Case 8 Enron: On the Side of the Angels*

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.

–**Jeffrey Skilling,** President and CEO, Enron Corporation

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 charging into the deregulated energy markets. Skilling defended Enron's activities, saying:

> We're on the side of angels. We're taking on the entrenched monopolies. In every business we're 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 to $90 region; by November 2001, it had declined 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 later plead guilty to conspiracy to manipulate markets in the California energy market,[2] and another, John Forney, would be arrested for conspiracy and wire fraud in the same California market.[3] 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. His first task was to defend HNG from a takeover bid by refocusing HNG on its core business. In a 1990 speech, Lay characterized his leadership:

> 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.[4]

Lay created Enron, a natural gas and oil company, in 1986, through the merger of HNG with InterNorth, a natural gas pipeline company, and other acquistions.[5] Lay, the merger's architect and Enron's first CEO, appeared to be one of the few individuals who recognized the opportunities of deregulation in the United States and privatization abroad. By the early 1990s, Enron owned an interest in a 4,100 mile pipeline in Argentina and commenced its power marketing business worldwide.

In 1994, *Fortune* ranked Enron 1st 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 busily expanded 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 United States for the second consecutive year. Enron had 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 just as dramatically: On December 31, 1996, Enron's stock listed at 21 7/16 (adjusted for a 1999 split), and on December 31, 2000, its price was 83 1/8. In the firm's entry foyer, a huge banner was placed, reading "World's Leading Company."[6] Skilling's license plate, which had once read "WLEC" (World's Leading Energy Company) changed to "WMM" (We Make Markets).[7]

Throughout 2001, as Enron's stock declined, its rankings dropped 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 ex-military, Harvard Business School, and ex-entrepreneurship types. A *Fortune* article described the employees as "aggressive, well-compensated traders."[8] Enron had developed 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.[9]

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.[10]

* This case was prepared from published materials by Professors Donald Schepers and Naomi A. Gardberg from Baruch College, City University of New York, to provide a basis for class discussion. Copyright © 2003 by the *Journal of Business and Applied Management*. Reprinted with permission of the *Journal of Business and Applied Management*. Readers may find the two Appendixes at the end of the case helpful in reading the case. Appendix A is a timeline of major events in this case. Appendix B is a glossary of various financial terms used in the case.

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.**[6]

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 everywhere I have been.[11]

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 arrived at an employee gathering with a tractor-trailer full of expensive sports cars. The floors of the parking garage were marked by words to remind employees of valued attributes: *bold, innovative, smart, united, ambitious, accomplished, resourceful, creative, confident, adventurous, adaptable,* and *undaunted.*[6]

Two realities of life existed at Enron: stock price and the Peer Review Committee (PRC).[12] 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."[13] Below that was "Translation: We do big, complex, and risky deals without blowing up Enron." Employees were rewarded for earnings that could be quickly booked, regardless of the long-term consequences. 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.[14]

Like many dot-coms in the 1990s, Enron had a high reward structure. More than 2,000 Enron employees were millionaires. Employees received free laptops and handheld devices, expensive ergonomic chairs, and lunches at Houston's finest restaurants. Enron's board of directors was also well compensated. Chosen by management, Enron directors received cash and stock worth $300,000 a year.[14]

Recruitment took place both in long, intense interviews and in visits to topless bars and strip clubs.[6] Once past an initial interview, candidates were invited to a "Super Saturday" session of eight 50-minute interviews. Offers would go out within a few days, and candidates who declined would be offered signing bonuses or other financial inducements.[12]

Central to Enron's human resource policy was Skilling's PRC, or what became known as the "rank and yank" process.[6] Every six months, each person would choose five individuals (four plus the immediate supervisor) to provide feedback on his or her performance. 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, in which 15 percent of those reviewed had to receive a 5. These individuals would then be "redeployed," meaning they had to search for another job in the organization or find themselves unemployed.

On the trading floor, men rated women as potential calendar models. When one of the "candidates" would walk onto the floor, someone would yell the name of the month to alert others of her presence.[6] Gambling was also prevalent. One year, the NCAA basketball pool supposedly reached almost $90,000.[15]

This culture spilled out of the doors and into Enron's relationships with others. On one occasion, Andy Fastow, the chief financial officer (CFO), was asked by a Citigroup banker if he understood the equations on the whiteboard in the conference room next to his office. Fastow replied, "I pulled them out of a book to intimidate people."[16]

Analysts who listened to the quarterly earnings report conference calls would be derided if they had questions about the details. 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, [expletive]."[6]

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.[12] 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 convey 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 the same year, Lay hired Skilling as CEO of Enron Gas Services (EGS), and Skilling hired Fastow as CFO. EGS was ultimately renamed Enron Capital and Trade Resources (ECT).

ECT provided financial and risk management services for Enron and its trading partners. The process, asset securitization, involves selling the rights to future cash-flow streams. 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 bundle a number of such investments together, separate the cash flows by level of risk, and put the result into securities it 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 transfers risk of default 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. Second, it moved Enron further toward Lay's vision of the company as 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 1990s, Enron was rapidly becoming a commodities market based in Houston. Even weather risk was commoditized and traded.[6] This was supplemented with an approach 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 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 a reference point for valuing a security. A model was constructed using a number of assumptions, and the security was then valued using that model. In reality, the prices were generated by computers, not by the market process. Enron relied on this procedure to establish prices (sometimes unrealistically high) for its new commodities (e.g., weather) when there were no reference prices.[9]

The second mechanism Enron used was the creation of *special-purpose entities.* SPEs are financial devices designed to give companies greater flexibility in finance and risk management. There are two requirements for SPEs to be legitimate: First, there must be a 3 percent outside equity position; 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, LJM1, and LJM2 and four investments named Raptors. In 1993, Joint Energy Development Investment (JEDI), a $500 million partnership between Enron and the California Public Employees Retirement System (CalPERS), was the first SPE created. 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.

SPEs would be used to solve Enron's financial problems. Enron not only brokered commodities contracts but actually bought and sold natural gas. 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.

As Enron expanded the use of SPEs, new investors were required to satisfy the SEC requirement of 3 percent outside equity investment. Fastow and Michael Kopper (managing director, Enron Global Finance, and a direct report to Fastow) established 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 "outside equity" in the SPEs.

Enron's need for a high credit rating drove the creation of over 3,000 SPEs to keep debt off the balance sheet.[9] Maturing markets meant decreasing profits, but profits were necessary to continue Enron's trading mechanism. The only way to create more profits was to open new commodity markets, exploit them quickly, and then create 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.

The SPEs presented Enron with the opportunity to disguise debt and loss as revenue, but they did not necessarily result in cash flow.[9] Enron would establish an SPE by issuing Enron stock to collateralize the SPE, and then it would engage other entities such as banks to invest in the SPE. Enron would then "sell" the SPE that it had set up 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," that is, fiber optic cable that was already laid but was as yet unusable. In both cases, Enron had a "make whole" contract with the SPE, ensuring 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, these SPE arrangements contained triggers, that is, valuation points at which 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 or provide cash sufficient to bring the value of Osprey up to cover its debt obligations.[17] 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 required 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.[18]

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, thereby understating Enron's debt by $4 billion, and overstating its $3.2 billion cash flow from operations by 50 percent.[19] An independent bank examiner, Neal Batson, found that Enron had recorded profit of $1.4 billion through similar transactions with six investment banks.[20]

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.[10]

The Enron culture was not without its system of checks and balances, particularly in 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 of overseeing and approving 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, risk components, a financial approval sheet, and an authorization page.[6] Corporate policy required approval from the relevant business unit, legal department, RAC, and senior management. Many of the DASH forms for SPEs had incomplete authorizations. In particular, Skilling's signature is blank on many of the DASH forms associated with the LJM deals.[18]

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. Some conclusions were phrased as questions ("Was this transaction done strictly on an arm's-length basis?"), and some revealed low standards ("Was Enron advised by any third party that this transaction was not fair, from a financial perspective, to Enron?").[18]

Enron formed 20 deals with 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, 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 board's audit and finance committees were assigned the task of reviewing all the previous year's transactions. The board also required that Skilling review and approve all LJM transactions, as well as review Fastow's economic interest in Enron and LJM.

Skilling, as COO and later CEO, did not sign many of the DASH forms for 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. At one level, accounting standards required adequate information for management to assert that the related-party transactions were at least comparable with those that would have taken place with unrelated parties. However, 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.[18]

Three International Deals

Rebecca Mark served as president of Enron Development Corporation. The power plant at Dabhol, India, was one of her achievements, though its overall value to Enron faded

over time. Mark finalized the $3 billion deal in 1995, partnering Enron with General Electric and Bechtel. Enron's share was 65 percent; GE and Bechtel each owned 10 percent; and the remaining 15 percent was owned by the state of Maharashtra electric utility. In addition to the partners, four lenders (the Industrial Development Bank of India, Citibank, Bank of America, and the Overseas Private Investment Corporation, a U.S. government agency) lent $2 billion.[21]

The Dabhol plant was troubled from the beginning with local and state authorities. The Clinton administration, at Lay's request, sent Ron Brown, secretary of commerce, to India in 1995 to keep the deal afloat. During construction, there were reports of human rights violations by guards.[22] Enron distanced itself from such instances, noting that it was only leasing the property, though it also paid the guards.

There were local benefits. Roads were constructed, and the local economy benefited from increasing levels of both employment and consumption. But when the plant opened in 1999, opposition exploded as energy bills rose as much as 400 percent. Maharashtra annulled its contract, and the plant was shuttered.

Mark also negotiated the Cuiaba project in Brazil. Enron had a 65 percent share in a gas-fired power generating plant and its associated pipelines. Construction exceeded the budget by over $120 million and showed no signs of profit. In 1999, LJM1 bought a 13 percent interest in the project for $11.3 million, enabling Enron to shield the associated debts from its balance sheet. In addition, the sale allowed Enron to mark to market a related power supply contract. With the sale and recognition of this contract, Enron booked a total of $65 million profit in the last half of 1999. Enron had a secret agreement with LJM1 to buy the interest back, should it be necessary for LJM1's profit. This buyback occurred in 2001, for $13.725 million.[23]

Azurix was a 1998 spin-off from Enron. Mark was named chair and CEO, with the mandate to create deals in the water supply industry. Enron's strategy was to assert itself as an international market maker in water. With Azurix divorced from Enron, these deals could be done under Enron oversight without the debt accruing to the balance sheet. Azurix went public in 1999, amassing $695 million in capital in the process.[12]

In 1999, Azurix acquired Wessex Water in the United Kingdom for $2.4 billion in cash and $482 million in debt.[24] Following that, Azurix bought the rights to an Argentinian water utility. These two acquisitions quickly undid Azurix, Mark, and any remaining Enron strategy involving hard assets. The Argentinian utility was plagued with contaminated water and labor union issues. The British government reduced the price Wessex could charge for its water. Mark was forced to resign in the summer of 2000, and she left Enron. Wessex Water was sold in 2002 to YTL Power International, a Malaysian firm, for $777 million in cash, with YTL also assuming $991 million in Wessex debt.[24]

It Comes Undone Six months after taking the reins as CEO on February 12, 2001, Skilling abruptly resigned, effective August 14, 2001. His 15 years at Enron were over, but Enron would haunt him long after. Skilling cited "personal reasons" as the cause, but there was widespread speculation that more was behind it.

Exhibit 1 provides a quick glance at Enron's profit and loss from 1998 to 2000. The declining gross margin indicates that Enron's nonderivatives business was losing money. Any profitability was coming from derivatives. In fact, Enron's derivatives profits were roughly equivalent to Goldman Sachs, Inc.'s annual net revenue.[9]

In the Raptor restructurings from late 2000 to early 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. 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, Enron consolidated the SPEs back to 1997. Hence, the balance sheets of Chewco, JEDI, and LJM were now part of Enron's balance sheet. These adjustments reduced Enron's income by $591 million, and increased its debt

Exhibit 1 Enron Corp. and Subsidiaries Consolidated Income Statement, 2000 (in millions)

	2000	1999	1998
Nonderivatives revenues	$93,557	$34,774	$27,215
Nonderivatives expenses	94,517	34,761	26,381
Nonderivatives 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.

by just less than $2.6 billion. And some feared that the restatements were insufficient.

In the midst of this restructuring, Milberg Weiss Bershad Hynes & Lerach, LLP, filed a class-action suit on behalf of Enron shareholders on October 22, 2001. As part of its filing, the lawsuit disclosed the names and amounts of stock sold by Enron insiders, both senior management and directors (see Exhibit 2).[6]

During this time, Enron's one hope was a proposed merger with Dynegy, a corporation once viewed by Enron employees as an insignificant competitor. This 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. 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 engendering a number of congressional hearings, the Enron bankruptcy also brought criminal charges by the government. David Duncan, Arthur Andersen's lead auditor for Enron, pleaded guilty to obstruction of justice in April 2002 for document shredding in connection with the Enron account. Kopper pleaded guilty in August 2002 to conspiracy to commit wire fraud and money laundering, losing almost approximately $12 million that he admitted he had improperly acquired through various SPE deals. Fastow was indicted in October 2002 on 78 counts for his role at Enron and in the various SPEs, and his accounts were frozen. On January 13, 2004, Fastow pled guilty to two counts, one for covering up financial problems and one for defrauding the company, and was sentenced to 10 years in a federal prison.[25] His wife, Lea, pleaded guilty to one count of tax fraud and received a 1-year sentence. On February 21, 2004, Jeff Skilling and Rick Causey were indicted for their roles, and on July 7, 2004,[26] Ken Lay was indicted for his.[25]

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' 401(k)s were primarily invested in Enron, and the employees were barred from selling their shares until they turned 55. Many of the 401(k)s were solely invested in Enron. As late as summer 2001, Ken Lay was predicting that Enron would regain much of its loss in stock price. His e-mail 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.[12]

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

Senior Management and Board Members	Proceeds from Enron Stock Traded between October 1998 and November 2001
J. Clifford Baxter[a]	$ 34,734,854
Robert A. Belfer[b]	111,941,200
Norman P. Blake Jr.[b]	1,705,328
Richard B. Buy[a]	10,656,595
Richard A. Causey[a]	13,386,896
James V. Derrick Jr.[a]	12,563,928
John H. Duncan[b]	2,009,700
Andrew S. Fastow[a]	33,675,004
Mark A. Frevert[a]	54,831,220
Wendy L. Gramm[b]	278,892
Kevin P. Hannon[a]	Unknown but substantial
Ken L. Harrison[a]	75,416,636
Joseph M. Hirko[a]	35,168,721
Stanley C. Horton[a]	47,371,361
Robert K. Jaedicke[b]	841,438
Steven J. Kean[a]	5,166,414
Mark E. Koenig[a]	9,110,466
Kenneth L. Lay[a,b]	184,494,426
Rebecca P. Mark[a,b]	82,536,737
Michael S. McConnell[a]	2,506,311
Jeffrey McMahon[a]	2,739,226
Cindy K. Olson[a]	6,505,870
Lou L. Pai[a]	270,276,065
Kenneth D. Rice[a]	76,825,145
Jeffrey K. Skilling[a,b]	70,687,199
Joseph W. Sutton[a]	42,231,283
Lawrence Greg Whalley[a]	Unknown but substantial

[a]Employee, Enron Corp.
[b]Member, Enron Board of Directors

Source: Cruver, B. 2002. *Anatomy of greed: The unshredded truth from an Enron insider.* New York: Carroll and Graf Publishers: 132–133.

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.[27] 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.

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.[28]

The Accounting Profession Fallout spread throughout the accounting profession as well, as reports of inadequate oversight continued throughout the fall of Enron. In fall 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, e-mailed David Duncan, the lead Enron auditor for Andersen, a reminder of the corporate policy on memo retention, leading to massive document shredding efforts at Andersen's Houston offices. Duncan later pleaded guilty to criminal obstruction of justice, and Temple was named by a grand jury as one of four or five "corrupt persuaders" who encouraged the destruction of documents.[29] Andersen itself was stripped of its license to audit public corporations in the United States and ceased to do business.

A major feature of the Sarbanes-Oxley Act was aimed at the conflict that some thought brought about the Enron scandal: 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.[9] Audit firms would no longer be allowed to offer consulting services to audit clients. 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.

The Charity Fallout Enron and its executives were very generous not only to 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, donations to United Way, and university endowments.

Enron also generously contributed to the causes of several of its directors.[30] 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 U.S. House of Representatives passed a bill dubbed the "Enron bill" that requires disclosure of certain contributions and noncash gifts to organizations associated with board members.

Conclusion This case is still writing its own ending. Many of the stakeholders will never recover from their losses. Criminal actions have resulted in some individuals going to jail and others being indicted and waiting for trial. Two of the investment banks, Citigroup and J.P. Morgan Chase, have settled investor lawsuits for $2.575 billion and $2.2 billion, respectively. Other investment banks still face civil actions.[31] And federal lawmakers are debating the cost of some provisions of the Sarbanes-Oxley Act. This case will evolve for years to come.

Appendix A Enron Timeline

1984		Ken Lay becomes CEO of Houston Natural Gas (HNG).
1985		HNG merges with Internorth. Lay becomes CEO of the new company.
1986		Company changes name to Enron, and moves to Lay's hometown, Houston.
1990		Skilling leaves McKinsey & Co. to join Enron as executive officer of Enron Gas Services. Skilling hires Andrew Fastow from banking industry.
1991		Enron adopts mark-to-market accounting strategy, reporting income and value of assets at their replacement cost. Fastow forms first legitimate SPEs.
1993		Deregulation of worldwide energy markets. Enron begins marketing power and forms first SPE, JEDI, with CalPERS to invest in natural gas projects.
1994		As deregulation in the United States grows, Enron begins trading electricity.
1996		Enron commences construction of the Dabhol power plant in India. Lay promotes Skilling to Enron's president and COO.
1997		Enron buys first electric utility, Portland General Electric. Fastow promoted to head new finance department. Enron applies energy-trading model to new commodities markets such as weather derivatives, coal, pulp and paper, and bandwidth capacity. Chewco (another SPE) created to purchase CalPERS' shares of JEDI1 so that CalPERS could participate in a larger partnership, JEDI2. Chewco never meets the 3 percent outside ownership and is never a legitimate SPE.
1998		Fastow named CFO. Enron begins power trading in Argentina, becoming first power marketer, and gains control of Brazilian utility. Enron acquires U.K. utility Wessex Water and forms Azurix, a global water business. It then takes Azurix public, retaining a 69 percent stake. Enron trades most of Enron Oil & Gas for cash and its properties in India and China.
1999		New Houston Astros baseball stadium named Enron Field. Skilling and Fastow present LJM partnerships to board of directors.
2000		
	February	*Fortune* names Enron "the most innovative company in America" for the fifth consecutive year.
	April	Enron creates the first Raptor SPE.
	August	Rebecca Mark resigns due to poor results at Azurix and tension with Skilling. Stock hits all-time high of $90 and revenue surpasses $100 billion, making Enron the seventh-largest company in the Fortune 500.
2001		
	February	Lay steps down as CEO. President and COO Skilling replaces Lay as CEO.
	August	Skilling resigns, and Lay becomes CEO again. Sherron Watkins, an Enron accountant, sends anonymous memo to Lay warning of potential accounting scandal.
	September	Arthur Andersen compels Enron to change an aggressive accounting action, causing a $1.2 billion reduction in Enron's equity.
	October	SEC launches investigation of Enron's off-balance-sheet partnerships. Enron changes its 401(k) pension plan administrator, preventing employees from selling Enron stock for 30 days. Fastow is put on leave. Enron establishes special committee to investigate third-party transactions, to be known as the Powers Report. Enron's stock drops to $11.
	November	Enron strikes deal with Dynegy, its largest energy-industry rival. Dynegy backs out of the deal once more details of Enron's finances are available. Enron stock trades at less than $1 per share.
	December	Enron files for Chapter 11 bankruptcy protection and lays off 4,000 employees.

(*continued*)

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2002		
	January	Watkin's memo leaked to Congress. U.S. Justice Department launches a criminal investigation into Enron's fall. Enron fires Arthur Andersen LLP. Enron sells its energy trading business to UBS's investment banking unit, sells Wessex Water to a Malaysian firm, and shuts down its broadband unit. Lay resigns, and McMahon becomes CEO. Former Enron Vice Chairman Cliff Baxter is found dead as government investigation deepens.
	February	Skilling testifies before Congress. Lay pleads the Fifth Amendment. Watkins testifies before Congress about her memo to Lay.
	April	Andersen lays off 7,000 employees. McMahon resigns as of June 1.
	August	Kopper pleads guilty to money laundering and wire-fraud conspiracy. Cooperates with authorities.
	October	Fastow indicted on 78 counts of federal fraud, conspiracy, and money laundering.
2003		
	May	Federal prosecutors file new charges against Fastow and two others. Fastow's wife and seven other former Enron officials are indicted for fraud and other criminal charges.
2004		
	January	Fastow pleads guilty on two counts and receives 10 years in federal prison. Lea Fastow pleads guilty to one count of tax fraud and receives a 1-year sentence.
	February	Skilling and Causey indicted on 42 counts, including securities fraud, wire fraud, and insider trading.
	July	Lay indicted on 11 counts, including wire and bank fraud, as well as making false statements.

Appendix B Glossary of Terms

Adjustment	A deduction made to financial statements to charge off a loss, as with a bad debt.
Asset-lite	Enron jargon for short-term or noncapital-intensive assets.
CalPERS	California Public Employees Retirement System.
DASH	Deal Approval Sheet.
Derivative	A financial instrument whose characteristics and value depend on the characteristics and value of an underlier, typically a commodity, bond, equity, or currency.
Downgrade	A negative change in an analyst's ratings for a security.
Hedge	An investment made to reduce the risk of adverse price movements in a security, by taking an offsetting position in a related security.
Insider stock sales	The selling of a company's stock by individual directors, executives, or other employees.
JEDI	Joint Energy Development Investment—an Enron SPE.
Mark to market	An accounting method that records the price or value of a security, portfolio, or account on a daily basis to calculate profits and losses or to confirm that margin requirements are being met.
Off balance sheet	A term pertaining to financing from sources other than debt and equity offerings, such as joint ventures, R&D partnerships, and operating leases.
Option	The right, but not the obligation, to buy (for a call option) or sell (for a put option) a specific amount of a given stock, commodity, currency, index, or debt at a specified price (the strike price) during a specified period of time.
Premium	The amount by which a bond or stock sells above its par value.

Privatization — The process of moving from a government-controlled system to a privately run, for-profit system.

Put option — An option contract that gives the holder the right to sell a certain quantity of an underlying security to the writer of the option at a specified price (strike price) up to a specified date (expiration date); also called *put.*

RAC — Risk Assessment and Control, an Enron department.

Rank and yank — Employee jargon for Enron's employee review process.

Securitization — The process of aggregating similar instruments, such as loans or mortgages, into a negotiable security.

SPEs — Special-purpose entities.

Write-down — A downward adjustment in the accounting value of an asset.

Yield — The annual rate of return on an investment, expressed as a percentage.

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