IESE Business School
University of Navarra
CBS

IES233
November 2012

Jeffrey Skilling, Bernie Madoff the Monster & the Other Smartest Guys of the Room

Enron and Madoff's Ponzi scheme: two scandals that changed U.S. history and prove just how weak the controlling mechanisms of developed economies are.

Enron, the seventh largest company in the United States, was declared bankrupt in December 2001 after its investment partnership proved to be masking a colossal mountain of debt (around $1.2 billion).

Similarly, Madoff's company, Bernard L. Madoff Investment Securities, was associated with a $65 billion fraud[1] that affected around 4,800 clients worldwide, including investment banks (e.g., Banco Santander, UniCredit, HSBC), hedge funds (e.g., Ascot Partners and Man Group PLC), charities (e.g., Mortimer B. Zuckerman Charitable Remainder Trust, JEHT Foundation), universities (e.g., New York University, Carnegie Mellon University), prominent private investors (e.g., the International Olympic Committee) and, of course, many Hollywood players.[2]

There are several similarities between the two stories, and there are at least two issues that should never be forgotten.

First, the people involved in these stories were incredibly smart; their professional trajectories were exceptional to say the least: Jeffrey Skilling, president of Enron, obtained an MBA from Harvard Business School and, before joining Enron, was the youngest partner of McKinsey in the history of the company; John Clifford Baxter, CEO of Enron North America, earned an MBA from Columbia University and moved up quickly within Enron; Richard Causey, Enron's chief accounting officer, obtained an MBA from the University of Texas at Austin and, before joining Enron, was a partner of Arthur Andersen. Similarly, Bernie Madoff was an icon of the North American financial sector.

[1] *The Guardian*, November 18, 2011.

[2] *The Wall Street Journal*, March 6, 2009.

This case was prepared by Professor Antonino Vaccaro and Tommaso Ramus, Post-Doctoral Research Fellow, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. November 2012.This case was written with the support of the CBS (Center for Business in Society), IESE.

Last edited: 12/21/12
2-313-008

Second, the storm that followed the outbreak of the two scandals literally destroyed the life of those people who thought they were smarter than everyone else. Jeffrey Skilling, for example, was sentenced to *24 years and four months* in prison and fined *$45 million*; John Clifford "Cliff" Baxter *committed suicide* in January 2002; and Andrew Fastow was sentenced to six years in jail followed by two years of probation. Arrested on December 10, 2008, Bernie Madoff was sentenced to *150 years in prison* on June 29, 2009, and his son Mark committed suicide exactly two years after his father's arrest, on December 10, 2010.

Let's now look at the drivers that caused the failure of two organizations that were supposed to prevent and eventually contrast the emergence of such criminal and dangerous networks; Arthur Andersen was serving as Enron's auditor at the time of the scandal, while the U.S. Securities and Exchange Commission (SEC) was supposed to control the activities of Bernie Madoff's firm.

Arthur Andersen and the Enron Disaster

Arthur Andersen served as Enron's auditor from 1985 up until October 2001, when the company filed for bankruptcy. At the time of the scandal, AA was the oldest auditing company and one of the largest consulting companies in the world: it employed around 85,000 top professionals located on five continents.

According to criminal investigators and specialists who analyzed the Enron disaster, Arthur Andersen played a major role.

Experts believe that there are several factors that can explain the behavior of AA's professionals.

One point is surely the long relationship developed between AA and Enron. AA professionals permanently occupied office space at Enron headquarters and other buildings, used the same type of badges to access Enron's infrastructures and were granted the same privileges (e.g., discount cards, etc.) as Enron employees. In such a context, new AA employees found it difficult to distinguish AA's professionals from Enron employees: "If someone had on a grey suit and a tie... well... you didn't really know if he was an Enron guy or a consultant."[3] Moreover, the continuous socialization between Enron's and AA's workforce favored some non-professional relationships that, in some cases, ended in marriages.

Another problem was caused by the heterogeneity of services offered by AA to Enron. The year before the bankruptcy, AA sold Enron $25 million in auditing services and another $28 million in consulting projects. It's worth mentioning that auditing services were not limited only to external auditing: a significant part of AA's auditing sales was associated with the activities of internal auditors that were responsible for the preparation of internal and external accounting documents.

Some experts have pointed out that additional problems were caused by the professional trajectories of many AA professionals. It was not that uncommon for a former senior

[3] Interview with a former AA partner.

manager, or even partner, of the auditing firm to move into a top management position in the energy company. This was the case, as we've already mentioned, of Richard Causey – a former AA partner who went on to become Enron's chief accounting officer. It was not that uncommon, therefore, for an AA professional to see his or her former boss become the client.

The Securities and Exchange Commission & Bernie Madoff the Monster

The U.S. Securities and Exchange Commission (SEC) is a U.S. federal agency primarily responsible for regulating the securities industry and overseeing the key participants in that market, including securities exchanges, brokers and securities dealers, investment advisors and mutual funds.[4]

Given these responsibilities, the SEC had the authority and the duty to control and eventually block Madoff's illegal activities.

Since 1992, the SEC had received six anonymous complaints (see **Exhibit 1**) about Madoff's firm that raised substantive red flags concerning its trading activities. The most important and detailed complaint was received by the SEC from Harry Markopolos, a derivatives expert who in 2001 worked for trading firm Rampart Securities Management and was asked by a client to try to design a product similar to Madoff's.

While studying Madoff's investment strategy, Markopolos identified 29 detailed and clear red flags regarding Madoff's investment strategy, which led him to report to the SEC that with all likelihood "Madoff Securities is the world's largest Ponzi scheme."[5]

The interesting part of the story is that since 1992 the SEC had investigated Madoff's firm at least five times; the SEC, however, always botched the inquiry. Even more paradoxically, SEC investigators always seemed to be looking in the right places to discover Madoff's Ponzi scheme, but they never got to the bottom of the inquiry by checking Madoff's clearinghouse account that would have proved that no trading activity was going on.

It is worth mentioning that, since the outbreak of the scandal, an SEC internal investigation (in collaboration with the FBI) has proven that no bribery, collusion or deliberate sabotage of those investigations had been carried out by SEC personnel who worked on investigations of Madoff's firm.[6]

So, why was the SEC unable to identify Madoff's scheme? As in the Enron case, there are several relevant explanations.

A brief explanation might be that a deep, detailed investigation of Madoff's activities was technically complex, time expensive and dangerous for any SEC employee. The scheme

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[4] http://www.sec.gov/about/whatwedo.shtml.

[5] Harry Markopolos, "The World's Largest Hedge Fund is a Fraud," 21-page report sent anonymously in November 2005 to SEC regulators.

[6] United States Securities and Exchange Commission Office of Inspector General, "Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme," http://www.sec.gov.

adopted by Madoff was indeed relatively complex and very well hidden through the adoption of multiple companies located in the United States, Europe and several fiscal paradises.

Moreover, Bernie Madoff had a well-know reputation as a high-profile businessman in the trading industry: he cofounded the Nasdaq, sat on the Board of the Security Industry Association, and advised the SEC on many electronic trading issues.

During all the investigations Madoff did nothing to conceal his power and influence in the financial market: he used well-known "impression management" strategies to embarrass SEC investigators.

For example, he used his image as a very well-connected and powerful person in showing anger for allegedly "stupid and inappropriate questions."

It's also worth mentioning that SEC investigators were too untrained and unskilled to carry out a complex examination like the one involving Madoff's trading activities. Most SEC employees were lawyers with no relevant financial industry experience, and thus no technical expertise. According to several experts, SEC employees did not deepen the investigations because they were not at all capable of spotting the inconsistencies in Madoff's answers and documents.

Some have argued that investigators could have asked for third party consultancy but didn't, probably because this would have been too time-consuming and "tremendously voluminous and difficult to deal with."[7]

Moreover, market and regulator rules didn't encourage investigators to carefully scrutinize Madoff's firm: during the 1990s and 2000s, unregulated transaction such as the ones managed by Madoff were not only allowed but also deliberately prompted by the U.S. government.

[7] Ibid.

Exhibit 1

Complaints Received by the SEC From 1992 to 2006 About Madoff's Activities[8]

Since 1992, the SEC had received six complaints about Madoff's firm that raised substantive red flags concerning his trading activities.

The first complaint dates to 1992, when the SEC was informed that an unregistered investment company was offering consistently high rate of returns for "100%" safe investments.

The second complaint dates to 2000 and was resubmitted to the SEC two more times, in 2001 and 2005, by financial trader Markopolos. The complaint was very detailed and pointed out significant inconsistencies in Madoff's investment strategy. Several experts declared that the indications of Markopolos would have been sufficient to identify Madoff's criminal activity.

The third complaint was presented by a market trader in 2003 who questioned Madoff's strategy and purported returns on investments, pointing out that neither were technically duplicable. In particular, the complaint showed that Madoff's strategy had no correlation to the overall equity markets of the last 10 years or more.

The fourth complaint dates to 2004, when the SEC discovered some internal e-mails of a registrant questioning the truthfulness of Madoff's investment strategy because of its unrealistically high return of investment and low volatility. One of the e-mails explained very clearly why Madoff had to be misrepresenting his option trading because of his insufficient volume of affairs.

Finally, the fifth and six complaints were submitted to the SEC in 2005 and 2006 by anonymous informants. Both complaints advised the commission to investigate Madoff's firm, since it was highly likely he was carrying out a fraud.

[8] Ibid.

Exhibit 2

Some Relevant Profiles Involved in the Enron Case

Name	Role in Enron	Criminal Charges	Current Situation
Andrew Fastow	Chief financial officer	Conspiracy, wire fraud, securities fraud, false statements, insider trading and money laundering.	Released after *six years in prison* and the forfeiture of $23.8 million in family assets. Now he works as a *document review clerk* for law firm in Houston.
Kenneth Lay	Founder, CEO and chairman of Enron	Securities fraud, wire fraud and making false and misleading statements.	*Dead* from a heart attack on July 5, 2006.
Jeffrey Skilling	Former CEO of Enron	Conspiracy, fraud and insider trading.	Serving *prison sentence of 24 years and four months. The court fined him $45 million.*
Richard Causey	Chief accounting officer of Enron	Conspiracy and fraud.	Completed his *five-and-a-half-year prison sentence* in October 2011. *He forfeited $1.25 million in a bank account*. He is working as an independent accounting professional in Houston.
Michael Kopper	Global finance manager	Money laundering and wire fraud.	Completed his *two-year prison sentence*; now he is working as chief strategy officer for a health center in Houston specialized in HIV/AIDS testing and treatment.
Sherron Watkins	Vice president of Enron	She is the whistle-blower who helped uncover the fraud.	She has co-written a book and has been giving speeches at congresses about the Enron scandal and the role of ethics in business.
Ben F. Glisan Jr.	Corporate treasurer of Enron	Conspiracy, wire fraud and securities fraud	Released to home confinement *after five years in prison* in September 2007; he was freed one year later. He agreed to forfeit nearly $1 million. He now heads his own financial advisory firm in Houston.
Lea Fastow	Wife of Andrew Fastow and assistant treasurer at Enron	Lying on tax return.	Reported to prison in July 2004; she was released in July 2005. She now runs an art consulting firm.

Exhibit 3

Some Relevant Profiles Involved in the Madoff Case

Name	Role in the Madoff's Firm	Criminal Charges	Current Situation
Bernie Madoff	Chairman of Bernard L. Madoff Investment Securities LLC from its startup in 1960 until his arrest on December 11, 2008.	Securities fraud, investment advisor fraud, mail fraud, wire fraud, money laundering, false statements, perjury, making false filings with the SEC.	He is now serving a *150-year prison* sentence.
Mark Madoff	Son of Bernie Madoff; turned in his father to the authorities in December 2008.	He was suspected of being involved in the fraud and having benefited from it.	*Committed suicide* on December 11, 2010.
David Kugel	Trader at Madoff's firm.	Pleaded guilty in federal court in New York to conspiracy, securities fraud, bank fraud, falsifying business records and falsifying the books of an investment advisor.	Still awaiting sentencing (he risks a maximum statutory sentence *of 85 years in prison*).
Peter Madoff	Younger brother of Bernie Madoff. He worked for more than 40 years with Bernie Madoff.	On June 29, 2012, Peter pleaded guilty in federal court to securities fraud.	*Agreed to a 10-year prison term and to forfeit all of his assets* including two homes on Long Island and a Ferrari for a value of $143.1 billion.
David G. Friehling	Madoff's listed accountant.	Securities fraud, false audit report.	Still awaiting sentencing (he risks a maximum statutory sentence *of 20 years in prison*).
Frank DiPascali	Chief financial officer at Madoff's firm.	He pleaded guilty to conspiracy, securities fraud, investment advisor fraud, mail fraud, wire fraud, perjury, income tax evasion, international money laundering, falsifying books and records of a broker-dealer, and falsifying books and records of an investment advisor.	*He faces a maximum of 125 years in prison.* He is awaiting his sentence in prison. Prosecutors are seeking more than $170 billion in forfeiture.
Annette Bongiorno	Secretary of Madoff. She rose to the level of supervisor and account manager.	Charged with allegedly having created false and fraudulent books and records, conspiracy, securities fraud, and tax-related charges. She is also being sued by the SEC for falsifying records.	Arrested in November 2010. *She faces up to 75 years in prison*.
Ruth Madoff	Wife of Bernie Madoff.	She was not directly involved in the fraud.	Ruth has not been charged with any crime and has not been questioned by prosecutors. She now lives in a house in Connecticut.

Additional Readings

More detailed information about the role of professionals in the Enron story (credit raters, strategic consultants, lawyers, etc.) can be found in the case study "Broken Trust: Role of Professionals in the Enron Debacle." Harvard Business School Case Study 9-903-804.

There are several books that provide a more detailed description of the overall Enron story: Brice, Robert. *Pipe Dreams: Greed, Ego, and the Death of Enron*. PublicAffairs, 2002; Fusaro, Peter C., and Ross M. Miller. *What Went Wrong at Enron: Everyone's Guide to the Largest Bankruptcy in U.S. History*. Wiley, 2002; and McLean, Bethany, and Peter Elkind. *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron*. Hardcover edition.

It is also possible to find a very extensive scientific literature about this case: Coffee, John. "What Caused Enron - A Capsule Social and Economic History of the 1990s." *Cornell L. Rev.* 269 (2003 – 2004); Bratton, William. "Enron and the Dark Side of Shareholder Value." In Socio-Economics and Corporate Law Symposium: The New Corporate Social Responsibility: Does Corporate Law Protect the Interests of Shareholders and Other Stakeholders?, *Tulane Law Review*, 76 (2001 – 2002): 1276 – 1362; and Healy, Paul, and Krishna Palepu. "The Fall of Enron." *Journal of Economic Perspectives* 17, no. 2 (June 1, 2003): 3 – 26 (24).