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Preventing the Next Enron

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Preventing The Next Enron

Pell Senior Thesis

John Cannaverde

Dr. Atkins

This paper will address the Pell theme of public policy. The conflicts of environment and conflict resolution are the public policy themes that will be discussed in this paper. Public policies are regulations put in place to protect the general public from harm. In recent times, corporate scandals have been a major issue of public policy. These scandals have brought into question current legislation and the integrity of businesses. Enron an American energy corporation was involved in one of the largest cases of corporate fraud in the 21st century. Enron executives abused market to market accounting and special purpose entities (SPEs). Ken Lay and Jeffrey Skilling, the past CEO's of Enron, failed to implement the business's code of ethics. Leaders are role models of an organization and they form the foundation for what is appropriate and inappropriate organizational behavior. A business's code of ethics is applied through business culture. Business culture is a mechanism that aligns values of the company with organizational processes and creates a natural selection process. This natural selection process is where people who do not share the same values are eliminated. Ken Lay and Jeffrey Skilling failed to create an ethical business culture. Jeffrey Skilling only cared about performance and Ken Lay lacked authority and confidence. To ensure high standards of ethics in a business, leaders must actively promote the code of ethics and entwine it into the business culture.

Ken Lay - "Kenny Boy"

Ken Lay was born in 1942 in Tyrone, Missouri. Lay was one of three children to Omer and Ruth Lay. The Lays were constantly struggling to make ends meet, "...until he was 11 years old, Ken Lay had never lived in a house with indoor plumbing – and at a young age, he set his mind on finding his fortune" (Mclean 4). The Lays owned their own

feed store in Tyrone until, they were met with disaster. Their delivery man crashed the delivery truck into another truck loaded full of chickens. This incident forced Omer to close his feed shop and become a traveling stove salesman. Unsuccessful at selling stoves, the Lays were left with no choice and moved in with their in-laws. Omer was a Baptist preacher and used his connections with the church to find a number of day jobs to provide for his family. Aware of his family's hardships, Lay always worked. As a kid he had jobs as a paper boy, raising chickens, and bailing hay. Lay's family struggles created his ambition to become part of the world of commerce.

Lay's parents Omer and Ruth never graduated from high school. But, Lay attended the University of Missouri. He painted houses, earned scholarships, and took out loans to pay for higher education. Lay wanted to become a lawyer but became captivated by business. Pinkney Walker, his economics teacher taught him, "...about politics and public policy, how government could shape markets" (Mclean 5). With the guidance of Pinkney Walker, Lay continued his education and received his master's degree in business.

In 1968, Lay entered the Navy ahead of the Vietnam draft. Lay intended to become a, "...shipboard supply officer, perhaps in the South China Sea, Lay was abruptly reassigned to the Pentagon" (Mclean 5). This reassignment was from the help of Pinkney Walker. Walker pulled some strings and had Lay assigned to conduct studies on military-procurement in Washington, D.C. While in Washington, Lay taught graduate students economics at George Washington University.

Pinkney Walker was appointed to the position of Federal Power Commission by President Richard Nixon. The Federal Power Commission was in charge of regulating the energy business. Walker brought Lay along as his top aide. Shortly after, The Whitehouse appointed Lay as Deputy Undersecretary of Energy. Lay did not serve very long as the Undersecretary of Energy. It was time to enter the world of business,

[I] feel it is now time I begin thinking about returning to the private sector and resuming my career in business. I would be most interested in being considered for possible job opportunities with Florida Gas Company. The natural gas industry, obviously, faces some very difficult challenges in the months and years ahead, and I would like to be in a position in industry to meet these challenges (Mclean 7).

By the end of the year Lay was Vice President for Corporate Planning. In 1976, Lay had progressed to President of the Pipeline Division at Florida Gas. Three years later he was president of the entire company. As president he was being paid \$268,000 a year.

Lay's belief in deregulation was met with great success when the nation went into an energy crisis,

One part of the nation's energy crisis was a persistent shortage of natural gas; in some regions, schools and factories had been forced to close because the gas needed to heat them was in such short supply. Gas producers argued that the problem was that the government-mandated price was simply too low to encourage new exploration efforts. So in 1978 Congress hiked the regulated price that would be paid to producers for some types of natural gas. At the same time, though, Congress passed legislation barring the use of natural gas for any new industrial boilers. Thus the first law was intended to increase supply, while the second was intended to depress demand. Although this was hardly full-scale deregulation, it was the government's first tentative step in that direction (Mclean 8).

This implementation of new policy had great success, "...the higher prices jump-started gas exploration and increased the nation's supply of natural gas" (Mclean 9). This also caused

the demand of natural gas to decrease. The rising prices led to customers switching to coal or fuel oil. The situation worsened when the government, "...freed utilities and industrial customers from their contracts to buy from the pipelines, allowing them to shop for better prices on the open market or turn to cheaper fuels" (Mclean 9). This hurt companies because they could no longer sell their huge volumes of gas at the higher prices.

Lay took advantage of the gas crisis. Working for Transco, Lay took natural gas contracts and created a fledging spot market. Transco was able to sell gas directly to their customers and pay Transco for transportation. Lay was seen as a major asset by the company, "[T]he Houston Chronicle wrote in 1983, 'Some analysts attribute the strength of Transco's stock price to Lay's credibility and his bold and unique accomplishments'" (Mclean 9). It is speculated that Transco would have made Lay CEO in 1989 with the retirement of the current CEO: Bowen.

However, Lay's opportunity to become CEO came much sooner. In 1984, Houston Natural Gas (HNG) named him CEO. After becoming CEO, his wife Linda Lay said "[I]t's fun to be king" (Mclean 10). Ken Lay's rapid success changed him, "[A] man of humble origins, Lay also became addicted to the trappings of corporate royalty" (Mclean 3). With Lay's economic background he believed, "...real deregulation – was coming soon. And when it did, he believed, the price of the commodity would reflect true market demand and the companies with the best pipeline networks would be the ones calling the shots" (Mclean 10). In his first six months of being CEO, he spent \$1.2 million on pipelines in California and Florida. At the same time he bought \$625 million in holdings outside the core pipeline business in coal mining and a fleet of barges. He operated on one theory: to get big fast.

From an investor point of view, HNG became an appealing company. Sam Segnar, the CEO of Internorth, made a pitch to buy HNG. Segnar was, “too eager for his own good” (Mclean 10). Segnar was flustered because a corporate raider Irwin Jacobs was buying shares of Internorth. His plan to deter the corporate raider was to expand InterNorth and increase its debt. Negotiations between the HNG and InterNorth led to the surprising agreement, “...that the smaller company’s younger management team ultimately end up in charge” (Mclean 11). The \$2.3 billion deal was approved only 11 days after the first phone call,

From a business standpoint, HNG InterNorth, as it was called seemed an elegant combination: with 37,500 miles of pipeline, the new \$12 billion company would have the largest gas-distribution system in the country, running from border to border, coast to coast. It would have access to the three fastest growing markets: California, Texas, and Florida (Mclean 12).

Lay walked away with a \$3 million profit from his stock and options. On paper the merger looked good, but InterNorth, “...came down with a bad case of buyer’s remorse” (Mclean 12). They realized they gave their company to Lay, “...HNG had almost as many seats (8) on the board as InterNorth (12)” (Mclean 12). InterNorth employees were aggravated that their company was given away by Segnar. Later, InterNorth discovered Lay persuaded Segnar to agree to the terms by providing a \$2 million severance package.

The InterNorth employees were very fearful that their Iowa based company would be moved to Texas. There were roughly 2,200 jobs that were at stake and Lay assured that the company would remain in Omaha. The McKinsey consultants, John Sawhill and Jeff Skilling made the recommendation that the company to move to Houston. Segnar resigned immediately after,

Afterward, all parties claimed that Segnar had voluntarily resigned. In truth the meeting had been a bloodbath, and he hadn't really had a choice. Convinced that Segnar had made a series of secret side deals with Lay to betray Omaha, the old InterNorth directors demanded his head. Of course, since the board didn't have another CEO candidate, it also meant that Ken Lay would become chief executive office immediately, instead of having to wait the agreed-upon 18 months (Mclean 12).

Lay quietly won over the board. He paired up with Arthur and Robert Belfer appointed to the board by both HNG and Internorth. Over the next three years Lay started to dissolve the Omaha office. He reorganized the board of directors placing Charles Walker (Pinkney Walker's brother), Herbert Winokur a Pentagon friend, and John Duncan the HNG director who hired Lay. In July 1986 Lay moved the corporate headquarters into a skyscraper located in Houston.

Shortly after the merger of HNG and InterNorth, the company was met with financial trouble. Lay's strategy of getting big fast was not working. Irwin Jacobs had partnered up with an investor group and was still buying shares. Lay was forced to tap into the company's pension fund to buy the groups 16.5 percent. Deregulation of energy utilities caused an enormous supply of gas on the market. Prices took a plunge and Lay's company was \$1 billion in liabilities. Lay was even having trouble coming up with a name for the company. The New York consulting firm had made the name Enteron. The *Wall Street Journal* said,

"Enteron was a term for the alimentary canal (digestive tract), turning the name into a laughingstock. Though it meant reprinting 75,000 covers that had already been printed for the annual report, the board convened an emergency meeting and went with a runner-up on the list: Enron" (Mclean 14).

In 1986, Enron reported a loss of \$14 million for the first year. January 1987, Enron's credit rating had fallen to junk status and there was worry about meeting payroll.

Enron Oil Trading was one of the only profitable departments of Enron. Oil Trading was strictly about trading and not oil. The oil traders, "...came to work everyday and made bets on the direction of crude oil prices" (Mclean 15). Oil trading was viewed as easy money and the top executives did not care about what the oil trading department did. At the time oil trading was the new thing to do. Companies traded oil future contracts promising to deliver oil in the future at the contracted price. This would reduce the risk that the price of oil would rise or fall. Louis Borget was the man in charge of Enron Oil and he loved playing the role. The traders all,

...drove company cars and ate daily catered lunches. A former trader name David Ralph Hogin recalls that Borget drove a Mercedes; when Hogin asked for a Mercedes, too he was told that 'Lou's the only one who has a Mercedes. Would you settle for a Cadillac?' (Mclean 17).

The office located in Valhalla, NY was far from modest and was described as sleek and modern. In 1985, Borget's trading division had made \$10 million. The following year they made \$28 million while the rest of the company lost money. That year Borget and a handful of traders received a \$9.4 million bonus. Borget described Enron Oil as the perfect modern business.

On January 23, 1987 David Woytek the head of the internal audit department received startling news. The Apple Bank in New York had told Woytek Tom Mastroeni had opened an Enron account and transferred close to \$5 million. \$2 million had gone to his

own personal account. They also found that the account was nowhere to be found on Enron's books. Woytek quickly notified Rich Kinder (Ken Lay's general counsel).

Rich Kinder assigned John Harding and Steve Sulentic to the case. They later explained it was a tactic to, "...move some profits from 1986 into 1987 through legitimate transactions" (Mclean 18). Woytek noted that the Enron management had requested that this be done. Borget would shift income to offset losses in the period. The shifting of profits was said to be for tax reasons. That would shift profits from month to month and year to year. Enron did this to increase the price of their stock. But, it also helped Enron get approved for bank loans. Enron was so thin on cash it needed to constantly acquire new loans to pay back maturing ones. Sulentic wrote a memo stating, "...the methods Borget and Mastroeni had used 'not acceptable,' but he didn't recommend any sort of punishment, not even a public admission of what had happened" (Mclean 19). Mastroeni admitted that he had diverted funds to his personal account and he insisted that he was intending to repay the money. Personal bank statements were presented. But, the auditors knew they were doctored because they had received the originals from the bank. Then Mastroeni changed his first explanation. He said that Borget and himself paid a bonus to a trader and did not want to have to explain it to corporate executives. The odd part about the situation is,

...most of Enron executives in the room appeared to accept Mastroeni's explanation. Mastroeni wasn't even reprimanded. Neither was Borget. 'No one pounded the table and said these guys are crooks. They thought they had the golden goose, and the golden goose just stole a little money out of their petty cash' (Mclean 19).

The internal auditors continued the investigation after. They found Borget had sold his company car and deposited the cash into the Apple Bank account. There was also \$106,500 worth of payments to a M. Yass. Comically this represents 'My ass.' Borget said M. Yass was an English broker who had facilitated the bonus to the Enron Trader. The auditors searched and found no M. Yass. The internal auditors did not get much further because the investigation was turned over to Arthur Andersen.

Arthur Andersen noted that the Apple Bank account was strictly for shifting profits and nothing else. They also discovered that the trader's internal control was not being followed. The traders were not to exceed eight million barrels of oil in a day or a loss of \$4 million. Arthur Andersen was not able to confirm if the department was compliant. Borget and Mastroeni had made it practice to destroy daily position reports. Arthur Andersen reported that the profit shifting would not have any material effects on the financial statements. Borget and Mastroeni were not just committing crimes for the company; they were stealing from it as well. It is estimated that the brokers had stolen \$3.8 million from Enron. The executives of Enron looked the other way because they wanted the stock brokers to keep making them millions.

More trouble struck for the traders on October 9, 1987. Borget told Seidl that for the last several months he had been betting that the price of oil was going to drop. He kept betting against the market and dug himself a hole so deep that there was no hope of climbing out. An executive Muckleroy had discovered that Enron Oil was short more than 84 million barrels. This disaster put Enron's debt over its net worth. Muckleroy quickly took charge of Enron Oil. He demanded to see the real books of Enron Oil. He then asked

Borget to leave the premises and security officers changed to the locks to the building. Muckleroy was able to reduce the \$1 billion debt into \$140 million. Muckleroy had said, “[I]f the market moved up three more dollars Enron would have gone belly up” (McClean 23). The SEC investigated Enron after this mishap. Both Borget and Mastroeni were brought up on charges of aiding and assisting the filing of a false corporate income tax return and Lay said they had victimized the company. This shifted away the blame from the company executives. As result of the SEC and U.S. attorney’s office investigations the company restated the last three and half years’ worth of financial statements.

Jeffrey Skilling - “The Prince”

Enron wanted to create a whole new innovative business and Jeffrey Skilling was the man for the job. Skilling was born in 1953 in Pittsburgh, Pennsylvania. He was one of four children to Betty and Thomas Skilling. His family was not poor as Ken Lay’s but his family was on the border of working class and middle class. His father was a salesman for a company that made large valves for heavy machinery. In high school Skilling was described as a loner and showed no interest in school. Like Lay, Skilling worked as child. He worked 50 hours a week at the age of 14 at the local TV station.

Skilling attended the Southern Methodist University in Dallas, Texas. He received a full scholarship for engineering. However, Skilling was broke because he had gambled away his previous earnings of \$15,000 in stock, he had invested in his father’s company, Henry Pratt. The stock took off from the purchase of \$8-9 a share to \$25. Convinced that the stock was still going up Skilling borrowed money against his shares to buy a car. But the stock dropped to \$2 a share and Skilling was forced to sell his shares to meet his loan

obligations. This did not steer Skilling away. One summer he was injured when a truckload of equipment fell on him. He received a compensation check for \$3,500. Once again he invested his money. This is time Skilling invested in discounted bonds. Skilling was predicting that the high interest rates would drop. But, they kept rising and he was forced to sell.

Skilling's interest in the stock market lead him to the world of business. In his engineering classes he received a 2.6 GPA. When in his business classes he received a 4.0 GPA. With Skilling's mediocre grades, he applied to Harvard Business School. Skilling took a gamble because he did not apply anywhere else. In his interview the dean asked, "Skilling are you smart?' 'I'm fucking smart,' he replied" (McLean 31). At one of his classes at Harvard,

John LeBoutillier, a Skilling classmate, remembers one class in which the students were discussing a product that might be – but wasn't definitively – harmful to consumers. The question for the class: what should the CEO do? "I'd keep making and selling the product," replied Skilling. "My job as a business man is to be a profit center and to maximize return to the shareholders. It's the government's job to step in if a product is dangerous" (McLean 31).

This is how Jeff Skilling viewed the responsibilities of government and business. Another influential moment is while he was at the Southern Methodist University. Skilling read a paper on converting commodities contracts into tradable securities. Skilling loved the idea and never forgot it.

When Skilling joined Enron, the natural-gas industry was very basic, just buyers and sellers communicating to each other. The system was very unpredictable and that was a problem. Skilling did not see a natural-gas industry, he saw, "...the needs of customers on

one side and the needs of suppliers on the other – and the gaps in-between where, he believed, serious money could be made” (Mclean 27). Skilling created the Enron Gas Marketing department. It essentially was a gas bank. The gas bank reduced the risk of fluctuating prices by locking it in at a contracted rate. The producers of natural gas would sell it to Enron. Then Enron would sell the natural gas at the price it was contracted at. Lastly, Skilling wanted to trade natural gas futures contracts. A natural gas future contract is an agreement to purchase natural gas in the future at a predetermined price. The natural gas futures trading department was setup the same as the Enron Oil trading department.

Skilling made a strange demand when he entered Enron. He wanted to use mark-to-market accounting for his new business. Skilling would not join Enron if he was not able to use mark-to-market accounting and called it a ‘lay-my-body-across-the-tracks-issue.’ Mark-to-market is also known as fair value accounting. The main difference between traditional accounting (historical cost) and mark-to-market accounting is, “...you’re forced to adjust the values on your balance sheet on a regular basis, to reflect fluctuations in the marketplace or anything else that might change the values” (Mclean 39). Another major difference is you can book an estimated value of a contract once it is signed.

Skilling’s argument for mark-to-market accounting is that it gives more relevant financial data. This financial data is seen as the true economic value at that point in time. A con to mark-to-market accounting is a reduction in reliability. This is because the values of assets are estimates. Skilling wanted to use mark-to-market accounting because he felt, “...a business should be able to declare profits at the moment of the creative act that would earn those profits” (Mclean 39). This is absurd, because it suggests that a product should

recognize income once it is designed. The first product is not even rolled off the assembly line, not mention sold. Enron's court-appointed bankruptcy examiner revealed that there was, "...no evidence of any effort to determine and use fair market values" (Mclean 205). So, these mark-to-market estimates completely doctored the financial statements to meet their goals.

Later on Lay merged Enron Finance with Enron Gas Marketing. The new business was renamed Enron Capital and Trade Resources (ECT). Skilling acted as if he was operating his own business. On the 39 floor of the Enron building employees were referred to as Skillingites, "[W]e had the authority to do anything and everything we wanted to do" (Mclean 57). Skilling promoted a culture of, "...risk-taking at Enron that sometimes even went beyond the boundaries he set" (Schwartz). As long as an associate was making Enron money he or she could break the Code of Ethics.

Skilling was a control freak at Enron. Tim Sullivan a technical services associate at Enron said, Skilling was unapproachable, fierce, and had a reputation for manipulation, "[O]ne executive bought a copy of Machiavelli's book 'The Prince' to understand Mr. Skilling's ways" (Schwartz). This one executive bought the book to understand how to approach Skilling. Skilling felt, "[I]t is much safer to be feared than loved, when, of the two, either must be dispensed with" (Schwartz). Skilling's powerful role in the company made, "...his arrogance harden, and he became so sure that he was the smartest guy in the room that anyone who disagreed with him was summarily dismissed as just not bright enough to 'get it' (Mclean 28). Skilling damaged Enron's organizational culture because of his unorthodox beliefs.

Andrew Fastow - *"The Illusionist"*

Enron was in a lot of trouble they did not have enough cash coming in the door. So, they brought aboard Andrew Fastow. Fastow's job was to create the illusion of increasing prosperity in the company. Fastow was described as the following: "[H]e might not have been the brightest guy in the world, but he was very, very hardworking" (McLean 138). Fastow wanted to prove to the company his worth. He kept asking Skilling for his own department. Finally, Skilling told Fastow to create his own unit. He kept bringing new business plans to Skilling and he kept sending him back. Fastow never came up with anything that could be a business. Fastow was called Andy Fast-Out due to his failures. Skilling did not punish Fastow and actually promoted him to Senior Vice President of Enron's management committee. Fastow was often accused of being a suck up, "...for naming his son after his boss" (McLean 139). Fastow was promoted to CFO in March 1998. But, Fastow was not qualified for the job, "Fastow knew so little about accounting that one person who knows him wasn't even sure he could dissect a balance sheet" (McLean 140). A CFO's primary responsibility is financial planning. Financial planning requires evaluating financial performance, forecasting, and directing to meet financial goals. Fastow was not qualified for the position and should not have been named CFO.

Fastow still saw his role as creating new financial structures. The first idea Fastow had was to issue more shares of stock. This would enable Enron to raise capital without having to pay it back. In the public offering they raised \$800 million. Fastow's Global Finance group was making \$20 billion in capital a year. Fastow used off-balance-sheet vehicles and complex transactions to make debt disappear and money appear. Fastow

created the structure called Whitewing. Whitewing was used to make debt into equity. They took out loans from Citigroup and bought \$1 million in preferred shares of Enron stock. This structure was very successful because the price of the stock had risen. They paid back Citigroup and they issued more debt. They removed Whitewing completely from the Enron balance sheets. The next entity they created was Osprey. They raised \$100 million in equity from banks and insurance companies. They then sold \$1.4 billion in debt to investors. They used this to buy a limited partnership interest in Whitewing. This allowed Whitewing to be off the balance sheet Enron,

Under accounting rules, Whitewing now qualified for off-balance-sheet treatment: it was partly owned by that ostensible third party, Osprey. About one-third of the new money went to pay back Citigroup's original Whitewing loan. The remainder was set aside to purchase assets from Enron. Whitewing was precisely the kind of vehicle that Fastow's Global Finance team marketed internally to help business units meet their financial goals (Mclean 156).

Fastow supported his \$1.4 billion debt with the value and dividends from the Enron stock, the assets of Whitewing, and promised that if the assets were not enough to pay back the debt it would make up the difference by issuing stock. Lastly, if Whitewing could not issue enough stock it would give out cash instead. These transactions allowed Enron to actually have cash flow.

Fastow used special purpose entities (SPEs) to generate cash flow and equity. SPEs were set up to purchase assets being securitized. A SPE was used to isolate risk by setting up an independent legal entity that owned just one asset. The investors who bought stock in the entity would get the benefits but also take the risk with that asset. But, the asset was isolated from the rest of the company. This allowed Enron to not include capital consisted

of debt raised by selling assets on the balance sheet. SPEs were supposed to be from independent money. But, Enron often stepped in giving a guarantee to the lenders. They often tossed in a total return swap. This meant that Enron guaranteed the investor a debt like return. Enron had sold an asset and booked the earnings, but the asset was not truly gone. This left Enron with additional debt to be paid back.

SPEs were becoming nearly impossible to find outside equity. So, Enron needed another source of equity. Fastow saw this as an opportunity to take advantage of Enron. He created a new project that was called LJM. This was the first initials to his wife and sons: Lea, Jeffrey, and Matthew. LJM was a private equity fund that favored certain employees. So, when Enron sold an asset, Fastow would be able to negotiate with himself. Fastow fought saying transactions would be faster because they would not need to find a new investor every time they wanted to create a SPE. The problem with LJM is that it had possibility for conflict of interest. LJM1 was funded with \$1 million of Fastow's money and \$15 million from outside investors,

LJM1 would then set up a subsidiary, called LJM Swap Sub. Swap Sub would sell a put option on the entire Rhythms stake to Enron, giving Enron the right to force Swap Sub to buy the Rhythms stock from Enron in June 2004 at \$56 a share. To compensate Fastow and his partners for taking this extraordinary risk, Enron would arrange the transfer of 3.4 million shares of its own stock, worth about \$267 million, to LJM, which then move almost half the holdings into Swap Sub. LJM also gave Enron notes for \$64 million, which helped Enron by adding to its reported cash flow" (Mclean 191).

This complicated structure protected Enron from having to book an accounting loss.

Fastow received a secret take of \$25.1 million from LJM1 and had told an executive, "[H]ell, if Skilling knew how much I made, he'd have no choice but to shut LJM down" (Mclean 328).

Fastow flew his entire group to a Mexican resort Los Cabos for four days after the success of LJM1 and he paid a \$52,000 tab with LJM. Later on Fastow was questioned about the internal controls of his personal business dealings. But, Lay had exempted Fastow from the Enron Code of Ethics.

Next was LJM2 which completed more than 20 transactions involving hundreds of millions of dollars. Fastow always insisted that he was helping Enron, “Fastow proudly informed the board that in less than six months his two LJMs had contributed \$229.5 million to Enron’s earnings, generated more than \$2 billion in cash flow, and, he insisted, save Enron \$2.3 million in fees” (McLean 2002). LJM every quarter made a profit and this was because LJM did Enron’s dirty work. They were warehousing troubled assets, allowing Enron to take it off the balance sheet. LJM was just making Enron look better and LJM was being paid very well for it.

Arthur Andersen

The accountants should have been keeping better tabs on Fastow. Arthur Andersen worked so closely with the Houston Corporate office that they were regarded as company executives. This violates The American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct. Auditors must remain independent from the company they are auditing. This is impossible if Arthur Andersen employees were regarded as company executives. Arthur Andersen viewed Enron as a high risk company. In their notes, “[C]lient is a first mover, and expects to push the edges of established convention, and where they

can, create new convention...often in very gray areas” (Mclean 147). Transactions were also very complex and there was not any clear explanation of them.

...the accountants were setting in motion a game of dodging responsibility. They privately agreed the idea was terrible but were expecting Lay and Skilling – or, surely, the board – to kill it. For their part, the board and management would later point to Andersen’s silence in justifying their conclusion that Fastow’s scheme was perfectly okay (Mclean 190).

Arthur Andersen failure to communicate their feelings about Fastow’s operations, allowed Fastow’s SPEs to continue without being contested.

Executives at Enron

Lay had hired many of his friends at Enron. These people were often very cutthroat. Rich Kinder was Lay’s friend since college. Kinder and Lay’s girlfriends at the University of Missouri were sorority sisters and best friends. Kinder was described as, “...a mean son of a bitch. You didn’t want to cross him. But he imposed the kind of discipline we didn’t have before, which we really needed” (Mclean 25).

After the InterNorth-HNG merger, Lay had hired lots of his old cronies. They had ill-defined jobs and a line straight to the man who had hired them. Morale was terrible. Backbiting had become part of the Enron culture. Power plays were a daily occurrence. And it was nearly impossible for the company to act decisively, because executives felt they could always get Lay to reverse a management decision. All the politicking had practically paralyzed the company (Mclean 26).

Skilling also hired “guys with spikes.” Skilling believed loyalty and performance could be bought with money. The relationship part was not as important as the money. Skilling did not care if they were team players either. He felt that the tension between employees would help come up with new ideas. But, this meant he often hired people that were jerks. One of Skilling’s hires was Lou Lung Pai. Lou Lung Pai had a problem with strip clubs. He

and other traders would often use Enron expense accounts for personal spending. Lay wanted to fire Pai and Skilling would say he would leave if he left. This was because he always got the job done. Employees realized that, "...it was easy to hold up Skilling for a raise or a bigger bonus or more options all they had to do was threaten to quit and Skilling would give into their demands" (McLean 59). Traders had so much power because they decided just how profitable the department was.

Twice a year every employee would be put under review. It would be based on feedback reports from bosses and colleagues. The two categories were communication/setting direction, and teamwork/interpersonal. But performance was the key factor, "If they were making money and being total jerks to people we'd always forgive them for that," says one early ECT executive... "If you weren't doing deals, we had trouble valuing your contribution to the company" (McLean 63). Skilling liked the reviews because he thought it brought out the best performance. Rewarding those who are performing well, "[B]ut many thought it brought out the worst of Enron: ruthlessness, selfishness, and greed" (McLean 64). Ruthlessness, selfishness, and greed do not create a business culture that is conducive with ethical behavior. Employee evaluations should not have been based on performance because it does not promote the Enron Code of Conduct. An emphasis should have been placed on teamwork/interpersonal and communication/setting direction.

The End of Enron

On December 13, 2000, Enron announced that Skilling would become the new CEO of Enron. Skilling had forced Lay to name him the new CEO. Skilling had told Lay,

...that he had another job offer. Indeed, earlier in the year, Skilling renegotiated his contract with a trigger: if he was not named CEO by the end of 2000, he could leave the company and collect a payout of over \$20 million (McLean 313).

Trouble was on the rise in late 2000. When Fastow's SPEs lost value and the Enron stock had stalled. The stock had fell \$5.06 on March 21st. The following day it fell another \$4.38. At an earnings release, Grubman an investor had asked Skilling why Enron had not completed a balance sheet. Skilling said that they could not disclose the balances until the right accounting is put together. Grubman then responded that Enron was the only financial institution that could not produce a balance sheet or cash-flow statement. Skilling said, "[W]ell, you're-you-well, uh, thank you very much. We appreciate it" (McLean 326). Then Skilling proceeded to call Grubman an asshole after Grubman questioned his last statement. The act made, "[J]aws drop around the table. A horrified Mark Palmer, listening in on the conference call with the rest of Enron's public-relations team, immediately ran upstairs with a note to Skilling, urging him to apologize right away" (McLean 326). Skilling just tossed the notes under a stack of papers in front of him. After a few more conference calls investors began to lose faith in Skilling. Skilling always had told investors that nothing was wrong and was seemed fixated on the stock price, "...he would spend 15 to 20 minutes of a one-hour presentation talking about the Enron stock and grousing that investors weren't recognizing Enron's greatness" (McLean 326). Skilling was also losing power over the company. The traders started to take over,

Skilling started to wipe tears from his eyes. 'The traders have taken over,' he told Rice darkly. 'These guys have gotten so powerful that I can't control them anymore.' Rice agreed to stay through the end of the third quarter – he had option vesting. But in truth, Rice was gone. When you added up all the

stock he had cashed in over the years, it came to over \$70 million (Mclean 335).

Shortly after on July 13, 2001, Skilling resigned from CEO. He had been the CEO for a brief six months. Traders had made a Titanic joke: “Women and children first – right after Jeff” (Mclean 349). Lay stepped in and once again became CEO. After the announcement of Skilling’s resignation, the stock fell to an astonishing \$40 a share.

On November 8, 2001 filed a Form 8-K, stating that their financial statements for the last four years contained significant accounting errors. The company was in big trouble. Enron calculated that it would need to repay \$9.1 billion in debt by the end of 2002. Shortly later on December 2, 2001, Enron filed for Chapter 11 bankruptcy. Lay flew up his six-man team up to the courthouse. Ironically, they flew up in the \$45 million corporate jet and stayed at New York’s Four Seasons Hotel.

Skilling was sentenced to 24 years and 4 months in prison for 19 counts of fraud, conspiracy, insider trading and lying to auditors. “Once in prison, Mr. Skilling could trim his sentence by 54 days a year with good behavior. And he could knock off one more year for participating in an inmate drug and alcohol treatment program” (Barrionuevo). Skilling had been struggling with alcoholism and was arrested in Manhattan in 2004. So, the judge required that Skilling attend the alcohol treatment program. Skilling will, “...be assigned to a federal prison in Butner, N.C., for medium and low-security inmates” (Barrionuevo). The judge also approved that Skilling pay \$45 million in restitution, “[U]nder the order, \$15.5 million will go to Mr. Skilling’s lawyers and another \$5 million to Enron shareholders...” (Barrionuevo). On January 6, 2009, Skilling lost his appeal. However the panel found,

“...that U.S. District Judge Sim Lake improperly applied a sentencing guideline that resulted in a longer prison term for Skilling, and ordered that he be resentenced” (The Associated Press). But, Skilling is still expected to have a lengthy term in prison. Lay was convicted of fraud and conspiracy in May of 2006. But, he died from heart-related problems before he was sentenced.

On November 17, 2006, Andrew Fastow was sentenced to six years in the Louisiana Federal Prison and two additional years under house arrest. Fastow plead guilty to two counts of conspiracy. He was fined \$50,000, and it was used to help the victims of the collapse. Fastow received a reduced sentence because he, “...led them to Enron’s founder, Kenneth L. Lay, and to former chief executive, Jeffery K. Skilling” (The Associated Press). Fastow testified that Lay knew about Enron’s financial problems and his testimony help build a case on both Lay and Skilling. In addition, the auditors Arthur Anderson were found guilty of destroying evidence. 200,000 Enron employees lost their jobs and approximately \$2 billion in stock.

Corporate Culture

Corporate Culture is one of the most important influences for ethical business behavior. The culture is the personality of the corporation, outlining the values and norms. Leadership is one of the most important aspects of an organization’s culture. This is because leaders set what is appropriate and inappropriate behavior. Good leadership by executives creates an ethical culture with high ethical standards. An ethical culture has equally distributed authority and shared accountability. The Ethical Code of Conduct is, “...clear, well communicated, is specific about expected procedures and practices,

thoroughly understood, and enforced” (Ardichvili 11-1). Corporate Codes of Ethics are “...any written statement of ethics, laws, or policy (or some combination thereof), delineating the obligations of one or more classes of corporate employees” (Harvard Law Review). These codes are not enforced by the law but the corporation. The Corporate Code of ethics creates structures that, “...simply facilitate good behavior by employees who want to do the right thing and, as a corollary, may help to prevent the kind of employee misconduct that could subject a company to liability” (Harvard Law Review 2127). These structures create a corporate culture with strong internal control.

The leaders at Enron failed because they did not promote an ethical culture through their Corporate Code of Conduct, “[T]he Enron debacle makes clear that a corporate code of behavior is only as good as the people charged with enforcing it and those who must demonstrate the importance of compliance by their example” (Harvard Law Review 2123). Leaders must continually demonstrate ethical behavior because, “[C]onsistent role modeling of such behavior forms the basis for a strong culture where everyone understands what is appropriate for the company” (Ardichvili 11-1). Skilling was not a good role model. He called an investor an asshole and dismissed employees for not being smart enough. Lay was not a good role model either, he only cared about appearances. Enron associates said, “[L]ay had the traits of a politician: he care about appearances, he wanted people to like him, and he avoided the sort of tough decisions that were certain to make others mad” (Mclean 3). Lay’s top executives knew this about him and knew they could get away with pretty much anything.

In the 1998 Annual Report Enron stated their values as respect, integrity, communication and excellence (See Appendix A). Enron also had a code of ethics (See Appendix B). The values stated above also represents that Enron knew its business goals, ethical boundaries, corporate social responsibility, and human rights. But, like much of Enron it was all about optics. The one value that Skilling wanted to achieve was excellence. However, Skilling wanted to push the limits to achieve excellence and this sacrificed the integrity of his business dealings. Skilling was caught up in the shareholder vs. stakeholder conflict. Skilling only wanted to improve the stock price to help the shareholder. But, he did not focus on the stakeholder. The stakeholders are the people who are affected by the company's actions.

An ethical business culture implements the company's code of conduct by incorporating ethics into decisions. By incorporating ethics into decisions employees become self-conscious of them,

Use of moral or ethics "talk" to address problem-solving and decision-making situations creates an awareness of the ethical dimension of such processes. Ethical cultures have leaders and member who engage in ethics talk regularly in pursuit of organizational activities (Ardichivili 11-1).

Not only does the business culture create ethical awareness, but it acts as a natural selection process. Associates who do not demonstrate the same values are often outcasts in the organization. In a corporate culture,

...where core business functions are aligned with organizational processes, an environment is nurtured 'that actively eliminates people who don't share the values' and sustainability over 'long periods of time.' This implies an existence of mechanisms that select for fitness between organizational values and individual values, a form of natural selection, which glean deleterious behavior from the ethical organization (Ardichivili 11-1).

Weeding out the associates who do not share the same values maintains the business culture and deters behavior that is not appropriate.

Conclusion

A study conducted determined that auditor detection rate, “[T]he statistical tests were rerun omitting these errors from consideration and yielded an overall detection rate of 59.04 percent...” (Waggoner 83). This study was conducted with employees from the Big 8 accounting firms. This means that auditors will miss 40 percent of accounting errors, regardless if the errors are intentional or not. Auditors cannot catch every act of corporate fraud. It should not only be the auditor’s responsibility but the company’s responsibility to prevent corporate fraud. Corporations should have an Organizational Code of Conduct. But, more importantly the Codes of Conduct should be implemented into the daily business activities. This will produce an ethical organizational culture. Ken Lay and Jeffrey Skilling failed to create an ethical business culture. Jeffrey Skilling only cared about stock performance and Ken Lay lacked the authority and confidence to effectively lead. Enron has taught us that leaders must actively promote the code of ethics through the use of business culture. This ensures that there are high standards of ethics and associates and corporate leaders are equally compliant.

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