

The Fall Enron

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(PFD File)

For Vince Kaminski, the in-house risk-management genius, the fall of Enron Corp. began one day in June 1999. His boss told him that Enron President Jeffrey K. Skilling had an urgent task for Kaminski's team of financial analysts.

A few minutes later, Skilling surprised Kaminski by marching into his office to explain. Enron's investment in a risky Internet start-up called Rhythms NetConnections had jumped \$300 million in value. Because of a securities restriction, Enron could not sell the stock immediately. But the company could and did count the paper gain as profit. Now Skilling had a way to hold on to that windfall if the tech boom collapsed and the stock dropped.

Much later, Kaminski would come to see Skilling's command as a turning point, a moment in which the course of modern American business was fundamentally altered. At the time Kaminski found Skilling's idea merely incoherent, the task patently absurd.

When Kaminski took the idea to his team -- world-class mathematicians who used arcane statistical models to analyze risk -- the room exploded in laughter.

The plan was to create a private partnership in the Cayman Islands that would protect -- or hedge -- the Rhythms investment, locking in the gain. Ordinarily, Wall Street firms would provide such insurance, for a fee. But Rhythms was such a risky stock that no company would have touched the deal for a reasonable price. And Enron needed Rhythms: The gain would amount to 30 percent of its profit for the year.

The whole thing was really just an accounting trick. The arrangement would pay Enron to cover any losses if the tech stock dropped. But Skilling proposed to bankroll the partnership with Enron stock. In essence, Enron was insuring itself. The risk was huge, Kaminski immediately realized.

If the stocks of Enron and the tech company fell precipitously at the same time, the hedge would fail and Enron would be left with heavy losses.

The deal was "so stupid that only Andrew Fastow could have come up with it," Kaminski would later say.

In fact, Fastow, Enron's chief financial officer, had come up with the maneuver, with Skilling and others. In an obvious conflict of interest, Fastow would run the partnership, sign up banks and others as investors, and invest in it himself. He stood to make millions quickly, in fees and profits, even if Enron lost money on the deal. He would call it LJM, after his wife and two children.

Stupid or not, Enron did it and kept doing more like it, making riskier and riskier bets. Enron's top executives, who fancied themselves the best of the brightest, the most sophisticated connoisseurs of business risk, finally took on more than they could handle.

Fastow's plan and Skilling's directive would sow seeds of destruction for the nation's largest energy-trading company, setting in motion one of the greatest business scandals in U.S. history.

On Oct. 16, 2001, Enron was forced to disclose \$1 billion in losses, more than half from LJM deals gone bad. Thus began a chain of events that would drive Enron's stock price into the dirt and force the company into bankruptcy proceedings, wiping out thousands of jobs and tens of billions of dollars in savings.

Enron was the first of the recent business scandals that have devastated investor faith, contributed to a multi-trillion-dollar market downturn and made corporate reform a political imperative.

The Washington Post examined Enron's epic collapse, focusing on the final five months, drawing on dozens of interviews with former Enron executives and employees and thousands of pages of Enron documents, records from an internal investigation, and sworn testimony from court cases and congressional hearings.

The company's story provides a powerful parable. Policymakers, investors and executives must grapple with its lessons today; business students and historians will study them for decades.

Enron was a fundamentally self-destructive institution, a house of cards where human error and a culture of ambition, secrecy and greed made collapse inevitable.

While Skilling has previously attributed Enron's demise to innocent misfortune -- a "classic run on the bank" -- the Houston firm was a victim of its own making, a virtual company with vastly overstated profits.

Skilling and Enron founder and chairman Kenneth L. Lay said they believe Enron remained profitable until its sudden collapse late last year. Skilling and Fastow declined to be interviewed for this article. Skilling has testified that he was unaware of any improper accounting or falsified financial statements. A spokeswoman for Lay said in a statement yesterday that Lay believes Enron's profits "were not inflated in any way."

Lay, who had turned day-to-day control over to Skilling in the late 1990s, was obliged as chairman of a company with 25,000 employees in 30 countries to "rely on talented people whose trustworthiness he had no reason to doubt," according to his spokeswoman, Kelly Kimberly.

Skilling, Lay's personally chosen successor as chief executive, was directly involved in the overstatement of profit, according to interviews and investigators' reports. He sponsored and approved accounting and tax gimmicks with private partnerships and funds that contributed billions in improper or questionable earnings. Those deals helped elevate Enron's stock price during the market's boom in the 1990s. Enron executives and directors sold \$1 billion worth of shares in the three years before the company collapsed.

Enron hailed 2000 as a breakout year with \$101 billion in revenue, more than double that of the year before, putting it at No. 7 on the list of largest U.S. corporations. Skilling, Lay, and 17 other officers and directors signed the 2000 financial statements, declaring them to be a true picture on which investors could rely.

The numbers were shams and the portrait was a fake, the record shows.

In 2001, Enron spent money faster than it was coming in. Most of its huge revenue gains came from power sales on its highly touted Internet energy-trading site. But revenue was padded in various ways. Traders swapped power with each other, internal memos state. Billions in loans were counted as cash from operations. And Enron's accounting inflated revenue from long-term contracts, former executives say.

Enron's profits were a mirage.

The company claimed that it earned \$979 million in 2000. But \$630 million of that came from improper accounting involving LJM and other partnerships, investigators for the company's board concluded. Another \$296 million in "profit" came from hidden tax-cutting transactions, not normal business operations.

Take away the accounting tricks and the company was making little profit, if any.

Enron used the bewildering complexity of its finances to hide its true nature. Some people had nagging suspicions. But like the cowed townspeople in the children's story, few questioned the emperor's new clothes.

"It's so complicated everybody is afraid to raise their hands and say, 'I don't understand it,' " Louis B. Gagliardi, an analyst with John S. Herold Inc. in Norwalk, Conn., said last year.

Enron's arc toward scandal and bankruptcy exposed the failure of watchdogs at every level. Its board defaulted on its oversight duties. Outside accountants ceded their independence and violated their profession's rules. Outside lawyers approved misleading deals and failed to vigorously pursue a crucial allegation of accounting misdeeds. Wall Street analysts led a cheering section while their firms collected enormous banking fees from the company. Regulators were overwhelmed by Enron's complexity. The media were blinded by its image of success.

Nobody looked inside the company and saw what wasn't there.

After Skilling gave Kaminski the assignment involving the LJM partnership in June 1999, the researcher and a member of his team worked through the weekend to check and recheck their analysis. On Monday morning, Kaminski was confident that it was a bad, even dangerous, deal for Enron. He told his immediate boss, Chief Risk Officer Richard Buy, that the Rhythms NetConnections-LJM partnerships venture should not go forward.

Kaminski described the deal as "heads the partnership wins, tails Enron loses."

Enron could not make the deal without the approval of its outside accounting firm, Arthur Andersen LLP.

But accountants there had the same reaction as Kaminski. Andersen partner Benjamin Neuhausen e-mailed his colleague David B. Duncan, head of Andersen's Enron audit team, to complain about Fastow's proposed role in LJM:

"Setting aside the accounting, idea of a venture entity managed by CFO is terrible from a business point of view. Conflicts galore. Why would any director in his or her right mind ever approve such a scheme?"

Duncan responded: "I really couldn't agree more."

But Duncan did not try to oppose the deal. In his e-mail to Neuhausen, Duncan wrote that Andersen would go along if Lay and Enron's 18-member board of directors approved the arrangement.

In a one-hour teleconference on June 28, 1999, that included five other items of business, the board approved the LJM proposal presented by Lay, Skilling and Fastow. It also gave Fastow permission to work simultaneously for LJM and Enron, despite the conflict of interest.

"I couldn't stop it," Buy told Kaminski. Kaminski wondered how hard he had tried.

Paraphrasing Winston Churchill's rebuke of Neville Chamberlain's appeasement of Hitler, Kaminski told a colleague that Buy had chosen shame over confrontation. The confrontation would come, Kaminski predicted.

Several days later, Kaminski was sitting in his office when the phone rang, according to one executive's account. It was Skilling, saying Kaminski was being transferred out of Buy's risk-management division because he was acting like a cop, trying to kill deals. People did not like it.

[A Patriarchal Visionary](#)

To understand Enron's fate, it helps to start with its beginnings.

In June 1984, when Ken Lay became chairman and chief operating officer of Enron's precursor, Houston Natural Gas, the firm's finances were a lot simpler. It was just a pipeline company. Lay quickly doubled its size by acquiring a Florida pipeline company.

But Lay's dreams were bigger still. Pipelines were profitable, and Lay wanted to create the largest pipeline system in the nation. The next year, Lay's firm merged with InterNorth Inc. Together, they owned about 40,000 miles of pipeline.

The company changed its name to Enron in 1986. It was just the beginning. Lay, its patriarchal visionary, was determined to create one of the biggest, most successful companies in the world.

With an ideological fervor for deregulation and a knack for winning influential friends, Lay campaigned for changes in federal energy rules that would allow natural gas to be sold on open markets like wheat or pork bellies. In doing so, he helped create an industry and made Enron a corporate political powerhouse.

In 1990, Lay hired the 36-year-old Skilling, a brilliant Harvard MBA who was a longtime Enron consultant, to pioneer the company's energy-trading operations. Skilling created the "gas bank," making Enron the first company to buy large volumes of gas from producers and resell it to industrial customers on long-term contracts. That stabilized the U.S. gas market, expanded gas production nationwide and fueled the phenomenal growth that Enron reported during the decade.

The synthesis of Lay and Skilling proved potent, putting Enron at a confluence of major political and financial currents. The deregulation of energy markets, spurred by the Reagan administration, created great opportunities. And Skilling's foray into energy trading came just as financial institutions were unleashing exotic investment tools -- a flow of money looking for opportunities.

A guru-like pitchman with a disdain for traditional business practices, Skilling was perfectly placed to ride the new wave. He gave the impression that pipelines were hopelessly boring. As he rose at Enron, he retooled the company in his own image: smart and arrogant, confident and flashy. He assembled a fast-moving band of self-described pioneers who embraced risky new ideas as the route to profits.

"We like risk because you make money by taking risk," Skilling said in an interview with University of Virginia business school professors two years ago. "The key is to take on risk that you manage better than your competitors."

Skilling was proud of pushing boundaries. He persuaded federal regulators to let Enron use "mark-to-market" accounting, an approved mechanism used by brokerages for securities trading. Skilling applied it throughout Enron's operations, from the Rhythms NetConnections transaction to its commodities trading. It allowed Enron to calculate revenue from long-term contracts and count much of it as immediate profit, although the money would not come in for years, if ever. For example, the company booked a \$65 million profit in 1999 based on its projection of natural-gas sales from a South American pipeline project. The pipeline had yet to be built.

In a bold stroke, Enron moved its gas and electricity trading online. Going far beyond energy, Skilling's young MBAs created unheard-of commodities markets -- even offering weather derivatives, contracts that gave businesses financial protection against the costs of heat waves or blizzards.

"We made the gas market in the United States what it is today," said Robert Hermann, Enron's former chief tax counsel. "We decided we could do the same thing with electricity, and we were well on our way to doing it. Then we thought we could do it with anything. We had people who thought they could sell hairballs if they could find the buyers."

Wall Street and the business press were dazzled. For six years running, Fortune magazine ranked Enron as the most innovative company in the nation. At an exclusive conference of intellectuals and political leaders at Davos, Switzerland, in 2000, Lay declared Enron the prototype of the "new economy" corporation. Lay described Enron executives as guerrillas fashioning bullets out of ideas.

"Somewhere out there is a bullet with your company's name on it, a competitor . . . that will render your strategy obsolete," Lay said. "You've got to shoot first."

'The World's Coolest Company'

As the nation's tech sector boomed in the late 1990s, Skilling said the transformed energy firm, with its online trading arm, deserved the sky-high stock price of a dot-com company. The market bought it. From 1998 to 2000, Enron's stock tripled in value.

"We're the world's coolest company," Skilling told the University of Virginia professors.

Lay even considered the idea of draping a giant pair of sunglasses around Enron's headquarters tower in Houston, Skilling joked.

"It was an intoxicating atmosphere," said Jeff S. Blumenthal, an Enron tax lawyer. "If you loved business and loved being challenged and working with unique, novel situations . . . it was the most wonderful place."

It wasn't just the ideas. The place was giddy with money. Enron paid employees \$750 million in cash bonuses in 2000, an amount approaching the company's reported profit that year.

The princes of Enron were its dealmakers or "developers," in-house entrepreneurs who launched businesses and structured deals so they could immediately claim huge profits for the company -- and bonuses for themselves -- while saving the problems for later.

From the company's earliest days, those princes flew around the world, overpaying for power plants in India, Poland and Spain, a water plant in Britain, a pipeline in Brazil, and thousands of miles of Internet cable. Enron accumulated 50 energy plants in 15 countries. Virtually none of them were profitable.

Lou L. Pai, a Skilling favorite, set up an Enron division that sold electricity to businesses. Pai received numerous stock options as compensation. He sold \$270 million worth of Enron stock in the 16 months before he left the company last year.

"The culture at Enron is all about 'me first, I want to get paid,' " Hermann said. "I used to tell people if they don't know why people are acting a certain way, go look up their compensation deal and then you'll know. There were always people wanting to do deals that didn't make sense in order to get a bonus."

Porsches replaced pickup trucks in the company parking lot as even secretaries became paper millionaires. There were mansions in Houston's posh River Oaks neighborhood, vacation homes in Aspen. Everybody went along for the company's wild ride.

In June 1999, when Kaminski opposed the Rhythms deal that Skilling and Fastow was promoting, his boss's wry response was telling.

"Next time Fastow is going to run a racket, I want to be part of it," Kaminski recalled his boss, Buy, saying.

To much of the world, Jeff Skilling looked like a genius. Between January and May 2000, the stock price had risen nearly 80 percent, to \$77 a share. Enron insiders -- Lay and Skilling among them -- had cashed out more than \$475 million worth of stock. Everybody was getting rich.

[A High-Tech Ponzi Scheme](#)

But Enron had created only an illusion of ever-expanding revenue and profits.

The company still needed increasing amounts of cash for its profligate new ventures and expanding energy-trading operations. Its grab bag of pipelines and plants could not produce enough money to drive the growth that Lay and Skilling demanded.

As Fastow explained in a CFO Magazine article, Enron could not keep borrowing in traditional ways without scaring lenders away and damaging its credit rating. Enron's investment-grade credit was just high enough to ensure that it could get the cash it needed to settle its energy contracts when they came due.

So Enron turned itself into a factory for financial deals that would pump up profit, protect its credit rating and drive up its stock price.

In the 1990s, banks and law firms began aggressively peddling "structured finance," complex deals in which companies set up separate affiliates or partnerships to help generate tax deductions or move assets and debts off the books. With Skilling's ascension to the presidency in 1997, Enron became increasingly dependent upon such deals to hit its financial targets.

"Skilling's participation in the LJM's and the other vehicles was probably the most important part of his job," said John Ballentine, a former president of an Enron pipeline subsidiary and a corporate vice president.

The company teamed up with the brightest minds in banking, accounting and law to create scores of secretive deals with exotic code names such as Braveheart, Backbone, Rawhide, Raptor and Yosemite.

Enron used the deals for various purposes. The LJM partnerships hedged risky stock investments such as Rhythms. An affiliate named Whitewing took billions of dollars of debt off of the company's books. In some cases, Enron "sold" money-losing foreign assets to the partnerships, added the proceeds to its quarterly financial statement and then bought the assets back in the next reporting period.

To entice banks and others to invest in the deals, Enron privately pledged millions of shares of its stock to guarantee against any losses. It was a risky gambit, exposing the company to losses if the price of its shares dropped and it could not cover its obligations.

It worked well for the short term, when Enron needed a quick boost for its quarterly earnings. But as Enron's trading expanded, its other businesses underperformed. Its debt and cash needs kept growing, so the company needed to make more and bigger "structured transactions" to keep the game going -- pledging increasing amounts of stock. Enron's strategy began to resemble what members of Congress would later call a high-tech Ponzi scheme.

[Name Enron's CFO](#)

In May 2000, Alberto Gude, an Enron vice president, went to see Lay just before Gude retired. He had known Lay since 1977 and wanted to warn him about the "selfishness" and "arrogance" of the team that had transformed the company. Lay said through his spokeswoman that he does not recall this specific conversation.

"I really believe you are in trouble," Gude recalled telling Lay. "Jeff Skilling and his team are not the same kind of people we are used to managing Enron."

According to Gude, Lay responded, "They are okay guys."

One of Skilling's "okay guys" was Andrew S. Fastow, then 38, Enron's chief financial officer since 1998. Skilling hired him from a Chicago bank where he specialized in numbingly complex deals to raise money for clients.

As the top finance man at Enron, Fastow was responsible for Enron's overall financial stability.

He was known as an intimidating and single-minded self-promoter. He liked to say that capitalism was about survival of the fittest. He flogged his team so furiously to close deals that they often made business calls in the middle of the night. Executives who attended meetings with Fastow recall him freely putting down older colleagues or anybody he perceived as weak.

As unpopular as he was, Fastow was untouchable. Skilling was positively enamored of him. "Fastow was Skilling's favorite," Enron lawyer Jordan Mintz said later.

But even Skilling later conceded to investigators that Fastow could be a "prickly guy that would tell you everything wrong about others and everything right about himself."

Fastow was also something of a mystery. He rarely attended the quarterly briefings Enron staged for financial analysts, making him the butt of a Wall Street wisecrack: "Name Enron's CFO."

He spent much of his time as managing partner of the LJM partnerships. Although he later said he spent only three hours a week on the partnerships, colleagues complained that he was constantly working on his own deals. He jetted to New York, California, Florida and the Caribbean, hunting investors.

For Enron, Fastow's effort was time well spent. LJM1 had been a huge success.

The Rhythms stock was worth nearly \$60 a share when the second quarter of 1999 ended, giving Enron a paper profit of about \$300 million. That windfall exceeded Enron's net income for the quarter. By the end of the year, Rhythms stock had dropped to about \$30 a share -- but thanks to the hedge with LJM1, Enron avoided reporting any losses on the decline.

It was easy to see the deal as an act of financial wizardry.

So Skilling supported Fastow's drive to create a much bigger private equity fund, LJM2, capitalized with more than \$300 million from outside investors -- more than 20 times the size of LJM1. This time, the board required Fastow's colleague, Chief Accounting Officer Richard A. Causey, to monitor what Fastow was doing.

But nobody reined in Fastow.

In raising money for LJM2, he was both ruthless and charming, colleagues said.

Fastow strong-armed Enron's major Wall Street banking partners, threatening to take away Enron's banking business if they did not put money into his fund, former Enron treasurer Jeffrey McMahan said later.

The banks put up a "huge outcry," but many ultimately invested, including J.P. Morgan Chase & Co., Citigroup Inc. and Merrill Lynch & Co.

"The banks complained they were being told that investing in LJM2 was a quid pro quo for future Enron business," McMahan later told investigators.

Fastow used the soft touch with people like Joe Marsh. A wealthy Floridian, Marsh had been approached in 2000 by his Merrill Lynch stock adviser about investing \$1 million in LJM2. Fastow's partnership would do deals with Enron, promising gaudy annual returns of 20 percent or more.

At first, Marsh was skeptical. "It sure sounded like a conflict of interest," he said. So his broker arranged for Marsh to do a conference call with other investors and Fastow.

Fastow was knowledgeable, at ease and persuasive, Marsh said. "He said he was putting in \$5 million of his own. His wife was mad at him for doing it, but he really believed in it," Marsh

said. Enron's lawyers and accountants, the board, Merrill Lynch, everyone had approved it. "It got flying colors." Marsh was convinced. He put in \$1.6 million.

Fastow had married into a wealthy Houston family. He wanted wealth of his own, colleagues said.

At Enron, Fastow made about \$2.4 million in salary, bonus and incentives. But he had long chafed at the huge bonuses that division chiefs were getting from big power plant and pipeline deals. He wanted a similarly lucrative payday for himself. He got one from LJM1 in the spring of 2000, when Enron and the partnership ended the Rhythms transaction.

Three London bankers who have been accused in criminal fraud complaints of joining with Fastow to cheat their bank in the Rhythms deal had a pithy take on what motivated him. "We should be able to appeal to his greed," one of the bankers e-mailed another in February 2000.

Fastow's dealings with the British bankers were not revealed until much later. Fastow's secret profit from LJM1 and the Rhythms deal was staggering: a \$1 million investment turned into a \$22 million profit in less than a year.

A Closely Held Secret

For a while, LJM2 looked like a great deal for everyone.

From 2000 on, the LJM deals provided most of Enron's profits, though they remained invisible to outside investors.

At the end of each financial quarter, whenever Enron needed to sell a pipeline or Internet cable, or execute a helpful commodities trade, it would turn to Fastow for almost instant results.

Even inside Enron, the exact details were a closely held secret. People gossiped that Fastow was getting rich, but nobody asked how rich.

Enron's board, which twice waived the company's code of ethics to allow Fastow's dual roles, could have asked, but it did not until too late. Board members later said they were misled by Enron executives. The board set up an elaborate system for monitoring Fastow, with three committees assigned to the task. But board members put little energy into it, repeatedly failing to ask pointed questions, a Senate subcommittee later concluded.

As Enron's chief financial officer, Fastow was supposed to be the company's financial watchdog, even in the LJM transactions. But Fastow personally profited if LJM bested Enron in negotiations. Some Enron colleagues say Fastow bullied subordinates to win an advantage for LJM. He pressured one, William Brown, to close a deal on terms unfair to Enron, Brown later told investigators.

As more colleagues came to believe that Fastow was enriching himself and a few close to him, the deals became a source of envy and suspicion.

In early 2000, McMahon complained to Skilling about Fastow's conflict of interest, McMahon later told investigators. Soon afterward Fastow confronted McMahon.

Fastow told McMahon that he "should have known everything said to Skilling would get back to him," McMahon recalled.

A week later, Skilling encouraged McMahon to take a job in another part of the company. Skilling replaced him with Ben F. Glisan, one of Fastow's closest aides.

The message flashed throughout Enron: Don't mess with Fastow.

When Mintz, a lawyer who worked under Fastow, later complained to Buy about the conflict, Mintz said Buy warned him not to "stick his neck out."

Enron had publicly identified Fastow as LJM's general manager in its proxy statements in 2000 and 2001. But in its quarterly and annual financial statements filed with the Securities and Exchange Commission, Enron had not named him. It merely referred in footnotes to "a senior officer of Enron," a vague description that troubled some Enron executives and left some investors in the dark.

But the word was getting out.

'Questionable Quality'

By spring 2001, Fastow's identity -- and his LJM role -- attracted attention from a few Wall Street analysts, financial speculators and journalists.

In May, a column on TheStreet.com cited a very critical analysis of Enron's finances by a private research firm, Off Wall Street, that alerts subscribers to high-priced stocks that are primed to fall. The analysis concluded that Enron's stock was worth only half of its \$59 price.

"It probably should come as no surprise that Enron management appears to have resorted to a variety of transactions that are of questionable quality and sustainability to manage and to boost its earnings," the analysis said.

In the center of the TheStreet.com's column was Fastow's name as the head of one of the questionable Enron partnerships that "consistently bugs analysts."

Others questioned why so many top Enron executives were leaving -- after cashing in stock. In June, U.S. News & World Report quoted skeptics asking whether Enron's financial reports masked an underachieving company. After starting 2001 in the \$80 range, the stock had drifted downward. By July it was below \$50.

Once investors and journalists started asking about LJM, Skilling "got concerned," Mintz and one of Enron's outside lawyers, Ronald T. Astin, later told investigators.

Some Enron lawyers had been saying all year that they wanted Fastow out of LJM. They were worried that the company would have to provide more details about Fastow's partnership to comply with SEC disclosure rules.

Mintz had written an internal memo stating there was "no possible legal argument" for not disclosing how much Fastow had profited personally from the LJM partnerships in the company's next proxy statement.

Enron was expecting a routine SEC review in the coming months, making it more urgent to get Fastow out of LJM.

But he was reluctant to walk away from the partnership. He tried at first to reduce his role, but the Andersen accountants said that Enron would have to disclose the relationship anyway.

Skilling sat down with Fastow and gave him a choice, Skilling later told investigators. He could be Enron's chief financial officer or run LJM, but he could not keep doing both.

Fastow wanted to think about it.

Ultimately, Fastow had what Mintz later described as a "melodramatic moment" and resolved to sell his interest to one of his closest associates, Michael J. Kopper, who left the company in order to take over LJM. Mintz did not know the terms.

Several Enron lawyers met to discuss whether Enron should know. A lawyer for Enron's main outside firm, Vinson & Elkins LLP, advised that Enron didn't have any obligation to know. So Enron didn't ask.

That summer, accounting professor Bala G. Dharan pointed out some opaque financial transactions in Enron's published financial statements to a class at Rice University in Houston. He flashed the cryptic reference to the "senior officer" on the screen. He wondered aloud about the executive's identity.

After class, a student -- an Enron employee -- approached. "Everybody knows that, Professor Dharan. It's Andy Fastow."

'Real Minor Things'

On July 12, 2001, in one of those routine rites of business, Skilling fielded questions from Wall Street analysts about the company's second-quarter financial results. Skilling batted away the analysts' mild queries. Enron had "outstanding" results, he said, a 40 percent increase in profit.

Finally, Skilling was asked an obscure-sounding question by Carol Coale, a securities analyst with Prudential Securities Inc. in Houston and a growing skeptic.

What about Enron's transactions with your "MLT affiliate" she asked, groping for the correct name, LJM.

Skilling mentioned there were "a couple of real minor things" with LJM, before dismissing the question: "There are no new transactions in LJM."

"He's lying to me," Coale thought. She, too, had been piecing together the sketchy clues from Enron's financial statements. She suspected that Enron was using LJM to hide big losses.

But she did not press him. People who dealt with Skilling knew not to do that. And despite her misgivings, Coale did not feel that she had enough information to advise investors to sell their Enron stock. By the end of July 2001, Lay and Skilling were on the road again, telling analysts that Enron had never been stronger.

The response was nearly unanimous: "Buy, buy, buy."

The full story of LJM remained hidden.

Second of five articles

Jeffrey K. Skilling was sketching the history of Enron Corp. for a newspaper reporter last summer, boldly comparing its impact on energy trading to the revolutionary changes that John D. Rockefeller's Standard Oil imposed on the petroleum industry a century before.

The moment the interview ended, the 47-year-old executive checked his desktop computer, where Enron's stock price flashed on the screen.

For Skilling, Enron's brash and relentlessly competitive chief executive, the price was critical to his success. It had been about \$79 a share when he became chief executive in February 2001. In typically audacious fashion, Skilling boasted to securities analysts that it should be \$126. Instead, it had tumbled.

By the beginning of August, the stock price was below \$46. If it kept falling, Enron's very foundations could crumble under the weight of an avalanche of debt, a threat known to only a few at the top of the company.

Nothing had gone right in the six months since Skilling had ascended to his dream job.

Enron abandoned a costly bid to become the leading supplier of first-run movies on the Web. Its other bright hope, retail electricity sales, was fading. The California energy crisis had stained the company as a greedy profiteer; in June, a protester hit Skilling with a pie. The company's costly power plant in India was mired in political controversy. Enron privately classified 45 percent of its \$9 billion in international projects as "troubled" assets.

The strain on Skilling, a man who hated to lose at anything, was unmistakable. Several months earlier, he lost his cool in a conference call with analysts, rebuking a skeptical fund manager with a crude anatomical reference. That shocked some Enron board members. One director began asking major investors, "What do you think of Skilling?"

[The bad news kept coming.](#)

On Aug. 7, the stock of an electricity retailer called the New Power Co. plunged 30 percent after it issued a gloomy financial report.

Enron had created New Power and spun it off as a publicly traded company, keeping a large stake for itself. At first, New Power's stock price climbed, giving Enron a \$370 million paper profit. The drop threatened to erase that gain.

More ominously, the New Power investment was linked to a much larger, multibillion-dollar structure, a confidential series of four investment vehicles called the Raptors. Those vehicles were funded by Enron and New Power stock.

Enron had used the Raptors to hedge its risky tech stock investments, protecting \$1 billion in income over the past 15 months. The fall in the New Power stock threatened to topple one of the Raptor structures, triggering a domino effect that would knock over the others.

By August, the various structures were insolvent or close to it. Enron had had to put millions of shares of its own stock into the Raptors to rescue them in the spring, or it would have been forced to report more than \$500 million in losses on its financial statements.

Skilling's job had become a nightmare of his own making.

He had pushed Enron to change constantly in a quest for the next new thing. Each annual report emphasized a different venture that would be its next big score.

"There was a new message every year," said David Micklewright, a managing director of D'Arcy Masius Benton & Bowles, Enron's advertising firm. "Because it made all these changes, it was considered a fluid and brilliant company. But in retrospect it did that because things weren't working, and it was time to move on."

'The Creative Ones'

In the first week of August, Skilling, who occupied an office suite on the 50th floor of Enron's Houston headquarters, dropped in on the seventh floor to deliver a pep talk. He addressed about 100 employees of Enron Energy Services, a troubled division unsettled by reorganizations and internal questions about whether it was really making any money.

Inside Enron, Skilling was accustomed to deference. But on this day, employees challenged him.

According to former Enron executive Margaret Ceconi, a worker asked: Why was Skilling selling his Enron stock? Skilling, who received about \$8.7 million in salary, bonuses and incentives that year, answered that he had instructed his brokers to make periodic sales for "estate planning" and to raise money for his new \$4.2 million house in opulent River Oaks.

Skilling assured the assembled employees that their division was doing great. "You are going to be a half-billion bottom-line company in the next couple of years," Ceconi recalled him saying.

Ceconi raised her hand. Exactly how would they do that?

"You guys are the creative ones," she recalled him saying. "That's what you guys are going to have to figure out."

A few hours later, Enron announced the layoff of dozens of employees in the division, including Ceconi.

Charismatic Strategist

At Enron, Skilling played by his own rules and bent others to his will. The son of a valve company manager, he grew up in New Jersey and Illinois, studied engineering at Southern Methodist University and earned an MBA from the Harvard Business School.

He was a born leader, said his youngest brother, Mark, who recalled his brother as a uniquely charismatic and creative child who led the adventures, from dam building to re-enacting the Apollo moon landing. His enthusiasms were ever-changing; the constant was the other children always followed him.

Skilling began working with Enron in 1986 as a consultant from the influential McKinsey & Co. consulting firm, whose partners had the ears of CEOs around the world. James W. Crownover, who hired Skilling at McKinsey's Houston office, remembered him simply as "outstanding in every respect" and "one of the most talented people we ever had."

A charismatic strategist, Skilling quickly won the confidence of Enron founder Kenneth L. Lay with his innovative ideas about trading natural gas.

"I don't think he has a non-strategic bone in his body," Lay said of Skilling.

Lay made him president of Enron's trading operations in 1990. Although Skilling had never run a business of any kind, he denounced traditional business practices in mesmerizing fashion.

He and Lay pursued a vision of a new Enron that would reinvent itself from a staid gas pipeline company into a global energy trader. In 1997, Lay made him company president, in charge of daily operations.

Physically short and slight, Skilling cultivated an in-your-face persona. He mocked competitors as foundering clipper ships. He led favored subordinates -- his "Mighty Man Force" -- on adventure trips, biking across Mexico and racing SUVs in the Australian Outback.

In April 2001, when Skilling had been Enron's chief executive all of two months, Worth magazine named him No. 2 of the 50 top chief executives in the nation, behind only Steve Ballmer of Microsoft.

Skilling "could out-argue God," recalled Tom Peters, a best-selling management expert who had worked with him at McKinsey.

But he also found smaller targets inviting, bullying the woman who ran office administration. From the moment he became an Enron executive, Skilling treated Mary Wyatt, a vice president in property management, as an enemy, deriding the "building Gestapo" as the epitome of narrow-minded traditionalism.

Disdainful of Enron's modular office system, Skilling demanded that his trading office have glass walls, to make it look more like a bank, Wyatt recalled. "That was pretty much the beginning of the end of the standard workplace," she said.

Skilling was the only Enron manager who refused to fully reimburse the company for his division's office space and cafeteria services. He got a cut-rate deal, Wyatt said. "He screamed and hollered," she said. "We ended up basically letting him do whatever he wanted."

'Rank and Yank'

Skilling set about imposing his philosophy on Enron.

He adopted what he called a loose-tight management structure that pushed executives and employees to be creative in pursuing the big deal. Loose meant taking risks. Tight meant central controls over critical parts of the operation, such as trading and credit risk.

"You want to try a new product with a customer, you don't have to ask me. Just do it. We just took away a lot of clutter," Skilling said in an interview with University of Virginia professors preparing a case study of Enron's management style in 2000.

Skilling told Robert Bruner, one of the professors, that as many as 20 executives reported to him directly, forcing him to delegate decisions widely. He said he depended on subordinates to bring problems to him.

He rarely sent e-mails, colleagues said, and did not prepare notes for his presentations to Enron's board. After approving the most complex tax transactions, designed to bring the company millions in deductions, he declined to accept copies of the documents, pushing them back across the table, a former executive said.

Being unconventional was good business, he asserted.

"I always said our weirdest people were our best people," he said. "Weird people come up with weird ideas. Hallelujah. It's the weird ideas that create new businesses."

But some were not so blinded by his light. Alberto Gude, a former Enron vice president in computer systems, remembered Skilling as an erratic manager who micromanaged projects he cared about, but was recklessly inattentive to the fundamentals. He had "a total lack of regard for how a business should be run," Gude recalled.

Once, when an Enron executive named Michael Ohannesian was meeting in a glass office with a vendor, Skilling walked past and made an obscene gesture behind the vendor's back. "He thought he was the smartest man in the world and everyone else was stupid," Ohannesian said.

Gude said: "We were creating a very arrogant management team. We were treating people, like vendors and providers, like dirt. We were trying to project a figure of Super Human."

Skilling imposed a Darwinian personnel system known as "rank and yank," where a committee of two dozen executives rated employees on a numerical scale to determine promotion, bonuses and firings. He told Harvard Business School researchers that his approach eliminated office politics, because "you can't kiss 20 asses at once." But many employees were demoralized by the system, saying it encouraged Machiavellian scheming and punitive paybacks.

Accounting That Mystified

Skilling's most important innovation may have been in spearheading a fundamental change in the way Enron did business. In 1992, he persuaded federal regulators to permit the company to use an accounting method known as mark to market. It was an accepted technique for brokerages and trading companies, who used it to record the value of their securities at the close of the market each day. Until Skilling, it had not been permitted for energy companies.

He won approval over the objections of some Securities and Exchange Commission staffers. That day, he gave an elated shout and a cheer went up in the office. The coup allowed the company to count projected earnings from long-term energy contracts -- money it might not collect for 20 years, if ever -- as current income.

Skilling personally benefited: His employment contract guaranteed him as much as 3 percent of the value of his division's business, and that value would soar with mark-to-market accounting.

Beginning in the mid-1990s, Enron's trading operations grew geometrically. By 2000, company revenue had increased to \$100 billion from \$13 billion in 1996, the year before Skilling became president. Former Enron employees would later assert the mark-to-market accounting technique was widely misused to inflate those numbers through manipulation of projected future revenue flows.

"When we marked to market, we were truly controlling our revenue. That was how your business model was set up," said Rudy Sutherland Jr., 35, a former Enron trading software manager. "You could always meet [Wall Street's] expectations."

Enron's accounting mystified almost everyone. Analysts, investors, even some top executives say they were baffled by it.

In a small meeting with Skilling in 2000, Robert J. Hermann, the company's former general tax counsel, asked, "Are we really making any money?"

Skilling acted surprised.

"He said, 'Yeah, why? What are you concerned with?' " Hermann later recalled.

Hermann told Skilling he was worried that the company was paying so little in taxes.

"I've always believed if you are making real money you pay taxes," Hermann said.

Skilling, Hermann said, explained that mark-to-market accounting allowed Enron to make money and grow without bringing in a lot of cash and paying a lot of taxes.

Hermann was in his office the next day when the phone rang. It was Skilling. He pleasantly inquired, "Are you comfortable with that explanation? Did that answer make sense? Are you comfortable?"

"Not entirely," Hermann said.

But he was not shocked either. He knew that Enron's numbers depended on a lot of arcane deals, and managers faced intense pressure to meet earnings targets. His tax division was a major profit center for the company, providing tax benefits that boosted the company's earnings by \$1 billion over five years.

"We believed we could just about do anything because we always did," Hermann said later.

"We would sit there and talk to each other in my department and say, 'I can't believe we are going to be able to make the earnings.' We'd say, 'But we always have.' And then we would."

The Raptors' Risks

By August 2001, however, the Enron alchemy was no longer working. Long-hidden problems were becoming unmanageable.

The gravest of these was the impending failure of the vastly complex Raptor transactions.

Skilling had ordered his experts to construct the deals and put his chief financial officer, Andrew S. Fastow, in charge. The four Raptor ventures were owned by Enron and a private investment partnership called LJM2, which was run by Fastow. His dual roles at the company and the partnership were an obvious conflict of interest, but Enron's board had approved it at the urging of Lay and Skilling.

The Raptors protected Enron's investments in risky start-up companies through a financial transaction called a hedge, which would cover Enron's losses if the stocks of New Power and the other start-ups fell.

Under accounting rules, Enron needed an independent investor to make such a hedge work. But no true outside investors would give Enron such a guarantee on reasonable terms because the risk was too great.

So Enron turned to LJM2. Under its agreement with the partnership, Enron contributed about \$2 billion in stock to the Raptors and LJM2 contributed \$120 million in cash.

But in a twist that would look highly suspicious to investigators later, Enron repaid LJM2's initial investment within six months, plus another \$40 million in profit. That left only Enron stock or stock pledges at risk in the deal.

In effect, Enron was hedging with itself and bearing all the risk.

The hedge worked as long as Enron's stock price stayed high, giving the Raptors the ability to cover any Enron investment losses.

If Enron's stock dropped in value, however, the Raptors would be unable to pay and the company would be exposed to large losses.

Enron's top officials were well aware of the Raptors' risks, documents and interviews show.

The previous summer a relatively new Enron lawyer named Stuart Zisman reviewed the Raptors in order to write a legal risk memo. He concluded that the transactions posed grave risks and "might lead one to believe that the financial books at Enron are being manipulated."

Zisman's boss, Mark Haedicke, responded by reprimanding him for using critical and inflammatory language, such as "cleverly designed" to describe the transactions.

After meeting with senior attorneys in his department, Zisman shifted his position, saying he did not know whether the transactions were being manipulated, but feared they might be.

A few months after Zisman's memo, the Raptors first got into trouble when two of the four partnership deals began to fail -- their obligations to Enron began to exceed their ability to pay.

Enron executives fixed the problem temporarily by having the two solvent Raptors cover the debt of the two failing ones.

The problems persisted and the Raptors had to be rescued again three months later in March 2001, just after Skilling took over as CEO. The solution: Fastow and Richard Causey, the chief accounting officer, arranged to transfer 12 million Enron shares, worth more than \$700 million at the time, into the Raptors from another partnership.

Causey later told investigators Skilling approved the solution.

This "solution" appalled some of the most senior accountants at Arthur Andersen LLP, Enron's outside auditor. Those accountants specialized in reviewing tricky accounting maneuvers. But Andersen approved the deals anyway, under strong pressure from its client. The only alternative for Enron was to face up to a \$500 million loss in the first quarter.

Skilling would later testify before Congress that he did not know the details of the Raptors' problems, would not have understood them if he had and left them to his top aides to solve. But Causey and other Enron executives said Skilling was "intensely interested" in efforts to solve the Raptors' problems, an assertion that Skilling denied.

Ryan Siurek, a senior director on Causey's team, told investigators that he believed Skilling was the "ultimate decision-maker" on the Raptors' rescue.

In fact, Siurek said that he helped Causey prepare a presentation laying out alternatives so Skilling could "make decisions" on the rescue.

Several senior Enron executives said the cautious Causey, one of Skilling's hand-picked lieutenants, would not have kept his boss in the dark on such a critical transaction.

On March 26, 2001, the day the Raptors' second rescue was executed, Siurek received a phone call. It was Skilling, offering thanks and congratulations.

Tragedy at Teesside

An Aug. 8 blast at Enron's Teesside Power Plant in England killed three workers.

The next day, Skilling flew there on a trip arranged by a public relations firm called Gentle Persuasion. He perched on the settee in the modest parlor of Philomena Higgins, whose son Darren, 28, was among the dead.

Higgins, 68, was so numb she would not have cared if the queen of England had stopped by offering condolences. "Where he came from I'm probably just a peasant," Higgins said. "Afterward, when I thought about it, it was very kind of him to fly over to visit the family. He seemed very genuinely concerned."

Days later, colleagues concluded that the Teesside tragedy compelled Skilling to rethink his life.

If his visit sparked an epiphany, Higgins did not notice.

"He didn't go into deep conversation," she said. "To be quite honest, if he said two dozen words that was about the whole of it. He stayed a half-hour, he passed on the condolences of the whole company, worldwide. He did shake my hand and give me a kiss on the cheek when he was going."

In the middle of August, Ken Lay returned from an overseas trip and met with Skilling, who went over a list of company business. At the end, Skilling added a shocker: He wanted to resign.

He said he wanted to spend more time with his family, mentioning teenagers and a "family issue," Lay would later recall. Skilling said the pressure had gotten to him. He could not do anything about Enron's dropping stock price. He could not sleep.

Lay asked Skilling to take the weekend to reconsider. In fact, Lay had been privately planning his own departure from Enron, he said later. Now, his handpicked successor was beating him to the door.

On Monday, Lay again implored Skilling to stay. But he was adamant. That night, an emotional Skilling informed the board of directors at a working dinner. Lay later said Skilling teared up. At the meeting, Causey and another Enron executive ticked off a litany of serious problems facing the company, from negative cash flow in the first half of the year to price-gouging investigations in California.

On Aug. 14, Skilling announced his resignation publicly. His last official performance was that day at Lay's side, as both men assured investors that there was no bad news lurking behind the departure. Enron had never been in better shape, they said.

The next day, Carol Coale, the Prudential Securities analyst who had been skeptical of Enron's claims of success, asked to meet with Skilling. She saw him in his office, next to the boardroom at the top of the Enron tower.

To Coale, he looked not just beaten, but broken. He talked about feeling exhausted and needing to attend to family problems. She asked why he had not allowed himself to get fired, so that he could collect a \$20 million severance package.

"I can't go around Houston and hold my head up if I've been fired by Enron," she recalled him saying. "Houston is a pretty small town."

Crownover, Skilling's former boss at McKinsey, called him after the resignation to offer condolences. "He had been going 100 miles an hour for a dozen years. I think he just got frazzled," Crownover said later. Skilling had finally failed at something.

"Somebody who's been that high up, has been lauded and has a high regard for his own ability, to go from the tip of the top to the bottom, I just think it got to be too much," Crownover said.

What Skilling knew about Enron's growing predicament remains the subject of much debate and speculation.

Skilling later testified before Congress that when he left, the company was "in strong financial condition" and "highly profitable." He depended on Enron's experts and outside lawyers and accountants, he said.

"I was not aware of any financing arrangements designed to conceal liabilities or inflate profitability," he said. "The financial statements issued by Enron, as far as I knew, accurately reflected the financial condition of the company."

A chief executive is entitled to rely on expert subordinates, but is responsible for overseeing them, said William McLucas, the Washington lawyer who headed the investigation of Enron launched by its outside directors. "There cannot be willful blindness," said McLucas, a former SEC enforcement chief.

The financial problems that Skilling said he was unaware of included the Raptors. But they were proposed and approved by Skilling and were responsible for most of Enron's reported profit in 2000 and 2001. Skilling also attended at least one board meeting where Andersen warned that Enron was using untested "high-risk" accounting maneuvers that might not withstand regulatory scrutiny, company records show.

In addition, Skilling personally approved Enron's confidential tax transactions that had created more than \$1 billion in one-time paper profits since 1997, according to Hermann, the former chief tax executive. Investors had no way of knowing that these profits were not coming from the company's ongoing businesses.

One former colleague said Skilling's position was unambiguous: He knew whatever he chose to know.

"He knew what *he* needed to know to win," said John Ballentine, former president of an Enron pipeline subsidiary. "That doesn't equate to knowing what the *company* needed."

When the Whistle Blew

On Aug. 15, the day after Skilling quit, a 41-year-old Enron vice president named Sherron Watkins wrote a now-famous anonymous letter to Lay suggesting that Skilling was running from an approaching storm.

"I am incredibly nervous that we will implode in a wave of accounting scandals," the letter said. "Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues. Enron has been very aggressive in its accounting." She specifically cited the Raptor transactions.

Watkins was not Enron's Mother Teresa. Ambitious like her peers, she worried about her future at Enron after an unsuccessful stint at the company's failing broadband Internet venture. She had gotten a temporary assignment to evaluate Fastow's LJM transactions, including the Raptors, as Enron pondered what to do with them. And that had led her to Enron's hollow center.

She did something unheard of inside the company: she blew the whistle so loudly it sounded all the way to the top of the headquarters tower.

In her memo, Watkins asked Lay to respond to her concerns during an all-employee meeting scheduled for that week. Reacting to a potential whistle-blower in their midst, Lay's top advisers drafted talking points for Lay to use at the meeting, in case the letter writer surfaced.

But nobody at the meeting asked the tough questions.

On Aug. 17, shrugging off the Skilling resignation, Lehman Brothers rated the company a "strong buy" and said: "The Enron machine is in top shape and continues to roll along. We don't see any reason to change our estimates or outlook."

Enron shares were trading at slightly more than \$36 a share.

In the third week of August, Chung Wu, a UBS PaineWebber broker in Houston, e-mailed 73 investment clients saying Enron was in trouble and advising them to consider selling their shares. Some of his clients were Enron executives, and the managers of the company's stock option plan soon heard about Wu's action. They demanded that he be disciplined.

PaineWebber handled personal investing for many Enron top executives, and the firm itself was recommending Enron to investors as "a strong buy." PaineWebber later said it fired Wu because he gave clients advice contrary to the company's without authorization.

On Aug. 20, Watkins, who had once worked at Arthur Andersen, made an ostensibly social phone call to a former colleague there, James A. Hecker.

After chatting about the job market and Skilling's resignation, Watkins raised some of the same concerns about LJM and the Raptors she had put in her letter to Lay. She told Hecker she thought Enron's financial disclosures were incomplete and misleading.

Hecker told her it sounded as if she had some good questions.

He hung up the phone concerned enough to write a three-page memo to alert Andersen about her concerns. He took care to vet his memo with David Duncan, the senior Andersen partner heading the Enron audit team.

Hecker e-mailed his colleague asking him to look for any " 'smoking guns' that you can't extinguish."

Andersen had okayed the Raptors deals for Enron. Trouble for Enron was trouble for Andersen.

'Train Wreck' Scenario

Shortly after writing her anonymous letter, Watkins identified herself. She met with Lay on Aug. 22. She brought with her a follow-up memo with more details. Watkins complained that Fastow and his LJM partners already had their investment repaid -- with a profit -- in the Raptor deals and thus had "no skin in the game." Enron bore all the risk. Now that risk was becoming a reality.

"All has gone against us," she concluded in the memo.

After assuring her he would look into the matter, Lay turned her letter over to Enron's general counsel, James Derrick. With Lay's approval, Derrick hired the company's main outside law firm, Vinson & Elkins, to conduct a preliminary inquiry to determine whether a fuller investigation was necessary.

One of the first people the law firm interviewed, on Aug. 27, was Fastow. He made it plain he was annoyed at being questioned.

Sure, some of his LJM deals were conducted in a "gray area" and would cause some "bad cosmetics" if news of them landed in the business press. But they had been approved by the board, by Andersen and by Enron's Office of the Chairman, which meant Lay and Skilling.

These were great deals for Enron, Fastow said. In the very first one, involving a hedge of an Enron investment in a tech stock called Rhythms NetConnections, Fastow noted that Enron had booked hundreds of millions in profit.

Fastow dismissed the "train wreck" scenario laid out in Watkins's letter. The letter writer was simply wrong, he said. The thrust of his interview was that the Raptors posed no serious threat to Enron.

But he glossed over the gravest risk. Written into the Raptors deal was Enron's promise to add as many shares of its own stock as needed to keep the Raptors structures solvent, up to a point. If Enron's stock fell below \$20 a share, the company could not make good on the promise. And the Raptors would go broke.

Four days later, on Aug. 31, the Vinson & Elkins lawyers interviewed Causey. It was true, he said, if Enron stock dropped to \$20 a share or below, the Raptors losses would begin appearing on the company's financial statements. In other words, at that point the train would go off the rails.

"All these consequences were known to Jeff Skilling and Ken Lay through discussion of this structure," Causey told the V&E lawyers.

That day, Enron stock closed at \$34.99 a share. It had lost more than \$10 a share that month. The \$20 precipice was drawing closer.

Third of five articles

David B. Duncan, the Arthur Andersen LLP partner in charge of the Enron Corp. audit team, had reason to be nervous when he sat down with two lawyers from a prominent Houston law firm, Vinson & Elkins LLP, on Sept. 5, 2001.

Enron Chairman Kenneth L. Lay had hired the lawyers from Enron's leading outside law firm to look into allegations of deceptive bookkeeping, corrupting conflicts of interest and hidden partnership investments gone dangerously awry.

Sherron Watkins, an Enron vice president and an accountant, put the allegations in an Aug. 15 memo to Lay. They were aimed right at Duncan, 43, a rising star at Andersen who made \$700,000 a year. His audit team had approved the risky partnership investments that propped up Enron's finances.

He had reason to be nervous, but he gave composed and reassuring answers.

There was no problem with Enron's accounting, Duncan told the lawyers.

While some of the accounting that troubled Watkins "may look facially questionable, it satisfies the technical requirements," Duncan told V&E lawyers Joseph C. Dilg and Max Hendrick III.

"Unique control features" are in place to protect Enron, top-drawer consultants had reviewed the deals for fairness and decision-makers "from the highest levels" of Enron had approved them, Duncan said.

Duncan didn't mention important facts. Watkins's allegations had reignited a serious dispute inside the accounting firm. Senior experts at the firm complained that Duncan's team *had* used improper accounting in approving the partnership investments code named the Raptors -- just as Watkins had alleged -- and then created a false paper trail to justify their actions, according to internal Andersen memos.

Duncan said nothing about that in his interview, according to the lawyers' notes.

'A Whitewash'

Five days later the two lawyers met with Watkins. She repeated the outlines of the calamity she had described to Lay:

The Raptors were failing and Enron would be faced with huge losses -- \$500 million was at risk. Enron's chief financial officer, Andrew S. Fastow, ran the outside partnership that had created the Raptors with Enron, a conflict of interest that the company's board had approved. Fastow was "blackmailing" banks to invest in the partnership, known as LJM2, and getting rich.

Watkins gave Dilg and Hendrick the names of five Enron executives and managers they should interview. The lawyers didn't question any of them, according to records V&E later released to Congress.

A few days later, the law firm reported to Lay that no further investigation was necessary.

The deals that troubled Watkins did have "bad cosmetics" and carried "a serious risk of adverse publicity and litigation," V&E would write in a private report to Enron.

Still, "The facts disclosed through our preliminary investigation do not, in our judgment, warrant a further widespread investigation by independent counsel and auditors."

Enron's investigation of itself was over almost before it began.

David Stulb, the head of Andersen's New York-based investigative unit, was later called to Houston to help with the Enron situation. He looked at the V&E report and said: "It's a whitewash."

Watkins had urged Lay not to hire Vinson & Elkins to investigate her concerns because its lawyers had worked on some of the very deals she challenged. Dilg, who was running the investigation, was the point man for V&E on the Enron account -- which paid the firm \$35 million that year.

But Lay not only hired V&E, he authorized the firm to conduct a limited, preliminary inquiry that would neither "second guess" Enron's accounting nor engage in a full-scale independent examination of company documents, a report by the law firm later said.

V&E lawyer Harry M. Reasoner, former managing partner, defended his firm's work. "We were not given the opportunity to do due diligence," Reasoner said, noting that his firm's lawyers had not had unfettered access to Enron employees and records. "You go back to Plato's question of who watched the watchers? You have to be able to trust somebody. In our investigation, Enron made the determination that they could rely on Arthur Andersen's accounting. That seemed very reasonable to us."

Duncan's reference to "control features" and approval from the "highest levels" amounted to the unspooling of a long alibi chain. Everybody associated with Enron was covered -- the lawyers, the accountants, the executives and members of the board. Each could argue they had relied upon the advice and actions of the others as they went along with the deals being questioned.

Watkins had warned that nothing less than a full investigation could save the company. The alibi chain would not hold.

"I realize that we have had a lot of smart people looking at this and a lot of accountants including AA&Co. have blessed the accounting treatment," Watkins, a former Andersen accountant, had cautioned in her memo. "None of that will protect Enron if these transactions are ever disclosed in the bright light of day."

[Incapable of Deceit](#)

Ken Lay was ill-prepared to manage the kind of crisis that Enron now faced. Lay, 59, had a PhD in economics from the University of Houston and a national reputation as a business innovator. He was deeply involved in some of Enron's biggest challenges, including the California energy crisis and its troubled power project in India. But he had not really run Enron's daily operations since the early 1990s.

By September 2001, he was more accustomed to striding the corridors of power than handling the controls of a Fortune 500 company.

In Enron's early years, he turned day-to-day management over to Richard D. Kinder, a lawyer with an exacting eye for costs. Kinder was nuts and bolts; Lay was big-picture. Both agreed that ultimate success depended on Wall Street, not the oil patch.

To keep its stock price high, Enron had to meet Wall Street's profit expectations.

Kinder was the stern taskmaster who implemented the Wall Street strategy.

"He would be screaming at us," recalled David G. Woytek, an accountant and former vice president for finance. " 'How can your earnings be down!' Everyone was intimidated. Even if prices were down, somehow you had to come up with earnings . . . because we can't disappoint the Street."

Even in its early years, Enron relied on some aggressive accounting to boost its reported earnings, Woytek said. "So many people would look the other way," said Woytek, who complained and was eventually pushed out. "I got ulcers."

Kinder, who left Enron in 1996, declined through a spokesman to comment on his tenure at the company.

As Kinder minded the store, Lay increasingly looked outward. He became known as a powerful lobbyist and prolific fundraiser for political and charitable causes. He enjoyed the perks of power.

He wanted everything to be first-class. Michael Muckleroy, former chairman of Enron Liquid Fuels Inc., once occupied one of the four corner offices on the 50th floor of Enron's headquarters in Houston, a mirror image of Lay's. A self-described "plug horse," Muckleroy was so embarrassed by the grandiosity of his top-floor office, with its 23-foot high ceiling, that he refused to meet clients and vendors there.

Lay moved steadily to the top of Houston's business and civic elite.

"Nothing of significance that was going on in Houston was not touched by Enron and Ken Lay," said James D. Calaway, president of the Center for Houston's Future, a civic organization.

When James W. Crownover, a former McKinsey & Co. executive in Houston, headed the city's United Way campaign in 2000, he asked Lay to take charge of major gifts. "He gave \$100,000 and challenged five other people to do the same, which they did."

Willie J. Alexander, an African American owner of a small human resources consulting firm, didn't crack Houston's stratified business establishment until he met Lay through Republican Party activities.

Lay became Alexander's mentor, arranged consulting contracts with Enron and sat down with him once a year for brainstorming sessions. To Alexander, Lay was caring, spiritual and incapable of deceit.

'I Need Their Earnings'

Lay's record at Enron was not so spotless.

At various times over the years, Enron's affable founder had ignored warnings, sidestepped problems and tolerated misdeeds, former executives said.

Fifteen years earlier, Muckleroy warned that two Enron executives working out of an office in Valhalla, N.Y., were making oil trades far larger than Enron had authorized.

But Lay brushed him off, Muckleroy said. "Ken was the kind of fellow, he did not like dissension. He did not like hostility. He did not like facing up to the music."

Eventually, internal auditors substantiated reports of fraudulent trading, but Lay wouldn't fire the traders. That shocked and angered Woytek, one of the internal auditors. "I was in the audit committee of the board of directors," Woytek recalled, "when Ken Lay said, 'I have decided not to terminate them. Instead we are going to put in controls to keep this from happening in the future. . . . I need their earnings.' "

Lay didn't fire the trading executives until their operation came up more than 50 million barrels of oil short and cost the company roughly \$140 million, almost destroying Enron, Muckleroy and other former executives said. The traders pleaded guilty to fraud and tax evasion.

In a written response to The Washington Post, Lay's spokeswoman, Kelly Kimberly, did not address Woytek's account of that meeting. But she noted that Lay and Enron's board responded to early signs of trouble in Valhalla by auditing the operation repeatedly.

James Alexander, former chief financial officer of Enron Global Power & Pipelines LLC, recounted another incident.

In 1995, he heard that employees who closed energy deals received bonuses based on their own dubious estimates of future profitability.

"Effectively, they could get away with whatever numbers they felt like," Alexander said.

When he approached Lay, he "didn't react at all," Alexander said. "He said, 'We'll have to talk to Rich [Kinder] about this.' . . . They say they investigated it. I never heard about it again."

Alexander said people were subsequently transferred out of his division, and he left Enron in 1996.

"Ken has always been hands off even in his best days," he said. "My surmise is he didn't want to be informed. His attitude was, 'I don't want to know.' "

Lay's spokeswoman responded that "to his knowledge, the matter was referred to Mr. Kinder, who did investigate the concerns. Mr. Lay is not aware of any retaliation against Mr. Alexander."

[Eight Dollars Away](#)

The Sept. 11 terrorists attacks on New York and Washington killed more than 3,000 people, stunned the nation and shut down Wall Street for four days. When trading resumed on the 17th, stock prices plunged. The Dow Jones industrial average lost more than 684 points.

Anxiety was general, but Enron had particular reason to worry.

Enron had committed 30 million shares worth about \$2 billion to the LJM2/Raptor deals. By using the Raptors as hedges, Enron had protected more than \$1 billion in profits it had already reported on its portfolio of start-up companies' stocks.

But the Raptors had been continually on the verge of failure because the Enron stock that supported them had been falling in value all year. Under its agreement with LJM2, Enron had to pledge more stock to the deals to prop them up.

Now the post-Sept. 11 stock drop threatened catastrophe.

If the stock price dropped below \$20 a share, the obligation to the Raptors would become so great that the company would not have enough available shares to honor its pledge.

For every dollar the stock dropped below \$20, Enron would be facing \$124 million in losses, according to an internal Enron document.

On Sept. 18, Enron shares closed at \$28.08. Disaster was eight dollars and change away.

Enron and its auditor were facing that disaster together.

The relationship was so close that Andersen's partners working on Enron had offices in the client's 1400 Smith St. tower alongside their Enron counterparts. Eighty-six Andersen people had left the firm to work for Enron since 1989. Among them: Watkins and Chief Accounting Officer Richard A. Causey, Duncan's regular golfing buddy. People at Enron referred to Andersen as "Enron Prep."

Causey described the relationship as a kind of collaboration, saying Andersen "gets all the documents and they walk down the path with Enron all the way." He liked to brag that Enron was so nakedly honest with its accountants that their relationship was "open kimono."

In fact, Andersen auditors had long been signing off on Enron accounting practices that pushed the envelope. And in some cases in-house experts said the Enron audit team had gone over the line, according to internal Andersen e-mails. Duncan and other Andersen partners later testified that their accounting decisions were not illegal or fraudulent.

When disputes arose -- particularly on the Raptors transactions -- Enron executives expected to get their own way, Andersen partners complained. Some described Enron's aggressive attitude as the "push back."

Patricia Grutzmacher, an Andersen employee, would later testify that she was told not to press her challenge to an Enron action. "It is what it is," she said a superior told her. "The higher-ups [at Enron] had already decided that it was going to be done."

Andersen's attitude changed when word of Sherron Watkins's warning reached the firm. Andersen was soon engaged in tense self-examination and finger-pointing.

'Intelligent Gambling'

Andersen experts had long expressed concern about Enron's accounting.

In February 1999, at a meeting of the Enron board of directors' audit committee in the Four Seasons Hotel in London, Duncan gave a detailed presentation on Enron's accounting, saying it was "high risk" in several categories with a high probability it could be questioned.

"Obviously, we are on board with all of these, but many push limits and have a high 'others could have a different view' risk profile," Duncan wrote on the margin of one of his presentation papers.

Two years later, on Feb. 5, 2001, 14 Andersen senior partners gathered by teleconference to discuss whether Enron was too risky a client to keep. A memo written the next day recited the concerns: Fastow's conflict of interest with LJM; Enron's reliance on LJM to meet the financial targets demanded by Wall Street; and Enron's use of "mark-to-market" accounting, which allowed arbitrary estimates of future-year profits to be counted as current income. Andersen partners called this practice "intelligent gambling."

They also discussed whether their fees -- at the time \$50 million year -- compromised their independence. They noted, "It would not be unforeseeable that fees could reach a \$100 million per year amount."

In the end, Andersen kept the client. The firm concluded that "it appeared that we had the appropriate people and processes in place to serve Enron and manage our engagement risks," the memo stated.

A \$710 Million Loss

By September 2001, the Enron-Andersen relationship was coming apart under the combined pressures of Sherron Watkins and the failing Raptor investment vehicles.

When the Raptors had gotten in trouble earlier, Enron and Anderson had always been able to come up with accounting and financing solutions.

Duncan's team had approved these fixes, most recently in March 2001, overriding the unit of senior partners named the Professional Services Group, which concluded that the solutions violated accounting rules. The PSG experts didn't like a temporary fix that "cross-collateralized" -- or linked -- the debts and assets of all four Raptors vehicles, but only for 45 days.

"I did not see any way this worked," Carl E. Bass, an accounting expert with the PSG, wrote on March 4, 2001. "In effect, it was heads I win, tails you lose."

Inside Andersen, the PSG's word was supposed to carry the day. But Duncan's team had sided with Enron.

After too many "fiesty" memos, Causey got Andersen to remove Bass in March 2001 from his oversight role on the Enron audit, Andersen partners confirm. The action angered and embarrassed Bass.

Now Watkins's memo raised the specter of public exposure of the accounting issues. Andersen's top partners took another look at the Raptors in September and, seeing the same facts, reached a different conclusion.

Operating in the climate created by Watkins, the firm reversed course and backed the PSG experts: Bass and the PSG team had been right; the Raptor fixes were improper.

As the Andersen partners pored over the Raptor files, Bass and the PSG made a stunning discovery: their original objections had been omitted from official memos, giving the appearance of a tacit endorsement.

When Andersen communicated its new opinion of the Raptors to Enron in September, it left Enron with few options, none of them good.

Andersen "made several key changes to the guidance that they originally provided" on the Raptors formation and the March 2001 fix of the Raptors, an internal Enron memo stated.

On Sept. 18, Causey briefed Lay and Enron's new chief operating officer, Greg Whalley, about the growing Raptor crisis. Whalley urged Lay to simply shut the Raptors down, and Lay agreed. The decision meant that Enron would be forced to report a \$710 million pretax loss -- \$544 million after taxes -- for the financial quarter ending in 12 days.

There was more bad news. Andersen, in its search through the Raptor files, had discovered it had made an unrelated error. Enron would have to acknowledge that it had overstated the value of its business to its shareholders -- its net worth -- by \$1.2 billion when it fixed the Raptors in the spring of 2001. But Enron executives and Andersen partners agreed that the error wasn't material because it was a net zero -- merely removing equity that had never been there in the first place.

Andersen accountants were getting stricter on a number of accounting fronts in September 2001. In addition to its Raptors reversals, the accounting firm was zeroing in on a crucial Enron strategy used to raise cash.

The firm's accountants seemed to be worried about Enron's extensive use of "prepay" financing -- cash that Enron received from J.P. Morgan Chase & Co. through an off-shore company named Mahonia.

At the time, Enron listed the Mahonia deals on its books as energy transactions, but they were in effect loans from the bank that Enron did not disclose, Senate investigators later contended. Bank officials stated that Mahonia was created to carry out these transactions and is legally independent from the bank.

Andersen was insisting that Enron have documentation showing that Mahonia was independent of the bank, a required condition for that kind of deal.

"Andersen is pushing back," Enron employee Michael Garberding said in a taped telephone call that month with bank officials.

In the same conversation, another Enron official said the bank should "make sure that Mahonia seems independent." A third executive told the bankers to ensure that the paperwork in the deal "doesn't have Chase showing up anywhere on the fax letterhead."

The 'Stretch'

On Sept. 19, Causey began a long-scheduled off-site brainstorming session at a Galveston, Tex., hotel with his staff. He calmly conducted business as usual, recalled Robert J. Hermann, then the company's top tax attorney and a managing director.

In preparation for the meeting, Causey handed out articles about the role of the chief financial officer in corporate life. Reading them, it was clear to Hermann that Enron didn't have a real CFO, someone responsible for all company finances including the accounting and income statements. Enron just had someone with the title: Fastow.

"I realized that there was nobody doing any planning in that company," Hermann said. "They were just managing it day to day and trying to get earnings for the quarter."

Hermann, like other senior executives, was under constant pressure to produce income to help Enron meet its earnings targets.

Hermann called it "the stretch" -- the gap between the sum managers knew they could deliver to the bottom line and what the bosses demanded.

By mid-September, the stretch had become intolerable. Hermann resolved to take the problem to Lay.

His tax department made a huge and unique contribution to Enron's bottom line. Members of his staff, working with some of the most prominent banks and law firms in the nation, engineered a series of intricate tax-reduction transactions that had boosted Enron's reported profits by nearly \$1 billion between 1995 and 2000.

The exotic deals were crafted to comply with the U.S. tax code, Hermann said. Former Enron chief executive Jeffrey K. Skilling approved them in small meetings attended by Hermann, Causey and another Enron tax attorney, Hermann said. The company disclosed the transactions, if somewhat cryptically, in footnotes to its financial statements.

But the magnitude of the tax department's contribution to reported earnings was a closely held secret, even inside Enron. When a tax lawyer generated a bar graph illustrating the combined impact of the deals, Causey ordered him not to disseminate it, Hermann said.

In 2000 alone, \$296 million, or 30 percent of the profit that Enron recorded in its annual report to shareholders, came from one-time tax-saving strategies rather than the company's energy supply and trading businesses, according to company records obtained by The Washington Post.

In one deal, code-named Teresa, Enron increased its reported profit by \$225 million. At the center of the deal was a convenient circularity: Enron lent itself money to boost its investment in its headquarters building so it could claim a huge depreciation deduction. Investors reading Enron's financial statements could not detect that this one-time windfall had not come from its business operations.

By September 2001, Hermann felt the pressure to do more had gotten out of hand. So many business divisions at Enron had failed to meet their earnings targets that Causey asked if the tax department could double its 2001 contribution to \$600 million, Hermann said.

Although he figured he could pull it off, he wondered why he should have to. Somebody at Enron should be figuring out how to make real money.

He telephoned Lay's secretary and asked for an appointment to talk about what was happening in the tax department and beyond.

"Every damn year the stretch kept going up," Hermann would later explain. "It just kept getting bigger and bigger. That to me was evidence of the fact we don't know what we're doing here. It bothered me. I wanted to tell him what was happening."

A week went by. Lay's secretary called Hermann back and said Mr. Lay was busy and would be unable to meet with him.

Hermann wondered: Unable or unwilling?

Lay's spokeswoman said recently that Lay has an open-door policy and "did attempt to set a meeting, but their calendars could not be matched for quite some time."

Life Savings

On the morning of Sept. 26, Lay led an Internet chat with Enron employees, many of whom had their life savings tied up in company stock. At the beginning of the year, Enron's 401(k) employee savings plan had \$2.1 billion in assets -- two-thirds of it Enron stock.

The stock had dropped to \$25 a share from \$90 a year before.

Lay said he was buying Enron stock and urged his workers to do the same.

He did not mention that he had transferred 556,055 shares to Enron in August and September to repay \$20 million in cash advances from the company. That year, his total compensation was \$103,559,793 in salary, bonuses, incentives, annuities and cash advances. (Lay said he received \$234,139,766 from sales of Enron stock between 1998 and late 2001.)

"My personal belief is that Enron stock is an incredible bargain at current prices, and we will look back in a couple of years from now and see the great opportunity that we currently have," Lay told employees.

Lay later said through a spokeswoman that he did not mislead the employees and still owns more than 1.2 million shares of Enron stock, which has lost nearly all its value.

'We'll Be Honest'

As Enron raced to shut down the Raptor transactions by the end of quarter, Vince Kaminski discovered that Enron's finance department had deceived his research team about the deals. He was livid.

Kaminski supervised a team of finance whizzes who calculated the likely future gains and losses in stock and commodities trading. They took great professional pride in getting their numbers right. They were Enron's monks, removed from the company's super-competitive deal-making environment.

Kaminski had never liked Enron's strategy of using its own stock to hedge its tech investments in deals with Fastow's private partnerships. He thought the risk involved and Fastow's conflict of interest created a situation where "heads the partnership wins, tails Enron loses."

Now Kaminski and two of his key associates discovered that they had been given incorrect and misleading data, which had distorted some of the team's earlier analyses of the Raptors deals.

And they'd recently been asked to perform calculations on some LJM deals without being told their work related to LJM or the Raptors.

By late September, Kaminski had become uncomfortable with the entire structure of the Raptors and concluded he was dealing with an accounting scam, he and two colleagues later told investigators for Enron's board.

It was clear to Kaminski that the Raptors had been used to hide losses and engage in illegal earnings management, he said. He called it "an act of economic self-gratification."

Kaminski told his former boss, Chief Risk Officer Richard Buy, that he would not do any more Raptor or LJM work, even "if it meant he would be fired," Kaminski later told investigators.

"Buy responded that [Kaminski] would not be fired because the new post-Skilling mantra was 'We'll be honest,' " Kaminski recalled.

In response, Skilling's attorney, Bruce A. Hiler, said that "the claim that my client was involved in anything questionable or illegal -- which he was not -- is fantasy."

An Enron Ritual

The Enron deal factory was still open for business.

As the Andersen partners noted with concern earlier that year, Enron was relying on deals with its complex private partnerships and high-risk accounting maneuvers to meet its profit targets.

Most of the company's profits in 2001 came from these arcane deals, not its regular ongoing business operations, board investigators concluded.

The deal-making was particularly intense at the end of each financial quarter.

The Raptors were becoming extinct, but Enron was busy on other fronts.

With September and the third quarter winding down, Enron executives raced to get earnings and cash in ways that had worked before.

Hermann's tax department prepared new transactions to generate tax savings.

Other Enron executives contacted J.P. Morgan Chase about doing a prepay deal that would deliver \$350 million to Enron before the quarter ended. An Enron manager told the bank that Enron would "take any money [it could get] now, even if it's on one-year basis," according to an e-mail obtained by Senate investigators. The prepay deal was closed on Sept. 28.

Enron had long sold off assets such as pipelines, power plants and fiber-optic networks, magnifying the gains with accounting maneuvers.

In late September, Enron finally finished negotiations with Qwest Communications International Inc. in Denver on a deal to exchange capacity on fiber-optic Internet networks and telecommunications services.

The value of those networks had plunged during a broad downturn in the telecommunications industry. The Qwest deal would cut Enron's losses on its network.

There was little if any business reason behind the exchange, one former Enron manager said. Qwest was buying non-operating network circuits from Enron that it didn't need. Enron had agreed to buy telecommunications services from Qwest over a 25-year period at a time when its own telecom operations were collapsing. Andersen was the accountant for both companies.

On the day the quarter closed, the companies finally made their deal, exchanging checks for \$112 million as initial payment.

Between Friends

In shutting down the Raptor transactions, one final step remained: Enron's buyout of the banks and other investors in LJM2.

Fastow had left LJM2 two months before, selling his interest to his former Enron colleague and friend, Michael J. Kopper. Some Enron employees were puzzled at how Kopper could have afforded to buy Fastow out. But Enron's lawyers were relieved. They hoped for an end to embarrassing questions about Fastow's conflict.

That conflict hadn't disappeared entirely.

As the Raptors were closed down, Enron had to work out how much it would pay the LJM2 investors. Enron's chief negotiator in the matter was none other than Fastow, who sat across the table from Kopper, representing LJM2. Fastow and Kopper declined to be interviewed. The Raptors had already been a good deal for LJM2, whose investors had been paid \$162 million -- the full amount of their initial investment plus a profit of \$40 million.

But that was not enough.

The two friends, Fastow and Kopper, agreed that Enron would pay LJM2 an additional \$35 million "termination fee." For Enron, the Raptors deal ended in a \$544 million loss.

Heads LJM2 wins, tails Enron loses.

Fourth of five articles

On Oct. 4, 2001, Kenneth L. Lay was on stage, one of the nation's most admired business executives presiding over an Enron Corp. energy summit at the Ritz-Carlton at Pentagon City. Appearing completely at ease, Lay told the assembled Washington policymakers that with more energy deregulation Enron and the nation would continue to flourish.

But Lay's Enron had only 59 days to live.

Back in Houston, Lay's treasurer, Ben F. Glisan, and another executive worked the phones, quietly breaking bad news to analysts for the nation's Big Three corporate credit-rating agencies: Enron was about to report significant losses for the third quarter. Its very survival depended on the rating agencies' pronouncements about its financial health.

But the Enron executives' efforts to explain the losses, more than half of which involved a secret series of financial deals code-named the Raptors, surprised and troubled the influential analysts.

"We were questioning and scratching our heads about the type of accounting they were using," John C. Diaz of Moody's Investors Service would later recall.

On Oct. 8, the company's outside board of directors -- friends and admirers of Lay -- gathered in Houston. Typically, board meetings were congenial celebrations of Enron tales of success. Directors accepted executives' confident assurances and a clublike atmosphere prevailed.

This time, company executives informed the board about the Raptors' losses, describing them as a one-time setback that didn't cast doubt on Enron's future. Board members also heard sketchy details about an anonymous employee who had raised questions about Enron's accounting. But Enron executives didn't identify the employee as Sherron Watkins, a company vice president, or disclose that her warnings were specifically about the Raptor transactions.

The directors later said they left the meeting thinking Enron was doing fine.

'Cease and Desist'

Elsewhere in the universe of people who lived and profited in Enron's orbit, fear was a contagion.

On Oct. 9, Nancy Temple, a 38-year-old lawyer in Arthur Andersen LLP's Chicago headquarters joined a conference call on Enron with two of the accounting firm's top lawyers. She jotted alarming news on her notepad: "Highly probable some SEC investigation."

Enron's third-quarter Raptor losses were not what most troubled Temple.

Andersen was deeply concerned about a Raptors accounting decision in the first quarter. With the four Raptors deals headed toward insolvency then, Enron had revived them by combining their debts and assets. Andersen's Enron audit team had approved the fix even though its own experts said it was improper.

Now, as internal scrutiny grew, Andersen partners felt they had to reverse that earlier decision.

Correcting this problem could require Enron to revise its first-quarter financial results. That news was sure to trigger a Securities and Exchange Commission inquiry into Enron's books -- with potentially grave consequences for the 88-year-old accounting firm.

Andersen's Enron files contained some big problems for the accounting firm and its client.

The firm's accountants had sparred among themselves for two years over high-risk methods that their Enron audit team had let the company use. The audit team had ignored the advice of Andersen's in-house experts more than once to please its demanding client. In that way, Andersen allowed Enron to exaggerate its earnings by hundreds of millions of dollars in recent years, investigators for Enron's board would later determine.

The accounting firm had good reason to fear the SEC. Less than four months earlier, the regulators had fined Andersen \$7 million for allowing another large company, Waste Management Inc., to issue deceptive financial statements. In that case, Andersen had also rejected the advice of its own in-house accounting experts. Andersen was now operating under a "cease and desist" order, enjoining the firm from further accounting abuses.

Fear of violating the cease-and-desist order if they ignored their experts once again was evident from Temple's notes. "Restatement and probability charge of violating C + D in WM," she wrote.

In the Waste Management case, the SEC documented the violations by using records retrieved from Andersen's own files.

The worried Andersen partners now turned their attention to their Enron files.

'Irretrievable'

On Oct. 10, Michael C. Odom in Andersen's Houston office stood in a crowded conference room and reminded colleagues to destroy any unneeded records. If documents are destroyed and litigation is filed the next day, "that's great," Odom said in his video presentation. "Whatever there was that might have been of interest to somebody is gone and irretrievable."

Some employees in Andersen's Houston office promptly deleted a large number of e-mails.

Temple had come to Andersen from a high-powered litigation firm, seeking a change of pace. She was new to the Enron case.

On Friday, Oct. 12, she sent a blandly worded e-mail to Houston, reminding Andersen workers there to comply with the firm's "document-retention" policy of destroying extraneous memos and e-mails.

On Monday morning, Shannon Adlong arrived at the accounting firm's suite of offices on the 37th floor of Enron's Three Allen Center. She was the secretary to David B. Duncan, Andersen's lead partner on the Enron account.

Adlong went to the break room. It was a mess.

"I noticed a couple of bags of shredding," Adlong said. "There was food everywhere, like they had been there the whole weekend."

She said a manager passing by mentioned that Duncan had gotten an e-mail saying that "we needed to start getting in compliance" with the document-retention policy.

Adlong noticed they were running low on bags. She ordered more. "AARRGGH: send more shredding bags," she wrote in an e-mail. "Just kidding. We have ordered some."

'Non-Recurring' Losses

Enron executives were readying a news release to announce the quarterly financial results.

The Raptor accounting issue that had troubled Temple would not be mentioned. Enron and Andersen were still trying to make it go away. Enron would report only the losses the board and the credit agencies had heard about -- they now totaled \$1 billion, more than half caused by the Raptors' continuing debt problems.

Chief Accounting Officer Richard A. Causey planned to characterize the losses as one-time, "non-recurring" problems that didn't signal trouble with the company's ongoing businesses.

Enron sent the draft news release to Andersen for review on Oct. 12, and partners there strongly objected to the "non-recurring" phrasing as misleading. In their view, some of the losses were just the opposite -- indications that core parts of Enron's businesses were not doing well. Shareholders had to be told, the auditors maintained. Duncan warned Causey that the SEC had taken action against companies for similarly misleading statements.

Duncan was troubled enough to write a memo to the file on Oct. 16 documenting his conversation with Causey and stating that he told him it was "misleading" to use the term "non-recurring."

Duncan sent Temple a copy to review.

Three hours later, Temple replied by e-mail, urging Duncan to tone down the memo, delete the word "misleading" and omit any reference to her, because that could be construed as a waiver of Andersen's attorney-client privilege. "If my name is mentioned it increases the chances that I might be a witness, which I prefer to avoid," Temple wrote.

A federal jury would later conclude that with that single action Temple became a "corrupt persuader" -- the term comes from the judge's instructions to the jury -- and on that basis would find Andersen guilty of obstruction of justice. Temple declined to testify, asserting her Fifth Amendment right against self-incrimination. She declined to be interviewed for this article, but her lawyer called the jury verdict unjust. "It can't be right that a lawyer's advice like that is obstruction," said Mark Hansen.

Enron's Oct. 16 news release was a masterpiece of modern business spin. The company emphasized that setting aside the \$1 billion in "one-time" losses, its profits had actually risen by 26 percent compared with the year before. The company was "very confident in our strong earnings outlook," Lay said in the release.

Lay repeated that rosy prognosis in a conference call with securities analysts later that day.

"We are committed to making the results of our core energy business more transparent to investors," he said, promising to provide more detail on the \$1 billion in losses "later in the call."

But Lay followed up with vague details and nearly impenetrable jargon.

He attributed the largest part of the \$1 billion loss -- \$544 million -- to "certain investments" in tech stocks and the "early termination in the third quarter of certain structured finance arrangements with a previously disclosed entity."

He left out important facts. The "structured finance arrangements" were the Raptor deals. The "previously disclosed entity" was LJM2, a private Enron partnership that had been run by Enron's chief financial officer, Andrew S. Fastow, until July 2001. LJM1 and LJM2 had done \$2 billion worth of business with Enron.

Lay also casually mentioned -- as if it were an aside -- that the value of shareholders' equity, the company's net worth, would be reduced by \$1.2 billion because of an accounting error in connection with that "early termination."

Andersen auditors had discovered the \$1.2 billion equity error in August, when they were digging through old records on the Raptor transactions in response to Watkins's memo. The error was Andersen's fault. It occurred when Enron funded the Raptors with shares of its stock. Enron got a note from the Raptor funds in return and Andersen wrongly advised Enron to count the note as shareholder equity.

David Fleischer of Goldman Sachs asked the key question: "How confident can we be that these will not be, you know, the last write-offs?"

Lay's response: "If we thought we had any other impaired assets, it'd be in this list today."

That was the toughest question Lay fielded. The analysts seemed satisfied.

Asked last week to comment on Lay's statements, a Lay spokeswoman responded: "Based on the information available to him from whatever source, Mr. Lay firmly believed his statements to be true."

Word Leaks Out

Watkins had warned Lay of a growing risk that the company's "funny accounting" would wind up in the newspapers.

On the morning of Oct. 17, it did. A Wall Street Journal article spotlighted Fastow's conflicting roles as both Enron's CFO and the head of LJM. The article pointed out that Enron's recent losses occurred in deals with Fastow's partnerships. But the newspaper quoted Lay as saying all was well -- no conflicts had been permitted.

The following day, another Journal story zeroed in on the \$1.2 billion reduction in shareholder equity. The reduction troubled people on Wall Street because Enron had done a poor job of explaining it. Moody's had put Enron's long-term debt on review for a possible downgrade.

In cryptic bits and pieces, the story of LJM finally was coming out.

Lay traveled to Boston that day to try to mollify about 40 investment-fund managers and securities analysts. Enron treated them to an elegant lunch at the Four Seasons Hotel. Cued by a PowerPoint presentation, Lay led the analysts through predictions of ever-rising revenue.

What the analysts wanted to know about was the \$1.2 billion error highlighted in that morning's paper. Instead, the Enron chairman attacked the critical press coverage, calling it an irresponsible wild goose chase. Lay vigorously defended Fastow and assured the audience there were no more losses coming from other private partnerships.

Gregory Phelps, who manages \$1 billion in energy and utility stocks at John Hancock Advisers Inc., noticed that Lay was looking right at him.

"This is a one-time thing," Lay said, according to Phelps. "There is nothing else out there."

Lay took one or two more questions, then suddenly looked at his watch and stopped. Lay's aides said, "We have to go" and just hustled out of there," Phelps said later.

'A Big Disconnect'

As dawn broke over Houston four days later, Oct. 22, news traveled over the financial wires: the SEC had launched a preliminary inquiry into Fastow and his partnerships.

At 8:30 a.m., Lay presided over a long-planned meeting with Enron's top-tier managers in the Dogwood room on the third floor of the Hyatt in downtown Houston. The meeting had been scheduled to review the company's third-quarter financial results. About 200 executives, the burnished elite of Enron's brain trust, attended.

Most hadn't yet heard about the SEC investigation, and Lay didn't mention it. Instead, he told those assembled that Enron's board and senior management were united behind Fastow. Lay wanted his executives to unite behind Fastow, too.

As Lay talked, some in the audience checked handheld BlackBerry messaging devices. News of the SEC investigation flashed. Enron's stock price flashed, too. The shares were plunging. Before the day was over, the stock would drop 20 percent, to \$20.65.

Sharp, testy questions erupted about the company's vulnerable position and Fastow and his private partnerships.

Lay tried to reassure the managers.

"Well, we don't think we did anything wrong, but knowing what we do now, we would never do it again," Lay said, according to Robert J. Hermann, then Enron's general tax counsel.

Hermann had everything invested in Enron: his professional pride, his network of golfing buddies and his retirement savings, worth more than \$10 million before Enron stock began to tumble.

Hermann raised his hand and said: "Ken, there is a big disconnect. How can you say we didn't do anything wrong, but would never do it again? Is 'what we know now' is that we got caught?"

Lay glared at Hermann. "It was like I'd put my head on the tracks," Hermann later recalled.

Vince Kaminski, the respected and normally reserved head of research, raised his hand and told Lay, "I'm in the terrible position of having to disagree with you."

"It's okay, anybody can," Lay said, according to one account. He invited Kaminski, a Polish-born mathematics whiz and expert in risk management, to speak.

Kaminski strode to the podium and accepted the microphone.

Enron should never have gotten involved in secret, high-risk deals with Fastow's private partnerships, he said. He had warned against that course back in June 1999.

"What Andy Fastow did was not only improper, it was terminally stupid," Kaminski said. "The only fighting chance we have is to come clean."

Lay looked "sort of blank," Hermann recalled. "It was like somebody getting pummeled, and he just stood there and took it."

Finally, Enron's new president, Greg Whalley, who had taken over when Jeffrey K. Skilling resigned in August, stepped in. "That's enough, Vince," he said.

[Fastow's Role](#)

Early the next morning, Oct. 23, Lay and a small group of advisers huddled in the conference room adjoining his 50th-floor office suite. The mood was tense.

In just a few minutes, Lay was scheduled to preside over a live webcast chat with securities analysts. Enron had to address the growing firestorm about Fastow's role in the LJM partnerships.

Enron's publicists and executives had drafted a carefully worded script. It suggested that no one at Enron was responsible for the LJM partnerships. Failure, it would seem, was an orphan.

With minutes to spare before the conference, Ronald T. Astin, a lawyer with Enron's outside law firm, Vinson & Elkins LLP, was asked to help fix the script. He rewrote it to say that it was Fastow who presented the LJM proposal to the board.

Fastow read Astin's changes and exploded, Astin later told investigators. Fastow yelled that Astin was wrong about who was responsible for LJM. "It was Skilling!" he shouted.

At 8:30 a.m. Houston time, financial analysts from Boston to San Francisco joined the conference by phone and Internet.

"There has been a lot of recent attention to transactions Enron previously entered into with LJM, a private equity partnership," Lay said, addressing LJM and Fastow head on. "Let me reiterate a couple of things. We clearly heard investor concerns earlier this year, and Andy Fastow, Enron's chief financial officer, ceased all affiliations with LJM."

Lay added that Fastow was doing "an outstanding job."

"We're very concerned the way Andy's character has been kind of loosely thrown about over the last few days in certain articles," Lay said. Fastow's role at LJM had been monitored rigorously so that Enron's interests would never be compromised, he said.

This conference call was much tougher than the one a week earlier. One questioner after another pressed Lay and his aides for more information about Fastow and Enron's hidden debt obligations.

"There is an appearance that you are hiding something," said Fleischer, the Goldman Sachs securities analyst who once had been such a strong Enron booster that he compared the company's magical earnings growth to Michael Jordan's scoring.

"We're not trying to conceal anything," Lay responded. "We're not hiding anything."

After the analysts call, Lay went almost immediately to another arena, a Hyatt ballroom packed with several thousand Enron employees.

"Let me say right up front, I am absolutely heartbroken about what's happened," Lay said.

"Many of you were a lot wealthier six to nine months ago, are now concerned about the college education for your kids, maybe the mortgage on your house, maybe your retirement, and for that I am incredibly sorry. But we are going to get it back."

Lay read a series of questions from the audience. Nerves were frayed. Decorum had vanished. One employee had written: "I would like to know if you are on crack? If so, that would explain a lot. If not, you may want to start because it's going to be a long time before we trust you again."

That very day Lay took a \$4 million cash advance from the company. Over the next three days, he would draw an additional \$19 million. He immediately repaid \$6 million of the amount by transferring his Enron stock to the company. That allowed him to unload stock but avoid an immediate reporting requirement. A board member later called this Lay's "ATM approach."

Lay's spokeswoman said recently: "He could not have done these transactions without Enron's knowledge. These transactions were in accordance with his employment contract."

Shredding Intensifies

The accountants at Andersen listened to Lay's conference call and were troubled. "The call did not go particularly well," Duncan would later say. "There were many pointed questions asked that the company appeared to struggle to fully answer."

Immediately afterward, Duncan held a meeting with his audit team and told them to get serious about complying with the company's document-retention policy.

Andersen had known for days that Enron could expect a SEC subpoena for its records, Duncan later testified. But none had arrived by that afternoon.

Andersen's Enron audit team asked Sharon Thibaut, the woman overseeing document shredding at Andersen's main Houston office, to send empty trunks for them to pack with documents they wanted destroyed. The auditors filled more than 18 trunks and more than 30 boxes.

E-mails flew back and forth between Andersen offices around the world as accountants discussed what to destroy.

Over the next few days, shredding at Andersen reached a crescendo and e-mail deletions nearly tripled.

Overwhelmed by the volume, Thibaut asked for extra help from the firm's outside disposal service, Shred-it. The company motto: "Your secrets are safe with us."

Andersen said later that the Enron documents were destroyed under its routine document-retention procedures and not in an effort to cover up anything.

A Simple Question

Enron's board of directors was just beginning to grasp the predicament.

For years board members had gone along compliantly with Enron's management. One former executive described board questions as "Tee-ball stuff: Are you happy with everything?"

Board member Charles A. LeMaistre, president emeritus of the M.D. Anderson Cancer Center at the University of Texas, told the Wall Street Journal that Fastow's LJM compensation was a way to keep him at Enron.

"We try to make sure that all executives at Enron are sufficiently well paid to meet what the market would offer," he said.

But neither LeMaistre nor the other directors knew just how lucrative a deal LJM had been for Fastow. Everybody had always tiptoed around the subject.

In the first year of LJM's existence, the board didn't ask for details on Fastow's income. Skilling asked a few questions but didn't obtain the right answers. In October 2000, the board asked its compensation committee to get the answer.

LeMaistre, head of the committee, chose a roundabout route, asking Enron's compensation director to provide the outside income of all top executives. He said he hadn't singled out Fastow because he didn't want to start office gossip.

He didn't get the information, so he asked again. When that attempt failed, LeMaistre gave up, he told Senate investigators.

Even as October wore on and the furor over Fastow's partnership deals grew, LeMaistre remained timid about confronting the young executive about how much money he'd made from LJM. He sought out Enron's general counsel, James V. Derrick, for advice in adopting just the right tone. Derrick prepared a polite script for LeMaistre: "We very much appreciate your willingness to visit with us."

Armed with the script, LeMaistre telephoned Fastow and posed the question: How much?

It was \$45 million, Fastow said.

LeMaistre wrote in the margin of his script: "incredible."

Fastow Departs

Fastow's answer stunned Lay, too, he said later. A day after publicly praising Fastow, Lay concluded he had to go.

Lay replaced him with former treasurer Jeffrey McMahon, who had questioned Fastow's conflicts in the spring of 2000 and soon found himself in another job with the company. Now, with those conflicts exposed to the light of day, McMahon took Fastow's job.

Lay announced Oct. 24 that Fastow had taken "a leave of absence."

"In my continued discussions with the financial community, it became clear to me that restoring investor confidence would require us to replace Andy as CFO."

That day, Carol Coale of Prudential Securities Inc., an early Enron skeptic, became the first analyst to break from the pack and issue a sell recommendation for Enron stock.

Chewco Emerges

Two days later, another problem emerged.

On Oct. 26, a subdued Ben Glisan faced his team of accountants and lawyers inside in-house attorney Kristina Mordaunt's office at the 1400 Smith St. headquarters tower.

Somebody tell me we didn't do this, he pleaded.

Glisan was Enron's treasurer, Fastow's clever and trusted aide. He had helped design the Raptor deals and dreamed up many of the colorful names for the company's confidential investment deals.

Soon after Fastow's abrupt departure, the media began getting tips about another Fastow deal named Chewco. The Wall Street Journal had just published a story raising questions about the deal.

So Glisan gathered his troops and dispatched a manager to retrieve the Chewco file. The file revealed a series of accounting errors.

In the waning days of 1997, Fastow's team had created Chewco Investments L.P., a confidential partnership that Enron needed in order to keep more than \$600 million in debt off the company's books, hiding it from analysts and ordinary investors. It was the first time the company had set up an off-the-books partnership run by one of its own employees, making it a precursor for the LJM1 and LJM2 private partnerships later run by Fastow.

Enron could have sought truly independent investors. But Fastow saw a different opportunity: Enron would create a private investment group and Fastow would assign his top deputy, Michael J. Kopper, to manage it.

Using code names to conceal their identities in the documents, Kopper and his domestic partner, a Continental Airlines employee named William Dodson, became Chewco's "owners." The pair put in \$125,000 of their own and borrowed \$11 million more from Barclays Bank. Enron guaranteed those loans, further undermining Chewco's independence from the company.

The deal had worked out splendidly for Kopper and Dodson. When Enron closed down the partnership early in 2001, it paid them \$10.5 million -- nearly 100 times their investment. Earlier, McMahon, then Enron's treasurer, had clashed with Fastow over the size of Kopper and Dodson's windfall, arguing that it should be no more than \$1 million. Fastow prevailed.

Kopper and Dodson have declined requests for interviews.

Chewco would prove disastrous for Enron. Accounting rules required that at least 3 percent of Chewco's funding come in the form of equity from outside investors in order for the partnership to be considered independent for bookkeeping purposes.

Through an apparent oversight back in 1997, Kopper and Dodson's stake in Chewco had fallen just short of the 3 percent outside equity stake required to make the deal conform to accounting rules.

In October 2001, leafing through the Chewco file, Glisan looked dejected. The error was plain to see.

"We're toast," Glisan said, according to one colleague's account.

Now Glisan would have to tell the beleaguered Lay about another mistake. Because Chewco was no longer considered independent of Enron, the company would have to restate its earnings downward, taking a \$405 million loss.

Technical Truth

Lay also had to deal with the SEC inquiry. Needing outside expertise, Lay hired former SEC enforcement chief William R. McLucas and his partners at the law firm of Wilmer, Cutler & Pickering. McLucas and his colleagues urged Lay to make an independent investigation of Fastow's conduct. Lay immediately agreed.

Williams Powers, dean of the University of Texas School of Law, was added to Enron's board to head the inquiry, aided by Wilmer, Cutler lawyers. Enron announced the appointment of the special investigative committee on Oct. 28. Soon, a squad of outside lawyers and accountants were fanning out through the company headquarters asking tough questions.

In this atmosphere a nervous Mordaunt told Enron general counsel Derrick that she'd invested with Fastow in an LJM deal. She didn't want Lay to be blindsided, she said.

Mordaunt was advised to talk to the outside attorneys, who had taken over most of the fourth floor of Enron's headquarters.

She told them her story: Nineteen months earlier, in March 2000, Kopper had invited her to join in a confidential investment deal that would take place when the LJM1 partnership was terminated. Fastow had organized it. Ben Glisan and other Fastow confidantes also got a piece of the deal.

They called the partnership Southampton Place, after a swank Houston neighborhood favored by many young Enron executives. Southampton bought out the interests of one of LJM1's principal investors, a British bank, and then Enron brought out Southampton, adding another step to the process -- and another round of profit-taking.

When the deal was concluded in May 2000, the partners' secret profits were astounding.

Glisan and Mordaunt had invested \$5,800 apiece. Each got back a cool million. The Southampton investors had worked on both sides of the deals Fastow structured between LJM and Enron. Glisan and Mordaunt were responsible for protecting Enron's interests as the deals were struck, negotiating for Enron against LJM. Yet they had allowed themselves to be made rich by LJM's conflicted general partner -- Andy Fastow.

Once the outside attorneys began hearing about Southampton, the Enron executives who'd invested in it were finished.

Glisan and Mordaunt were confronted, fired and escorted from the building.

Glisan declined a request for an interview through his lawyer. Mordaunt's attorney, Hayden Burns, said she did not know the deal was improper when she invested. Mordaunt, in a second interview with Wilmer, Cutler attorneys, broke down. She felt distress because "there was so much about these transactions that she did not know," Burns said.

When McMahon had succeeded Fastow he asked Glisan whether he was involved in any outside partnerships. No, Glisan said, McMahon later told investigators.

So after Glisan was sent home in disgrace, McMahon called him.

Why had Glisan lied? McMahon asked him.

He had only invested in a *subsidiary* of a partnership that did business with Enron, Glisan replied.

So it wasn't a lie, technically, he said.

Calling on Friends

Enron's bankers were starting to get worried, and the company executives feared they would desert them. That would be the death blow. The company had borrowed billions of dollars from the leading banks of New York, Switzerland, Canada and Germany, backing the debt with promises of Enron shares. If Enron's stock price fell below specified trigger points and its

credit was downgraded in tandem, the lenders could demand immediate payment, bankrupting the company.

The stock price had already fallen below the triggers. Only the company's investment-grade credit rating remained as a buffer against approaching disaster.

The three major private credit-rating firms had given Enron slack in the past. Now a decision by any one to severely downgrade Enron's credit would cut the company's lifeline of cash from banks, triggering a relentless sequence of loan defaults.

Lay still had friends in Washington, cultivated through six presidencies by his extensive political fundraising for both parties. His calls were taken by the top people.

On Oct. 28 and 29, Lay told two members of President Bush's cabinet about Enron's growing financial crisis. He said to Commerce Secretary Donald L. Evans that Enron would "welcome any kind of support" in heading off a threatened credit downgrade by one of the credit agencies, Moody's Investors Service.

Bush administration officials looked at Enron's plight, then backed away from any intervention.

On Oct. 29, Enron locked down its company 401(k) savings plan for two weeks, barring employees from selling Enron stock they had purchased for their retirement. More than \$1 billion of the plan's funds had been invested in the company's stock at the beginning of the year, when the stock was selling for nearly \$80 a share. Those savings were vaporizing as the price plunged.

Enron said the action had been planned for a long time to make administration changes to the savings plan. Enron employees later filed a lawsuit alleging that the company blocked them from selling in an effort to prevent the stock's collapse from accelerating.

During the lockdown, Enron's stock price dropped 28 percent, from \$13.81 to \$9.98.

Another Memo

On Oct. 29, Moody's cut Enron's credit rating to just above junk-bond level, noting that the disclosures about Fastow's partnerships had severely damaged market confidence in the company.

Sherron Watkins, the woman whose memo on Aug. 14 had unleashed the maelstrom, sat down to write another one.

In her Oct. 30 memo she coolly calculated all the angles.

For herself, she made a bid for a big new job. She was available "ASAP" to become Lay's personal "devil's advocate," unraveling knotty accounting and unmasking employees who were lying out of self-preservation.

For Lay and Enron, she plotted a course of damage-control to "rebuild investor confidence."

Step 1: Blame subordinates. The "culprits are Skilling, Fastow, Glisan and Causey."

"Lay to be open about his involvement or more importantly, his lack thereof," her memo said. "Lay to admit that he trusted the wrong people."

Step 2: Blame the lawyers and accountants. "Mistake #2: he relied on V&E and Arthur Andersen to opine on their own work." Lay should now fire both firms.

Step 3: Lay should be a statesman and work the system.

"This is a problem we must all address and fix for corporate America as a whole. Ken Lay and his board were duped by a COO who wanted (earnings) targets met no matter what the consequences, a CFO motivated by personal greed and 2 of the most respected firms, AA&Co and V&E, who had both grown too wealthy off Enron's yearly business and no longer performed their roles."

The bad news, Watkins concluded, was that Enron's sins had been "horrific."

The good news, she wrote, was that "Nobody wants Ken Lay's head. He's very well respected in the community."

Last of five articles

On Nov. 1, 2001, as the stock markets opened, Enron announced that help was on the way: Its two lead bankers, J.P. Morgan Chase and Citigroup, had agreed to provide \$1 billion in additional loans, doubling the company's stockpile of cash.

Enron chairman and chief executive Kenneth L. Lay seized on the news as a rallying point. The cash "will further solidify Enron's standing as the leading market maker in wholesale energy," he declared.

But time and cash were running out on Enron Corp. As November began, investors were fleeing the Houston company and its stock was in a free fall because of damaging disclosures about its finances. Some energy companies were refusing to trade with it, and its funds were quickly being depleted.

The banks had long been Enron's indispensable partners, publicly and privately. They had raised billions of dollars for the company, promoted its stock and invested in the private LJM2 partnership that had become Enron's torment. Now they were trying to protect their investment.

The next evening, Nov. 2, the audit committee of Enron's board of directors assembled for a report on the company's cascading problems.

The mood quickly turned foul.

Lay took aim at his company's accountants, Arthur Andersen LLP, according to detailed notes taken by Andersen attorney Nancy Temple. Andersen auditors had recently reversed a decision they had made back in March involving complex investments called the Raptors. As a result, Enron had to report a half-billion-dollar loss in October. Enron executives resented what they called the "flip-flop."

In good times, Enron's executives, lawyers and accountants worked together to keep the company's deal factory humming.

Now they pointed fingers at each other, Temple's notes show.

"If we had done this right in the first quarter, we wouldn't be here today," Lay said, referring to the accountants' reversal.

Chief Accounting Officer Richard A. Causey -- on the hot seat as Enron's problems mounted -- tried to share blame with Andersen and the company's equally prestigious outside law firm, Vinson & Elkins LLP.

An Andersen partner shot back that the accountants would have done better if Enron hadn't concealed the role of an Enron executive, Michael J. Kopper, as an investor in an off-balance-sheet partnership.

This kind of hidden arrangement was an especially sore subject. Shocked board members had learned a week earlier that Andrew S. Fastow, Enron's ousted chief financial officer, had pocketed \$45 million from the LJM partnerships. The board had granted him permission to run LJM despite the conflict of interest.

Now, board members learned that Kopper, Fastow's former right-hand man at Enron, had secretly made millions running an Enron-backed partnership called Chewco.

"Who withheld the facts? Did Fastow know?" one board member demanded. No one offered answers, Temple's notes show.

"We have to tell the SEC," said board member Wendy L. Gramm, the notes record.

Three days later, on Nov. 5, Fitch Ratings, one of the credit-rating agencies whose decisions would now determine whether Enron survived, downgraded the company's debt to the lowest investment grade. Another rating agency, Moody's Investors Service, was on the verge of doing the same.

Devastating Disclosures

On Nov. 8, the news that had demoralized the audit committee burst into public view.

In a report to shareholders and the Securities and Exchange Commission, the company admitted that it had broken accounting rules in a deal with Fastow's LJM1 partnership and Chewco. Correcting those errors would force Enron to restate its profit figures back to 1997. That would erase \$586 million from its bottom line.

Enron was under scrutiny from the SEC and an investigative committee launched by its board.

Big secrets kept coming out.

For a company that depended on the confidence of its lenders for its trading, the disclosures were devastating. The credit-rating agencies and the banks wouldn't like the news.

That same day, Robert E. Rubin, the former Treasury secretary now with Citigroup Inc., called Peter R. Fisher, an undersecretary of the Treasury. Rubin asked what Fisher thought of the idea of calling the rating agencies to encourage them to work with Enron's bankers to see if there was an alternative to an immediate credit downgrade. Fisher responded, the Treasury said later, that he didn't think that was a good idea. He didn't make a call.

Enron's stock closed at \$8.41 a share that day, a 90 percent plunge from its peak the year before.

An Unlikely Savior

The company's only hope for survival now hinged on a takeover by its smaller Houston rival, Dynegy Inc. For Lay, it was a humbling position. Dynegy had been Enron's overlooked little brother, following its footsteps through the 1990s. Outside of the energy-marketing industry, Dynegy was an unknown. That was about to change.

On Nov. 9, as both Moody's Investors and Standard & Poor's downgraded Enron's debt to just above junk-bond status, Dynegy announced an agreement to buy its rival.

The deal would combine the companies under Dynegy's founder and chief executive, Chuck Watson. Although it might take six months to complete, Dynegy and its major investor, ChevronTexaco Corp., pledged to pump \$1.5 billion immediately into Enron's parched bank accounts. Enron put up a large pipeline network as collateral.

That day was a triumph for Watson -- who would run the combined companies -- after years spent in Enron's shadow. Now, incredibly, Enron had stumbled and fallen into his lap.

He insisted that Enron's problems were manageable.

"We know the company well," Watson said at a news conference. "It's not like we just started fresh. I'm confident that it's as solid as we thought it was."

But Watson and Dynegy were in for some surprises.

Four days earlier, Andersen had notified Enron about "possible illegal acts" involving the Chewco partnership. No one told Dynegy, company executives would later say.

Soothing Analysts

As part of the Dynegy deal, Lay was scheduled to get a "golden parachute" -- a payoff that amounted to \$60 million to buy out his three-year contract. But on Nov. 13, after the perk was disclosed by Bloomberg News, Lay announced that he would forgo it. It didn't look good at a time when many of his employees and investors were losing millions as the company's stock plunged.

The next day, Nov. 14, he presided over a conference call with analysts, working hard to persuade Wall Street and the energy markets that the deal would succeed.

Lay shouldered responsibility for the mismanagement and concealment that marred the company's performance. Investigations were continuing and might turn up new facts but the culture of secrecy had ended, he promised.

"Everything we know now, you know," he said.

He turned the hard questions over to Enron's new top operating officers, President Greg Whalley and Chief Financial Officer Jeffrey McMahon.

Whalley confirmed that energy companies that once looked to Enron as the industry leader now wanted no part of the long-term energy transactions that were Enron's specialty. But he said things were looking up.

Whalley denied that Enron was facing a cash drain. The company had the cash it needed, McMahon added.

Double-Edged Provision

But cash was draining out of Enron, undercutting the energy-trading operation that had been its crown jewel.

It would now become its millstone.

Nearly all of Enron's revenue was coming from its energy-trading operations. EnronOnline, its nearly two-year-old Web-based trading operation, was the leading U.S. trader of gas and electricity. The company praised it as the perfect synthesis of a dot-com "new economy" venture and a staple of the old economy, gas.

Enron's energy trading generated most of its record \$101 billion in revenue in 2000, more than double the year before. But its profits were paper thin. In 2000, the company made only a penny on the dollar. Its profit picture was worsening in 2001, and its need for cash was increasing.

In 2000, the company's cash flow from operations had actually declined by \$2.5 billion, analysts calculated. The company was spending cash faster than it was coming in in the first half of 2001, too, Causey had told the board in August.

In its customary hard-nosed fashion, Enron had insisted that its trading partners have adequate credit to make good on contracts when they came due. If a trading partner ran into financial trouble that lowered its credit rating, Enron could demand an immediate cash deposit to take care of the problem.

But this provision, written into Enron's contracts, cut both ways.

By mid-November, the energy traders still willing to do business with Enron were insisting on burdensome upfront cash deposits, accelerating the company's cash drain at the worst possible time.

'A \$690 Million Bullet'

On Nov. 19, the big public news of the day was the filing of the company's quarterly financial report. Enron revealed that it had run through more than \$1.5 billion in cash since announcing the Dynegy deal, just 10 days before. Much of the cash was apparently extracted by companies now demanding more collateral from Enron on existing long-term energy transactions.

That was just part of the bad news.

Enron had told Dynegy before their merger that its European trading operations had a \$53 million operating profit in the July-September quarter. But in its disclosure, Enron reported that its European operations had actually taken a \$21 million loss.

Most devastating was Enron's disclosure that a \$690 million loan, due to be settled in two years, might have to be repaid within weeks because of the latest drop in Enron's credit rating, to one level above junk-bond status.

If Enron's credit rating was reduced to junk status, confidential clauses in its financing contracts required it to accelerate payments on an additional \$3.9 billion in debt from two off-the-book partnerships. Analysts immediately concluded that Enron couldn't pay.

The appearance of these obligations was the last crack in Enron's carefully crafted facade.

The magnitude of Enron's debt had been one of its most carefully guarded secrets, a fundamental reason for the web of private and off-balance-sheet financial deals Fastow's team had spun.

In September, Enron had said its debts totaled \$12.5 billion. But it had billions more in off-balance-sheet obligations.

Enron's two lead bankers had become important enablers in the company's efforts to disguise its debt, a Senate subcommittee would later conclude. The banks deny that assertion.

Officials at J.P. Morgan and Citigroup worked with Enron finance executives to develop a series of transactions called prepays that on the surface looked like sales of commodities -- in most cases, natural gas. But they worked like hidden loans, Senate investigators said.

Instead of being disclosed as debt, the funds that Enron received from the banks were commingled with trading revenue on the company's financial statements. The transactions were a crucial source of cash, but investors could not tell that the funds would have to be repaid -- just like loans. Bank officials said the deals were legal and Enron reported them as trading transactions.

The company had raised \$8 billion in this way since the mid-1990s. As its problems mounted in 2001, Enron drew on prepays even more heavily, raising \$5 billion in the first half of the year alone.

Watson was surprised by the debt disclosure, which he would later call a "\$690 million bullet in the head."

Watson demanded to meet with Lay the next day. He wanted answers.

"I said that I had to know exactly where the \$1.5 billion went," Watson said later. Lay's answers didn't satisfy Watson.

A spokeswoman for Lay said he disputed Watson's account. Had the Dynegy chief executive asked about Enron's cash position, Lay would have turned the question over to his chief financial officer, she said.

Watson had cast himself as Enron's savior. But he made some Enron executives uneasy -- they wondered whether his real goal was to scuttle the merger and run off with Enron's pipeline.

The revelations about the \$690 million obligation and the vanishing cash gave Watson an opening to back out of the deal.

Negotiations Seesaw

In the days after Thanksgiving, Lay tried to salvage the Dynegy deal. He was now willing to accept less than half of the original purchase price. Enron's major lenders, who could not free

themselves from the company without accepting huge losses, agreed to put more money into the deal.

Gathered at a Westchester, N.Y., conference center on Nov. 23, Lay and his team met hour after hour with Dynegy representatives. Watson, in touch by phone, stayed in Mexico for a family vacation. Negotiations seesawed for several days.

On Nov. 26, Lay boarded an Enron corporate jet for home, believing, aides said, that negotiators had made progress and that an agreement was within reach.

As his plane sat ready for takeoff, Lay got a phone call. Watson would not go along after all, aides told him.

Enron had produced too many surprises.

Watson complained that no one could tell him what Enron was really worth. The deal was dead.

Lay had failed, and the company he had built over the past 15 years was failing with him. From the summit of success just two years earlier, Lay could not unload his company even at a bargain price to a smaller rival. His house of cards had tumbled.

'A Pretty Good Meltdown'

Enron's bankers, meanwhile, were scrambling. On Nov. 26, a J.P. Morgan banker exchanged e-mails with a business associate quoting a colleague as saying Enron was close to defaulting on its prepay contracts and "in the grip of 'a pretty good meltdown.' "

The same day another J.P. Morgan banker sent an e-mail recounting a "Large Exposures Meeting" where bankers calculated that Enron owed the bank \$353 million just on mark-to-market energy trades. The next day, a puzzled J.P. Morgan vice chairman responded: "still hard for me to get a fix on this . . . What is our loss potential?"

On Nov. 28, the credit-rating agencies downgraded Enron to junk-bond status, after concluding the Dynegy takeover would not succeed. Enron's stock price dropped from \$4.11 to 61 cents. That day, Enron shut down its online trading business, just shy of its two-year anniversary.

Only bankruptcy was left.

A Surprise Bonus

That same day, Enron's chief tax counsel, Robert J. Hermann, returned from vacation to find panicked colleagues scrambling to salvage what they could of their life savings.

Word was spreading that the company might file for bankruptcy protection that weekend.

The company was letting some executives get money out of one of its deferred-compensation plans, where employees had banked salaries and bonuses in flush times. By 9:30 a.m. Hermann had submitted a form asking to withdraw \$60,000 from the only plan he participated in that was permitting withdrawals.

Anxious to help a friend, Hermann quickly e-mailed the form to retired Enron vice president Alberto Gude. By about 10 a.m., Gude had filled out the form and shot it back. Hermann's secretary rushed to turn it in.

Hermann, still an important Enron insider, received his money the next day. Enron wired it into his bank account, he said. But with money running out, Enron favored current employees over retirees. Gude never received a penny.

Throughout the week, there had been rumors that some people were getting generous bonuses to entice them to remain through the difficult months ahead.

At about 5 p.m. on Friday, Nov. 30, Hermann was sitting in his office when the phone rang. It was his boss, telling him somewhat mysteriously to leave headquarters and meet him across the street in Enron's new building, where builders were still applying the final touches.

Hermann did. His boss presented him with two envelopes, telling him one contained a bonus check for Hermann, and the other held checks for more than a dozen key employees in the tax department.

Hermann's heart sank. The banks were closed. By Monday morning there wouldn't be a bank in Houston that would cash a check from Enron.

"What good is it?" Hermann thought, walking back to his office.

He lifted the flap on one of the envelopes. It was filled with cashier's checks. This was Enron after all, and the company still knew how to pay a bonus.

"I thought 'how are they going to make this work?' " Hermann recalled. "But dammit, somebody had figured it out."

Alone at the End

Ken Lay was alone. He drew back a privacy curtain in the emergency room of St. Luke's Episcopal Hospital and padded into view bare-legged, wearing a half-tied hospital gown, slippers and a confused expression.

It was Saturday, Dec. 1, less than 24 hours before the fast-ebbing braggadocio of Enron, the self-proclaimed World's Leading Energy Company, finally dissolved into bankruptcy.

Lay wanted out of the hospital. He was needed at an important meeting downtown. The besieged executive locked eyes with the first person he encountered and mistook him for an emergency-room worker.

"Do you know when I'm going to be able to get out of here?" Lay asked a shocked Jeff S. Blumenthal, 38, an Enron tax attorney. Blumenthal happened to be at St. Luke's waiting for his wife, who had fallen off a horse, to be X-rayed.

"Well, I sure don't; I don't work here," Blumenthal recalled saying, embarrassed, as he tugged his scruffy weekend sweater to indicate it wasn't medical garb. He directed Lay to a nearby nurse.

"I thought, 'surely, the guy's not in here with chest pains' because nobody was paying much attention to him," Blumenthal recalled in an interview. In fact, Lay told him he was there with an earache.

"There were six rooms in the emergency room," Blumenthal said. "All six were filled with patients. Everybody had somebody with them, a wife, a husband, a couple of kids. He was the only one who was all alone."

The Meteoric Rise: January to June 2000 . . .

July 2000 to December 2000 | January 2001 to July 2001

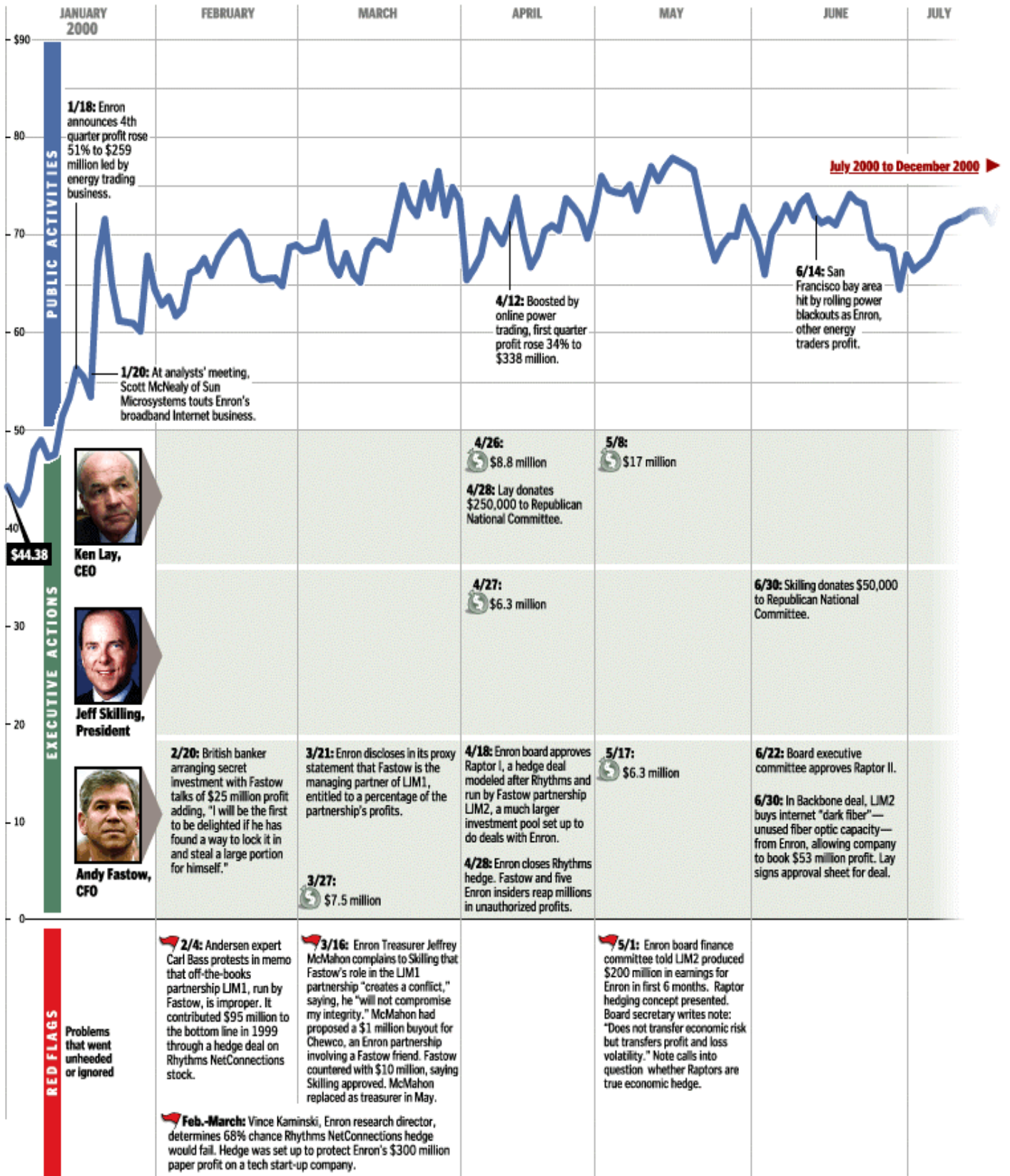
Enron's stock price was the lifeblood of the company. The strategy of Chief Executive Officer Kenneth Lay and President Jeffrey Skilling was to continually come up with new markets and businesses that would create excitement and drive the stock up. The stock began surging at the beginning of 2000 because Enron was anointed as a 'new economy' company by analysts. But beneath

the surface, Enron was propping up earnings by using a series of complex transactions with off-the-books partnerships, LJM1 and LJM2, run by Chief Financial Officer Andrew Fastow. The deals were purposely obscured in the company's financial statements.

KEY

- Daily closing stock price
- Red flags Problems that went unheeded or ignored
- Traditional stock sale
- Stock Transfer

Lay transfers some of his Enron stock to the company to repay an equivalent amount on a draw from a line of credit. By calling the transfers "loan payments" instead of stock sales, Lay avoids immediate reporting requirement. The board members refer to this as Lay's "ATM approach."



The Peak: July to December 2000 . . . January 2000 to June 2000 January 2001 to July 2001

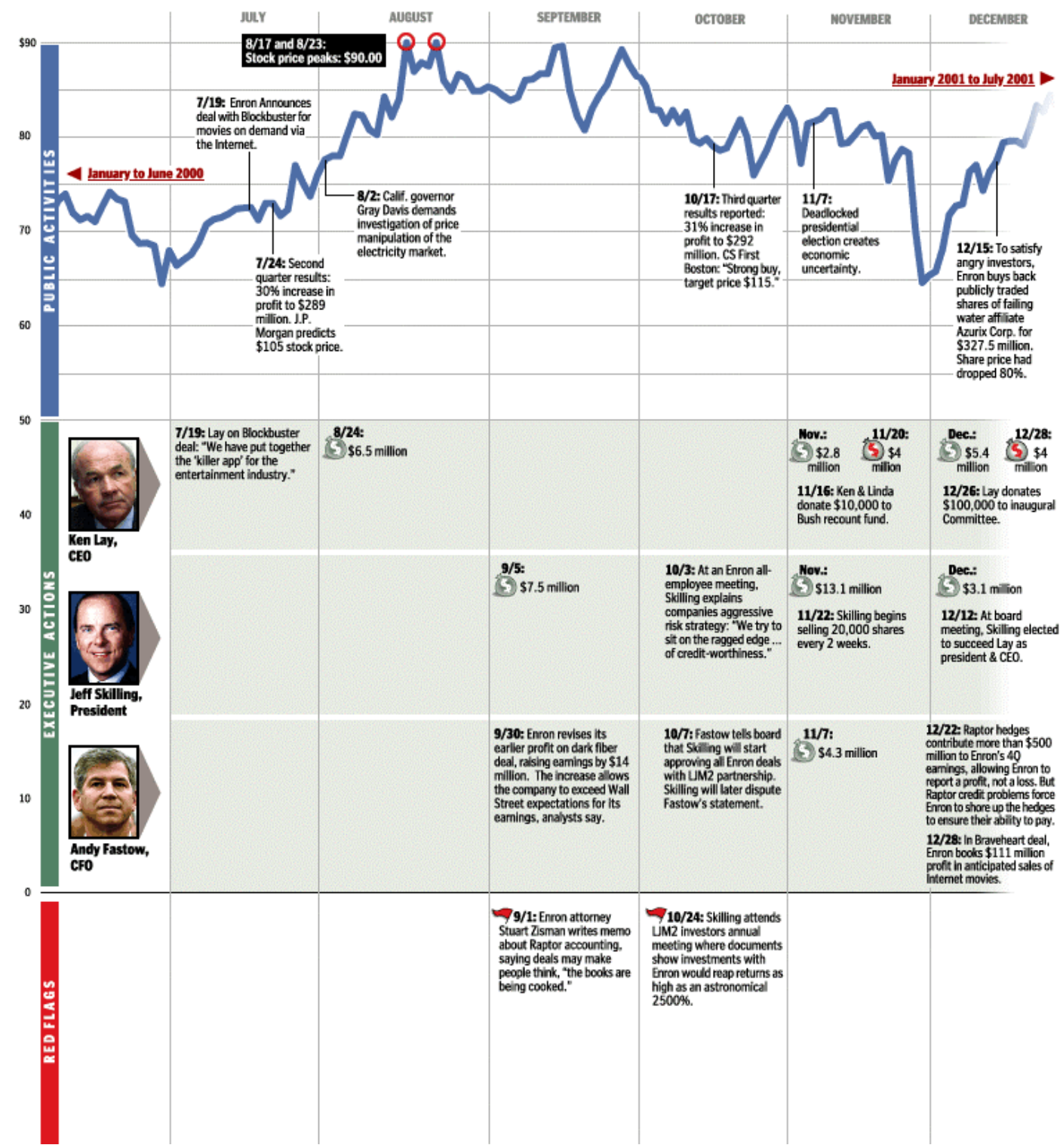
Enron's stock price was the lifeblood of the company. The strategy of Chief Executive Officer Kenneth Lay and President Jeffrey Skilling was to continually come up with new markets and businesses that would create excitement and drive the stock up. The stock shot up in July to hit a peak of \$90 a share in August, doubling in price since the beginning of the year. But beneath the

surface, Enron was propping up earnings by using a series of complex transactions with off-the-books partnerships, LJM1 and LJM2, run by Chief Financial Officer Andrew Fastow. The deals were purposely obscured in the company's financial statements.

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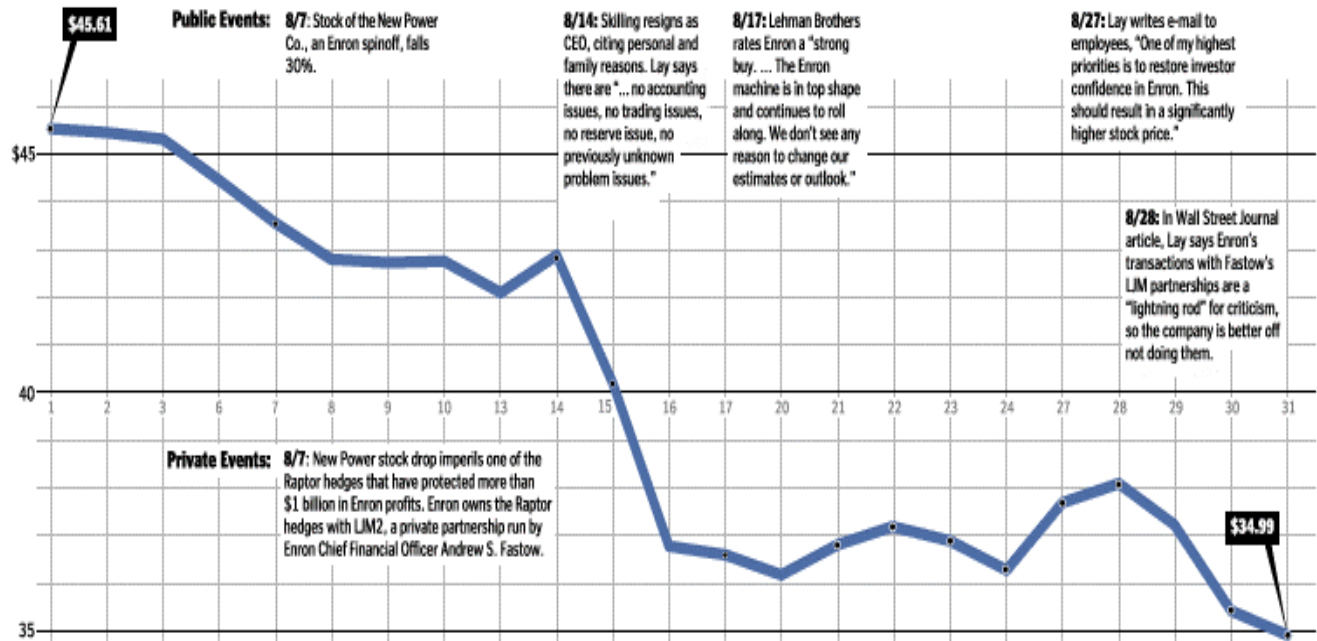
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The Downward Spiral: August 2001

Two dramatic events occur—one public, one private. Chief executive Jeffrey K. Skilling shocks Chairman Kenneth L. Lay and the business world by announcing his resignation on Aug. 14. The next day, Enron Vice President Sherron Watkins writes Lay anonymously, warning that she fears Enron will “implode in a wave of accounting scandals.” Lay asks Enron’s lawyers, Vinson & Elkins, to do a preliminary investigation.



Public Events are shown above the graphic line of the company's stock price

Private Events are shown below the line

Stock Transfers

Lay transfers some of his Enron stock to the company to repay an equivalent amount drawn on a company line of credit. One board member refers to this as Lay's "ATM approach." By calling the transfers "loan payments" instead of stock sales, Lay avoids immediate public reporting requirement.

Red flags Warning signals that went unheeded

Research by Margot Williams and Lucy Shackelford, graphics by Michael Drew

Red flags

- 8/15: Sherron Watkins, Enron finance executive, sends anonymous letter to Lay questioning accounting practices for Raptor deals: "I am incredibly nervous that we will implode in a wave of accounting scandals..."
- 8/21: UBS Paine Webber broker tells clients Enron is in trouble and suggests they sell. He is fired after Enron officials complain.
- 8/21: Arthur Andersen LLP audit executive writes memo to colleagues about a Watkins' call alerting firm to Enron accounting problems.

- 8/22: Enron employee e-mails regarding Raptor problems: "Oops."
- 8/22: Watkins meets with Lay.
- 8/28: In e-mail addressed to Enron board, employee Margaret Ceconi alleges company covered up big losses in retail energy sales. "Lying was rewarded in the culture at Enron," she said.

Lay's stock transactions
 8/21-30:

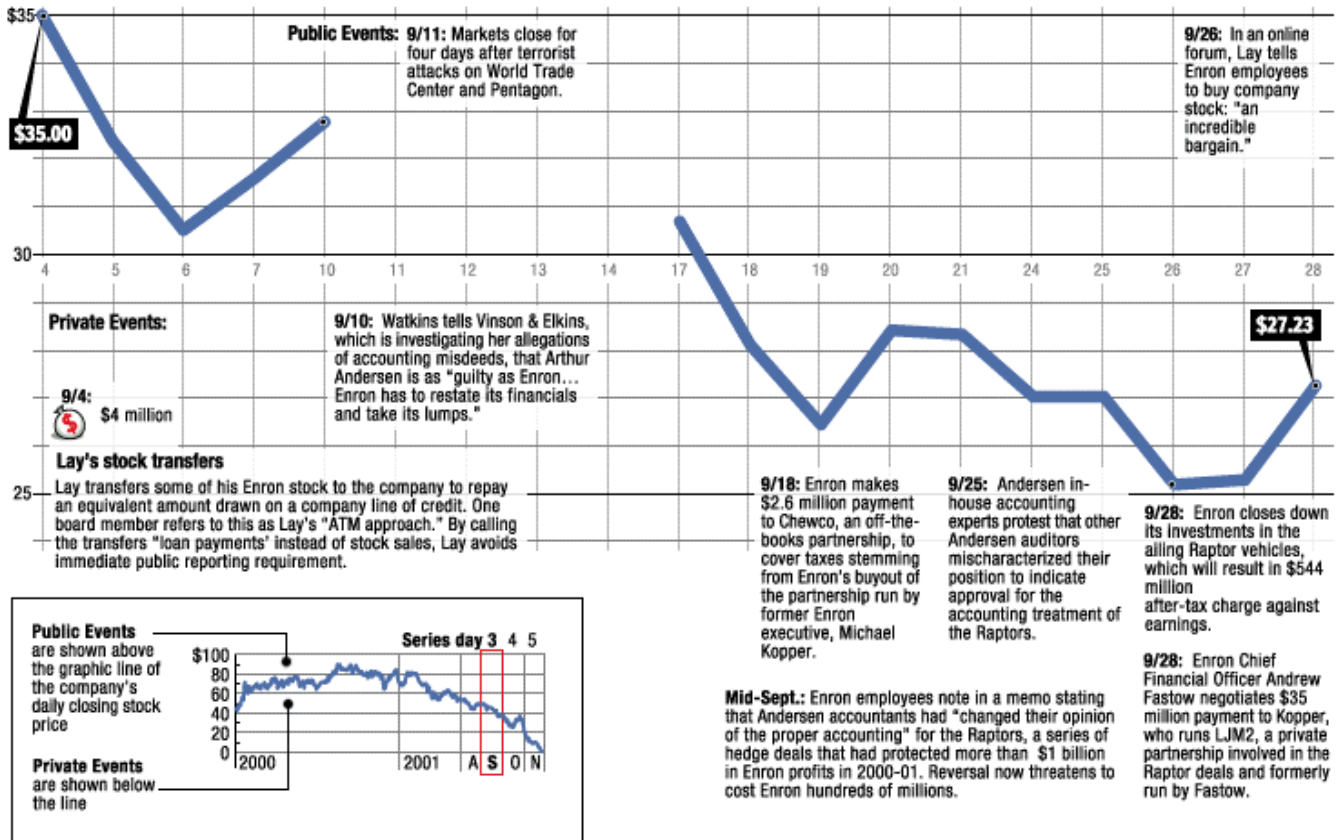
 Four transfers net: \$16 million

Internal investigation

- 8/24: Enron's outside law firm Vinson & Elkins, investigating Watkins' charges, conducts first interview.
- 8/27: In interview with law firm, Fastow says, "Train wreck" scenario laid out by Watkins for Raptor deals is unlikely. "Although the structure may be in a gray area, it is fully approved by Arthur Andersen and is fully disclosed," Fastow tells lawyers.
- 8/30: Vinson & Elkins interviews Enron executive Jeffrey McMahon, who says he "cannot believe that the accounting is not absolutely perfect. It has been carefully reviewed."
- 8/31: Vinson & Elkins interviews Chief Accounting Officer Richard Causey, who says Enron will experience losses to its income statement from Raptor transactions if Enron stock falls below \$20 a share. Causey says he has "discussed these risks with Skilling and Lay."

The Downward Spiral: September 2001

The Sept. 11 terrorist attacks briefly interrupt Enron's growing troubles. But soon Kenneth Lay, back as chief executive officer, must deal with internal allegations of accounting errors, a costly reversal by accountants on the treatment of Enron's Raptor deals and rising debt obligations in those deals.

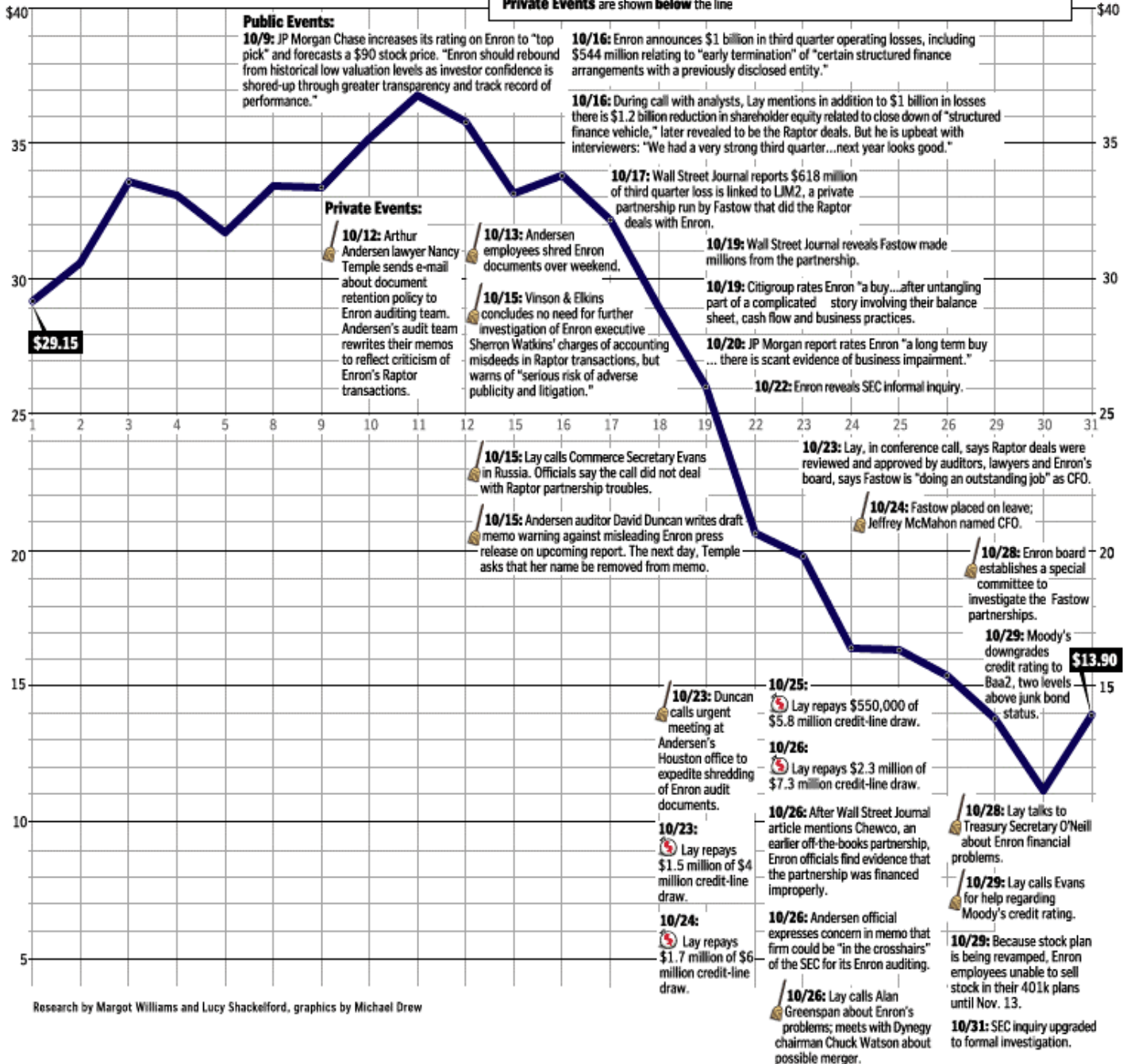
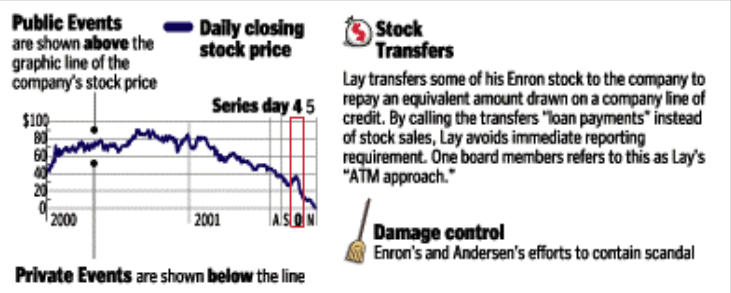


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THE WASHINGTON POST

The Downward Spiral: October 2001

Enron discloses \$1 billion in third quarter losses, touching off a crisis of confidence among creditors, investors and employee shareholders. Revelations of a \$1.2 billion reduction in shareholder equity and profiteering by Chief Financial Officer Andrew Fastow accelerates the slide of the company's stock. Damage control efforts begin, with Enron's accountants shredding documents and Chief Executive Officer Ken Lay calling presidential cabinet members and meeting with rival Dynegy to discuss a merger.



The Downward Spiral: November 2001

Reeling under the previous month's announcements of a billion dollars in losses, Enron suffers further blows as it admits on Nov. 8, to accounting errors that resulted in \$586 million in overstated profits between 1997 and 2000. Eleven days later, the company further reveals that it owes \$690 million immediately and that \$3.9 billion in obligations will come due if its credit is downgraded to junk bond status. That leaves the company with only one option: merge with Dynegy. When that fails, Enron is forced to declare bankruptcy.

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