

February 2, 2002

Learning Old Lessons From a New Scandal

By PHILLIP L. ZWEIG

In sifting through the rubble of Enron for new lessons on how to prevent such debacles, investigators will likely come up empty-handed. Unfortunately, the only true lesson seems to be that every lesson must be relearned by a new generation.

It was 20 years ago that one of the most notorious financial debacles in American history, that of Penn Square Bank, prompted outrage, litigation and Congressional hearings. So far, there's no evidence that Kenneth L. Lay, the former Enron chief executive and chairman, or other Enron officials emulated Bill Patterson, Penn Square's flamboyant, fun-loving energy lending chief, in drinking amaretto out of his Gucci loafers. But both were variations on the classic oil-patch boom-and-bust story. Other striking similarities: both scandals involved corporate boards, auditors and fund-raisers for the campaigns of politicians named George Bush.

Penn Square was a goofy little bank, based in an Oklahoma City shopping center, whose shady financial dealings triggered the near-failure of Continental Illinois, then the country's seventh-largest bank. Penn Square's troubles stemmed from more than \$2.5 billion in dubious loans it made to customers in the petroleum industry at the height of the oil boom. It then sold most of those loans to larger banks, and when the price of oil dropped in the early 1980's, so did the value of the creditors' collateral, much of which — like Penn Square's "earnings" — was inflated or even illusory to begin with.

By the time the mess was cleaned up, Continental Illinois had averted failure only through a \$4.5 billion federal bailout — then the largest in history. Mr. Patterson was eventually charged with violations of United States banking laws and was sentenced to two years in federal prison in 1988.

First and foremost, Penn Square and Enron are monumental examples of the failure of corporate governance and the hazards of rubber-stamp boards. At Penn Square, Mr. Patterson and other executives ran circles around a retired Air Force general, a local car dealer, a physician and various assorted businessmen, none of whom bothered to ask questions until the bank began its descent into insolvency. Some of the directors, in fact, received sweetheart loans from Penn Square, an illegal practice.

Likewise, outside auditors at both Enron and Penn Square were mired in conflicts of interest. After firing Arthur Young & Company (now Ernst & Young), which had tarnished it with a qualified opinion, Penn Square hired Peat, Marwick, Mitchell & Company (now KPMG). Peat Marwick saw fit to give the bank a clean bill of health about three months before it failed. As it turned out, Penn Square had also made loans to Peat partners for investments in real estate and drilling funds. They also invested heavily in at least one partnership sponsored by a major Penn Square borrower.

Like Enron, Penn Square amassed huge liabilities off the balance sheet, which contributed to its demise. Penn Square issued millions of dollars in letters of credit, which can be legally counted off the balance sheet, to enable doctors and dentists to buy into an array of limited partnerships sponsored by its oil and gas customers. When the partnerships failed, these investors defaulted on their loans.

Both Enron and Penn Square also played prominent political roles. Whether Enron's millions in contributions to politicians and political parties bought regulatory forbearance that enabled it to

delay its day of reckoning remains unclear. But in both instances the contributions certainly bought access that helped convey an aura of invincibility. Some of Penn Square's easy money found its way to Oklahoma's so-called "Republican Eagles," who were major backers of the 1980 Republican ticket of Ronald Reagan and George Bush.

Congress and regulators will now be tempted to write new laws to plug every loophole and cover every contingency in a futile bid to avoid all future Enrons. But Congressional hearings on the Penn Square fiasco were largely inconclusive; they resulted in no major legal or regulatory reform.

Maybe the Congressional inquiries into Enron — there are at least a dozen of them — will be more productive. Then again, with both Penn Square and Enron, perhaps only the marketplace can mete out the most effective discipline: letting them fail.

Phillip L. Zweig is author of "Belly Up: The Collapse of the Penn Square Bank."