
</tr>
</tbody>
</table>

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Joseph W. Sutton\textsuperscript{a} \hspace{1cm} $42,231,283$
Lawrence Greg Whalley\textsuperscript{a} \hspace{1cm} "Unknown but substantial"

\textsuperscript{a} Employee, Enron Corp.

\textsuperscript{b} Member, Enron Board of Directors


During this time, Enron's one hope was a proposed merger with Dynegy, a corporation once viewed by Enron employees as an insignificant competitor. Now, Dynegy was the only thing between Enron and absolute disaster. However, the merger also died of the same problems that had plagued Enron: fear of what was not disclosed. The merger was announced on November 9, the day after the restatements. On November 28, Standard & Poor's downgraded Enron debt to junk status, Dynegy declared the merger dead, and Enron's share price dropped from $3.69 at opening to $0.61 at close. On December 2, 2001, Enron filed for Chapter 11 bankruptcy protection, and Jeff McMahon (Executive Vice President, Finance, and Treasurer, Enron Corp.) was named president and CEO following Ken Lay's resignation on January 23, 2002. McMahon would in turn resign in April 2002.

THE AFTERSHOCKS

Criminal Actions

In addition to a number of Congressional hearings, the Enron bankruptcy also brought criminal actions by the government. David Duncan, Andersen's lead auditor for Enron, pleaded guilty of obstruction of justice in April 2002 for document shredding in connection with the Enron account. Kopper, the individual Fastow relied on so heavily, pleaded guilty in August 2002 to conspiracy to commit wire fraud and money laundering. He would lose approximately $12 million that he admitted he had improperly acquired through the various SPE deals in which he had been involved. Fastow was indicted in October 2002 on 78 counts for his role at Enron and in the various SPEs, and his accounts were frozen.

The Retirement Vanishes

Enron had been a significant holding in many large funds, particularly pension funds that sought to invest by industry segment. Enron employees were particularly invested in the stock. Their 401(k)s were primarily Enron, and they were barred from selling their shares until they turned 55. In fact, due to the rise of the stock price, even then many held on. Many were solely invested in Enron. As late as the summer of 2001, Ken Lay was predicting that Enron would regain much of its loss in stock price. His email
announcing the resignation of Skilling as CEO, and his own resumption of that post, ends with this:

- Our performance has never been stronger; our business model has never been more robust; our growth has never been more certain; and most importantly, we have never had a better nor deeper pool of talent throughout the company. We have the finest organization in American business today. Together, we will make Enron the world’s leading company.  

At the same time, however, Lay was busy selling much of his Enron stock. During 2001, Lay is reported to have sold $70 million in Enron shares. For almost an entire year, he was selling between 3,000 and 4,000 shares each workday. He sold some shares back to the company to repay a loan from Enron. By doing so, he not only disposed of the stock, but also circumvented disclosure laws that would have required him to report insider stock sales.

In October 2001, Enron was scheduled to switch money managers for its 401(k) plans. The switch created a window of days where employees would be barred from trading their stock. The dates of this blackout window were not well understood by rank-and-file employees, and many thought it started earlier than it actually did. The blackout was to start October 19, and end November 20, though employee protests forced the end-date to be moved up to November 12. Enron, which had once had a stock price over $90, was $8.41 on November 13, 2001.

The pension funds of every state were invested, to some extent, in Enron stock. The estimated loss to these funds was $1.5 billion. Florida lost $328 million, California $142 million, and Georgia $122 million. A portion of the pension and endowment funds of the University of California was invested, losing $145 million in the demise.

The Accounting Profession

Fallout spread throughout the accounting profession as well, as reports of inadequate oversight continued throughout the fall of Enron. In the fall of 2001, the Houston office of Arthur Andersen shredded documents associated with the Enron account. Nancy Temple, a lawyer associated with Arthur Andersen’s Chicago offices, emailed David Duncan, the lead Enron auditor for Andersen, a reminder of the corporate policy on memo retention. As a result, large numbers of documents in Andersen’s Houston offices were shredded before Department of Justice officials could impound them. Duncan later pleaded guilty to criminal obstruction of justice over the document shredding. Temple was named by a grand jury as one of four or five “corrupt persuaders” who encouraged the destruction of documents. Andersen itself was stripped of its license to audit public corporations in the U.S., and ceased to do business.
The Energy Industry

The energy industry was severely wounded by the Enron affair. Financing for energy corporations dried up. In the summer of 2002, one energy executive commented, "We have $30 oil and $10 natural gas, and we should be busy as hell. Instead, we're not able to do anything." Because oil and natural gas explorations can take years to develop into productive fields, the result of this dearth of capital would be felt for years to come. Some smaller corporations went bankrupt due to lack of financing for exploration. For these corporations and their employees, the effects were immediate.

The energy trading business became untenable, as well. In August 2002, Aquila began its withdrawal from energy trading due to sluggish business. In November 2002, El Paso Energy decided to discontinue its energy trading unit after a third quarter loss of $69 million, and UBS announced the closure of the trading floor it had acquired from Enron, citing market contraction.

The Charity Fallout

Enron and its executives were very generous to not only their hometown of Houston but to educational institutions nationwide and the favorite causes of its board members. Initiatives included sponsorship of Enron Field (home to the Houston Astros), college scholarships, United Way and university endowments.

Locally, Enron donated 50 college scholarships to Houston high school students. In 2001 after the severe flooding in Houston, Enron organized a program with the United Way and local businesses to help city residents. In the project of siting Houston's new baseball stadium, Lay was instrumental in convincing local business leaders to support the location of the new field in a rundown part of Houston.

In speaking of Enron Jacqueline S. Martin, president of United Way of the Texas Gulf Coast said "If anything happens to them [Enron], it's going to be a major loss to this community." But something did happen to Enron. In 2002 Enron announced it would be unable to fulfill its $10 million in pledges. This included a $5 million donation to Rice University's Jesse H. Jones Graduate School of Management to fund chairs in e-commerce and risk management. However, the Lay Family foundation confirmed its intent of fulfilling its $3 million pledge for the Ken Lay Center for the Study of Markets in Transition.

Enron also generously contributed to the causes of several of its directors. For instance, when the president of M.D. Andersen Cancer Center, John Mendelsohn, became an Enron director and member of its audit committee, Enron and Lay donated $332,150 to the center. Of $60,000 donated to a think tank at George Mason University, $45,000 was contributed after Wendy Lee Gramm (wife of then Senator Phil Gramm, R-TX, and an associate of the center), became an Enron board member. Concerned with an appearance of conflict of interest and a threat to independence, the
US House of Representatives passed a bill dubbed the "Enron Bill" to require disclosure of certain contributions and non-cash gifts to organizations associated with board members. Under reforms Nasdaq is considering, a board member affiliated with a charity that receives more than $200,000 or 5 percent of its budget from the company would be considered an insider. Charities are concerned that the new proposals will become an accounting and paperwork nightmare as well as reduce contributions.

Regulatory Oversight

Enron was the beginning of a series of disclosures of corporate fraud. MCI/WorldCom, Tyco, Adelphia, and a host of other companies began restating numbers as questions were raised concerning their accounting practices. Criticism of lax oversight by Boards of Directors was particularly pointed. In response, President Bush vowed to hunt fraud in the corporate world. One response to this series of disclosures was the Sarbanes-Oxley bill, signed by President Bush in the summer of 2002. Sarbanes-Oxley was aimed primarily at reform in the public accounting and auditing industries. One feature of the bill was that the external auditor would no longer be employed by corporate management, but rather by the audit committee of the board of the corporation. The external auditor would report to the audit committee not only in regard to the final numbers on the balance sheet, but also on the quality of financial controls and systems used in the corporation.

A second major feature of Sarbanes-Oxley was aimed at the conflicts that some thought brought about Enron: the mix of consulting and audit business. Andersen had both audit and consulting relationships with Enron, earning $52 million in 2001, split almost equally between consulting and audit fees. Enron was Andersen's largest client.\(^\text{11}\) Audit firms would no longer be allowed to offer consulting services to those corporations it audited. In addition, a number of other services were also proscribed, such as actuarial services, expert witnessing, and investment banking services, to name a few. In short, many of the services rendered by audit firms in attempts to generate extra revenue are now banned.

Sarbanes-Oxley also charged the Securities and Exchange Commission (SEC) to establish an audit oversight panel to monitor the auditing profession. Even before the panel was seated, however, it would be caught by exactly that which it was charged to oversee: corporate fraud. Harvey Pitt, the chair of the SEC, nominated William H. Webster, a retired federal judge who had served as the head of both the C.I.A. and the F.B.I., to serve as the head of the new commission. Pitt failed to disclose to the SEC that Webster was involved as audit chair of a corporation undergoing a fraud investigation, and both Pitt and Webster resigned in the end.

A Financial Supplement is also available from JBAM for those who wish to pursue at greater depth the financial issues surrounding Enron's collapse. Contact Donald Scheper at Donald_Scheper@baruch.cuny.edu for Teaching Notes requests. Requestors will have to demonstrate faculty status (full-time or adjunct) as part of the request.
Endnotes


5 A more detailed history of the origin of Enron can be found at www.hoovers.com.

6 Enron was the firm’s second renaming try. Its first choice – Enteron, which means alimentary system or bowel – was rejected only after substantial resources had been expended. Seigel, A. 1988. Common sense on corporate identity. Across the Board, June: 27-35.


10 Private conversation with one of the authors.

11 Testimony of Frank Partnoy in Hearings before the United States Senate Committee on Governmental Affairs, January 24, 2002.

12 1999 Annual Report, Enron Corp.


18 Raghavan, A., Kranhold, K., & Barriounuevo, A. 2002. Full speed ahead: How Enron bosses created a culture of pushing limits – Fastow and others challenged staff, badgered bankers; Porsches, Ferraris were big – A chart to “intimidate people”. August 26, 2002; A1

19 Note 8, Q3 SEC filing, 2001.

20 Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. (the Powers Report)


30 McWilliams, G. 2001. Fall of a power giant: CEO Lay was generous to hometown, but now Houston feels pain of fallout. Wall Street Journal, November 30: A8.
