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Academy Address, August 3, 2003, by Sherron Watkins

Introduction to the address by Academy President Jone L. Pearce

It is my pleasure to introduce Sherron Watkins, the Academy of Management’s 2003 Distinguished Executive Speaker. By now, her story as the former vice president of Enron Corporation who tried to bring what she called “an elaborate accounting hoax” to the attention of Enron’s chief executive officer is well known. In August 2001, responding to his invitation to employees to put any concerns in a comment box, she did so. When he did not address her explosive charges at a subsequent company-wide meeting, she sought a face-to-face meeting with him. A month later the CEO announced to employees that “our financial liquidity has never been stronger,” while exercising his own $1.5 billion in stock options, just ahead of the company’s announcement of a $618 million quarterly loss. When United States Congressional investigators uncovered her letter buried in boxes of documents, they brought Ms. Watkins before the United States Senate in February 2002 to testify about her warnings. Her articulate, detailed accounts rocked the foundations of the corporate world and the accounting profession worldwide, with consequences still playing themselves out.

Ms. Watkins joined Enron in late 1993, initially managing Enron’s $1 billion-plus portfolio of energy-related investments held in Enron’s now-infamous investment vehicles. Later at Enron she moved to the international group focusing on mergers and acquisitions around the world, then to its broadband unit, and finally returned to investment-vehicles portfolio management in June 2001 where she worked until leaving Enron in November 2002. Before Enron she was a portfolio manager with MG Trade Finance Corporation and an auditor with Arthur Anderson. Sherron has just completed a co-authored book, Power Failure: The Inside Story of the Collapse of Enron (New York: Doubleday, 2003).

Ms. Watkins is a particularly appropriate executive for the Academy to honor now. First, her courage and integrity are extraordinary. As the Financial Times wrote on February 27, 2003, “To her champions, the letter was a principled act, one particularly risky for a female middle manager in a male-dominated office. What she did took courage, says Philip Hilder, her lawyer, and she did it because it was the right thing to do.”

I am pleased that the Academy of Management can join the many others in lauding this courage. We join, among others, Time Magazine, who named Ms. Watkins, along with Coleen Rowley of the United States’ Federal Bureau of Investigation and Cynthia Cooper of WorldCom, as their 2002 Persons of the Year for being “people who did right just by doing their jobs rightly.” Just the names of a few of the awards she has received will give you a flavor of the wide admiration she has engendered: the Scales of Justice Award, Everyday Hero’s Award, Women Mean Business Award, and she has been named Woman of the Year by many, many groups. She is an extraordinary model of courage and integrity in management.

Finally, there is another reason why I am pleased that the Academy of Management could honor her this year. She is a middle manager, when our awards usually have gone
to chief executives. This is important. She serves as a reminder to all of us that organizations are not run solely by their chief executives, but also by the thousands of managers and professionals who make the millions of daily decisions it takes to make an organization.

For too long, we have neglected middle managers. These are the people who know what is really going on and who often persevere to keep organizations operating in the adverse environments brought on by chief executives’ mergers, buy-outs, spin-offs and re-organizations. Too often we have just reflected our society’s “cult of the CEO.” This bias leads too many to dismiss and devalue the critical managerial work done by those not at the apex of the hierarchy, those doing that critical work which the vast majority of our students will be doing. Ms. Watkins’ principled actions serve to remind us that these managers and professionals can make history and are ignored at everyone’s peril.

Good afternoon, ladies and gentlemen. I am very pleased to be able to speak to you today. I am extremely honored to receive your Distinguished Executive Award.

My life has sure changed a lot in two years. It’s amazing what a seemingly innocuous job change can do. In the summer of 2001 I switched jobs at Enron, taking a less taxing back-office position with Andy Fastow, Enron’s chief financial officer, so that I could better manage career and home-life issues. I had a toddler at home and wanted to be sure I made time for her.

I had had some heady times at Enron. I had managed a $1 billion portfolio of assets, traveled with the top executives on the company jets to help sell deals, courted clients in Beaver Creek, Colorado, for ski weeks or for a day at the Masters Golf Tournament. I traveled all around the globe chasing deals for Enron—to Chile, Peru, Panama, the Philippines, Korea, South Africa, Guinea in western Africa—with stop-offs in Hong Kong, London, and Paris to woo bankers.

But trying to always climb the corporate ladder also meant a lot of time away from home—be that in travel or just late night hours at the office. I decided to take a back-office job at Enron—a job that would mean less advancement potential and lower bonuses, but at least I’d be home by six o’clock to be with my daughter.

Little did I know that my job change would so markedly change my life.

I am now making a living on the lecture circuit. I have spoken at several conferences across the country—to a wide variety of audiences. I have been telling of my personal experiences at Enron in the hopes that I could raise awareness about the pressures in the everyday workplace, the weaknesses in the watchdog groups, and the need for real reform and real change, not only in the accounting industry but also on Wall Street.

You’d think that the Enron corporate-scandal story would die down—certainly the fraudulent behavior should be less, but what is troubling is that the poor behavior has not lessened. Unfortunately, at Enron and at far too many other companies of late, we are seeing a class of imperial CEOs who behave more like dictators of resource-rich Latin American or African countries, treating their country’s or, in this case, their company’s assets as their own.

I want to go into a bit of my Enron story before I go into why I think investors have become soured on business leaders in general.

Enron Background

The back-office role that I took in June of 2001 was simply to prioritize the assets that Enron had for sale: nearly 200 of them, worth billions of dollars. I was reviewing book values and estimated market values, estimating the potential gain or loss on sale—trying to determine where Enron could get the biggest bang for its buck as the company tried to sell assets to raise cash that could be used to lower debt.

That’s when I ran into what I thought was the worst accounting fraud I’d ever seen. Enron had allowed Andy Fastow to enter into an unprecedented conflict of interest: as chief financial officer of Enron, where his fiduciary duties meant looking out for the best interests of Enron, while also becoming general partner of an investment partnership, LJM, where Andy raised $600 million of limited-partner monies and was charged with maximizing returns for limited partners. Trouble was that LJM’s business was to do business with Enron. In every transaction, Andy had to choose between Enron or LJM. I did not know it at the time, but we have all since learned that LJM served primarily to help Enron meet its financial-statement targets for 1999, 2000, and 2001. Nearly all of
the transactions had no economic substance, no real risk transfer from Enron to LJM.

In the summer of 2001, I stumbled across the Raptors, LJM vehicles that had agreed to pay Enron a locked-in value for certain assets by hedging Enron’s equity investments. Some of those assets were tech investments that had once been high-flying stocks but were now depressingly low priced. By the summer of 2001, these Raptor entities owed Enron in excess of $700 million under these hedge deals. The spreadsheet showed several hundred million dollars of that $700 million amount as potential Enron losses. I didn’t quite get that, and I started to make some inquiries. The general explanation was that the Enron stock that had been used to capitalize the Raptor entities had declined in value such that Raptor would have a shortfall and would be unable to fully cover the hedge price that it owed to Enron. When I asked about the outside capital invested in the Raptor structures, I never heard reassuring answers. Basically, I couldn’t find any.

Now, I hadn’t practiced accounting in over ten years, but I knew accounting had not gotten that creative—basically Enron was hedging with itself.

My first reaction was find another job—then confront Jeff Skilling, Enron’s CEO, on my last day. Trouble was that Jeff Skilling beat me to it and resigned on August 14th, citing personal reasons that never quite materialized.

Two days after he quit, he told the Wall Street Journal that his personal reason was primarily that he just couldn’t sleep at night. The stock price was going down. It started the year 2001 at about $80 a share, but by the summer, it was about $45. He was depressed about the stock price, didn’t know how he was going to get it back up, and just couldn’t sleep at night. So it was stressing him out too much. He had about $100 million in the bank, and so he basically decided to “call in rich.” That, to me, is pathetic. I thought there should be the equivalent of a corporate court martial. A Navy battleship captain can’t just decide in the middle of a skirmish. “I’m tired and I’m going back to land.” He would be court martialed; you can’t abandon your crew.

To me, Skilling knew that we had hit an iceberg, that we were taking on water, that it was probably lethal, and he was choosing to go home. I thought Ken Lay, who was stepping back in—coming out of retirement to return to the CEO spot—had no knowledge that he was stepping onto a sinking ship. I really acted more from a knee-jerk reaction that I had to let him know that the company had probably committed accounting fraud.

I initially sent a one-page anonymous letter to Lay, but within a week I was meeting with Lay armed with more memos I had drafted to help explain the problems facing the company. When I met with Ken Lay, I was both optimistic and naïve. I not only expected that a thorough investigation would occur, but I also expected Enron to establish a crisis management team to address the financial peril Enron would face when the accounting was exposed, which in my opinion was sure to happen. In the long run, companies rarely get away with “cooking the books.” But no other top executives came forward to back me up, Ken Lay gravitated toward good news and didn’t quite accept what I was saying.

Enron and its team of investigative attorneys decided nothing was amiss but that we should unwind the transactions that I had questioned because the optics weren’t good and they were a distraction from core business. That unwind wiped out $1.2 billion from shareholders’ equity and started Enron’s free fall ultimately ending in bankruptcy, roughly six weeks after the press release of the 2001 third-quarter results announcing the unwind.

Enron filed for bankruptcy on a Sunday, Decem-
November 2, 2001, unfortunately wiping out retirement savings for far too many of our over 20,000 worldwide employees. On Monday, December 3rd, over 4,000 employees were dismissed with absolutely nothing, no severance check, not even an assurance that insurance coverage would be offered via COBRA. Typical mass severances are orderly, even somewhat personal, with employees at least meeting with a human resources representative who addresses their personal concerns. Typical severance is anywhere from three to six months pay—a cushion, albeit small, of routine paychecks allowing the person a period of time to find another job with little disruption to his or her family's routine.

In Enron's case, there was nothing personal about it. Employees were summoned to floor meetings where they were told that the prior Friday's paycheck would be their last. Severance would amount to a $4,000 check they'd receive sometime in the near future. Insurance coverage via COBRA was uncertain and up to the Creditors' Committee. The employees were told to go back to their desks, pack up personal items, and leave. All employees left that day, three weeks before Christmas, calculating how much they had in savings and how many months they could keep up household expenses before liquidating retirement plans or selling homes.

Worse, we all found out in January 2002 that 25 executives received three-month retention bonuses in the last week of November 2001. Many of these executives had been the ones conducting the floor meetings on December 3rd when nearly 5,000 employees were let go. While there is nothing inherently wrong with retention bonuses, in Enron's case they were exorbitantly high. These 25 executives paid themselves nearly $55 million. One person got $8 million, another $5 million, another $2 million, two more paid themselves $1.5 million, several people received $700,000, $600,000, and $400,000 bonuses. Enron's annual salaries for these managing directors was closer to $300,000 per year—so many of these "special" bonuses were three to five times annual base pay. To me, these executives are just as crooked as Andy Fastow. They stuck their hands in the cash drawer the week before bankruptcy and crammed wads of cash into their own pockets.

Many speculate that the executives at Enron had become too focused on their personal bottom lines and either had culpability in the accounting shenanigans themselves or chose to put their heads in the sand because they did not want the gravy train of money coming to them in the form of bonuses and stock option sales to stop.

Leadership Failures

Unfortunately, the problem is not just Enron. The U.S. Department of Justice has 16 guilty pleas or indictments of former Enron executives. Enron's problems even nailed three NatWest bankers and unfortunately brought about the demise of Arthur Andersen. But in total there are nearly 50 executives at half a dozen companies that have pled guilty or have been criminally indicted—from Adelphia, World Com, ImClone, Tyco, and Healthsouth. The frauds may be different, but the basic bottom line has been the same: the top guys rode off into the sunset with multi-millions, and the shareholders and employees of the companies lost.

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The oft-repeated phrase accompanying each executive pleading not guilty is the same: "Mr. So-and-So is a man of integrity; he has the highest ethics." Many probably were decent guys at some point, but it sure doesn't look that way now. What happened? Many use the analogy of a frog in boiling water—if a frog is thrown into a pot of boiling water, it will jump out and save itself. If a frog is in a pot of cool water that is slowly heated, it will stay in the pot until it boils to death.

Enron's accounting moved from creative, to aggressive, to fraudulent, like the pot of water moving from cool to lukewarm to boiling; those involved with the creative transactions soon found themselves working on the aggressive transactions and were finally in the uncomfortable situation of working on fraudulent deals.

Some have likened corrupt corporate behavior to carnival time down in Rio. Supposedly when you put on your carnival mask for the week-long celebration, all sorts of racy behavior is acceptable behind that mask. It's not you; it's carnival. Well, too many ethical employees find themselves participating in less-than-ethical deals and transactions and comfort themselves that it's not them; it's the behavior that's expected behind the corporate mask.

What I want to know is, how do you, as a leader, ensure that the corporate mask is one of integrity, of the highest ethics and principles? How do you ensure that a corporate value system exists? What
I’ve come to realize is that leadership is tough, very tough. All eyes are on you, and the slightest erosion in values at the CEO level is magnified in the trenches.

Ken Lay, although well known for his charitable giving and his verbal commitment to Enron’s four core values (Respect, Integrity, Communication, and Excellence), was not quite walking the walk. For example, he always had Enron employees use his sister’s travel agency. And not just us; the local Andersen office and Enron’s outside attorneys, Vinson and Elkins, were pressured into using her agency as well. Trouble was that it provided neither low cost nor good service. Domestically, you could manage, but when it came to international travel—that agency sucked. I was stuck in Third World countries, where I didn’t speak the language, without a hotel room or with an insufficient airline ticket home, despite paperwork that indicated otherwise. The incompetence was hard to understand. I would try using a different agency, but after one or two expense reports, I’d get a finger-wagging voice mail or email reminding me that I needed to use Enron’s preferred agency, Travel Agency in the Park; we all called it Travel Agency in the Dark.

In some perverse way, Andy Fastow might have justified his behavior by saying to himself, “Well, my LJM partnership is helping Enron meet its financial statement goals. Why can’t I just take a little for myself, just like Lay has been taking a little Enron money and transferring it to his sister for all these years?”

**Corporate Watchdog Groups**

It’s clear now that there were problems in the executive suite at Enron and in the other companies accused of fraudulent behavior, but what happened to all the watchdog groups in business to protect investors?

That whole system failed at Enron. Enron’s outside auditors failed. The legal counsel Enron receives is suspect. The investment bankers and traditional bankers seem to have been “in on it.” Arthur Andersen is out of business because of Enron. The Securities and Exchange Commission (SEC) slapped JP Morgan Chase and Citicorp with $300 million in fines for their role in Enron’s financial-statement manipulations. Neil Batson, the court-appointed examiner, has issued his third report, naming at least five other financial institutions as well as over a dozen Enron officers that are at the very least guilty of civil securities fraud. This past spring, Eliot Spitzer and the SEC fined a group of investment banks for their faulty research. Most of the Wall Street analysts still had Enron ranked a “strong buy” as late as October 2001. The analysts’ glowing reports about Enron were clearly not objective—they appear to be severely conflicted by the investment-banking fees generated by the analysts’ sister operations.

**What’s Next?**

We’ve got new legislation; the Sarbanes-Oxley Act was signed into law last summer. The new bill clearly takes aim at the rampant abuses that have shaken investors. It represents a broad overhaul of corporate fraud, accounting, and securities laws. But it’s got some holes that have to be filled by the SEC and the courts. Better yet, Eliot Spitzer, the New York State Attorney General, and the SEC are taking hard lines, aggressively trying to clean up the problems, at least on Wall Street.

Trouble is, trust has been lost, and it’s almost impossible to regain trust once it’s gone. I’ve spoken about Enron and clearly fraudulent behavior, but the lack of confidence in business leaders stems from more than just criminal behavior. Now most investors truly believe the game is rigged, and they’re not coming back to play until they see real change, real reform.

**Corporate America’s Ills**

A July 2002 Gallup Poll asked the public “whether most members in a particular group could be trusted, or if you can’t be too careful in dealing with members of those groups.” Twenty groups were listed including doctors, protestant ministers, Catholic priests, and journalists. Public confidence in business leaders is at its lowest point in decades. It’s right around a 20 per cent confidence level, right by car salesmen. Even accountants rank much higher than CEO’s of large companies—with 51 per cent of people responding that you can trust accountants—and this in the wake of the Andersen collapse. These figures indicate a real trust crisis.

I worry about the true leadership nature of many of our CEO class today. I am concerned that so few of them have spoken up or taken action to embrace the spirit of corporate reform. I actually hear more of them mumbling and complaining about the latest reform actions as “stifling innovation” or “inhibiting the risk-taking that made this country great.”

Look at this past April’s news—the CEO of American Airlines, Don Carty, talked his employees into huge pay cuts and pension fund concessions while hiding the fact from his employees that he and his
executive cronies were lining their pockets with big fat bonuses and a bankruptcy-proof pension fund. Nearly the same complaints happened the month before at Delta airlines.

Last year, Jack Welch ruined his otherwise stellar reputation. His ugly divorce proceedings brought to light a very lucrative annual package for Jack Welch’s retirement years. $2.5 million a year in benefits including corporate jet services, a Manhattan apartment, tickets to sporting and cultural events—the list is too numerous to recount. Welch’s explanation is that the terms were part of a negotiated compensation package from several years ago. He forsook current compensation back then for these perks now. Oh, and he’s willing to pay for some of these services now that they’ve been disclosed to the public. Isn’t that interesting? Was his contract structured that way originally because the SEC requires the annual disclosure of CEO compensation, but not the compensation of retired executives? It appears that the SEC will now have to add a new disclosure requirement, including retired executives as well, so that shareholders understand what their company is truly paying its top executives.

Unfortunately these examples of less-than-ethical leaders are not uncommon. Besides Enron, Worldcom, Adelphia, Tyco, ImClone, Healthsouth, and Wall Street’s Merrill Lynch, Credit Suisse, Citigroup, Morgan Stanley, JP Morgan Chase, et al., there are wonderful examples to stumble across routinely:

- In the telecommunications sector alone, Global Crossing and Qwest executives have been under the investigative spotlight.
- In Enron’s energy sector, particularly associated with the California energy crisis, you’ve got Dynegy, El Paso, Reliant, BP, and others being investigated.
- Xerox and KPMG have had accounting issues,
- So have Halliburton and AOL Time Warner.
- Boeing has been in the news of late for their competitive bidding process for the government’s rocket business. That company’s story demonstrates how difficult it is to establish and maintain an ethical value system within a company. In 1996 heated competition with Lockheed for rocket business led to the hiring of a Lockheed employee by Boeing. In 1999, Lockheed binders and information were discovered/dislosed, and Boeing dismissed two employees, one of whom was the former Lockheed employee. Boeing returned two documents to Lockheed in 1999. Oops, turns out Boeing had more documents; this past spring, eleven boxes were returned to Lockheed. Boeing appears to have a pretty solid ethics program, with many employees understanding exactly what is expected of them; however, there are others that misinterpreted management pressure to gather competitor information as an indirect call to get confidential information. Once caught, the guilty were dismissed, but did Boeing react appropriately in 1999? It would appear from recent Air Force actions/fines, combined with the fact that Boeing has found eleven boxes of Lockheed data on site, that the company’s efforts to rectify their transgressions in 1999 were lacking.
- Eliot Spitzer and the SEC have uncovered loads of evidence indicating that in the raging bull market, Wall Street research analysts were pumping stock to the everyday Main Street investors while internally considering the stocks as trash. To the delight of plaintiff attorneys, tons of emails from retail brokers have surfaced chastising upper management about research that was fattening the investment-banking wallets of the Wall Street houses while ripping off the small retail customer. A record-setting $1.4 billion settlement was reached with eight Wall Street firms concerning either their fraudulent research (three firms), or their exaggerated research (five firms).

The average investor today has a distrust of the accounting numbers and a disdain for the exorbitant pay packages given to top management. The compensation packages of top executives have been creeping up over the past several years and have been fully disclosed; however, average investors didn’t notice or didn’t complain as long as their own stock investments rose in value. Now investors view these quasi-guaranteed multi-million dollar compensation packages as evidence enough of wrongdoing.

Where are the business leaders standing up for reform? I have seen only a handful of top people speak out. Henry Paulson at Goldman has made a few encouraging remarks, Sam Palmisano at IBM is walking the walk, cutting his own bonus for 2003, and Charles Schwab executives set a policy that the top folks would receive no bonus in layoff years. In all, there are maybe a dozen good examples, clearly not enough. In fact, when journalists, investor watchdog groups, academicians, and the like are asked to name ethical companies and business leaders, the list seems to fade after about a dozen companies have been named.

Warren Buffet, the second richest man in the country (who by the way pays himself less than $400,000 a year and got so rich by putting himself in
the same boat as his shareholders and buying Berkshire Hathaway stock out of his own pocket), said earlier this year that he'll believe there's been real reform when he opens proxy statements and sees that CEOs have cut their pay. He along with many others was disappointed.

The pay scale has gotten way out of hand. CEO pay was 42 times that of average workers in 1980; 85 times that of average workers in 1990, and an astounding 531 times average worker pay by 2000. And now, a rather well known 2003 Fortune story (the one with the pig head on the cover) reported that in 2002, median CEO pay increased by 14 percent, to a whopping $13.2 million a year for 2002.

What to Do?

The business press is far too full of bad news lately. I realize that in many cases a few bad apples have spoiled the whole barrel, but what do we do about it now?

Business leaders have to understand that leadership is afforded to them by the followers only when those followers (the employees, the shareholders) can trust them. Ethical moral leadership is key. In order to flourish, a successful capitalist system must be predicated on fairness, honesty and integrity. In fact, many scholars describe the capitalist system as a three-legged stool—economic freedom, political freedom, and moral responsibility. A weakness in any one and the stool topples.

It is unfortunate that we must now regulate the moral-responsibility leg of the stool, but to borrow E.J. Dionne's words from a Washington Post column he wrote on Enron in January 2002, he quoted from James Madison in the Federalist Papers, who said that if men were angels, no government would be necessary. E.J. Dionne added that "if capitalists were angels we could deregulate everything." Clearly capitalists are not angels. I don't think anyone ever thought they would be, but it would appear that we have to put some teeth back in existing governmental oversight if we are to protect this country's capitalist system. We must not lose this opportunity to ensure that the appropriate safeguards are in place so we can all be comfortable again investing our hard-earned dollars in this country's equity market.

It's a shame that we have to legislate moral responsibility, but we have seen problems in the past that were lessened by legislation—child labor abuse, environmental pollution, etc. Business leaders in those days complained about the restrictions and about the government killing our economic system with overly burdensome regulations. Same song, different verse, but we all survived.

If today's crop of business leaders doesn't want even more restrictive laws enacted, then it's time to act. They need to truly live by the spirit of existing laws and regulations, and to behave as if they are leading and running a company for others—the shareholders, the customers, the employees—and not for themselves. A truly fed-up mass of investors will demand stricter regulations. The noise is out there, and it goes beyond expensing stock options. Paul Volcker has suggested eliminating the use of fixed-price stock options for the top guys altogether. The six-month holding period on stock-option exercise that the SEC had in place for top executives until 1991 might be reinstated. Shareholders might be able to nominate their own board slate without a proxy fight. It could get a lot worse.

I want to conclude with a sincere acknowledgement that leading a large corporation is an extremely tough job. I'm not so sure I would want the pressures and the attention and the responsibilities. But it is also a rare privilege that brings extraordinary riches. Remember the average household income in the U.S. is around $32,000 per year and 90 per cent of Americans don't break the $100,000 a year mark. For all of them, anyone making $1 million a year, much less $13.2 million, must be an incredible person, one of extreme intelligence and selfless leadership. Our CEOs need to be sure they earn it.

I appreciate the opportunity to address this group today, and I look forward to any questions you might have.

Jone L. Pearce is professor of organizational behavior and interim dean, Graduate School of Management, University of California, Irvine. She received her Ph.D. from Yale University and conducts research on workplace interpersonal processes, such as trust, and how these processes may be affected by political structures, economic conditions, and organizational policies and practices. She has published two scholarly books and over 70 journal articles. Contact: jlpearce@uci.edu.