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Review of

"Conspiracy of Fools"

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Kurt Eichenwald's *Conspiracy of Fools* (Broadway Books, 2005) is a spellbinding account of the rise and fall of Enron. In nearly 700 pages the reader finds answers to "what happened?" and "how did it happen?" Based on retrospective interviews with more than a hundred primary and secondary actors in this drama, the author creates multiple, parallel story lines. He jumps back and forth between these sub-plots in a manner that maintains energy and gives the reader many natural stopping points.

The great strengths of *Conspiracy* are that it's thorough, extremely well-written, captivating, and, finally, it rings true. The author avoids the easy, simple conclusions that all the executives are "guilty" of crimes or plain greed and that the media-lionized whistle-blower is pure of heart. We see the ultimate outcome as personal tragedies for Jeff Skilling (President) and Ken Lay (CEO) even though they are undeniably culpable. Culpability and guilt are not synonymous, however, and different readers will have widely different judgments to render on these two men.

The view of Andrew Fastow is not so murky. He and a handful of his associates did indeed lie, cheat, and steal for personal gain. Fastow's principle "contribution" to Enron was the creation of structured finance transactions to skirt accounting rules. This one-sentence description doesn't tell the reader much. Eichenwald gives many examples to flesh out the concept. The story of "Alpine Investors" provides the simplest case.

The company wished to sell the Zond Corporation, a wind-farm operator, prior to the closing of Enron's purchase of Portland General. Instead of simply finding a real buyer, Fastow created Alpine Investors to pay $17 million for Zond. Enron lent $16.5 million to Alpine so that Alpine could then pay the

$17 million to Enron! Apparently, the accounting and legal rules at the time permitted Enron to declare this transaction a "sale" of Zond as long as independent investors provided 3% of the purchase price ($510,000). Presumably, this independent 3% stake would be a first-loss position. But taking the junior position (first loss) rather than a more senior position has little meaning when Alpine owns just one asset.

Why did Enron consider Alpine to be a smart trade? Clearly Enron continued to bear the risk of Zond. Alpine could not re-pay the $16.5 million loan if Zond failed or if Alpine eventually sold Zond for less than the $16.5 million. Instead of having Zond on its balance sheet, after the "sale" Enron simply had the loan to Alpine. Apart from the desire to show a loan on the balance sheet rather than a wind-farm operator, there existed a regulatory reason to create the appearance that Enron did not own Zond.

Beyond creating a transaction that deliberately distorts accounting (which may not have been overtly illegal), Fastow and his people siphoned off considerable cash for themselves either through fees, hidden equity interests, or other negotiated terms that were outrageously detrimental to Enron itself. That is, Enron (and, hence, its shareholders) would lose millions of dollars that Fastow and his people would pocket. In the Alpine Investors example, Fastow himself furtively provided $419,000 of the $510,000 "independent" investment.

An unavoidable weakness of *Conspiracy* is the primary reliance on retrospective interviews. In hindsight, all issues can seem perfectly clear. Hence, interviews with former Enron employees paint a picture of widespread concern with Fastow and his machinations years in advance of the collapse. My sense is that the stated recollection of concern is sub-consciously exaggerated. For example, how many Enron people resigned in protest, frustration, and disgust? I remember only one in *Conspiracy* and this person was a fairly low-level risk analyst. Vince Kaminski, VP of research and one of the smartest and most ethical of the Enron story, did not resign. In fact, in one vignette we learn he is recruiting new graduates at Berkeley. If you truly believe your employer is corrupt, then you resign. If that's difficult, for whatever reason, why would you hire young people into the fire?

The point here is that the employees' actions, rather than their words, indicate the ambiguity of the Enron wrongdoings. After all, if *Arthur Andersen*, a premier accounting firm, has complete familiarity with Enron transactions and is not uncomfortable, perhaps Fastow's transactions were "acceptable" in some sense. If I had been Vince Kaminski, for example, I might have questioned the wisdom of the accounting for certain transactions, but I would likely have deferred to *Andersen*'s approval.

The bigger problem with the Enron structured transactions is that they were stupid. People like Lay, Skilling, Rick Buy (Chief Risk Officer), and Rick

Causey (Chief Accounting Officer) bear responsibility, if not guilt, for stupidity. For example, executing a hedge transaction with an SPV (special-purpose vehicle) for which Enron itself provides credit support clearly gives no benefit. Even if accounting rules reward such trades, they hurt the shareholders. Another example is the issuance of structured notes with names like "Osprey", "Yosemite", and "Marlin". Investors purchased these notes since Enron itself backed the repayment of interest and principal (albeit indirectly) and the yields of these notes exceeded what the market would require for straight Enron risk. In the best case (that is, no bankruptcy), then, Enron paid higher yields than necessary. All they gained was the accounting illusion that Osprey, Yosemite, and Marlin were "off balance sheet".

Causey and Skilling are culpable for the deeper stupidity of believing the "accounting myth". They fought tirelessly with *Andersen*, the SEC and others for accounting treatment that would strengthen Enron's GAAP financial statements. But accounting is not real. As president, Skilling's primary responsibility was to lead the charge to determine meaningful, correct, and robust measures of shareholder value and to apply such measures in high-level business decisions. Running a business with GAAP accounting as your guide is analogous to making investment decisions based on the income tax code. Eichenwald recounts a heart-warming argument among Skilling, Lay, and Rebecca Mark (a senior executive and Skilling's political adversary) over how to measure the value of a business. This conversation showed Skilling at his best and one wonders why he didn't apply this clarity of thought to Fastow's SPV's.

Though a small point, I differ somewhat with Eichenwald in his mild contempt for mark-to-market accounting. Enron certainly bungled mark-to-market in that they were actually applying, in the words of one sniping executive, "mark-to-guess". But the Enron abuse does not disprove the mark-to-market concept altogether. The best article I've read recently on this question is that of […] in *GARP Risk Review*, …. [need to fill this in]

Another reason that Eichenwald's *Conspiracy* is great is that it prompts the reader to ask more questions. It's too easy to conclude that Enron was a "bad" company with some "bad" executives. Though true, that characterization doesn't help us improve our own firms. All companies have elements of Enron such as excessive concern for appearances (as opposed to real issues) in the financial statements, turf battles, intrigues, and secrecy among senior executives, and undue appreciation of revenue generation relative to support functions.

So what is it that makes good organizations "good"? The very top executives of a company must declare and demonstrate that these Enron-like elements are unacceptable. Senior executives set the culture. This is the greatest failure of Skilling and Lay. By omission, they and the Board of Directors permitted Fastow's fraud. They did not confront or even notice the secrecy in

which Fastow and his people shrouded the SPV transactions to the detriment of Enron shareholders.

Finally, let's examine the Chief Risk Officer (CRO). Eichenwald implies that Rick Buy's role was minimal when times were good. There's no evidence of important guidelines or principles that Buy promulgated to impose risk management. There's no indication that Buy supervised meaningful measurement of risk across Enron. If anything, he appears to have discouraged such efforts that Vince Kaminski proposed due, apparently, to his sense that he lacked the political strength vis-à-vis Fastow to gain executive approval for enterprise-wide risk management.

Yet as the corporate death approached, Rick Buy found himself to be much more popular. Every external investigation gave the CRO a starring role. There are two lessons here. It may ultimately be catastrophic for an organization to have a CRO who is either not competent or politically weak and marginalized (though many apparently good years may pass). In the way of personal advice for the CRO, the position is perilous. When disaster strikes, you will be accountable. Make sure it's your disaster. That is, be effective now (when times are good).