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Resisting Corporate Corruption

2nd edition
Cases in Practical Ethics from Enron through the Financial Crisis

Stephen V. Arbogast

Scrivener Publishing

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Acknowledgements

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Special thanks also go to the Enron resisters, Sherron Watkins, Jordan Mintz and Vince Kaminski. These three gave generously of their time during the writing of the first edition. Each then came to my Ethics and Finance class at the Bauer College to discuss their case studies. The discussions were not always easy for them. Frequently they involved searching critiques of their actions and their reasons for not taking other routes. All three remained open to the discussion, and actively participated in the “what else could have been tried” brainstorming. Sherron Watkins has also been a steady font of information about corporate governance, business ethics and whistleblowing. It was Sherron who put me in contact with Richard Bowen; the Citigroup cases were made possible as a result.

Thanks go also to those who looked at the outline for this 2nd edition or the cases themselves and offered encouragement and suggestions. Gretchen Morgenson and Bethany Mclean both looked at the book’s outline and encouraged me to proceed. Loren Steffy, business columnist for the Houston Chronicle, did the same. Loren also put me in touch with Francine McKenna, whom he described as a most valuable source on accounting and audit issues. Francine completely lived up to that reputation. Several cases, notably the AIG case, were significantly improved as a result. Richard Bowen patiently guided me through the labyrinth of Citigroup’s organization and controls system.

Eric Kolchinsky, the former Moody’s Managing Director, deserves special recognition. Despite having to rebuild his career from scratch following his forced departure from Moody’s, Eric found time to educate me on the methodologies used to rate subprime mortgage securities. He also candidly described the life of a whistleblower in the financial world. This shed light on certain inadequacies in the Sarbanes Oxley (SOX) whistleblower protections,
a reality recognized by the fact that such protections were enhanced by
Dodd-Frank.

Dr. Praveen Kumar, Finance Department Chair at the Bauer College of
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cases and to compile the tactical toolkit described in this 2nd edition. Dr.
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Her passion for the cause of resisting corporate corruption also led her to
argue that "Watchdog Blogs" could be an important option for resisters. Her
contribution here is reflected especially in the Lehman Brothers case and in
the Note on Blogs and Lawyers.

Last but not least, more than thanks go to my wife, Deborah, and my
son, Greg. Their love and encouragement, plus the occasional reminder to
take a needed break, were essential to sustaining me during the writing of
this work.
I first met Stephen Arbogast in 2006, when he was doing research on the first edition to *Resisting Corporate Corruption*, an incredible case study focused solely on the Enron scandal. The case studies included those of the key players, the well known names of Ken Lay, Jeff Skilling and Andy Fastow, but also, it delved into the lesser known executives at Enron whose actions or lack thereof became critical to the success of the accounting and legal fraud that took place at the company. Extensive research was done in these case studies to reveal the subtleties of corporate opposition to the truth and the difficult options middle level executives and managers faced, including me. Careful study of these cases can help young professionals spot ethics issues early enough to address them, and also furnish tactical options for promoting ethical outcomes and protecting themselves.

In December of 2001, the Enron Corporation collapsed into bankruptcy and scandal, and my life and career changed drastically in ways I could never have imagined when I graduated from the University of Texas at Austin with accounting and business honors degrees twenty years prior.

I met with Enron’s Chairman and CEO, Ken Lay, in August of 2001, to warn him of hidden accounting problems that I believed could kill the company if not corrected. I was certain he’d form a crisis management committee to address the imminent peril, but he (perhaps purposely) did not ‘hear’ me. The problematic structures were written off in a way that is not permitted by the accounting rules. Rampant speculation from Wall Street, coupled with perplexing financial moves at Enron, combined to realize my worst fears - “the company imploded in a wave of accounting scandals.” Enron filed for bankruptcy just six short weeks after the disclosure of the questionable write offs.

My memos to Lay were discovered by Congress and I was subpoenaed to testify about Enron. My life was never the same. From the Congressional investigations and testimony, to shareholder litigation, to becoming a government witness at criminal trials, to a swarm of media attention culminated in *Time* magazine’s Person of the Year issue in December of 2002 with Coleen Rowley, Cynthia Cooper and me, pictured on the cover titled “The Year of the Whistleblowers”. Deserved or not, the label Enron whistleblower means
I will not work in Corporate America again, but I have found a passion of sorts, and that is speaking around the globe of my first hand account of Enron’s ethical and leadership lessons.

After a decade of speaking on the topic, I am often dismayed at two grave misunderstandings about ethics and being ethical. First, that “teaching ethics at the college level is pointless, it is too late to mold a value system at that age.” The second is the naïve outlook most college students maintain regarding the ethical challenges they will face in their career, namely that the ethical dilemma will be clearly seen and the choice to do the right thing, easy to make.

The financial scandal at Enron produced twenty-one felons, eleven served hard time, ten served probation, and one, Ken Lay, died before his sentencing for securities fraud convictions. Arthur Andersen, Enron’s auditing firm, collapsed under a federal indictment for obstruction of justice (shredding documents), four Merrill Lynch bankers and three Nat West bankers were found guilty of various crimes akin to abiding and abetting Enron’s shaky financial schemes. Hundreds more, at Enron, Andersen and various banks and law firms were targeted by the Department of Justice and investigated, often spending their life savings to avoid indictments. Others lost CPA licenses, paid fines and otherwise had their careers and reputations ruined. Chase, Citibank and Canadian Imperial Bank (CIBC) settled Enron shareholder litigation with payments of $2 billion each.

What happened? A complete breakdown in moral values? Yes, but the scary part is that the breakdown was not by outright intent, but more by small steps in the wrong direction.

Enron employees made the wrong choices, choosing unethical paths, but all of them, (at least nearly all of them), never thought they were breaking the law, they did not intend to break the law (for the most part, white collar criminals rarely intend to break the law). They rationalized their behavior. Ethical choices as an adult are masked. Of course if asked to do something wrong, we’d all say NO. But if that choice is disguised, and presented in a positive manner, all the psychological tests from Yale’s Milgram shock tests of the 60s, to Stanford’s prison experiment in the early 70s, show that ninety percent of us will choose to act unethically, even extremely unethically.

This is the reason I believe so strongly that universities must require ethics as a core curriculum in all business degrees. The complaint that one cannot teach or mold values at the college level is irrelevant; that is not the point. We must teach ethics so that our business graduates will not freeze like a deer-in-the-headlights when unexpectedly faced with an ethical challenge. The frozen-in-fear reaction will result in the same consequence as the deer, by not taking action, the ethical challenge leaves you as road kill. You have ‘gone along’ with it, just by not doing anything.
Ethics courses that utilize case studies like those in Resisting Corporate Corruption cause students to work through a wide variety of ethical challenges. They also provide a tool kit of sorts for students to utilize in the real world. This kind of practical ethical training is essential. Without any knowledge of how to spot and address an ethical challenge, most employees will fall victim. The pressures are just too great to do otherwise.

Case studies also help to dispel the second misunderstanding about ethical dilemmas, which is that the ethical choice will be easy to see and respond to appropriately. I am shocked at the number of college students that firmly believe they’d quit; walk out the door, as soon as unethical behavior is asked of them. I know of no one who, when the moment of truth arrived, has taken that stance. The pathway to avoid unethical behavior is rarely clear-cut, and often fraught with unexpected turns and outcomes. Studying these crooked and perilous paths, with some succeeding and some ending in ethical lapses, helps prepare students for the real world.

Stephen Arbogast’s second edition of his book, Resisting Corporate Corruption, is a perfect example of real life ethical case studies. The second edition retains valuable lessons from Enron, but has been updated to include real life examples from the corporate and financial scandals that continued throughout the decade, culminating in the financial collapses in 2008 of Wall Street powerhouses.

Rarely will employees do wrong when asked to do so outright, but when an inappropriate course of action is masked properly, it is rare for employees to challenge it. Students of Resisting Corporate Corruption will benefit from the authenticity and accuracy of the cases, hopefully helping them in their careers to either avoid or prevent another Enron, Countrywide or Lehman Brothers from happening.

Sherron S. Watkins,
September 2012
Preface to the Second Edition

I T IS INCUMBENT WHEN WRITING A SECOND EDITION to explain why one is necessary. This is especially the case for a work whose foundation consists of case studies about the Enron scandal. After all, Enron’s demise is now more than ten years in the past.

The reasons for considering a 2nd edition began to materialize in fall 2007. It was at that time that news began to surface about Citibank having stashed billions of questionable mortgage securities in “Structured Investment Vehicles (SIVs).” Citi used these SIVs to keep both toxic assets and associated debts off its balance sheet; incredibly, the bank then took the SIVs back on its books, and did so at the worst possible time. Citi was under siege. Its stock was plummeting, and its creditors were withdrawing funding. This sounded a lot like Enron’s last year. The analogy immediately raised questions – how was Citibank even able to use SIVs in this way? Didn’t the post-Enron reforms, the Sarbanes-Oxley law (SOX) and the FASB Variable Interest Entity rules preclude such gamesmanship?

As the financial crisis unfolded more uncomfortable episodes surfaced. Many suggested that the lessons of Enron’s demise had not been applied. Once again public audit firms seemed compliant in the face of questionable accounting. Financial statements proved opaque or misleading. Fraud turned mortgage securities into ticking time bombs. Managements seemed to lose a grip on their financial condition – until markets revealed it to them in stark terms at the eleventh hour. Whistleblowers went unheeded, except where they were being fired and defamed.

The events of 2007-08 thus suggested the financial world suffered from many of the ills that afflicted Enron. It was clear that unethical practices were not being avoided by top management; neither were they being deterred by law or regulation. Whether this was a product of ignoring the lessons of Enron, or different fundamentals for the financial industry was unclear.

I began to consider writing a 2nd edition in order to find out.
From the 1st to the 2nd Edition

The 1st edition of Resisting Corporate Corruption started with a similar purpose. Appalled by the sheer audacity of the frauds perpetrated at Enron, I set out to discover how this had happened with so little resistance. The heart of my question was this – what happened to the employees and executives of integrity? Why had there been so little “push back” within the ranks at Enron?

To get at this question, the 1st edition examined critical moments when a major ethical issue hung in the balance. A key decision maker was the focus of each Enron case. Some cases focused on top executives, e.g. Ken Lay and Jeff Skilling. Others dealt with less prominent figures (e.g. Ben Glisan) or even obscure individuals, like auditor David Woytek. The cases were chosen because, with the benefit of hindsight, an important ethical issue was at stake. The case protagonists were people in a position to influence the outcome.

Research was undertaken to identify all the conflicting interests and pressures influencing the decision. This included the “politics” of the situation, i.e. the organizational dynamics and personality traits that enter into real world situations. Each case ended with the decision maker’s choice hanging in the balance.

The final step involved devising “solutions” for each case. The goal here was to identify an alternative path to a more ethical outcome. This involved identifying the correct ethics issue, the associated business problems, an alternative business strategy to the one involving problematic behavior, and tactics to implement the alternative course. This step-by-step process coalesced into the method outlined in the “How to do an Ethics Case Study” essay. The purpose of devising such solutions was less to second guess what happened, and more to train students to identify ethics issues and think tactically about how to secure satisfactory outcomes.

Having outlined a general methodology, the next task was its application to concrete cases. This happened in the classroom. The 1st edition became the basis for a new course, “Finance and Ethics”, at the C.T. Bauer College of Business. This course explored the options available to Enron’s executives and the tactical options available for resolving the case dilemmas. Jordan Mintz, Vince Kaminski and Sherron Watkins participated in this process, coming to class, listening to student presentations, and thinking out loud about “what might have been done differently.” The resulting tactical options and solutions were then distilled and collected into a tactical “toolkit” for working ethics issues.

This toolkit was devised by applying to ethics issues the same organizational political arts that get used to secure operating budgets or a project approval. This toolkit is discussed in Essay 4 below. Creation of the toolkit
gave rise to a broader conclusion. Business ethics needs to incorporate this kind of practical training into its curricula. Students need to be able to figure out how to fight for ethical outcomes on ground that is often complicated and hostile.

Resisting Corporate Corruption, 2nd edition, springs from an impulse similar to that which produced the 1st. Stunned and outraged at the scandalous behavior visible during the financial crisis, I wondered how this could have happened a scant six years after Enron's collapse. Nothing seemed to have changed. Was this in fact true? If so, was this because important Enron lessons had gone unheeded? The 2nd edition attempts to find this out.

The 2nd edition's methodology is similar to the 1st. This time, however, the cases cover numerous firms. Events at Countrywide Mortgage, Fannie Mae, Citigroup, Goldman Sachs, Bear Stearns, Moody's Investors Services, AIG and Price Waterhouse Coopers are examined. Four of these firms, Fannie Mae, Citigroup, Goldman and Moody's, are the subject of multiple cases. This allows for an examination of ethical issues earlier in their gestation, and then a second look after conditions have become critical. Students can then reflect on whether the agonies faced by Fabrice Tourre and Daniel Mudd would have developed if Hank Paulson and Jim Johnson had acted differently years earlier.

The financial crisis cases also update students on changes in the "resistance landscape" since Enron. Students are informed about the protections ensconced in the SOX and Dodd-Frank legislation. They then have an opportunity to consider the plights of Eric Kolchinsky, Richard Bowen, Matthew Lee and Sherry Hunt as they struggle against illegal practices at Moody's, Lehman Brothers and Citigroup. Some of the resisters' "real time" thinking is offered in these cases.

Finally, the 2nd edition allows students to test the tactical toolkit derived from the Enron cases. Were there viable "solutions" to the financial crisis cases? Would the tactics applied to Enron’s dilemmas have gained any traction within Goldman or Citigroup? The thirteen financial crisis cases offer a chance to test tactical plans and think through what might have been done differently. This time however, we don't start from scratch.

Organizing the 2nd Edition

Resisting Corporate Corruption, 2nd edition, again offers the key Enron case studies. A new case covers Enron's manipulative trading practices in the California power market. The "resister" cases with their tactical options are here as well along with 1st edition essays on how to do an ethics case and on the economic rationales for financial control. A new essay attempts
to summarize the lessons of Enron as a prelude to studying the financial crisis.

To introduce the financial crisis, this author provides a personal memoir of how Wall Street changed between 1973 and 2004. During this span I witnessed major changes in banker objectives, their treatment of clients, and in firm cultures. Hopefully this memoir provides helpful background about the larger forces that produced these changes in the financial industry.

The financial crisis cases fall into three categories. The first tries to shed light on how changing business models undermined controls. Here we deal primarily with top managers responsible for their firm’s ethical culture. These include Angelo Mozilo of Countrywide, Jim Johnson of Fannie Mae, and Goldman Sach’s Henry Paulson. Their cases depict both the pressures and ethical choices they faced.

The second set of cases focuses on what might be called “the unheeded lessons of Enron.” Here again we take up the consequences of decayed controls and compromised gatekeepers. Among these consequences is dubious financial disclosure. The Citigroup case, in particular, provides a detailed look at a bank’s use of off-balance sheet entities to disguise its exposure to subprime mortgage securities. We also get to see conflict of interest issues as Goldman Sachs works with hedge fund manager John Paulson on the “ABACUS” subprime CDO deal. The set concludes with AIG facing off against its auditor, Price Waterhouse Coopers – a case which examines whether SOX’ attempt to improve the client/auditor power balance has overcome the dilemmas posed by a willful client.

The final set of cases updates the circumstances facing resisters. Here is where students get to consider whether SOX’ whistleblower protections have made a difference. The cases tell cautionary tales about the challenges awaiting whistleblowers. Yet, these stories offer hope in different forms. The whistleblowers got to tell their stories in public forums. All gave detailed accounts of unsound practices which have been digested by regulators. Here students will get to consider whether the whistleblowers adopted courses represented the best of available tactical options. Here also they get to brainstorm on the tactics of resistance in the age of blogs and social media.

A final essay reflects on the lessons of Enron, SOX and the financial crisis with an eye to reconsidering how best to teach business ethics in the future.

Two preliminary conclusions deserve mention. First, the ethical lessons of Enron are still very relevant. The reappearance of similar issues during the financial crisis strongly suggests that several causes of Enron’s demise have yet to be remedied. As for the second conclusion – it would seem that the combination of innovative instruments and huge trading-based business models is very threatening to ethics. This combination promotes efforts by
financial firms to exploit information advantages. When these cannot be created via authentic innovation, the temptations to resort to unethical practices seem large indeed.

The cases that follow are thus offered in the hope that they may contribute to assuring there is not another episode where the lessons of Enron must be revisited.

Houston
December 23, 2012
R esisting Corporate Corruption, 2nd edition is intended for use by Business School faculty in a full semester MBA course. Selected cases are also recommended for incorporation into Law School and continuing legal education courses (CLE). Corporations and financial firms will find many of the cases helpful for business practices and ethics training.

The book is best used within a full semester framework. The 1st edition provided the central text for a 13 week course, Finance and Ethics, at the University of Houston’s C.T. Bauer College of Business. This course was taught three times from 2008-2011. Students typically prepared and presented solutions to two cases per class. The solutions emphasized the method discussed in the Essay: How to Work an Ethics Case (see Essay 1). The professor supplemented the case work with short lectures introducing controls subjects and business practice issues, e.g. the role of internal audit, guidelines for related party transactions. Finally, notable resisters were brought into class to review proposed solutions to their cases. These visitors included Enron’s Sherron Watkins, Jordan Mintz, and Vince Kaminski, and Eric Kolchinsky of Moody’s.

The solutions developed from this course work are compiled and available in the Solutions Manual to Resisting Corporate Corruption. This CD can be obtained from www.scrivenerpublishing.com. Teachers considering use of the 2nd edition are encouraged to look at the Solutions Manual. It will provide concrete examples of the kinds of tactical toolkits and plans which were alluded to in the Preface. Since business ethics is not physics, these solutions may not be the only or even the best possible plans. The key point is to get students thinking within this framework and motivated to find better solutions within today’s circumstances.

Resisting Corporate Corruption, 2nd edition now comprises 27 case studies, versus 17 in the 1st edition. A typical 13 week semester course can readily accommodate 22 case presentations. This leaves time for introductory material and a midterm. This approach also leaves room for including outside material and some cases that can be used as exams.

Individual cases can be assigned as exams. “Court Date Coming in California” served this purpose in the UH-Bauer courses, with students asked
to produce PowerPoint slides framing a solution and draft letters providing instructions to Enron executives and outside counsel. Several cases make use of attachments labeled "Historical Recreation." Most times these are presented as draft documents meant to capture a protagonist's thinking or the work of a staff. It is important to note that these are not actual historical documents. Rather, they are teaching materials designed to provide background and frame choices for the case decision maker. This technique has been used because the public record frequently provides relevant information, just not in the condensed format most compatible with a case study. Where this technique is used, faculty should consult the Author's Note at the end of the case. It will describe the reasons for providing the attachment and the source material on which it is based.

Law and financial training courses will want to select individual cases suited to their particular focus. For example, several cases contain material on securities laws, SEC rules, and the challenges of public disclosure from a difficult set of facts. Others discuss the role of internal audit and its need to sustain political support for investigations into sensitive areas. These cases can provide a practical dose of reality to complement a fundamental treatment of what the law says or how audits are conducted.

Select cases (and central issues) recommended for use by Law Schools and CLE programs include:

- New Counsel for Andy Fastow (SEC disclosure, use of outside counsel)
- Court Date Coming in California (severe legal exposure, unhelpful counsel opinion)
- Lay Back...and Say What? (SEC Rule 10b-5 exposure & CEO public remarks)
- Whistleblowing before Imploding in Accounting Scandals (Whistleblowers pre-SOX)
- Time to Report Moody's to the SEC? (Rating Agency liability exposure)
- Take CitiMortgage to the Feds? (False Claims, Dodd-Frank Acts' whistleblower incentives)

Specific case recommended for internal business practice/ethics training include:

- Enron Oil Trading A & B (Audit irregularity investigations & management political support)
- Enter Mark-to-Market (C): The Disease Spreads to Enron Clean Fuels (Resisting flawed accounting aimed at favoring business units over the general interest)
- Adjusting the Forward Curve in the Back Room (Manipulative accounting tied to "Mark-to-ModeV assumptions)
- Jeff Skilling and LJM: The "Shoot the Moon" Meeting (Abusive related party transactions)
Write to Rubin? Pressure on Underwriting Standards at Citigroup
(Control structures in large organizations; political pressures on underwriting practices)

Take CitiMortgage to the Feds? (Quality assurance and reporting of major violations)

Finally, faculty needs to strike a certain balance in the perspective brought to teaching this material. When discussing how to resist unethical behavior, there is a need to impress upon students that they enjoy more tactical options than is widely imagined. Conventional wisdom often argues that tough cases distill down to “go along” or “go.” This mentality needs to be challenged. The cases provided here should convey that many more options exist, and that individuals have already used them successfully. Individual resistance can make a difference, even in pretty dire circumstances.

At the same time, the difficulties awaiting resisters should not be underplayed. Students unlucky enough to face circumstances analogous to those of Watkins, Kolchinsky, Lee or Hunt will not have an easy time. Knowing their stories, knowing too the new legal protections and communications options in play, can help them confront the difficult choices they face.

Instilling the broader perspectives offered by these cases may also enable future executives to spot and defuse ethics problems before they reach the critical conditions portrayed in this book.
SECTION I
The Enron Cases

PART I
DEMOLISHING FINANCIAL CONTROL, NEUTERING THE GATEKEEPERS
Case Study 1

Enron Oil Trading (A):
Untimely Problems from Valhalla

This environment is hardly giving us room to breathe.
The last thing we need is a public scandal.

It was the end of the business day, February 1, 1987. Ken Lay, CEO of Enron Corporation, sat at his desk, ruminating over his agenda for the following day. Tomorrow's schedule showed a morning meeting with Internal Audit and two top officers from Enron Oil Trading (EOT). Louis Borget, president of EOT and Tom Mastroeni, the treasurer, were coming down from their headquarters in Valhalla, New York. They had been called to Houston to answer charges of opening undisclosed bank accounts to conduct unauthorized transactions.

Lay had already heard a bit about the controversy. He again skimmed an Internal Audit memo (Attachment 1) that summarized the issues. The essence of the matter concerned an account opened by EOT at the Eastern Savings Bank. Borget and Mastroeni were the authorized signatories on the account but had failed to report its existence to Enron's Houston headquarters. Millions of dollars from EOT trades had found their way into this account. More worrisome, some $2 million had then been transferred into Mastroeni's personal account at the same bank. Internal Audit suspected that Borget and Mastroeni had EOT engaging in unauthorized and/or fictitious trading, skimming money for personal gain.

Houston oversight of EOT was the responsibility of John Harding and Steve Sulentic. Lay sought out their views upon receiving Internal Audit's report. Eventually, they got back to Lay with a story that the undisclosed account involved transactions that were legitimate and in Enron's interests. The transactions in question were "twinned trades": equal and offsetting buy/sell transactions used to move profits from one accounting quarter to another; such trades, they observed, were not uncommon in the trading business. Borget and Mastroeni would come to Houston, bring their bank records, and explain everything. Lay had pressed lightly on the point of
EOT's not reporting the Eastern Savings account to Houston and had gotten an answer to the effect that perhaps some unfortunate shortcuts had been taken but the underlying motives were ok.

Ken Lay hoped that this would turn out to be true. As he pondered how to run tomorrow's meeting, his mind wandered back over Enron's recent history and current predicaments.

**Natural Gas Pipelines in Crisis**

Ken Lay had only joined Enron in June 1984. It was not then known as Enron; the company that Lay took over as chairman and CEO was called Houston Natural Gas (HNG). Lay had assumed the helm at a difficult transition time for the natural gas pipeline industry. Long-standing players, such as HNG, were finding that the industry business model was rapidly changing. Prior to the mid-1980s, natural gas producers sold gas to pipeline owners under long-term contracts. In order to induce producers to commit their gas, pipeline owners customarily provided long term deals with floor prices and a commitment to "take or pay" for gas: take a minimum volume of gas at a stipulated price or pay the cash equivalent of having taken the specified gas amount.

Two things happened in the 1980s to destabilize this model. The first concerned the value of newly produced natural gas; prices had fallen to rock-bottom levels, below $2 per million BTUs. The second was a regulatory change. No longer would pipeline operators be able to lock out producers who didn't commit to ship through their lines. Instead, gas producers were now able to sell directly to end users and require pipelines to ship their volumes for a simple transport tariff.

These changes rocked the gas pipeline industry. Newly developed gas started finding its way directly to end users at the low spot market price. Major carriers increasingly found themselves burdened with gas purchased earlier at higher prices under take-or-pay contracts. Pipeline company financial conditions deteriorated. Debt ratings were downgraded. The carriers labored to work their way out from under disadvantageous contracts. HNG was no exception.

Ken Lay thought he knew how things would play out. His assessment was that natural gas market deregulation would continue to progress; from this, he concluded that future profitability would become a function of scale—that is, the biggest pipeline companies with the most extensive networks would become low-cost providers and would end up dominating a market of natural gas production sold largely at spot prices and moved via low-cost logistics.

As if on cue, the gas pipeline industry began to consolidate. Again, HNG was no exception. In April 1985, a call came from Omaha-based Inter-North
suggested a merger. Inter-North was approximately three times the size of HNG. However, its senior management was aging, its board was divided and both were uncertain about how to cope with the deregulated market. A corporate raider, Irwin Jacobs, was stalking the company. Inter-North needed a deal.

Immediately prior to the merger talks, HNG stock was trading at $45 a share. In just eleven days, Lay was able to extract both a $70 per HNG share price (a 56 percent control premium) and a commitment that he would move up to CEO after a couple of years. The Inter-North/HNG merger closed within the year, and the new entity was christened Enron in 1986.

Unfortunately, the merger did little to alleviate the pipeline company’s immediate economic straits. Profitability was miserable. The natural gas glut seemed to produce ever-lower prices. Enron had to face this deteriorating environment with more than $1 billion in take-or-pay contract liabilities. Enron reported a $79 million loss for 1985, its first year of operation. Attachment 2 details Enron’s financial performance for 1985-’86. Although Enron reported net profits of $556 million for 1986, the bulk of that reflected recoveries of past income taxes. Enron’s financial condition was more accurately reflected by the following: earnings before interest and taxes (EBIT) $230 million; interest expense: $421 million.

Enron was now heavily debt laden, the product of Inter-North’s having used debt to fund the premium price for HNG’s stock. To some extent, this leveraging up of the company had been intentional Irwin Jacobs’ group was being paid $350 million to hand over its Inter-North stake and go away. Inter-North thus reckoned that a heavy debt burden would act as shark repellent for future raiders; however, high debt levels also hamstrung the newly merged entity. Ken Lay found that his firm’s bank loans contained covenants requiring quarterly interest expense to be covered 1.2 times by EBIT; failure to do so would mean an event of default. Enron would be especially exposed in such case, as the firm also had more than $1 billion of commercial paper outstanding. These unsecured short-term promissory notes had to be rolled over continuously. A hiccup on bank loan covenants could spark a full-fledged financial crisis should it lead commercial paper buyers to flee from Enron’s paper.

In January 1987, Moody’s Investors Service downgraded the company’s long term rating to below investment grade, i.e. to junk status.

This perilous financial condition meant that Ken Lay spent much of 1986 focused on maintaining liquidity and avoiding the default triggers in Enron’s bank loans. Lay froze senior executive pay and sold some pipeline assets. Enron stayed afloat, but the company was barely scraping by.

In fact, a good portion of the company’s razor-thin margin for error was being contributed by a little-known and understood entity, EOT. Inter-North had created the subsidiary back in 1984. Trading oil commodities was a rel-
atively new business at that time. Inter-North chose to enter the business by hiring an established trader, Louis Borget. Inter-North lured him away from Gulf States Oil and Refining, where Borget had set up a similar unit three years earlier. The package to induce Borget to move included bonuses tied to the profits produced by the trading operation.

EOT immediately began to report profits. In 1985, when the merged Inter-North/HNG lost $79 million, EOT made $10 million. In 1986, when Enron couldn’t cover interest expense with operating earnings, EOT reported profits of $28 million.

Ken Lay still wasn’t sure what to do to fix Enron’s financial problems. He believed that long term, deregulation would reward his company. For the near term, Enron seemed bogged down in a bad business environment of low prices, intense competition, and the burdens of high debt. One thing he did know was that EOT’s contribution was helping the company cope in the short run while it waited for the longer run to bring improved conditions.

Lay had another, more political problem closer to home. The board of Inter-North had rebelled against his predecessor, Sam Segnar, concluding that he had caved in to HNG’s demands during the merger negotiations. Segnar had ended up paying with his corporate head. Lay replaced him but soon faced bitter resistance from former Inter-North directors on a series of secondary but highly symbolic issues: the appointment of Enron’s public accountant and the relocation of Enron’s headquarters to Houston. The issues eventually were resolved, with Lay getting his way on the relocation. Lay had also begun to replace former Inter-North directors with selections more supportive of his leadership. Still, at the outset of 1987, Ken Lay was a CEO under the microscope, facing a board that was divided and in some cases personally bitter toward him.

None of this was lost on Ken Lay as he skimmed over Internal Audit’s memo yet another time.

**Considering the Options**

Lay’s mind quickly focused on shaping an outcome for the meeting.

What do I do to resolve this issue? I’d better walk into this meeting with some idea of the answer we want at the end.

What really matters here? What issues take priority over others? I have to give preference to the financial condition of our company. This means that EOT’s profit-generating capability needs to be preserved. Moreover, a financial scandal right now could be devastating. Not only might EOT’s profit contributions be affected, but Enron’s past financial results might have to be restated. Accounting restatements are yellow flags, signs that something major is amiss inside a company. It wouldn’t be long before Enron’s equity analysts and lenders get wind of unreported bank accounts, and dubious