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CROOKED BUSINESS, ENRON STYLE

Kristopher Kehner†

Power Failure: The Inside Story of the Collapse of Enron.
By Mimi Schwartz and Sherron Watkins.

I. INTRODUCTION

Ken Lay, Jeffery Skilling, and Andy Fastow were all rich and powerful executives at Enron. Then Enron imploded in a truth-is-stranger-than-fiction corporate scandal. But what do we really know about the inside culture at Enron; the personalities of Lay, Skilling, and Fastow; and the specifics of the scandal? In the book, Power Failure: The Inside Story of the Collapse of Enron, the reader is treated to an inside look at the events, culture, and personalities behind the scandal. In the wake of the Enron scandal, the federal government has taken actions to prevent Enron-like disasters, and many Enron executives have scurried to avoid legal culpability.²

II. THE ENRON STORY AS TOLD IN POWER FAILURE:
LAY, SKILLING, AND FASTOW

The authors of Power Failure do an excellent job of telling the Enron Story. To truly understand the changes in the law, it helps

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to know the underlying story of Enron. The authors of *Power Failure* brilliantly describe the rise and fall of the major players in the Enron scandal: Lay, Skilling, and Fastow.

Lay is portrayed as a person more interested in rubbing shoulders with politicians and performing philanthropy than with running Enron. With Lay not interested in the nuts and bolts business of Enron, COO Rich Kinder was left to run the corporation. Kinder wanted the CEO job when Lay left, which he assumed would happen in 1996. When Lay renewed as CEO in 1996, Kinder left. In his absence, Jeff Skilling was made COO.

One of the most insightful but less-known happenings of the Enron scandal was the internal power struggle between Skilling and Rebecca Mark. Mark was “a deal maker.” Lay, as was most people, was impressed with Mark, and Lay saw her as a possible replacement for himself when he stepped down. Because Skilling wanted Lay’s CEO job, Skilling saw Mark as a threat. In an effort to push her out, Skilling planted an attorney named Amanda Martin to keep an eye on Mark. Skilling used Martin’s information to point out the weaknesses in Mark’s projects. The authors described this as “Mark walk[ing] blithely into a trap . . . .” However, the trap was merely running a business. While I thought the authors went too far in romanticizing Mark with this language, I understood why Mark was forced out of Enron—survival of the meanest. When the business Mark ran foundered,

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3. See SCHWARTZ & WATKINS, supra note 1, at 24, 120, 196. “Lay[,] . . . with powerful allies[,] handpicked [a congressman’s] replacement.” Id. at 196.
4. See id. at 195. Enron gave to museums and had the baseball field of the Houston Astros named Enron Field. See id. Further, “Lay became a hero to the African American community . . . . a godfather to local black businessmen.” Id. at 195-96. Of course, with all this philanthropy, it is no surprise that Lay claims to have no knowledge of the shenanigans that went on at Enron. See Matt Daily, *Enron’s Ken Lay Denies Wrongdoing* (Jan. 19, 2004), at http://www.namibian.com.na/2004/january/marketplace/041C50118F.html (last visited May 15, 2004).
5. See SCHWARTZ & WATKINS, supra note 1, at 96.
6. See id. at 99.
7. See id.
8. See id.
9. See id. at 106-07.
10. See id. at 108, 117.
11. See id. at 107-08.
12. See id. at 109.
13. See id. at 110, 116-17.
14. Id. at 198.
15. See id. at 198-99.
With this type of infighting, it is no surprise that people like Andy Fastow came into power. Fastow has come to embody all that was wrong with Enron, a point that came across powerfully in *Power Failure*. Fastow worked his way up the ranks of Enron and became one of Skilling’s favorites. Despite failing at running his first division, Fastow rededicated himself to Enron in an attempt to keep his job.

Fastow realized that “no one at Enron seemed to care how he had financed [a project] . . . .” Being desperate to keep his job, Fastow began creating special-purpose entities that essentially created a loan that does not show up as debt on the balance sheet. These special-purpose entities required a third party to buy three percent of the entity, thereby making the third party the owner, but allowed Enron to run the entity and own the other ninety-seven percent of the entity, essentially keeping the benefits of ownership without any of the downsides. Of course, the third-party investor stood to make millions of dollars on relatively small investments. The authors of *Power Failure* were most impressive when they described these complex financial transactions—they put these extremely complex business deals into understandable terms.

Unfortunately for Enron, these special-purpose entities were what finally caused the ultimate collapse of the corporation. The special-purpose entity agreements contained a clause that called for acceleration of the debt if their bond grade dropped below investment grade. That debt was never reported on the balance sheets. The $3.9 billion of off-balance sheet debt was triggered when the grade of the bonds fell below investment grade, forcing Enron into bankruptcy.

A more shocking allegation in *Power Failure* was that Fastow

16. See id. at 200. It is not as though Mark was left out in the cold; she sold her Enron stock for $80 million. See id.
17. See id. at 151-52.
18. See id. at 157.
19. See id.
20. Id. at 159.
21. See id. at 160.
22. See id.
23. See id. at 163.
24. See id. at 330, 339.
25. See id. at 330.
26. See id. at 160.
27. See id. at 339.
engaged in many conflict-of-interest transactions. Enron needed a third party to invest $11 million to make the three percent to form a special-purpose entity. 28 Fastow volunteered to make the $11 million investment and to make himself owner of the special-purpose entity, despite being a senior executive at Enron, a clear conflict of interest. 29 Skilling, much to his credit, denied Fastow’s request. 30 Fastow decided to put one of his cronies, Michael Kopper, in charge of the special-purpose entity; Kopper was not senior management, but was an Enron employee. That fact would not have to be stated on Enron’s proxy statements. 31 The board approved the deal. 32 Skilling made Fastow Enron’s CFO in 1998 as a result of these transactions because he got the job done. 33 After he was made CFO, Fastow finally got what he wanted—he was made the “outside” owner of two special-purpose entities. 34

In addition, other Enron employees participated in behavior that would appall most people. Successful men degraded women. 35 There were also many excesses from the executives. 36 Enron executives mocked executives from other corporations because they believed the other executives were losers. 37 Altogether, Enron considered its own lack of professionalism as a bit of a joke. 38

III. THE SARBANES-OXLEY ACT AS A RESPONSE

The Sarbanes-Oxley Act (SOX) was the government’s response to Enron-like corporate scandals. It is interesting to ponder whether the changes in the law would have prevented the Enron scandal as described in Power Failure. While certain provisions of SOX are discussed below, it is important to remember that there are several other provisions of SOX that relate to Enron. 39

28. See id. at 161.
29. See id. at 162.
30. See id.
31. See id.
32. See id. at 163. The board minutes showed that Kopper’s involvement was not discussed. Id.
33. See id. at 164.
34. See id. at 172-73. The board approved this transaction and waived any conflict of interest. See id.
35. See id. at 79. Ken Rice talked about how he wished Rebecca Mark’s breasts were larger. See id. at 194.
36. See id. at 193-96.
37. See id. at 8.
38. See id. at 79.
39. See § 302, 116 Stat. at 777 (certification of SEC reports by officers); § 304,
In response to the special-purpose entities that brought Fastow to power, Congress and the President ordered a General Accounting Office (GAO) Study in SOX of special-purpose entities\(^40\) and the investment banks that helped Enron structure these deals.\(^41\) Before Enron, federal financial regulators did not consider these special-purpose entities to be high risk;\(^42\) however, after the Enron scandal, federal regulators will take a closer look at these transactions.\(^43\) Merely taking a “closer look” at Enron is dubious because, with the amount of power that Enron executives had, it is doubtful that a closer look by the government would have stopped Fastow.

Additionally, SOX added conflict-of-interest provisions to prevent directors and officers from Enron-like conflict-of-interest transactions by requiring directors, officers, and owners of ten percent or more of a corporation to report that fact to the SEC (Securities and Exchange Commission).\(^44\) For example, Fastow would have been required to report his interest in the special-purpose entities that he owned because he was an officer at Enron. While this sounds good and is a step in the right direction, the conflict-of-interest transactions involving Kopper would not have to be reported to the SEC because Kopper was not an officer or a board member and did not own at least ten percent of the securities. To catch special-purpose entities, Congress should cast a wider net that requires people like Kopper to report to the SEC.

Further, SOX requires issuers of certain securities to have either a code of ethics for their chief financial officers or an explanation of why the corporation does not have a code.\(^45\) Therefore, CFOs like Andy Fastow would be required to adhere to a code of ethics if Enron had one. While it is questionable whether Fastow would have adhered to such a code, SOX allows a corporation not to adopt a code of ethics if the corporation has a

\(^{40}\) See id. § 401(c), 116 Stat. at 786.
\(^{41}\) See id. § 705(a)(1), 116 Stat. at 799.
\(^{43}\) See id. at 6.
\(^{45}\) See id. § 406(a), 116 Stat. at 789.
reason for that decision. I can see no reason why a corporation should not have a code of ethics for its CFO because the CFO is a fiduciary position, like a lawyer, and lawyers have an extensive ethical code.\footnote{See generally Model Code of Prof’l Responsibility (2004); Model Rules of Prof’l Conduct (2004).}

If SOX had been in place during the Enron scandal, the results of the scandal may have been different; however, I doubt the difference would have been substantial.

IV. ENRON EXECUTIVES’ LEGAL PROCEEDINGS


While Lay’s claims of innocence, and Skilling’s to a lesser extent, appear to be supported by the book,\footnote{According to the book, Lay seemed more interested in the public face of Enron, not running the business. See Schwartz & Watkins, supra note 1, at 24, 196, 120, 195. This is more consistent with a CEO who does not know what other members of upper management are doing.} these claims seem hollow. First, both were top executives and board members, which
meant that they signed off on Fastow’s transactions which included the special-purpose entities and conflict-of-interest transactions. Second, Lay, as CEO, is responsible for the people under him, especially since Lay admits that he trusted Fastow.\(^{52}\) While Skilling may have had no idea about the specific details of Fastow’s schemes, Skilling has some level of culpability because he chose to turn the other way and was not concerned about how the transactions were completed.

Additionally, the punishment of Fastow and Kopper is inadequate because Fastow and the Enron executives took away so much from so many people. For example, Diana Peters, a former Enron employee, lost $75,000 in her 401(k), her pension, her health insurance, and her job when Enron went under.\(^{53}\) A short time after losing her job and health insurance, Peters’ husband was diagnosed with a brain tumor.\(^{54}\) This is in addition to the stigma of being an ex-Enron employee looking for a job in a tight job market, even though most employees did nothing wrong. The losses of the rank-and-file employees can be contrasted against the twenty members of upper-level management who received seventy-five percent of the $55 million set aside for severance pay for Enron employees before Enron declared bankruptcy.\(^{55}\)

V. CONCLUSION

_Power Failure_ provides interesting insight into Enron and the legislation following the Enron scandal. While the Sarbanes-Oxley Act is certainly a good start to preventing more Enrons, it does not go far enough in certain respects. The problems manifested in _Power Failure_ are still possible because no act of Congress can address the underlying issue of the occasional crooked corporate officer or director. While some social commentary suggests that the problem is pervasive,\(^{56}\) I believe that it is rare. Simply put, investors need more protections, like SOX, to weed out crooked officers and directors.

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52. See id. at 311.
54. Id.
55. See SCHWARTZ & WATKINS, supra note 1, at 342-43.