CASE 3

The Fall of Enron: A Stakeholder Failure

Once upon a time, there was a gleaming headquarters office tower in Houston, with a giant tilted "E" in front, slowly revolving in the Texas sun. The Enron Corporation, which once ranked among the top *Fortune 500* companies, collapsed in 2001 under a mountain of debt that had been concealed through a complex scheme of off-balance-sheet partnerships and investor'loss of confidence. Forced to declare bankruptcy, the energy firm laid off five thousand employees; thousands more lost their retirement savings, which had been invested in Enron stock. The company's shareholders lost tens of billions of dollars after the stock price plummeted. The scandal surrounding Enron's demise engendered a global loss of confidence in corporate integrity that continues to plague markets, and eventually it triggered tough new scrutiny of financial reporting practices such as the Sarbanes–Oxley Act in 2002. To understand what went wrong, let's examine the history, culture, and major players in the Enron scandal.

HISTORY

The Enron Corporation was created out of the merger of two major gas pipeline companies in 1985. Through its subsidiaries and numerous affiliates, the company provided products and services related to natural gas, electricity, and communications for its wholesale and retail customers. Enron transported natural gas through pipelines to customers all over the United States. It generated, transmitted, and distributed electricity to the northwestern United States and marketed natural gas, electricity, and other commodities globally. It was also involved in the development, construction, and operation of power plants, pipelines, and other energy-related projects all over the

We appreciate the work of Neil Herndon, who wrote the previous edition of this case under the direction of O. C. Ferrell, and Melanie Drever, who assisted in this edition. This case is for classroom discussion rather than to illustrate either effective or ineffective handling of an administrative, ethical, or legal decision by management. All sources used for this case were obtained through publicly available material and the Enron website.

world, including the delivery and management of energy to retail customers in both the industrial and commercial business sectors.

Throughout the 1990s, Chairman Kenneth Lay, chief executive officer (CEO) Jeffrey Skilling, and chief financial officer (CFO) Andrew Fastow transformed Enron from an old-style electricity and gas company into a $150 billion energy company and Wall Street favorite that traded power contracts in the investment markets. From 1998 to 2000 alone, Enron's revenues grew from about $31 billion to more than $100 billion, making it the seventh-largest company of the *Fortune* 500. Enron's wholesale energy income represented about 93 percent of 2000 revenues, with another 4 percent derived from natural gas and electricity. The remaining 3 percent came from broadband services and exploration. Enron-Online—the company's worldwide Internet trading platform—completed on average over five thousand transactions per day, buying and selling over eighteen hundred separate products online that generated over $2.5 billion in business every day.

There was every reason to believe that Enron was still financially sound in the third quarter of 2001, even though a bankruptcy examiner later reported a discrepancy in Enron's claimed net income and cash flow. This was done under certain accounting assumptions after the bankruptcy. For the third quarter of 2001, Enron's wholesale business generated a potential $754 million of earnings (before interest and taxes), an increase of 35 percent from the previous year. This represented over 80 percent of Enron's worldwide earnings. It was acknowledged by all parties that Enron's wholesale business was highly profitable and growing at a rapid rate. Even in the fourth quarter of 2001, Lay believed that Enron was still a growing viable company for the long run, based on physical volume moving through the pipelines.

A Timeline of the Enron Scandal

1985 Houston Natural Gas merges with Omaha-based InterNorth; the resulting company is eventually named Enron Corporation. Ken Lay, who had been CEO of Houston Natural Gas, becomes chairman and CEO the following year.

2000 Annual revenues reach $100 billion, and the Energy Financial Group ranks Enron as the sixth-largest energy company in the world, based on market capitalization.

February 2001 Jeff Skilling takes over as CEO. Lay remains chairman.

August 2001 Skilling unexpectedly resigns for "personal reasons," and Lay steps back into the CEO job. That same month, a letter from an Enron executive raises serious questions about the company's business and accounting practices.

October 2001 Enron releases third-quarter earnings, showing $1 billion in charges, including $35 million related to investment partnerships headed by Andrew Fastow, Enron's former CFO. Fastow is replaced as CFO.

October 22, 2001 Enron announces that the Securities and Exchange Commission (SEC) has launched a formal investigation into its "related party transactions."

November 8, 2001 Enron restates earnings for 1997 through 2000 and the first three quarters of 2001.

December 2, 2001 Enron files for protection from creditors in a New York bankruptcy court.

December 3, 2001 Enron announces that it is laying off four thousand employees.

January 9, 2002 The Justice Department announces that it is pursuing a criminal investigation of Enron.

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A Timeline of the Enron Scandal (continued)

January 14, 2002 U.S. House and Senate lawmakers return campaign contributions from Enron.

January 24, 2002 Lay resigns as chairman and CEO of Enron. The first of at least eight congressional hearings on Enron begins.

January 30, 2002 Enron names Stephen Cooper, a restructuring specialist, as acting CEO.

February 4, 2002 A report by a special committee of Enron's board investigating the energy trader's collapse portrays a company riddled with improper financial transactions and extensive self-dealing by company officials.

May 2, 2002 Enron announces plans to reorganize as a small company with a new name.

October 2, 2002 Fastow voluntarily surrenders to federal authorities after prosecutors indicate they will file charges for his role in the company's collapse.

October 31, 2002 Fastow is indicted on seventy-eight counts of masterminding a scheme to artificially inflate the energy company's profits.

February 3, 2003 Creditors of Enron sue Lay and his wife, Linda, to recover more than $70 million in transfers.

July 11, 2003 Enron finally announces a plan to restructure and pay off creditors after five deadline extensions.

July 2003 J. P. Morgan Chase and Citigroup pay nearly $300 million to settle allegations from the SEC, New York State and New York City, that they helped Enron manipulate its financial statements and mislead investors.

September 2003 Merrill Lynch avoids prosecution related to the Nigerian barge deal by acknowledging that some employees may have broken the law and by implementing reforms.

October 2003 Wesley Colwell, former chief accounting officer for Enron's trading unit, agrees to pay $500,000 to settle SEC allegations of manipulating earnings by using trading profits to offset massive losses in Enron's retail energy unit. He is still cooperating with the Justice Department but faces no criminal charges.

December 2003 Canadian Imperial Bank of Commerce avoids prosecution by accepting responsibility for crimes committed by employees who knowingly participated in complicated transactions that wrongly moved assets off of Enron's balance sheet so that the energy company could inflate earnings.

April 30, 2003 Fastow's wife, Lea, is charged with tax crimes and conspiracy for participating in husband's deals.

September 10, 2003 Former Enron treasurer Glisan pleads guilty to conspiracy and is sentenced to five years in prison.

January 14, 2004 Andrew Fastow pleads guilty to two counts of conspiracy and agrees to serve ten years in prison.

January 22, 2004 Causey pleads innocent to conspiracy and fraud charges.

February 19, 2004 Skilling, added to the Causey indictment, pleads innocent to more than thirty criminal counts including conspiracy, fraud, and inside trading.

May 6, 2004 Lea Fastow pleads guilty to filing a false tax form and is sentenced to the maximum sentence of one year in prison.

July 8, 2004 Lay surrenders after being indicted. He pleads innocent.

July 15, 2004 Bankruptcy judge confirms Enron's reorganization plan in which most creditors will receive about one-fifth of the about $63 billion they're owed in cash and stock.

October 19, 2004 Federal judge grants Lay a separate bank fraud trial but rules that Lay, Skilling, and Causey will be tried together on other charges.

February 2005 Raymond Bowen, Jr., finance chief at Enron from the aftermath of its failure through his resignation in October 2004, agrees to pay $500,000 to settle SEC allegations that he knew or should have known some assets were grossly overvalued to falsely inflate profits. Bowen did not admit or deny the allegations and faces no criminal charges.

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A Timeline of the Enron Scandal (continued)

May 31, 2005 The Supreme Court overturns the Arthur Andersen conviction.

December 28, 2005 Causey pleads guilty to securities fraud and agrees to serve seven years in prison in exchange for cooperating with the government.

January 30, 2006 The Lay and Skilling trial begins.

May 25, 2006 Lay and Skilling are convicted of conspiracy to commit securities and wire fraud. Lay is convicted in a separate bank fraud case.

July 5, 2006 Lay dies of a heart attack, erasing his conviction. A person who dies before an appeal is not considered convicted.

SOURCES: "A Chronology of Enron's Woes: The Accounting Debacle," *Wall Street Journal* online, March 20, 2003, http://online.wsj.com; "A Chronology of Enron's Woes: The Investigation," *Wall Street Journal* online, March 20, 2003, http://online.wsj.com; "Enron Timeline," *Houston Chronicle* online, January 17, 2002, http://www.chron.com/cs/CDA/story.hts/special/enron/1127125; Kristen Hays, "16 Cents on $1 for Enron Creditors," *Austin American-Statesman* online, July 12, 2003, http://www.statesman.com; "Key Dates Leading to Convictions of Lay, Skilling," *USA Today,* May 26, 2006, 3B; Associated Press; "Enron Who's Who," *USA Today* online, http://www.usatoday.com/money/industries/energy/2006-01-26-enron-whos-who_x.htm (accessed June 1, 2006).

ENRON'S CORPORATE CULTURE

When describing Enron's corporate culture, people like to use the words *arrogant* or *prideful,* perhaps justifiably. The firm employed competent, creative, and hardworking employees and recruited the best and brightest graduates from top universities. In 2001 *Fortune* magazine ranked Enron the twenty-second best company to work for in America. A large banner in the lobby at corporate headquarters proclaimed Enron "The World's Leading Company," and Enron executives blithely believed that competitors had no chance against it. Skilling even went so far as to tell utility executives at a conference that he was going to "eat their lunch." There was an overwhelming aura of pride, carrying with it the deep-seated belief that Enron's people could handle increasing risk without danger.

The culture also was about a focus on how much money could be made for many executives, at many levels, that shared in a stock option incentive program. For example, after the Enron collapse, it was alleged that Enron's compensation plans seemed less concerned with generating profits for shareholders than with enriching employee wealth. This may have been the result of the highly competent and aggressive employee culture that was motivated by the desire to improve their financial position. Enron's corporate culture reportedly encouraged risky behavior, if not breaking the rules.

Skilling appears to be the executive who created a system in which Enron's employees were rated every six months, with those ranked in the bottom 20 percent forced out. This "rank-and-yank" system helped create a fierce environment in which employees competed against rivals not only outside the company but also at the next desk. Delivering bad news could result in the "death" of the messenger, so problems in the trading operation, for example, were covered up rather than being communicated to management.

Lay once said that he felt that one of the great successes at Enron was the creation of a corporate culture in which people could reach their full potential. He said that he wanted it to be a highly moral and ethical culture and that he tried to ensure that people did in fact honor the values of respect, integrity, and excellence. On his desk was

an Enron paperweight with the slogan "Vision and Values." Lay maintained that he was always concerned about ethics, and he continued to discuss the ethical and legal ramifications of the Enron disaster even after his conviction. The business ethics issue involved in his indictment was that he lied about the financial condition of Enron, but he continued to maintain that he had openly dealt with all issues that were brought to his attention. Some of the people inside Enron believed that nearly anything could be turned into a financial product and, with the aid of complex statistical modeling, traded for profit. Short on assets and heavily reliant on intellectual capital, Enron's corporate culture rewarded innovation and punished employees deemed weak. An important question is, How much does a CEO know about misconduct in a corporation?

Aggressive and highly intelligent Enron employees, in many divisions, were "pushing the limits" and bending the rules to achieve success. This highly competitive risk culture existed in a corporation that was trying to redefine how the energy industry did business. Lawyers, accountants, and the board of directors approved key decisions. As intelligent and creative as Enron's executives were, no one person, under Enron's organizational system of checks and balances, could orchestrate the schemes that created the demise of a company that large. The downfall took many layers of "pushing the envelope" and a great deal of complacency on the part of employees who, at many levels in the organization, saw wrongdoing and ignored it. To some extent, the Enron failure was the result of a free-enterprise system that rewarded risk taking and a corporate culture that pushed complex financial decisions to the edge. In addition, the right environmental conditions evolved in the financial markets, especially the dot-com bubble, contributing to Enron's stock collapse. Enron was the perfect corporate storm (or disaster) that required many failures by multiple stakeholders.

ENRON'S ACCOUNTING PROBLEMS

Enron's bankruptcy in December 2001 was the largest in U.S. corporate history at the time. The bankruptcy filing came after a series of revelations that the giant energy trader had been using partnerships, also called special-purpose entities (SPEs). These off-balance-sheet financing approaches are the heart of losses and write-offs that turned Enron into a disaster. In a meeting with Enron's lawyers in August 2001, the company's then CFO, Fastow, stated that Enron had established the SPEs to move assets and debt off its balance sheet and to increase cash flow by showing that funds were flowing through its books when it sold assets. Although these practices produced a very favorable financial picture, outside observers believed they might constitute fraudulent financial reporting because they did not accurately represent the company's true financial condition.

According to John C. Coffee, Columbia University law professor, once formed by Enron, the SPEs would then borrow debt from banks, and Enron would typically guarantee that debt. Although such guarantees are not unusual when SPEs are used, far less common (and indeed unique) was the fact that the principal asset of many Enron SPEs was Enron restricted stock. Thus, if Enron's stock price declined, the SPE's assets would be insufficient to cover the bank debt, and Enron would have to assume it.

In reality, these SPEs were legal entities, and many investment banks were involved as third-party investors becoming partners in these entities. Most companies engage in third-party transactions to move debt off the balance sheet. For example, a company builds its own plant or office building, sells it to a group of investors, and then leases back the property for its business purposes but still maintains some ownership. In other words, SPEs can be an asset that helps facilitate daily business operations.

Most of the SPEs at Enron were alleged to be entities in name only, and Enron funded them with its own stock and maintained control over them. This is not too different from leasing back property that can be used for storage, transportation, or other energy-related activities. After the crash of Enron's stock price, any assets associated with the SPE system had to be written off. Enron had to take a $1.2 billion reduction in equity in late 2001 because of the SPE write-off.

After Enron restated its financial statements for fiscal 2000 and the first nine months of 2001, its cash flow from operations dropped from a positive $127 million in 2000 to a negative $753 million in 2001. In 2001, with its stock price falling, Enron faced a critical cash shortage. Already shaken by questions about lack of disclosure in Enron's financial statements and by reports that executives had profited personally from the partnership deals, investor confidence collapsed, taking Enron's stock price with it.

For a time, it appeared that Dynegy might save the day by providing $1.5 billion in cash, secured by Enron's premier pipeline Northern Natural Gas, and then purchasing Enron for about $10 billion. But when Standard & Poor downgraded Enron's debt below investment grade on November 28, some $4 billion in off-balance-sheet debt came due, and Enron didn't have the resources to pay. Dynegy terminated the deal. On December 2, 2001, Enron filed for bankruptcy. Enron faced twenty-two thousand claims totaling about $400 billion.

Many complex accounting issues related to determining the value of Enron. For example, sometimes accounting rules changed, and different opinions emerged on which rules applied, such as the accounting rules governing goodwill. *Goodwill* is the difference between what a company pays for an entity and the book value of that company's net assets. For example, changes to the accounting rules governing goodwill required Enron to disclose impairments to certain of its assets including interests in Wessex Water, a business located in Bath, England. Companies such as Enron depend on accounting firms to determine what rules apply to valuing goodwill as well as other assets. The government alleged that Enron's claim of being committed to a water-growth strategy was flawed because it would require Enron to disclose impairments in certain of its assets related to goodwill. According to Lay, Enron's accounting firm, Arthur Andersen, communicated that the company was in compliance with the goodwill accounting rules and the government's claims of flawed disclosures were wrong.

THE WHISTLE-BLOWER

Assigned to work directly with Fastow in June 2001, Enron vice president Sherron Watkins, an eight-year Enron veteran, was given the task of finding some assets to sell off. With the high-tech bubble bursting and Enron's stock price slipping, Watkins was

troubled to find unclear, off-the-books arrangements backed only by Enron's deflating stock. No one could explain to her what was going on. Knowing that she faced difficult consequences if she confronted then-CEO Skilling, she began looking for another job, planning to confront Skilling just as she left for a new position. Skilling, however, suddenly quit on August 14, saying he wanted to spend more time with his family. Chairman Lay stepped back in as CEO and began inviting employees to express their concerns and put them into a box for later collection. Watkins prepared an anonymous memo and placed it into the box. When Lay held a company-wide meeting shortly thereafter and did not mention her memo, however, she arranged a personal meeting with him.

On August 22, Watkins handed Lay a seven-page letter that she had prepared outlining her concerns. She told him that Enron would "implode in a wave of accounting scandals" if nothing was done. On the other hand, Watkins continued to perform her duties at Enron and participate in all business matters. Lay arranged to have Enron's law firm, Vinson & Elkins, look into the questionable deals. There is evidence that Lay followed up on Watkins's concerns with appropriate action. Watkins sold $30,000 worth of stock in August 2001 and some options in late September. She claimed that she was panicked by the 9/11 terrorist attacks and about the company. She sold another block and netted about $17,000. She had more information than most people, and it is possible the government could have charged her for insider trading if she truly believed Enron was going to become bankrupt.

Watkins alleges that her computer's hard drive was confiscated and she was moved from her plush executive office suite on the top floors of the Houston headquarters tower to a lower-level plain office with a metal desk. That desk was no longer filled with the high-level projects that had once taken her all over the world on Enron business. Instead, now a vice president in name only, she claimed she faced meaningless "make-work" projects. In February 2002, she testified before Congress about Enron's partnerships and resigned from Enron in November. Although Watkins claims to be a whistle-blower, most of her statements were made after Enron filed for bankruptcy and was a financial disaster. In addition, there is no factual evidence that her earlier claims and concerns had any merit.

THE CHIEF FINANCIAL OFFICER

CFO Fastow was indicted in October 2002 by the U.S. Department of Justice on ninety-eight federal counts for his alleged efforts to inflate Enron's profits. These charges included fraud, money laundering, conspiracy, and one count of obstruction of justice. Fastow pled guilty to two counts of conspiracy, admitting to orchestrating a myriad of schemes to hide Enron debt and inflate profits while enriching himself with millions. He surrendered nearly $30 million in cash and property and agreed to serve up to ten years in prison once prosecutors no longer needed his cooperation. He was a key government witness against Lay and Skilling. His wife, Lea Fastow, former assistant treasurer, quit Enron in 1997, first pled guilty to a felony tax crime, admitting to helping hide ill-gotten gains from her husband's schemes from the government. Withdrawing her plea, she then pled guilty to a newly filed misdemeanor

tax crime. In July 2005, she was released from a yearlong prison sentence, followed by a year of supervised release.

Federal prosecutors argued that Enron's case is not about exotic accounting practices but fraud and theft. They contend that Fastow was the brain behind the partnerships used to conceal some $1 billion in Enron debt and that this led directly to Enron's bankruptcy. The federal complaints allege that Fastow defrauded Enron and its shareholders through the off-the-balance-sheet partnerships that made Enron appear to be more profitable than it actually was. They also allege that Fastow made about $30 million both by using these partnerships to get kickbacks that were disguised as gifts from family members who invested in them and by taking income himself that should have gone to other entities. Lay maintained that Enron found no visible flaws in Fastow's ethical background before hiring him as CFO and was taken by surprise when Fastow's personal gains from the off-balance-sheet partnerships were discovered. Lay believed that Fastow's manipulations of the off-balance-sheet partnerships were a key factor in the Enron disaster.

Fastow alleges that he was hired to arrange the off-balance-sheet financing and that Enron's board of directors, chairman, and CEO directed and praised his work. He also claims that both lawyers and accountants reviewed his work and approved what was being done and that "at no time did he do anything he believed was a crime." Skilling, chief operating officer (COO) from 1997 to 2000 before becoming CEO, reportedly championed Fastow's rise at Enron and supported his efforts to keep up Enron's stock prices.

The case against Fastow was largely based on information provided by the managing director, Michael Kopper, a key player in the establishment and operation of several of the off-the-balance-sheet partnerships. Kopper, a chief aide to Fastow, pled guilty to money laundering and wire fraud. He agreed to serve ten years in prison and to surrender some $12 million that he earned from his dealings with the partnerships. Others charged in the Enron affair were Timothy Belden, Enron's former top energy trader, who pled guilty to one count of conspiring to commit wire fraud and three British bankers—David Bermingham, Giles Darby, and Gary Mulgrew—who were indicted in Houston on wire-fraud charges related to a deal at Enron. They used secret investments to take $7.3 million in income that belonged to their employer, according to the Justice Department. The three, employed by the finance group Greenwich National Westminster Bank, were arrested in 2004, faced extradition, and pled innocent.

THE CHIEF EXECUTIVE OFFICER

Former CEO Skilling is widely seen as Enron's mastermind. He was so sure that he had committed no crime that he waived his right to self-incrimination and testified before Congress that "I was not aware of any inappropriate financial arrangements." However, Jeffrey McMahon, who took over as Enron's president and COO in February 2002, told a congressional subcommittee that he had informed Skilling about the company's off-the-balance-sheet partnerships in March 2000, when he was Enron's treasurer. McMahon said that Skilling had told him "he would remedy the situation."

Calling the Enron collapse a "run on the bank" and a "liquidity crisis," Skilling said that he did not understand how Enron went from where it was to bankruptcy so quickly. He also said that the off-the-balance-sheet partnerships were Fastow's creation. Skilling is also reported to have sold 39 percent of his Enron holdings before the company disclosed its financial troubles.

THE CHAIRMAN

Lay became chairman and CEO of the company that was to become Enron in February 1986. A decade later, Lay promoted Skilling to president and COO and then, as expected, stepped down as CEO in February 2001, to make way for Skilling. Lay remained as chairman of the board. When Skilling resigned in August 2001, Lay resumed the role of CEO.

Lay, who held a doctorate in economics from the University of Houston, contended that he knew little of what was going on even though he had participated in the board meetings that allowed the off-the-balance-sheet partnerships to be created. He said he believed the transactions were legal because attorneys and accountants approved them. In the late summer of 2001, he was reassuring employees and investors that all was well at Enron, based on strong wholesale sales and physical volume being delivered through the Enron marketing channel. Although cash flow does not always follow sales, there was every reason to believe that Enron was still a company with much potential. On February 12, 2002, on the advice of his attorney, Lay told the Senate Commerce Committee that he was invoking his Fifth Amendment rights not to answer questions that could be incriminating.

Prosecutors looked into why Lay began selling about $80 million of his own stock beginning in late 2000, even while he encouraged employees to buy more shares of the company. It appears that Lay drew down his $4 million Enron credit line repeatedly and then repaid the company with Enron shares. These transactions, unlike usual stock sales, do not have to be reported to investors. Lay said that he sold the stock because of margin calls on loans that he had secured with Enron stock and that he had no other source of liquidity.

VINSON & ELKINS

Enron was Houston law firm Vinson & Elkins' top client, accounting for about 7 percent of its $450 million revenue. Enron's general counsel and a number of members of Enron's legal department came from Vinson & Elkins. Vinson & Elkins seems to have dismissed Watkins's allegations of accounting fraud after making some inquiries, but this does not appear to leave it open to civil or criminal liability. Of greater concern are allegations that Vinson & Elkins helped structure some of Enron's special-purpose partnerships. Watkins, in her letter to CEO Lay, indicated that the law firm had written opinion letters supporting the legality of the deals. In fact, Enron could not have done many of the transactions without such opinion letters. Although the law

firm denies that it has done anything wrong, legal experts say the key question is whether or not Vinson & Elkins approved deals that it knew were fraudulent.

Documents reviewed by *BusinessWeek* indicate that their experts felt that Vinson & Elkins had concerns about the legitimacy of Enron's business practices. So far, the law firm has yet to pay any damages nor have any of its lawyers faced professional misconduct charges by the Texas bar. Enron's bankruptcy trustee is attempting to settle with Vinson & Elkins for $30 million. The Securities and Exchange Commission (SEC) continues to investigate the advice provided to Enron by the firm. In addition, there is an attempt to hold Vinson & Elkins liable for the $40 billion in investor losses resulting from the Enron collapse.

MERRILL LYNCH

The prestigious brokerage and investment banking firm of Merrill Lynch faced scrutiny by federal prosecutors and the SEC for its role in Enron's 1999 sale of Nigerian barges. Merrill Lynch allegedly bought the barges for $28 million, of which Enron financed $21 million through Fastow's oral assurance that Enron would buy Merrill Lynch's investment out in six months with a 15 percent guaranteed rate of return. Merrill Lynch went ahead with the deal despite an internal Merrill Lynch document that suggested that the transaction might not be appropriate. Merrill Lynch denies that the transaction was a sham and said that it never knowingly helped Enron to falsify its financial reports.

The barge deal was not among the financial blunders that pushed Enron into bankruptcy in 2001. However, prosecutors claimed that it showed Enron was willing to employ suspect financial practices to meet lofty earnings targets. Four former Merrill Lynch executives and two former mid-level Enron executives were charged with conspiracy and fraud related to the transaction. The defense attorneys disputed the government's claims. Enforcement Director Stephen Cutler said,

> Even if you don't have direct responsibility for a company's financial statements, you cannot turn a blind eye when you have reason to know what you are doing will help make those statements false and misleading. At the end of 1999, Merrill Lynch and the executives we are suing today did exactly that: They helped Enron defraud its investors through two deals that were created with one purpose in mind—to make Enron's financial statements look better than they actually were.

ARTHUR ANDERSEN LLP

In its role as Enron's auditor, Arthur Andersen was responsible for ensuring the accuracy of Enron's financial statements and internal bookkeeping. Andersen's reports were used by potential investors to judge Enron's financial soundness and future potential before they decided whether to invest and by current investors to decide if their funds should remain invested there. These investors would expect that Andersen's certifications of accuracy and application of proper accounting procedures were independent

and without any conflict of interest. If Andersen's reports were in error, investors could be seriously misled. However, Andersen's independence has been called into question. The accounting firm was a major business partner of Enron, with more than one hundred employees dedicated to its account, and it sold about $50 million a year in consulting services to Enron. Some Andersen executives even accepted jobs with the energy trader.

Andersen was found guilty of obstruction of justice in March 2002 for destroying Enron-related auditing documents during an SEC investigation of Enron. As a result, Andersen has gone out of business. The U.S. Supreme Court overturned the obstruction-of-justice decision, but Andersen had closed its doors.

It is still not clear why Andersen auditors failed to ask Enron to better explain its complex partnerships before certifying Enron's financial statements. Some observers believe that the large consulting fees received from Enron unduly influenced Andersen. However, an Andersen spokesperson said that the firm had looked hard at all available information from Enron at the time. But shortly after she spoke to Enron CEO Lay, Watkins had taken her concerns to an Andersen audit partner, who reportedly conveyed her questions to senior Andersen management responsible for the Enron account. It is not clear what action, if any, Andersen took.

THE BREAKUP OF ENRON'S ASSETS

Enron's demise caused tens of billions of dollars of investor losses, triggered a collapse of electricity-trading markets, and ushered in an era of accounting scandals that precipitated a global loss of confidence in corporate integrity. Now companies must defend legitimate but complicated financing arrangements, even legitimate financing tools tainted by association with Enron. On a more personal level, thousands of former Enron employees struggle to find jobs, while many retirees have been forced to return to work in a bleak job market because their Enron-heavy retirement portfolios were wiped out. One senior Enron executive committed suicide.

In July 2003, Enron announced its intention to restructure and a plan to pay off its creditors. Pending creditor and court approval of the plan, most creditors would receive between 14.4 cents and 18.3 cents for each dollar they were owed—more than most expected. Under the plan, creditors would receive about two-thirds of the amount in cash and the rest in equity in three new companies, none of which would carry the tainted Enron name. The three companies were CrossCountry Energy Corporation, Prisma Energy International Inc., and Portland General Electric.

CrossCountry Energy would retain Enron's interests in three North American natural gas pipelines. CrossCountry Energy, formed from Enron's domestic gas pipeline assets, was immediately placed on the market for creditor compensation. On September 1, 2004, Enron announced an agreement to sell CrossCountry Energy to CCE Holdings LLC (a joint venture between Southern Union Company and a unit of General Electric) for $2.45 billion. The money would be used for debt repayment and represented a substantial increase over the previous offer made by NuCoastal LLC earlier in 2004.

Prisma Energy International would take over Enron's nineteen international power and pipeline holdings. Prisma Energy International, formed out of Enron's remaining overseas assets, emerged from bankruptcy as a main-line descendant of Enron through a stock offering to Enron creditors. Currently, many of Prisma's assets remain under direct Enron ownership with Prisma operating in a management capacity.

The third company, Portland General Electric (PGE), was founded in 1889 and ranks as Oregon's largest utility. PGE was acquired by Enron during the 1990s and emerged from bankruptcy as an independent company through a private stock offering to Enron creditors.

All remaining assets not related to CrossCountry, Prisma, or PGE were liquidated. As of 2006, CrossCountry was under CCE Holdings ownership, while the PGE and Prisma deals remained to be consummated. Enron emerged from Chapter 11 bankruptcy protection in November 2004 but will likely be wound down once the recovery plan is carried out. Enron's remaining assets are grouped under two main subsidiary companies: Prisma Energy International and PGE, both of which will likely be spun off.

On November 14, 2004, all of Enron's outstanding common stock and preferred stock was canceled. Each person who was the record holder of Enron Corporation stock on that day was allocated an uncertificated, nontransferable interest in one of two trusts that held new shares of Enron Corporation. In the very unlikely event that the value of Enron's assets exceeds the amount of its allowed claims, distributions would be made to the holders of these trust interests in the same order of priority of the stock that they previously held.

According to the Enron website in 2006, it was in the midst of liquidating its remaining operations and distributing its assets to its creditors. Even with the conviction of Enron executives, the justice system will not reform the way that corporate America runs businesses. Many businesspeople see this as an event outside their lives and businesses, very much like passing the traffic accident and thinking it can never happen to them. To prevent future Enron-type failures, the corporate culture, corporate governance, and reward systems will have to change in many organizations. In most cases, a CEO acting alone cannot "sink the ship," and many of the structural, cultural, and corporate governance conditions that caused the collapse of Enron haven't been removed from corporate America.

THE LAY AND SKILLING TRIAL

On May 25, 2006, a Houston jury found Kenneth Lay and Jeffrey Skilling guilty on all counts of conspiring to hide the company's financial condition in 2000 and 2001. During the case, the judge dealt a blow to the two defendants when he told the jury that they could find the defendants guilty of consciously avoiding knowing about wrongdoing at the company. Many former Enron employees refused to testify because they were not guaranteed that their testimony would not be used against them at future trials convicting them. Many questions about the accounting fraud remained after the trial. The verdict was a total victory for federal prosecutors who had spent four years building a criminal case against the two men who had played a key role in building

Enron as a role model for the energy industry. Sean M. Berkowitz, director of the Justice Department's Enron Task Force, said "You can't lie to shareholders, you can't put yourself in front of your employees' interests, and no matter how rich and powerful you are you have to play by the rules." The verdict was a blow to Lay and Skilling who testified that "Enron was a fundamentally sound company brought low in a market panic spurred by short sellers and negative media reports." On the other hand, the government maintained that Enron used deceptive accounting and bogus claims of the growth potential of new business units.

The jury found Lay, 64 years old, guilty of six counts of conspiracy and fraud. Skilling, 52 years old, was convicted on eighteen counts of conspiracy and securities fraud but acquitted on nine out of ten counts of illegal insider trading. On the way out of the courtroom, Lay said he was "shocked" by the verdict. "I firmly believe I am innocent of the charges against me as I've said from day one." Then juror Wendy Vaughan said, "I felt it was their duty to know what was going on." Outside the courthouse, prosecutors said the trial should send a message to executives who manipulate their companies' earnings.

Many people don't feel much sympathy for Skilling and Lay because so many people lost a lot of money, but there is an alternative viewpoint. A number of law professors and lawyers have concerns about the Enron Task Force's prosecution of Lay and Skilling, accusing the government of "criminalizing corporate agency costs." In other words, the government is accused of misusing criminal laws to punish questionable business transactions and bad management decisions. In a civilized society, do we imprison people for the rest of their lives because they may have made some bad business decisions?

No doubt, this was a very complex case, and even the most hard-core antibusiness types are queasy with the conclusion of this tragedy. There was not conclusive evidence that there was intent to defraud investors, although investor losses were massive. The important question is, Was there complacency at all managerial levels about rule bending among some employees or was there massive corruption at all levels? One of the key prosecution elements was complacent negligence, that Skilling and Lay just turned a blind eye.

The truth is that the jury would have had to understand the entire corporate culture as well as many systemic embedded business decisions at Enron to know for sure that Lay and Skilling were guilty of their charges. Bad business decisions were made, but there is uncertainty as to the true involvement and intent of many of the CEO's decisions. Society and the courts tend to simplify events and blame all that goes wrong on just a few individuals. At this stage of understanding, there are few people who understand how an organizational culture can evolve with complacency and constant reinforcement from coworkers driving bad decisions. In our society, we are taught that the opinion of trusted professionals such as accountants and lawyers can be followed in business decisions. In this case, the accounting firm Arthur Andersen, internal and external attorneys, as well as the board of directors approved the key decisions at Enron.

Lay said he never intended to harm anyone; in fact, he came back as CEO after Skilling stepped down and at the insistence of the Enron board of directors to provide leadership and attempt to save the company. A decision that he and his wife both

regretted. As CEO, Lay was responsible for thirty thousand employees operating in thirty countries. He managed an exceptional group of employees, as eluded to in the film *Enron: The Smartest Men in the Room.* Great leaders are often given accolades for their accomplishments, and Lay was no exception in the "heyday" of Enron. But most will acknowledge that the heart of their success, or in this case, ultimate failure, is the people with whom they surround themselves and place in positions of authority. The people who Lay trusted, such as Fastow (convicted former CFO), were key operatives in the day-to-day decision making at Enron. It was a complex maze of events that caused the failure of Enron.

On July 5, 2006, Ken Lay died of a heart attack in Aspen, Colorado. He was awaiting sentencing and still maintaining his innocence. Lay had endured a five-month trial but was working hard to develop an appeal of his conviction. He did not feel that it was possible to get a fair trial in Houston and indicated that the jury had not even read his indictment. He thought he was convicted because as CEO he was charged with responsibility for what happened at Enron, even if he was unaware of wrongdoing. The heart of the case against Lay was that he allegedly lied about the financial condition at Enron. Federal courts, including the Fifth Court of Appeals, hold that a defendant's death erases a conviction. Lay stated that he wanted to be of use to society and would continue to do that in any way possible. In the five weeks before his death, he read several drafts of this case and tried to provide insights about what happened at Enron. He wanted to share his knowledge and perspective about Enron with future business leaders.

QUESTIONS

1. How did the corporate culture of Enron contribute to its bankruptcy?
2. Did Enron's bankers, auditors, and attorneys contribute to Enron's demise? If so, what was their contribution?
3. What role did the CFO play in creating the problems that led to Enron's financial problems?

SOURCES: Personal conversations with Ken Lay between May 27, 2006, and June 20, 2006, by O. C. Ferrell and Linda Ferrell; Associated Press, "Enron Who's Who," *USA Today* online, http://www.usatoday.com/money/industries/energy/2006-01-26-enron-whos-who_x.htm (accessed June 1, 2006); Mark Banineck and Mary Flood, "Enron's Top Execs Are Guilty, Guilty," *San Antonio Express News,* May 26, 2006, 1A; Alexei Barrionuevo, Jonathan Weil, and John R. Wilke, "Enron's Fastow Charged with Fraud," *Wall Street Journal,* October 3, 2002, A3–A4; Eric Berger, "Report Details Enron's Deception," *Houston Chronicle,* March 6, 2003, 1B, 11B; Maria Bartiromo, "The Ones Who Got Away," *BusinessWeek* online, June 12, 2006, http://www.businessweek.com/magazine/content/06_24/b3988122.htm?campaign_id=search (accessed June 7, 2006); Christine Y. Chen, "When Good Firms Get Bad Chi," *Fortune,* November 11, 2002, 56; Andrew Dunn and Laurel Brubaker Calkins, "Death to Hinder Feds," *Denver Post,* July 6, 2006, C1; Peter Elkind and Bethany McLean, "Feds Move Up Enron Food Chain," *Fortune,* December 30, 2002, 43–44; John R. Emshwiller, "Enron's Kenneth Lay is Dead at 64," *Wall Street Journal* online, July 6, 2006, A1, http://www.online.wsj.com/article_print/SB115210822917098397.html (accessed July 6, 2006); "Enron's Last Mystery," *BusinessWeek* online, June 12 2006, http://www.businessweek.com/magazine/content/06_24/b3988056.htm?campaign_id=search (accessed June 7, 2006); Enron Website, for facts about Enron, www.enron.com (accessed

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