Enron Scandal: The Fall of a Wall Street Darling

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Enron Corp. is a company that reached dramatic heights, only to face a dizzying collapse. The story ends with the bankruptcy of one of America's largest corporations. Enron's collapse affected the lives of thousands of employees and shook Wall Street to its core. At Enron's peak, its shares were worth $90.75, but after the company declared bankruptcy on December 2, 2001, they plummeted to $0.67 by January 2002. To this day, many wonder how such a powerful business disintegrated almost overnight and how it managed to fool the regulators with fake, off-the-books corporations for so long.

Enron Named America's Most Innovative Company

Enron was formed in 1985 following a merger between Houston Natural Gas Co. and Omaha-based InterNorth Inc. Following the merger, Kenneth Lay, who had been the chief executive officer (CEO) of Houston Natural Gas, became Enron's CEO and chairman and quickly rebranded Enron into an energy trader and supplier. Deregulation of the energy markets allowed companies to place bets on future prices, and Enron was poised to take advantage.

The era's regulatory environment also allowed Enron to flourish. At the end of the 1990s, the dot-com bubble was in full swing, and the Nasdaq hit 5,000. Revolutionary internet stocks were being valued at preposterous levels and consequently, most investors and regulators simply accepted spiking share prices as the new normal.

Enron participated by creating Enron Online (EOL), an electronic trading website that focused on commodities in Oct. 1999. Enron was the counterparty to every transaction on EOL; it was either the buyer or the seller. To entice participants and trading partners, Enron offered up its reputation, credit, and expertise in the energy sector. Enron was praised for its expansions and ambitious projects and named "America's Most Innovative Company" by *Fortune* for six consecutive years between 1996 and 2001.

By mid-2000, EOL was executing nearly $350 billion in trades. At the outset of the bursting of the dot-com bubble, Enron decided to build high-speed broadband telecom networks. Hundreds of millions of dollars were spent on this project, but the company ended up realizing almost no return.

When the recession began to hit in 2000, Enron had significant exposure to the most volatile parts of the market. As a result, many trusting investors and creditors found themselves on the losing end of a vanishing market cap.

The Collapse of a Wall Street Darling

By the fall of 2000, Enron was starting to crumble under its own weight. CEO Jeffrey Skilling had a way of hiding the financial losses of the trading business and other operations of the company; it was called mark-to-market accounting. This is a technique used when trading securities where you measure the value of a security based on its current market value, instead of its book value. This can work well for securities, but it can be disastrous for other businesses.

In Enron's case, the company would build an asset, such as a power plant, and immediately claim the projected profit on its books, even though it hadn't made one dime from it. If the revenue from the power plant were less than the projected amount, instead of taking the loss, the company would then transfer these assets to an off-the-books corporation, where the loss would go unreported. This type of accounting enabled Enron to write off losses without hurting the company's bottom line.

The mark-to-market practice led to schemes that were designed to hide the losses and make the company appear to be more profitable than it really was. To cope with the mounting losses, Andrew Fastow, a rising star who was promoted to CFO in 1998, came up with a devious plan to make the company appear to be in great shape, despite the fact that many of its subsidiaries were losing money.

1985

Enron is formed following a merger between Houston Natural Gas Co. and InterNorth Inc.

1995

Enron is named "America's Most Innovative Company" by Fortune. The firm goes on to win this award for six consecutive years.

1998

Andrew Fastow is promoted to CFO, he ultimately spearheads the creation of a network of companies that help hide Enron's losses.

2000

Enron's shares skyrocket to an all-time high of $90.56.

Feb.12, 2001

Jeffrey Skilling replaces Kenneth Lay as CEO. However, Lay remains a member of the board of directors.

Aug.14

Skilling resigns suddenly, and Lay takes over once again. Enron's broadband division also reports a massive $137 million loss. Analysts became weary of the company and subsequently drop their ratings for Enron's stock. In turn, the company's share price dives to $39.95, a 52-week low.

Oct.12

Arthur Andersen legal counsel tells auditors to destroy all Enron files, except Enron's most basic documents.

Oct. 16

Enron reports a $618 million loss and $1.2 billion value write off. Enron's stock drops further to $33.84.

Oct. 22

Enron announces it's facing a SEC probe. Shares fall to around $20.75 that day, following the announcement.

Nov. 8

Enron admits it has been inflating its income by around $586 million since 1997.

Nov. 29

Arthur Andersen becomes another casualty of the Enron scandal as the SEC expands its investigation.

Dec. 2

Enron files for Chapter 11 bankruptcy. Its stock closes at $0.26.

Jan. 9, 2002

The Justice Department launches a criminal investigation.

Jan. 15

Enron is suspended from the NYSE.

June 15

Enron's accounting firm, Arthur Andersen is convicted of obstructing justice.

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How Did Enron Use SPVs to Hide its Debt?

Fastow and others at Enron orchestrated a scheme to use off-balance-sheet special purpose vehicles (SPVs), also know as special purposes entities (SPEs) to hide mountains of debt and toxic assets from investors and creditors. The primary aim of these SPVs was to hide accounting realities, rather than operating results.

The standard Enron-to-SPV transaction occurred when Enron transferred some of its rapidly rising stock to the SPV in exchange for cash or a note. The SPV would subsequently use the stock to hedge an asset listed on Enron's balance sheet. In turn, Enron would guarantee the SPV's value to reduce apparent counterparty risk.

Enron believed that its stock price would keep appreciating — a belief similar to that embodied by Long-Term Capital Management before its collapse. Eventually, Enron's stock declined. The values of the SPVs also fell, forcing Enron's guarantees to take effect. One major difference between Enron's use of SPVs and standard debt securitization is that its SPVs were capitalized entirely with Enron stock. This directly compromised the ability of the SPVs to hedge if Enron's share prices fell. Just as dangerous and culpable was the second significant difference: Enron's failure to disclose conflicts of interest. Enron disclosed the SPVs to the investing public—although it's certainly likely that few understood even that much — but it failed to adequately disclose the non-arm's length deals between the company and the SPVs.

Arthur Andersen and Enron: Risky Business

In addition to Andrew Fastow, a major player in the Enron scandal was Enron's accounting firm Arthur Andersen LLP and its partner David B. Duncan, who oversaw Enron's accounts. As one of the five largest accounting firms in the United States at the time, it had a reputation for high standards and quality risk management.

However, despite Enron's poor practices, Arthur Andersen offered its stamp of approval, which was enough for investors and regulators alike, for a while. This game couldn't go on forever, however, and by April 2001, many analysts started to question the transparency of Enron's earnings, and Andersen and Eron were ultimately prosecuted for their reckless behavior.

The Shock Felt Around Wall Street

By the summer of 2001, Enron was in a free fall. CEO Ken Lay had retired in February, turning over the position to Skilling, and that August, Jeff Skilling resigned as CEO for "personal reasons." Around the same time, analysts began to downgrade their rating for Enron's stock, and the stock descended to a 52-week low of $39.95. By Oct.16, the company reported its first quarterly loss and closed its "Raptor" SPE, so that it would not have to distribute 58 million shares of stock, which would further reduce earnings. This action caught the attention of the SEC.

A few days later, Enron changed pension plan administrators, essentially forbidding employees from selling their shares, for at least 30 days. Shortly after, the SEC announced it was investigating Enron and the SPVs created by Fastow. Fastow was fired from the company that day. Also, the company restated earnings going back to 1997. Enron had losses of $591 million and had $628 million in debt by the end of 2000. The final blow was dealt when Dynegy (NYSE: DYN

Dynegy Inc

DYN

9.04

+3.20%

), a company that had previously announced would merge with the Enron, backed out of its offer on Nov. 28. By Dec. 2, 2001, Enron had filed for bankruptcy.

Enron Gets a New Name

Once Enron's Plan of Reorganization was approved by the U.S. Bankruptcy Court, the new board of directors changed Enron's name to Enron Creditors Recovery Corp. (ECRC). The company's new sole mission was "to reorganize and liquidate certain of the operations and assets of the 'pre-bankruptcy' Enron for the benefit of creditors." The company paid its creditors more than 21.7 billion from 2004-2011. Its last payout was in May 2011.

Enron Execs and Accountants Prosecuted

Once the fraud was discovered, two of the preeminent institutions in U.S. business, Arthur Andersen LLP, and Enron Corp. found themselves facing federal prosecution. Arthur Andersen was one of the first casualties of Enron's prolific demise. In June 2002, the firm was found guilty of obstructing justice for shredding Enron's financial documents to conceal them from the SEC. The conviction was overturned later, on appeal; however, despite the appeal, like Enron, the firm was deeply disgraced by the scandal.

Several of Enron's execs were charged with a slew of charges, including conspiracy, insider trading, and securities fraud. Enron's founder and former CEO Kenneth Lay was convicted of six counts of fraud and conspiracy and four counts of bank fraud. Prior to sentencing, though, he died of a heart attack in Colorado.

Enron's former star CFO Andrew Fastow plead guilty to two counts of wire fraud and securities fraud for facilitating Enron's corrupt business practices. He ultimately cut a deal for cooperating with federal authorities and served a four-year sentence, which ended in 2011.

Ultimately, though, former Enron CEO Jeffrey Skilling received the harshest sentence of anyone involved in the Enron scandal. In 2006, Skilling was convicted of conspiracy, fraud, and insider trading. Skilling originally received a 24-year sentence, but in 2013 his sentence was reduced by ten years. As a part of the new deal, Skilling was required to give $42 million to the victims of the Enron fraud and to cease challenging his conviction. Skilling remains in prison and is scheduled for release on Feb. 21, 2028.

New Regulations As a Result of the Enron Scandal

Enron's collapse and the financial havoc it wreaked on its shareholders and employees led to new regulations and legislation to promote the accuracy of financial reporting for publicly-held companies. In July of 2002, then-President George W. Bush signed into law the Sarbanes-Oxley Act. The Act heightened the consequences for destroying, altering or fabricating financial records, and for trying to defraud shareholders. (For more on the 2002 Act, read: *How The Sarbanes-Oxley Act Era Affected IPOs*.)

The Enron scandal resulted in other new compliance measures. Additionally, the Financial Accounting Standards Board (FASB) substantially raised its levels of ethical conduct. Moreover, company's boards of directors became more independent, monitoring the audit companies and quickly replacing bad managers. These new measures are important mechanisms to spot and close the loopholes that companies have used, as a way to avoid accountability.

The Bottom Line

At the time, Enron's collapse was the biggest corporate bankruptcy to ever hit the financial world. Since then, WorldCom, Lehman Brothers, and Washington Mutual have surpassed Enron as the largest corporate bankruptcies. The Enron scandal drew attention to accounting and corporate fraud, as its shareholders lost $74 billion in the four years leading up to its bankruptcy, and its employees lost billions in pension benefits. As one researcher states, the Sarbanes-Oxley Act is a "mirror image of Enron: the company's perceived corporate governance failings are matched virtually point for point in the principal provisions of the Act." (Deakin and Konzelmann, 2003). Increased regulation and oversight have been enacted to help prevent corporate scandals of Enron's magnitude. However, some companies are still reeling from the damage caused by Enron. Most recently, in March 2017, a Toronto-based investment firm was granted the okay by a judge to sue former Enron CEO Jeffery Skilling, Credit Suisse Group AG, Deutsche Bank AG, Bank of America's Merrill Lynch unit over losses incurred by purchasing Enron shares.