Dec 2001: The Large Enron Company is Bankrupt

- The company was seen as a huge success.
  - In spite of problems that were mostly hidden.
- Thousands of workers now lose jobs and savings.
- Many suppliers are not paid for services.
- The experts noted that finances were fuzzy.
  - But accountability was not demanded.

Why is it that so many people buy into hype and wonderful promises?

- Even when the plans are fuzzy.
- Even when some strange things are going on.

As Enron crashes, angry workers and shareholders ask,
Where were the firm's directors?
The regulators?
The stock analysts?

Enron's 401(k) plan, available to its 21,000 employees and loaded with the company's stock, has been devastated. The

Still, there's a search for accountability, to make sure nothing like this happens again. John Dingell, ranking member of the House Energy Committee, said it best: "Where was the SEC? Where was the Financial Accounting Standards Board? Where was Enron's audit committee? Where were the accountants? Where were the lawyers? Where were the investment bankers? Where were the analysts? Where was common sense?" Byron Wien, an investment strategist at Morgan Stanley Dean Witter, says, "This is an indictment of a lot of different things, from the debt-
POWER FAILURE

As Enron crashes, angry workers and shareholders ask, Where were the firm's directors? The regulators? The stock analysts?

Enron's gleaming Houston headquarters and the firm's Henry Hub gas pipeline in Louisiana

By DANIEL KADLEC

CHARLIE SANCHEZ was working at his computer in the eight-man office of Houston-based energy market managers Gelber & Associates last Wednesday when the quotes for natural-gas futures went blank. Then West Coast spot prices for gas vanished. One by one the handful of markets that update continuously on his screen darkened like spent light bulbs. "Within a minute the screen was blank," recalls Sanchez. There was nothing wrong with his PC. But there was something terribly wrong with the company that managed all those quotes: the brash energy-trading giant called Enron.

After weeks of escalating financial troubles, business had effectively collapsed in many of Enron's most important markets. Only months earlier, Enron was considered one of the most innovative U.S. companies, having brought new-economy tools such as Internet trading and sophisticated hedging strategies to the old business of matching producers and consumers of electricity, oil, natural gas—and eventually some 800 other commodities and services. Its operations directly or indirectly touch almost every American home and business.

Enron's immolation—sparked by slumping energy prices, dubious accounting and trading practices and piles of debt—surprised just about everyone from regulators to investors to thousands of soon-to-be-jobless Enron employees. Now, as the company prepares to file for bankruptcy protection in the U.S., probably this week, huge questions loom as to how widespread the damage will be, who is to blame and what is going to be done about it.

No fraud or other illegal behavior has been proved—though those issues will be examined in a spate of lawsuits, congressional hearings and an investigation by the Securities and Exchange Commission. This much seems clear: what went wrong was not Enron's business plan—which other firms are already emulating. Rather, Enron's fatal flaw was management hubris, tactlessly encouraged by board members, regulators, politicians and stock analysts—many with financial ties to Enron—who looked the other way as warning lights began to flash. Feeling it could do no wrong, the company too often pursued unprofitable markets, obscured the costs and stiff-armed anyone who asked for an explanation. It began taking sides in complicated trades...
WHO ELSE GETS HURT?

The slide in Enron's stock has hit millions of Americans who are indirectly exposed to the company's fortunes.

Alliance Capital, which nearly doubled its Enron stake this summer as the stock price slid from $49 to $27, hasn't said whether it unloaded any of the 43 million shares it owned as of Sept. 30. Janus had 41 million Enron shares as of that date but has dumped them. Putnam says it began selling most of its 23 million shares in late October.

J.P. Morgan Chase and Citigroup stand to lose about $500 million and $400 million, respectively, in noncollateralized loans and other unsecured Enron deals.

Enron's meltdown has cost Ohio's state pension fund $69 million; New York's, $60 million; and California's, $45 million. Fortunately, pension checks won't reflect the losses.

But those losses appear to be sufficiently spread out to make a wider financial crisis unlikely. There's been no talk of a bailout like the one in 1998 for the failed hedge fund Long Term Capital Management. And so far, energy prices are stable—good news for consumers heading into winter.

Still, there's a search for accountability, to make sure nothing like this happens again. John Dingell, ranking member of the House Energy Committee, said it best: "Where was the SEC? Where was the Financial Accounting Standards Board? Where was Enron's audit committee? Where were the accountants? Where were the lawyers? Where were the investment bankers? Where were the analysts? Where was common sense?" Byron Wien, an investment strategist at Morgan Stanley Dean Witter, says, "This is an indictment of a lot of different things, from the debt-

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rating agencies to bank lending practices."

There have been warnings in the accounting abuses revealed by smaller corporate blowups in recent years, including appliance maker Sunbeam in 1998 and travel-services firm CUC International after it became Cendant in a 1997 merger. But Enron fell much harder and faster. Its stock had nearly tripled in two years, to $90 in August 2000. It booked sales of more than $100 billion last year, seventh on the FORTUNE 500. Its chairman, Kenneth Lay, 59, was a celebrity in Houston, a pillar of civic and charitable causes. An early financial supporter and confidant of George W. Bush, Lay was the only energy executive to be invited for a one-on-one with Dick Cheney when the Vice President was framing the Administration’s energy policy. Enron led the energy industry in 1999-2000 campaign contributions, giving both parties—but mostly Bush and the G.O.P.—$2.3 million overall, nearly twice as much as Exxon-Mobil, according to the Center for Responsive Politics.

Just 10 years ago, Enron was a stodgy pipeline company, generating 85% of its revenue through the transmission of natural gas. By this year, although the company still controls 30,000 miles of pipeline, 80% of its revenue was generated on trading screens. Enron markets electricity and other energy assets, and the company’s new form of energy trading is the one that has garnered the most attention.

And they were well on their way. Before signing a deal with August, Enron’s hard-charging chief operating officer, Jeff Skilling, was using supercomputers and fiber-optic cable to operate a global trading grid. The ultimate goal was to touch another cubic foot of natural gas, yet to make billions by trading it. By 1998 Skilling’s vision was taking shape, and he had become Lay’s heir apparent.

Enron’s headquarters in Houston exuded success. The garage housed Ferraris and Porches, and the company’s new skyscraper was going up next door. But Skilling made a huge mistake. Enron, already saddled with about $5 billion in money-losing investments from utilities around the world, borrowed $1 billion more in the past three years to get into the business of trading data-transmission capacity on fiber-optic cables.

To minimize the impact of this debt on Enron’s financial statements, Enron insiders say, Skilling and chief financial officer Andrew Fastow created a complex partnership that did business with Enron but whose finances were not subject to much scrutiny. When these partnerships first began to come under the microscope three months ago, Enron was unwilling to explain them fully. In August, Lay, who is said to have been looking for shareholders interests, told the New York Times, “I just can’t help you on that... You’re getting way over my head.” An Enron spokesperson says the remark was taken out of context.

In the face of confusion about Enron’s finances, investors began to flee the company’s stock. Rating agencies downgraded their assessments of the safety of Enron’s bonds. Those moves caused lenders to demand immediate payment of hundreds of millions of dollars in debt. And those who...
had traded with Enron became reluctant to continue, for fear they would not be repaid.

Losing business, Enron executives tried to sell the company to competitor Dynegy, but that deal fell apart last week. The death blow came on Nov. 19 in a filing by Enron with the SEC, detailing $690 million in debt that had to be paid almost immediately. Enron's stock plunged. "We were renegotiating daily because every time I turned around their stock price was falling," Chuck Watson, CEO of Dynegy, told Time. "It got to the point where there was hardly any equity left in the business."

Says a source close to Lay: "The Greeks would have loved this story. It's got hubris, ambition and a great disaster at the end."

That disaster falls on many shoulders. Washington policymakers must determine how to better regulate an obviously under-supervised energy-trading market—but without creating so much red tape and uncertainty that they choke off development of new wells, pipelines and power plants. "Our committee is keenly aware of the need for enhanced oversight," says Senator Jeff Bingaman, the New Mexico Democrat who chairs the Energy and Natural Resources Committee and has called for hearings on the Enron debacle.

Another stage in this drama is the impact on the administration of 401(k) retirement plans. Bobbie and Jerry Dotson are Enron employees who live in Baker, Fla. They lost most of their life savings of $1.5 million when Enron's stock tanked, taking down their 401(k) account, which was loaded with company shares. Bobbie, 62, just in for retirement last month. She had anticipated a monthly check of at least $800 plus her pension. Now she will consider herself lucky to get even the estimated $317 monthly pension that company officials recently quoted to her. "We trusted the company because we had so many years with them," she says.

The Dotsons have a familiar problem. Many 401(k) plans do not give employees the flexibility to diversify properly, and even when they do, employees hold a large slug of their employer's stock—an average of 62% in Enron's case. In 1996, Senator Barbara Boxer, a California Democrat, introduced a bill that would have required that 401(k) plans have no more than 10% of assets in the sponsoring company's stock. Firms that offer 401(k) plans negotiated against it, and the bill went nowhere. Now, "Enron is a call to arms," says Mike Scarborough, president of Scarborough Group of Annapolis, Md., which advises 401(k) participants. "Corporations need to do something about that, or change will get forced down their throats."

The demise of Enron further tarnished the reputations of stock analysts at big bro-
The Enron Debacle
Spotlights Huge Void
In Financial Regulation
Energy Firm Lobbied Hard
To Limit the Oversight
Of Its Trading Operations

Keeping Ms. Born at Bay

Dec 13, 2001

By Michael Schroeder
And Greg Ip
Staff Reporters of The Wall Street Journal
Washington—A year ago, when most of the political world was obsessed
with the deadlocked presidential election, Enron Corp., was quietly but aggressively
lobbying Congress. Its object: a little-noticed bill shaping federal policy toward the
complex financial instruments known as
over-the-counter derivatives.

In 1988, the Houston energy giant, originally
a utility that produced and transported natural gas and electricity, had began shifting its focus to energy trading. It soon came to view the burgeoning market for derivatives—financial instruments
that derive their value from an underlying commodity or wager on the future—as the
cornerstone of its ambitious expansion plans. And it wanted as little government interference
with that market as possible.

The company’s lobbying campaign was so aggressive that staff members of one congressional committee asked a lobbyist for an Enron-led industry group to negotiate
major aspects of the bill directly with regulators. In the end, Enron had provisions inserted in the law that blocked federal oversight of some of its major corporate
product lines, such as energy and metals derivatives, and its EnronOnline energy-trading network.

Now, once-mighty Enron is in bankruptcy court. Its market value has plunged
since last year to about $500 million from more than $7 billion. But one of the most
striking features of its rapid decline was that financial regulators had little clue what
was going on inside Enron. That’s at least partly because Enron—as much as any company
in America—had invested a lot of time and money over the past decade in keeping
government out of its business.

‘Crisis of Confidence’

Yesterday, the House Financial Services Committee heatedly jumped in; lawmakers heard from Joseph Berardino, chief executive of accounting firm Arthur
Andersen LLP, who said that Enron’s collapse had created a “crisis of confidence” in the accounting profession. And they heaped criticism on the company and on
Andersen, its auditor, for issuing financial statements they said failed to reflect the
shakiness of Enron’s condition.

Rep. John LaFalce, a New York Democrat, echoed the sentiments of many committee members when he called Enron’s collapse a wake-up call. “How many more
Enrons are out there, and what are the systemic factors that made this collapse and other future collapses possible?” asked Mr. LaFalce.

Yesterday, the Securities and Exchange Commission said it is considering new regulations this year to require more precise disclosures about companies’ accounting policies. And federal energy regulators said they are planning new rules for energy-derivatives accounting.

The Enron debacle spotlights an enormous void in the nation’s system of financial
regulation, and it is rekindling a difficult debate over just how that gap should be filled.

Innovations in technology and finance

have helped obliterate clear distinctions between banks, brokerage firms and newer hybrids, such as Enron, which built a privately run online trading empire that handled
huge volumes of electricity and natural gas.

Multiple Standards

These days, it’s possible for exchanges, which once required centralized trading floors crowded with traders, to spring up overnight in cyberspace. Meanwhile, financial regulators, hewing to decades-old divisions of authority, continue to keep a close watch on banks, brokerage firms and conventional exchanges, while leaving new entrants such as Enron to police themselves.

There now is a widespread consensus among policy makers that, at the very least,
the nation needs stricter accounting rules that would force companies such as Enron to do a better job of disclosing their financial conditions. Other industry watchers
would go further. Enron, they say, was one of the country’s leading commodities markets. It had amassed a $10 billion portfolio of derivatives.

In many ways, the Enron debacle raises the same questions that arose three years ago, after the near-failure of hedge fund Long-Term Capital Management—a private investment fund for wealthy individuals that made leveraged bets on financial markets. Long-Term Capital’s misplaced wagers, many based on derivatives, almost triggered a meltdown in glo-
How former CEO Jeff Skilling's strategy backfired

THE FALL OF ENRON
Cover Story

How ex-CEO Jeff Skilling’s strategy grew so complex that even his boss couldn’t get a handle on it

To former Enron CEO Jeffrey K. Skilling, there were two kinds of people in the world: those who got it and those who didn’t. “It” was Enron’s complex strategy for minting rich profits and returns from a trading and risk-management business built essentially on assets owned by others. Vertically integrated behemoths like ExxonMobil Corp., whose balance sheet was rich with oil reserves, gas stations, and other assets, were dinosaurs to a contemptuous Skilling. “In the old days, people worked for the assets,” Skilling mused in an interview last January. “We’ve turned it around—what we’ve said is the assets work for the people.”

But who looks like Tyrannosaurus Rex now? As Enron Corp. struggles to salvage something from the nation’s largest bankruptcy case, filed on Dec. 2, it’s clear that the real Enron was a far cry from the nimble “asset light” market maker that Skilling proclaimed. And the financial maneuvering and off-balance-sheet partnerships that he and ex-Chief Financial Officer Andrew S. Fastow perfected to remove everything from telecom fiber to water companies from Enron’s debt-heavy balance sheet helped spark the company’s implosion. “Jeff’s theory was assets were bad, intellectual capital was good,” says one former senior executive. Employees readily embraced the rhetoric, the executive says, but they “didn’t understand how it was funded.”

Neither did many others. Bankers, stock analysts, auditors, and Enron’s own board failed to comprehend the risks in this heavily leveraged trading gi-

ant. Enron’s bankruptcy filings show $13.1 billion in debt for the parent company and an additional $18.1 billion for affiliates. But that doesn’t include at least $20 billion more estimated to exist off the balance sheet. Kenneth L. Lay, 59, who had nurtured Skilling, 48, as his successor, sparked the first wave of panic when he revealed in an Oct. 16 conference call with analysts that deals involving partnerships run by his CFO would knock $1.2 billion off shareholder equity. Lay, who had been out of day-to-day management for years, was never able to clearly explain how the partnerships worked or why anyone shouldn’t assume the worst—that they were set up to hide Enron’s problems, inflate earnings, and personally benefit the executives who managed some of them.

That uncertainty ultimately scuttled Enron’s best hope for a rescue: its deal to be acquired by its smaller but healthier rival, Dynegy Inc. Now Enron is frantically seeking a rock-solid banking partner to help maintain some shred of its once-mighty trading empire. Already, 4,000 Enron workers in Houston have lost their jobs. And hundreds of creditors, from banks to telecoms to construction companies, are trying to recover part of the billions they’re owed.

From the beginning, Lay had a vision for Enron that went far beyond that of a traditional energy company. When Lay formed Enron from the merger of two pipeline companies in 1985, he understood that deregulation of the business would offer vast new opportunities. To exploit them, he turned to Skilling, then a McKinsey & Co. consultant. Skilling was the chief nuts-and-bolts-operator from 1997 until his departure last summer, and the architect of an increasingly byzantine financial structure. After he abruptly quit in August, citing personal reasons, and his right-hand financier Fastow was ousted Oct. 24, there was no one left to explain it.

Much of the blame for Enron’s collapse has focused on the partnerships, but the seeds of its destruction were planted well before the October surprises. According to former insiders and other sources close to Enron, it was already on shaky financial ground from a slew of bad investments, including overseas projects ranging from a water...
business in England to a power distributor in Brazil. "You make enough billion-dollar mistakes, and they add up," says one source close to Enron's top executives. In June, Standard & Poor's analysts put the company on notice that its underperforming international assets were of growing concern. But S&P, which like BusinessWeek is a unit of The McGraw-Hill companies, ultimately reaffirmed the credit ratings, based on Enron's apparent willingness to sell assets and take other steps.

Behind all the analyses of Enron was the assumption that the core energy business was thriving. It was still growing rapidly, but margins were inevitably coming down as the market matured. "Once that growth slowed, any weakness would start becoming more apparent," says Standard & Poor's Corp. director Todd A. Shipman. "They were not the best at watching their cost." Indeed, the tight risk controls that seemed to work well in the trading business apparently didn't apply to other parts of the company.

Skilling's answer to growing competition in energy trading was to push Enron's innovative techniques into new arenas, everything from broadband to metals, steel, and even advertising time and space. Skilling knew he had to find a way to finance his big growth plans and manage the international problems without killing the company's critical investment-grade credit rating. Without a clever solution, trading partners would flee, or the cost of doing deals would become insurmountable.

"HE'S HEARTBROKEN." No one ever disputed that Skilling was clever. The Pittsburgh-born son of a sales manager for an Illinois valve company, he took over as production director at a startup Aurora (Ill.) TV station at age 13 when an older staffer quit and he was the only one who knew how to operate the equipment. Skilling landed a full-tuition scholarship to Southern Methodist University in Dallas to study engineering, and went to work for Enron, where he rose through the ranks to become one of the company's top traders.

JANUARY, 1997 Jeffrey Skilling is named president and COO. In six years, he had put Enron on the map as a natural-gas and electricity trading powerhouse.

JULY Enron pays $3.2 billion for Portland General Electric to combine the utility's wholesale and retail electricity exposure with Enron's natural-gas and electricity marketing and risk-management skills.

AUGUST Enron branches out beyond energy, introducing commodity trading of weather derivatives.

MAY, 1998 Rebecca Mark, a rising star who helped chip Enron's $3 billion power plant in Dabhol, India, in the early '90s, is named vice-chair. She had been a rival to Skilling as a successor to Chairman and CEO Ken Lay.

REBECCA MARK

JULY Enron pushes into foreign markets, paying $1.3 billion for the main power distributor to São Paulo and $2.4 billion for Britain's Wessex Water. Wessex becomes a building block for Mark's new global water business, Azurix Corp.

APRIL, 1999 Enron agrees to pay $100 million to name Houston's new baseball stadium Enron Field.

JUNE Enron sells a third of Azurix to the public, raising $695 million.

DABHOL: MARK MADE A NAME FOR HERSELF WITH THE POWER PLANT

NOVEMBER Skilling launches EnronOnline, a Net-based commodity trading platform. A few days later, proclaiming "this is Day One of a potentially enormous market," he introduces trading of broadband capacity.

SKILLING'S STRATEGIES THAT WENT SOUR

THE BIG IDEA

- Create an "asset light" company. Skilling applied Enron's trading and risk-management skills to power plants and other facilities owned by outsiders. To maintain a high credit rating and raise capital, Enron moved many of its own assets off the balance sheet into complex partnerships.

- Expand Enron's energy trading expertise into a vast array of new commodities to sustain earnings growth. Skilling envisioned taking on markets ranging from paper goods to metals to broadband capacity.

- Skilling tried to boost Enron's stock, with little success. Enron's stock price fell below $7, even though the stock market was soaring.

THE TALKING POINTS

- Enron tried to sell stock, with little success. Enron's stock price fell below $7, even though the stock market was soaring.

- Enron tried to raise capital, but investors were wary of the company's risky business model.

- Enron tried to expand into new markets, but the company was not well positioned to compete in these areas.

- Enron tried to improve its credit rating, but the company's risky business model made it difficult for investors to trust the company.

- Enron tried to cut costs, but the company was not able to do so effectively.

- Enron tried to sell assets, but the company was not able to do so effectively.

- Enron tried to increase its revenue, but the company was not able to do so effectively.

- Enron tried to increase its profit margin, but the company was not able to do so effectively.

- Enron tried to improve its liquidity, but the company was not able to do so effectively.

- Enron tried to improve its capital structure, but the company was not able to do so effectively.

- Enron tried to improve its strategic alignment, but the company was not able to do so effectively.

- Enron tried to improve its management, but the company was not able to do so effectively.

- Enron tried to improve its risk management, but the company was not able to do so effectively.

- Enron tried to improve its internal controls, but the company was not able to do so effectively.

- Enron tried to improve its financial reporting, but the company was not able to do so effectively.

- Enron tried to improve its corporate governance, but the company was not able to do so effectively.

- Enron tried to improve its reputation, but the company was not able to do so effectively.

- Enron tried to improve its investor relations, but the company was not able to do so effectively.

- Enron tried to improve its human resources, but the company was not able to do so effectively.

- Enron tried to improve its technology, but the company was not able to do so effectively.

- Enron tried to improve its procurement, but the company was not able to do so effectively.

- Enron tried to improve its partnerships, but the company was not able to do so effectively.

- Enron tried to improve its strategic alliances, but the company was not able to do so effectively.

- Enron tried to improve its intellectual capital, but the company was not able to do so effectively.

- Enron tried to improve its brand, but the company was not able to do so effectively.

- Enron tried to improve its innovation, but the company was not able to do so effectively.

- Enron tried to improve its customer satisfaction, but the company was not able to do so effectively.

- Enron tried to improve its employee satisfaction, but the company was not able to do so effectively.
TETYWHAT WENT WRONG?

THE PROBLEM

- Some partnerships required Enron to kick in stock if its rating and stock price fell below a certain point. Enron could be left holding the bag on about $4 billion in debt. With its stock and asset values falling, Enron was vulnerable. And when things started to unravel, its murky finances spooked investors and lenders.

- Enron tried to do too much, too fast, with little or no return. It invested $1.2 billion in fiber-optic capacity and trading facilities, but the broadband market crashed. And it was never able to show that it could generate the profits it got from energy trading in markets such as metals.

- Enron's "intellectual capital" was Skilling's pride and joy. He recruited more than 250 newly minted MBAs each year from the nation's top business schools. Meteorologists and PhDs in math and economics helped analyze and model the vast amounts of data that Enron used in its trading operations. A forced ranking system weeded out the poor performers. "It was as competitive internally as it was externally," says one former executive.

- It was no surprise then that Skilling would turn to a bright young finance wizard, Fastow, to help him find capital for his rapidly expanding empire. Boasting an MBA from Northwestern University, Fastow was recruited to Enron in 1990 from Continental Bank, where he worked on a merger after seeing unanticipated debt and cash flow problems in Enron's 10Q filing. Enron's credit is downgraded to junk status.

JULY, 2000 Enron launches online metals trading.

AUGUST A power shortage darkens California, and state politicians blame Enron and other energy outfits. Problems at Azurix drive its stock to $5, down from $19 at the IPO. Mark resigns as Azurix' chief and an Enron director.

SEPTEMBER Enron launches online trading of wood products.

DECEMBER Skilling is promoted to CEO, effective Feb. 2001. Enron's stock has soared 87% in 2000. Enron offers to take Azurix private.

MARCH, 2001 California officials investigate alleged price gouging by Enron and other power marketers.

JUNE Enron execs sold shares in the first half as the stock slid 39%. Skilling's total: $17.5 million.

ANDREW FASTOW

OCT. 16 Enron reports a third-quarter loss of $618 million and shrinks shareholder equity by $1.2 billion, citing losses due partly to partnerships run by then-CFO Andrew Fastow.

OCT. 22 Enron says the SEC has started an inquiry into Fastow's partnerships. Two days later, he's out.

OCT. 31 Enron sets up a committee to conduct an investigation of its accounting.

NOV. 8 Net income is revised back through 1997, trimming it by $586 million.

NOV. 9 Dynegy Corp. agrees to buy Enron for $10 billion.

NOV. 15 Lay says Enron made billions of dollars of "very bad investments."

NOV. 19 Enron says it may have to repay a $690 million note and take a $700 million pretax charge.

NOV. 28 Dynegy bolts out of the

CHUCK WATSON
Cover Story  THE FALL OF ENRON

EVERYONE LOVED ENRON
Here's what some management gurus said about Enron's rise, and what they think now

JAMES J. O'TOOLE
Professor, Univ. of Southern Calif.

BEFORE
"Leadership is not a solo act—it is a shared responsibility, a chorus of diverse and complimentary voices. To an unusual degree, [Enron] is chock-full o' leaders..."

AFTER
"Egg all over the face is an understatement. As embarrassing as it is, we basically took the word of Lay and his people. Was there a way to spot that the emperor was wearing no clothes? I don't think so."

CHRISTOPHER A. BARTLETT
Professor, Harvard Business School

BEFORE
"Skilling and Lay created a hotbed of entrepreneurial activity and an engine of growth."

AFTER
"There are absolutely some strong, helpful lessons to learn by what they did right. Unfortunately, all those are trumped by the mistakes they made."

GARY HAMEL
Chairman of consultant Strategos

BEFORE
"Enron isn't in the business of eking the last penny out of a dying business but of continuously creating radical new business concepts with huge upside."

AFTER
"Do I feel like an idiot? No... If I misread the company in some way, I was one of a hell of a lot of people who did that."

SAMUEL E. BODILY
Professor, University of Virginia

BEFORE
"Skilling and others have led a transformation in Enron that is as significant as any in business today. This is brand new thinking, and there are broad implications for other companies."

AFTER
"History can't be very kind to it. It's sad: The innovation and ideas and what was good about what they did may be lost in the demise of the company."

leveraged buyouts. Articulate, handsome, and mature beyond his years, he became Enron's CFO at age 36. In October, 1999, he earned CFO Magazine's CFO Excellence Award for Capital Structure Management. An effusive Skilling crowed to the magazine: "We didn't want someone stuck in the past, since the industry of yesterday is no longer. Andy has the intelligence and the youthful exuberance to think in new ways."

But Skilling's fondness for the buttoned-down Fastow was not widely shared. Many colleagues considered him a prickly, even vindictive man, prone to attacking those he didn't like in Enron's group performance reviews. Fastow, through his attorney, declined to comment for this story. When he formed and took a personal stake in the LJM partnerships that blew up in October, the conflict of interest inherent in those deals only added to his colleagues' distaste for him. Enron admits Fastow earned more than $30 million from the partnerships. The Enron CFO wasn't any more popular on Wall Street, where investment bankers bristled at the finance group's "we're smarter than you guys" attitude. Indeed, that came back to haunt Enron when it needed capital commitments to stem the liquidity crisis. "It's the sort of organization about which people said, 'Screw them. We don't really owe them anything,'" says one investment banker.

While LJM—and Fastow's direct personal involvement and enrichment—shocked many, the deal was just the latest version of a financing strategy that Skilling and Fastow had used to good effect many times since the mid-90s to fund investments with private equity while keeping assets and debt off the balance sheet. Keeping the debt off Enron's books depended on a steady or rising stock price and an investment-grade credit rating. "They were put together with good intentions to offset some risk," says S&P analyst Ron M. Barone. "It's conceivable that it got away from them."

Did it ever. The off-balance-sheet structures grew increasingly complex and risky, according to insiders and others who have studied the deals. Some, with names like Osprey, Whitewing, and Marlin, were revealed in Enron's financial filings and even rated by the big credit-rating agencies. But almost no one seemed to have a clear picture of Enron's total debt, what triggers might hasten repayment, or how some of the deals could dilute shareholder equity. "No one ever sat down and added up how many liabilities would come due if this company got downgraded," says one lender involved with Enron. Many investors were unaware of provisions in some deals that could essentially dump the debts back on Enron. In some cases, if Enron's stock fell below a certain price and the credit rating dropped below investment grade—once unimaginable—nearly $4 billion in partnership debt would have to be covered by Enron. At the same time, the value of the assets in many of these partnerships was dropping, making it even harder for Enron to cover the debt.

HIGH HOPES. Skilling tried to accelerate the sale of international assets after becoming chief operating officer in 1997, but the efforts were arduous and time-consuming. Even as tech stocks melted down, Skilling was determined not to scale back his grandiose broadband trading dreams or the resulting price-to-earnings multiple of almost 60 that they helped create for Enron's stock. At its peak in August, 2000, about a third of the stock's $90 price was attributable to expectations for growth of broadband trading, executives estimate.

That rapidly rising stock price—up 55% in '99 and 87% in

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The Fall of Enron

2000—gave Skilling and Fastow a hot currency for luring investors into their off-balance-sheet deals. They quickly became dependent on such deals to finance their expansion efforts. "It was like crack," says a company insider. Trouble is, Enron's stock came tumbling back to earth when market valuations fell this year. By April, its price had fallen to about 55. And its far-flung operational troubles were taking their own toll. In its much-hyped broadband business, for instance, a capacity glut and financial meltdown made it hard to find creditworthy counterparties for trading. And after spending some $1.2 billion to build and operate a fiber-optic network, Enron found itself with an asset whose value was rapidly deteriorating. Even last year, company executives could see the need to cut back an operation that had 1,700 employees and a cash burn rate of $700 million a year.

"Something to prove." And the international problems weren't going away. Enron's 65% stake in the $3 billion Dabhol power plant in India was mired in a dispute with its largest customer, which refused to pay for electricity. Some Indian politicians have despaired of the deal for years, claiming that cunning and even corrupt Enron executives cut a deal that charged India too much for its power.

Enron's ill-fated 1998 investment in the water-services business was another drag on earnings. Many saw the purchase of Wessex Water in England as a "consolation prize" for Rebecca P. Mark, the hard-charging Enron executive who had negotiated the Dabhol deal and other investments around the world. With Skilling having won out as Lay's clear heir apparent, top executives wanted to move her out of the way, say former in-siders. A narrowly split board approved the Wessex deal, which formed the core of Azurix Corp., to be run by Mark. But Enron was blindsided by British regulators who slashed the rates the utility could charge. Meanwhile, Mark piled on more high-priced water assets. "Once [Skilling] put her there, he let her go wild," says a former executive. "And she's going to go wild because she has something to prove." Mark spent too much on a water concession in Brazil and ran into political obstacles. She declined to comment for this story.

But if Azurix was a prime example of Enron's sketchy investment strategy, it also demonstrated how the company tried to disguise its problems with financial alchemy. To set up the company, Enron formed a partnership called the Atlantic Water Trust, in which it held a 50% stake. That kept Wessex off Enron's balance sheet. Enron's partner in the joint venture was Marlin Water Trust, which consisted of institutional investors. To help attract them, Enron promised to back up the debt with its own stock if necessary. But if

Enron's credit rating fell below investment grade and the stock fell below a certain point, Enron could be on the hook for the partnership's $915 million in debt.

The end for Enron came when its murky finances and less-than-forthright disclosures spooked investors and Dynegy. The clincher came when Dynegy's bankers spent hours sifting through a supposedly final draft of Enron's about-to-be-released 10-Q—only to discover two pages of damning new numbers when the quarterly statement was made publicly available. Debt coming due in the fourth quarter had leapt from under $1 billion to $2.3 billion. Even worse, cash on hand—to which Dynegy had recently contributed $1.5 billion—shrank from $3 billion to $1.2 billion. Dynegy "had a two-hour meeting with the new treasurer of Enron, who had been in that seat for two weeks," said a source close to the deal. "He had no clue where the numbers came from."

Respect for Assets. Skilling and Fastow face most of the wrath of reeling employees. "Someone told me yesterday if they see Jeff Skilling on the street, they would scratch out his eyes," says a former executive. One of Fastow's lawyers, David B. Gergen, says his client has been the subject of death threats and anti-Semitic tirades in Internet chat rooms. "Naturally people look for scapegoats, but it would be wrong to scapegoat Mr. Fastow," says Gergen.

He confirms that Fastow has hired a big gun to handle his civil litigation: David Boies's firm, which represented the Justice Dept. in its suit against Microsoft Corp. On Dec. 5, Milberg Weiss Bershad Hynes & Lerach filed a suit against Fastow, Skilling, and 27 other Enron executives, saying they illegally made more than $1 billion off stock sales before Enron tanked. And a source at the Securities & Exchange Commission says four U.S. Attorney Offices are considering whether to pursue criminal

Charges against Enron and its officers.

Would the cash squeeze have caught up to Enron, even without Skilling's and Fastow's fancy financing? Credit analysts still argue that the debt would have been manageable, absent the crisis of confidence that dried up Enron's trading business and access to the capital markets. But even they have a new respect for old-fashioned, high-quality assets. "When things get really tough, hard assets are the kind you can depend upon," says S&P's Shipman. That's something Enron's whiz-kid financials failed to appreciate.

By Wendy Zellner and Stephanie Anderson Forest in Dallas with Emily Thornton, Peter Coy, Heather Timmons, Louis Lavelle, and David Henry in New York, and bureau reports

Heat: Four U.S. Attorney Offices are considering whether to pursue criminal charges against Enron and its officers.

Laid-off workers with their belongings.
ENRON: LET US COUNT THE CULPRITS

Enron Corp.'s bankruptcy is a disaster of epic proportions by any measure—the height from which it fell, the speed with which it has unraveled, and the pain it has inflicted on investors, employees, and creditors. Virtually all the checks and balances designed to prevent this kind of financial meltdown failed. Unless remedied, this could undermine public trust, the capital markets, and the nation's entire equity culture. Even now, no one really knows what liabilities are buried inside dozens of partnerships or the role ex-CEO Jeffrey Skilling played in creating a byzantine system of off-balance-sheet operations. A culture of secrecy and a remarkable lack of transparency prevented any realistic assessment of the company's financial risk. Nothing less than an overhaul of the auditing profession is now required to police accounting standards. Wall Street, mutual funds, and the business press would also do well to rethink why each, in its own way, celebrated what is now revealed to be an arrogant, duplicitous company managed in a dangerous manner (page 30).

What is increasingly clear is that Skilling, a former McKinsey & Co. consultant and Harvard Business School grad, tried to craft Enron as a new kind of virtual trading giant, operating outside the scrutiny of investors and regulators. Enron's numerous partnerships were shrouded in secrecy, tucked away off the balance sheet. They were used to shift debt and assets off the books while inflating earnings. The chief financial officer ran and partially owned two partnerships, a clear conflict of interest. Enron leveraged itself without a reality check by any outsider.

ASLEEP. Hardly anyone inside the company was urging caution, certainly not chairman Ken Lay. The independent auditing committee on the board of directors was clearly asleep. Given Enron's arcane financial engineering, the committee probably relied on Arthur Andersen, the auditor, for information. But Andersen didn't blow any whistles. No surprise there. It made more money selling consulting services to Enron last year than it did auditing the company. Criticizing Enron's books might have jeopardized consulting work. Similar conflicts of interest stopped Wall Street analysts from pulling the plug on Enron. Even as Enron slid toward bankruptcy, "buy" recommendations were being issued by analysts whose firms were doing investment-banking business with the company, or were hoping to.

Did anyone really know what was going on inside Enron? The rating agencies, Moody's Investor Service and Standard & Poor's, presumably had better access than average investors, but neither downgraded Enron's credit rating to below investment grade until the bitter end. The rating agencies argue that they downgraded Enron sooner, they would have simply pushed the company into bankruptcy earlier. Here's a flash: So what? Moody's and S&P have one basic job—assessing risk for investors. If they couldn't penetrate Enron's complex financial engineering, the rating agencies should have said so.

The business press, including BusinessWeek, did no better. It celebrated Skilling's vision of Enron as a virtual company that could securitize anything and trade it anywhere. The press blithely accepted Enron as the epitome of a new, post-deregulation corporate model when it should have been much more aggressive in probing the company's opaque partnerships, off balance sheet maneuvers, and soaring leverage. TRAGIC. Enron's fall is made all the more tragic because of the pain inflicted on its thousands of employees. Not only are many losing their jobs, but some 12,000 are also losing most of their retirement savings. In perhaps its most egregious risk-management error, employees mostly held Enron stock in their 401(k)s, yet the company prevented them from selling until they reached the age of 54. People could only watch as the stock plummeted from $89 to a dollar. Diversification, particularly in retirement accounts, is the cardinal rule in managing risk. Enron broke that rule, as have other companies.

Enron's tale is a clarifying event. It reveals key weaknesses in the financial system that must be corrected as the U.S. moves forward in the 21st century. If America is to have an equity culture in which individuals invest in stocks and provide the capital for fast economic growth, the market must be able to correctly value companies. This requires making financial data readily available and easily comprehensible.

To restore public confidence, several steps should be taken. After accounting disasters at MicroStrategy, Cendant, Lucent, Cisco, and Waste Management, it is clear that self-regulation is not working. Conflicts of interest within auditing firms remain widespread. Investors can ignore analysts on TV who work for investment firms. But someone has to play the role of the honest watchdog. Unless the Big Five auditing firms clean up their act, they will wind up with a federally chartered oversight body. It is equally clear that current standard accounting rules aren't sufficient. Loopholes allowed Enron to fool everyone, making a mockery of public disclosure.

Regulators should also insist that corporations give their employees choice in their 401(k)s. Some 30% of assets held in 1.5 million 401(k) plans are in the stock of the company sponsoring the plan. This lack of diversification puts too many people at risk.

In the end, the Enron story is about a secretive corporate culture that failed in its primary business mission: to manage risk. Had the Federal Reserve and other central banks not flooded the global economy with liquidity in recent months, Enron's collapse could have posed a deep threat to the financial markets. It's past time to fix the system.
Putting an End to the Corporate Numbers Game

Has anyone considered the impact on the economy of these phony numbers (“Confused about earnings?” Cover Story, Nov. 26)? When things were on the upswing, and companies were manipulating numbers in order to boost profits, I suspect that this contributed to the “bubble.” Now, does anyone have the numbers by throwing away their income statements by throwing away all the trash they have accumulated over the years, contributing to the collapse of the financial markets during the past year. In both cases, the use of phony numbers has exacerbated the swings in the financial markets and therefore the national economy.

James F. Reed
Traverse City, Mich.

A study by our Center for Business Innovation that took place showed a far worse operating performance over the long term than companies that avoided such efforts. Companies that avoided large special items increased their earnings by nearly 3% for each year during a 10-year period that the company took large special items—a finding that held for numerous industries. (The set of companies studied was the Russell 3000 index.) The study also found that companies which take large special items commanded higher price-earnings ratios than those that avoid charges.

Over the past 10 years, there appears to have been a payoff in higher valuations from taking special charges. This last observation might help explain the increasing prevalence of special charges over the past 10 years.

Eric Mankin
Cap Gemini Ernst & Young
Cambridge, Mass.

The Securities & Exchange Commission should consider adopting a system of financial examination used by both banking and insurance regulators. Audits should be taken from the public company’s discretion and be subject to a lottery-type selection system run under the auspices of the Office of Chief Accountant of the SEC.

An audit “rotation” system of SEC companies would ensure independence of the auditor and a direct line to report on questionable issues and practices. This process may well result in the formulation of “fewer options” of financial reporting by management and greater consistency of SEC firms, further aiding external analysis and comparability.

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For years, CPA firms have mainly adopted a stance as confident of their audit clients than as independent auditors. With the advent of “lert reporting,” CPA firms no longer face stiff penalties when their mistakes contribute to investor losses. CPAs have lost the professionalism that Congress intended they have when it granted them a

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Readers Report

You’re not alone. Here’s what companies should do if they need to.

William P. Kapner Jr.

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Enron's bankruptcy

Wasted energy

Lessons must be learnt from America's largest corporate bankruptcy

THE end was not unexpected, but it was still spectacular. On December 2nd Enron, once America's seventh-biggest company, filed for Chapter 11 bankruptcy. Only days earlier, its bonds had been downgraded to junk and Dynegy, a smaller energy-trading rival, had pulled out of a planned takeover. Enron is the largest company ever to go bankrupt.

Disentangling the resultant mess (and lawsuits) will keep legions of lawyers employed for years to come. The company's opaque accounting makes it hard even now to understand why it got into trouble, and whether the cause was bad luck or worse (see our special report, pages 61-62). The close links between Enron's chairman, Kenneth Lay, and George Bush will keep the affair in the political limelight. And Enron's staff, whose retirement fund was, at the company's urging, mostly invested in Enron shares that they, unlike the company's bosses, were then unable to sell, deserve public sympathy. But if America's capital markets are to stay the cynosure of the world, some quick lessons need to be drawn.

The most important concern auditing. Enron has restated its profits for the past five years, chopping $600m off its earlier numbers. The company's auditor was Andersen, now a target of many lawsuits. Last year Enron paid Andersen a fat audit fee of $25m; it also paid the firm $27m for consulting services. In June Andersen paid $7m to settle a case brought by the Securities and Exchange Commission (sec) over its audit of Waste Management, another company that had to restate its profits; in that case, the audit fee was $48m, and consulting income was $31m. Accounting firms insist that there is no conflict of interest in consulting for audit clients. But every fresh scandal increases public scepticism. After Enron, the sec should do what its former chairman, Arthur Levitt, has long urged: ban accounting firms from doing consulting work for their audit clients.

Accounting rules also need updating. One reason why investors did not understand Enron's books is that the company shifted many debts into off-balance-sheet vehicles. In most countries, such debts are consolidated into the main accounts. That ought to happen in America as well. Similarly, the sec should tighten its disclosure requirements for all public companies. And it should discourage the practice of investing staff retirement funds in company shares.

Next come lessons for Wall Street, particularly investment

banks and credit-rating agencies. Just as in the dotcom bubble, Wall Street's highly paid equity analysts have done lamentably. Right up to last week, such reputable firms as UBS Warburg, Goldman Sachs and Lehman had buy or hold recommendations on Enron. Once again, the suspicion is of a conflict of interest: equity recommendations are motivated by a desire to win corporate-finance work or to protect big borrowers. Luckily, the past two years have taught investors to treat equity research sceptically—a lesson Enron will reinforce.

The rating agencies are harder to deal with. Financial markets increasingly depend on them. The new Basel accords on bank capital may even give rating agencies a bigger role in determining how much capital banks set against loans. Yet there is good reason to suspect that the rating agencies succumbed to pressure, from Enron and its banks, not to downgrade the company's debt, because that was sure to tip it into bankruptcy. The agencies need to re-establish their independence if their credibility is not to go the same way as the analysts'.

Last are regulatory lessons. There is a risk of turning any bankruptcy into an excuse for massive new regulation. Some have argued that energy is too important to be left to markets of the sort that Enron pioneered; or that, since it was engaged in financial speculation, Enron should have been regulated like a bank. Neither conclusion is justified. Energy deregulation has brought huge benefits in lower prices and more secure supplies: energy trading will continue to grow regardless of Enron's collapse. Nor would it be wise to subject all companies with financial arms to stiffer bank regulation. Enron's energy exchange was, however, explicitly exempted from oversight by financial regulators; that should be changed.

In the end, the best lessons of all will come from the mere fact of Enron's bankruptcy. Investors and bankers may learn not to trust companies that report mysteriously spectacular profit growth; auditors will be warier of bosses' pressure to sign dodgy accounts; rating agencies and regulators may be more nervous about companies that do not come clean about all their activities. In the drama of capitalism, bankruptcy plays an essential part—until the next boom.