Resisting Corporate Corruption

CASES IN PRACTICAL ETHICS FROM ENRON THROUGH THE FINANCIAL CRISIS

Stephen V. Arbogast

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Cases in Practical Ethics from Enron Through the Financial Crisis

Third Edition

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I first met Stephen Arbogast in 2006, when he was doing research on the first edition to *Resisting Corporate Corruption*, an in-depth 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 it also 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. Arbogast’s extensive research in these case studies revealed 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.

The second edition of *Resisting Corporate Corruption* retained the valuable lessons from Enron, but was updated to include real life examples from the corporate and financial scandals that continued throughout the decade of the 2000s, culminating in the financial collapse of large Wall Street institutions in 2008. This third edition to *Resisting Corporate Corruption* is a must read for all students of American capitalism and specifically anyone considering a career on Wall Street or in public company finance and M&A. The new case studies on Goldman Sachs’ conflict of interest in the El Paso transaction as well as the Corzine/MF Global and the Citi-Banamex cases offer amazing insights into just a few of the complicated and ethically challenging issues facing those in finance today. In reading these cases, including the incredible documentation/evidence presented, my first thought was that the ethical choice is very clear, so why the hand-wringing angst? What made the decisions cloudy? My conclusion in these new cases mirrors my experiences at Enron—that the incentives in place through stock-option heavy compensation structures and bonus schemes subconsciously force a rationalization of unethical behavior in leaders and managers.

After nearly two decades of speaking on Enron and the topic of ethical leadership, I am often dismayed at two grave misunderstandings about ethics and being ethical. First, that “teaching ethics at the college level is pointless, that it is too late to mold a value system at that age.” The second is the naive 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 accounting scandal at Enron resulted in devastating shareholder and creditor financial losses but on a more personal note, it produced over two dozen felons; twelve Enron executives served prison time, eight 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 NatWest bankers were found guilty of various crimes akin to aiding and abetting Enron’s shaky financial schemes, and all seven bankers served at least some time in prison. Hundreds more, at Enron, Andersen and various banks and law firms were targeted and investigated by the Department of Justice, 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 of Commerce (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 wrong choices, choosing unethical paths. Almost all of them never thought they were breaking 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 usually masked. Of course if asked outright to do something illegal, we’d might 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, sometimes extremely unethically.

This is the reason I believe so strongly that universities must require ethics as a core curriculum in all business degrees. The argument that ethical values cannot be taught 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.

Arbogast’s 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 have been shocked at the number of college students who firmly believe they’d quit; walk out the door at the moment unethical behavior is required 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 the winding and perilous paths presented in the case studies, with some succeeding and some ending in ethical lapses, will help prepare students for the real world. Just as the financial crisis of 2008 showed us that the lessons of Enron had not been fully absorbed, the new cases added to this third edition reveal that the challenges exposed by the Wall Street financial collapse remain with us today.

It is also my fervent hope that students of Resisting Corporate Corruption will be able to take action without the historical consequences of whistleblowing. When 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. Lay, perhaps purposely, did not “hear” me. Deserved or not, the label Enron whistleblower means I cannot work in Corporate America again. I now speak around the globe of my firsthand account of Enron’s ethical and leadership lessons. It is not my chosen career path. I appreciate that new corporate legislation offers protections and a bounty program for whistleblowers and having that awareness through the work required by these case studies might be invaluable to more than just a few.

Sherron S. Watkins
February 2017
This 3rd Edition of *Resisting Corporate Corruption* takes us beyond the Financial Crisis. The new case studies explore whether the causes of that Crisis have been addressed. They also examine whether conditions surrounding those who resist corruption have evolved such that resisters have the necessary support to do the right thing and not be punished for it.

The 1st Edition, published in 2007, dealt only with Enron. It asked two questions: 1) How does a firm as famous as Enron become thoroughly corrupted; and 2) How can honest executives within such a firm resist this descent? Since 2007, these cases have been repeatedly taught in courses at the University of Houston and the Kenan-Flagler Business School, University of North Carolina at Chapel Hill. Enron resisters Sherron Watkins, Jordan Mintz and Vince Kaminski came to classes where their cases were discussed.

This process brought increasing clarity to answering these questions. Enron was led by a CEO, Ken Lay, who did not value sound financial control. Early in Enron’s existence, he signaled to the Board and to employees that he would sacrifice controls to address immediate business pressures. Lay also repeatedly promoted individuals like Jeff Skilling who shared a similar indifference to controls and sound accounting. Skilling particularly played a major role in undermining the integrity of Enron’s financial reports and the position of the accounting firm Arthur Andersen.

These developments signaled Enron’s employees that any rule could be bent if the party intent on doing so was clever. Agents like Andy Fastow rose to the occasion. When Enron’s performance faltered, they brought forward cover-up schemes of unimaginable complexity and audacity. Lay and Skilling welcomed the schemes. The story from there is well known. The seeds planted early on by Lay and Skilling, when they dismantled internal audit and sound accounting, are still not appreciated. The lesson worth taking away is this—firms get corrupted when the CEO is weak on financial control and allows agency behavior to corrupt the accounting, compensation and promotion systems.

Enron’s corporate resisters enjoyed no legal protection. However, effective resistance was still possible within the firm. Mintz, Kaminsky and Watkins enjoyed a measure of success by picking their resistance issues carefully and taking them to targeted executives. Mintz showed how an attorney can go to outside counsel to buttress a position opposing corrupt actions. Watkins picked the right issue, the
fraudulent accounting for Fastow’s partnership deals. Unfortunately, she picked the wrong recipient, sending her letter to Ken Lay. By leaving a paper trail, however, she left investigators a clear path to follow.

The 2nd Edition, published in 2013, asked how an entire industry could become corrupted. Its case studies revealed the Financial Crisis to be analogous to a major traffic accident. Many elements were involved, each one contributing to a chain of causation that produced a massive pile-up with carnage. Each case revealed one or more elements in the chain—from Goldman Sachs’ deliberate choice to favor Big Trading over banking, to Countrywide’s decision to follow AmeriQuest into toxic mortgage products, to Moody’s sacrifice of sound ratings methodologies for market share, to AIG’s failure to reserve for the risks embedded in the subprime credit default swaps it wrote. One constant from the Enron story became apparent. In the Financial Crisis cases there also were CEOs, Corzine, Mozilo, McDaniel, Greenberg and Sullivan, who subordinated sound financial control for other priorities.

The 2nd Edition also asked whether the landscape for resisters had improved. The answer is a qualified yes. Sarbanes-Oxley (SOX) provides a foundation of legal protection. The favorable publicity surrounding Sherron Watkins, WorldCom resister Cynthia Cooper, and others improved the public’s image of whistleblowing. However, these improvements were not enough to bring forth effective whistleblowing in the Financial Crisis. Three whistleblowers of note appeared: Richard Bowen at Citigroup, Eric Kolchinsky at Moody’s and Matthew Lee at Lehman Brothers. All dealt with managements unresponsive to their disclosures and willing to punish whistleblowing. All ended up leaving their companies without accomplishing much in the way of influencing business conduct. Each provided lessons of what not to do as a resister. Kolchinsky adamantly asserted that SOX did not provide protection for whistleblowers on Wall Street.

This industry-wide failure of whistleblowing was recognized in the wake of the Financial Crisis. Gaps in the SOX whistleblower protections were plugged by the Dodd-Frank law. Whistleblowers were also given the incentive of a Federal bounty program run by the Securities and Exchange Commission (SEC). Subsequently, a substantial whistleblowing legal industry developed. Whistleblowers can now choose from multiple legal firms who provide assistance in return for a share of potential bounties. A National Whistleblowers Center helps guide resisters trying to figure out what to do. The Whistleblower’s Handbook is available to educate business people before they have to confront a crisis.

These developments profoundly change the landscape for resisting corporate corruption. Are they enough to help turn back the tide of corruption visible during the Financial Crisis?

This brings us to the purpose of this 3rd Edition. Scandals have continued since the Crisis and the passage of Dodd-Frank. Are these evidence that underlying problems haven’t been fixed? Or, are they the spasms of an industry on a glide path to a safer and more ethical course of conduct? The new cases provide the opportunity to explore these questions—the major post-Crisis scandals are here: MF
Global, LIBOR and Banamex. Two cases, Morgan Stanley’s revisions to compensation and Goldman’s handling of the El Paso-Kinder Morgan merger, provide opportunities to consider whether bank CEOs are sorting out the conflicts inherent in their Big Trading business models. The MF Global and CitiMortgage cases present new junior employees, Edith O’Brien and Sherry Hunt, struggling with classic resistance issues within the new landscape. Do these endangered employees enjoy fundamentally better conditions for resisting corruption than in the past?

This 3rd Edition retains the classic Enron cases which chart that firm’s trajectory to fraudulent demise. Almost all of the Financial Crisis cases return, the omissions being the follow-up Fannie Mae and Moody’s cases. A new essay summarizes the causes of the Financial Crisis as illuminated by these case studies. A primer on Dodd-Frank is provided to provide context for the post-Crisis cases. Finally, two closing essays have been added, one summarizing the best tactics available to motivated resisters and the second providing an assessment of whether the conditions promoting corporate corruption have been adequately addressed.

We conclude this Preface with this point: the legal conditions for external whistleblowing have never been stronger and the support available has never been so accessible. Potential whistleblowers with evidence of profound wrongdoing now have a chance to disclose it to authorities without facing financial ruin. For those resisters still seeking to work within the firm, there is still the need to master resistance tactics and organizational smarts.

Most resisters will want to tread this internal path if at all possible. These cases provide a laboratory for developing this skill set in advance of a personal, firm, or industry crisis.

Chapel Hill, North Carolina,
January 23, 2017
Note to Faculty: How to Use this Book

_Resisting Corporate Corruption_, 3rd 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 (CLE) courses. 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 from 2008–2014. 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-related 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 Enron case solutions developed from this course work were compiled and are available in the _Solutions Manual to Resisting Corporate Corruption_. This CD can be obtained from www.scrivenerpublishing.com. Teachers considering use of the 3rd 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_, 3rd edition, now consists of 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. Other cases used as final exams
Note to Faculty: How to Use this Book

include Subprime Heading South at Bear Stearns and Write to Rubin. Instructors interested in viewing examples of these exams can contact the author at Stephen_Arbogast@kenan-flagler.unc.edu.

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 member. 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)
- Take CitiMortgage to the Feds? (False Claims, Dodd-Frank Acts’ whistleblower incentives)

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

- Enron Oil Trading A & B (Audit irregularity investigations & management political support)
- Enter Mark-to-Market: Exit Accounting Integrity? (Manipulative accounting and interaction with firm’s CPA)
- Adjusting the Forward Curve in the Back Room (Manipulative accounting tied to “Mark-to-Model” assumptions)
• 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)
• Too Big to Know What’s Going On at Banamex? (Financial control,
  fraud and collusion at an overseas affiliate, FCPA implications)

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, know-
ing too the new legal protection and communication 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 condi-
tions portrayed in this book.
Acknowledgements

As a third edition, this book owes an obvious debt to all who encouraged the publication of the first two editions. This especially includes all of my ExxonMobil colleagues, who were responsible for training me in the fundamentals of finance, controls and business ethics. Thanks also go to my publisher, Martin Scrivener, who supported the vision of the book from its inception.

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Section 1
THE ENRON CASES

Part 1
DEMOLISHING FINANCIAL CONTROL, NEUTERING THE GATEKEEPERS