10 Things We Didn't Learn From Enron Scandal

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Ten years after the energy and commodities firm Enron collapsed under the weight of a massive fraud, much has changed about how corporate America does business and much, unfortunately, has remained the same, with new frauds and excessive risk-taking exposed all too frequently.

"We did learn some lessons and people were more careful, but greed creeps back in again," said Lawrence Weiss, professor of international accounting at Tufts University's Fletcher School of Law and Diplomacy.

Before the bankruptcy of WorldCom in 2002, Enron's bankruptcy was the largest in U.S. history. Names like AIG and WorldCom may have replaced Enron in the vernacular when referring to corporate meltdowns and greed. Enron executives Kenneth Lay, Jeff Skilling and Andrew Fastow -- all convicted of white collar crimes -- emblemized the bad side of the one percent before the term existed.

Once the darling of Wall Street, Enron was the country's seventh-largest company with a soaring stock price that grew more than 100 percent in 2000. The company collapsed in a matter of months as the media and the public became aware of its faulty accounting and business practices.

1. Conflicts of interest continue to occur

Sen. Carl Levin, D-Mich., chairman of the permanent subcommittee on investigations which reported on the role of Enron's board and investment banks' response to lessons learned from Enron, said the Enron scandal did not put an end to corporate malfeasance.. "One lesson we haven't learned from Enron is that corporations will engage in conflicts of interest, and some won't stop until action is taken," he said. Enron allowed its chief financial officer, Andrew Fastow, to set up a fund called LJM and engage in suspect deals that made Enron's books look better, Levin said. In the years after Enron was exposed, companies like Goldman Sachs and Citibank set up synthetic CDOs, sold shares in them to clients, and then made money betting against their own clients. "Conflicts of interest will continue to plague Wall Street until regulators use the new Dodd-Frank provisions to prohibit them," he said. Peter Elkind, editor at large with Fortune magazine, investigative reporter and co-author of Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron with Bethany McLean, said business, especially the financial world, can't be left to regulate itself. "The risks that traders take pose risks for all of us," he said.

2. If it's too good to be true, it probably is

Weiss said at the most basic level, the key lesson from the South Sea Bubble, Enron, and Madoff Ponzi scheme is knowing whether a business itself makes sense. "For Enron, the firm was growing at a fantastic rate and the question was how were they doing it? The answer, one knows with hindsight, was they were committing massive fraud," he said. "This then begs the question of whether it was obvious at the time. I would argue that at best, the firm smelled very bad."

First, Weiss said, the cash flows did not match the profits even after many years which should have raised a red flag. Next, it was difficult if not impossible to understand exactly how the firm made money. "They employed brilliant people. Okay, but how did these people create the wealth? What exactly were they doing? Trading energy, trading weather futures, trading broadband," he said. "And they could do this and make a fortune, and no one could copy it? How was it shown on their financial statements?" Weiss said one could not understand how Enron valued things, or management had discretion in the valuations which allowed management to choose their profit number. "If it looks too good to be true it probably is, or people's inherent greed often gets the better of their judgment," he said.

3. Regulators and the regulated continue their dance

Opinions over the role of regulators are mixed. Many say regulators need teeth to enforce rules and weed out shady accounting. Many in the business community say business regulation is doing more harm than good for an already fragile economy. Elkind said regulatory agencies need to have the weapons and funding to closely monitor new, ever more powerful financial instruments. Weiss said the Sarbanes Oxley Act, which created new standards for accounting firms, boards and management, was a "clear overreaction" to the Enron scandal, which is "understandable." Weiss said good and bad came as a result of its passage in 2002. Given the lopsided votes in favor of the law, Weiss said it was likely not well-read by lawmakers before it was passed. "When you pass these laws, it adds a level of complexity that is hard for many companies, especially small companies," he said. "You probably could have gotten benefit of Sarbanes Oxley with a smaller law that avoided the pitfalls that companies complain about." Weiss said the same could be said of the Dodd-Frank Act, or Obama's healthcare plan. "Some people like them a lot, but they're just so complex. Instead of the massive amount of documents can't we do one thing at a time, isolate and make it clear, so we have a sense of the repercussions?"

4. Transparency is vital

Elkind said companies must clearly disclose the risks they are taking and regulators need to require them to do so. Stephen Lubben, law professor at Seton Hall University School of Law, said recent years have also shown the limits of the ever-increasing disclosure obligations imposed on companies. "The changes made after Enron did little to avoid the shocking failures at AIG and other financial companies," he said. "At some level, we might be better off with a simple cigarette-style warning -- this investment is not guaranteed; you could lose all of your money -- than the phone book style SEC reports that are currently distributed to investors."

5. More capital is better

If you increase capital requirements for financial institutions, you decrease risk, Elkind said. Higher capital requirements and less leverage reduce the danger of a catastrophe. "You're not so far out on the ledge," he said.

6. Excessive leverage is as dangerous as a bad bet

Corporations still use accounting tricks to hide debt. Enron allegedly made prepay deals worth

billions of dollars, such as pretending to engage in energy swaps with other companies but they were actually dealing with offshore companies that were banks, in essence to receive loans. Today banks have refused to devalue their troubled assets, say some economists. Olympus managed to hide losses for two decades and admitted only recently to doing so. Unlike Enron, Olympus came clean on its own.

7. Corporate leadership makes all the difference in the world--for good and for bad

Former Enron CEO Jeffrey Skilling reportedly led the company's risky bets to revolutionize the market for natural gas and commodities trading. It was his CFO, Andrew Fastow, allegedly idolized Skilling, and did his part to cook the books, hiding billions of dollars in debt. In 2006, Skilling was convicted of 19 criminal counts, including one count of insider trading, related to his role in the massive fraud. Skilling was alleged to have dumped $15.5 million in Enron stock in an insider trade more than two months before the company declared bankruptcy. Skilling was sentenced to 45 years in prison and fined $45 million.

8. Preferred stockholders get preferred treatment

Lubben said the recent financial crisis showed that small investors still do not fully understand where shareholders stand in the priority line -- the "food chain" -- of large corporations. "The basic answer is that a common shareholder only gets paid if everyone else has been paid," he said. "Often that means they don't get paid at all. In Enron, and more recent cases like GM and Lehman, this really seemed to surprise some investors. Obviously this is a problem in all bankruptcy cases, but it is especially acute in a situation where a big, well-known company fails will little warning." The company's 20,000 employees lost not only their jobs and medical insurance but retirement savings in company stock. In 2001 Enron employees lost $1.2 billion in retirement funds and $2 billion in pension funds while Enron's top execs cashed in $116 million in stock, according to the film, "Enron: The Smartest Guys in the Room." The average severance pay was $4,500 while the top executives were paid bonuses totaling $55 million.

9. Still building fragile financial structures

"We could have taken a deep look at the special purpose vehicles, derivatives, repos, and the rest of the 'new' finance that was core to Enron's business model, in order to see what needed to be done better," Mark Roe, professor at Harvard Law School, said. "The outright fraud of the type that was the core of Enron's ultimate collapse --- bogus transactions that generated accounting entries but not real profits --- was contained after Enron (even if other frauds, like Madoff's arose)." That's the good news, Roe said. "We muddled through and avoided more Enron-type frauds and collapses, which isn't bad. But we still built, and we're still building, too many fragile financial structures that fail too often." Examples include Bear Stearns and Lehman Brothers in the run-up to the financial crisis and MF Global's implosion just recently, he said. "After Enron, we could have, but didn't, take the opportunity to re-think what's the core of what's economically valuable in managing risk in the derivatives business and financing firms via repos and special purpose vehicles," Roe said. "We could have taken the opportunity to preserve the valuable in the new finance and carve out the excess. We didn't, but we still could and we still should."

10. Important names make mistakes too

Alex Gibney, filmmaker who produced "Enron: The Smartest Guys in the Room," said the big lesson that wasn't learned was Enron was aided and abetted by most important investment banks in America and around the world. "One of the things most people forget about Enron, it wasn't an outlier," he said, explaining that it engaged in risky activities with venerated banks. "Just because it's a big respectable bank, don't think they're not into gambling," Gibney said. Many transactions -- ultimately at the collapse of the company -- involved some of the largest banks in the country. "These frauds don't happen in a vacuum," Weiss said in agreement. "Lots of people were aware or should have been aware. Lawyers, bankers, auditors and many employees saw stuff that they knew was wrong or was suspicious and said little or nothing. We need to create the right incentives to keep people honest - or at least not afraid to speak out."