

Enron: How Leadership Led to the Downfall of the Company

Introduction

Enron filed for bankruptcy in November 2001 and this led to a series of enquires and court cases that shook the business world and general public. But this was not the only case of wrongdoing as WorldCom, Global Crossing and Charter Communications joined Enron as target of SEC probes. At the time of bankruptcy, the company was the seventh largest in the world on the basis of turnover and was considered as a phenomenal success story since last many years (Gordon, 2002). And due to its might, Enron made a huge sound when it came crashing down.

Various researchers studied the company and reasons behind this downfall. The major reasons cited are improper trade practices, accounting frauds, corporate culture and ethics in general (Peppas, 2003). The source of all these reasons can be traced to the unethical practices of the leadership. Examining the role of the top leaders in the debacle of Enron provide good insights into how unethical practices erode the culture of a company and the ways in which this can be avoided.

This report talks about how the role played by Kenneth Lay and Jeffery Skilling led to the downfall of Enron and the lessons to be learnt from this incident. The report then talks about emerging trends and best practices in the field of ethical leadership and how different leadership could have prevented the debacle at Enron.

Outline of Events at Enron

The major events occurring at Enron that led to its downfall are outlined below. The outline is taken from an article on USA Today (2006)

1990 — CEO Kenneth Lay hires Jeffrey Skilling to lead the company's effort to focus on commodities trading in the deregulated markets. Andrew Fastow is one of Skilling's first hires later that year.

1997 — Skilling named president and chief operating officer of Enron. Fastow creates Chewco, a partnership, to buy the University of California pension fund's stake in another joint venture dubbed JEDI, but Chewco doesn't meet requirements to be kept off Enron's balance sheet.

1999 — Fastow creates the first of two partnerships, LJM, purported to "buy" poorly performing Enron assets and hedge risky investments. It helps the company hide debt and inflate profits.

August 2000 — Enron shares reach high of \$90.

Oct. 16, 2001 — Enron announces \$638 million in third-quarter losses and a \$1.2 billion reduction in shareholder equity stemming from write-offs related to failed broadband and water trading ventures as well as unwinding of so-called Raptors, or fragile entities backed by falling Enron stock created to hedge inflated asset values and keep hundreds of millions of dollars in debt off the energy company's books.

Oct. 19, 2001 — Securities and Exchange Commission launches inquiry into Enron finances.

Nov. 19, 2001 — Enron restates its third-quarter earnings and says a \$690 million debt is due Nov. 27.

Nov. 28, 2001 — Enron stock plunges below \$1

Dec. 2, 2001 — Enron goes bankrupt, thousands of workers laid off.

Aug. 21, 2002 — Kopper pleads guilty to money laundering and conspiracy, the first ex-Enron executive to strike a deal with prosecutors. He identifies a string of partnerships designed to falsely portray Enron as financially healthy while enriching him, Fastow and others.

Sept. 12, 2002 — Three former National Westminster Bank bankers indicted for wire fraud for siphoning off millions of dollars in income intended for their employer through investments in a Fastow partnership.

April 30, 2003 — Counts against Fastow increased to 98. Five other former broadband executives charged with lying to Wall Street and investors about capabilities of Enron's broadband network to inflate company stock. Former Enron treasurer Glisan charged with conspiracy and money laundering for participating in Fastow-controlled deals.

Jan. 14, 2004 — Andrew Fastow pleads guilty to two counts of conspiracy and agrees to serve 10 years in prison.

May 25, 2006: Lay, Skilling found guilty on most counts against them.

Literature Review

Though the debate and discussion on leaders and ethics have grown lately after the episode of Enron and other scandals, various authors have researched on the topic long before.

There are various definitions of ethical leadership proposed by various authors. Brown et al. (2005, pp118) gave a simple definition of ethical leadership – “*acting in ways consistent with appropriate norms and promoting this behavior to one’s followers*”. The authors here do not equate ethics with morality, rather they indicate that ethics depends on the norms being followed in the particular situation in that society. Hence, ethics can differ based on the situation and conditions. Also, it is essential for leaders to make that they are promoting ethical leadership to the followers, practicing it privately is not enough when others look up to them. Ciulla (1995, pp 12) defines leadership as an act of process of influencing others in order to achieve an objective.

It has been long believed that personality traits such as honesty and integrity are essential for a person being perceived as an effective leader. Various authors such as Kirkpatrick and Locke (1991) and Posner and Schmidt (1992) have highlighted the connection between a leader’s integrity and honesty with his/her effectiveness as a leader. This connection was studied in detail by Trevino et al. (2003) during their exploratory research where they conducted survey with senior executives of various organizations. Based on this survey, following characteristics of ethical leaders were identified:

- Trustworthiness and honesty
- Principled decision makers
- Fair towards others
- Care about the employees in the organization and the broader society
- Behave in an ethical manner in professional and personal lives

The authors call this as *moral manager* dimension of leadership. Moral leaders treat ethics as an important part of the way of working and influence others in the organization to follow the same ethics. They also tend to reward people following the ethics and punish people overlooking this aspect.

Ethics and difference between leaders and followers

Ethics can be tied in with leadership theories by understanding the ethics that leaders have to follow.

Ethics can be followed by anyone irrespective of his or her position, but one needs to understand what an ethical conduct means for a leader and how it is different from ethics followed by others. Ciulla (2005) highlights the following ways in which ethics practiced by leaders is different

- **Power and virtue:** Leaders have more power and influence as compared to followers. The source of power can be expertise, position, charisma or personality. Leaders, who have more power, are more responsible for what they do. Greater ethical dilemmas and difficulties arise as power increases. Solomon (1998) argues that power to a leader can also come from being moral. The author believes

that trust is one of the most important factor leading to power and that leaders need to gain trust, and more importantly give it back.

- **Altruism and self-interest:** A leader by definition has to look after the followers and place the interest of others' before his or her interests. Some authors claim that altruism is a good standard to judge ethical leadership. Kanungo and Mendonca (1996) argue that in organizations, leaders are effective only when they act based on concern for others and their decisions are based on good for others even if it means a personal cost for them. However, there are differing views on whether being altruistic is a good benchmark for being an ethical leader. Avolio and Locke (2002) argue out that if altruism and consequently ethical leadership pertains to self sacrifice, the leaders will take up a job that does not offer any rewards and the sole aim would be to serve others. They point out that no leader would accept such a role in an organization, highlighting the problem with using altruism as a benchmark for leadership.
- **Leaders as super-utilitarians:** Leaders often make decisions that have an impact on large number of people. These people can belong to an organization, a community or a country. In case of a leader, as opposed to a follower, any failure has an impact on large number of people. Hence, a moral failure affects a huge number of people. This makes morals and ethics magnified in case of leaders. They have to be more careful about these since many more people are connected with them.

Leadership theories related to Ethical leadership

Brown and Trevino (2006) argue that three leadership theories are closely related to ethical leadership:

Transformational leadership theory, spiritual leadership theory and authentic leadership theory.

Similarities and differences between these theories and the theory of ethical leadership are discussed below:

- **Authentic leadership:** Luthans & Avolio (2003) define authentic leaders as the ones who give a lot of emphasis on how they view morals, ethics, strengths and knowledge. These leaders are also aware of how others perceive these qualities in them. The biggest points of similarity between ethical and authentic leadership theory are that both promote altruism, acting with integrity and ethical decision making. Also, emphasis is given on leaders being role models for the followers. The biggest difference between the two theories comes from the fact that while ethical leaders lay more emphasis on morality, authentic leaders lay emphasis on self-awareness.
- **Spiritual leadership:** Fry (2003) defines spiritual leadership as the one based on the ethics and values as applicable in various religious texts. The similarity between this type of leadership and ethical

leadership includes integrity towards work and others and concern for others. The difference lies in the fact that spiritual leaders lay emphasis on hope and faith.

- Transformational leadership: Burns (1978) defines transformational leadership as the leadership style that changes significantly the life of people and the society in which the leader operates. It is meant to bring about big changes in the lives of follower, thereby making their lives better and more fruitful. Similarity between this leadership and ethical leadership remains altruism, integrity and ethical decision making. At the same time, the difference is that transformation leaders lay emphasis on values and vision, while ethical leaders are more transactional and lay emphasis on morality and ethical standards.

Enron's downfall: Was the leadership responsible?

Enron is one of the biggest failures in the world of business history of US. While dubious accounting practices are said to be the reason for failure, these practices were driven by the top leaders and hence bad leadership can be considered to be the reason for the organization's failure. Researchers have studied various aspects of Enron that lead to its failure. These aspects include trading practices at Enron, ethics followed in the company (Peppas, 2003), importance of corporate governance in an organization (Vinten, 2002). Research and reports by these authors clearly show how Kenneth Lay and Jeffrey Skilling were primarily responsible for driving Enron to its demise. Some authors such as Jenkins (2003) even point out that the actions of these two leaders have resulted in a loss of confidence in the corporations. The articles mentioned above clearly support the statement – “Leaders from Enron are accountable for its downfall as they were not ethically and morally responsible”

Cruver (2003) gives insights on the workings of Lay and Skilling. They point out that these leaders were ruthless and engaged in worst form of self promotion. They assigned nomenclatures such as “the Darth Vader” and “the prince” to themselves and to the top employees. These leaders run Enron like a cult, hiring young people and following work regimes stretching up to 80 hours a week. The employees were made to believe that they are a part of world changers, but at the same time, employees were fired at whims of managers. The leadership at the helm was responsible for creating an aura of invincibility and to promote the idea that everything is fair in order to become the biggest company on the planet.

Kenneth Lay showed the signs of being a transformational leader from the start of his career. Throughout his career, he has been a supporter of free market and fervently advocated deregulation of energy market. His passion for deregulated energy market and the resulting profit to be made out of it is said to cloud his ethical judgment when he was at the helm of Enron. According to Ethical Resource

Center (2010), Leo Wise, former Enron prosecutor, point out that unethical top management at Enron destroyed the culture and passed on wrong message the employees. Lay highlighted his attitude towards the ethics and rules by his statement in court – “*you should not be a slave to rules*”. Because of such attitude of the top leaders and permeation of bad culture, employees at the lower levels mimicked unethical behavior in order to meet their aggressive compensation targets. The culture at Enron encouraged internal competition and to compete with someone who is cheating, everyone has to start following. At times, people with better conscience tend to do bad things in order to overcome temporary hiccups and planned to straight things right, but they never got out of the soup. All the lapses arose since the leadership of Lay and Skilling promoted achieving short term goals at any cost. The leaders at Enron engaged in the following actions that eroded the culture and ultimately led to downfall of the company:

- With the sole aim to achieve short term financial goals, they put the companies and employees at risk by engaging in malicious practices.
- They engaged in financial tweaking in order to inflate the performance of Enron. This created a bubble that ultimately busted.
- It was made sure that top leaders earn their incentives even during bad times, by playing with performance measurement metrics and targets.

When it was clear to the top leaders that the company may go down, Kenneth Lay started selling Enron shares as he knew that the value of the shares is going to erode. At the same time, he encouraged employees and investors to buy the stock. Lay was used to the extravagant lifestyle funded by money from Enron, used company resources including private jets for his and his family’s use. He also engaged in worse form of nepotism buy forming whole companies in order to engage family and friends (Behr, 2004).

Skilling was the main driver behind the inflated and over estimated financial statements of the company. He pushed for adoption of the accounting concept of “mark at market” at Enron (McLean and Elkind, 2003). This enabled Enron to recognize the revenue from any future deal and include net present value of the future projects in the earnings. This allowed Enron to inflate the earnings and even forge non existing earnings, propagating false impression of company performance. This is said to be one of the major reasons of the collapse of Enron. Skilling directed Enron’s traders to create false energy shortage by manipulation electricity market of California. This was done to increase energy prices. Skilling, like Lay, also sold Enron shares based on inside information when an imminent collapse of the company became obvious to him.

The top leaders and senior executives at Enron were paid very high salaries even when the company was going down. They enjoyed large bonuses and huge expense accounts. At the same time, the leaders engaged in every opportunity to make more money by engaging in special entities and fake partnerships (Prentice, 2003; Seeger, 2003).

Overall, the acts of the Kenneth Lay and Jeffrey Skilling created a culture of fraud and cheating at Enron that permeated the whole organization and encouraged unethical behavior among the employees. The sole aim of the two leaders was to make money for them. The practices and fraud of these two leaders was primarily responsible for downfall of Enron.

Ethics: Emerging trends and best practices in business leadership

The importance of ethics and moral responsibility of business leaders have become unquestionable. Many organizations are taking steps in order to promote ethical behavior among the employees and are trying hard to be seen as a moral and responsible corporate citizen. An emerging trend is to increase the Corporate Social Responsibility programs and publishing the results of these initiatives. It has become important to appear as good in the eyes of employees, customers and investors. For example, Nestle has released Water Management Report to highlight the efforts made in the direction of sustainable water management and to signal company's commitment to this issue (Nestle, 2007). Many companies publish similar reports on sustainability, CSR and corporate governance.

George (2007) tracks the type of leaders we had in nineteenth century and the emerging trend in business leadership when it comes to ethical behavior. He highlights the following best practices for a leader (pp14)

- *Gaining self-awareness;*
- *Practicing your values and principles under pressure;*
- *Balancing your extrinsic and intrinsic motivations;*
- *Building your support team;*
- *Staying grounded by integrating your life; and*
- *Understanding your passions and purpose of your leadership*

Another upcoming trend in the area of ethics in business arena is the appointment of Chief Ethics Officer, who would be responsible for developing policies rules and code of conduct for various situations of dilemma, conducting training, developing audit plans and pursuing cases involving ethical

principles (Vallabhaneni, 2008). Collins (2009) lists the following factors that are emerging and fast becoming best practices in terms of ethical behavior in business world

- Hiring ethical people through a job screening process
- Designing effective code of ethics and raising awareness for the same
- Developing and employing ethical decision making framework
- Periodic ethics training for employees at all levels in the organization
- Designing an effective ethics reporting system and encouraging people to use it
- Empowering ethical employees

What could have prevented Enron's collapse?

As discussed in a previous section, leadership of Kenneth Lay and Jeffrey Skilling was the main reason of the downfall of Enron as the unethical behavior of these two leaders permeated the whole organization.

What clearly emerges is the lack of correct leadership philosophy followed by Lay and Skilling. They both followed the policy of making money for themselves in any way and eliminating any voice that emerged against them. The leadership philosophy based on ethics and moral responsibilities would have prevented the fiasco at Enron. Coupling of Enron's ethical pronouncements with rest of its operations would have helped keep the company on the correct path (Weaver et al. 1999). Though there was a code of conduct and ethics at Enron, it was reduced to a mere document. Had the leadership inherited the spirit of that document and promoted the same within the organization, the corporate culture would have evolved in a more ethical manner. Solomon (1992) argues that in many cases a leader's main source of influence is not his/her technical capability, but ethical behavior of the leader and the moral virtues including honest, integrity and fairness.

Lay and Skilling projected the image of being charismatic leaders and convinced people of the spectacle that they can bring. The leadership quality of being grounded and ensuring the growth of followers would have helped Enron avoid the debacle. Following ways in which different leadership could have made a difference in Enron's case are:

- A better leadership would have made sure that the corporate culture at Enron was conducive to the ethical and moral growth.
- Hiring would have been better, rather than promoting people who were ready to comply in the wrongdoings.
- The leaders would not have been involved in ultimate self praise and spectacular showings.

- Better systems would have been designed that would have caught the fraudulent activities

Overall, the leadership philosophy of inclusive growth ensuring the growth of everyone in an ethical manner would have prevented Enron's collapse.

Conclusion

Enron has become a case study regarding how unethical and bad leadership can lead to the downfall of mighty corporations. Various researchers have studied the relationship between ethics and leadership. All the researchers acknowledge the importance of being perceived as moral and ethical in order to become an effective leader. Also, the way in which ethics is practiced by leaders is different from the way it is practiced by others and leaders need to be more careful about their and their subordinates' actions.

It clearly emerges that the leadership of Kenneth Lay and Jeffrey Skilling was primarily responsible for the debacle at Enron. These leaders were engaged in unethical practices to garner money and this seemed to be their sole aim. Lay was involved in many fraudulent partnerships to push up the prices of Enron and Skilling was primarily responsible for fraudulent accounting practices that inflated and overestimated earnings of the company. Both Lay and Skilling frantically sold the shares of Enron when it became clear to them that they would not be able to sustain the practices at Enron for long. Kenneth Lay and Jeffrey Skilling created a culture of fraud and cheating at Enron that permeated the whole organization and encouraged unethical behavior among the employees.

Business world has learnt a lot from the episode of Enron and various initiatives are underway to promote ethics and moral behavior in business. Various trends are emerging and best practices are being set up to guide leaders in case of an ethical dilemma. Some companies have created a position of Chief Ethics Officer in order to promote ethics in their organizations. Enron's collapse would have been avoided by lack of greed and ethical leadership.

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