

Philosophy 104, Business Ethics, Queens College, Spring 2007

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Lecture Notes, February 16

## I. The end of Enron

Enron came crashing down in no more than a month, soon after September 11, 2001.

For a long time, investors had been bewildered by the complexity of Enron's various businesses.

Bethany McLean, who co-wrote *The Smartest Guys in the Room*, had written one of the earliest negative articles about Enron, which had been a high-flying company for so long.

In February 2001, in *Fortune*, she called Enron a black box; see *Conspiracy* 422.

The typical reaction from Enron to questions about how they made their money was vague and belittling.

Skilling told McLean, as he told many others, that she just did not understand Enron.

The funniest example of Enron's arrogance toward investors involves Skilling's exchange with Richard Grubman on a quarterly conference call, *Conspiracy* 444-5.

Grubman was a short-seller, which meant he made money when stocks went down in value.

The story about Skilling was widely circulated.

The complexity of Enron's finances made it very difficult to understand, even for sophisticated analysts.

When Skilling suddenly resigned after less than a year as CEO, in August 2001, many people, both inside and outside the company, worried that the black box was hiding dirty secrets.

Enron's stock had already been falling, with the market.

Lay had pledged to be clearer and more forthcoming about all financial data.

Enron's strategy then became to blame Skilling for all the problems.

Rick Buy's nice quote, in *Conspiracy* 525.

Rebecca Smith and John Emshwiller, *Wall Street Journal* reporters, made Enron's obscurity clear in their book, *24 Days*.

Here is an example, from their analysis of Enron's 8K, an SEC form which details adjustments to previous filings, in November 2001:

Some of the LJM deals were vexingly complex. For example, Enron sold part of its broadband network of fiber-optic cable to LJM2 in June 2000 for \$100 million. Of that amount, LJM2 gave Enron \$30 million in cash and the rest in the form of a note. The company immediately recorded a \$67 million pretax gain on the sale. Enron then helped LJM2 quickly resell some of the cable to unnamed "industry participants" for \$40 million, with Enron taking another \$20.3 million as a marketing fee. LJM2 sold the rest of the cable in December 2000 for \$113 million to an unnamed special-purpose entity, with financial connections back to Enron, which had been created to buy the asset. With part of those proceeds, it paid off its \$70 million note to Enron, although the company somehow ended up with a \$61 million credit exposure under a derivative contract with an unnamed lender to the special-purpose entity that bought the cable from LJM2. Not bad considering that the fiber-optic cable being passed around wasn't yet operative. Increasingly, Enron looked less like a real company and more like a financial funhouse (p 187).

And this was Enron trying to be clear!

## II. Lay

Lay seems to have operated above all the financial manipulation.

Eichenwald portrays him as culpable mostly for obliviousness.

Lay himself, for example in his [interview with Larry King](#), claimed not to be aware of any wrongdoing until the third week of October 2001.

That is hard to believe.

He was convicted of fraud.

And, there was a precedent for fraud at Enron.

For example, Enron had an early and eerily precedental history of fraudulence, in the Valhalla oil-trading scandal (Topic K on the reading guide).

In Valhalla, NY, there was an oil trading operation, run by Louis Borget and Thomas Mastroeni.

The banks into which Borget and Mastroeni were skimming funds, had alerted Enron to the problem.

They had been paying a fake consultant, M.Yass, and taking the money.

Borget and Mastroeni had also played with their accounting, in a book-out maneuver.

In 1986, the traders had made a lot of money.

In order to take the pressure off of the following year, they wanted to shift income to 1987.

They made trades with some companies at a loss which reduced their profits for 1986.

Then, they did reverse transactions the following year, so that the profits moved to 1987.

In small, this is the kind of earnings manipulation that Fastow did later.

In the Valhalla case, there was another twist: the companies with whom they supposedly did the deals did not really exist.

Borget and Mastroeni had invented them, which ensured their control over the transaction.

The details of the Valhalla scandal are interesting, but not particularly relevant to the later problems.

More interesting is the way that Lay's actions in the case do not portend well.

No one, for a long time, would have seen the problem this way.

Still, one can note that Lay was extremely lenient, and forgiving.

His attitude was to sweep the problem under the rug.

Borget and Mastroeni showed forged records to the auditors, but Lay almost let it go, *Conspiracy* 18-9.

When Borget complained about internal auditors, Lay called them back to Houston, pp 34-5.

Borget eventually did get fired, but only because he almost ran the company into bankruptcy with maybe a billion dollars in trading losses.

And again, there were two sets of books.

Lay was also seen as no saint by folks in Omaha, even well before the Enron collapse.

Skilling had first worked with Lay, as a consultant for McKinsey, on a merger between Omaha's InterNorth and Lay's HNG.

InterNorth's CEO, Sam Segnar, had worked out a merger, in 1985, with HNG, to avoid a takeover.

Omahans were promised that the company would retain headquarters in Omaha.

But, a year later, the company moved headquarters to Houston.

Ask an Omahan today, and she or he will tell you, angrily, that there was a secret understanding to abandon Omaha as soon as possible.

Lay was forever perceived as the villain in the move.

See *The Smartest Guys in the Room*, 12-13.

### III. Lay's stock sales

Ken Lay sold around \$70 million in stock in the last few months before Enron's collapse. Some of the anger at Lay after the collapse arose from worries about insider trading, and the block on sales of Enron stock that was placed by Enron in its final days, from October 26, 2001, through November 12, 2001.

Some Enron officials have been found guilty of insider trading. Paula Rieker, the board secretary, for instance, got two years' probation. Many have been acquitted, or found guilty on other charges. Acquittals are not necessarily indications of absolution. Still, in Lay's case, there does seem to be a good reason for stock sales. He had most of his money in Enron stock, which he used as collateral on bank loans for cash. As the stock price went down, the banks started calling in their loans. Further, the block was pre-planned, and may have helped some employees. See *Conspiracy* 546, and 637-8.

The problem with Lay's stock sales seems to be with his candor with his own employees about the state of the company.

If Lay told his employees to sell, he would adversely affect the stock itself, and much of his wealth was in Enron stock.

### IV. Were the prosecutions justifiable?

What if Lay really was as clueless as Eichenwald describes? Skilling also publically denies knowledge of Fastow's reckless accounting. Eichenwald seems to support the claim that Lay and Skilling were duped by Fastow. Fastow, in his deposition, gives up Skilling in at least two cases; see paragraphs 36-40; 62. But, let's put Fastow's deposition aside, and grant Lay and Skilling their cluelessness. What follows?

It then looks as if the prosecutions of Lay and Skilling were politically motivated. It looks as if the government wanted scapegoats. It seems hard to believe that such scapegoating would be ethically justifiable.

On the one hand, it seems that Lay and Skilling are responsible for the scandal, since they were the executives in charge of Enron at the time. On the other hand, it seems absurd to expect CEOs to know all the workings of their many employees. If they really were duped, then their responsibility is mitigated.

So, the question of whether Lay and Skilling were justifiably maligned and prosecuted comes down to a question of facts.

People are presumed innocent in the eyes of the law, until proved guilty in court. But, people are not "innocent until proven guilty".

People are innocent or guilty depending on what they have done.

The problem for us in determining whether retributive punishment is required is to figure out what was really in Skilling and Lay's minds.

What was lost in all the deletions and shredding at Andersen and Enron?  
Can we really believe Skilling and Lay?

In response to the scandal, Congress passed the [Sarbanes-Oxley act](#).  
Here's the [SarbOx Wikipedia article](#).

One of the goals of SarbOx is to hold managers responsible for the work of their employees.  
In particular, CEOs must certify financial reports.  
SarbOx will effectively cut off the Lay/Skilling defense, which was not particularly successful, anyway.

#### V. Transition from Enron to ethics.

We have been considering the facts of the Enron case.  
We have looked at some of the lawbreaking.  
But, there is a difference between legality and morality.  
It is time to put ourselves in position to evaluate the case on an ethical basis.

For example, was it morally acceptable for Lay to lie to his employees about the state of the company, when they were considering whether to keep their Enron stock, or sell it?

Is lying ever morally acceptable?

We need to examine the ethics of lying generally, and then try to apply it to the Enron case.

You will be asked to perform this kind of task in your papers.

I hope to have the assignment to you in the next week or so.

We start by looking at the role of religion in ethics.

#### VI. Euthyphro, and excising religion

Religion has played an important role in the history of ethics.  
It has been supposed that morality, in some way, comes from God.  
In this course, we will discuss morality without appealing to religion.  
The non-religious approach to morality raises the question whether one can have ethics without religion.

We start by reading an excerpt from Plato's dialogue *Euthyphro*.

In this dialogue, we will find an argument for separating morality from religion.

The *Euthyphro* seeks to answer, "What is piety?"

We might think of the question in the *Euthyphro*, instead, as "What is ethical?" Or "What is good?"

The same formal question will apply.

At the beginning of the dialogue, Euthyphro claims that he has to prosecute his father because it is the pious thing to do.

In ancient Athens, criminal trials were prosecuted by individual citizens.

Socrates himself is soon to be prosecuted by three Athenians (Meletus, Anytus, and Lycon) for corrupting the youth and teaching new gods.

Socrates is amazed to find that Euthyphro would claim to know so well what is pious that he could charge his father with murder.