



Enron's Ken Lay: Captain of a Modern-day Titanic?

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Wharton management professor [Michael Useem](#) remembers the day that Sherron Watkins, the former Enron vice president who blew the whistle on the company, made a memorable presentation at a seminar on leadership. She likened Enron to the Titanic, and said its former CEO, Kenneth Lay, could best be understood as the captain of the doomed ship.

“The ship has taken a hit in the bow and water is gushing in,” Useem says, recalling Watkins’ remarks. “The captain knows something is wrong, but he makes sure the band is still playing and the cocktail glasses are still full while his ship is going down.”



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Such was the tale that federal prosecutors also told – albeit in less colorful, more legalistic language – in an indictment that was made public on July 8 in Houston . The government alleged that Lay and other former Enron officials, including Jeffrey Skilling, who succeeded Lay as CEO, and Richard Causey, former chief accounting officer, conspired to deceive shareholders, regulators and the public.

Useem and other Wharton faculty members say that the arrest of Lay, who was handcuffed when taken into court, was much anticipated. But they disagree as to whether it took investigators an inordinately long time – more than two years – before filing charges. They also say that Lay is walking a public relations tightrope in his extraordinary decision to defend himself publicly by such actions as holding a lengthy news conference and appearing on CNN’s *Larry King Live*. The Wharton experts stress that Lay must be presumed innocent until proven guilty of the criminal charges. But they agree that even if he is acquitted, his leadership of Enron was nonetheless abysmal in the months preceding the company’s collapse at the end of 2001.

“There were no signs [investigators] were dragging their feet in any way; it was just a tough case to crack,” says Useem, director of Wharton’s [Center for Leadership and Change Management](#). “By all outward appearances, there were no smoking guns, no memos, nothing written, and a lot of delegation of authority to his [Lay’s] underlings. As a result, it was hard to find definitive evidence. “

[Thomas W. Dunfee](#), professor of social responsibility in business and an attorney, says: “One could argue that longer is better so that the government can build its strongest case: Find out what kind of testimony you think will support it, the nature of the records and all of that.”

[Thomas Donaldson](#), a legal studies professor and, like Dunfee, an expert on business ethics, acknowledges that the Enron case is complex but says the investigation “definitely was too long.” He

continues: “One could speculate that the reason it took as long as it did was not only because [prosecutors] had to get cooperation from a huge number of people but also because, even now, they were not able to get what they wanted. I’m surprised the case is based largely on stuff we knew from the get-go and from events that were occurring as Enron was imploding.”

Indeed, the indictment focuses on actions that Lay allegedly took after public scrutiny was brought to bear on the accounting gimmicks and complex partnerships known as “special purpose entities” that left the energy giant in such dire financial straits. The firm eventually collapsed and brought down the accounting firm of Arthur Andersen, its auditor, with it.

The indictment charges Lay with 11 criminal counts. It says that he helped doctor financial statements to paint a falsely optimistic picture of the company’s health in the months leading up to its filing in U.S. bankruptcy court for protection from creditors in December 2001. The filing came just four months after Skilling’s sudden resignation as CEO, on Aug. 14, 2001, which shocked investors and triggered scrutiny of Enron. After Skilling’s departure, Lay resumed the post of CEO at the company he had founded 16 years before, and took over the “leadership” of the conspiracy, the indictment alleged. In the ensuing months, Lay took steps to falsely inflate Enron’s stock price so that he could profit from stock transactions and lied about Enron’s financial condition to the public, stock analysts and Enron employees, according to the indictment.

Watkins testified before a U.S. senate committee in February 2002 that she had met with Lay on Aug. 22, 2001, and provided him with memos she had drafted to help explain the problems facing the company. She testified that she expected Lay to conduct a thorough investigation but that he did not.

Lay, 62, has denied the allegations. At a news conference just hours after he pleaded not guilty, he told reporters that he took responsibility for what happened at Enron but that he had committed no crimes. He also said that even though he accepted responsibility, “that does not mean I know everything that went on at Enron.” In an interview with CNN’s King on July 12, Lay defended his actions once more and said that he had instructed Enron’s outside law firm to conduct an investigation into what Watkins had told him at their meeting. He also said that he believed Enron was in good financial condition in the months prior to its Chapter 11 filing.

According to the government, even though Lay knew that Enron was going to announce a huge loss for the third quarter of 2001, he told employees in an Internet chat discussion on Sept. 26 of that year that he had encouraged management to purchase Enron shares. Lay also is accused of urging employees to buy Enron stock at a time when he himself was selling shares. Lay told King that he did indeed sell shares, but only because he had to meet margin calls from banks that had loaned him money and held the shares as collateral. Lay said he still owned one million shares of Enron at the time the company went under, plus options for six million more.

The July 8 indictment, known as a “superseding indictment,” added Lay to a case already pending against Skilling and Causey, both of whom have entered pleas of not guilty. Another key figure in the case, former Enron chief financial officer Andrew Fastow, pleaded guilty to two counts of conspiracy in January and is expected to be a key government witness. Fastow admitted that he set up the special purpose entities and paid himself millions of dollars. His wife, Lea, who served as assistant treasurer at Enron, also pleaded guilty in connection with the case and began serving a one-year prison term on July 12.

The faculty members say that Lay's behavior in the months leading up to Enron's collapse, if true, demonstrated an extraordinary failure of leadership.

"The Titanic is an accurate analogy: The captain of the ship has to be looking for icebergs," Donaldson says. "One would have expected a man who was lionized by his own people to have helped save the [passengers] when the ship was hit. Lay appears to have done exactly the reverse. To extend the analogy, he pulled the life jackets away because of a misguided, self-interested desire to keep the stock value high ... In order to keep the stock value high, he said things that were not true about the health of the company."

Useem says that Lay should have known what was going on. "There was evidence [in the form of Skilling's resignation and Watkins' memo] that by August 2001 he did know the company was in dire straits and for that the prior argument is not a defense. There was certainly plenty to show that, going into September 2001, Lay was aware or unequivocally should have been aware."

A Critical Question

A key question in the case – and for corporate governance in general – is whether Lay (and by extension other CEOs) can honestly say that while he took responsibility for Enron's demise, he did not know what was going on. "There can be circumstances where that would be a legitimate statement," Dunfee says. "Accounting firms have shown that you can get smart people in there and they can bamboozle you for a while. When Sherron Watkins came to him and said, 'There's a real problem with these special purpose entities,' he did go to the outside law firm and ask for a report. But apparently he limited the focus [of the law firm's investigation] and that's an issue in this case."

It is hard to believe, Dunfee adds, that Lay was unaware of what was going on in the company. At some point, when there's a lot of smoke drifting through the premises, "you direct somebody to find out what's causing the smoke. Enron can fairly be described as a case of multiple-gatekeeper failure. The accountants failed, the outside law firm failed, the audit committee of the board failed, the board as a whole failed. Lay's got a lot of company."

Donaldson puts it this way: "People just abhor powerful leaders of organizations saying, 'I'm not responsible for this; it was all these little people that made it happen.' But we need to look at that statement carefully. How could it be possible that Lay takes responsibility but didn't do anything wrong?" Someone can be negligent not necessarily by performing a wrongful act, Donaldson adds, but by failing to take action to put an end to wrongdoing. "Let's say Lay did not know about the details of the [special purpose] entities. He should have known, and he's responsible for knowing. The fact that he didn't know is a form of negligence and we should hold him accountable for it."

A Risky Move

According to Useem, Lay took a chance holding the press conference on the day he was arrested, in that his decision could be interpreted as a sign of either strength or weakness. "If it indeed reflects his own self

confidence that he's done nothing wrong, then a bold declaration at a press conference reflects inner strength. On the other hand, if the press conference is just to use the media to fight back against the prosecutors, it may be a sign of weakness in anticipating a loss in court."

Donaldson says it is difficult to predict whether the government will win its case against Lay, but the task is made easier by Lay's image. "If this were just anyone with the same factual situation, it would be more difficult [to win a conviction]. Lay has turned into a public rogue and for that reason it's easier to bring a jury or, for that matter, judges to convict in instances where there's a lot of publicity. I take it that was part of Lay's strategy [in holding the news conference] – to blunt some of that publicity. That's why he's standing on a soap box and trying to smile and put a better face on a bad situation."

Dunfee suggests that prosecutors will have a hard time keeping a presentation of mind-numbing accounting transactions and business partnerships simple for jurors. "This is very complex stuff," he notes. The challenge for the government is to not "completely lose and confuse the jury ... I suspect jury selection will be really important in this case," including whether people with some business sophistication are chosen to serve.

If Lay did the things he is accused of doing, Donaldson says it is important that he be convicted and "not get off because of some quirk." But he adds that even if Lay is acquitted, the scandals at Enron and other companies in recent years have already sent a strong message to executives that their reputations can be permanently sullied if they engage in criminal or unethical behavior.

"The power of this case lies as much in pictures as in sentencing," Donaldson explains. "When you view Lay doing the perp walk, when you see pictures of him with his hands behind his back in handcuffs, if you're a CEO, you are given pause."

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