

The Enron Scandal

by Stephen Copp

The global impact of the Enron scandal

The scandal which has emerged at Enron has had an enormous global impact, almost certainly encompassing many readers of *Faith in Business Quarterly*. Enron's shareholders, many of whom were pensioners in Enron's pension scheme, which relied heavily upon Enron stock, have seen the value of its shares go from moving towards \$100 by December 2000 to junk bond status¹. Enron's directors, including, UK non-executive director, Lord Wakeham, face mammoth litigation which is estimated to exceed the insurance taken out to protect them and therefore places their personal assets at risk². President and Chief Operating Officer, Jeffrey McMahon, has resigned effective June 1st 2002³ whilst former vice-chairman, Clifford Baxter, was found to have committed suicide, found in the front seat of his Mercedes Benz, a revolver and suicide note by his side, in January 2002⁴. Enron employed 21,000 staff in more than 40 countries⁵, who face much uncertainty and worry, especially since Enron employees invested on average 60% of their retirement plans in Enron⁶. Creditors face substantial losses with more than 1000 companies having lost out on deals worth billions of pounds and may only receive a fraction of what



they are owed⁷. Enron's four companies in Europe transpired to owe each other more than £2.2 billion through a series of tangled inter-company debts⁸. The reputation of auditors, Andersens, is in shreds and it also faces an uncertain future as clients and staff are made redundant⁹ or desert¹⁰. Even the political establishment has been touched by Enron: it seems that roughly 75% of all US senators and congressmen accepted campaign contributions from Enron and that it was the 12th largest donor to George Bush's campaign¹¹. Controversy has erupted in the UK with allegations of Enron donations to the Labour Party¹². Yet economically the long-term impact of Enron may well be marginal and indeed even lead to the strengthening of the US economy¹³.

Developing a Christian perspective

Clearly, it will take much time before the various investigations into Enron's downfall are complete and therefore only tentative conclusions may be drawn at this stage. However, much has already emerged to provide significant pointers as to the form a Christian perspective on the scandal might take. In doing so, I will make a number of assumptions as to what a Christian perspective on business should be, which are briefly as follows¹⁴:

1. People have been created in the image of God but are inherently sinful: the consequence of this is that all levels of systems and regulation should be devised on the basis that people should be encouraged to attain the highest but hindered from doing the lowest.
2. Markets, which rely for their operation on the protection of people, property and promises, and result in competition, risk and innovation, best provide opportunities for people to attain the highest and therefore should be encouraged and only interfered with by exception: however, markets do result in distributional inequalities which people who benefit from them have a duty to respond to.

3. Authorities which rely in practical terms on the exercise of power, are particularly susceptible to sin, either by seeking personal benefits or abusing others, and therefore the risk that regulators, audit partners, company directors and others with governance roles, will do wrong in this way should be narrowly circumscribed.

4. Organisations, whether governmental, corporate or other, are comprised of individuals whose business or institutional character is indivisible from their private character; where the governance of an organisation is pervaded by sin, unchecked by the law, it will be inherently unsustainable and, in the long run, fail.

The “real-world” does in fact conform to a large extent to these principles with deviations from them being punished. Business does result in far more benefits from unleashing creativity than harm from scandal; attempts to replace markets with systems that rely on compulsion tend to fail; the role of regulators is strictly delimited in a democratic society. However, the adequacy of controls over audit partners, company directors and others with governance roles, is currently undergoing much debate. This article will examine the Enron scandal in the light of these principles and will demonstrate their effectiveness.

Background to the scandal

Enron is a relatively new company, formed in July 1985 by a merger

between Houston Natural Gas and Internorth, a natural gas company based in Omaha, Nebraska, leaving a natural gas pipeline with 37,000 miles of pipe¹⁵. Within 4 years Enron began trading in natural gas commodities and became the largest natural gas merchant in North America and the UK¹⁶. In November 1999, Enron Online was launched averaging about 6000 transactions a day worth about \$2.5 billion¹⁷. By 28th December 2000 Enron had become the US's 7th most valuable company¹⁸.

Scandal appears to have emerged at Enron in August 2001, when

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Sherron Watkins, an Enron employee, wrote to Kenneth Lay, Enron's Chairman and former CEO, warning of accounting irregularities that posed a threat to Enron¹⁹. In essence, these involved \$1 billion of debts allegedly hidden in numerous off-balance sheet partnerships, sometimes named after Star Wars characters, although one of the key offenders, Raptor, seems to owe more to Jurassic Park²⁰. Andrew Fastow, Enron's former Finance Director, had seen a \$25,000 investment in one partnership grow into \$4.5 million in a matter of weeks, with other executives enjoying similarly spectacular returns. In October 2001 Andersens, Enron's auditors, started to destroy audit documents²¹.

The powerful US SEC commenced a minor enquiry into conflicts of interest shown by the off-balance sheet partnerships when Enron reported losses of \$638 million with a \$1.2 billion reduction in shareholder equity relating to the partnerships²². Andrew Fastow was sacked within 8 days²³. By the end of the month there was a formal SEC investigation²⁴. By early November Enron revised its financial statements for the previous 5 years to show not massive profits as before but losses of \$568 million²⁵. Before the end of November Enron's shares had fallen to less than \$1 each; its credit rating was reduced to junk bond status; and shortly after it filed for Chapter 11 bankruptcy protection²⁶. In 2002 the US Justice Department began a criminal investigation and before January 2002 was out Clifford Baxter had committed suicide²⁷. By February 2002 litigation had been commenced by 430 former Enron staff seeking to recover hundreds of millions of dollars lost to their pension schemes²⁸.

Employee Incentives and culture

Central to a Christian analysis of what went wrong at Enron is a close look at what incentives were employed by the company. It seems that these were highly suspect with the remuneration plans of senior management being so tightly geared to the share price and the scale of rewards generated of such a scale as to beggar belief²⁹. Further, managers

in turn employed a system known as “rank or yank” whereby every employee’s performance was ranked 1 – 5³⁰. Employees who gained a 5 were out – the bottom 15% of workers were fired each year – with those who gained the best ranks being rewarded with staggering incentives – Bonus Day being known as Car Day because of extraordinary sports cars being awarded to the most successful³¹. The resulting impact on the corporate culture of Enron is scarcely surprising. On the one hand, Sherron Watkins, the whistleblower, complained that Enron was “... an aggressive place to work with staff enduring a climate of fear that made complaining difficult ...”³²

However, a former energy trader has been reported as saying that “It was insane ... there were no rules for people, even in our personal lives. Everything was about the company and everything was supposed to be on the edge – sex, money, all of it”³³.

From a Christian perspective then if we return to the principle that systems and regulation should be devised on the basis that people should be encouraged to attain the highest but hindered from doing the lowest, the Enron scandal appears to have been caused in no small part due to the flawed incentives that existed and the distorted culture to which they gave rise. In principle, incentivising management to increase share price is a desirable goal: growth in share price is a measure of how well the company’s managers are looking after the assets entrusted to them and should result in the owners, often pensioners, being well-

provided for. But at Enron it seems the stakes were made so high as to become a temptation for managers to engage in wrongdoing and to create a culture in which such wrongdoing was accepted or encouraged. Once structures such as those at Enron are in place, even if in principle an individual should seek to resist them (see, for example, Exodus 23: 2 “Do not follow the crowd in doing wrong”), this may not be feasible, leaving resignation as the only (and for many a very costly) solution. Certainly, past and present employees of Enron and the auditors should now speak up or they will share moral responsibility for the

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scandal. The principle underlying this derives from Leviticus 5:1 “If a person sins because he does not speak up when he hears a public charge to testify regarding something he has seen or learned about, he will be held responsible”. It also accords with the New Testament principle of love of one’s neighbour. However, those who established such incentive systems bear the greatest culpability, being not only responsible for their own wrongdoing but for that which they caused others to commit³⁴. There can be little doubt that the intense loyalty demanded of Enron’s employees – like that of so many employers – would have placed any Christian in conflict with their loyalty to God.

Off balance sheet finance

Off-balance sheet finance has been said to be difficult to define because it implies that certain things belong on the balance sheet and that those that escape the net are deviations from the norm whereas there are no authoritative general principles which determine conclusively what should be on the balance sheet and when³⁵. Accordingly, to an accounting standard setter the expression carries the connotation of devious accounting, intended to mislead the reader, whereas there is room for more honourable use of the term, for example, where companies for sound commercial reasons wish to share with other parties the risks and benefits associated with certain assets and liabilities³⁶. Off-balance sheet finance has tended to occupy the central stage in much of the debate about the Enron scandal. However, once the

issue of management incentives is identified as a potentially major issue then it becomes clear that the means by which share price is inflated becomes secondary. Nonetheless, it remains of importance here because the doctrine of disclosure which underpins the Anglo-American system of company law relies upon shareholders and others being appropriately informed. As one well-known American judge, Mr Justice Brandeis, put it: “Sunlight is the best of disinfectants; electric light the best policeman”³⁷. Which, of course, returns us in a sense to the question of incentives. Management which knows that its actions will receive public scrutiny will be most unlikely to break the law or act in a morally reprehensible fashion. And by and

large this has been one of the great successes of the Anglo-American approaches to company law (perhaps with the notable exception of directors' remuneration!): after all companies which are the subject of scandal are the exception.

From a Christian perspective, reliance upon disclosure as a principle of regulation to influence behaviour has much to commend it. When Jesus sent out the twelve disciples he encouraged them saying "So do not be afraid of them. There is nothing concealed that will not be disclosed, or hidden that will not be made known. What I tell you in the dark, speak in the daylight; what is whispered in your ear, proclaim from the roofs"³⁸. More generally, it is in line with the biblical approach to free will. Indeed, the Enron scandal has served a useful function here. There seems to be a measure of consensus that the US accounting and audit requirements were flawed; the US Financial Accounting Standards Board did require the disclosure of relationships such as those Enron enjoyed with the off balance sheet partnerships but the rules were unduly prescriptive unlike those in the UK and therefore easily evaded³⁹. The rules therefore can be improved and little more needs to be said on the issue.

The scramble to blame and avoid blame

After any major corporate collapse there is the unedifying spectacle of a scramble to blame and avoid blame. For obvious reasons the board and the auditors are in the immediate firing line followed by the regulators. This is unsurprising: they have the

deepest pockets to meet any legal claim and provide a useful focus for the inevitable anger. The board of directors of Enron has been attacked on a number of counts. It has been alleged that the board suspended Enron's code of ethics to approve the off balance sheet partnerships⁴⁰. More generally, Enron has been attacked for weak corporate governance in not possessing a clear leader of its non-executive directors, the independence of its non-executives and for its audit committee failing to hold its accounts up to appropriate scrutiny⁴¹. Four Enron directors, however, have responded to a US Senate Committee investigation that they were not to blame because key

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Enron executives and the auditors hid key information from them⁴². Andersens, now removed as auditors of Enron, have come under scrutiny amongst vigorously defended allegations that its staff improperly shredded relevant documents and that it was too cosy with Enron: Andersens Houston office audited Enron since 1984 and Enron hired Andersens personnel into senior finance jobs⁴³. However, it must be borne in mind that if the relevant accounting standards were flawed then Andersens' culpability may be limited; also, even if there was impropriety, the question of incentives must be considered: at present auditors are in the immediate firing line – innocent or guilty – whenever there is a major corporate

collapse. Such a system must put an enormous strain on integrity and merits reconsideration⁴⁴. Regulators have also been criticised⁴⁵. Indeed, the list of bodies investigating the Enron scandal is vast, including the SEC, the US Justice Department, the FASB, 9 committees or sub-committee's of Congress and 2 separate White House task forces⁴⁶. In the UK the Myners committee has been established to review the effectiveness of non-executive directors⁴⁷.

From a Christian perspective there should be caution in rushing to judgement. The behaviour of groups in seeking to judge others is generally the subject of criticism in the New Testament; when the teachers of the Law and the Pharisees wished to stone an adulterous woman, Jesus responded "If any one of you is without sin, let him be the first to throw a stone at her"⁴⁸. It is important, therefore, to avoid this and attempt to criticise with love and a desire for truth. The gift of prophecy is a more desirable gift than that of hindsight. No doubt had the directors, auditors and regulators been able to foresee what could happen they would have acted differently and it is remarkable in some ways that they did not. Nonetheless, the capacity of those in positions of authority to be blinded to the significance of their own actions is commonplace and may well have a spiritual significance⁴⁹. Some support for this is provided by the evidence of the private lives of some of the key figures in the scandal. Clifford Baxter, Enron's former vice-chairman, is said always to have put his family before his career, leaving his desk at 6pm to

drive home, taking his children to Disneyland each year, and to have supported several local charities, including giving £3,000 to his local Catholic church in 2000⁵⁰. Shortly after his death, a crowd of several hundred past and present Enron workers held a prayer vigil at a Baptist church in Houston addressed by the Reverend Jesse Jackson⁵¹. It would seem probable, especially in a US context, if some at least of those who participated in the Enron scandal were Christians. It would be wrong to demonise Enron (as evidenced by media use of terms such as “Enronised” or “Enronitis”) and the people associated with its fall; that would be easy for then we put them into a separate category, somehow different from ourselves, and therefore less disturbing to judge. But that option is not open to us. Instead, we are caused to ask much more painful questions as to how we apply “faith in business”.

Conclusions

The Enron scandal has had a major impact both in terms of those within the company – shareholders, directors and employees – and those outside – its auditors, creditors and regulators. If anything it is surprising that the economic impact of the collapse of the US’s 7th largest company has been so relatively slight. Perhaps its true significance lies more in the awkward questions which it forces those concerned with business, or indeed anyone concerned with large organisations generally, to face. Certainly at present whilst investigations are incomplete and legal proceedings pending only highly provisional conclusions may be drawn. Nonetheless, the four

principles which were set out at the beginning for a Christian perspective on business stand the test of Enron. Somewhere within Enron there were those with practical authority who used it to seek personal benefits by creating incentive schemes so outrageous that not only did they cause themselves to sin but led them to encourage others to do so. Not surprisingly, given the culture that resulted, Enron eventually failed. The role of markets, supported by US bankruptcy legislation, has been to pick up the pieces.

There is a danger of Christian triumphalism, however, over these provisional conclusions. They imply

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that somehow there is a distinct category of human affairs known as business and that somehow “we” Christians are able to provide a detached perspective from outside on “it” or “them”. However, the facts are likely to contradict this. Enron was the US’s 7th largest company. Given the high proportion of professing Christians in the US in all probability there were a high proportion of Christians in Enron. And if not inside Enron amongst the families of those who worked there, its auditors, lawyers, bankers or regulators. What were they all doing? A key question is as to what US Christians have been taught about business. Certainly the stereotypical image of US Christianity is one of

an emphasis on a “prosperity gospel”. The effect of such a gospel might well be that Christians might fail to question exactly where their company’s money comes from, what they are doing to earn it and to make them very reluctant to risk losing it. Yet it is a strange irony that Enron happened to be based in Houston, Texas. One of the most influential books on the author as a student was *A New Way Of Living* by Michael Harper (London: Hodder & Stoughton, 1973) based on the extraordinary growth of the Church of the Redeemer, based in inner city Houston, Texas, and its development of a community life-style encompassing both wealthy professionals, business-people and human wreckage. Whilst much may have changed in nearly 30 years more than a stereotypical “prosperity gospel” had been preached where Enron was based. What went wrong?

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