“Whistleblowing’ before imploding in Accounting Scandals

A Case Study in Accounting Fraud Whistleblowing pre-Sarbanes Oxley

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Abstract

This case presents Sherron Watkins at a moment of ethical decision. She had decided to resign from Enron after discovering accounting frauds associated with her boss, CFO Andy Fastow. However, CEO Jeff Skilling resigned before she could leave. This brought Ken Lay back as CEO. Watkins thought there was a chance Lay might want to right Enron’s listing ship. She has drafted an anonymous letter advising him of the fraud and recommending specific remedies. Should she deliver it the next day?

Watkins possesses a strong moral compass and the technical knowledge of a trained accountant. Will these be enough in the face of an organization which has been committing fraud for some time? Will her informing top management of these problems result in their taking corrective measures and protecting Watkins from the certain wrath of her boss? Or will it mean that Enron attempts to discover and then “shoot the messenger?” Watkins is the principal breadwinner in her family. Being marginalized within Enron, or fired and never working in industry again are some of the potential consequences if she guesses wrong about Ken Lay’s response.

The case offers a number of ethics issues and tactical questions to ponder. What exactly is the nature of the accounting fraud associated with Enron’s “Raptor” vehicles? If Watkins is right about fraud, how did both Arthur Anderson and the law firm, Vinson & Elkins sign off on the transactions? Is there any way to undo the damage now without bringing down the company? Students standing in Watkins’ shoes must consider that they will be pressed to answer such questions if Lay delves into the acqusations. They must also decide whether to self-identify, whether to seek support from other Enron employees, and whether Ken Lay is the right recipient for the letter.

Faculty teaching the case will want to point out the scant legal protection afforded corporate whistleblowers in 2001. Watkins herself did not realize the extent of her vulnerability. Sarbanes-Oxley and Dodd-Frank have since extended considerable protection to whistleblowers. Faculty and students will want to consider how much this improves the risks incurred by those willing to disclose illegality at their firms. It is also important to discuss exactly what a whistleblower must do to be protected, and the types of evidence regulatory agencies will want to see to deem the whistleblower credible.

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The anonymous letter's text was finished. Sherron Watkins stared at the words and debated her course of action yet again. In front of her lay several envelopes. One was addressed to Ken Lay, Enron's Chairman and now returning as CEO. Unless Sherron came up with a better idea, her letter was headed for the mailbox where Enron's management collected employee feedback.

Watkins' re-read the draft (see Attachment 1), trying to gauge its likely impact. If it made it to Ken Lay, it should get his attention. Sherron was telling him in no uncertain terms that ruin was stalking Enron. During the last few months, working again in Andy Fastow's Global Finance, she had come across 'the worst accounting fraud I'd ever seen'. Bits and pieces of this story were starting to leak out to the press. If the full story ever got out, Sherron was convinced it could quickly lead to Enron's demise.

Until today, August 14, 2001, Watkins had regarded this outcome as a matter of time. So long as Jeff Skilling was Enron's CEO (Skilling assumed this position in February 2001), she felt little chance existed that Enron would take the radical steps necessary to reconstitute its finances. Skilling had been the senior enabler of Enron's aggressive accounting and Special Purpose Entity (SPE) deals. Andy Fastow was Skilling's protégé. Watkins doubted that Skilling would openly repudiate Fastow or his self-dealing structures. So, she had resolved to leave Enron. Her resume was out circulating. Once she had a job, the plan was to hand Skilling a letter of protest on her way out the door.

Only, Skilling had beaten her to the punch. In a stunning development, Skilling had today resigned as CEO only six months after assuming the post he had coveted for years.

Skilling's departure changed Watkins' calculus. Ken Lay was stepping back in as CEO. Watkins regarded Lay with mixed feelings. His most dynamic years were behind him. Lay was not a detail man, and as his staff often commented, 'he gravitates toward good news'. Lay had also been present during all the developments of the past several years. He had signed off on Fastow's deals. Still, it was clear that Lay felt responsible for Enron. He had led the firm for over fifteen years, seen it rise from obscurity to global prominence. His decision to return as CEO conveyed commitment. Lay would be motivated to save Enron. He also had not been the actual architect of recent business strategies. Conceivably, he might be able to change course and save the ship.

Hence Watkins had revised her plan, deciding to approach Lay with both a warning and a recovery proposal. Because she was unsure what to expect from Lay, the warning would be delivered anonymously. If Lay responded, she was prepared to come forward with specific 'fix-it' suggestions. Lay had scheduled an 'all-employee' meeting for August 16. A mailbox was set up to receive employee questions. Watkins had tapped out her draft with the intention of dropping it in the box before the meeting.

Now that the letter was written, something approaching panic had seized her. She hadn't slept well in days. Some of the anxiety involved the risks she would be taking. Sherron was both primary breadwinner in her family and mother of a young child. If she came forward or was otherwise identified and then was fired, she might well enter an employment 'netherworld', i.e. being both unemployed and 'damaged goods'.

The rest of the panic involved the correctness of her course of action. Watkins was now plagued with doubts. These did not involve her assessment that Enron was in trouble; she was convinced the SPE accounting was fraudulent, that sooner or later it would come out, and when it did the news could crush Enron's fragile financial structure. Rather, the doubts centered on two other questions: 1) was she taking the information to the right audience? And, 2) would her suggestions improve Enron's chances to survive or was she merely hastening its demise?

Watkins ripped through her options one more time. In addition to Ken Lay, she had the option to take her disclosures to the Enron Board; the Finance Committee, chaired by Herbert S. Winoker, would be the proper entry point. Alternatively, Watkins could take her disclosures 'outside'.

One external road led to the SEC. Enron was a publicly listed company. The SEC had jurisdiction over public company financial disclosure. Presumably it would be interested in fraudulent reporting by a company as prominent as Enron. This path ultimately led to a formal SEC investigation. Another road led to the media, especially the financial press. Fortune, The Wall Street Journal, and others were already circling Enron, sensing hidden issues and hungry for inside information. Watkins could feed them such information, could calibrate the pace and extent of disclosure and could insist on anonymity.

Somehow, Sherron had to choose a course of action, knowing that by doing so she herself could be accepting no small responsibility for Enron's fate; and, she had to choose a course that gave her a reasonable chance to survive professionally. "Whistleblowers' did not always enjoy a long professional life-expectancy.

Watkins went over her facts one more time to make sure she had a case and resolve which road to take.

Welcome back, now Meet the Raptors

Sherron Watkins was no Enron newcomer. After working for Arthur Anderson (AA) and then Metalgessellshaft AG, she joined Enron in 1993. Sherron's initial assignment involved working for Andy Fastow. She worked for Fastow for almost three years, managing the JEDI joint venture with CalPERS and becoming wary of both his finance deals and his approach to internal politics in the process. Then, a good opportunity opened up. Enron International (EI) was expanding from 'greenfield' gas pipeline and power plant development into the finance and acquisition arena. Sherron jumped at the chance to join this new group and leave Fastow's world. After 'closing' a significant M&A transaction in 1998, Watkins was promoted to Vice President.

By the start of 2000, Skilling was effectively shutting down the International focus. EI's employees were strongly encouraged to join one of two shiny new business ventures, Enron Energy Services and Enron Broadband Services (EBS). Watkins chose EBS. By 2001, circumstances had changed again. For one thing, EBS was imploding. Watkins had been told to look for another job elsewhere within Enron. For another, Watkins now had a two year old child. Suddenly being on the road and putting in 'deal hours' didn't work so well. So, Sherron went looking for a less taxing position. Actually finding another slot that fit her personal situation proved difficult, however; she also needed to find something quickly if she had any hope for a decent placement in the annual employee rankings done each year end. With some reluctance, she accepted an offer from Fastow to return to his shop.

Watkins reported to Global Finance M&A in late June 2001. Her immediate assignment was to take a list of potential asset sales and prioritize them for cash and earnings impacts. Quickly she discovered that several assets on the list had been 'hedged' with certain SPEs called 'Raptors'.

The Raptors turned out to be a family of SPEs owned by LJM2, the investor partnership organized and run by Andy Fastow. The Raptors had been conceived for the express purpose of hedging the value of certain 'merchant assets'. Enron defined merchant assets as assets or operations which could be sold; consequently, they were treated as marketable commodities suitable for 'mark to market' accounting. In several cases this meant Enron had already booked operating profits derived from supposed appreciating asset values. These profits were vulnerable should the asset values later reverse and decline. In such case, Enron was exposed to having to record 'mark-to-market' losses. The Raptors had been conceived as a means to insulate Enron's reported financials from such occurrences.

Upon closer inspection, the Raptors turned out to be exotic creatures. For one thing, they were operated by an Enron insider. CFO Andy Fastow acted as their General Partner, operating under an express conflict of interest waiver granted by Enron's Board. For another, although the structure of a Raptor deal was mind-numbingly complex, when Watkins peered through the boxes and lines what she saw was a phony hedge. At bottom, Enron appeared to be providing the Raptors with Enron shares or rights to shares; these formed the principal if not sole basis by which a Raptor could make good on any hedge payments owed to Enron. Said differently, Enron was hedging with itself.

The Raptor 1 deal illustrated this point. Attachment 2 provides a schematic depiction and a description of this LJM transaction.

It didn't take long for Watkins to peer through the Raptor boxes and arrows to realize the essence of what was happening. Sherron remembered her reaction as follows:

> *"In completing my work, it became obvious that certain hedged losses incurred by the Raptors were actually coming back to Enron. The general explanation was that the Enron stock that had been used to capitalize the Raptor entities had declined in value such that the Raptors would have a shortfall and would be unable to pay back what they owed to Enron. When I asked about third-party money or outside equity at risk, I never heard reassuring answers – basically the answer was that it just wasn't there. I was highly alarmed by this fact.* ***My understanding as an accountant is that a company could never use its own stock to directly generate a gain or, as in Enron's case, avoid a loss on its income statement****". (emphasis added)*

By this point, four Raptor entities existed. Collectively they had ‘lost’ over $700 M on the hedges provided to Enron. Specific assets on Watkins’ list, Avici, New Power, and Hanover Compressor were responsible for hundreds of millions in Raptor losses. Avici alone was down 90% versus the value at which it had been hedged.

With Enron’s stock in decline, the Raptors could not cover these losses out of their capitalization. With its stock and credit rating already under pressure, Enron was reluctant to fix the Raptors by infusing even more stock. The alternative was to accept the credit impairment of the Raptors and recognize a loss in Enron’s reported P/L. Since Enron had been less than clear when reporting the nature and condition of the related party SPEs, recognizing losses would provoke a firestorm of questions and demands for further disclosure. Enron had ‘boxed’ itself in.

Watkins recalled her assessment of Enron’s predicament:

> *“…it didn’t take me long to discover the flaw in the Raptor transactions. The Raptor deals expired sometime in 2003 and 2004. It was like staring at a time bomb. When I discovered the problems with the Raptors, my first reaction was to leave Enron as fast as I could. This was some of the worst accounting fraud I had ever seen.”*

Skilling, however, had beaten Sherron Watkins out the door. Skilling left on August 14, 2001 citing ‘personal reasons’. Enron’s Board asked Ken Lay to step back in as CEO and he agreed.

Pondering an Approach to Ken Lay

Watkins recalled her first reaction to the news of Skilling’s departure. She felt that his exit indicated Enron’s condition was even worse than she had thought. At first she couldn’t make sense out of why Skilling would surrender the job he had fought for many years to obtain. ‘Personal reasons’ didn’t cut it as a justification. No, Skilling must have decided Enron was in deep trouble. As Watkins noted she had written in her draft letter:

> *“Skilling looked down the road and knew this stuff was unfixable and would rather abandon ship now than resign in shame in two years.”* (see Attachment 1)

She had also concluded that Ken Lay didn’t fully appreciate what he was stepping back into, and that she had to warn him. Thus she had decided to send Lay a warning letter now, rather than passing him a protest note later as she left for another job.

Watkins pondered for a moment what she hoped her letter might accomplish. Taking stock, she found she hoped Lay would launch a thorough investigation of the related-party transactions. She also expected that Lay would establish a crisis management team to address the dangers Enron would face should its accounting liberties be exposed – which Watkins believed would happen sooner or later.

Watkins knew that the company was more vulnerable than was commonly understood. Enron’s core trading business was hugely dependent on having an investment grade credit rating. Watkins saw Enron's Baa rating as endangered. Enron had many skeletons in its closet. It owed far more in financial obligations than it reported, and many of its new businesses were failing miserably (see Attachment 3 for a summary of business line issues). It wouldn't take much to puncture the aura of invincibility that sustained the markets' willingness to feed Enron's appetite for capital. Once investors discovered that their cash was going down drains as opposed to funding the next big idea, financing would rapidly dry up…the company's debt rating would be downgraded to junk....trading would be severely impacted….and, Enron's stock price would tank. This would trigger a need to recapitalize shaky Special Purpose Entities (SPEs) with new Enron stock. Credit rating and stock price would further decline. The company would face a death spiral.

This was the deadly scenario that lay behind Watkins' warning that the company could 'implode in a wave of accounting scandals '.

Clearly, Enron needed time to get on top of problems and reverse questionable deals. That argued for working inside the company. Once warned however, would Lay take necessary corrective measures? Here Watkins had her doubts. What was Ken Lay capable of doing at this moment? Watkins determined that three questions held the answer to Lay's probable course of action:

1. How much did Ken Lay know about Enron's perilous condition? Did he understand that much of the accounting was fraudulent and that the financial structure was fragile?
2. Was Lay coming back with a repair plan or just coming back to fill an unexpected opening? What first moves would he make, indicative of what new direction?
3. Who would Lay rely upon for advice? In the past, Lay relied upon strong #2's, Rich Kinder and then Skilling. Who would play that role now and to what effect?

Attachment 4 outlines Lay's leading internal choices to replace Skilling.

As she pondered these questions, Watkins considered her other options. Foremost among these was going straight to Enron's Board. Watkins reflected that the possibilities there were intriguing:

1. The Board likely had not been given full disclosure regarding the questionable related-party transactions. Giving the Board new, disturbing information would invite them to demand both full disclosure and corrective measures
2. Second, the Board could insist on a change of course. It could take the matter of 'defending the past' out of management's hands
3. Perhaps most important, the Board could if necessary change Enron's management. At a minimum, the Board could ensure that Ken Lay selected a team dedicated to confronting Enron's problems; this would be critical given the complicity of many senior Enron executives in questionable deals

But would Watkins' letter ever reach the Board and if so would they act? These same directors had approved Fastow's conflict of interest waiver and every major related party transaction from *Whitewing* and *Chewco* to the LJM deals. Were they not just as complicit as Skilling and Fastow?

Bypassing management by going directly to the Board would also turn Watkins into an 'internal whistleblower'. By this Watkins meant someone who regards the established management channels to be so compromised that warning disclosures must be delivered ‘out of channels’. Watkins knew what attaining ‘whistleblower’ status meant:

> *“What you hear about all the whistleblower stereotypes is true. You really get treated like a pariah…given no responsibilities, nothing to do…[until you’ve] seen the handwriting on the wall and found another job.”*

At this point in time, neither Federal nor Texas law afforded protection to private sector whistleblowers. Watkins could be fired by Enron and would have ‘no cause of action’ for wrongful dismissal. However, the full legal context was somewhat more complicated. Attachment 5 provides a more detailed description of the legal framework surrounding whistleblowers in 2001.

Watkins certainly felt at risk of being fired for taking her disclosures ‘outside the company’. Going openly to the SEC would run precisely this risk. Enron would do everything in its power to discredit her and her information. They would point to the Board’s review of each transaction, its approval of Fastow’s conflict of interest waiver, and the safeguards initiated to monitor these arrangements. Arthur Anderson’s sign-off of every deal and Enron’s footnotes in its public filings would be cited as proof of the accounting’s probity. Enron would ‘circle the wagons’, declare that no accounting rules had been broken and that Sherron Watkins was just a disgruntled employee. None of this would make it easy for Watkins to find new employment. It would take outside investigators years to get to the bottom of any allegations, by which time Watkins career could be in shambles.

That did leave the option of disclosing information anonymously to the financial press. Several reporters were on the scent of Enron’s accounting problems. In March 2001, Bethany McLean had published an article ‘*Is Enron Overpriced’* in Fortune magazine. McLean and her colleague Peter Elkind continued to follow the Enron accounting story, paying particular attention to the related-party transactions. The Wall Street Journal was also showing more interest in Enron’s story. WSJ’s articles published after Skilling’s departure increasingly asserted that all was not what it seemed at Enron.

However, Watkins knew that leaking information posed serious risks. If Enron discovered or even guessed that she was doing the leaking, Watkins would be gone in a heartbeat; who then would hire an obviously untrustworthy employee? From a company-oriented perspective, what would leaking information accomplish? Possibly it might force Enron’s management and Board to get serious about corrective measures. Lenders and Rating Agencies might demand more information and then proper action. On the other hand, leaking involved partial disclosure and possible misinterpretation. The markets might simply run for cover, dumping Enron’s stock and refusing to rollover its commercial paper. Watkins might then be precipitating the very death spiral she was seeking to avoid.

A Decision to go Forward

The draft letter still lay on the desk. What should Watkins do with it?

Watkins reflected that the answer to this question might depend upon defining what she was trying to achieve. Was her priority to:

- End abusive practices
- Save Enron from financial melt-down, or
- Assure that the broader financial system's integrity was protected and Enron punished for wrongdoing?

Ideally Watkins wanted to see all of these goals achieved. Practically she knew her course of action might have to target one at some expense to the others.

There also was the question of tactically managing whatever path she chose. Could Watkins make her allegations 'stick' when they were challenged? Which allegation and what support would she use to overcome the 'complexity and veil of propriety' that Enron had draped over its finances? Who would stand with her when the corrupted elements within Enron closed ranks and fired back?

Within a couple of days, Ken Lay would start appointing new leadership and charting Enron's path forward. Should she send her letter to Lay or choose another route? Now was the moment of choice if Sherron Watkins wanted to influence those decisions.

Attachment 1

Draft Anonymous Memo
to Enron CEO Ken Lay

Dear Mr. Lay,

Has Enron become a risky place to work? For those of us who didn't get rich over the last few years, can we afford to stay?

Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues. Enron has been very aggressive in its accounting—most notably the Raptor transactions and the Condor vehicle. We do have valuation issues with our international assets and possibly some of our EES MTM positions.

The spotlight will be on us, the market just can't accept that Skilling is leaving his dream job. I think that the valuation issues can be fixed and reported with other goodwill write-downs to occur in 2002. How do we fix the Raptor and Condor deals? They unwind in 2002 and 2003, we will have to pony up Enron stock and that won't go unnoticed.
To the layman on the street, it will look like we recognized funds flow of $800 mm from merchant asset sales in 1999 by selling to a vehicle (Condor) that we capitalized with a promise of Enron stock in later years. Is that really funds flow or is it cash from equity issuance?

We have recognized over $550 million of fair value gains on stocks via our swaps with Raptor, much of that stock has declined significantly—Avici by 98%, from $178 mm to $5 mm, The New Power Co by 70%, from $20/ share to $6/ share. The value in the swaps won't be there for Raptor, so once again Enron will issue stock to offset these losses. Raptor is an LJM entity. It sure looks to the layman on the street that we are hiding losses in a related company and will compensate that company with Enron stock in the future.
I am incredibly nervous that we will implode in a wave of accounting scandals. My 8 years of Enron work history will be worth nothing on my resume, the business world will consider the past successes as nothing but an elaborate accounting hoax. Skilling is resigning now for "personal reasons" but I think he wasn't having fun, looked down the road and knew this stuff was unfixable and would rather abandon ship now than resign in shame in 2 years.

Is there a way our accounting guru's can unwind these deals now? I have thought and thought about how to do this, but I keep bumping into one big problem—we booked the Condor and Raptor deals in 1999 and 2000, we enjoyed a wonderfully high stock price, many executives sold stock, we then try and reverse or fix the deals in 2001 and it's a bit like robbing the bank in one year and trying to pay it back 2 years later. Nice try, but investors were hurt, they bought at $70 and $80/ share looking for $120/ share and now they're at $38 or worse. We are under too much scrutiny and there are probably one or two disgruntled "redeployed" employees who know enough about the "funny" accounting to get us in trouble.

What do we do? I know this question cannot be addressed in the all employee meeting, but can you give some assurances that you and Causey will sit down and take a good hard objective look at what is going to happen to Condor and Raptor in 2002 and 2003?

Attachment 2

Raptor 1 Transaction – Description

Initial Capitalization:

Fastow's vehicle, LJM2 initially injected some cash into an SPE called Talon (the Raptor vehicle in this case). Enron formed its own entity called Harrier. Enron capitalized Harrier with its common stock and contracts to deliver stock. Harrier then used these in an exchange transaction with Talon: An exchange of promissory notes among Talon and Harrier allowed Enron to report 'operating cash generation' for accounting purposes (Talon's was far bigger). Harrier also contributed the stock and stock contracts to Talon, balancing the exchange. These arrangements effectively completed Talon's capitalization.

Hedge Instruments:

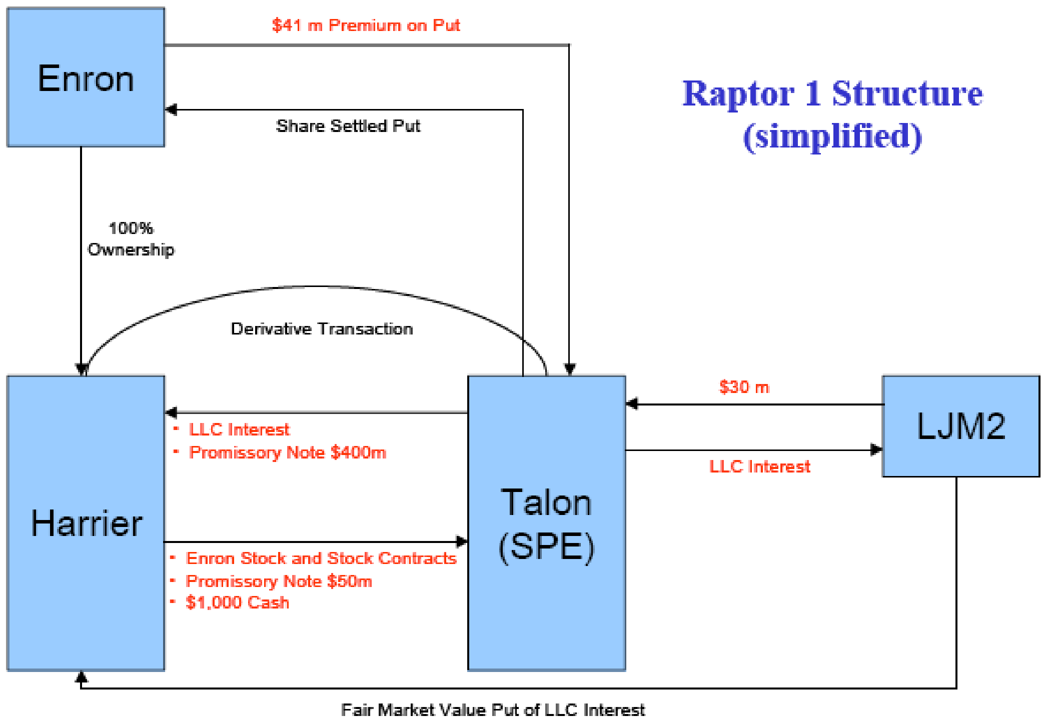
Talon then wrote a 'Share Settled Put' in favor of Enron. This derivative gave Enron the right to 'put' designated merchant assets to Talon at a specified value, one set to protect Enron's accounting values for the assets. The structure 'worked' in the sense that if the merchant assets' value declined, the value of Enron's put from Talon should increase by a similar amount. Thus, Enron's accounting results would be hedged. Talon's ability to pay Enron cash for the value of the put would in the final analysis depend upon its ability to liquidate Enron stock.

Cash Distributions/Investors' Net Position

As a last piece of the puzzle, Enron paid Talon $41 M cash as the 'premium' for the purchase of another 'put' option, this one on Enron's stock. This cash inflow allowed Talon to make a distribution to LJM of 'fees and profits'; in reality, this distribution amounted to a complete return of LJM's invested capital in Talon plus an $11 M profit. Fastow and his investor group thus had no net funds left at risk in the deal.

Attachment 2 continued

Raptor 1 Transaction - Schematic



Source: Powers committee report

Attachment 3

Summary of Enron's Troubled Business Lines
Mid-Year: 2001

By mid-2001, Enron organized itself into five reporting segments:

Transportation and Distribution: Includes regulated industries; interstate transmission of natural gas; management and operation of pipelines; electric utility operations such as the Portland General utility

Wholesale Services: Trading operations; commodity sales and services; risk management products and financial services to wholesale customers; plus, development, acquisition and operation of power plants, natural gas pipelines and other energy related assets – including both international assets and 'merchant' asset investments

Retail Energy Services: Sales of natural gas and electricity directly to end-use customers, particularly in the commercial and industrial sectors, and the outsourcing of energy-related activities such as the management of energy requirements for fixed facilities

Broadband Services: Construction and management of a nationwide fiber-optic network, the marketing and management of bandwidth and the delivery of high-bandwidth content

Corporate and Other: Includes operation of water, renewable energy businesses and clean fuels plants, as well as overall corporate activities.

Historic Performance of these segments prior to 2001 had been as follows:

$ M EBIT

	1998	**1999**	**2000**
Transportation and Distribution			
Transportation Services	351	380	391
Portland General	286	305	341
Wholesale Services	968	1317	2260
Retail Energy Services	(119)	(68)	165
Broadband Services	-	-	(60)
Corporate and Other	(32)	(4)	(615)
EBIT ex-Minority interest	1582	1995	2482

By the end of the first half of 2001, the following situations characterized these Enron segments:

$ M EBIT

	1Q '01	**2Q '01**
Transportation and Distribution		
Transportation Services	133	77
Portland General	60	65
Wholesale Services	755	802
Retail Energy Services	40	60
Broadband Services	(35)	(102)
Corporate and Other	(158)	(109)
EBIT ex-Minority interest	795	793

Earnings reported for Retail Energy Services do not include more than $500 M of trading and mark-to-market contract losses which are either unrecognized to date or have been incorporated into Wholesale Services' results

Broadband Services' (EBS) business model has failed to progress. A joint venture with Blockbuster to provide network transmission for their video content has been terminated. EBS fiber optic network has a large amount of spare capacity in an industry suffering from spare capacity. Downsizing and restructuring EBS will require a charge against equity of at least $180 M.

The Corporate and Other segment includes 'non-core' businesses. The troubled Dabhol power project in India and the Azurix water venture results are reflected in this segment. Developments at Azurix are such that the value of that venture will have to be impaired by at least $287 M. This segment also contains various merchant investments, whose value has been hedged by the Raptor related-party transactions.

Cash Flow deteriorated sharply in the 1H'01:

$ M Cash Flow

	Six Months ended June '01	**June '00**
Net Cash from Operations	(1337)	(547)
Net Cash from Investment Activities	(1161)	(2254)
Net Cash from Financing	1971	3231
Change in Cash	(527)	430

Consequently, corporate indebtedness of all types, on and off-balance sheet, has reached $34 billion, an increase of $$14 billion over the last 12 months.

Attachment 4

Candidates to become Enron's President & COO in wake of Jeff Skilling's resignation

Candidates within Enron

Mark Frevert: 46 years of age; Chairman and CEO of Enron Wholesale Services since June 2000; CEO Enron Europe from 3/97 to 6/00; held various positions in Enron Capital and Trade Resources Corp. (ECT) from 1993 until 3/97

Greg Whalley: 39 years of age; Head of Wholesale Trading; set up Enron Europe's trading operations in 1996; generally regarded as having the loyalty of Enron's traders; joined Enron in 1993 after getting an MBA from Stanford Business School; served in the U.S. Army after graduating from West Point in 1984

Stanley C. Horton: 51 years of age; Chairman and CEO of Enron Transportation Services since 1/97; senior positions in Enron Operations Corp. since 1993; representative of Enron's 'old guard' pipeline organization

Andrew S. Fastow: 39 years of age; Executive VP and CFO, Enron Corp. since 7/99; CFO since 3/98; Managing Director, Retail and Treasury, ECT from 5/95 to 1/97; widely regarded as expert in off-balance sheet and structured finance

Richard A. Causey; 41 years of age; Chief Accounting Officer, Enron Corp. since 3/98; Held various positions in ECT from 1993-97; CPA formerly employed by Arthur Anderson and regarded as expert in managing relations with that auditing firm

Candidates outside Enron

J. Clifford Baxter: 42 years of age; Enron's former Chief Strategy officer, CEO of Enron North America and Senior VP Corporate Development; resigned May 2001; close personal relationship with Skilling but one of the few who could openly disagree with him. Regarded as an expert dealmaker, but considered emotionally volatile.

Kenneth D. Rice: 42 years of age; former CEO of Enron Broadband Services and before that CE) of ECT-North America from 3/97 to 6/99; regarded as top marketer/sales executive; resigned from Enron in June 2001

Richard Kinder: 58 years of age; former Enron COO who resigned in 1996 after not being offered the CEO position. Regarded as effective executive who made Enron's operations more efficient and profitable; after resigning, became co-founder of Kinder Morgan Energy Partners, a highly successful Master Limited Partnership specializing in mid-stream assets. Likely would not take an Enron position under Ken Lay

Attachment 5

<u>Legal Position of ‘Whistleblowers’ in Texas, circa 2001</u>

‘Whistleblower’ is a somewhat imprecise term, generally describing an individual who reports incidents of fraud, waste, abuse or criminal activity to persons perceived as having the ability to take corrective action. Whistleblowers are often categorized by certain distinctions: (1) those that make disclosures to external authorities or the media vs. (2) those who make reports to financial control staff or higher executives within the firm; those who suffer retaliation by their employer after making their disclosure, whether internal or external in nature, are also often treated as a separate category.

As of 2001, the only legal protection offered to Whistleblowers in Texas was found in the Texas Whistleblowers Act. This law protects ***public*** employees against retaliation in the event they make a good faith report of violations of law to law enforcement authorities. Public employees are here defined as those who work for a state, local or governmental agency. Corporate employees are not covered. Moreover, Texas case law (Austin v. Health Trust, Inc.-The Hosp. Co., 1998) makes clear that the state does not recognize a ‘cause for action’ for corporate employees who may be discharged after acting as a whistleblower. This means that an employee so discharged may not sue for restoration of position and/or damages.

Texas corporate whistleblowers can have recourse to filing a ***Sabine Pilot*** claim. Such a claim relates to a 1985 case, Sabine Pilot Service, Inc. v. Hauck, and establishes that all Texas employees, public or private, may bring lawsuits alleging “discharge of an employee for the sole reason that the employee refused to perform an illegal act.” A legal analysis prepared contemporaneously with the events of this case illustrated the ‘Sabine Pilot doctrine’:

> *“…an employee’s duties involve recording accounting data that she knows to e misleading onto records that are eventually relied on by others in preparing reports to be submitted to a federal agency (e.g., SEC, IRS, etc.)…If the employee alleges that she was discharged for refusing to record (or continuing the practice of recording) the allegedly misleading data, then she has stated a claim under the Sabine Pilot doctrine.”*

The same analysis indicated that Sabine Pilot cases, even meritless ones, are risky, expensive and time consuming to litigate. The principal risks are: a) the company’s books and activities will be subjected to the legal discovery process; and b) sympathetic juries may award damages or compensation even when the employee in question was discharged for reasons other than those alleged in the law suit.

Federal law also did not offer meaningful protection to corporate employees in 2001, a fact corrected by the subsequent Sarbanes-Oxley Act.

Author's Note

The facts of this case are drawn from Sherron Watkins' account in *Power Failure, the inside story of the collapse of Enron* (by Mimi Swartz with Sherron Watkins). These facts are confirmed and supplemented by the accounts in *The Smartest Guys in the Room* and *Conspiracy of Fools.* Insight into Sherron Watkins motives and state of mind is found in her article, *Ethical Conflicts and Enron: Moral Responsibility in Corporate Capitalism,* published in the California Management Review (Haas School of Business, UC Berkley, 2003). This article documents Watkins' initial reaction to the Raptor vehicles' and includes her thinking on why she went to Ken Lay and what she'd do different in retrospect. Watkins' direct quotes are drawn from this article.

Attachment 1 reflects the text of Watkins' final letter as provided in Appendix A of *Power Failure…* Attachment 2 is as provided in the Powers Committee Report (pg. 101). Attachment 3's annual and quarterly financial results are as presented in Enron's SEC reports as filed on April 2, 2001, May 15, 2001 and August 14, 2001. The discussion of distressed business line results and Enron's cash flow/indebtedness at the end of Attachment 3 reflects the account given in *Conspiracy of Fools.* According to this source, CFO Fastow provided the $34 billion debt figure to both COO Gene Whalley and to the Enron Board during 3Q '01. The impairments for EBS and Azurix reflect actual amounts incorporated into Enron's 3Q net worth reduction, announced in October 2001.

There is no evidence from the extensive record on Sherron Watkins that she deliberated courses of action *ex ante* other than submitting her letter to Ken Lay. Her article in the California Management Review mentions that in retrospect she wishes she had taken her issues directly to the Enron Board. This case is written from the perspective of 'what if' Watkins had systematically considered all of her options. Reports of Watkins feeling anxiety about her decision to go to Ken Lay, the reactions of colleagues, and about the consequences of her actions for Enron are historically grounded.

The discussion of Sherron Watkins' legal situation as a 'whistleblower' is based upon Leslie Griffin's article, "Whistleblowing in the Business World*",* published in *Enron, Corporate Fiascos and Their Implications,* edited by Nancy B. Rapoport and Bala G. Dharan. Griffin discusses Texas statute and case law as well as the different definitions of 'whistleblower'. She also quotes from Vincent and Elkins attorney Carl Jordan's e-mail discussing Enron's legal situation regarding Sherron Watkins. The case's quote from a 'contemporaneous legal analysis' is drawn from this source.

There is no indication from the historical record that Watkins was aware of her legal situation when she decided to write her anonymous letter. Material on whistleblower's legal status circa 2001 is included to encourage recognition that the legal protection afforded whistleblowers should be an important consideration for 'resisters' debating whether to work internally or take concerns to external authorities.

Reportedly Watkins was shocked to discover 'after the fact' that Enron explored the legalities of potentially firing her. Watkins' quote about the status of whistleblowers is drawn from her California Management Review article.

Subsequent to this episode, Congress passed the Sarbanes-Oxley Act. This law offers unprecedented protection for whistleblowers, described by Leslie Griffin as follows in her article:

> *"It expands both criminal sanctions and civil liability against retaliating employers, including any companies that file reports under the Securities and exchange Act. The statute's reach is broad. 'Unlike most other federal statutes that protect employees…the Sarbanes-Oxley Act holds individual executives, agents and supervisors* **personally liable** *for unlawful retaliation, and it makes retaliation a* **felony offense** *under federal criminal law."*

Griffin goes on to quote Houston labor and employment lawyers Laurence Stuart who observed: "**We call this the 'Sherron Watkins provision**."