The Smartest Guys in the Room – Peter Elkind

[00:00:06] Welcome back to Bribe, Swindle or Steal. I'm Alexandra Wrage, and I'm speaking today with an award-winning investigative reporter, a 20-year-veteran of Fortune Magazine and the tenacious and talented author of "The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron." This book, about the collapse of Enron, was made into an excellent documentary that was ultimately nominated for an Academy Award. The author has also written about Viktor Kozeny, the pirate of Prague, and recently back in the news about the EB-5 visa program that permits wealthy foreign investors to fast-track U.S. green cards. Peter Elkind, thank you for joining me.

[00:00:42] Good to be with you, Alexandra.

[00:00:43] This is an interesting time to be revisiting this story. The Enron scandal dates back more than 15 years. It was really 2001-2002, a time when Enron and WorldCom and Tyco were all mentioned together as evidence that corporate misconduct was rampant. Enron is still used as a synonym for fraud, but I think we could use a refresher on this story.

[00:01:04] Enron stood out among all of those big scandals as the gorilla of them all because it was sort of a crossover hit. It was a business scandal that made the front pages, and it did so partly because of all the political connections the company had with the Bush administration and suspicions that it affected politics as well.

[00:01:24] Right. Houston-based organization at the time, it was the beginning of the end. It was No. 7 on the Fortune 500, and then it was a year and a half later they were in Chapter 11 bankruptcy.

[00:01:35] Yes. The other striking thing about it is that it was not just a company that was big, but it was also a company that was wildly acclaimed. Fortune Magazine named it the most innovative company in America for, as I recall, five years in a row. As it turned out, they were indeed innovative — in fact, in ways we couldn't even imagine. What was really quite so shocking about Enron was that it was really cruising along as this extraordinary company, a very successful, big company, almost until the very end when it disappeared and imploded, and its value went to nothing.

[00:02:07] How did that happen? How did the problems come to light?

[00:02:09] It happened gradually, only over the last year of the company's life. Enron was a company — to back up a little bit — Enron was a company that had its modern history with Ken Lay, who's regarded as a visionary. But the man who really transformed it into the Enron that blew itself up — albeit in collaboration with Lay — was Jeff Skilling. The notion about Enron that was so destructive, and eventually blew the company up, was that it didn't need physical assets. It didn't need real dollar profits, but rather it could book profits on projected revenues over deals over 10, 15, 20 years to come. Basically, that allowed enormous amount of freedom to book profits however they envisioned them, however Jeff Skilling and Enron needed to satisfy Wall Street. They could basically make up the numbers as they went along, and they did this partly through this vehicle of doing long-term deals where they could play with the numbers, but also by creating a whole bunch of off-balance sheet entities that allowed them to buy and sell assets — in some cases to entities that they controlled themselves in all kinds of self-dealing. There was corruption in many ways, but really, at core, a sort of intellectual corruption and a sort of philosophical corruption that allowed all this to happen.

[00:03:34] That's fascinating. Near the end of the book, I think it's in the afterword, there's a quote that says, "In many ways, Enron was a legal fraud."

[00:03:41] Yes. By the way, I co-authored the book with Bethany McLean, who is a terrific journalist. The sense in which that's true is that Enron was extremely skillful at following the literal letter of the rules, more specifically in accounting. They were quite clever about exploiting precise language that allowed them to do certain things. Even when you added those things up, they amounted to something that was, on its face, absurd. There's an anecdote in the story, if I'm remembering this correctly, that if you have the definition of what constitutes a duck, it's got a big beak. It's got feathers. It has various physical body parts. At Enron, we basically sort of put a fake beak on a pig and paste on feathers and say, "Oh, it's a duck. Obviously, it's a duck, because we follow the rules. It has these things that the rules say are required," in essence. And, in fact, obviously, if you dress up a pig as a duck, it's not a duck. It's still a pig. They did that accounting equivalent of that throughout the company's life, and they did it probably by having a lot of very smart people — too smart for their own good —people inside of Enron, but also having a lot of very skillful enablers who played a part in making all this possible. That included investment banks, banks, law firms and analysts, and all the other people who should've known better as well and didn't keep Enron from doing bad stuff that they did.

[00:05:07] Previously on this podcast, we've spoken with Bernie Madoff's defense counsel, and one of the issues that came through really clearly in that conversation was that Madoff knew it wasn't sustainable. He knew to an absolute certainty that when the market turned, even slightly, it was all going to come crashing down around him. Was there a sense, as you researched this, that the leadership at Enron thought they could keep this up indefinitely?

[00:05:36] Yes. I think there was a feeling that they could keep it up indefinitely. Certainly Skilling had that view, I think. There were different levels of knowledge and understanding of what was going on within the hierarchy of Enron. Some people just didn't know enough to know better, that even those people in many cases kind of scratched their heads as the company continued to do deals that defied the laws of gravity. For example, Enron had a lot of really interesting ideas that were ahead of their time, and they were so far ahead of their time that they literally didn't quite yet work. One of them was broadband, for example. They were in the broadband business and were boasting of their ability to deliver broadband to trade broadband, to do video on demand before it was technically possible. The people that were in the business knew it wasn't technically possible. And yet, the company was announcing deals and booking profits of 50, 60, 150 million dollars in the broadband business. The people on the ground in those individual businesses saw things going on that they knew didn't make sense, that they were booking profits when there was really no money that could be rolling in because the business couldn't do yet what it was promising to do. They were troubled, in some cases. Then at higher levels, there were a few people that understood what was going on and thought it couldn't go on forever. One of them, certainly prominently, was Sherron Watkins, a mid-level financial executive. She came forward, first wrote an anonymous letter to Ken Lay, then the CEO and chairman of the company, and said, "I'm terribly afraid we're going to implode in a wave of accounting scandals." Her letter was incredibly prescient. Of course, that's exactly what happened to Enron, ultimately. She not only wrote the letter anonymously, she later came forward and met with Lay. Lay acted as though he took this very seriously and then immediately referred the matter for internal investigation to Vinson & Elkins, which was the law firm that did all of Enron's deals. He basically charged with investigating this allegation of fraud the law firm that actually did the deals that were allegedly fraudulent. That was their notion of a serious investigation after allegations of fraud were raised. There were people across the board at Enron that were suspicious. They were worried. They were in disbelief. But a lot of people there also were dazzled by the incredible press, the enormous bluster of Jeff Skilling, the notion that these were brilliant people, and who were we to question their methods? There was a lot of that, a lot of literal intellectual intimidation that went on that discouraged the normal skepticism that should take place in business. Then internally, also, the mechanisms of oversight that should exist at a company were extremely weak at Enron, and they were deliberately so. Jeff Skilling had set it up that way so that Enron had a board that was very well pedigreed but really people who were asleep at the switch, who were not aggressively challenging anything that was being done. It had an internal review process, a whole group that was supposed to vet deals and make sure they were sound. But whenever they came up against the traders, the people that were doing the deals and were standing to make a lot of money, Skilling would be the arbiter, and he would rule in favor of the traders and not the group of reviewers who said, "This doesn't make sense." In addition, Enron had an internal legal counsel, who was a very nice fellow, but weak and wouldn't stand up. All the people, as well as outside lawyers — and Arthur Andersen, too, for that matter — all the people that should provide oversight in a company doing all these complex questionable things just weren't willing to stand up and say no.

[00:09:28] It's always really interesting to see how things can go so horribly wrong. We had a whistleblower, as you've mentioned — Sherron Watkins — but almost all of the other controls broke down. How did the information come to light? Sherron Watkins initially reported her concerns anonymously and then came forward, but she came forward internally.

[00:09:53] Yes, she did. Part of what happened was that there started to be some skepticism on the part of a few outside people — in particular, a short seller named Jim Chanos. He offered his suspicions and concerns, and he admittedly was selling the company short, so looking to profit on the decline of the stock. But he tipped off Bethany, my co-author at Fortune, and she wrote a story earlier in 2001, the year the company went bankrupt at the end of the year. She wrote a story basically asking the question, "How does Enron make its money?" It seems like a fundamental question, one natural to ask and should be easy to answer. As she asked this question, she called up analysts who had buy ratings on stock, and some of them literally said, "Well, geez. If you figure it out, let me know." It was a trust-me story. Enron described itself openly as a black box, as a company that was too complex for mere analysts and investors to understand, one that had such brilliant leadership and was so sophisticated that people should invest in it nonetheless. Of course, this violates cardinal rule No. 1: If you don't understand something, stay away. Run away.

[00:11:09] Just going back to the interview again with Madoff's lawyer — Ike Sorkin. This was an absolute fundamental principle of Madoff's scheme — if you needed to know how he was doing it, he wouldn't let you in the club. He just said that. He told people he wasn't going to explain his process, and they either wanted in or they didn't. He was very arrogant. He didn't really care. So it's fascinating. We talk so much about due diligence and understanding your investments at both the personal level and, obviously, at the institutional level. In both of these cases, too — probably the most dramatic cases of the decade — the market just got comfortable with opacity.

[00:11:50] Yes, it did. Part of it was the incredible sales job that the leadership of Enron did, this notion that they were so brilliant that they were beyond question. Just as Madoff did, Jeff Skilling and Ken Lay created this aura of, "Nobody should challenge them. Nobody dare challenge them." And if they did, they were too stupid to understand what they were doing and too stupid to deserve to be in a deal with Enron. After Enron went bankrupt years later, I periodically talked to people for other stories, and they learned I'd worked on this book. They were people of business who would come to me and say, "You know, back before Enron collapsed, they came to me with a deal. Their guys came in, and they gave me this big pitch. It was this incredibly creative thing, and they talked about how much money we'd all make. I scratched my head and said, 'Well, I don't understand how that works.' So I didn't do it, and they'd say, 'Boy, you're making a big mistake. You're being a fool for not signing on with us.'" And the reaction was, "Boy, you know, I dodged a bullet there. I avoided a business deal with Enron, which could have cost me a fortune and my reputation." But they had basically stuck by the principle of, "If I don't understand how this works, I'm not going to get into it with these guys." I must have heard that story from a half-dozen people. The reaction from the Enron people when somebody would pass, would say, "You're just an idiot. You're making a horrible mistake." Of course, they think it's the best move they've ever made. You asked, by the way, how this all got exposed. One of the ways in which it got exposed — it's a case where fraying bits and pieces of the scandal were becoming evident with Bethany raising the first fundamental questions in her story, and then a little bit more. The Wall Street Journal came to understand that the CFO of Enron, Andy Fastow, was involved in running an outside partnership, an outside investment vehicle, that was doing deals with Enron. They wrote about that and about how much money Fastow was getting paid to do deals with Enron that essentially inflated the company's profits and, as it turned out, also hid debt, inflated cashflow. They didn't know half of it, but they did get onto some of it to be sure. That created a growing sense of crisis within Enron because there were no good answers, no good explanations, for what they had done. The board of Enron itself didn't appear to have known that this was going on. That led to Fastow's departure and a growing scandal, and things rapidly unraveled from there.

[00:14:25] It's always fascinating to break down who the victims are, and it's easier in some of these cases than others, obviously. There was a loss to shareholders that totaled about US$70 billion, so that's pretty easy to spot. The employees lost their jobs basically overnight. I remember seeing pictures of them all with boxes in front of the building. But there was also the issue of — and maybe you can help me understand this better — that the executives, the senior leadership pulled their cash out, but the employees' money, their investment was bound up in retirement accounts.

[00:15:03] Yes, well, that's exactly right. Specifically, there was a lockdown period as Enron stock was crashing that kept employees from taking their own stakes out of the company as things were falling apart. Meanwhile, Ken Lay, who the chairman of the company at that stage, was declaring almost until the very bitter end — pretty much to the bitter end — to employees, to the public, to the world that there was nothing wrong with Enron, that all the allegations about the company were false, that Enron, just like America in the aftermath of 9/11 — incredibly, if you make this comparison — Enron was under attack from outside, and it was unfair. So Lay made these proclamations and also insisted that he was increasing his stake in Enron. Well, he had bought some shares in the public market but, at the same time, he was engaging in this incredible subterfuge to unload far more of his shares and to sell Enron stock. He had an extraordinary deal with the board. He had a credit line where he could draw, as I recall, up to US$7.5 million at a time. They get him cash and then pay it back with Enron shares, and he did this as the company was rapidly declining, not once, not twice, but multiple times. He would take out the full credit line of US$5 million, and then it was US$7.5 million, and then he would pay it back with Enron stock. He would do this time and time again. He did this repeatedly. This came out in his criminal trial. As a board member later said, he was treating it like a god-damn ATM machine, and eventually, withdrew tens of millions of dollars, sold off tens of millions of dollars in Enron stock in this method, even while he was claiming he was increasing his stake in the company.

[00:16:56] Would you, based on all your research, say that Ken Lay was really the mastermind behind this? I know you've mentioned Jeff Skilling, and Jeff Skilling, of course, is the one who went to prison — Ken Lay died before he was convicted of anything, died of a heart attack — but if you had to point to the architect of the whole scandal, is there one person? Or was there more collusion than that?

[00:17:18] Well, first of all, Ken Lay was convicted but died before he was sentenced.

[00:17:22] Oh, yes.

[00:17:23] You're lawyers. You know this better than I do, but I think he goes down on the books as an innocent man because he didn't have a chance to exhaust his appeals either. But in terms of who's responsible, who are the architects, I think it's an unusual partnership between Lay and Skilling. You have to start with those two. Lay, in the sense that he was this really beloved son of a preacher, genteel, nice guy, and the public, gentler, kinder face of Enron. Skilling, on the other hand, could be very scathing, acerbic, nasty individual.

[00:17:58] He was pretty slick in some of his interviews.

[00:18:00] He was, indeed. He was, indeed, and very smart — in fact, boasted of being smart — very self-conscious of his own intelligence. In fact, in his interview for Harvard Business School, after he got a mediocre record at SMU as an undergraduate, he was on the cusp of whether he'd get admitted. The dean of Harvard Business School, as was later recounted, asked him, "Skilling, are you smart?" And he said, "I'm fucking smart." Anyway, he got into Harvard Business School, became a Baker Scholar, went to McKinsey, had the sort of reputation for incandescently brilliant. But to get back to the question of what role he played, he was the architect. He was the man who had the diabolically brilliant notions of how to make all of this work and put it all in in place. There were others who played certainly critical roles in making it happen, who executed for him, who enabled for him. Fastow, of course, is a major figure in that way, but there are many others. It's quite a few who went to jail as well, to prison. But Skilling is the man who was the evil genius behind it all. Lay, on the other hand, was aware of what was going on and helped make it possible because of his own goodwill that he generated personally.

[00:19:14] I try to wrap up these podcasts with some lessons learned. It's tricky with Enron because it was so awful from start to finish, and the scandal was so complete in the fall from grace, so total. But based on the people you spoke to and everything you learned during this exhaustive investigative process, what would you say to Ken Lay or Jeff Skilling of the 1990s?

[00:19:42] I would say, "You do yourself a terrible disservice to disable the checks and balances that any big corporation has and requires. No man is so smart that he should basically turn off all the warning lights and turn off all the mechanisms that are supposed to keep you from making terrible mistakes."

[00:20:01] My question actually kind of assumes that they didn't want it to go exactly as it did, so that's probably the wrong question to ask. A better question might be the board or the next layer down of management.

[00:20:10] From the lesson of outsiders, what's to be learned, I think one of the huge takeaways for me and for us — myself and Bethany as we did this book — was we thought it was all about numbers and financial chicanery and mechanisms. It was really about culture, and it's an incredible statement about how much leadership matters in a company. Usually, I think of that in good terms, but in this case, it's for evil, basically. Jeff Skilling was an incredibly charismatic leader, incredibly skillful and able to create a culture of disbelief about what the company was doing, a culture of willful blindness about how they were doing business. He's an example of how much one man at the top of the company can really make a difference in the case of Enron in a tragically bad way.

[00:21:00] It's interesting times because we have a president now who ran on a platform of rolling back the regulatory burden on corporations. I understand this swings a bit like a pendulum as we go through periods of scandal and then periods where companies feel they are unduly burdened by regulation. But I hope we learned something from 2001-2002 and that hat trick of Enron, WorldCom and Tyco. All that news broke within about 12 months, and the backlash to that, of course, with Sarbanes-Oxley and other regulations — well, they shouldn't be tossed out with the bathwater.

[00:21:40] No, it should not. I think that's one of the lessons to be sure of these scandals is that oversight is necessary. Human greed and arrogance is a very powerful thing, and it needs a check. It needs a balance. Even within a giant company, all of those mechanisms that you think are in place can be subverted, and thus you need other people to do the right thing. You need systems that will provide oversight.

[00:22:05] You and Bethany did great work on this, and I think it's just going to remain the history book for the case, so thank you for that and for your continued interesting research into corruption and financial crimes in its different iterations. Thank you for speaking with me, Peter.

[00:22:21] Good to be with you. Thanks, Alexandra.