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Lessons from Enron– And Why We Don't Learn from Them

By Nancy B. Rapoport

By speaking up, you might help to avoid future Enrons.

Recently, a cab driver said something that really caught my attention: "Remember when we thought that Enron was so bad? Those were the good old days."

He was right.

We were all shocked by Enron (and WorldCom, and Tyco, and Global Crossing, and Parmalat, and so on) because it never occurred to us that companies could lie to us for so long. We assumed that audits could catch lies, or that free markets could catch lies, or (at the very least) that employees would catch lies. We were wrong.

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In 2004, Bala G. Dharan and I studied Enron in an attempt to learn from it so that we would be able to prepare people to prevent future Enrons.[1] We wrote roughly the 84th book on Enron; even more books on the subject have appeared since then. Our first edition discussed the history of scandals before Enron, what went into the Enron fraud, and what we might be able to do differently in the future. And guess what? We now have the scandals resulting from subprime loans, derivatives, Ponzi schemes involving Bernie Madoff, Ramalinga Raju of Satyam Computer Services and Texas billionaire Allen Stanford, and the mismanagement of Fannie Mae and Freddie Mac. Our first edition didn't do anything to stop future Enrons.

Looking back, I'm not surprised. Our book looked at structural problems without examining how human nature might affect even the best of structures. So our second edition spends a lot more time on how humans (even the brightest of them) make stupid mistakes. We don't expect to stop future Enrons any more. But it is important to point out why we can't stop them and what you might learn from recent economic history. Here are the lessons that I've learned from Enron and later incidents of financial mismanagement:

- Structures, by themselves, do nothing to stop people from making dumb mistakes.
- Never base your structures on the presumption that people are good (even if you believe that they are).
- Don't trust; verify.
- If it sounds wrong to you, it may well be wrong.
- Someone has to slow down decisions by speaking up, and *you* are that someone.

Structures, by Themselves, Do Nothing to Stop People from Making Dumb Mistakes

Enron had tons of structures in place to prevent fraud. Unfortunately, it didn't follow them.

Take the Enron ethics code, a copy of which I picked up from eBay. The cornerstone of Enron's ethics code was a four-part mnemonic: RICE,[2] which stood for respect, integrity, communication and excellence. Anyone who ever negotiated with Enron knows that Enron was exceptionally aggressive, didn't follow through on many of its promises, made deals that looked real but were actually not what they seemed, and made big, flat-out-dumb deals. So much for following Enron's own ethics rules.

What about Chief Financial Officer Andrew Fastow's self-dealing with LJM and LJM2, the structures that took certain Enron assets off Enron's balance

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sheets at a profit of more than $40 million to Fastow? Enron's board approved Fastow's self-dealing (more than once), with the proviso that there would be structures that protected Enron. No one, however, paid any attention to whether or not Enron (or LJM) used those structures.

Here's another example: In exploring how the banks may have colluded with Enron, the Enron examiner found the following:

> Not only was Citigroup sophisticated in structured finance, it understood that structured finance could be misused. At the time many of these [Enron] transactions were being completed, Citigroup's Global Capital Structuring group applied an "appropriateness test" to help determine whether the bank should engage in a particular transaction. Transaction Execution packages were required to include a written questionnaire that set out ten areas of review. These questions went beyond the objective financial criteria such as the client's credit risk and focused on the more subjective measures of the transaction.
>
> The ten areas, which had to be addressed and approved by the "Designated Responsible Senior" for each transaction, were as follows:
>
> 1. Lack of transparency (Business Objective)—The true economic substance of the transaction cannot be determined from the structure without significant analysis.
>
> 2. Secrecy of identity of true party—The true identity of a party to the transaction cannot be determined because of the use of SPV's [sic] or charitable trusts in offshore tax havens or bank secrecy jurisdictions.
>
> 3. Circularity—The transaction is essentially circular with the customer being both the ultimate lender and borrower and/or ultimate buyer and seller.
>
> 4. Fragmentation—The transaction is structured so that no one document describes the whole transaction, making it possible for a reader to review documents for a segment of the transaction and not understand that it is part of a larger transaction.
>
> 5. Unusual terms—The transaction is off-market or contains terms which are significantly different from what one would expect.
>
> 6. Absence of rules/guidance—The applicable regulatory/legal/accounting/tax systems lack developed rules or guidance for complex products.
>
> 7. Event risk in regulatory/legal/accounting systems—The rules governing the transaction are not predictable and could be subject to sudden application of tighter standards, or heightened prosecution because of political or social developments.
>
> 8. Multiple jurisdictions—Multiple jurisdictions are involved with internal approvals sought individually in each making the process harder to manage and the risk of oversight of the entire transaction greater.
>
> 9. Lack of confirmation of customer assurances—The absence of third party confirmations (e.g., regulators, auditors, appraisers) of customer assurances on sensitive issues.
>
> 10. Disproportionate impact—The transaction will have a significant impact on the customer's financial condition or results, and will not be required to be disclosed.[3]

Now, that's a pretty sensible list. You probably have a list like that, or similar guidelines, in your own organization. The problem with this list is that even though several of Enron's transactions with Citigroup triggered more than one (heck, more than *five*) of the warning signs on this list, Citigroup went through with the transaction anyway. Lesson? The structure was fine. But no one at Citigroup used it to avoid transactions that failed the "smell test."

Never Base Your Structures on the Presumption That People Are Good (Even if You Believe That They Are)

Regulations are great at giving people guidelines about what to do when they *want* to comply with

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the rules, but they're awful at guiding people who want to get around the rules. These folks don't believe that they're going to get caught, or they just like living near (over?) the edge. You need to build structures that make it difficult for people to cheat, even if you can't envision your colleagues being cheats or liars. I've read far too many stories of people who, for example, used the same person to open the mail, deposit the checks and balance the books—only to find out that that very nice person was embezzling thousands of dollars while looking just as sweet as pie. If you ever find yourself in the position of drafting structures at your company—the rules and regulations that will govern your department—don't make the mistake of assuming that because you're nice and honest, everyone else will be, too.

Don't Trust; Verify

In one of my favorite cases, the well-known law firm Kaye, Scholer was sanctioned for trusting its client to tell the truth, even though the client had been caught in a big lie before. (Among the client's[4] other foibles, the principals of the company forged computer leases—for computers that never existed—by lying upside down underneath a glass coffee table and tracing necessary signatures. Talk about contorting the financials!) There's nothing wrong with assuming that most things that someone is telling you are true, but double-check every once in a while to reassure yourself. (NINJA[5] loans come to mind, perhaps?) And, for goodness' sake, if someone has lied to you—again, think Enron—don't continue to deal with that person without verifying every possible statement that that now-proven liar makes.[6]

If It Sounds Wrong to You, It May Well Be Wrong

Sherron Watkins's famous memos to Ken Lay—the anonymous first memo and the second one, which she signed—warned Lay that Enron might "implode in a wave of accounting scandals"[7] after Jeff Skilling, the company's former CEO, suddenly resigned. Watkins had suspected that several of the company's recent deals were fishy, and she urged Lay to "fess up and fix the problems." Watkins is an accountant, and she was far from alone in being one of the many intelligent employees at Enron. Not everybody knew about the shaky deals, but enough people did. (How hard is it to realize that Merrill Lynch wasn't buying three Nigerian barges from Enron, near the end of a fiscal quarter, not to own those barges but to take them off Enron's books for a while?)

My guess is that a lot of people at Enron just assumed that they were "missing something" when they saw fishy-looking deals. They assumed that their bosses knew something that they themselves didn't and that—if they knew the whole story—then they'd understand that the fishy-looking deals were really fine. In fact, the fishy-looking deals *were* fishy. They were real stinkers. But the way that humans tend to think caused these very bright folks to talk themselves out of questioning those deals.

People commonly make a number of these cognitive errors. We humans are subject to peer pressure. We're subject to assuming that someone else will take care of the problems, so that we don't have to do anything ourselves when we see something wrong. We talk ourselves into believing that something that we know is wrong is justified.

Stanley Milgram did a study in the 1960s—replicated just in the past 12 months—in which he invited an experimental subject and an actor (playing an experimental subject) into a very scientific-looking experiment on memorization. The actor randomly "drew" the role of "student," leaving the real experimental subject to play the role of "teacher." Every time the student missed a memorized word pair, the teacher was supposed to give him an electric shock. The fancy machine that Milgram hooked up to the student was fake, but it looked pretty real, and the shocks were supposed to increase by 15 volts each time the student missed a word pair. The machine let the teacher "shock" the student all the way up to 450 volts. Had the machine been real, such a high voltage would have killed the student. In fact, the student was just acting when he screamed, behind a screen, that the teacher was causing him intense pain.

Milgram found out that more than 60 percent of the subjects were willing to shock the students all the way to 450 volts—in essence, that more than 60 percent of subjects were willing to kill someone that they'd just met. Why? Milgram's

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theory was that, in order for someone to stop the experiment, he would have to admit to himself that what he'd been doing was wrong. To stop giving the shocks at, say, 90 volts, he'd have to admit that the 75-volt shock was wrong, too. Thanks to the theory of cognitive dissonance, people were unwilling to admit that they were "bad people" who would shock someone just because a guy in a white coat told them to do it. Because they didn't want to think of themselves as bad, they'd justify to themselves that what they were doing was important or it was "out of their hands" because the experimenter was taking responsibility for the actor-subject's "pain."

Cognitive dissonance affects all of us. We all talk ourselves into doing dumb things, justifying what we're doing to ourselves. We can't actually stop being human, which means that we can't avoid cognitive dissonance. We can, however, recognize that we're privy to such cognitive mistakes. Being aware that you will make these mistakes keeps you just a little more sensitive to them, and being aware may also help you undo those mistakes after you make them.

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Someone Has to Slow Down Decisions by Speaking up, and *You* Are That Someone

Why did Enron fail? Why have the subprime lenders failed? Why have all of these fancy new ideas to make money in the market failed? They all failed, in part, because people who did figure out that something wasn't right didn't speak up—or didn't speak up to the right people. It's easy to give into peer pressure. It's unnerving to think about making a fuss over something, only to find out that you were wrong and that the great majority of people were right. Most of us don't want to take that risk. But someone has to be brave and speak up when he or she doesn't understand how a deal works or why the lawyers and accountants have blessed something that just looks wrong. If those in, say, the rating agencies had disclosed the risks of these subprime tranches to the market, perhaps fewer people would have invested in them. (Who was the genius who decided that the mathematical models proved that people who couldn't afford high mortgages in the first place would somehow be able to pay off those mortgages over time?) If someone had just spoken up to say, "Should someone who makes $40,000 a year be buying a $750,000 house?" perhaps we could have slowed down the financial juggernaut that has just run us over. Lesson: If you see something that you think might be wrong, speak up. Maybe you're wrong. But just maybe you're right, and, by speaking up, you might help to avoid future Enrons.

Endnotes

[1] Nancy B. Rapoport and Bala G. Dharan, Eds., ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS (Eagan, MN: Foundation Press, 2004).

[2] As a graduate of Rice University in Houston, the fact that Enron—based in Houston—used this acronym for its ethics code and then violated it repeatedly irks me no end.

[3] Third Interim Report of Neal Batson, Court-Appointed Examiner, in *In re Enron Corp.*, Case No. 01-16034 (AJG), June 30, 2003, at 52–54 (footnotes omitted).

[4] The client's name was "OPM Leasing." "OPM" stood for "other people's money," a true sign of a Ponzi scheme if ever there were one.

[5] "No income, no job or assets."

[6] Do I believe that "once a liar, always a liar?" Yes, most of the time I do. I don't believe that liars are that different from you and me. But I do believe that someone who has lied about something important has made it that much easier to lie again, just because he or she has crossed over the social rule that lying is a bad thing.

[7] Memorandum from Sherron Watkins to Kenneth Lay, August 15, 2001, available at *http://energycommerce.house.gov/107/hearings/02142002Hearing489/tab10.pdf.*

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