

**SECTION I**  
*The Enron Cases*

**PART I**  
**DEMOLISHING FINANCIAL  
CONTROL, NEUTERING  
THE GATEKEEPERS**

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## Case Study 1

# Enron Oil Trading (A): Untimely Problems from Valhalla

*This environment is hardly giving us room to breathe.  
The last thing we need is a public scandal.*

**I**T WAS THE END OF THE BUSINESS DAY, February 1, 1987. Ken Lay, CEO of Enron Corporation, sat at his desk, ruminating over his agenda for the following day. Tomorrow's schedule showed a morning meeting with Internal Audit and two top officers from Enron Oil Trading (EOT). Louis Borget, president of EOT and Tom Mastroeni, the treasurer, were coming down from their headquarters in Valhalla, New York. They had been called to Houston to answer charges of opening undisclosed bank accounts to conduct unauthorized transactions.

Lay had already heard a bit about the controversy. He again skimmed an Internal Audit memo (Attachment 1) that summarized the issues. The essence of the matter concerned an account opened by EOT at the Eastern Savings Bank. Borget and Mastroeni were the authorized signatories on the account but had failed to report its existence to Enron's Houston headquarters. Millions of dollars from EOT trades had found their way into this account. More worrisome, some \$2 million had then been transferred into Mastroeni's personal account at the same bank. Internal Audit suspected that Borget and Mastroeni had EOT engaging in unauthorized and/or fictitious trading, skimming money for personal gain.

Houston oversight of EOT was the responsibility of John Harding and Steve Sulentic. Lay sought out their views upon receiving Internal Audit's report. Eventually, they got back to Lay with a story that the undisclosed account involved transactions that were legitimate and in Enron's interests. The transactions in question were "twinned trades": equal and offsetting buy/sell transactions used to move profits from one accounting quarter to another; such trades, they observed, were not uncommon in the trading business. Borget and Mastroeni would come to Houston, bring their bank records, and explain everything. Lay had pressed lightly on the point of

EOT's not reporting the Eastern Savings account to Houston and had gotten an answer to the effect that perhaps some unfortunate shortcuts had been taken but the underlying motives were ok.

Ken Lay hoped that this would turn out to be true. As he pondered how to run tomorrow's meeting, his mind wandered back over Enron's recent history and current predicaments.

## Natural Gas Pipelines in Crisis

Ken Lay had only joined Enron in June 1984. It was not then known as Enron; the company that Lay took over as chairman and CEO was called Houston Natural Gas (HNG). Lay had assumed the helm at a difficult transition time for the natural gas pipeline industry. Long-standing players, such as HNG, were finding that the industry business model was rapidly changing. Prior to the mid-1980s, natural gas producers sold gas to pipeline owners under long-term contracts. In order to induce producers to commit their gas, pipeline owners customarily provided long term deals with floor prices and a commitment to "take or pay" for gas: take a minimum volume of gas at a stipulated price or pay the cash equivalent of having taken the specified gas amount.

Two things happened in the 1980s to destabilize this model. The first concerned the value of newly produced natural gas; prices had fallen to rock-bottom levels, below \$2 per million BTUs. The second was a regulatory change. No longer would pipeline operators be able to lock out producers who didn't commit to ship through their lines. Instead, gas producers were now able to sell directly to end users and require pipelines to ship their volumes for a simple transport tariff.

These changes rocked the gas pipeline industry. Newly developed gas started finding its way directly to end users at the low spot market price. Major carriers increasingly found themselves burdened with gas purchased earlier at higher prices under take-or-pay contracts. Pipeline company financial conditions deteriorated. Debt ratings were downgraded. The carriers labored to work their way out from under disadvantageous contracts. HNG was no exception.

Ken Lay thought he knew how things would play out. His assessment was that natural gas market deregulation would continue to progress; from this, he concluded that future profitability would become a function of scale—that is, the biggest pipeline companies with the most extensive networks would become low-cost providers and would end up dominating a market of natural gas production sold largely at spot prices and moved via low-cost logistics.

As if on cue, the gas pipeline industry began to consolidate. Again, HNG was no exception. In April 1985, a call came from Omaha-based Inter-North

suggesting a merger. Inter-North was approximately three times the size of HNG. However, its senior management was aging, its board was divided and both were uncertain about how to cope with the deregulated market. A corporate raider, Irwin Jacobs, was stalking the company. Inter-North needed a deal.

Immediately prior to the merger talks, HNG stock was trading at \$45 a share. In just eleven days, Lay was able to extract both a \$70 per HNG share price (a 56 percent control premium) and a commitment that he would move up to CEO after a couple of years. The Inter-North/HNG merger closed within the year, and the new entity was christened Enron in 1986.

Unfortunately, the merger did little to alleviate the pipeline company's immediate economic straits. Profitability was miserable. The natural gas glut seemed to produce ever-lower prices. Enron had to face this deteriorating environment with more than \$1 billion in take-or-pay contract liabilities. Enron reported a \$79 million loss for 1985, its first year of operation. Attachment 2 details Enron's financial performance for 1985-'86. Although Enron reported net profits of \$556 million for 1986, the bulk of that reflected recoveries of past income taxes. Enron's financial condition was more accurately reflected by the following: earnings before interest and taxes (EBIT) \$230 million; interest expense: \$421 million.

Enron was now heavily debt laden, the product of Inter-North's having used debt to fund the premium price for HNG's stock. To some extent, this leveraging up of the company had been intentional Irwin Jacobs' group was being paid \$350 million to hand over its Inter-North stake and go away. Inter-North thus reckoned that a heavy debt burden would act as shark repellent for future raiders; however, high debt levels also hamstrung the newly merged entity. Ken Lay found that his firm's bank loans contained covenants requiring quarterly interest expense to be covered 1.2 times by EBIT; failure to do so would mean an event of default. Enron would be especially exposed in such case, as the firm also had more than \$1 billion of commercial paper outstanding. These unsecured short-term promissory notes had to be rolled over continuously. A hiccup on bank loan covenants could spark a full-fledged financial crisis should it lead commercial paper buyers to flee from Enron's paper.

In January 1987, Moody's Investors Service downgraded the company's long term rating to below investment grade, i.e. to junk status.

This perilous financial condition meant that Ken Lay spent much of 1986 focused on maintaining liquidity and avoiding the default triggers in Enron's bank loans. Lay froze senior executive pay and sold some pipeline assets. Enron stayed afloat, but the company was barely scraping by.

In fact, a good portion of the company's razor-thin margin for error was being contributed by a little-known and understood entity, EOT. Inter-North had created the subsidiary back in 1984. Trading oil commodities was a rel-

atively new business at that time. Inter-North chose to enter the business by hiring an established trader, Louis Borget. Inter-North lured him away from Gulf States Oil and Refining, where Borget had set up a similar unit three years earlier. The package to induce Borget to move included bonuses tied to the profits produced by the trading operation.

EOT immediately began to report profits. In 1985, when the merged Inter-North/HNG lost \$79 million, EOT made \$10 million. In 1986, when Enron couldn't cover interest expense with operating earnings, EOT reported profits of \$28 million.

Ken Lay still wasn't sure what to do to fix Enron's financial problems. He believed that long term, deregulation would reward his company. For the near term, Enron seemed bogged down in a bad business environment of low prices, intense competition, and the burdens of high debt. One thing he did know was that EOT's contribution was helping the company cope in the short run while it waited for the longer run to bring improved conditions.

Lay had another, more political problem closer to home. The board of Inter-North had rebelled against his predecessor, Sam Segnar, concluding that he had caved in to HNG's demands during the merger negotiations. Segnar had ended up paying with his corporate head. Lay replaced him but soon faced bitter resistance from former Inter-North directors on a series of secondary but highly symbolic issues: the appointment of Enron's public accountant and the relocation of Enron's headquarters to Houston. The issues eventually were resolved, with Lay getting his way on the relocation. Lay had also begun to replace former Inter-North directors with selections more supportive of his leadership. Still, at the outset of 1987, Ken Lay was a CEO under the microscope, facing a board that was divided and in some cases personally bitter toward him.

None of this was lost on Ken Lay as he skimmed over Internal Audit's memo yet another time.

## Considering the Options

Lay's mind quickly focused on shaping an outcome for the meeting.

What do I do to resolve this issue? I'd better walk into this meeting with some idea of the answer we want at the end.

What really matters here? What issues take priority over others? I have to give preference to the financial condition of our company. This means that EOT's profit-generating capability needs to be preserved. Moreover, a financial scandal right now could be devastating. Not only might EOT's profit contributions be affected, but Enron's past financial results might have to be restated. Accounting restatements are yellow flags, signs that something major is amiss inside a company. It wouldn't be long before Enron's equity analysts and lenders get wind of unreported bank accounts, and dubious

transactions. They'd assume the worst and wonder what else they didn't know. The result could be a major crisis of confidence leading to a liquidity crisis for Enron.

Borget and Mastroeni have undoubtedly broken some rules. That's not a total surprise coming from traders and their culture. We have to find some means to limit abuses while leaving EOT's risk-taking culture intact.

What exactly are the allegations of wrong doing here? It seems that Borget and Mastroeni either received or thought they'd received signals from Houston to manage the timing of EOT's reported profits. They responded by doing some of what others in their industry also do—twinned trades that give another party profits in one period to be offset by profits returned in the subsequent period. Such trades are not illegal. They altered quarterly results, but that's not uncommon: Everybody "manages earnings" one way or another. The worst that can be said is that they executed these trades in a fashion that was less than above board. Clearly, they must have assumed that not everyone in Houston was on board with managing earnings. Why else would they have not reported the new bank accounts? And what's this about company money going into Mastroeni's personal account? Whatever the reason, and I'm sure they'll have one, that's got to stop.

What to do about it all? How best to keep the big picture in mind but still send a message that excess won't be tolerated?

With this, Ken Lay picked up a pen and began to outline a set of options. He began by listing categories of possible remedial actions:

- Immediate issue management
- Personnel discipline
- Organizational reform
- Transactional rules
- Process reform
- Organizational oversight

He then expanded each bullet point with possible options to consider:

- Immediate issue management
  - o Define the transgressions associated with EOT bank accounts, trades, and the mingling of corporate money with personal accounts, and the mitigating circumstances.
  - o Ensure that Enron's financial condition is a major factor shaping any resolution of the incident.
  - o Determine the "materiality" of accounting issues and the need for any restatement of public financial reports.
- Personnel discipline: options
  - o Terminate Borget or Mastroeni or both.
  - o Terminate Harding or Sulentic, or both.
  - o Discipline some or all of the above in terms of future compensation, responsibilities, and title.

- Possible organizational reforms
  - Revise Houston's oversight of EOT, either changing out current management and/or intensifying oversight in terms of stewardship reviews and/or oversight of controls.
  - Embed new management at EOT:
    - New trading personnel loyal to Houston management, charged to learn EOT's business model.
    - New financial management loyal to Houston charged to ensure that controls are sound and rules are respected.
    - A financial controls advisor assigned to EOT for the indefinite future.
- Transactional rules
  - Have Internal Audit recommend new/clarified rules for authorizing and reporting bank accounts, trades, and unit financial results.
  - Have the chief accounting officer and/or Arthur Andersen opine on the acceptability of twinned trades done solely for the purpose of managing earnings; consider whether such trades might have other economic rationales.
- Process reform
  - Reconsider established EOT trading limits and Enron's process for obtaining exceptions; ensure that limits are proportionate to unit profit objectives
- Organizational oversight
  - Decide whether EOT merits a full-time Internal Audit presence; determine also the frequency and timing of audits and the role of Arthur Andersen as external auditor.
  - Review who should be EOT's legal counsel and whether that presence should be in Houston or Valhalla.

Well, I clearly have a range of options available. Possibly I can blend a couple of different actions to not upset the apple cart while still making it clear to EOT that there are boundaries.

It flitted through Lay's mind that the meeting's outcome would go some distance toward setting the tone on financial control for the newly merged company:

There have been whispers in Houston that EOT is not respecting its oil-trading limits. The division's open position is not supposed to exceed eight million barrels; if losses exceed \$4 million, the open position is to be liquidated. Some of Enron's Houston-based traders are questioning how EOT could generate the profits it was reporting without breaching these boundaries. After all, trading limits contain the magnitude of gains as well as losses. Still, nothing hard has surfaced. Perhaps this is only professional jealousy at work.

Whatever I decide, it will have to be smoothly executed. Enron is in no position to absorb public scandal. This will have to be handled carefully.

It also occurred to Lay that this episode could contain an opportunity. Sometimes, rule breaches are expressions of pressures that need to be resolved; under such pressures, managers sometimes choose the path of least resistance. Was EOT one of these cases? If so, was there a way Lay could use EOT to deliver a message that might reverberate positively throughout the struggling pipeline business?

Lay packed up his notes without making a firm decision on a course of action. He found himself leaning toward correcting the abuses without firing anybody. However, he would reserve judgment on the severity of corrective actions until he heard the full story. Lay also reflected that the oil-trading business was something of a mystery. It was relatively new and not a heritage HNG business; profits seemed to be closely tied to the quality of the individuals doing the trading. In 1986, Borget himself had told the Enron Board that oil trading "as done by professionals in the industry today, using the sophisticated tools available, can generate substantial earnings with virtually no fixed investment and relatively low risk"<sup>1</sup>

Lay resolved to listen carefully to what emerged between the lines at tomorrow's meeting—especially to the vibes regarding how EOT generated its profits. Would there be anything more to the auditors' allegations than what he had already seen in writing and heard from Harding and Sulentic? If so, Lay might have to adjust his plan of action right there at the meeting.

## The Meeting with Internal Audit

The meeting convened with Borget and Mastroeni present, along with Enron general counsel Rich Kinder, as well as Harding and Sulentic. David Woytek and John Beard represented Internal Audit. Lay opened the meeting, calling on EOT president Lou Borget to address Internal Audit's concerns.

Borget and Mastroeni laid out the following facts. EOT had been highly profitable in 1986. As this became known, company managers requested that they find a way to shift some profits into 1987. They were told to do this by "whatever legitimate business practice we could." As a result, EOT resorted to matched, or twinned, trades that would net out over the period 1986-'87. Borget observed that such trades were commonly used by other trading companies. Mastroeni stated that EOT had identified three firms interested in boosting their 1986 profits: Isla Petroleum, Southwest Oil and Commodities, and Petropol Energy. EOT then entered into trades with those three entities, selling oil at prices that delivered profits to them during December 1986; the deal was for EOT to buy back oil and recoup equal gains during the first part

of 1987. Mastroeni explained that they opened the Eastern Savings Bank account as a place to hold cash proceeds from the 1986 sales. However, because this account was in Enron's name, Mastroeni stated that he had moved money to his personal account to avoid attracting attention and complicating Enron's year-end statements. Their intention was to return all funds to Enron in 1987.

Sulentic then added that it was all a misunderstanding, that Borget and Mastroeni believed that they were acting in Enron's best interests. He added: "I say we accept that mistakes were made, do what needs to be done to correct them, and move on to a profitable 1987."<sup>2</sup>

Ken Lay then spoke, making it clear that he disapproved of the methods EOT had used to accomplish its goals. He asked whether anyone else at the meeting had anything to add.

David Woytek spoke up, pointing out that the bank statements EOT had brought to the meeting had been altered. Transactions showing funds transfers into and out of the accounts had been removed. Woytek had the statements provided by the Eastern Savings Bank to document the point.

Mastroeni then explained that the deleted transactions referred to a disputed bonus paid to a trader. The individual in question had been fired near the end of 1985. He had retained a lawyer and threatened to sue the company if his anticipated year-end bonus was not paid. After some discussion, a close-out settlement of \$250,000 had been agreed on. Woytek asked Mastroeni why, if that were so, there was any need to alter the bank records. Mastroeni replied that the incident had nothing to do with the transactions under discussion at this meeting, so they simply took them out of the bank statements to avoid confusing the issues.

Lay listened to the conversation as it surged back and forth. What he had just heard amounted to new information; Borget and Mastroeni had brought doctored bank records to the meeting.

They had made a decision not "to confuse" the issues, in the process attempting to prevent some transactions from coming under scrutiny.

It was getting close to the moment when Lay would need to end the discussion and focus the meeting on what actions should be taken. Lay had now heard Borget/Mastroeni's stories explaining the opening of the unreported bank account, the origins of the funds transfers into the account and the outflow of money to Mastroeni's account. How much could he take those stories at face value? And how should this new information—that EOT's managers had altered bank records—influence the perspectives and options he had mulled over the night before?

**Attachment 1 Historical Recreation (HRC)****MEMORANDUM**

January 25, 1987

To: Mr. David Woytek  
From: John Beard  
SUBJECT: Possible Irregularities at Enron Oil Trading

This memo intends to summarize our findings so far regarding potential financial irregularities at Enron Oil Trading (EOT) and to lay out the issues requiring further investigation.

On January 23, Internal Audit was contacted by an officer at the Eastern Savings Bank. The bank had identified unusual activity involving an Enron bank account and wanted to verify with company officials that certain transactions were legitimate.

The officer reported that Tom Mastroeni, treasurer of EOT, had recently opened an account at the bank. Mastroeni and EOT president Louis Borget are listed as signers on the account. Immediately following the account opening, transfers totaling \$5 million flowed into the account from a bank located in the Channel Islands, a European tax-haven location. Subsequently, funds in excess of \$2 million left the account and were transferred to another account registered in Tom Mastroeni's name. Eastern Savings has cooperated by sending us statements documenting both the account opening and the funds flows into and then out of this new account.

We have checked Enron's corporate registry of bank accounts and can find no evidence of the Eastern Savings Bank account having been recorded on the company's books.

We have interviewed Steve Sulentic and John Harding, EOT's contact executives in Houston. They advise that since 1985, EOT has, at their request, taken actions to move accounting profits from one reporting period to another. Apparently, the actions involved are twinned trades, i.e. simultaneously negotiated sale/buy oil trades having different time periods. In the typical transaction, EOT would sell oil one month forward at a price attractive to the buyer and contract to purchase the oil back two months forward at an equally attractive price. The net effect of the two trades is zero, but if done at the end of an accounting period, the first transaction creates a loss for EOT, with an offsetting gain recorded in the subsequent period.

It is unclear whether Messrs. Harding and Sulentic knew of the precise mechanism used by EOT to move profits between accounting periods. However, these executives indicate that such transactions are not unusual among oil traders. Sulentic and Harding now believe that the transactions that led to funds transfers into the Eastern Savings account may have resulted from EOT's entering into year-end 1986 twinned trades. They also indicate that Borget and Mastroeni are available to come to Houston to clarify this matter.

As of this moment, we do not know whether the funds transfers represent legitimate EOT business transactions, trades done solely for accounting purposes, or irregular activity. It is certainly a concern that funds flowed through the Eastern Savings account and into the personal account of a company officer; such activity involving an amount over \$2 million is highly irregular. It is also a "red flag" that this activity took place in a new account set up in circumvention of clear corporate guidelines requiring the reporting of all new bank accounts to corporate headquarters. To the extent that these transactions are irregular, they may represent theft of corporate funds. To the extent that the transactions are found to be legitimate, their "off-the-books" nature could require restatement of financial records and reported results for 1986.

The issues requiring further investigation are thus the following:

- For what purpose was the new account at Eastern Savings Bank opened?
- Why was this account's opening not reported to Houston? Failure to do so is a direct violation of company control standards.
- Was there any substantive business purpose associated with the cash transfers that entered the Eastern Savings Bank account?
- What justification can be provided for corporate funds being transferred to the personal account of an employee?
  - Are all corporate funds accounted for?
  - When will the funds be returned? If not immediately, why not?
- If the underlying transactions were entered into solely for the purposes of altering EOT's reported earnings, do Enron's 1986 financial statements need to be restated?

In conclusion, the facts known to date are of grave concern and warrant a full investigation. The potential implications include loss of corporate funds as well as misstatement of records, deliberate manipulation of records, and the creation of fictitious losses with impacts on Enron's financial statements and tax returns for the year ending 12/31/86.

**Attachment 2****Enron Corporation**

Summary Financial Statements, 1985-86\*

\$ Millions

<b>Year</b>	<b><u>1985</u></b>	<b><u>1986</u></b>
Revenue	9,767	7,454
Earning Before Interest & Taxes (EBIT)	554	230
Interest Expense	(337)	(421)
Taxable Income	234	(191)
Income Taxes, net	(109)	565
Income from Continuing Operations Before Extraordinary Charges	<u>163</u>	<u>374</u>
Net Income	(79)	557
Total Debt	4,356	3,538
Net Worth	1,492	1,203
Debt/Total Capital	74%	75%
EBIT/Interest Expense	164%	55%
Operating Cash Generation	682	478
Investment/Acquisitions, net	(2,357)	756
Financing, net	1,641	(963)
Change in Cash	(35)	270

\* Figures may not be additive because of other items, charges and rounding

## Author's Note

This case relies principally on the accounts of the Valhalla financial control issues provided in *The Smartest Guys in the Room* (pp. 15-19) and *Conspiracy of Fools* (pp. 15-19). Both books treat the episode in detail and with minor discrepancies provide accounts that are consistent as to the facts.

Each book offers some details not provided by the other. For example, *The Smartest Guys in the Room* provides details of the trading limits in existence at EOT, the financial condition and bank covenants of Enron at that time, and the fact that David Woytek sent Ken Lay a memo describing the EOT twinned trades as creating "fictitious losses". *Conspiracy of Fools* provides a detailed account of the meeting of EOT's Borget and Mastroeni, Enron Internal Audit, and Enron management. This work also confirms that Lay attended that meeting and gave explicit instructions as to what remedial actions were to be taken.

*The Smartest Guys in the Room* (p. 18) identifies Steve Sulentic and John Harding as Borget's Houston-based nominal superiors. That work quotes "internal documents, court testimony and notes detailing these events" in describing how the two executives articulated a rationale for Borget to "move some profits from 1986 into 1987 through legitimate transactions". Sulentic's defense of the traders' actions as a "misunderstanding" appears in *Conspiracy of Fools* (p. 18).

Several portions of the case are created for purposes of surfacing the issues and options facing Ken Lay. Lay's thoughts on the night before the meeting have been crafted for these purposes. They do not represent any sort of historical record found in any published source. This applies also to the list of options he outlines while sitting in his office. The portrayal is, however, consistent with (1) the fact that he received a memo from David Woytek on the possible irregularities and (2) the actions taken by Lay at the end of and right after the meeting. It is also apparent from the content of the memo forwarded by David Woytek that Lay had heard at least a preliminary version of the "twinned trade to move accounting profits" story that Harding and Sulentic articulated at the actual meeting. Lay's options list has obviously been expanded beyond the actions he actually endorsed in order to provide students with a full range of choices to consider.

The account of the meeting with Internal Audit is based upon the two sources cited.

Attachment 1, Beard's memo to Woytek, is a Historical Recreation (HRC) intended to summarize the facts known to the

auditors prior to the meeting with Borget and Mastroeni. However, it is factually based, being grounded in not only the general accounts provided in the sources but also in: (1) the fact that Woytek did provide a memo to Lay and other senior managers, (2) published comments from Beard's notes, and (3) a published quote from Woytek's memo describing the twinned trades as creating "fictitious losses".

Attachment 2 is drawn from Enron's restated public financial filings.

## Notes

1. *The Smartest Guys in the Room*, p. 17.
2. *Conspiracy of Fools*, p. 18.