Enron: What Caused the Ethical Collapse?

Introduction

Kenneth Lay, former chairman and chief executive officer (CEO) of Enron Corp., is quoted in Michael Novak's book *Business as a Calling: Work and the Examined Life* as saying, "I was fully exposed to not only legal behavior but moral and ethical behavior and what that means from the standpoint of leading organizations and people." In an introductory statement to the revised *Enron Code of Ethics* issued in July 2000, Lay wrote: "As officers and employees of Enron Corp., its subsidiaries, and its affiliated companies, we are responsible for conducting the business affairs of the companies in accordance with all applicable laws and in a moral and honest manner." Lay went on to indicate that the 64-page *Enron Code of Ethics* reflected policies approved by the company's board of directors and that the company, which enjoyed a reputation for being fair and honest, was highly respected. Enron's ethics code also specified that "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 to the employee financial gain separately derived as a direct consequence of his or her employment with the Company."

Enron's ethics code was based on respect, integrity, communication, and excellence. These values were described as follows:

> Respect. We treat others as we would like to be treated ourselves. We do not tolerate abusive or disrespectful treatment. Ruthlessness, callousness and arrogance don't belong here.
> Integrity. We work with customers and prospects openly, honestly and sincerely. When we say we will do something, we will do it; when we say we cannot or will not do something, then we won't do it.
> Communication. We have an obligation to communicate. Here we take the time to talk with one another . . . and to listen. We believe that information is meant to move and that information moves people.
> Excellence. We are satisfied with nothing less than the very best in everything we do. We will continue to raise the bar for everyone. The great fun here will be for all of us to discover just how good we can really be.

Given this code of conduct and Ken Lay's professed commitment to business ethics, how could Enron have collapsed so dramatically, going from reported revenues of $101 billion in 2000 and approximately $140 billion during the first three quarters of 2001 to declaring bankruptcy in December 2001? The answer to this question seems to be rooted in a combination of the failure of top leadership, a corporate culture that supported unethical behavior, and the complicity of the investment banking community.

Enron’s Top Leadership

In the aftermath of Enron’s bankruptcy filing, numerous Enron executives were charged with criminal acts, including fraud, money laundering, and insider trading. For example, Ben Glisan, Enron’s former treasurer, was charged with two-dozen counts of money laundering, fraud, and conspiracy. Glisan pled guilty to one count of conspiracy to commit fraud and received a prison term, three years of post-prison supervision, and financial penalties of more than $1 million. During the plea negotiations, Glisan described Enron as a “house of cards.”

Andrew Fastow, Jeff Skilling, and Ken Lay are among the most notable top-level executives implicated in the collapse of Enron’s “house of cards.” Andrew Fastow, former Enron chief financial officer (CFO), faced 98 counts of money laundering, fraud, and conspiracy in connection with the improper partnerships he ran, which included a Brazilian power plant project and a Nigerian power plant project that was aided by Merrill Lynch, an investment banking firm. Fastow pled guilty to one charge of conspiracy to commit wire fraud and one charge of conspiracy to commit wire and securities fraud. He agreed to a prison term of 10 years and the forfeiture of $29.8 million. Jeff Skilling was indicted on 35 counts of wire fraud, securities fraud, conspiracy, making false statements on financial reports, and insider trading. Ken Lay was indicted on 11 criminal counts of fraud and making misleading statements. Both Skilling and Lay pled not guilty and are awaiting trial.

The activities of Skilling, Fastow, and Lay raise questions about how closely they adhered to the values of respect, integrity, communication, and excellence articulated in the *Enron Code of Ethics*. Before the collapse, when Bethany McLean, an investigative reporter for Fortune magazine, was preparing an article on how Enron made its money, she called Enron’s then-CEO, Jeff Skilling, to seek clarification of its “nearly incomprehensible financial statements.” Skilling became agitated with McLean’s inquiry, told her that the line of questioning was unethical, and hung up on McLean. Shortly thereafter Andrew Fastow and two other key executives traveled to New York City to meet with McLean, ostensibly to answer her questions “completely and accurately.”

Fastow engaged in several activities that challenge the foundational values of the company’s ethics code. Fastow tried to conceal how extensively Enron was involved in trading for the simple reason that trading companies have inherently volatile earnings that aren’t rewarded in the stock market with high valuations—and a high market valuation was essential to keeping Enron from collapsing. Another Fastow venture was setting up and operating partnerships called related party transactions to do business with Enron. In the process of allowing Fastow to set and run these very lucrative private partnerships, Enron’s board and top management gave Fastow an exemption from the company’s ethics code.

Contrary to the federal prosecutor’s indictment of Lay, which describes him as one of the key leaders and organizers of the criminal activity and massive fraud that lead to Enron’s bankruptcy, Lay maintains his innocence and lack of knowledge of what was happening. He blames virtually all of the criminal activities on Fastow. However, Sherron Watkins, the key Enron whistleblower, maintains that she can provide examples of Lay’s questionable decisions and actions. As Bethany McLean and fellow investigative reporter Peter Elkind observe: “Lay bears enormous responsibility for the substance of what went wrong at Enron. The problems ran wide and deep, as did the deception required in covering them up. The company’s culture was his to shape.” Ultimately, the actions of Enron’s leadership did not match the company’s expressed vision and values.

Enron’s Corporate Culture

Enron has been described as having a culture of arrogance that led people to believe that they could handle increasingly greater risk without encountering any danger. According to Sherron Watkins, “Enron’s unspoken message was, ‘Make the numbers, make the numbers, make the numbers—if you steal, if you cheat, just don’t get caught. If you do, beg for a second chance, and you’ll get one.’” Enron’s corporate culture did little to promote the values of respect and integrity. These values were undermined through the company’s emphasis on decentralization, its employee performance appraisals, and its compensation program.

Each Enron division and business unit was kept separate from the others, and as a result very few people in the organization had a “big picture” perspective of the company’s operations. Accompanying this emphasis on decentralization were insufficient operational and financial controls as well as “a distracted, hands-off chairman, a compliant board of directors, and an impotent staff of accountants, auditors, and lawyers.”

Jeff Skilling implemented a very rigorous and threatening performance evaluation process for all Enron employees. Known as “rank and yank,” the annual process utilized peer evaluations, and each of the company’s divisions was arbitrarily forced to fire the lowest ranking one-fifth of its employees. Employees frequently ranked their peers lower in order to enhance their own positions in the company.

Enron’s compensation plan “seemed oriented toward enriching executives rather than generating profits for shareholders” and encouraged people to break rules and inflate the value of contracts even though no actual cash was generated. Enron’s bonus program encouraged the use of non-standard accounting practices and the inflated valuation of deals on the company’s books. Indeed, deal inflation became widespread within the company as partnerships were created solely to hide losses and avoid the consequences of owning up to problems.

Complicity of the Investment Banking Community

According to investigative reporters McLean and Elkind, “One of the most sordid aspects of the Enron scandal is the complicity of so many highly regarded Wall Street firms” in enabling Enron’s fraud as well as being partners to it. Included among these firms were J.P. Morgan, Citigroup, and Merrill Lynch. This complicity occurred through the use of *prepays*, which were basically loans that Enron booked as operating cash flow. Enron secured new prepays to pay off existing ones and to support rapidly expanding investments in new businesses.

One of the related party transactions created by Andrew Fastow, known as LJM2, used a tactic whereby it would take "an asset off Enron's hands—usually a poor performing asset, usually at the end of a quarter—and then sell it back to the company at a profit once the quarter was over and the 'earnings' had been booked." Such transactions were basically smoke and mirrors, reflecting a relationship between LJM2 and the banks wherein "Enron could practically pluck earnings out of thin air."

Epilogue

The Enron Code of Ethics and its foundational values of respect, integrity, communication, and excellence obviously did little to help create an ethical environment at the company. The full extent and explanation of Enron's ethical collapse is yet to be determined as legal proceedings continue. Fourteen other Enron employees—many high level—have pled guilty to various charges; 12 of these are awaiting sentencing, while the other two, one of whom is Andrew Fastow's spouse, have received prison sentences of at least one year. Juries have convicted five individuals of fraud, as well as Arthur Andersen, the accounting firm hired by Enron that shared responsibility for the company's fraudulent accounting statements. Three of the convicted individuals were Merrill Lynch employees involved in the Nigerian barge deal with Fastow. Ken Lay and Jeff Skilling, along with Richard Causey, Enron's former chief accounting officer, are awaiting trial. Lay faces 11 criminal counts, Skilling faces 35 criminal counts, and Causey faces 31 criminal counts. Five executives from Enron's broadband division are also awaiting trial. Three bank executives from Britain who had been involved in a complicated series of deals in a Fastow partnership are fighting extradition. In addition, there are 114 unindicted co-conspirators in the federal government's case against Lay and Skilling.

Questions for Discussion

1. What led to the collapse of Enron under Lay and Skilling?
2. How did the top leadership at Enron undermine the foundational values of the Enron Code of Ethics?
3. Given Kenneth Lay's and Jeff Skilling's operating beliefs and the Enron Code of Ethics, what expectations regarding ethical decisions and actions should Enron's employees reasonably have had?
4. How did Enron's corporate culture promote unethical decisions and actions?
5. How did the investment banking community contribute to the ethical collapse of Enron?

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