Enron scandal

The Enron scandal , revealed in October 2001 , eventually led to the bankruptcy of the Enron Corporation , an American energy company based in Houston , Texas , and the de facto dissolution of Arthur Andersen , which was one of the five largest audit and accountancy partnerships in the world . In addition to being the largest bankruptcy reorganization in American history at that time , Enron was cited as the biggest audit failure .

Enron was formed in 1985 by Kenneth Lay after merging Houston Natural Gas and InterNorth . Several years later , when Jeffrey Skilling was hired , he developed a staff of executives that , by the use of accounting loopholes , special purpose entities , and poor financial reporting , were able to hide billions of dollars in debt from failed deals and projects . Chief Financial Officer Andrew Fastow and other executives not only misled Enron 's board of directors and audit committee on high @-@ risk accounting practices , but also pressured Andersen to ignore the issues .

Enron shareholders filed a $ 40 billion lawsuit after the company 's stock price , which achieved a high of US $ 90 @.@ 75 per share in mid @-@ 2000 , plummeted to less than $ 1 by the end of November 2001 . The U.S. Securities and Exchange Commission (SEC) began an investigation , and rival Houston competitor Dynegy offered to purchase the company at a very low price . The deal failed , and on December 2 , 2001 , Enron filed for bankruptcy under Chapter 11 of the United States Bankruptcy Code . Enron 's $ 63 @.@ 4 billion in assets made it the largest corporate bankruptcy in U.S. history until WorldCom 's bankruptcy the next year .

Many executives at Enron were indicted for a variety of charges and some were later sentenced to prison . Enron 's auditor , Arthur Andersen , was found guilty in a United States District Court of illegally destroying documents relevant to the SEC investigation which voided its license to audit public companies , effectively closing the business . By the time the ruling was overturned at the U.S. Supreme Court , the company had lost the majority of its customers and had ceased operating . Employees and shareholders received limited returns in lawsuits , despite losing billions in pensions and stock prices . As a consequence of the scandal , new regulations and legislation were enacted to expand the accuracy of financial reporting for public companies . One piece of legislation , the Sarbanes @-@ Oxley Act , increased penalties for destroying , altering , or fabricating records in federal investigations or for attempting to defraud shareholders . The act also increased the accountability of auditing firms to remain unbiased and independent of their clients .

Rise of Enron

In 1985 , Kenneth Lay merged the natural gas pipeline companies of Houston Natural Gas and InterNorth to form Enron . In the early 1990s , he helped to initiate the selling of electricity at market prices , and soon after , the United States Congress approved legislation deregulating the sale of natural gas . The resulting markets made it possible for traders such as Enron to sell energy at higher prices , thereby significantly increasing its revenue . After producers and local governments decried the resultant price volatility and asked for increased regulation , strong lobbying on the part of Enron and others prevented such regulation .

As Enron became the largest seller of natural gas in North America by 1992 , its trading of gas contracts earned $ 122 million (before interest and taxes) , the second largest contributor to the company 's net income . The November 1999 creation of the EnronOnline trading website allowed the company to better manage its contracts trading business .

In an attempt to achieve further growth , Enron pursued a diversification strategy . The company owned and operated a variety of assets including gas pipelines , electricity plants , pulp and paper plants , water plants , and broadband services across the globe . The corporation also gained additional revenue by trading contracts for the same array of products and services with which it was involved .

Enron 's stock increased from the start of the 1990s until year @-@ end 1998 by 311 % , only modestly higher than the average rate of growth in the Standard & Poor 500 index . However , the stock increased by 56 % in 1999 and a further 87 % in 2000 , compared to a 20 % increase and a

10 % decrease for the index during the same years . By December 31 , 2000 , Enron 's stock was priced at $ 83 @.@ 13 and its market capitalization exceeded $ 60 billion , 70 times earnings and six times book value , an indication of the stock market 's high expectations about its future prospects . In addition , Enron was rated the most innovative large company in America in Fortune 's Most Admired Companies survey .

= = Causes of downfall = =

Enron 's complex financial statements were confusing to shareholders and analysts . In addition , its complex business model and unethical practices required that the company use accounting limitations to misrepresent earnings and modify the balance sheet to indicate favorable performance .

The combination of these issues later resulted in the bankruptcy of the company , and the majority of them were perpetuated by the indirect knowledge or direct actions of Lay , Jeffrey Skilling , Andrew Fastow , and other executives . Lay served as the chairman of the company in its last few years , and approved of the actions of Skilling and Fastow although he did not always inquire about the details . Skilling constantly focused on meeting Wall Street expectations , advocated the use of mark @-@ to @-@ market accounting (accounting based on market value , which was then inflated) and pressured Enron executives to find new ways to hide its debt . Fastow and other executives " created off @-@ balance @-@ sheet vehicles , complex financing structures , and deals so bewildering that few people could understand them . "

= = = Revenue recognition = = =

Enron and other energy suppliers earned profits by providing services such as wholesale trading and risk management in addition to building and maintaining electric power plants , natural gas pipelines , storage , and processing facilities . When accepting the risk of buying and selling products , merchants are allowed to report the selling price as revenues and the products ' costs as cost of goods sold . In contrast , an " agent " provides a service to the customer , but does not take the same risks as merchants for buying and selling . Service providers , when classified as agents , are able to report trading and brokerage fees as revenue , although not for the full value of the transaction .

Although trading companies such as Goldman Sachs and Merrill Lynch used the conventional " agent model " for reporting revenue (where only the trading or brokerage fee would be reported as revenue) , Enron instead selected to report the entire value of each of its trades as revenue . This " merchant model " was considered much more aggressive in the accounting interpretation than the agent model . Enron 's method of reporting inflated trading revenue was later adopted by other companies in the energy trading industry in an attempt to stay competitive with the company 's large increase in revenue . Other energy companies such as Duke Energy , Reliant Energy , and Dynegy joined Enron in the wealthiest 50 of the Fortune 500 mainly due to their adoption of the same trading revenue accounting as Enron .

Between 1996 and 2000 , Enron 's revenues increased by more than 750 % , rising from $ 13 @.@ 3 billion in 1996 to $ 100 @.@ 8 billion in 2000 . This extensive expansion of 65 % per year was unprecedented in any industry , including the energy industry which typically considered growth of 2 ? 3 % per year to be respectable . For just the first nine months of 2001 , Enron reported $ 138 @.@ 7 billion in revenues , which placed the company at the sixth position on the Fortune Global 500 .

= = = Mark @-@ to @-@ market accounting = = =

In Enron 's natural gas business , the accounting had been fairly straightforward : in each time period , the company listed actual costs of supplying the gas and actual revenues received from selling it . However , when Skilling joined the company , he demanded that the trading business adopt mark @-@ to @-@ market accounting , citing that it would represent " true economic value . "

Enron became the first non @-@ financial company to use the method to account for its complex long @-@ term contracts . Mark @-@ to @-@ market accounting requires that once a long @-@ term contract was signed , income is estimated as the present value of net future cash flow . Often , the viability of these contracts and their related costs were difficult to estimate . Due to the large discrepancies of attempting to match profits and cash , investors were typically given false or misleading reports . While using the method , income from projects could be recorded , although they might not have ever received the money , and in turn increasing financial earnings on the books . However , in future years , the profits could not be included , so new and additional income had to be included from more projects to develop additional growth to appease investors . As one Enron competitor stated , " If you accelerate your income , then you have to keep doing more and more deals to show the same or rising income . " Despite potential pitfalls , the U.S. Securities and Exchange Commission (SEC) approved the accounting method for Enron in its trading of natural gas futures contracts on January 30 , 1992 . However , Enron later expanded its use to other areas in the company to help it meet Wall Street projections .

For one contract , in July 2000 , Enron and Blockbuster Video signed a 20 @-@ year agreement to introduce on @-@ demand entertainment to various U.S. cities by year @-@ end . After several pilot projects , Enron recognized estimated profits of more than $ 110 million from the deal , even though analysts questioned the technical viability and market demand of the service . When the network failed to work , Blockbuster withdrew from the contract . Enron continued to recognize future profits , even though the deal resulted in a loss .

= = = Special purpose entities = = =

Enron used special purpose entities ? limited partnerships or companies created to fulfill a temporary or specific purpose to fund or manage risks associated with specific assets . The company elected to disclose minimal details on its use of " special purpose entities " . These shell companies were created by a sponsor , but funded by independent equity investors and debt financing . For financial reporting purposes , a series of rules dictate whether a special purpose entity is a separate entity from the sponsor . In total , by 2001 , Enron had used hundreds of special purpose entities to hide its debt . Enron used a number of special purpose entities , such as partnerships in its Thomas and Condor tax shelters , financial asset securitization investment trusts (FASITs) in the Apache deal , real estate mortgage investment conduits (REMICs) in the Steele deal , and REMICs and real estate investment trusts (REITs) in the Cochise deal .

The special purpose entities were used for more than just circumventing accounting conventions . As a result of one violation , Enron 's balance sheet understated its liabilities and overstated its equity , and its earnings were overstated . Enron disclosed to its shareholders that it had hedged downside risk in its own illiquid investments using special purpose entities . However , investors were oblivious to the fact that the special purpose entities were actually using the company 's own stock and financial guarantees to finance these hedges . This prevented Enron from being protected from the downside risk . Notable examples of special purpose entities that Enron employed were JEDI , Chewco , Whitewing , and LJM .

= = = = JEDI and Chewco = = = =

In 1993 , Enron established a joint venture in energy investments with CalPERS , the California state pension fund , called the Joint Energy Development Investments (JEDI) . In 1997 , Skilling , serving as Chief Operating Officer (COO) , asked CalPERS to join Enron in a separate investment . CalPERS was interested in the idea , but only if it could be terminated as a partner in JEDI . However , Enron did not want to show any debt from assuming CalPERS ' stake in JEDI on its balance sheet . Chief Financial Officer (CFO) Fastow developed the special purpose entity Chewco Investments limited partnership (L.P.) which raised debt guaranteed by Enron and was used to acquire CalPERS 's joint venture stake for $ 383 million . Because of Fastow 's organization of Chewco , JEDI 's losses were kept off of Enron 's balance sheet .

In autumn 2001 , CalPERS and Enron 's arrangement was discovered , which required the discontinuation of Enron 's prior accounting method for Chewco and JEDI . This disqualification revealed that Enron 's reported earnings from 1997 to mid @-@ 2001 would need to be reduced by $ 405 million and that the company 's indebtedness would increase by $ 628 million .

= = = = Whitewing = = = =

Whitewing was the name of a special purpose entity used as a financing method by Enron . In December 1997 , with funding of $ 579 million provided by Enron and $ 500 million by an outside investor , Whitewing Associates L.P. was formed . Two years later , the entity 's arrangement was changed so that it would no longer be consolidated with Enron and be counted on the company 's balance sheet . Whitewing was used to purchase Enron assets , including stakes in power plants , pipelines , stocks , and other investments . Between 1999 and 2001 , Whitewing bought assets from Enron worth $ 2 billion , using Enron stock as collateral . Although the transactions were approved by the Enron board , the asset transfers were not true sales and should have been treated instead as loans .

= = = = LJM and Raptors = = = =

In 1999 , Fastow formulated two limited partnerships : LJM Cayman . L.P. (LJM1) and LJM2 Co @-@ Investment L.P. (LJM2) , for the purpose of buying Enron 's poorly performing stocks and stakes to improve its financial statements . LJM 1 and 2 were created solely to serve as the outside equity investor needed for the special purpose entities that were being used by Enron . Fastow had to go before the board of directors to receive an exemption from Enron 's code of ethics (as he had the title of CFO) in order to manage the companies . The two partnerships were funded with around $ 390 million provided by Wachovia , J.P. Morgan Chase , Credit Suisse First Boston , Citigroup , and other investors . Merrill Lynch , which marketed the equity , also contributed $ 22 million to fund the entities .

Enron transferred to " Raptor I @-@ IV " , four LJM @-@ related special purpose entities named after the velociraptors in Jurassic Park , more than " $ 1 @.@ 2 billion in assets , including millions of shares of Enron common stock and long term rights to purchase millions more shares , plus $ 150 million of Enron notes payable " as disclosed in the company 's financial statement footnotes . The special purpose entities had been used to pay for all of this using the entities ' debt instruments . The footnotes also declared that the instruments ' face amount totaled $ 1 @.@ 5 billion , and the entities notional amount of $ 2 @.@ 1 billion had been used to enter into derivative contracts with Enron .

Enron capitalized the Raptors , and , in a manner similar to the accounting employed when a company issues stock at a public offering , then booked the notes payable issued as assets on its balance sheet while increasing the shareholders ' equity for the same amount . This treatment later became an issue for Enron and its auditor Arthur Andersen as removing it from the balance sheet resulted in a $ 1 @.@ 2 billion decrease in net shareholders ' equity .

Eventually the derivative contracts worth $ 2 @.@ 1 billion lost significant value . Swaps were established at the time the stock price achieved its maximum . During the ensuing year , the value of the portfolio under the swaps fell by $ 1 @.@ 1 billion as the stock prices decreased (the loss of value meant that the special purpose entities technically now owed Enron $ 1 @.@ 1 billion by the contracts) . Enron , which used a " mark @-@ to @-@ market " accounting method , claimed a $ 500 million gain on the swap contracts in its 2000 annual report . The gain was responsible for offsetting its stock portfolio losses and was attributed to nearly a third of Enron 's earnings for 2000 (before it was properly restated in 2001) .

= = = Corporate governance = = =

On paper , Enron had a model board of directors comprising predominantly of outsiders with significant ownership stakes and a talented audit committee . In its 2000 review of best corporate boards , Chief Executive included Enron among its five best boards . Even with its complex corporate governance and network of intermediaries , Enron was still able to " attract large sums of capital to fund a questionable business model , conceal its true performance through a series of accounting and financing maneuvers , and hype its stock to unsustainable levels . "

= = = = Executive compensation = = = =

Although Enron 's compensation and performance management system was designed to retain and reward its most valuable employees , the system contributed to a dysfunctional corporate culture that became obsessed with short @-@ term earnings to maximize bonuses . Employees constantly tried to start deals , often disregarding the quality of cash flow or profits , in order to get a better rating for their performance review . Additionally , accounting results were recorded as soon as possible to keep up with the company 's stock price . This practice helped ensure deal @-@ makers and executives received large cash bonuses and stock options .

The company was constantly emphasizing its stock price . Management was compensated extensively using stock options , similar to other U.S. companies . This policy of stock option awards caused management to create expectations of rapid growth in efforts to give the appearance of reported earnings to meet Wall Street 's expectations . The stock ticker was located in lobbies , elevators , and on company computers . At budget meetings , Skilling would develop target earnings by asking " What earnings do you need to keep our stock price up ? " and that number would be used , even if it was not feasible . At December 31 , 2000 , Enron had 96 million shares outstanding as stock option plans (approximately 13 % of common shares outstanding) . Enron 's proxy statement stated that , within three years , these awards were expected to be exercised . Using Enron 's January 2001 stock price of $ 83 @.@ 13 and the directors ? beneficial ownership reported in the 2001 proxy , the value of director stock ownership was $ 659 million for Lay , and $ 174 million for Skilling .

Skilling believed that if employees were constantly worried about cost , it would hinder original thinking . As a result , extravagant spending was rampant throughout the company , especially among the executives . Employees had large expense accounts and many executives were paid sometimes twice as much as competitors . In 1998 , the top 200 highest @-@ paid employees received $ 193 million from salaries , bonuses , and stock . Two years later , the figure jumped to $ 1 @.@ 4 billion .

= = = = Risk management = = = =

Before its scandal , Enron was lauded for its sophisticated financial risk management tools . Risk management was crucial to Enron not only because of its regulatory environment , but also because of its business plan . Enron established long @-@ term fixed commitments which needed to be hedged to prepare for the invariable fluctuation of future energy prices . Enron 's bankruptcy downfall was attributed to its reckless use of derivatives and special purpose entities . By hedging its risks with special purpose entities which it owned , Enron retained the risks associated with the transactions . This arrangement had Enron implementing hedges with itself .

Enron 's aggressive accounting practices were not hidden from the board of directors , as later learned by a Senate subcommittee . The board was informed of the rationale for using the Whitewing , LJM , and Raptor transactions , and after approving them , received status updates on the entities ' operations . Although not all of Enron 's widespread improper accounting practices were revealed to the board , the practices were dependent on board decisions . Even though Enron extensively relied on derivatives for its business , the company 's Finance Committee and board did not have enough experience with derivatives to understand what they were being told . The Senate subcommittee argued that had there been a detailed understanding of how the derivatives were organized , the board would have prevented their use .

= = = = Financial audit = = = =

Enron 's auditor firm , Arthur Andersen , was accused of applying reckless standards in its audits because of a conflict of interest over the significant consulting fees generated by Enron . During 2000 , Arthur Andersen earned $ 25 million in audit fees and $ 27 million in consulting fees (this amount accounted for roughly 27 % of the audit fees of public clients for Arthur Andersen 's Houston office) . The auditor 's methods were questioned as either being completed solely to receive its annual fees or for its lack of expertise in properly reviewing Enron 's revenue recognition , special entities , derivatives , and other accounting practices .

Enron hired numerous Certified Public Accountants (CPAs) as well as accountants who had worked on developing accounting rules with the Financial Accounting Standards Board (FASB) . The accountants searched for new ways to save the company money , including capitalizing on loopholes found in Generally Accepted Accounting Principles (GAAP) , the accounting industry 's standards . One Enron accountant revealed " We tried to aggressively use the literature [GAAP] to our advantage . All the rules create all these opportunities . We got to where we did because we exploited that weakness . "

Andersen 's auditors were pressured by Enron 's management to defer recognizing the charges from the special purpose entities as its credit risks became known . Since the entities would never return a profit , accounting guidelines required that Enron should take a write @-@ off , where the value of the entity was removed from the balance sheet at a loss . To pressure Andersen into meeting Enron 's earnings expectations , Enron would occasionally allow accounting companies Ernst & Young or PricewaterhouseCoopers to complete accounting tasks to create the illusion of hiring a new company to replace Andersen . Although Andersen was equipped with internal controls to protect against conflicted incentives of local partners , it failed to prevent conflict of interest . In one case , Andersen 's Houston office , which performed the Enron audit , was able to overrule any critical reviews of Enron 's accounting decisions by Andersen 's Chicago partner . In addition , after news of U.S. Securities and Exchange Commission (SEC) investigations of Enron were made public , Andersen would later shred several tons of relevant documents and delete nearly 30 @,@ 000 e @-@ mails and computer files , causing accusations of a cover @-@ up .

Revelations concerning Andersen 's overall performance led to the break @-@ up of the firm , and to the following assessment by the Powers Committee (appointed by Enron 's board to look into the firm 's accounting in October 2001) : " The evidence available to us suggests that Andersen did not fulfill its professional responsibilities in connection with its audits of Enron 's financial statements , or its obligation to bring to the attention of Enron 's Board (or the Audit and Compliance Committee) concerns about Enron 's internal contracts over the related @-@ party transactions " .

= = = = Audit committee = = = =

Corporate audit committees usually meet just a few times during the year , and their members typically have only modest experience with accounting and finance . Enron 's audit committee had more expertise than many . It included :

Robert Jaedicke of Stanford University , a widely respected accounting professor and former dean of Stanford Business School

John Mendelsohn , President of the University of Texas M.D. Anderson Cancer Center

Paulo Pereira , former president and CEO of the State Bank of Rio de Janeiro in Brazil

John Wakeham , former United Kingdom Secretary for Energy

Ronnie Chan , a Hong Kong businessman

Wendy Gramm , former Chair of U.S. Commodity Futures Trading Commission

Enron 's audit committee was later criticized for its brief meetings that would cover large amounts of material . In one meeting on February 12 , 2001 , the committee met for an hour and a half . Enron 's audit committee did not have the technical knowledge to question the auditors properly on accounting issues related to the company 's special purpose entities . The committee was also unable to question the company 's management due to pressures on the committee . The United

States Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs ' report accused the board members of allowing conflicts of interest to impede their duties as monitoring the company 's accounting practices . When Enron 's scandal became public , the audit committee 's conflicts of interest were regarded with suspicion .

= = = = Ethical and political analyses = = = =

Commentators attributed the mismanagement behind Enron ? s fall to a variety of ethical and political @-@ economic causes . Ethical explanations centered on executive greed and hubris , a lack of corporate social responsibility , situation ethics , and get @-@ it @-@ done business pragmatism . Political @-@ economic explanations cited post @-@ 1970s deregulation , and inadequate staff and funding for regulatory oversight . A more libertarian analysis maintained that Enron ? s collapse resulted from the company ? s reliance on political lobbying , rent @-@ seeking , and the gaming of regulations .

= = = Other accounting issues = = =

Enron made a habit of booking costs of cancelled projects as assets , with the rationale that no official letter had stated that the project was cancelled . This method was known as " the snowball " , and although it was initially dictated that such practices be used only for projects worth less than $ 90 million , it was later increased to $ 200 million .
In 1998 , when analysts were given a tour of the Enron Energy Services office , they were impressed with how the employees were working so vigorously . In reality , Skilling had moved other employees to the office from other departments (instructing them to pretend to work hard) to create the appearance that the division was larger than it was . This ruse was used several times to fool analysts about the progress of different areas of Enron to help improve the stock price .

= = Timeline of downfall = =

In February 2001 , Chief Accounting Officer Rick Causey told budget managers : " From an accounting standpoint , this will be our easiest year ever . We 've got 2001 in the bag . " On March 5 , Bethany McLean 's Fortune article Is Enron Overpriced ? questioned how Enron could maintain its high stock value , which was trading at 55 times its earnings . She argued that analysts and investors did not know exactly how Enron was earning its income . McLean was first drawn to the company 's situation after an analyst suggested she view the company 's 10 @-@ K report , where she found " strange transactions " , " erratic cash flow " , and " huge debt . " She telephoned Skilling to discuss her findings prior to publishing the article , but he called her " unethical " for not properly researching the company . Fastow cited two Fortune reporters that Enron could not reveal earnings details as the company had more than 1 @,@ 200 trading books for assorted commodities and did " ... not want anyone to know what 's on those books . We don 't want to tell anyone where we 're making money . "
In a conference call on April 17 , 2001 , then @-@ Chief Executive Officer (CEO) Skilling verbally attacked Wall Street analyst Richard Grubman , who questioned Enron 's unusual accounting practice during a recorded conference call . When Grubman complained that Enron was the only company that could not release a balance sheet along with its earnings statements , Skilling replied " Well , thank you very much , we appreciate that ... asshole . " This became an inside joke among many Enron employees , mocking Grubman for his perceived meddling rather than Skilling 's offensiveness , with slogans such as " Ask Why , Asshole " , a variation on Enron 's official slogan " Ask why " . However , Skilling 's comment was met with dismay and astonishment by press and public , as he had previously disdained criticism of Enron coolly or humorously .
By the late 1990s Enron 's stock was trading for $ 80 ? 90 per share , and few seemed to concern themselves with the opacity of the company 's financial disclosures . In mid @-@ July 2001 , Enron reported revenues of $ 50 @.@ 1 billion , almost triple year @-@ to @-@ date , and beating

analysts ' estimates by 3 cents a share . Despite this , Enron 's profit margin had stayed at a modest average of about 2 @.@ 1 % , and its share price had decreased by more than 30 % since the same quarter of 2000 .
As time passed , a number of serious concerns confronted the company . Enron had recently faced several serious operational challenges , namely logistical difficulties in operating a new broadband communications trading unit , and the losses from constructing the Dabhol Power project , a large power plant in India . There was also increasing criticism of the company for the role that its subsidiary Enron Energy Services had in the California electricity crisis of 2000 @-@ 2001 .
On August 14 , Skilling announced he was resigning his position as CEO after only six months . Skilling had long served as president and COO before being promoted to CEO . Skilling cited personal reasons for leaving the company . Observers noted that in the months before his exit , Skilling had sold at minimum 450 @,@ 000 shares of Enron at a value of around $ 33 million (though he still owned over a million shares at the date of his departure) . Nevertheless , Lay , who was serving as chairman at Enron , assured surprised market watchers that there would be " no change in the performance or outlook of the company going forward " from Skilling 's departure . Lay announced he himself would re @-@ assume the position of chief executive officer .
The next day , however , Skilling admitted that a very significant reason for his departure was Enron 's faltering price in the stock market . The economist Paul Krugman asserted in his New York Times column that Enron was an illustration of the consequences that occur from the deregulation and commodification of things such as energy . A few days later , in a letter to the editor , Kenneth Lay defended Enron and the philosophy of the company :
The broader goal of [Krugman 's] latest attack on Enron appears to be to discredit the free @-@ market system , a system that entrusts people to make choices and enjoy the fruits of their labor , skill , intellect and heart . He would apparently rely on a system of monopolies controlled or sponsored by government to make choices for people . We disagree , finding ourselves less trusting of the integrity and good faith of such institutions and their leaders .
The example Mr. Krugman cites of " financialization " run amok (the electricity market in California) is the product of exactly his kind of system , with active government intervention at every step . Indeed , the only winners in the California fiasco were the government @-@ owned utilities of Los Angeles , the Pacific Northwest and British Columbia . The disaster that squandered the wealth of California was born of regulation by the few , not by markets of the many .
On August 15 , Sherron Watkins , vice president for corporate development , sent an anonymous letter to Lay warning him about the company 's accounting practices . One statement in the letter said : " I am incredibly nervous that we will implode in a wave of accounting scandals . " Watkins contacted a friend who worked for Arthur Andersen and he drafted a memorandum to give to the audit partners about the points she raised . On August 22 , Watkins met individually with Lay and gave him a six @-@ page letter further explaining Enron 's accounting issues . Lay questioned her as to whether she had told anyone outside of the company and then vowed to have the company 's law firm , Vinson & Elkins , review the issues , although she argued that using the law firm would present a conflict of interest . Lay consulted with other executives , and although they wanted to dismiss Watkins (as Texas law did not protect company whistleblowers) , they decided against it to prevent a lawsuit . On October 15 , Vinson & Elkins announced that Enron had done nothing wrong in its accounting practices as Andersen had approved each issue .

= = = Investors ' confidence declines = = =

By the end of August 2001 , his company 's stock value still falling , Lay named Greg Whalley , president and COO of Enron Wholesale Services and Mark Frevert , to positions in the chairman 's office . Some observers suggested that Enron 's investors were in significant need of reassurance , not only because the company 's business was difficult to understand (even " indecipherable ") but also because it was difficult to properly describe the company in financial statements . One analyst stated " it 's really hard for analysts to determine where [Enron] are making money in a given quarter and where they are losing money . " Lay accepted that Enron 's business was very complex

, but asserted that analysts would " never get all the information they want " to satisfy their curiosity . He also explained that the complexity of the business was due largely to tax strategies and position @-@ hedging . Lay 's efforts seemed to meet with limited success ; by September 9 , one prominent hedge fund manager noted that " [Enron] stock is trading under a cloud . " The sudden departure of Skilling combined with the opacity of Enron 's accounting books made proper assessment difficult for Wall Street . In addition , the company admitted to repeatedly using " related @-@ party transactions , " which some feared could be too @-@ easily used to transfer losses that might otherwise appear on Enron 's own balance sheet . A particularly troubling aspect of this technique was that several of the " related @-@ party " entities had been or were being controlled by CFO Fastow .

After the September 11 , 2001 attacks , media attention shifted away from the company and its troubles ; a little less than a month later Enron announced its intention to begin the process of selling its lower @-@ margin assets in favor of its core businesses of gas and electricity trading . This policy included selling Portland General Electric to another Oregon utility , Northwest Natural Gas , for about $ 1 @.@ 9 billion in cash and stock , and possibly selling its 65 % stake in the Dabhol project in India .

= = = Restructuring losses and SEC investigation = = =

On October 16 , 2001 , Enron announced that restatements to its financial statements for years 1997 to 2000 were necessary to correct accounting violations . The restatements for the period reduced earnings by $ 613 million (or 23 % of reported profits during the period) , increased liabilities at the end of 2000 by $ 628 million (6 % of reported liabilities and 5 @.@ 5 % of reported equity) , and reduced equity at the end of 2000 by $ 1 @.@ 2 billion (10 % of reported equity) . Additionally , in January Jeff Skilling had asserted that the broadband unit alone was worth $ 35 billion , a claim also mistrusted . An analyst at Standard & Poor 's said , " I don 't think anyone knows what the broadband operation is worth . "

Enron 's management team claimed the losses were mostly due to investment losses , along with charges such as about $ 180 million in money spent restructuring the company 's troubled broadband trading unit . In a statement , Lay revealed , " After a thorough review of our businesses , we have decided to take these charges to clear away issues that have clouded the performance and earnings potential of our core energy businesses . " Some analysts were unnerved . David Fleischer at Goldman Sachs , an analyst termed previously ' one of the company 's strongest supporters ' asserted that the Enron management " ... lost credibility and have to reprove themselves . They need to convince investors these earnings are real , that the company is for real and that growth will be realized . "

Fastow disclosed to Enron 's board of directors on October 22 that he earned $ 30 million from compensation arrangements when managing the LJM limited partnerships . That day , the share price of Enron decreased to $ 20 @.@ 65 , down $ 5 @.@ 40 in one day , after the announcement by the SEC that it was investigating several suspicious deals struck by Enron , characterizing them as " some of the most opaque transactions with insiders ever seen " . Attempting to explain the billion @-@ dollar charge and calm investors , Enron 's disclosures spoke of " share settled costless collar arrangements , " " derivative instruments which eliminated the contingent nature of existing restricted forward contracts , " and strategies that served " to hedge certain merchant investments and other assets . " Such puzzling phraseology left many analysts feeling ignorant about just how Enron managed its business . Regarding the SEC investigation , chairman and CEO Lay said , " We will cooperate fully with the S.E.C. and look forward to the opportunity to put any concern about these transactions to rest . "

Two days later , on October 25 , despite his reassurances days earlier , Lay dismissed Fastow from his position , citing " In my continued discussions with the financial community , it became clear to me that restoring investor confidence would require us to replace Andy as CFO . " However , with Skilling and Fastow now both departed , some analysts feared that revealing the company 's practices would be made all the more difficult . Enron 's stock was now trading at $ 16 @.@ 41 ,

having lost half its value in a little more than a week .
On October 27 the company began buying back all its commercial paper , valued at around $ 3 @.@ 3 billion , in an effort to calm investor fears about Enron 's supply of cash . Enron financed the re @-@ purchase by depleting its lines of credit at several banks . While the company 's debt rating was still considered investment @-@ grade , its bonds were trading at levels slightly less , making future sales problematic .
As the month came to a close , serious concerns were being raised by some observers regarding Enron 's possible manipulation of accepted accounting rules ; however , analysis was claimed to be impossible based on the incomplete information provided by Enron . Industry analysts feared that Enron was the new Long @-@ Term Capital Management , the hedge fund whose bankruptcy in 1998 threatened systemic failure of the international financial markets . Enron 's tremendous presence worried some about the consequences of the company 's possible bankruptcy . Enron executives accepted questions in written form only .

= = = Credit rating downgrade = = =

The main short @-@ term danger to Enron 's survival at the end of October 2001 seemed to be its credit rating . It was reported at the time that Moody 's and Fitch , two of the three biggest credit @-@ rating agencies , had slated Enron for review for possible downgrade . Such a downgrade would force Enron to issue millions of shares of stock to cover loans it had guaranteed , which would decrease the value of existing stock further . Additionally , all manner of companies began reviewing their existing contracts with Enron , especially in the long term , in the event that Enron 's rating were lowered below investment grade , a possible hindrance for future transactions .
Analysts and observers continued their complaints regarding the difficulty or impossibility of properly assessing a company whose financial statements were so cryptic . Some feared that no one at Enron apart from Skilling and Fastow could completely explain years of mysterious transactions . " You 're getting way over my head , " said Lay during late August 2001 in response to detailed questions about Enron 's business , a reaction that worried analysts .
On October 29 , responding to growing concerns that Enron might have insufficient cash on hand , news spread that Enron was seeking a further $ 1 ? 2 billion in financing from banks . The next day , as feared , Moody 's lowered Enron 's credit rating from Baa1 to Baa2 , two levels above junk status . Standard & Poor 's also lowered Enron 's rating to BBB + , the equivalent of Moody 's rating . Moody 's also warned that it would downgrade Enron 's commercial paper rating , the consequence of which would likely prevent the company from finding the further financing it sought to keep solvent .
November began with the disclosure that the SEC was now pursuing a formal investigation , prompted by questions related to Enron 's dealings with " related parties " . Enron 's board also announced that it would commission a special committee to investigate the transactions , directed by William C. Powers , the dean of the University of Texas law school . The next day , an editorial in The New York Times demanded an " aggressive " investigation into the matter . Enron was able to secure an additional $ 1 billion in financing from cross @-@ town rival Dynegy on November 2 , but the news was not universally admired in that the debt was secured by assets from the company 's valuable Northern Natural Gas and Transwestern Pipeline .

= = = Proposed buyout by Dynegy = = =

Sources claimed that Enron was planning to explain its business practices more fully within the coming days , as a confidence @-@ building gesture . Enron 's stock was now trading at around $ 7 , as investors worried that the company would not be able to find a buyer .
After it received a wide spectrum of rejections , Enron management apparently found a buyer when the board of Dynegy , another energy trader based in Houston , voted late at night on November 7 to acquire Enron at a very low price of about $ 8 billion in stock . Chevron Texaco , which at the time owned about a quarter of Dynegy , agreed to provide Enron with $ 2 @.@ 5 billion in cash ,

specifically $ 1 billion at first and the rest when the deal was completed . Dynegy would also be required to assume nearly $ 13 billion of debt , plus any other debt hitherto occluded by the Enron management 's secretive business practices , possibly as much as $ 10 billion in " hidden " debt . Dynegy and Enron confirmed their deal on November 8 , 2001 .

Commentators remarked on the different corporate cultures between Dynegy and Enron , and on the " straight @-@ talking " personality of the CEO of Dynegy , Charles Watson . Some wondered if Enron 's troubles had not simply been the result of innocent accounting errors . By November , Enron was asserting that the billion @-@ plus " one @-@ time charges " disclosed in October should in reality have been $ 200 million , with the rest of the amount simply corrections of dormant accounting mistakes . Many feared other " mistakes " and restatements might yet be revealed .

Another major correction of Enron 's earnings was announced on November 9 , with a reduction of $ 591 million of the stated revenue of years 1997 ? 2000 . The charges were said to come largely from two special purpose partnerships (JEDI and Chewco) . The corrections resulted in the virtual elimination of profit for fiscal year 1997 , with significant reductions for the other years . Despite this disclosure , Dynegy declared it still intended to purchase Enron . Both companies were said to be anxious to receive an official assessment of the proposed sale from Moody 's and S & P presumably to understand the effect the completion of any buyout transaction would have on Dynegy and Enron 's credit rating . In addition , concerns were raised regarding antitrust regulatory restrictions resulting in possible divestiture , along with what to some observers were the radically different corporate cultures of Enron and Dynegy .

Both companies promoted the deal aggressively , and some observers were hopeful ; Watson was praised for attempting to create the largest company on the energy market . At the time , Watson said : " We feel [Enron] is a very solid company with plenty of capacity to withstand whatever happens the next few months . " One analyst called the deal " a whopper [...] a very good deal financially , certainly should be a good deal strategically , and provides some immediate balance @-@ sheet backstop for Enron . "

Credit issues were becoming more critical , however . Around the time the buyout was made public , Moody 's and S & P both reduced Enron 's rating to just one notch above junk status . Were the company 's rating to fall below investment @-@ grade , its ability to trade would be severely limited if there was a reduction or elimination of its credit lines with competitors . In a conference call , S & P affirmed that , were Enron not to be bought , S & P would reduce its rating to low BB or high B , ratings noted as being within junk status . Additionally , many traders had limited their involvement with Enron , or stopped doing business altogether , fearing more bad news . Watson again attempted to re @-@ assure , attesting at a presentation to investors that there was " nothing wrong with Enron 's business " . He also acknowledged that remunerative steps (in the form of more stock options) would have to be taken to redress the animosity of many Enron employees for management after it was revealed that Lay and other officials had sold hundreds of millions of dollars ' worth of stock during the months prior to the crisis . The situation was not helped by the disclosure that Lay , his " reputation in tatters " , stood to receive a payment of $ 60 million as a change @-@ of @-@ control fee subsequent to the Dynegy acquisition , while many Enron employees had seen their retirement accounts , which were based largely on Enron stock , ravaged as the price decreased 90 % in a year . An official at a company owned by Enron stated " We had some married couples who both worked who lost as much as $ 800 @,@ 000 or $ 900 @,@ 000 . It pretty much wiped out every employee 's savings plan . "

Watson assured investors that the true nature of Enron 's business had been made apparent to him : " We have comfort there is not another shoe to drop . If there is no shoe , this is a phenomenally good transaction . " Watson further asserted that Enron 's energy trading part alone was worth the price Dynegy was paying for the whole company .

By mid @-@ November , Enron announced it was planning to sell about $ 8 billion worth of underperforming assets , along with a general plan to reduce its scale for the sake of financial stability . On November 19 Enron disclosed to the public further evidence of its critical state of affairs . Most pressingly that the company had debt repayment obligations in the range of $ 9 billion by the end of 2002 . Such debts were " vastly in excess " of its available cash . Also , the success of measures to preserve its solvency were not guaranteed , specifically as regarded asset sales and debt refinancing . In a statement , Enron revealed " An adverse outcome with respect to any of these matters would likely have a material adverse impact on Enron 's ability to continue as a going concern . "

Two days later , on November 21 , Wall Street expressed serious doubts that Dynegy would proceed with its deal at all , or would seek to radically renegotiate . Furthermore , Enron revealed in a 10 @-@ Q filing that almost all the money it had recently borrowed for purposes including buying its commercial paper , or about $ 5 billion , had been exhausted in just 50 days . Analysts were unnerved at the revelation , especially since Dynegy was reported to have also been unaware of Enron 's rate of cash use . In order to end the proposed buyout , Dynegy would need to legally demonstrate a " material change " in the circumstances of the transaction ; as late as November 22 , sources close to Dynegy were skeptical that the latest revelations constituted sufficient grounds .

The SEC announced it had filed civil fraud complaints against Andersen . A few days later , sources claimed Enron and Dynegy were renegotiating the terms of their arrangement . Dynegy now demanded Enron agree to be bought for $ 4 billion rather than the previous $ 8 billion . Observers were reporting difficulties in ascertaining which of Enron 's operations , if any , were profitable . Reports described an en masse shift of business to Enron 's competitors for the sake of risk exposure reduction .

= = = Bankruptcy = = =

On November 28 , 2001 , Enron 's two worst @-@ possible outcomes came true : Dynegy Inc. unilaterally disengaged from the proposed acquisition of the company , and Enron 's credit rating was reduced to junk status . Watson later said " At the end , you couldn 't give it [Enron] to me . " The company had very little cash with which to operate , let alone satisfy enormous debts . Its stock price fell to $ 0 @.@ 61 at the end of the day 's trading . One editorial observer wrote that " Enron is now shorthand for the perfect financial storm . "

Systemic consequences were felt , as Enron 's creditors and other energy trading companies suffered the loss of several percentage points . Some analysts felt Enron 's failure indicated the risks of the post @-@ September 11 economy , and encouraged traders to lock in profits where they could . The question now became how to determine the total exposure of the markets and other traders to Enron 's failure . Early calculations estimated $ 18 @.@ 7 billion . One adviser stated , " We don 't really know who is out there exposed to Enron 's credit . I 'm telling my clients to prepare for the worst . "

Enron was estimated to have about $ 23 billion in liabilities from both debt outstanding and guaranteed loans . Citigroup and JP Morgan Chase in particular appeared to have significant amounts to lose with Enron 's bankruptcy . Additionally , many of Enron 's major assets were pledged to lenders in order to secure loans , causing doubt about what , if anything , unsecured creditors and eventually stockholders might receive in bankruptcy proceedings .

Enron 's European operations filed for bankruptcy on November 30 , 2001 , and it sought Chapter 11 protection two days later on December 2 . It was the largest bankruptcy in U.S. history (before being surpassed by WorldCom 's bankruptcy the next year) , and resulted in 4 @,@ 000 lost jobs . The day that Enron filed for bankruptcy , the employees were told to pack their belongings and were given 30 minutes to vacate the building . Nearly 62 % of 15 @,@ 000 employees ' savings plans relied on Enron stock that was purchased at $ 83 in early 2001 and was now practically worthless .

On January 17 , 2002 , Enron dismissed Arthur Andersen as its auditor , citing its accounting advice and the destruction of documents . Andersen countered that it had already ended its relationship with the company when Enron became bankrupt .

= = Trials = =

= = = Enron = = =

Fastow and his wife , Lea , both pleaded guilty to charges against them . Fastow was initially charged with 98 counts of fraud , money laundering , insider trading , and conspiracy , among other crimes . Fastow pleaded guilty to two charges of conspiracy and was sentenced to ten years with no parole in a plea bargain to testify against Lay , Skilling , and Causey . Lea was indicted on six felony counts , but prosecutors later dismissed them in favor of a single misdemeanor tax charge . Lea was sentenced to one year for helping her husband hide income from the government .

Lay and Skilling went on trial for their part in the Enron scandal in January 2006 . The 53 @-@ count , 65 @-@ page indictment covers a broad range of financial crimes , including bank fraud , making false statements to banks and auditors , securities fraud , wire fraud , money laundering , conspiracy , and insider trading . United States District Judge Sim Lake had previously denied motions by the defendants to have separate trials and to relocate the case out of Houston , where the defendants argued the negative publicity concerning Enron 's demise would make it impossible to get a fair trial . On May 25 , 2006 , the jury in the Lay and Skilling trial returned its verdicts . Skilling was convicted of 19 of 28 counts of securities fraud and wire fraud and acquitted on the remaining nine , including charges of insider trading . He was sentenced to 24 years and 4 months in prison . In 2013 the United States Department of Justice reached a deal with Skilling , which resulted in ten years being cut from his sentence .

Lay pleaded not guilty to the eleven criminal charges , and claimed that he was misled by those around him . He attributed the main cause for the company 's demise to Fastow . Lay was convicted of all six counts of securities and wire fraud for which he had been tried , and he was subject to a maximum total sentence of 45 years in prison . However , before sentencing was scheduled , Lay died on July 5 , 2006 . At the time of his death , the SEC had been seeking more than $ 90 million from Lay in addition to civil fines . The case of Lay 's wife , Linda , is a difficult one . She sold roughly 500 @,@ 000 shares of Enron ten minutes to thirty minutes before the information that Enron was collapsing went public on November 28 , 2001 . Linda was never charged with any of the events related to Enron .

Although Michael Kopper worked at Enron for more than seven years , Lay did not know of Kopper even after the company 's bankruptcy . Kopper was able to keep his name anonymous in the entire affair . Kopper was the first Enron executive to plead guilty . Chief Accounting Officer Rick Causey was indicted with six felony charges for disguising Enron 's financial condition during his tenure . After pleading not guilty , he later switched to guilty and was sentenced to seven years in prison .

All told , sixteen people pleaded guilty for crimes committed at the company , and five others , including four former Merrill Lynch employees , were found guilty . Eight former Enron executives testified ? the main witness being Fastow ? against Lay and Skilling , his former bosses . Another was Kenneth Rice , the former chief of Enron Corp. ' s high @-@ speed Internet unit , who cooperated and whose testimony helped convict Skilling and Lay . In June 2007 , he received a 27 @-@ month sentence .

Michael W. Krautz , a former Enron accountant , was among the accused who was acquitted of charges related to the scandal . Represented by Barry Pollack , Krautz was acquitted of federal criminal fraud charges after a month @-@ long jury trial .

= = = Arthur Andersen = = =

Arthur Andersen was charged with and found guilty of obstruction of justice for shredding the thousands of documents and deleting e @-@ mails and company files that tied the firm to its audit of Enron . Although only a small number of Arthur Andersen 's employees were involved with the scandal , the firm was effectively put out of business ; the SEC is not allowed to accept audits from convicted felons . The company surrendered its CPA license on August 31 , 2002 , and 85 @,@ 000 employees lost their jobs . The conviction was later overturned by the U.S. Supreme Court due to the jury not being properly instructed on the charge against Andersen . The Supreme Court ruling theoretically left Andersen free to resume operations . However , the damage to the Andersen name has been so great that it has not returned as a viable business even on a limited scale .

NatWest Three

Giles Darby , David Bermingham , and Gary Mulgrew worked for Greenwich NatWest . The three British men had worked with Fastow on a special purpose entity he had started called Swap Sub . When Fastow was being investigated by the SEC , the three men met with the British Financial Services Authority (FSA) in November 2001 to discuss their interactions with Fastow . In June 2002 , the U.S. issued warrants for their arrest on seven counts of wire fraud , and they were then extradited . On July 12 , a potential Enron witness scheduled to be extradited to the U.S. , Neil Coulbeck , was found dead in a park in north @-@ east London . Coulbeck 's death was eventually ruled to have been a suicide . The U.S. case alleged that Coulbeck and others conspired with Fastow . In a plea bargain in November 2007 , the trio plead guilty to one count of wire fraud while the other six counts were dismissed . Darby , Bermingham , and Mulgrew were each sentenced to 37 months in prison . In August 2010 , Bermingham and Mulgrew retracted their confessions .

Aftermath

Employees and shareholders

Enron 's shareholders lost $ 74 billion in the four years before the company 's bankruptcy ($ 40 to $ 45 billion was attributed to fraud) . As Enron had nearly $ 67 billion that it owed creditors , employees and shareholders received limited , if any , assistance aside from severance from Enron . To pay its creditors , Enron held auctions to sell assets including art , photographs , logo signs , and its pipelines .

In May 2004 , more than 20 @,@ 000 of Enron 's former employees won a suit of $ 85 million for compensation of $ 2 billion that was lost from their pensions . From the settlement , the employees each received about $ 3 @,@ 100 . The next year , investors received another settlement from several banks of $ 4 @.@ 2 billion . In September 2008 , a $ 7 @.@ 2 @-@ billion settlement from a $ 40 @-@ billion lawsuit , was reached on behalf of the shareholders . The settlement was distributed among the main plaintiff , University of California (UC) , and 1 @.@ 5 million individuals and groups . UC 's law firm Coughlin Stoia Geller Rudman and Robbins , received $ 688 million in fees , the highest in a U.S. securities fraud case . At the distribution , UC announced in a press release " We are extremely pleased to be returning these funds to the members of the class . Getting here has required a long , challenging effort , but the results for Enron investors are unprecedented . "

Sarbanes @-@ Oxley Act

Between December 2001 and April 2002 , the Senate Committee on Banking , Housing , and Urban Affairs and the House Committee on Financial Services held multiple hearings about the Enron scandal and related accounting and investor protection issues . These hearings and the corporate scandals that followed Enron led to the passage of the Sarbanes @-@ Oxley Act on July 30 , 2002 . The Act is nearly " a mirror image of Enron : the company 's perceived corporate governance failings are matched virtually point for point in the principal provisions of the Act . "

The main provisions of the Sarbanes @-@ Oxley Act included the establishment of the Public Company Accounting Oversight Board to develop standards for the preparation of audit reports ; the restriction of public accounting companies from providing any non @-@ auditing services when auditing ; provisions for the independence of audit committee members , executives being required to sign off on financial reports , and relinquishment of certain executives ' bonuses in case of financial restatements ; and expanded financial disclosure of companies ' relationships with unconsolidated entities .

On February 13 , 2002 , due to the instances of corporate malfeasances and accounting violations ,

the SEC recommended changes of the stock exchanges ' regulations . In June 2002 , the New York Stock Exchange announced a new governance proposal , which was approved by the SEC in November 2003 . The main provisions of the final NYSE proposal include :
All companies must have a majority of independent directors .
Independent directors must comply with an elaborate definition of independent directors .
The compensation committee , nominating committee , and audit committee shall consist of independent directors .
All audit committee members should be financially literate . In addition , at least one member of the audit committee is required to have accounting or related financial management expertise .
In addition to its regular sessions , the board should hold additional sessions without management .