BOOK REVIEW

THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND THE SCANDALOUS FALL OF ENRON by Bethany McLean and Peter Elkind

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The story of Enron's rise and fall resonates with human failing on nearly every level. It is a story of greed, of arrogance, of professional and personal infidelity, and of willful ignorance. In an era in which our capacity for outrage has surely been diminished, Enron's story still commands our attention, if not for the novelty of the misdeeds involved, for the sheer magnitude of their impact, and for the broad-based complicity of institutions charged with the responsibility of knowing better.

The dizzying speed with which Enron collapsed is certainly a strong indication that this was not a normal company. At its peak, on August 23, 2000, Enron's stock sold for ninety dollars a share, with a resulting $70 billion valuation for the company. As of October 2000, Enron had provided a 1,400% return on capital invested in 1990. That return incorporated an 89% return in 2000 alone. In 2001, for the sixth straight year, *Fortune* had named Enron "America's Most Innovative Company," while securities analysts gushed over the company's prospects. And then, beginning in early 2001, Enron's stock price began a breakneck race to the bottom, resulting in its declaration of bankruptcy on December 2, 2001. In January 2004, Andrew Fastow, Enron's Chief Financial Officer from 1998 to 2001 plead guilty to securities fraud, and as of July 2004, three of the most powerful remaining figures in Enron's history, Chairman and CEO Ken Lay, President and one-time CEO Jeff Skilling, and Chief Accounting Officer Richard Causey had been put under indictment for conspiracy to commit securities fraud.

Enron's story has been told many times, from various angles. Newspaper readers were treated to timely, in-depth stories covering Enron's fall and subsequent legal proceedings by *Washington Post* writers Peter Behr and April Witt, by *New York Times* correspondent Kurt Eichenwald, and *Wall Street Journal* reporters Rebecca Smith and John Emshwiller. A spate of early books covered some of the most revealing, if not downright titillating, aspects of the scandal, including *Power Failure,* co-authored by Mimi Swartz and Enron-insider Sherron Watkins. What distinguishes *The Smartest Guys in the Room* is the scope of its coverage and the nearly fantastic tale it tells of the interwoven relationships between Enron's dysfunctional management and the stewards of public trust charged with the responsibility of protecting Enron's investors, customers, and pensioners.

As to Enron's management, McLean and Elkind go a long way to answering the perplexing question of how a corporate culture can go so badly

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awry. By its very nature, for all the faith we place in capitalism as an engine of prosperity and an impartial arbiter of merit, it just as surely provides an incentive to individuals to bend or break rules and to enrich themselves in the process. Yet, we live in the confidence that our institutions are largely law-abiding and that the individuals within them endeavor to keep faith with those to whom they owe an obligation of confidence. What made Enron unique, and what McLean and Elkind do such a thorough job of detailing, is that by the time of its demise, the company had become a caricature of capitalism. The environment was one in which individuals were rewarded handsomely and, in some instances, obscenely, for closing deals, but rarely for follow-up, and for showcasing earnings, while hiding debt and ignoring critical cash flow. In the name of entrepreneurial endeavor, it was also an environment that permitted individuals to enrich themselves at the corporate trough to the company's detriment, and often through deals reflecting astonishing conflicts of interest.

As McLean and Elkind make clear, there were four keys to Enron's economics and, ultimately, its demise. The first sprung from Enron's view that the value of every deal could be banked at the outset of a deal's life, based on its anticipated cash flow. The idea's financial expression lay in "mark-to-market" accounting, which permitted Enron to book the value of each deal in its first year, based on expected returns. The idea found further expression in Enron's compensation system, under which individuals were rewarded lavishly for "origination," while little thought was given to an incentive to carry though with the remainder of the obligation. For much of the 1990's this idea fueled Enron's fantastic earnings growth, and funded ever more ambitious projects, not to mention Enron's trademark lifestyle.

Yet Enron's penchant for front-loading the value of its deals had a dark side that was a significant part of the company's undoing. To begin with, for all the financial leverage it provided at times when new deals were plentiful, mark-to-market accounting left the company no earnings to bank when the deals slowed down. Moreover, while mark-to-market accounting permitted optimistic up-front estimates, the associated rules also called for Enron to reevaluate each deal when pricing expectations changed, creating unanticipated liabilities. And finally, the extraordinary pressure on Enron employees to enter as many new deals as possible, whatever a realistic appreciation of their value, created a vast incentive to give short shrift to due diligence, and to paper over shortcomings with optimistic estimates. If reckless, Enron's upper management was not oblivious to these risks. As recounted by McLean and Elkind, when asked by a banker what would happen to Enron when the slurry of new deals dried up, CFO Andrew Fastow commented: "It implodes."

The second key attribute of Enron's economic life was its dependence on so-called "Special Purpose Entities" (SPEs) in order to transfer debt off its books. While the concept will stymie most lay people, it permitted Enron to create ostensibly independent corporate forms to which Enron would transfer its debt. These entities solicited investors, essentially creditors, to whom Enron pledged its equity as an assurance of repayment. The genius of these entities was that they enabled Enron to avoid reporting debt on its balance sheet. In the case of those deals that ultimately spelled Enron's demise, they also required

Enron to assume the debt if its stock fell below specified levels, which, of course, it did. Accounting rules governing the deals further required that the entities demonstrate a degree of independence by soliciting a minimum three-percentage point ownership by ostensibly independent sources. In nearly all cases, these "independent" investors included Enron CFO Andrew Fastow, his family, and friends. McLean and Elkind report that by the time of his departure, Fastow had collected over $60 million in returns and fees for managing and investing in these entities.

Enron's third defining characteristic, although one that has least captured the public's attention, was what McLean and Elkind report to have been a thoroughgoing lack of discipline, if not downright incompetence, in basic business management. Enron's profligacy with respect to corporate lifestyle was never a secret, from its gleaming new headquarters to management's use of the fleet of corporate jets for personal travel. What was less evident was that Enron's record keeping for significant segments of its business was a shambles. When, in the fall of 2000, Enron tried to come to grips with the financial catastrophe of its Energy Services division, responsible for its failed attempt to create a competitive retail market, what was unearthed was not only that most of the agreements that were earlier marked-to-market and monetized in earnings reports had been losing money with evolving prices, but that the company could not even keep track of the money that it did receive on these deals. The bungling included mislaying customer checks in the amount of $10 million, stashed under employee desks. More globally, when Fastow finally left the company in the fall of 2001 and Enron attempted to come to grips with its off-balance sheet losses, it found it impossible even to develop a clear picture of its total indebtedness, a matter that was ultimately critical in scaring off Dynegy as a suitor, Enron's last hope for financial salvation.

For it all, the one thing at which Enron excelled was promoting itself on Wall Street. Throughout its history, if Enron demonstrated one skill consistently, it was its ability to convince Wall Street that it was the magic kingdom. Perhaps above all, this is what created Enron's value. And what is most astonishing is that this game was played successfully until nearly the day Enron collapsed. From Ken Lay to Jeff Skilling and on down, Enron liked to see itself as a company of ideas, the prophet of a new millennium in which competitive markets would replace regulation with Enron leading the charge. It was an idea with which Wall Street fell in love. McLean and Elkind report that the company was touted as the "[t]he industry standard for excellence" by Deutsche Bank analysts, and likely to grow at 15–18% annually, according to Donaldson, Lufkin & Jenrette as of 1999. Only eleven months before it declared bankruptcy, and at a time when its share price stood at eighty-two dollars, McLean and Elkind report that Enron crowed to securities' analysts in their January 2001 conference call that the stock price should legitimately be $126, a figure discounted only somewhat by a Goldman Sachs' analyst to $110. Goldman was hardly alone.

The story of Wall Street's complicity in the Enron catastrophe is of a piece with the analysts' failure to appreciate that business fundamentals would ultimately bury the beloved high tech./telecommunications industry as well. The herd mentality made virtual heretics of those who questioned the community's received wisdom. A significant reason for this, as McLean and Elkind report, and as has been widely discussed elsewhere, is the overpowering financial incentive the investment houses had to embrace Enron in order to secure even a small piece of their investment banking business. The authors' tale of the steps Enron took in order to ensure that Merrill Lynch fired John Olson, an early critic from his days with CSFB, is chilling. Enron made it unmistakably clear that Merrill would enjoy none of Enron's business unless Olson were shut down. Within months, Olson was fired.

Was all of this criminal? It is no small indication of criminality that the threat of conviction was sufficient for Andrew Fastow to agree to a ten-year prison term and a guilty plea instead of facing trial. As to others, the critical questions are who knew what, and when, and whether the wool was intentionally pulled over investors' eyes. As persuasive as the McLean and Elkind account is, it is frustratingly bereft of source material, as is perhaps the nature of an investigative piece in which sources are to be protected. Still, some substantial confirmation of the story is that the criminal indictment of Ken Lay, Jeffrey Skilling, and Rick Causey handed up on July 8, 2004, is a virtual abstract of the McLean and Elkind book. Presumably, investigators have been closely following this and other stories in order to piece together their own.

McLean and Elkind do allow that Enron's management "may well have believed their own rhetoric" about the company's future. With so much of the company's financial foundation linked to its stock price, Enron's future depended on the assumption that the value of its equity would continue to rise forever. Of course, as Gordon Geko instructed us in the 1980s, the value of a stock is a matter of perception, and it was ultimately Wall Street's lack of confidence that triggered Enron's downfall. Like some character in a children's fairytale, Enron could fly so long as the market believed it could, and when Wall Street finally came to the realization that the company lacked wings, down it came. To at least some extent, it appears that Enron's senior executives lived in a fantasy of their own creation.

Moreover, McLean and Elkind report that Arthur Anderson, Enron's now extinct accountants, and Enron's attorneys were at least nominally present while the deals that ultimately spelled its demise were cut, and often called upon to pass upon them. Indeed, when Enron was heading for the rocks, and its Board given little choice but to come to grips with Sherron Watkins' now famous memorandum to Ken Lay detailing the Company's travails, McLean and Elkind report that Enron's attorneys undertook an investigation on the Board's behalf which, a special board panel later concluded, was a "whitewash." Whitewash or not, it is a near certainty that Lay, Skilling, and Causey will argue in their defense that their expert counsel and advisors saw no wrongdoing. In addition, if not all of Enron's modus operandi was in full view, there was certainly enough information about Enron's off-balance sheet machinations, much of it in publicly disclosed financial documentation, along with its mark-to-market methodology, to give investors reason to pause. They did not.

Whether or not Enron was criminal, what McLean and Elkind establish most persuasively is that Enron was a poorly conceived business, supported by financial chicanery. As McLean and Elkind summarize the situation: "Those who want to blame all of Enron's woes on the greedy CFO claim that Enron was a good business brought down by Andy Fastow. But that was never true. Enron was a bad business that was, for a time, propped up by Andy Fastow."

As to energy trading, something at which Enron was quite good, Enron's legacy will be a function of its greed, not its competence. McLean and Elkin describe most effectively the "amoral" atmosphere Enron's trading room operated, an atmosphere in which traders took any available advantage of the operative rules governing the nascent market in California in order to maximize gains. In this respect, Enron was not different from others in the field, and the reviewer can remember FERC Commissioners publicly pleading with the marketers to refrain from taking advantage of a system that was evidently poorly conceived, and regulators who were ill-equipped to defend the public. That plea fell on deaf ears. As McLean and Elkind describe it, Enron's traders saw no point in voluntarily reigning themselves in, while Enron's senior management seemed oblivious to the long-term damage they would do to the public's receptivity for the entire competitive experiment.

Some significant chapters in Enron's story have yet to be told. It remains an open question whether all of the broad-ranging allegations of criminality will stick. And there will continue to be some substantial dickering over Enron's carcass in bankruptcy. But the most interesting of the outstanding questions is what the legal and policy implications of Enron's story ultimately will be. Long before Enron's financial model dominated headlines, the company was best known for its aggressive advocacy of a deregulated model for electric and gas sales. Enron was certainly not the progenitor of this idea, which dates back at least as far as early deregulation of the telephone and trucking industries, and was fairly well advanced in the wholesale natural gas markets by the time Enron emerged as a substantial player in energy markets. Still, by the mid-1990s, Enron had become deregulation's best known promoter. In its development of a wholesale trading platform, and certainly in connection with its aggressive push for retail access, Enron's public mission was to make the world safe for its deregulated business plan. It is some indication of just how successful Enron was in identifying itself with this mission that the circumstances of the company's demise have become reason for public officials to question electric deregulation in all of its forms. It is not mere coincidence that the deregulation movement stalled with Enron's collapse.

In the long run, perhaps Enron's legacy will have no impact on the state of energy markets. But with Enron's disappearance, deregulation proponents lost their most aggressive and best funded advocate, while deregulation's opponents found an evil poster child for their cause. Without a doubt, Enron's collapse has substantially altered the trajectory of a revolution, if not its outcome.