The Collapse of Enron

On December 2, 2001, Enron Corporation filed for bankruptcy. The company’s sudden collapse—the largest business failure in U.S. history to date—came as a shock to many. Just months earlier, Fortune magazine had named Enron the most innovative company in America for the sixth consecutive year. The Houston, Texas-based firm, ranked seventh on the Fortune 500, was widely considered to be the premier energy trading company in the world. At its peak in 2000, Enron employed 19,000 people and booked annual revenues in excess of $100 billion. At a meeting of executives in January 2001, chairman and CEO Kenneth Lay had said that the company’s mission was no longer just to be the world’s greatest energy company; rather, its mission was to become simply “the world’s greatest company.”¹

The pain caused by Enron’s abrupt failure was widely felt. The company immediately laid off 4,000 employees, with more to follow. Thousands of Enron employees and retirees saw the value of their 401(k) retirement plans, many heavily invested in the company’s stock, become worthless almost overnight. “We, the rank and file, got burned,” said one retiree, who lost close to $1.3 million in savings. “I thought people had to treat us honestly and deal fairly with us. In my neck of the woods, what happened is not right.”² Shareholders and mutual fund investors lost $70 billion in market value. Two banks—J.P. Morgan Chase and Citigroup—faced major write-downs on bad loans. Not only did Enron creditors, shareholders, and bondholders lose out, confidence also fell across the


market, as investors questioned the integrity of the financial statements of other companies in which they held stock.

In the aftermath, many struggled to unravel the messy story behind Enron’s collapse. Congressional committees initiated investigations, prosecutors brought criminal charges against Enron executives and their accountants for obstruction of justice and securities fraud, and institutional investors sued to recoup their losses. Some blamed Arthur Andersen, Enron’s accounting firm, for certifying financial statements that had arguably wrongfully concealed the company’s precarious financial situation; some blamed the board of directors for insufficient oversight. Others pointed to a go-go culture in which self-dealing by corrupt executives was condoned, or even admired, while others faulted government regulators, industry analysts, and the media for failing to uncover the company’s weaknesses. It will likely take years for the courts to sort through the wreckage.

**Enron Corporation**

Enron Corporation was formed in 1985 through a merger of Houston Natural Gas and InterNorth of Omaha, Nebraska. The union created a mid-sized firm whose main asset was a large network of natural gas pipelines. The company’s core business was distributing natural gas to utilities.

The central figure from the outset of Enron’s history was Kenneth L. Lay. The son of a Baptist minister from rural Missouri, Lay trained as an economist at the University of Missouri and the University of Houston and briefly taught college-level economics. After a stint with Exxon, Lay accepted a post in the Nixon administration, serving in the Federal Energy Commission and, later, in the Interior Department as deputy undersecretary for energy. Following the Watergate scandal, Lay returned to the private sector in 1974, taking the first in a series of executive positions at various energy companies. Lay became CEO of Houston Natural Gas in 1984, and he assumed the top job at Enron in 1986, shortly after the merger. One observer described Lay as a man of “considerable charm, homespun roots,
and economic expertise" who tended to play an "outside" role, leaving the
day-to-day management of his company in the hands of others.³

A strong proponent of free markets, Lay felt that the deregulation of the
1980s presented an opportunity for the fledgling company. Historically, the
U.S. energy industry had been highly regulated. Utilities were granted
monopolies for specific regions, and regulators controlled the prices of
electricity and natural gas. Pipeline operators could transport only their own
natural gas, not that of other producers. In the 1980s, however, a series of
legislative actions at both federal and state levels removed many of these
restrictions. For the first time, energy producers were free to compete, buy
and sell at market prices, and use each other's distribution networks. The
promise of deregulation, touted by lawmakers at the time, was that
competition would lead to greater efficiencies, lower prices, and better
service for consumers.

Deregulation caused problems for both producers and users of energy,
however, because prices for the first time became highly volatile. In the
past, energy users (an industrial company or regional utility, for
example) could buy extra natural gas or electricity from producers on the
spot market on an as-needed basis. Once prices were free to fluctuate,
however, this approach became riskier for both parties. The customer did
not want to be forced to buy when prices were high, and the producer did
d not want to be forced to sell when prices were low.

Enron moved to provide an ingenious solution: the company would
leverage its large network of pipelines to set up a "gas bank" that would
act as the intermediary in this transaction, reducing market risk. Enron
would sign contracts with producers to buy their gas on a certain date at
a certain price, and other contracts with users to sell them gas on a
certain date at a certain price. Presuming that both parties were willing to
pay a slight premium to insure against risk, Enron could make money on
the spread. Enron had clear advantages as a market maker in natural gas:
it owned pipelines that could be used to transport the product from

³ Fusaro and Miller, p. 9.
producer to user, and it had strong institutional knowledge of how markets in the industry operated.

The idea man behind this innovation was Jeffrey Skilling. A graduate of the Harvard Business School and a partner in the consulting firm McKinsey & Company, Skilling had been brought in by Lay in the late 1980s to advise Enron on the company’s response to deregulation. The gas bank, in itself, was a clever idea, but Skilling went further. He developed a series of other products, called energy derivatives, for Enron’s trading partners. These products included options, which allowed companies to buy gas in the future at a fixed price, and swaps, which allowed them to trade fixed prices for floating prices and vice versa. In 1990, Skilling left McKinsey to become CEO of Enron Gas Services, as the gas bank came to be known. In 1996, he was promoted to the position of president and chief operating officer of Enron and, in February 2001, to CEO.4

We Make Markets

Enron’s core gas services division was highly profitable, but by the mid-1990s its growth had begun to level out, as competitors entered the market and both buyers and sellers became more sophisticated and thus able to drive harder bargains. The challenge, as Skilling saw it, was to maintain Enron’s growth by extending the business model that had worked so well in natural gas into a range of other commodities. As he later explained this strategy to an interviewer:

If you have the same general [market] characteristics, all you have to do is change the units. Enron has a huge investment in capabilities that can be deployed instantly into new markets at no cost.5

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In particular, Skilling sought to trade commodities in industries with characteristics similar to those of natural gas—ones that were undergoing deregulation, had fragmented markets, maintained dedicated distribution channels, and in which both buyers and sellers wanted flexibility.6

- **Electricity.** One of the most obvious markets for Enron to enter was electric power. Deregulation of electric utilities in many states—most notably California—presented an opportunity for Enron to use its trading capabilities to buy and sell contracts for electricity. Enron already owned some gas-fired power plants, and it moved to build and buy facilities designed to supply electricity during periods of peak demand. Enron also moved to expand this business internationally, especially in nations undergoing energy deregulation or privatization.

- **Water.** In 1998, Enron acquired Wessex Water in the United Kingdom and changed its name to Azurix, with the ambitious goal of operating water and wastewater businesses globally.

- **Broadband.** The company formed Enron Broadband Services in January 2000. Portland General Electric, which Enron acquired in 1997, provided the core fiber optic network for this service. The idea was to supply customers with access to bandwidth at future dates at guaranteed prices. Enron believed these contracts would appeal to customers who did not want to rely on the public Internet or build their own telecommunications networks.

- **Pulp, Paper, and Lumber.** Enron launched clickpaper.com, an online market for the purchase of contracts for the delivery of wood products, and bought a newsprint company to ensure a ready source of supply.

Skilling told an interviewer from *Frontline* in March 2001: “We are looking to create open, competitive, fair markets. And in open,

competitive, fair markets, prices are lower and customers get better service.... We are the good guys. We are on the side of the angels.”

By 2001, Enron was buying and selling metals, pulp and paper, specialty chemicals, bandwidth, coal, aluminum, plastics, and emissions credits, among other commodities. At the height of its power, 1,500 traders housed in Enron’s office tower in Houston were trading 1,800 different products. As the *New York Times* later noted in an editorial, Enron was widely viewed as “a paragon of American ingenuity, a stodgy gas pipeline company that had reinvented itself as a high-tech clearinghouse in an ever-expanding roster of markets.” Reflecting the general enthusiasm, Skilling replaced his automobile vanity license plate, which had read WLEC (World’s Largest Energy Company) with WMM (We Make Markets).

**Insisting on Results**

In his 1999 letter to shareholders, Lay described the company’s attitude towards its employees this way: “Individuals are empowered to do what they think is best.... We do, however, keep a keen eye on how prudent they are.... We insist on results.”

Enron used a recruitment process designed to hire individuals who were smart, hard working, and intensely loyal. The company preferred to hire recent graduates. After an initial screening interview, candidates were brought to the Houston office for a “Super Saturday,” during which they were individually interviewed for 50 minutes by eight interviewers, with only 10-minute breaks between interviews.

Even candidates who survived this strenuous hiring process, however, could not count on job security. Within the company, management used

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9 Fusaro and Miller, p. 70.

a "rank and yank" system in which new recruits were ranked every six months, and the 15 or 20 percent receiving the lowest scores were routinely terminated. Enron's highly competitive and results-oriented culture "created an environment," in the words of one observer, "where most employees were afraid to express their opinions or to question unethical and potentially illegal business practices."\(^{11}\)

On the other hand, employees were encouraged to take initiative and were handsomely rewarded when their efforts paid off. Louise Kitchen, chief of the European gas trading unit, for example, organized a team to develop an online trading system. When it was adopted as the basis for a company-wide division, Kitchen was promoted to president of Enron Online.

Executive compensation was also results-based. According to Enron's 2001 proxy statement:

The basic philosophy behind executive compensation at Enron is to reward executive performance that creates long-term shareholder value. This pay-for-performance tenet is embedded in each aspect of an executive's total compensation package. Additionally, the philosophy is designed to promote teamwork by tying a significant portion of compensation to business unit and Enron performance.\(^{12}\)

Executive compensation was primarily comprised of salary, bonus, and stock options, as shown in Exhibit 1. In addition, the company routinely loaned money to top executives, forgiving the loans if the terms of their contracts were fulfilled. Enron also awarded some executives equity stakes in various business units, which could be converted into stock or cash under certain conditions. For example, Skilling held a 5 percent

\(^{11}\) Fusaro and Miller, p. 52. Enron's "rank and yank" system is described in Malcolm Gladwell, "The Talent Myth," The New Yorker, September 16, 2002.

\(^{12}\) Enron, SEC Schedule 14A (proxy statement), March 27, 2001, p. 15.
stake in the retail energy unit, which he converted into $100 million worth of stock in 1998.\(^{13}\)

### Exhibit 1: Top Executive Compensation, 2000

<table>
<thead>
<tr>
<th></th>
<th>Base Salary</th>
<th>Bonus</th>
<th>Other</th>
<th>Stock Options</th>
<th>Total</th>
<th>Stock Options as % of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lay</td>
<td>1.3</td>
<td>7.0</td>
<td>.4</td>
<td>123.4</td>
<td>132.1</td>
<td>93%</td>
</tr>
<tr>
<td>Skilling</td>
<td>.9</td>
<td>5.6</td>
<td>--</td>
<td>62.5</td>
<td>69.0</td>
<td>91%</td>
</tr>
</tbody>
</table>

*Note:* All figures are in millions of dollars, rounded to the nearest $100,000. “Stock options” represents stock options exercised and sold in 2000, *not* granted in 2000. These figures do not include the value of perquisites, such as personal use of company aircraft.


During Enron’s final years, many top executives sold significant blocs of company stock. Between October 1998 and November 2001, according to a lawsuit later filed by shareholders, Lay sold $184 million worth of Enron stock; Skilling, $71 million; and Andrew Fastow, Enron’s CFO, $34 million. All three men sold large blocs in late 2000 or early 2001.\(^{14}\)

### Politics as Usual

Political action was an important part of Enron’s overall strategy. The company’s primary policy goal was to promote deregulation and reduce government oversight in the range of markets in which it traded. It maintained an office in Washington, D.C. staffed by over 100 lobbyists and also used outside lobbyists for specialized assignments. The company spent $2.1 million on lobbying in 2000 alone.\(^{15}\) Enron was also a major campaign contributor. From 1994 on, Enron was the largest

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\(^{14}\) Insider trading data computed by Milberg Weiss Bershad Hynes & Lerach LLP; available online at www.enronfraud.com.

\(^{15}\) “The Fall of the Giant: Enron’s Campaign Contributions and Lobbying,” Center for Responsive Politics; available online at www.opensecrets.org.
contributor to congressional campaigns in the energy industry, giving over $5 million to House and Senate candidates, mostly to Republicans (see Exhibit 2). In 2000, it gave $2.4 million in political contributions.


<table>
<thead>
<tr>
<th>Election Cycle</th>
<th>Total Contributions</th>
<th>Soft Money Contributions</th>
<th>Contributions from PACs</th>
<th>Contributions from Individuals</th>
<th>% to Democrats</th>
<th>% to Republicans</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>$163,250</td>
<td>N/A</td>
<td>$130,250</td>
<td>$33,000</td>
<td>42%</td>
<td>58%</td>
</tr>
<tr>
<td>1992</td>
<td>$281,009</td>
<td>$75,109</td>
<td>$130,550</td>
<td>$75,350</td>
<td>42%</td>
<td>58%</td>
</tr>
<tr>
<td>1994</td>
<td>$520,996</td>
<td>$136,292</td>
<td>$189,565</td>
<td>$195,139</td>
<td>42%</td>
<td>58%</td>
</tr>
<tr>
<td>1996</td>
<td>$1,141,016</td>
<td>$687,445</td>
<td>$171,671</td>
<td>$281,900</td>
<td>18%</td>
<td>81%</td>
</tr>
<tr>
<td>1998</td>
<td>$1,049,942</td>
<td>$691,950</td>
<td>$212,643</td>
<td>$145,349</td>
<td>21%</td>
<td>79%</td>
</tr>
<tr>
<td>2000</td>
<td>$2,441,398</td>
<td>$1,671,555</td>
<td>$280,043</td>
<td>$489,300</td>
<td>28%</td>
<td>72%</td>
</tr>
<tr>
<td>2002</td>
<td>$355,959</td>
<td>$304,909</td>
<td>$32,000</td>
<td>$17,050</td>
<td>6%</td>
<td>94%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$5,951,570</td>
<td>$3,567,260</td>
<td>$1,146,722</td>
<td>$1,237,588</td>
<td>26%</td>
<td>74%</td>
</tr>
</tbody>
</table>

Note: Soft money contributions were not publicly disclosed until the 1991–92 election cycle. Soft money contributions were banned in 2002.

Enron CEO Kenneth Lay also had close personal ties with the Bush family. In 1992, Lay had chaired the host committee for the Republican National Convention in Houston at which George H. Bush was nominated to run for a second term as president. Enron donated $700,000 to George W. Bush’s various campaigns between 1993 and 2001. Lay and his wife personally donated $100,000 to the younger Bush’s presidential inauguration.

Over the years, Enron’s efforts to influence policymaking enjoyed significant success, as illustrated by the following examples:

- **Commodities Futures Regulation.** The job of the Commodities Futures Trading Commission (CFTC), a federal agency, is to regulate futures contracts traded in an exchange. From 1988 to 1993, the CFTC was chaired by Wendy Gramm, an economist and wife of then-Congressman Phil Gramm (Republican-Texas). In 1992, Enron
petitioned the CFTC to exempt energy derivatives and swaps—such as those in which it was beginning to make a market—from government oversight. In January 1993, just days before President Clinton took office, Wendy Gramm approved the exemption. The following month, after she had left office, Gramm was invited to join Enron's board of directors. According to Enron's filings with the SEC, Gramm received somewhere between $.9 and $1.8 million in salary, fees, and stock option sales and dividends for her service on the board between 1993 and 2001.\(^\text{16}\)

- **Securities and Exchange Commission (SEC).** In 1997, the SEC granted Enron an exemption for its foreign subsidiaries from the provisions of the Investment Company Act of 1940, a law designed to prevent abuses by utilities. The law barred companies it covered from shifting debt off their books, and barred executives of these companies from investing in affiliated partnerships. After it had failed to win the exemption it wanted from Congress in 1996, Enron hired the former director of the investment management division at the SEC as a lobbyist to take the company's case directly to his former colleagues. He was successful. The year 1997 was the last in which the SEC conducted a thorough examination of Enron's annual reports.\(^\text{17}\)

- **Commodity Futures Modernization Act.** This law, passed by Congress in late 2000, included a special exemption for Enron that allowed the company to operate an unregulated energy trading subsidiary. Senator Phil Gramm, chair of the powerful banking committee, was instrumental in getting this provision included in the bill despite the opposition of the president's working group on financial markets. Over the years, Enron had been the largest single


corporate contributor to Gramm's campaigns, with $260,000 in gifts since 1993.\textsuperscript{18}

Reviewing the history of Enron's efforts to limit government oversight, one reporter concluded, "If the regulators in Washington were asleep, it was because the company had made their beds and turned off the lights."\textsuperscript{19}

**Off the Balance Sheet**

As Enron forged ahead in the late 1990s as a market-maker in a wide range of commodities, it began to assume increasing amounts of debt. Even though Skilling had touted the value of an "asset light" strategy, entry into markets for such varied commodities as water, steel, and broadband required that Enron buy significant hard assets. Enron's aggressive new business ventures required, by some estimates, on the order of $10 billion in up-front capital investments. Heavy indebtedness, however, posed a problem, because credit-worthiness was critical to the company's ability to make markets in a wide range of commodities. Other parties would be unwilling to enter into contracts promising future delivery if Enron were not viewed as financially rock-solid, and the company had to maintain an investment-grade credit rating to continue to borrow money on favorable terms to fund its new ventures. A complicating factor was that several of the company's major new initiatives fell far short of expectations and some—broadband in particular—were outright failures.

Beginning in 1997, Enron entered into a series of increasingly complex financial transactions with several special purpose entities, or SPEs, evidently with the intention of shifting liabilities (debt) off its books. After the bankruptcy, these transactions were investigated by a special


committee of the Enron board, which released its findings in a document now known as the Powers Committee Report.

Under standard accounting rules, a company could legally exclude an SPE from its consolidated financial statements if two conditions were met: (1) an independent party had to exercise control of the SPE, and (2) this party had to own at least three percent of the SPE’s assets. The independent party’s investment had to be “at risk”; that is, not guaranteed by someone else.\textsuperscript{20} The obvious problem was that if Enron intended to burden the SPEs with debt, no truly independent party would want to invest in them.

A key figure in many of these transactions was Andrew S. Fastow. Described as a “financial whiz kid,” Fastow had joined Enron Finance in 1990. He developed a close relationship with Skilling and rose quickly, becoming chief financial officer (CFO) of Enron in 1998, at age 37. Speaking of Fastow’s selection, Skilling told a reporter for CFO magazine, “We needed someone to rethink the entire financing structure at Enron from soup to nuts. We didn’t want someone stuck in the past…. Andy has the intelligence and youthful exuberance to think in new ways.”\textsuperscript{21}

The SPEs Enron set up in the five years leading up to its bankruptcy included the following:

- **Chewco.** In 1997, Enron created Chewco, an SPE named after the Star Wars character Chewbacca. Fastow invited a subordinate, Michael Kopper, to become the required “independent” investor in Chewco. Kopper and a friend invested $125,000 of their own funds and, with Enron providing collateral, got a $11 million loan from Barclays Bank. Between 1997 and 2000, Kopper received $2 million in management fees for his work on Chewco. In March 2001, Enron repurchased Chewco from its “investors”; Kopper and his friend


\textsuperscript{21} “Andrew S. Fastow: Enron Corp.,” *CFO Magazine*, October 1, 1999.
received more than $10 million. The Powers Committee concluded that “our review failed to identify how these payments were determined or what, if anything, Kopper did to justify the payments.”

- **The LJM Partnerships.** In 1999, Enron created two partnerships known as LJM1 and LJM2 (the initials of Fastow’s wife and children). Unlike Chewco, where he had delegated this role to a subordinate, Fastow himself served as general partner and invested $1 million of his own money. Enron proceeded to transfer various assets and liabilities to the LJMs, in a way that benefited its bottom line. For example, in the second half of 1999, the LJM transactions generated “earnings” of $229 million for Enron (the company reported total pre-tax earnings of $570 million for that period).

- **Raptor Partnerships.** In 1999 and 2000, Enron established four new even more ambitious SPEs, collectively known as the Raptor Partnerships, with such fanciful names as talon, timberwolf, bobcat, and porcupine. In a series of extremely complex financial maneuvers in the final five quarters before declaring bankruptcy, Enron conducted various transactions with and among the Raptors and between the Raptors and the LJMs that generated $1.1 billion in “earnings” for the firm. Among other actions, Enron loaned large blocs of its own stock to the Raptor partnerships in exchange for promissory notes, which were then posted to Enron’s balance sheet as notes receivable.

Fastow made out handsomely on these deals. According to the Powers Committee Report, he eventually received almost $50 million for his role in the LJM partnerships and their transactions with the Raptors, in addition to his regular Enron compensation. In its review of Enron’s SPE transactions, the Powers Committee Report concluded:

> These partnerships...were used by Enron Management to enter into transactions that it could not, or would not, do with unrelated commercial entities. Many of the most significant transactions

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apparently were designed to accomplish favorable financial statement results, not to achieve bonafide economic objectives or to transfer risk.... They allowed Enron to conceal from the market very large losses resulting from Enron’s merchant investments....

Manipulating Revenue

Moving liabilities off the books was one way to make the company’s financial condition look better than it was. Another way was to manipulate revenue. In the period preceding its collapse, Enron used a number of accounting practices apparently aimed at inflating revenues or reducing their volatility.

- **Mark-to-Market Accounting.** Mark-to-market (MTM) is an accounting procedure that allows companies to book as current earnings their expected future revenue from certain assets. The Financial Accounting Standards Board (FASB), the organization that establishes generally accepted accounting principles, approved MTM in the early 1990s. Aggressively using this procedure, Enron counted projected profits from many deals in the year they were made. For example, in 2000 Enron entered into a partnership with Blockbuster to deliver movies on demand to viewers’ homes over Enron’s broadband network. The venture fell apart within a few months, after pilot projects in four U.S. cities failed. Nonetheless, Enron booked $110 million in profits in late 2000 and early 2001, based on the anticipated value of the partnership over twenty years. In 2000, mark-to-market gains accounted for over half of Enron’s reported pretax earnings.

- **Sham Swaps.** In the wake of its collapse, Enron was investigated by the SEC for possible sham swaps. For example, on the last day of the

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23 Powers Committee Report, p. 4.


third quarter 2001, as the company’s stock price was falling, Enron entered into an agreement with the telecommunications firm Qwest to exchange assets. Qwest and Enron agreed to buy fiber optic capacity from each other, and the two companies exchanged checks for around $112 million to complete the swap. According to the New York Times, “the deal enabled Enron to book a sale and avoid recording a loss on...assets, whose value in the open market had dropped far below the price on Enron’s books.”

- Prudence Accounts. Enron traders routinely split profits from their deals into two categories—one that was added directly to the company’s current financial statements, and the other that was added to a reserve fund. These so-called prudence accounts, according to Frank Partnoy, an expert in finance who testified before the U.S. Senate Committee on Governmental Affairs, functioned as “slush fund[s] that could be used to smooth out profits and losses over time.” The use of prudence accounts made Enron’s revenue stream appear less volatile than it actually was. As Partnoy noted, “such fraudulent practices would have thwarted the very purpose of Enron’s financial statements: to give investors an accurate picture of a firm’s risks.”

The Best Interests of the Company

The two groups most responsible for overseeing the legal and ethical integrity of the company’s financial reporting were Enron’s board of directors and its auditors, Arthur Andersen’s Houston office. In January 2001, Enron’s board was comprised of 17 members. Of the 15 outside members, many had long personal and business associations with Lay and were considered loyal supporters of his policies. Although the board included only two insiders (Lay and Skilling), other members of top management frequently attended, sitting around the edge of the boardroom. The full board typically met five times a year. Members of

20 Testimony of Professor Frank Partnoy, Senate Committee on Governmental Affairs, January 24, 2002, online at: http://www.senate.gov/~gov_affairs/012402partnoy.htm.

Enron’s board were unusually well compensated. In 2001, for example, each director received $381,000 in total compensation. (By comparison, the average director compensation for the top 200 companies that year was $152,000; and for companies in the petroleum and pipeline industries, $160,000).  

The quality of the company’s financial reporting was the responsibility of the audit and compliance committee. Chaired by Robert Jaedicke, emeritus professor of accounting and former dean of the Stanford Business School, the committee also included Wendy Gramm and four others. The audit committee typically met for an hour or two before the regular board meetings, often for discussions with the company’s professional auditors.

The board’s first substantive involvement with the SPEs run by Fastow and his associates came in 1999. Fastow’s dual roles as both CFO and general partner of the LJM partnerships potentially violated Enron’s code of ethics, which prohibited an officer from owning or participating in “any other entity which does business with...the company.” An exception could be made if the participation was disclosed to the chairman and CEO and was judged not to “adversely affect the best interests of the company.” Accordingly, in June and again in October, the board reviewed and approved the LJM partnerships and voted to suspend its code of ethics in this instance to permit Fastow to run the partnerships.

However, the board seemed sufficiently concerned that it put additional controls in place; it required both an annual board review and that the chief accounting officer and chief risk officer review all transactions.

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29 Other members of the audit committee were: John Mendelsohn, president of the M.D. Anderson Cancer Clinic; Paolo V. Ferraz Pereira, former president of the State Bank of Rio de Janeiro; John Wakeham, former British Secretary of State for Energy; and Ronnie Chan, chairman of a large property development group in Hong Kong.

30 Earlier, the board had provided a cursory review of Chewco, but had apparently been unaware of Kopper’s role.
with the partnerships. In October 2000, the board added additional restrictions, including provisions that Skilling personally sign off on all related approval sheets. In May 2001, an Enron attorney discovered that Skilling had not signed these documents, as the board had required, so he sent a message to the CEO that he needed to sign the papers at his convenience. Skilling never replied.\footnote{31}{“Enron’s Many Strands: The Company Unravels,” \textit{New York Times} February 10, 2002.} As for the mandated board review, the Powers Committee later concluded that although the audit committee had periodically reviewed the SPEs, “these reviews appear to have been too brief, too limited in scope, and too superficial to serve their intended function.”\footnote{32}{Powers Committee Report, p. 24.}

In its oversight function, the board and its audit committee relied heavily on the professional advice of Enron’s auditor, Arthur Andersen, which repeatedly told the board it was “comfortable” with the partnership transactions. Founded in 1913 and Enron’s auditor since 1985, Andersen was one of the “Big Five” accounting firms. Since the early 1990s, Andersen’s Houston office had acted both as the company’s external and internal auditors, in an arrangement called an “integrated audit,” in which Enron subcontracted much of its “inside” work to the firm.\footnote{33}{“Court Documents Show Andersen’s Ties With Enron Were Growing in Early ’90s,” \textit{Wall Street Journal}, February 26, 2002.} Andersen also did considerable consulting and non-auditing work for its client. All told, Enron was a very important client of the Houston office. In 2000, for example, Andersen received $25 million for audit and $27 million for non-audit services from Enron. Between 1997 and 2001, Andersen received around $7 million for its accounting work on the Chewco, LJM, and Raptors transactions.

Relations between Enron and Arthur Andersen were unusually close. Many Andersen accountants had office space at Enron and easily mingled with their co-workers. “People just thought they were Enron employees,” said one former Enron accountant.\footnote{34}{“Were Enron, Andersen Too Close to Allow Auditor to Do Its Job?” \textit{Wall Street Journal}, January 21, 2002.} Moreover, mobility
between Andersen and its client was high; indeed, at the time of the bankruptcy, the company’s chief accounting officer, Richard Causey, had formerly been in charge of Andersen’s Enron audit.

Andersen’s own structure gave considerable autonomy to local offices like the one in Houston. Like other big accounting firms, Andersen had a professional standards group (PSG) at its corporate headquarters whose job was to review difficult issues that arose in the field. Unlike others, however, Andersen’s PSG did not have the authority to overrule its field auditors in case of disagreement. An investigation by Business Week showed that on four different occasions, the Enron audit team went ahead despite PSG objections to various aspects of its accounting for the Enron partnerships. Finally, Enron requested that its chief critic be removed from the PSG. Andersen headquarters complied.35

Later, responding to criticism of its actions as Enron auditors, Andersen simply stated that it “ignored a fundamental problem: that poor business decisions on the part of Enron executives and its board ultimately brought the company down.”36

A Wave of Accounting Scandals

On March 5, 2001, Fortune magazine published a cover story, written by reporter Bethany McLean, under the title “Is Enron Overpriced?” In the article, McLean challenged the conventional wisdom that Enron stock—which had returned 89 percent to investors the previous year and was selling at 55 times earnings—was an attractive buy. Calling Enron’s financial statements “nearly impenetrable,” she interviewed a number of stock analysts who, although bullish on Enron stock, were unable to explain exactly how the company made money. One called the company’s financial statements “a big black box.”37

35 “Out of Control at Andersen,” Business Week, April 8, 2002.


What *Fortune* did not know at the time was that the fragile structure of partnerships Enron had constructed rested on the high price of the company’s stock. Much of the partnerships’ assets consisted of Enron stock or loans guaranteed by Enron stock. If the share price declined too far, this would trigger a need for more financing from the company. Prior to Enron’s announcement of first quarter 2001 results, and then again prior to the second quarter results, Andersen worked furiously to restructure the partnerships to prevent the necessity of consolidating them with Enron’s books. The Powers Committee later commented that these efforts were “perceived by many within Enron as a triumph of accounting ingenuity by a group of innovative accountants. We believe that perception was mistaken…. [The] Raptors were little more than a highly complex accounting construct that was destined to collapse.”

In late July, Enron’s stock slid below $47 a share—the first “trigger” price for the partnerships. On August 14, Skilling abruptly resigned as president and CEO, citing undisclosed personal reasons. Lay, who had been serving as chairman, resumed the role of CEO. In a memo to Enron employees that day, Lay assured them:

> I have never felt better about the prospects for the company. All of you know that our stock price has suffered substantially over the last few months. One of my top priorities will be to restore a significant amount of the stock value we have lost as soon as possible. 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 business today. Together, we will make Enron the world’s leading company.

The following day, Sherron S. Watkins, an accountant and Enron vice president who worked under Fastow, wrote a memo to Lay to express her concerns about the company’s accounting practices. She stated frankly:

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39 The full text of Lay’s memo appears in Fusaro and Miller, p. 201.
I am incredibly nervous that we will implode in a wave of accounting scandals. My 8 years of Enron work history will be worth nothing on my resume, the business world will consider the past successes as nothing but an elaborate accounting hoax. Skilling is resigning now for “personal reasons” but I think he wasn’t having fun, looked down the road and knew this stuff was unfixable and would rather abandon ship now than resign in shame in 2 years.

She added:

I have heard one manager...say, “I know it would be devastating to all of us, but I wish we would get caught. We’re such a crooked company.”

After a detailed review of the “questionable” accounting practices of the SPEs, Watkins recommended that Lay bring in independent legal and accounting experts to review the propriety of the partnerships and to prepare a “clean up plan.”

Lay followed Watkin’s advice—to a point. He brought in attorneys from Vinson & Elkins, the Houston law firm that had long been Enron’s outside counsel and that had helped prepare the legal documents for the partnerships. In his instructions, Lay indicated that he saw no need to look too closely into the accounting. The lawyers interviewed Fastow, Enron’s auditors, and several others, and then reported back to Lay on September 21 that although the accounting was “creative” and “aggressive,” it was not “inappropriate from a technical standpoint.”

Yet, despite these assurances, the partnerships were unraveling as Enron’s stock price dropped (see Exhibit 3) and could no longer be supported by even the most aggressive accounting. On October 16, under pressure from its auditors, Enron announced a charge against earnings of $544 million and a reduction in shareholders’ equity of $1.2 billion related to transactions with the LJM partnerships. On October 22, the

40 The full text of Watkin’s memo appears in Fusaro and Miller, pp. 185–191.
SEC initiated a probe of the SPEs; Fastow was fired the following day. Then, on November 8, Enron further shocked investors by restating all of its financial statements back to 1997 because "three unconsolidated entities [i.e., the partnerships] should have been consolidated in the financial statements pursuant to generally accepted accounting principles." These restatements had the effect of reducing income for 1997 to 2000 by $480 million, reducing shareholders' equity by $2.1 billion, and increasing debt by $2.6 billion.41

Company executives frantically went searching for a white knight to purchase the company. Dynegy, another Houston-based energy trader and longtime rival, initially agreed to buy Enron for $8.9 billion on November 9. After Dynegy's CEO and board had taken a careful look at Enron's books, however, they changed their minds and withdrew the offer. The rating agencies immediately downgraded Enron to junk status, and the stock dropped below $1 a share and was delisted from the New York Stock Exchange.


41 Based on data reported in the Powers Committee Report, p. 6.
As the company imploded, Enron tried to call in its political chits in one last Hail Mary move. Lay and other top executives placed urgent calls to commerce secretary Donald Evans, treasury secretary Paul O’Neill, and other administration officials, reportedly asking them to lean on banks to extend credit to the company. They declined to do so. Later asked why he had not helped Enron, Evans said that it would have been an “egregious abuse” to have intervened. O’Neill simply stated, “Companies come and go…. Part of the genius of capitalism is, people get to make good decisions or bad decisions, and they get to pay the consequence or enjoy the fruits of their decisions.”\(^{42}\)