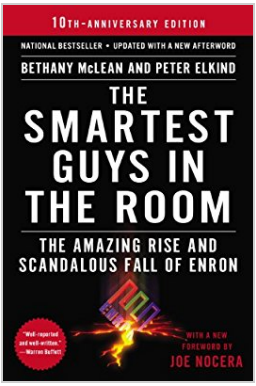

The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron

By Bethany McLean, Peter Elkind

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The tenth-anniversary edition of the definitive account of the Enron scandal, updated with a new chapter

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Editorial Review

Review
"The best book about the Enron debacle to date."
—BusinessWeek

"The authors write with power and finesse. Their prose is effortless, like a sprinter floating down the track."
—USA Today

"Well-reported and well-written."
—Warren Buffett

About the Author
Bethany McLean and **Peter Elkind** collaborated on this book when they both were *Fortune* senior writers. McLean, a former investment banking analyst for Goldman Sachs, is now a contributing editor to *Vanity Fair* and lives in Chicago. Elkind, an award-winning investigative reporter, is now an editor-at-large for *Fortune* and lives in Fort Worth, Texas.

FOREWORD

In February 2001, as the editorial director of *Fortune* magazine, I helped edit a short, rigorous story—just four pages long—by a young writer named Bethany McLean, who had joined the magazine some six years earlier from Goldman Sachs and quickly become one of *Fortune's* brightest stars. Her story was entitled, simply, "Is Enron Overpriced?"

At its core, Bethany's article asked one very straightforward question: *How does Enron make its money?* For years the company had been a Wall Street darling, its stock moving steadily upward with each new quarter's rising profits. It was seen as the paradigmatic example of a company that had transformed itself from an old-economy stalwart—operating pipelines that moved natural gas—to a new-economy marvel, creating dazzling efficiencies and hedging risks (like the weather!) that no one had ever thought to hedge before. Just a month before Bethany's story ran, *Businessweek* had put Enron's chief executive, Jeffrey Skilling, on its cover, posing with what appeared to be harnessed electricity in his hand, with the cover line "Power Broker."

But Bethany had been poring through Enron's financial documents, and what she realized was not just that they were complicated (most big companies have complicated financials) but that they were incomprehensible, even indecipherable. She started calling around to the Wall Street analysts who were so bullish on Enron, asking her simple question.

Some of them told her that Enron was a company you just had to trust. One analyst admitted to her that the company's earnings were "a black box." When she reached Skilling himself, the Enron CEO first complained that she "didn't get it," something he often said to people who questioned Enron. Then he hung up the phone on her. The Enron public-relations department insisted that if she would just come to Houston and visit the company's headquarters, the fog would soon lift. But with our deadline fast approaching, the Enron PR department decided that if Mohammed wouldn't come to the mountain, they would have to visit

Fortune. The company sent a small contingent to New York to meet with Bethany and her editors, including me. Andy Fastow, the company's chief financial officer, led the Enron team.

It would later be blindingly obvious that Fastow had not told us the truth—how could he, given that much of Enron's earnings were the result of accounting manipulations that created the illusion of profitability? But even in the moment it was clear that Fastow's goal was pretty much the same as those financials Bethany had been poring through: to obfuscate and confuse. I can't remember all the details, but I vividly recall Bethany asking sharp, pointed questions about the company's business model and Fastow responding with lengthy, nearly unintelligible answers about how Enron was like Toyota, how it should be thought of as a logistics company, etc., etc.—even though Enron's main business wasn't actually moving anything from place to place, but rather trading.

And then something happened that Bethany and I would never forget. As the meeting was drawing to a close and the Enron executives were putting on their coats, Fastow turned to Bethany and said, "I don't care what you say about Enron. Just don't make me look bad."

It was such a jarring thing for him to say on the eve of what was clearly going to be an unflattering article about his company. In retrospect, it was a tip-off—to the mentality of the people running Enron and to the fact that there was indeed something fishy about those financial statements—Fastow was, after all, Enron's CFO. It was a real signal that Bethany—whose story wound up raising all the right questions, even if she didn't yet have all the answers—was on to something.

Some articles drop like bombshells. Bethany's wasn't like that. Instead, it slowly seeped into the consciousness of Wall Street. Enron's stock had been in the 70s when Bethany's story was published, not far from its all-time high. Ever so steadily, it began to sink. In April, Skilling was questioned on a conference call by an investor who asked his own tough questions. "Asshole," Skilling muttered under his breath. In August, Skilling suddenly and unexpectedly quit as chief executive—a move that was all the more stunning because he had taken over as CEO just six months earlier from Enron founder Ken Lay. Though Skilling had effectively been running the company for years, everyone knew how much he had wanted the actual title of chief executive. His resignation triggered a flurry of skeptical stories and questions.

And then came October. With the stock having fallen into the high 30s—and Lay, back as CEO, trying to persuade a now-skeptical Wall Street that everything was fine—the *Wall Street Journal* revealed that Fastow had made tens of millions on the side running a pair of limited partnerships that had done business with Enron. That story helped accelerate the feeding frenzy that was already developing, both in the press and on Wall Street, around Enron. By November, Fastow was gone, sacrificed by Lay as he desperately tried to keep Enron afloat. But like any company that trades for a living—just like Lehman Brothers or Bear Stearns seven years later—once Enron had lost the confidence of its trading partners, it was toast. On December 2, 2001, the company filed for bankruptcy.

Even then, though, nobody knew the full story of what had brought down Enron. Fastow's LJM partnerships got the immediate blame—both inside and outside of Enron—but one of the main points of *The Smartest Guys in the Room* is that Fastow wasn't actually the one who brought down Enron. His chicanery—which he'd later testify was approved by Skilling—was actually what was propping up Enron. The real story was that Enron's businesses weren't making much money, and that much of their profits were phony. The whole point of Fastow's dealings, from Enron's point of view, was to make it appear that the company was a profit machine that it clearly wasn't. (And if Fastow skimmed a little on the side, well, what can you do?) Enron's aura had been such that nobody had ever bothered looking into the internal strife, the macho posing, the rampant greed—and the dysfunction in the company's executive suite, starting with the out-to-lunch Lay and the emotionally unstable Skilling.

Right after Enron filed for bankruptcy, Bethany wrote a terrific cover story about the company's decline and fall in which she touched on some of these larger themes. In editing the article I realized how well-sourced she was, but I could also clearly see that there was a much bigger, more important story here than simply a crooked CFO who was lining his pockets. Her story made it obvious that the rise and fall of Enron would make a terrific book.

So I went to my bosses and suggested that we—*Fortune* magazine—take advantage of Bethany's Enron reporting and write a book about what had happened. Because there was so much to unravel, I suggested she team up with Peter Elkind, a Texas-based *Fortune* writer who had written a series of fabulous investigative sagas for the magazine. Happily, everyone agreed. In 2003, Portfolio published the first edition of *The Smartest Guys in the Room*. I am biased, of course, but I contend that it remains the single most authoritative account of this landmark event.

It is far more than that, though. *The Smartest Guys in the Room* is an almost anthropological examination of the nature of corporate scandal. Why do values go awry? What happens when the wrong person gets a big job? Why is it so tempting to post false profits instead of telling the truth? How distorting is the prospect of stock market riches?

In the immediate aftermath of Enron, there were at least a half-dozen other big corporate blowups: WorldCom turned out to be cooking its books, and CEO Bernie Ebbers went to jail. Tyco became embroiled in scandal, and its chief, Dennis Kozlowski, also went to prison. But none of these disasters have resonated like Enron. At many business schools, studying Enron is part of the curriculum. Just recently, Andy Fastow, who was released from prison in 2011, gave an unpaid speech in Las Vegas at a conference of fraud examiners. He drew a full-house crowd of 2,500 people. Afterward, some of the fraud examiners and convention staffers asked to have their pictures taken with him. Explained one: "He's part of history."

Enron remains the defining scandal of the 21st century. None of those other scandals had the staying power—or the canary-in-the-coal-mine quality—of Enron. This was partly because no other modern-day company, prior to the financial crisis of 2008, had Enron's vaunted reputation. But it is also because almost everything we later found out about how Enron operated was a harbinger of scandals yet to come. Off-balance-sheet vehicles. Banks doing things they shouldn't to generate fees. Ratings agencies giving safe ratings to investments that were clearly doomed to fail. Corporate executives using every means possible to maximize short-term revenues—and boost their own multimillion-dollar bonuses—even when those means were, at best, unethical.

Congress held hearings in the wake of the Enron bankruptcy; it even passed a law, Sarbanes-Oxley, that was intended to prevent future scandals. (Among other provisions, the law calls for the CEO and CFO of a publicly traded company to sign a document attesting to the validity of its numbers. Despite numerous instances of post-Enron fraud, the power of that document has never been tested in court.) Newspapers and magazines wrote dozens of articles about how to prevent future Enrons. Jeffrey Skilling and Kenneth Lay were tried and given lengthy sentences (Lay, of course, died of a heart attack before he ever spent a day in jail). And then we all moved on.

No one can say for sure whether a more rigorous Washington response to Enron might have prevented the financial crisis of 2008. But I tend to think so. Both Enron and the financial crisis were the products of the same deregulatory impulse that seized Washington in the 1990s. Enron had exposed the deep, systemic flaws of the ratings agencies. The off-balance-sheet vehicles Enron used were the same kind of vehicles banks used to hold their collateralized debt obligations—the so-called toxic assets that did so much damage to the financial system when they collapsed. And they existed for the same reason: to hide debt.

On one level, the Enron scandal, as told in the pages that follow, is simply a great, rollicking tale. When Bethany and Peter set out to write *The Smartest Guys in the Room*, telling that story is all they were really trying to do. But it is impossible to read this book today, a decade after it was first published, and not wonder what might have been—if everyone had been willing to pay just a little more attention.

Joe Nocera
July 2013
Op-Ed columnist
The New York Times

AUTHORS' NOTES AND ACKNOWLEDGMENTS

Enron is well on its way to becoming the most intensively dissected company in the history of American business. This book is published as that process continues, with investigations and litigation that will surely drag on for years. Because our aim has been to chronicle the company's rise and fall—amazing and scandalous indeed—we have deliberately ended our narrative with Enron's filing of the largest bankruptcy case in U.S. history. We leave it to others to describe the resulting investigations and trials, as well as the jockeying over Enron's spoiling remains.

Enron's story is a sprawling tale, and, during the 16 months of intensive reporting that produced this book, it has taken us down many trails. A good portion of our work involved poring through a mountain of public and private documents involving Enron and the colorful cast of players—executives, bankers, auditors, lawyers, investors, and analysts—who appear in these pages. We have reviewed divorce records, executive calendars, personnel files, court records, depositions, personal e-mails, letters, consultants' studies, internal memos and presentations, board minutes, SEC filings, congressional testimony, and dozens of reports from Wall Street analysts. This massive written record, much of it contemporaneous with what we describe, has provided an extraordinary window into events involving Enron.

Ultimately, though, this is a story about people. We believe we have gained considerable insight into the thinking and behavior of virtually every major character in this book. We have conducted hundreds of interviews with people who worked at every level of the company, from the fiftieth-floor executive suite to the board of directors to the secretarial pool, in addition to scores of others who worked outside Enron. Yet for an assortment of understandable reasons—in some cases, involving the continuing criminal investigations; in other cases, involving the stigma that results from any association with Enron—many of those who spoke to us insisted on talking on "background" only. Under this arrangement, the information provided was on the record—we could use it freely—but we could not identify the source by name. This allowed many sources who would otherwise have been constrained to speak openly to us. On occasion, with those who saw themselves as likely government targets, facing possible surveillance, our arrangements assumed a cloak-and-dagger quality, with clandestine meetings arranged through coded messages. A few other individuals discussed events in great detail but only through trusted personal surrogates. The result is a book that relies, in considerable part, on unnamed sources.

We are exceedingly grateful for the cooperation, trust, and patience of all those (both named and unnamed) who spoke with us—in more than a few cases, a dozen times or more. Their participation in this project was an act of faith, and their insight has been invaluable.

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This book was made possible through the support of *Fortune* magazine. The idea for it took hold shortly

after Enron filed for bankruptcy, when we realized that there was an extraordinary and compelling business narrative in the company's collapse and that we wanted to tell that story. We also realized something else: piecing together the fall of Enron was going to be an unusually challenging reporting task. For the reasons discussed above, many of the principals were hardly in a position to talk publicly about their experience. Enron's financial machinations were also complicated, requiring considerable time and effort to understand—and then to explain.

What made our work manageable was the active involvement of Joseph Nocera, editorial director for the magazine. He served as impresario for this project, guiding us as we did our reporting, then acting as editor extraordinaire once we started writing. He is a true partner in the creation of this book. We are grateful to his wife, Julie Rose, too, who lived through the challenging times of this endeavor along with the rest of us.

Rik Kirkland, *Fortune*'s managing editor, allowed us to dedicate a year and a half to this project and never wavered from his strong and vocal support. Jeff Birnbaum tapped into his wealth of Washington sources, landing key interviews and pulling together the Washington angles to the Enron story. Colleagues Carol Loomis, Carrie Welch, Laury Frieber, Pattie Sellers, Tim Smith, David Rynecki, David Kirkpatrick, and John Helyar were generous with their advice and wisdom. Brian O'Reilly shared the extensive interviews he conducted with Enron executives for his story, "The Power Merchants," published in *Fortune*'s April 17, 2000, issue. We received valuable reporting aid from former *Fortune* reporter Suzanne Koudsi. The Time Inc. Business Research Center, especially Doris Burke and Patricia Neering, provided fabulous research help. Arlene Lewis Bascom kept track of the book's finances. Alix Colow pulled together the photos. Former Assistant Managing Editor James Impoco edited the original Enron story in *Fortune* written by coauthor McLean and was there with an encouraging word when we most needed it. Time Inc. editor in chief Norman Pearlstine and editorial director John Huey gave their blessing to this project. We hope the result justifies so much faith in us from so many.

We are appreciative of our many colleagues in journalism who broke fresh ground in reporting on Enron, notably *Forbes*'s Toni Mack, who was asking tough questions back in 1993 and was generous with her friendship and counsel a decade later; freelance writer Harry Hurt; *Texas Monthly*'s Mimi Swartz; Delroy Alexander, Greg Burns, Robert Manor, Flynn McRoberts, and E. A. Torriero of the *Chicago Tribune*, for their excellent four-part series on the fall of Arthur Andersen; Peter Behr and April Witt, for their early five-part series on the demise of Enron in the *Washington Post*; and the *Houston Chronicle*'s Tom Fowler and Mary Flood, who overcame the hometown paper's coziness with Enron's hierarchy to dig into the story. University of San Diego law professor and author Frank Partnoy offered early insights into Enron that were very helpful. The work of *Wall Street Journal* reporters Rebecca Smith and John Emshwiller made them players in the Enron tale. In the postbankruptcy period, the *New York Times*, led by Kurt Eichenwald, blanketed the story, covering dozens of angles. We also want to acknowledge the work and generous encouragement of *Times* business writer David Barboza and Washington correspondent Rich Oppel.

Amid much finger pointing in the nation's capital, several congressional committees did yeoman work. The U.S. Senate's Permanent Subcommittee on Investigations, through its detailed reports and hearings on Enron's incestuous relationship with commercial and investment banks, shed considerable light on dark corners of the Enron tale. We are grateful for the assistance of the committee and its staff, including Elise Bean, Robert Roach, and Mary Robertson. The Senate Committee on Governmental Affairs produced enlightening work on the watchdogs that didn't bark—government regulators, Wall Street analysts, and credit agencies.

Our stalwart agent, Liz Darhansoff, served as a fierce negotiator, sage critic, and fervent advocate. Our editor, Adrian Zackheim, instantly understood how a complex business story could make a gripping tale and was with us all the way. We'd also like to thank Will Weisser, Mark Ippoliti, Alex Gigante, David Hawkins, and Bonnie Soodek.

Finally, we owe our greatest debt to our loved ones.

Bethany's parents, Helaine and Robert McLean, while far removed from the specifics of Enron, added their wisdom to the age-old human elements of the story. Her sister Claire McLean offered constant words of encouragement and perfect company for the occasional shoe-shopping break. Bethany's husband, Chris Wilford, kept a glass (or two) of wine waiting long into the night. And Barolo provided a constant reminder of what it really means to be a bulldog.

David Elkind, Ellen Duncan, and Mary Clare Ward aided this project in untold ways. Laura Elkind, Peter's wife, did double duty, offering insightful editorial suggestions and tending bravely to the home front (Stephen, Landon, George, Adele, and Sam) while enduring long absences and late nights of writing with remarkable patience, support, and grace.

To all of them, we are especially grateful.

—Bethany McLean and Peter Elkind
September 2004

CAST OF CHARACTERS

OUR VALUES

RESPECT: We treat others as we would like to be treated ourselves. We do not tolerate abusive or disrespectful treatment. Ruthlessness, callousness, and arrogance don't belong here.

INTEGRITY: We work with customers and prospects openly, honestly, and sincerely. When we say we will do something, we will do it; when we say we cannot or will not do something, then we won't do it.

COMMUNICATION: We have an obligation to communicate. Here, we take the time to talk with one another . . . and to listen. We believe that information is meant to move and that information moves people.

EXCELLENCE: We are satisfied with nothing less than the very best in everything we do. We will continue to raise the bar for everyone. The great fun here will be for all of us to discover just how good we can really be.

—From Enron's 1998 Annual Report

INTRODUCTION

On a cool Texas night in late January, Cliff Baxter slipped out of bed. He stuffed pillows under the covers so his sleeping wife wouldn't notice he was gone. Then he stepped quietly through his large suburban Houston home, taking care not to awaken his two children. The door alarm didn't make a sound as he entered the garage; he'd disabled the security system before turning in. Then, dressed in blue jogging slacks, a blue T-shirt, and moccasin slippers, he climbed into his new black Mercedes-Benz S500 and drove out into the night.

At 43, John Clifford Baxter, the son of a Long Island policeman, had made it big in Texas. Before quitting his job eight months earlier, he had served as vice chairman of a great American corporation, capping a decade-long career as the company's top deal maker. Baxter was rich, too—thanks to a generous helping of stock options, a millionaire many times over. But as he cruised the empty streets of Sugar Land, Texas, Baxter was drowning in dark thoughts. Always given to mood swings, he had become deeply depressed in recent days, consumed by the spectacular scandal that had engulfed his old company.

Everyone seemed to be after him. A congressional committee had already called; the FBI and SEC would surely be next. *Would he have to testify against his friends?* The plaintiffs' lawyers had named him as a defendant in a huge securities-fraud suit. Baxter was convinced they were having him tailed—and rummaging through his family's trash. Then there was the media, pestering him at home a dozen or more times a day: *Did he know what had gone wrong? How could America's seventh-biggest company just blow up? Where had the billions gone?* No one, at this early stage, viewed Baxter as a major player in the company's crash. Yet he took it all personally. In phone calls and visits with friends, he railed for hours about the scandal's taint. It's as if "they're calling us child molesters," he complained. "That will never wash off."

Desperate to get away, he'd spent part of the previous week sailing in the Florida Keys. Sailing was one of Baxter's passions. For years, he'd decompressed floating on Galveston Bay aboard his 72-foot yacht, *Tranquility Base*. But he'd sold the boat several months earlier. When Baxter returned from Florida, his doctor prescribed antidepressants and sleeping pills and told him to see a psychiatrist. He'd called the shrink's office that day to make an appointment. But when the receptionist explained that the schedule was booked until February, Baxter hung up—he wasn't going to wait that long.

Less than 48 hours later, at about 2:20 A.M. on January 25, 2002, Baxter stopped his Mercedes on Palm Royale Boulevard, a mile and a half from his home. It was cloudy and a bit chilly that evening by Texas standards—about 48 degrees—but the sedan was tuned to an interior temperature of precisely 79. An open package of Newport Lights sat in the center console, a bottle of Evian water in the cup holder. Baxter's black leather wallet lay on the passenger seat. Baxter parked the car in the middle of the street, with the doors locked, the engine running, and the headlights burning. Then he lifted a silver .357 Magnum revolver to his right temple and fired a bullet into his head.

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Seven days later, Cliff Baxter's friends from Enron gathered to mourn. The Houston energy giant's collapse into bankruptcy had already become the biggest scandal of the new century. Baxter's death had stoked the media bonfire and tossed a fresh element of tragedy into a bubbling stewpot of intrigue. Enron's influence ranged widely—from Wall Street to the White House. So feared was this company, so powerful were its connections, so much was at stake that there was open speculation Baxter had actually been murdered—the target of a carefully staged hit, aimed at silencing him from spilling Enron's darkest secrets. The rumblings had forced the Sugar Land police department to treat an open-and-shut case—Baxter had even left a suicide note in his wife's car—like a capital-murder investigation, requiring DNA testing, handwriting experts, ballistics studies, and blood-spatter tests.

The Texas memorial service took place after Baxter was buried in a private ceremony in his hometown on Long Island. He was laid to rest in a plot he had secretly purchased there just a few weeks earlier, in the throes of his deepening funk. An Enron corporate jet—a remaining vestige of the company's imperial ways—flew Cliff's family and a few others east for the funeral.

Now it was Houston’s turn. The precise location of the service—the ballroom of the St. Regis, the city’s swankiest hotel—remained a secret until noon that day, at the insistence of Carol Baxter. Cliff’s widow was bent on avoiding the press. She blamed reporters’ intrusions for pushing her husband over the edge. So the 100 hand-picked guests who pulled up to the valet-parking station on this Friday afternoon had been summoned by furtive phone calls just two hours earlier.

For 90 minutes, those who knew Baxter—family members, fellow “boat people” from his beloved yacht club, and Enron friends—heard warm stories about his gentler side. There were images of Cliff with his family, Cliff sailing, Cliff fronting his rock band. Baxter was a gifted musician. When police found his body, there were two guitar picks in his wallet. Everyone left the service with a compact disc of his favorite songs, prepared with the help of J. C. Baxter, Cliff’s 16-year-old son. The opening track was perhaps Cliff’s favorite: a bouncy pop tune called “Perfect Day.”

On this perfect day

Nothing’s standing in my way

On this perfect day

Nothing can go wrong

It’s a perfect day

Tomorrow’s gonna come too soon

I could stay

Forever as I am

On this perfect day

It was a tragedy layered on tragedy, but there wasn’t much talk about the company’s Icarus-like fall among the former Enron executives thrust together again that afternoon. This wasn’t the time for such grim shoptalk; what’s more, their lawyers had pointedly instructed them to avoid such conversations. Ken Lay, Enron’s founding father, was conspicuously absent. At the insistence of the company’s creditors, he had finally yielded his job as CEO and chairman just two days before Baxter’s death; Lay sent his wife, Linda, to attend the service instead. Enron’s deposed chief financial officer, a onetime whiz kid named Andrew Fastow, was missing, too; he and Baxter had fought bitterly.

But former chief executive officer Jeffrey Skilling—once touted as a brilliant visionary and the man who shaped Enron in his own image—was very much in evidence. Baxter had been his closest confidant at Enron, the nearest thing Skilling, who kept his own counsel, had to a sounding board. Widely feared during his reign at Enron, known for his unflinchingly Darwinist view of the world, Skilling spent the service in tears.

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In the months after Cliff Baxter’s memorial service, Jeff Skilling could often be found in an otherwise empty hole-in-the-wall Houston bar called Muldoon’s, downing glasses of white wine. A short, fit man of 48 with slicked-back hair and cool blue eyes, Skilling typically appeared in faded jeans, a white T-shirt, and a two-day growth of beard. This is where he came to brood over what had happened at Enron—often for hours at a time.

More than anyone else, Skilling had come to personify the Enron scandal. Part of it was his audacious refusal, in the face of a dozen separate investigations, to run for cover. Alone among Enron's top executives summoned before a circuslike series of congressional hearings, Skilling had ignored his lawyers' advice to take the Fifth and defiantly spoken his piece. The legislators were convinced that Skilling had abruptly resigned as CEO of the company—just four months before Enron went belly up—because he knew the game was over. But Skilling wouldn't have any of it. At the time he quit, he insisted, he believed Enron was "in great shape"; he had left for "personal reasons." The nationally televised testimony was vintage Skilling: articulate, unapologetic, and prickly. He didn't hesitate to lecture, even scold, U.S. senators.

"Enron was a great company," Skilling repeatedly declared. And indeed that's how it seemed almost until the moment it filed the largest bankruptcy claim in U.S. history. *Fortune* magazine named it "America's most innovative company" six years running. Washington luminaries like Henry Kissinger and James Baker were on its lobbying payroll. Nobel laureate Nelson Mandela came to Houston to receive the Enron Prize. The president of the United States called Enron chairman Lay "Kenny Boy." Enron had transformed the way gas and electricity flowed across the United States. And it had bankrolled audacious projects around the globe: state-of-the-art power plants in third world countries, a pipeline slicing through an endangered Brazilian forest, a steel mill on the coast of Thailand.

As Skilling saw it, Enron had fallen victim to a cabal of short sellers and scoop-hungry reporters that triggered a classic run on the bank. Privately, he would grudgingly acknowledge occasional business mistakes—including one, the failure of Enron's broadband venture, that cost the company more than $1 billion. Yet Skilling remained remarkably unwilling to accept any personal responsibility for the company's demise. "You're not going to find one memo where Skilling said, 'Fuck with the numbers,' " he told a friend. "It isn't there." He was reluctant even to pronounce judgment on Fastow, his handpicked finance chief, who—the U.S. Justice Department alleged—had not just done a lousy job as CFO but stolen millions and collected kickbacks right under Skilling's nose. What happened to Enron, Skilling insisted, was part of the brutal cycle of business life. "Shit happens," he liked to say. Enron was a *victim*.

Unfortunately for Skilling, no one else believed that. Enron, which once aspired to be known as "the world's greatest company," became a different kind of symbol—shorthand for all that was wrong with corporate America. Its bankruptcy marked not merely the death of a company but the end of an era. Enron's failure resonated powerfully because the entire company stood revealed as a sort of wonderland, where little was as it seemed. Rarely has there ever been such a chasm between corporate illusion and reality. The public scrutiny Enron triggered exposed more epic business scandals—tales of cooked books and excess at companies like Tyco, WorldCom, and Adelphia. Enron's wash swamped the entire U.S. energy industry, wiping out hundreds of billions in stock value. It destroyed the nation's most venerable accounting firm, Arthur Andersen. And it exposed holes in our patchwork system of business oversight—shocking lapses by government regulators, auditors, banks, lawyers, Wall Street analysts, and credit agencies—shaking faith in U.S. financial markets.

Yet Skilling continued to plead his case with a compelling arrogance. At different times, before different audiences, he could be self-righteous, self-pitying, sarcastic, profane, even naive. Sometimes, he was all of these things at once. Periodically, he'd launch into an extended rant: about the media, about politicians, about the aggressive tactics of government prosecutors ("Welcome to North Korea"). The investigation was "a travesty," Skilling declared. "It makes me ashamed to be an American."

Even after the bankruptcy filing, he continued to exult over the innovative ways in which Enron went about its business. In an industry built on brawn, Enron prided itself on being a company that ran on brains. And Enron *was* smart—in many ways, too smart as it turned out. Just as he had when Enron was riding high, Skilling labeled ExxonMobil a "dinosaur"—as though it didn't matter that the oil giant was thriving while

Enron was nearly extinct. “We were doing something special. *Magical*.” The money wasn’t what really mattered to him, insisted Skilling, who had banked $70 million from Enron stock. “It wasn’t a job—it was a mission,” he liked to say. “We were changing the world. We were doing God’s work.”

In the public eye, Enron’s mission was nothing more than the cover story for a massive fraud. But what brought Enron down was something more complex—and more tragic—than simple thievery. The tale of Enron is a story of human weakness, of hubris and greed and rampant self-delusion; of ambition run amok; of a grand experiment in the deregulated world; of a business model that didn’t work; and of smart people who believed their next gamble would cover their last disaster—and who couldn’t admit they were wrong.

In less combative moods, Skilling reflected on his plight. “My life is fucked,” he said. He would tear up as he spoke about what building Enron had cost him: he had destroyed his marriage, ignored his kids. “People didn’t just go to work for Enron,” Skilling would tell acquaintances. “It became a part of your life, just as important as your family. *More* important than your family. But at least I knew we had this company.”

Skilling was seeing a psychiatrist and taking antidepressants. “I view my life as over,” he said during an extended dark spell. Before his funk eased, in the months after Baxter took his own life, Skilling openly mulled over whether his friend had done the right thing. “Depending on how it plays out, it may reach a point where it’s not worth sticking around,” he said. “Cliff figured out how it was going to play out.”

CHAPTER 1

Lunch on a Silver Platter

It is no accident that Ken Lay’s career in the energy business began—and, most likely, ended—in the city of Houston, Texas.

Houston was the epicenter of that world, home to giants like Exxon, Conoco, and Pennzoil. Spindletop, the legendary field that triggered the first Texas oil boom, back in 1901, is just up the road. To the south and east, sprawled over thousands of acres, lie refineries, petrochemical plants, gas-processing facilities, and tank farms—the grimy monstrosities that feed the nation’s hunger for plastics, fertilizer, heat, electricity, and gasoline.

For most of the twentieth century, Houston’s economy rose and fell with the price of crude. In the 1970s, when an Arab oil embargo was strangling the rest of America, Houston boomed. By 1987, when lower energy prices were pumping fresh life into the country, the city was flat on its back.

Houston also perfectly reflected the culture of the energy business. It was sprawling and rough, lusty and bold, wide open to opportunity and worshipful of new money. A city built on a swamp, Houston was a place where a man with a wildcatting spirit could transform himself virtually overnight; a like-minded company could remake itself, too.

The romance and myth in the energy business, of course, had always been about oil. It was crude that built empires, inspired legends, and launched wars. It was oil that the Mideast sheiks used to hold America hostage. It was oil that created the towering fortunes of Rockefellers and Hunts.

But Ken Lay’s destiny lay in a humbler hydrocarbon: natural gas. Transparent, odorless, lighter than air, natural gas, composed mostly of methane, lies trapped in underground pockets, often beside oil deposits. America has long had vast reserves of gas, and it burns far more cleanly than either coal or oil. Yet for the first half of the last century, America had little use for the stuff. It was a mere by-product in the quest for oil, priced so cheaply it wasn't worth laying new pipelines to move it across the country. Instead, natural gas was usually just burned off as waste or was pumped back into the ground to maintain pressure to extract more oil.

By the 1950s, however, the perception of natural gas had begun to change. Gas was never going to attain the mythic status of oil—not even after Enron arrived on the scene—but it gradually became useful and even important. A flurry of pipeline construction had linked gas supplies in Texas and Louisiana with the rest of the country. Dozens of new petrochemical plants—many along the gulf coast of Texas—relied on natural gas as their basic fuel. By the time Richard Nixon took office in 1969, gas heated a large percentage of the nation's homes and powered thousands of industrial sites year-round. Still, except for the occasional pipeline explosion, natural gas remained largely an afterthought, literally beneath notice, crawling silently about the country at ten miles per hour through a network of buried steel.

Back in those less complicated times, there were lots of industries that operated more or less by rote: the old banker's motto, for instance, was "3-6-3": take money in at 3 percent, lend it out at 6 percent, and be on the golf course by 3 P.M. But few industries were as downright sleepy as the gas-pipeline business. Yes, there was the occasional pipeline company that explored for gas, too; exploration has always been the most romantic part of the energy business. But mostly the pipeliners bought gas from oil giants and smaller independent exploration companies, then moved it across the country through their networks of underground pipes. Most of the gas went directly to industrial customers, while the rest was sold to regional gas utilities, which piped it to smaller businesses and consumers.

It was all very simple and straightforward—especially since every step of the process was under government control. The federal government regulated interstate pipelines, dictating the price they paid for gas and what they could charge their customers. (State agencies regulated intrastate pipelines in much the same fashion.) However much executives spent on operations, whether for moving gas or redecorating their offices, Washington let them recover their costs and tack on a tidy profit. "In the pipeline business, you'd have to make one or two decisions a year," says one former Enron executive. "Everyone who operated in it was pretty much brain dead."

It wasn't until the 1970s that things began to change—or at least to change enough to attract the interest of a bright, shrewd, and intensely ambitious young man like Ken Lay. Far from being afraid of the coming changes, Lay wanted to push things along, to accelerate the pace of change. In later years, colleagues joked about his penchant for taking rapid action—*any* action—describing Lay's management style as "Ready, fire, aim."

A Baptist preacher's son, Lay believed powerfully in the dogma of deregulation. He sermonized about the virtues of unshackling the gas industry, propelling it into a new, deregulated world, where the free market set prices. In this new world, surely, there would be winners and losers: those who had the skills to thrive in a deregulated universe and those who didn't. From the start, he saw himself as one of the winners. He could envision taking control of a lowly pipeline company and transforming it into the first "gas major," a company with the power, brains, resources, and global reach of the oil giants.

Lay usually expressed his preference for deregulation in ideological terms; his training as an economist had taught him that free markets simply worked better than markets controlled by the government, he liked to say. But he also believed that deregulation would create opportunities to make money—lots of money. And making money was terribly important to Ken Lay.

In later years, when Enron was at the peak of its powers, Lay was viewed as he'd always wanted the world to see him—as a Great Man. He was acclaimed as a business sage, a man of transcendent ideas who had harnessed change in an industry instinctively opposed to it. In the public face he presented, Lay seemed to care deeply about bettering the world. He spent much of his time on philanthropy: in Houston, he was the go-to man for charitable works, raising and giving away millions. He spoke often about corporate values. And he was openly religious. “Everyone knows that I personally have a very strict code of personal conduct that I live by,” he once told an interviewer for a religious magazine called *The Door*. “This code is based on Christian values.”

Lay was a hard man not to like. His deliberately modest midwestern manner—Lay made a point of personally serving drinks to subordinates along for the ride on Enron’s flagship jet—built a deep reservoir of goodwill among those who worked for him. A short, balding man with an endearing resemblance to Elmer Fudd, he remembered names, listened earnestly, and seemed to care about what you thought. He had a gift for calming tempers and defusing conflict.

But this style, soothing though it may have been, was not necessarily well suited to running a big corporation. Lay had the traits of a politician: he cared deeply about appearances, he wanted people to like him, and he avoided the sort of tough decisions that were certain to make others mad. His top executives—people like Jeff Skilling—understood this about him and viewed him with something akin to contempt. They knew that as long as they steered clear of a few sacred cows, they could do whatever they wanted and Lay would never say no. On the rare occasion when circumstances forced his hand, he’d let someone else take the heat or would throw money at a problem. For years, Lay seemed to float, statesmanlike, above the fray, removed from the tough day-to-day business of cracking heads in corporate America. Somehow, until Enron fell, Ken Lay never seemed to get his hands dirty.

A man of humble origins, Lay also became addicted to the trappings of corporate royalty. For years, he spent most of his time playing power broker. He traded personal notes with presidents, pulled strings in Washington, and hobnobbed with world leaders. Back in Houston, he was known as someone whose ring any aspiring politician needed to kiss. Indeed, there was talk he would someday run for mayor—if he didn’t accept a president’s call to serve in the cabinet instead. Some of that, unquestionably, came with the territory; some of it even benefited Enron. But it came at a big cost: over time, he lost touch with his company’s business.

Though few people complained about it before Enron fell, Lay’s behavior also betrayed a powerful sense of personal entitlement. Long after his annual compensation at Enron had climbed into the millions, Lay arranged to take out large personal loans from the company. He gave Enron jobs and contracts to his relatives. And Lay and his family used Enron’s fleet of corporate jets as if they owned them. On one occasion, a secretary sought to arrange a flight for an executive on Enron business only to be told that members of the Lay family had reserved *three* of the company’s planes.

At lunchtime, top Enron executives, who worked on the richly paneled fiftieth floor of the company’s headquarters tower in downtown Houston, routinely dispatched their assistants to fetch lunch so they could eat at their desks. Most ate their sandwiches on deli paper. Not Ken Lay. When his meal arrived, his staff carefully unwrapped it, placed the food on fine china, and served him lunch on a covered silver platter.

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There was no fine china in Kenneth Lee Lay’s early life. He grew up dirt-poor. Indeed, the Enron chairman’s history is a classic Horatio Alger story. He was born in 1942 in Tyrone, Missouri, an agricultural dot on the map in the Ozarks. Before Lay became a business celebrity, the region’s most famous former resident was Emmett Kelly, the circus clown known as Weary Willie.

Lay portrays his childhood, spent largely in tiny farm towns with outhouses and dirt roads, in Norman

Rockwellesque terms. But the Lays were always struggling—until he was 11 years old, Ken Lay had never lived in a house with indoor plumbing—and at a young age, he set his mind on finding his fortune.

His parents, Omer and Ruth Lay, had three children; he was the middle child, after Bonnie and before Sharon. For a time, the Lays owned a feed store. Then disaster wiped them out: the Lays' deliveryman crashed a truck, slaughtering a load of chickens. Omer had to take to the road as a traveling stove salesman; the family followed from town to town, until they were finally forced to move in with in-laws on a farm in central Missouri. Omer, a Baptist lay preacher who held a succession of day jobs to feed the family, started selling farm equipment. Acutely conscious of the family circumstances, young Ken always worked: running paper routes, raising chickens, baling hay. "It's hard for me not to think Ken was an adult when he was a child," his sister Sharon said years later. The hardship honed Lay's ambition. He later spoke of spending hours on a tractor, daydreaming about the world of commerce, "so different from the world in which I was living."

Lay's parents never made it past high school, but college transformed his life. The family eventually resettled in Columbia, Missouri, where all three children attended the University of Missouri. Omer worked as parts manager in a Buick dealership then as a security guard at the university library while preaching at a small Baptist church. Ken painted houses, earned scholarships, and took out loans to pay his way through school.

Lay was a devoted and stellar student, serious beyond his years, with a natural intellectual bent. He'd entered college planning to become a lawyer but became enraptured by the study of economics during an introductory class taught by a popular professor named Pinkney Walker. He discovered that theory and fresh ideas fascinated him. But his passion always had a pragmatic side. He cared about politics and public policy, how government could shape markets. "Ken was one of these 4.0 guys who had some street sense," says Phil Prather, a Missouri classmate and lifelong friend. "Most 4.0 guys I know are a bunch of savants."

Although Lay stood out for his brains, he was never the stereotypical egghead who spent every waking moment in the library. Though slight, low-key, and quiet—he struggled for years to overcome a mild stammer—he was popular as well. At Missouri he won election as president of Beta Theta Pi, the university's largest and most successful fraternity. (Among Lay's predecessors in the Missouri frat house: Wal-Mart founder Sam Walton.) Lay became an inveterate collector of relationships. At each major stop in his early life, he forged bonds that lasted for decades. These weren't only personal acquaintances. Time and again, he would tap his growing network: for a job, for a favor, or to surround himself with those he trusted. This skill propelled his climb.

The first key relationship, in fact, was with Pinkney Walker. Walker was drawn by Lay's brains and ambition and quickly became his mentor. "We just hit it off with each other from the first," remembers Walker. "It was always inevitable that he would be a man of wealth." After a lifetime of pinching pennies, Lay was eager to start making money. But after graduating Phi Beta Kappa in economics, he remained in school to get his master's degree after Walker convinced him that he would be better off in the long run with a master's on his résumé. Lay finished school in 1965.

For the next six years, Lay paid his dues: first in Houston, at Humble Oil (a forerunner to Exxon), where he worked as an economist and speechwriter while taking night classes toward his Ph.D., then in the navy, in which he enlisted in 1968, ahead of the Vietnam draft. Originally intended to become a shipboard supply officer, perhaps in the South China Sea, Lay was abruptly reassigned to the Pentagon. This assignment introduced him to Washington. Lay later attributed such critical turns in his life to divine intervention, but in this instance, there was no miracle involved: Pinkney Walker had pulled some strings for his protégé. Instead of putting in his tour of duty at sea, Lay spent it conducting studies on the military-procurement process. The work provided the basis for his doctoral thesis on how defense spending affects the economy. At night he taught graduate students in economics at George Washington University.

At each of these early stops, Lay received a taste of life at the top. At Humble, he wrote speeches for CEO Mike Wright; at the Pentagon, he recruited a high-level officer to provide support for his work as a lowly ensign.

By then Lay was a father of two. He was married to his college sweetheart, Judith Diane Ayers, the daughter of an FBI agent from Jefferson City, Missouri. They met in French class, and like so many others, Judie recalls being drawn by Ken's "maturity and dependability." Ken and Judie wed in the summer of 1966, after she completed her journalism degree. Ken was 24, Judie 22. Their children, Mark and Elizabeth, arrived in 1968 and 1971.

Before joining the navy, Lay had promised Exxon (the name had been changed from Humble) that he would return to the company. But once again, Pinkney Walker had other ideas. President Richard Nixon had just named Walker to the Federal Power Commission—then the agency regulating the energy business—and Walker wanted Lay as his top aide. The new commissioner placed a call to Exxon's CEO, urging him to let Lay off the hook. "I made it clear to him he was making a friend," says Walker.

Though Walker wound up staying only 18 months in Washington, it was long enough for his young deputy to make an impression. In October 1972, the Nixon White House tapped Lay for a new post as deputy undersecretary of energy in the Interior Department. He became one of the administration's point men on energy policy. Lay's new government position paid him a higher salary than was typical for such rank, thus requiring a special exemption from the U.S. Civil Service Commission. Interior Secretary Rogers Morton made the request. "The potential of an energy crisis is of immense proportion," wrote Morton. Without the exemption, "the Department of the Interior cannot hope to attract a man of Dr. Lay's stature and unique talents." Lay was 30 years old.

What a time it was to be making energy policy for the United States! Or rather, what a time it should have been. In early 1973, shortly after Lay began his new job, the country suffered electrical brownouts and natural-gas shortages. Then came the Arab oil embargo. Pump prices soared, and people had to line up for blocks to get gasoline for their cars. Government officials warned Americans to curtail long vacation trips. After decades of consuming ever more energy, the country was in the midst of a full-fledged energy crisis. The president capped the year by announcing that because of the crisis, he wouldn't light the national Christmas tree.

But the Interior Department's new deputy undersecretary of energy wasn't around long enough to effect policy. Concluding that the energy crisis was bound to mean big changes for the staid old pipeline industry, Lay decided the time was ripe to exit the government and head into the world of business. In September 1973, less than a year after he arrived at the Interior Department, Lay put out a feeler to W. J. (Jack) Bowen, CEO of a midsize pipeline company called Florida Gas, whom he'd met at a public hearing in his capacity as deputy undersecretary. "As you know, I have been involved in energy policy making in Washington for the past two and one-half years," Lay wrote, using Interior Department stationery. "I feel it is now time I begin thinking about returning to the private sector and resuming my career in business. I would be most interested in being considered for possible job opportunities with Florida Gas Company. The natural gas industry, obviously, faces some very difficult challenges in the months and years ahead, and I would like to be in a position in industry to help meet these challenges."

Bowen, a West Point graduate, met with Lay in Washington then brought him and Judie down for a visit to the company's headquarters in the Orlando suburb of Winter Park. Bowen also personally called his references: Lay's old boss at Exxon, a rear admiral in the Pentagon, and, of course, Pinkney Walker. Bowen took notes on their comments. "Never had a better man technically. Would like to have—tops!" declared the admiral. "Head's screwed on straight," said Walker. "Think a great deal of him. . . . Good worker. Very smart," added the Exxon man, who went on to offer the only cautionary note: "Maybe too ambitious." By year's end, Lay was in Winter Park as vice president for corporate planning, with a starting salary of $38,000 a year plus 2,500 stock options.

Bowen left the next year for Transco Energy, a much bigger pipeline company in Houston. That only accelerated Lay's rapid ascent. By 1976 he was president of the pipeline division at Florida Gas; by 1979, president of the entire company. For the first time in his life, Ken Lay was flush. He owned a $300,000 house, joined the Winter Park Racquet Club, and bought a beach condo on the Florida coast and a ski condo in Utah. In 1980 Lay made $268,000.

His marriage, however, was falling apart. The preacher's son was carrying on an affair with his secretary, a divorced mother of three named Linda Phillips Herrold, who would become his second wife. Newspaper profiles later described Lay's divorce as "amicable." And indeed, in the years after his split, Lay established a remarkably cordial relationship with his first wife. Over the years, Lay even paid for Judie and their two kids to accompany him, Linda, and Linda's children on family ski trips and cruises. When friends showed up for the Lays' Christmas parties in Aspen, they were startled to discover *both* of his wives there, mixing amiably. Says one friend: "I was expecting to see Judie in Ken's Christmas card."

But if the aftermath was friendly—a testament to Lay's ability to smooth over any conflict—the split itself was anything but. Lay began talking to Judie about separating in late 1980. About that time he called up his old boss, Transco chairman Jack Bowen, told him he had "domestic problems," and asked if Bowen had a job for him in Houston. Once again, a key relationship Lay had forged paid off. Bowen, then 57, hired the 39-year-old Lay as Transco's president—and his heir apparent. In late April 1981 Lay filed for divorce, requesting custody of his two children, just days before officially beginning his new job in Houston. About this time, Linda Herrold was also transferred to Florida Gas's Houston office.

Judie responded in court papers that Ken was unfit to have custody. A few weeks later, Judie suffered what doctors later called a "psychotic episode" resulting from "manic-depressive illness." She spent several months undergoing treatment at hospitals in Houston and North Carolina. At one point, at her doctors' urging, Ken had signed legal papers to have his estranged wife involuntarily committed. The psychiatrists treating Judie concluded that the episode was triggered by the couple's impending divorce. As one psychiatrist later testified in deposition: "The divorce or the thought of a divorce hit her very hard. 'It was like dying,' as she put it."

By the end of 1981, Judie had recovered, and the year-long courtroom sparring resumed. As a court date loomed, her lawyers deposed Lay, Jack Bowen, and Bill Morgan, a University of Missouri frat brother Lay hired to work for him as an attorney at Florida Gas. The two sides finally signed settlement papers in June 1982, with the trial just a week away. Under the agreement, Judie would get primary custody of the children. Lay would make a lump-sum payment of $30,000 plus $500 a month in child support, alimony of $72,000 a year for four years, and $36,000 a year thereafter. (Lay later voluntarily increased his payments to Judie on five occasions—most recently in 1999, to $120,000 a year.)

A Florida Gas executive named John Wing—who later played a big role at Enron—served as the legal witness for Lay at the three-minute hearing in which the divorce was finalized. When it was over, Lay headed straight to the Orlando airport, where a Transco jet was waiting to fly him to Texas. Lay and Linda Herrold were married one month later in Houston.

Judie Lay, who still lives in Winter Park, credits her ex-husband for extending an olive branch. About three years after the divorce, she says, their children told her that Ken and Linda had invited them all to go skiing together for Christmas—and that he would pay for her hotel room. “We didn’t all sit down under the Christmas tree the first year,” she says. “It kind of gradually became more togetherness. The bad times sort of flowed away. We’re all good friends now. He’s treated me very nicely.”

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It was at Transco that Ken Lay came to be widely regarded as a rising star. Unlike Florida Gas, Transco was a big-time company. It controlled a 10,000-mile pipeline system that provided almost all of New York City’s natural gas and served large portions of New Jersey and much of the Southeast. But it wasn’t just the size of the company that allowed Lay to shine; it was the condition of the pipeline industry. The business was in terrible shape.

One part of the nation’s energy crisis was a persistent shortage of natural gas; in some regions, schools and factories had been forced to close because the gas needed to heat them was in such short supply. Gas producers, not surprisingly, argued that the problem was that the government-mandated price was simply too low to encourage new exploration efforts. So in 1978 Congress hiked the regulated price that would be paid to producers (as exploration companies are called) for some types of natural gas. At the same time, though, Congress passed legislation barring the use of natural gas for any new industrial boilers. Thus the first law was intended to increase supply, while the second was intended to depress demand. Although this was hardly full-scale deregulation, it was the government’s first tentative step in that direction.

Unfortunately for the pipeline industry—and here was the great irony of the situation—the new rules worked far too well. Sure enough, the higher prices jump-started gas exploration and increased the nation’s supply of natural gas. But at the same time, demand for gas began dropping precipitously, not only because of government action but because as natural gas prices rose, many industrial customers switched to coal or fuel oil, which were suddenly cheaper. Over time, this put the pipeline companies in an impossible position.

Why? Because the pipelines, eager to protect themselves against future shortages, had started cutting long-term deals with individual producers to take virtually all the gas they could provide at the very moment when demand was dropping. The contracts they’d signed were called “take or pay,” meaning they were obliged to pay for the gas at the new higher rates *even if they didn’t need it*. Then, in the mid-1980s, the government made a bad situation even worse when it took its next small step toward deregulation: it freed utilities and industrial customers from their contracts to buy from the pipelines, allowing them to shop for better prices on the open market or turn to cheaper fuels.

But the government refused to let the pipelines out of their expensive take-or-pay commitments. This put pipeline companies between a rock and a hard place: stuck with huge volumes of gas at prices they could no longer pass on to customers. As a result, many of the companies became technically insolvent, and a few went bankrupt. Some form of relief was obviously needed—from Washington, the gas producers, or the courts. Over time, the companies pursued all three avenues: lobbying, negotiating, and litigating. Orchestrating it all took years and proved expensive. It wasn’t until the late 1980s and early 1990s that the crisis finally ended and the natural-gas business, including the pipeline industry, was largely deregulated.

But though the beginning of this crisis was bad for the industry, it was certainly good for Ken Lay. With his Ph.D. in economics, his Washington experience, and his long advocacy of deregulation, Lay seemed like just the right man for the new age. With the industry in paralysis, he began helping Transco work through its take-or-pay problem by setting up a fledgling spot market for natural gas, where producers who let Transco out of its take-or-pay obligation could sell directly to their customers, paying Transco just to move the gas.

Thoughtful and articulate, Lay was in demand at industry conferences and Capitol Hill hearings. “Ken isn’t bound by tradition,” declared John Sawhill, head of the global energy practice for the consulting firm, McKinsey & Company. Even Wall Street viewed him as a major asset. The *Houston Chronicle* wrote in 1983, “Some analysts attribute the strength of Transco’s stock price to Lay’s credibility and his bold and unique accomplishments.”

If Lay had stayed at Transco, he probably would have become CEO in 1989, when Bowen planned to retire. But as it turned out, he didn’t have to wait nearly that long to become a chief executive. In the summer of 1984, opportunity came knocking, and he eagerly answered the call. It came in the form of a meeting with a man named John Duncan, who had helped put together the old conglomerate Gulf & Western, and was a key board member of a midsize pipeline company called Houston Natural Gas (HNG).

Lay and Duncan had gotten to know each other a few months earlier, when HNG had been trying to repel a takeover attempt by a corporate raider and Transco had offered to act as a white knight—a friendly alternative acquirer. Ultimately, Transco’s help wasn’t needed, but Lay had clearly made an impression. In their meeting, which took place over breakfast on a Saturday morning, Duncan popped the question: would Lay consider becoming CEO of HNG? He didn’t require a lot of convincing. “By Sunday morning,” Lay later recalled, “it was sounding kind of interesting.”

Houston Natural Gas had a special place in the city. Though smaller than many local rivals—annual revenues were $3 billion—it had for years assumed the role of the “hometown oil company.” Part of that was its heritage: the company dated back to 1926, and it had long been the prime gas supplier to the huge industrial plants on the Texas coast. Part of it was due to Robert Herring, its longtime chairman, who was active in every important civic project and charitable event in town. Herring’s wife, Joanne, was an international socialite, and the couple’s home in exclusive River Oaks—one of America’s wealthiest neighborhoods—became Houston’s preeminent salon, a place where oilmen mixed with international royalty. Herring had died of cancer in October 1981; HNG, though still profitable, hadn’t been quite the same since. His successor, 60-year-old M. D. Matthews, was a nondescript caretaker type. Even after the takeover attempt was repulsed, HNG’s modest debt made it a juicy target for corporate raiders. And the takeover battle had left the HNG board convinced that it needed stronger leadership.

On Monday, Lay won Jack Bowen’s blessing for his departure, and in June 1984, at the age of 42, Ken Lay became chairman and chief executive officer of Houston Natural Gas. After her husband assumed his big new job, Linda Lay exulted to a friend: “It’s fun to be the king.” HNG would serve as the foundation for building Enron.

From the moment he walked in the door, Lay operated on one theory: get big fast. His core belief, as ever, was that deregulation—*real* deregulation—was coming soon. And when it did, he believed, the price of the commodity would reflect true market demand and the companies with the best pipeline networks would be the ones calling the shots. In just his first six months, Lay spent $1.2 billion on two pricey acquisitions that dramatically extended HNG’s pipeline system into the growth markets of California and Florida. (The Florida pipeline had been owned by Lay’s old company, Florida Gas.) He even talked to his old friend, Jack Bowen, about a deal with Transco. At the same time he unloaded $625 million in holdings outside the core pipeline business, including coal-mining properties and a fleet of barges.

Then came a bit of luck. In April 1985 Lay got a call out of the blue from a man named Sam Segnar, the CEO of InterNorth, a big Omaha pipeline company. Because Lay was in Europe at the time courting investors, John Wing, his old deputy from Florida Gas—who had just hired on as HNG’s chief strategy officer—handled the call. Segnar wanted to pitch the idea of InterNorth’s buying HNG. But it quickly became apparent that Segnar was too eager for his own good.

InterNorth, three times the size of HNG, had long been one of the most respected operators in the pipeline business. Among its 20,000 miles of pipeline was a genuine prize: Northern Natural, the major north-south line feeding gas from Texas into Iowa, Minnesota, and much of the rest of the Midwest. For decades, InterNorth had assumed a role in Omaha much like that of HNG in Houston. It was the caretaker of civic causes—the number one corporate citizen. Like HNG it had been run for years by a beloved figure, Bill Strauss. Under Strauss, InterNorth was a quiet, steady company with low debt and terrific cash flow that paid executives modest salaries and carefully watched expenses.

But in 1981 Strauss had turned the company over to Segnar, a charmless personality who upset many in frugal Omaha with a series of ham-handed moves. He purchased a company jet, bought a corporate ranch in Colorado, and closed the fifteenth-floor corporate dining room to all but a few top executives, who were served by white-gloved waiters. Worst of all, Segnar made a string of bad diversification investments. InterNorth was also powerfully motivated by the fact that Irwin Jacobs, a corporate raider, was buying up its shares. Jacobs's looming presence sent Segnar into a panic. He persuaded the board that the only way to make InterNorth "sharkproof" was to make the company bigger and dramatically increase its debt. Buying HNG would accomplish both goals.

Lay and Segnar turned over negotiations to Wing and Rocco LoChiano, Segnar's top deputy. They met at the St. Regis Hotel in Houston and quickly started talking price. At the time, HNG was trading at about $45 per share. LoChiano figured HNG was worth perhaps $60, $65 tops. But Wing, a canny negotiator, took advantage of InterNorth's desperation to strike a deal, and quickly brought the price up to $70 a share. And that wasn't all. Wing demanded that the smaller company's younger management team ultimately end up in charge. Amazingly, LoChiano and Segnar agreed: Lay would replace Segnar, then 57, as CEO and chairman of the combined company after just 18 months. "I think I get this," LoChiano told Wing over a cup of coffee. "We're the rich old ugly guy with all the money, and you're the good-looking blonde." Wing laughed. "Yeah, that's right," he replied.

Just 11 days after the first phone call, the two CEOs won approval for the $2.3-billion deal from their respective boards. From a business standpoint, HNG InterNorth, as it was called, seemed an elegant combination: with 37,500 miles of pipeline, the new $12 billion company would have the largest gas-distribution system in the country, running from border to border, coast to coast. It would have access to the three fastest growing gas markets: California, Texas, and Florida. And it had some $5 billion in debt, surely more than enough to put it safely beyond the reach of raiders like Irwin Jacobs. As for Ken Lay, he wound up with a personal windfall: a $3 million profit from converting his stock and options in the wake of the merger.

Mergers that sound good on paper often wind up facing a far harsher reality. Such was the case with HNG InterNorth. There were two fundamental issues. The first was that almost immediately after the transaction closed, the InterNorth directors came down with a bad case of buyer's remorse. As the implications of the deal sunk in, they began to realize that even though their company was the acquirer, they had pretty much given away the store to the Texans. Why, they now wondered, did HNG come before InterNorth in the new name when InterNorth had been the acquirer? Why was Segnar so quick to agree to give the CEO job to Lay in 18 months? Did it have anything to do with promises of a fat severance package? (Segnar ended up walking away with $2 million.) Why did HNG have almost as many seats (8) on the new board as InterNorth (12)? The more they thought about how they'd been snookered, the madder they got, but they were far angrier at their man, Segnar, than at Ken Lay, whose company had done the snookering.

Among the old-line InterNorth directors, the biggest fear of all was that the Texans were planning to move the company's headquarters to Houston, even though everyone concerned, including Lay, had repeatedly promised that the company would remain in Omaha "for the forseeable future." This wasn't just a matter of jobs (though 2,200 were at stake); it was also a question of civic pride. It quickly became evident that the promises really weren't worth much. Houston, after all, was the center of the U.S. energy business. Once the merger went through, the issue became so heated that the board created a special committee to study the matter. The committee retained the management-consulting firm, McKinsey & Company, to make a recommendation.

The McKinsey consultants, who included Lay's old friend John Sawhill and a young partner named Jeff Skilling, were scheduled to unveil their recommendation to the board on November 11, 1985, a frosty day in Omaha, at the Marriott Hotel. They were indeed going to advise the company to move to Houston. But the meeting quickly took a different turn, and the consultants were told to wait outside. Hours later, Segnar stepped out of the board meeting with tears in his eyes. He shook Sawhill's hand. "I'm leaving InterNorth," he told the consultant.

Afterward, all parties claimed that Segnar had voluntarily resigned. In truth, the meeting had been a bloodbath, and he hadn't really had a choice. Convinced that Segnar had made a series of secret side deals with Lay to betray Omaha, the old InterNorth directors demanded his head. Of course, since the board didn't have another CEO candidate, it also meant that Ken Lay would become chief executive immediately, instead of having to wait the agreed-upon 18 months.

As a counterweight to Lay, the board brought back Bill Strauss as nonexecutive chairman and some even tried to mount a bid to reclaim the company for the River City. But the effort quickly fizzled when Strauss refused to lead the charge and quit after just four months, giving Lay the chairman's title, too. It wouldn't have succeeded in any case, for Lay had quietly won control of the board. A father-son pair of old InterNorth directors, Arthur and Robert Belfer, had lined up behind Lay. Two new directors, appointed after the merger by agreement between both sides, also turned out to be Texas partisans.

Over the next three years, the Omaha bloc was purged, and Lay started packing the board with his own directors, including a powerful Washington lobbyist named Charls Walker—Pinkney Walker's brother—and an old Pentagon friend named Herbert (Pug) Winokur. John Duncan, the HNG director who had hired Lay, became head of the executive committee. And the corporate headquarters? The directors resolved to split the difference, maintaining an executive headquarters in Omaha and an operating headquarters in Houston. But that arrangement obviously couldn't last long, and it didn't. In July 1986 Lay announced that the company's corporate headquarters would relocate to Houston, to a silver-skinned downtown skyscraper at 1400 Smith Street.

In Omaha, this decision was bitterly resented for years to come.

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There was a second issue looming, of far more consequence than the question of where to put the company's headquarters. It was this: all the good things Ken Lay assumed would happen once the HNG-InterNorth merger took place simply weren't happening. For the moment, Lay's get big fast strategy was only bringing bigger problems.

Irwin Jacobs? Even though the new company was now drowning in debt, the raider and an investor group allied with him still wouldn't go away. Lay wound up having to shell out about $350 million—a modest premium to the market price—to buy out the group's 16.5 percent stake. There wasn't enough cash in the corporate coffers to pay the greenmail, so Lay had to tap the company's pension plan for the money.

Deregulation? All of a sudden, there was a glut of gas on the market, prompting prices to plunge to levels no one had ever imagined. That only multiplied the company's take-or-pay problem. Lay's new business had more than $1 billion in take-or-pay liabilities.

Lay seemed unable to assemble a coherent management team amid bitter political infighting involving not just the old HNG and InterNorth executives but also the pipeline businesses he'd acquired the year before and a handful of well-paid friends that Lay had hired from outside.

Lay even ran into trouble coming up with a trendy new name for the company. After four months of research, the New York consulting firm Lay had hired had settled on Enteron in time for the merged business's first annual meeting, in the spring of 1986. But then the *Wall Street Journal* reported that Enteron was a term for the alimentary canal (the digestive tract), turning the name into a laughingstock. Though it meant reprinting 75,000 covers that had already been printed for the new annual report, the board convened an emergency meeting and went with a runner-up on the list: Enron.

Oh, and just for good measure, Lay had to battle the government of Peru, which nationalized the company's Peruvian production assets just a month after he'd become CEO. That alone produced a $218 million charge to earnings.

In early 1986 Enron reported a loss of $14 million for its first year. Lay announced a series of cost-cutting measures and job cuts. He froze pay for top executives and started selling off assets to cut debt, including 50 percent of the Florida pipeline he purchased just two years earlier.

Enron's financial situation had grown so dire that by January 1987 Moody's had downgraded its credit rating to junk status. One former executive recalls that during this period there was even worry about meeting payroll. "The company was in deep shit," Bruce Stram, then vice president of corporate planning, says.

What Ken Lay and Enron desperately needed was a fresh source of profits—while there was still time.

CHAPTER 2

"Please Keep Making Us Millions"

Not every part of the old InterNorth wound up being relocated to Houston; at least one small division stayed right where it was. That unit was InterNorth's oil-trading business, which had its offices in a suburb of New York City, in a small town called Valhalla, about an hour's drive from Wall Street. Enron Oil, as it was renamed, wasn't anything like the rest of the company's gritty industrial operations. It was "the flashy part" of the business, as one employee later put it.

After the merger, Enron tucked Enron Oil away in a division that was a hodgepodge of businesses with little in common other than that they all made some of their money outside the United States. In Enron's financial reports, earnings from the oil-trading operation weren't broken out separately, and Enron didn't talk up its oil trading to Wall Street analysts or investors. But that only heightened the importance of the operation internally. The traders were a kind of secret weapon in the ongoing struggle to improve Enron's financial appearance. For unlike most of the rest of Enron, oil trading actually made money. Internal financial reports often bragged about the profits the traders were producing.

In more than location, the oil traders were closer to the freewheeling world of Wall Street than to the slow-moving, capital-intensive, risk-averse world of natural gas pipelines. Oil trading was about *trading*, not about oil. It was pure speculation: the oil traders came to work every day and made bets on the direction of crude oil prices. Enron's top brass knew very little about how the trading operation worked, and, if truth be told, they didn’t much care. Oil trading looked like fast easy money, and that’s all that mattered.

Of course, easy money is rarely as easy as it looks; such was the case with Enron’s oil trading division. By the time Ken Lay and his minions in Houston realized something was horribly wrong—more accurately, by the time they were willing to face up to what they should have seen all along—the oil traders had come within a whisker of bankrupting the company. And Wall Street had its first indication that Enron and its leader didn’t always play by the rules that were supposed to apply to publicly held corporations. Although it took place a long time ago, it seems obvious now that the Enron Oil scandal was the canary in the coal mine.

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The man who created Enron Oil was named Louis Borget. Within Enron, he was a shadowy figure who divulged as little as possible about the details of his operation and kept a wary distance from Houston. To most Enron employees—even most of the top executives—he was little more than a voice at the other end of the telephone line, cryptically telling them that everything was just fine.

Borget was born in 1938 in New York, the son of an abusive, alcoholic father. According to court documents, he shined shoes to make money for his family at the age of nine. A brilliant student, he graduated from high school by the time he was 16. From there, he joined the army, where he learned to speak fluent Russian, then put himself through night school at New York University. In 1964, he took a job with Texaco, where he slowly rose through the ranks, becoming special assistant to the chairman and later running a small division. But after 17 years with Texaco, he abruptly left the oil giant, signing on with a company called Gulf States Oil and Refining, which wanted him to set up an oil-trading division. Three years after that, in January 1984, InterNorth came calling, asking him to set up *its* oil-trading subsidiary and offering him a lucrative package, which included Wall Street–style bonuses based on whatever profits he brought in. By the time of the InterNorth-HNG merger, Borget’s operation was about a year and a half old.

Back then, oil trading was the hot new thing, both on Wall Street and in the oil patch. The big oil companies had long traded contracts promising to deliver oil in the future. This was a way to lock in a profit and mitigate the risk that oil prices would rise or fall. But the business had been limited by a couple of factors. For one thing, there was no standard contract for oil, which meant that the details of every trade had to be hammered out separately. And second, these contracts, by definition, meant that a cargo of oil would be delivered (or received) at a certain time in the future. Because there was so little trading—so little liquidity, as they say in the business—there was little opportunity and a lot of risk for those who didn’t actually want to take possession of the oil. These factors tended to keep most speculators away.

In 1983 the New York Mercantile Exchange began to trade crude oil futures, in effect, a standard version of these contracts. Yes, the contract still theoretically came with the obligation to deliver, or receive, oil in some future month. But now that there was a standard contract, it could be traded many times over before anyone had to receive any oil. (If, indeed, oil was received at all: many times, the contracts were settled financially.) Suddenly oil looked a lot like other commodities, such as soybeans or pork bellies, or a financial instrument, like a stock or a bond. Suddenly, you could speculate in the stuff.

As a general rule, trading begets more trading. As a market becomes liquid—meaning that it’s easier to find a willing buyer or seller—it attracts more participants. That further increases the liquidity, which further attracts new participants. Fueled by this so-called virtuous circle, the oil-trading business exploded in the mid-1980s. Texaco and the other major oil companies were no longer content to trade merely as a price hedge. Now they hoped to make money purely on the act of trading. It wasn’t long before they all had trading desks. And it wasn’t just the energy industry that piled in. Wall Street firms like Drexel Burnham

Lambert (whose most famous employee was Michael Milken) and Goldman Sachs jumped into the business. So did many less reputable players, sketchy fly-by-nighters who saw a chance to make quick profits. By some accounts, those early years in the oil-trading business were wild and woolly. There were all kinds of little scams being run, even by the reputable trading firms. Yet there was also a seemingly limitless opportunity to make money.

Borget, for his part, loved playing the role of a big-time oil trader. He kept Dom Pérignon and caviar in the office refrigerator for afternoon toasts. He and his traders dressed casually—Borget would even wear jeans—before the term business casual was widespread. They all drove company cars and ate daily catered lunches. A former trader named David Ralph Hogin recalls that Borget drove a Mercedes; when Hogin asked for a Mercedes, too, he was told that "Lou's the only one who has a Mercedes. Would you settle for a Cadillac?" Enron Oil's offices in Valhalla were sleek and modern and sheathed in glass, a far cry from the more modest quarters favored by energy industry executives. Borget himself could be charming, but he also could be intimidating; he had an odd combination of corporate polish and a trader's swagger. "He was very intelligent, very imposing, sophisticated, and slick," recalls someone who knew him then. Traders were loyal to him; they liked both his unflappability and his steadfastness in sticking by his trading decisions.

"We were the golden-haired boys in the Enron fold," recalls Hogin. In 1985, the year of the InterNorth-HNG merger, Borget's group made $10 million. The following year—a year when Enron's ongoing business lost money—the oil traders made $28 million for the company. That year their bonus pool was $9.4 million, to be split among just a handful of traders. (Borget kept the lion's share for himself.) And there was every expectation that Borget and his crew would keep pumping profits into the company. As Borget himself put it reassuringly, in a 1986 report he prepared for the Enron board: oil trading "as done by professionals in the industry today, using the sophisticated tools available, can generate substantial earnings with virtually no fixed investment and relatively low risk. . . ." In other words, it was the perfect modern business.

Or was it?

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The first sign that Enron Oil might not be what it appeared came in early 1987. On the morning of January 23, David Woytek, the head of Enron's internal audit department, received a startling phone call from someone at the Apple Bank in New York. An Enron account had been opened by a man named Tom Mastroeni. Mastroeni was a nervous yes-man who served as the treasurer of Enron Oil. Wire transfers amounting to about $5 million had been flowing in from a bank in the Channel Islands, and over $2 million had flowed out to an account in Mastroeni's name. Alarmed, Woytek immediately called Enron's general counsel, Rich Kinder, who was rapidly becoming Ken Lay's most trusted lieutenant.

Kinder told Woytek to track down Borget's nominal superiors, John Harding and Steve Sulentic, who oversaw Enron Oil from Houston. While Woytek tried to track down the two men, his deputy, John Beard, made another frightening discovery: the Apple Bank account could not be found anywhere on Enron's books. To the auditors, this reeked of disaster. Beard jotted his worst fears in his notes: "misstatement of records, deliberate manipulation of records, impact on financials for the year ending 12/31/86."

But according to internal documents, court testimony, and notes detailing these events, Sulentic and Harding had an explanation for the whole thing. The Apple Bank account was part of a tactic Borget had used to "move some profits from 1986 into 1987 through legitimate transactions," Woytek noted in a memo; Borget had done so because "Enron management had requested" it. Nor was this the first time that Borget had shifted profits. Since 1985, the oil trader had been setting up prearranged deals with other entities—they had names like Isla, Southwest, and Petropol—that in essence allowed Enron Oil to generate a loss on one contract then have the loss cancelled out by a second contract that would generate a gain in the same amount. Using this technique, Borget had repeatedly moved income from one quarter to another. In his memo, which he sent to Lay and other Enron executives, Woytek described this as the creation of "fictitious losses."

Harding now insists that whatever happened was not profit shifting, just the "prepayment of expenses," and that he believed Borget's actions were perfectly legal. But in testimony given over a decade ago, Borget said that Harding asked him to shift profits, originally for tax reasons. He also said that Harding approved bonuses as if the shifted profits from Enron Oil had remained in the year in which they were earned. For his part, Sulentic later testified that Enron Oil and other subsidiaries were "routinely instructed by Enron senior management to shift profits from month to month and year to year."

It was easy enough to understand why Enron would want to do this: like every public company, it hoped to show Wall Street that it could produce steadily increasing earnings, which is what the stock market rewards. Indeed, lawyers later charged that Enron used the profit shifting for precisely that purpose. But it also had a more pressing reason: Enron's ability to get bank loans absolutely depended on its ability to show earnings. Under the terms of its long-term bank debt, Enron was required to produce a certain amount of income every quarter, at least 1.2 times the interest on its debt. What's more, because Enron was so strapped for cash, it constantly needed new loans to pay back maturing loans. In 1986, for instance, Enron had over $1 billion in commercial paper—short-term loans that mature quickly—that needed to be refinanced. With all its mid-1980s problems, Enron was constantly on the verge of being in violation of its loan agreements. As Lay put it in an Enron annual report about that time: "The present business climate provides no margin for error."

Later, in court testimony, Borget described Enron Oil as "the swing entry to meet objectives each month." Extra earnings in one quarter didn't do Enron much good—unless the income could somehow be deferred to help the company meet its targets in the next quarter. It was all very logical, really. Profit shifting can be done legally—though even then it amounts to earnings manipulation. What subsequent events showed was that no one wanted to dig deeply enough to see if Borget and Mastroeni were staying on the right side of the law.

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On February 2 Borget and Mastroeni were summoned to Houston. They met in the office of a man named Mick Seidl, an old Ken Lay buddy who had followed Lay from Florida Gas to Enron and served as his number two. Woytek and Beard, the internal auditors, were there, as were a number of Enron's senior executives, including Kinder, Harding, and Sulentic. (Some people remember Lay being present; Harding says he wasn't there.) Sulentic defended the transactions. In a memo he wrote summarizing his views, he argued that Enron Oil's Apple Bank account, and its transactions with Isla, Southwest, and Petropol "represents a sincere effort on their [Borget and Mastroeni's] part to accomplish the objective of a transfer of profitability from 1986 to 1987." He did concede that the methods Borget and Mastroeni had used were "not acceptable," but he didn't recommend any sort of punishment, not even a public admission of what had happened.

Next up was Mastroeni. While admitting that he had diverted funds to his personal account, he insisted that it was merely part of the profit-shifting tactic and that he had always intended to repay the money. He presented bank statements, however, that the auditors knew had been doctored, because they had gotten the original documents from Apple Bank. What was Mastroeni's explanation? He and Borget had paid a bonus to a trader and didn't want to have to explain it to corporate executives. Stunningly, most of the Enron executives in the room appeared to accept Mastroeni's explanation. Mastroeni wasn't even reprimanded. Neither was Borget. Says an Arthur Andersen accountant who was involved, "No one pounded the table and said these guys are crooks. They thought they had the golden goose, and the golden goose just stole a little money out of their petty cash."

Still, the internal auditors continued to dig. They discovered a $7,800 deposit into the Apple Bank account from the sale of Borget's company car. There were payments totalling $106,500 to an M. Yass. Was this a play on "My ass?" Not at all! Borget said he was an English broker who had faciliated the bonus to the Enron trader; Mastroeni claimed he was a Lebanese national. They searched directories of trading organizations looking for the names Isla, Southwest, and Petropol and came up empty-handed. They went to Valhalla but didn't get very far. Finally, they got the word: they were to return to Texas and turn the investigation over to Enron's accountants at Arthur Andersen. "Fieldwork . . . not completed based on advise [*sic*] from Houston," jotted Beard at the time. There was no doubt by then what the auditors thought of the Enron Oil operation. "They were a bunch of scam artists," one of them said years later.

For the next few months, the Arthur Andersen team took up the investigation, but they didn't get much further than the internal auditors did. The Enron executives were terrified of offending Borget. Before the accountants went to Valhalla to interview Borget, Seidl sent the head oil trader a memo detailing Andersen's concerns so that he would be better prepared to address them. After one conference call among Arthur Andersen, Seidl, and Borget, Seidl sent a telex to Borget. "Lou," it read. "Thank you for your perservance [*sic*]. [Y]ou understand your business better than anyone alive. Your answers to Arthur Andersen were clear, straightforward, and rock solid—superb. I have complete confidence in your business judgment and ability and your personal integrity." Then he added, "Please keep making us millions. . . ."

In late April, Arthur Andersen discussed its findings with the audit committee of the board. The accountants told the board that they "were unable to verify ownership or any other details" regarding Enron Oil's supposed trading partners. They noted that the Apple Bank transactions had no purpose beyond shifting profits. And they'd found a few other troubling things. For instance, Enron Oil was supposed to have strict controls to prevent the possibility of large losses; its open position in the market was never supposed to exceed 8 million barrels, and if losses reached $4 million, the traders were required to liquidate the position. Yet when the Arthur Andersen auditors had tried to check whether Enron Oil was complying with the policy, they later reported, they discovered that Borget and Mastroeni had made a practice of "destroying daily position reports."

Still, Andersen refused to opine on the legality of what had come to be known internally as Borget and Mastroeni's "unusual transactions," claiming that it was beyond their professional competence. Nor were the auditors willing to say whether the profit shifting had a material effect on Enron's financial statements. Both things would require the company to disclose the transactions to the Securities and Exchange Commission, restate its earnings, and face possible sanctions from the IRS. Instead, the auditors said, they were relying on Enron itself to make those determinations. And Enron did. Arthur Andersen noted that the firm had received a letter from Rich Kinder and another Enron lawyer concluding that "the unusual transactions would not have a material effect on the financial statements . . . and that no disclosure of these transactions is necessary."

And that, stunningly enough, was that. According to the minutes of that same board meeting, "Dr. Jaedicke called upon management for a matter that involved Enron Oil Corporation that was investigated by the company and subsequently investigated by Arthur Andersen. . . . After a full discussion, management recommended the person involved be kept on the payroll but relieved of financial responsibility and a new chief financial officer of Enron Oil Corporation be appointed. The committee agreed with reservations. . . ."

"Management," says Woytek, was Lay—who openly said at the board meeting that the traders made too much money to let them go. And the new watchdog chief financial officer was none other than Steve Sulentic, who, once he moved to Valhalla, reported to Borget. "Dr. Jaedicke" referred to Dr. Robert

Jaedicke, then the dean of the Graduate School of Business at Stanford and the head of Enron's audit committee.

Two months later, what lawyers later called a "whitewash" was completed when an Enron lawyer wrote a memo—which Kinder eventually sent to the board—concluding that the profit-shifting deals were "legitimate common transactions in the oil trading business" and that they did not "lack economic substance." In other words, there was no reason to report the transactions to the outside world. It was an absurd position to take, given that an in-house auditor had called the transactions "fictitious." But not terribly surprising. As one lawyer on the Enron side remarked many years later, "Enron knew they were crooks. But they thought they were profitable crooks."

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As it turned out, Borget and Mastroeni weren't engaging in criminal acts just for the good of the company. They were stealing from Enron as well. They were keeping two sets of books, one that was sent to Houston and one that tracked the real activities of Enron Oil. They were paying exorbitant commissions to the brokers who handled their sham transactions and demanding kickbacks. The so-called counterparties—Isla and Southwest and Petropol—weren't legitimate trading entities. They were creations of Borget and Mastroeni, phony companies they set up in the Channel Islands. Mastroeni's Apple Bank account was indeed one of the places he and Borget were hiding money they had skimmed from the company. In total, the two men and the other brokers stole some $3.8 million from Enron. And with Ken Lay and the other Houston executives so willing to look the other way, they would have gotten away with it, too, except that they made the one mistake Enron couldn't abide. They stopped making money.

Back in Houston there had always been a few executives who were skeptical of the oil traders. One was Mike Muckleroy, the head of Enron's liquid-fuels division and a former naval officer. An experienced commodities trader, Muckleroy had begun to hear rumors in mid-1986 that Enron Oil was making massive bets on the direction of oil prices. One thing that had long seemed obvious to Muckleroy was that Enron Oil had to be ignoring the trading limits that were supposed to prevent the traders from huge losses. Nothing else made sense. After all, the limits didn't just keep losses under control; they also had the inevitable effect of limiting gains as well. To Muckleroy, it just didn't seem possible that the Enron's oil traders could be racking up their eye-popping profits without exceeding their trading limits. He took his worries to Seidl, who scoffed and replied that Muckleroy must be jealous of Borget's bonus.

The rumors wouldn't go away. At least a half dozen times, Muckleroy says, he pressed his concerns with Seidl. Finally, Seidl sent him to Lay. But the Enron CEO was no more interested in looking into it than Seidl had been; he told Muckleroy that he was being paranoid. "What do I have to do to get you to understand that this could do devastating damage to our company?" Muckleroy asked Lay. Then, in the summer of 1987, Muckleroy began to hear from friends in the business, as he later recalled, "that we were huge on the wrong side of a trade." But so unconcerned were the Enron brass that at the company's mid-August board meeting, the Enron board *increased* Borget's trading limits by 50 percent. One skeptical Enron executive who attended that meeting returned to his office and told a colleague: "The Enron board believes in alchemy."

It wasn't until October that the truth began to come out—and then only because there was simply no way to hide it any longer. On October 9, 1987, Seidl met Borget for lunch at the Pierre hotel in Manhattan. It was supposed to be a social lunch; Seidl's wife was upstairs in her room, waiting to join them. But as soon as Borget explained the situation to Seidl, he immediately called his wife and told her to stay put. He spent the rest of the lunch trying to absorb what Borget was telling him. For months, Borget had been betting that the price of oil was headed down, and for months, the market had stubbornly gone against him. As his losses had mounted, he had continually doubled down, ratcheting up the bet in the hope of recouping everything when prices ultimately turned in his direction. Finally, Borget had dug a hole so deep—and so potentially catastrophic—that there was virtually no hope of ever fully recovering. Borget was confessing because he had no choice.

This time, Seidl understood the gravity of the situation. He called Houston immediately after the lunch and, in a panicked tone, declared that as a result of Borget's trading losses, Enron was "less than worthless." Within two hours, he was on a plane to Newfoundland to meet Lay, who was returning from Europe and had to stop there to have his jet refueled. In Houston, Muckleroy was on his way back from lunch when he was confronted by an ashen Rich Kinder, who had just talked to Seidl. Muckleroy hopped on the next plane to New York to see if there was any way he could salvage the situation.

Muckleroy quickly discovered that things were far worse than anyone realized. Enron Oil was short over 84 million barrels. The position was so huge that it amounted to roughly three months' output of the gigantic North Sea oil field off the coast of England. If Enron were forced to cover its position, it would have been on the hook for well over $1 billion. "Less than worthless" was exactly the right description: when you added $1 billion-plus to Enron's $4 billion in debt, the company's total debts outstripped its net worth. And, of course, given how strapped the company was for cash, there was simply no way it could cover its trading losses without filing for bankruptcy.

But Enron got lucky. Exactly the right person had gone to Valhalla to take charge of the problem. Experienced commodities trader that he was, Muckleroy took one look at Enron Oil's books and sat Mastroeni down. "Unfortunately, I've had to kill people in my past," he told the terrified treasurer, "and I sleep like a baby." He demanded to see the real books. At eight the next morning, Mastroeni produced them. Muckleroy told Borget to leave the premises and asked Enron's security officer to change the locks on the doors. Then he went to work.

For the next three weeks, he and a small team of traders worked 18- to 20-hour days. His goal was to shrink the size of the position so that when the company finally had to settle up, the loss would at least be manageable. His only hope was to bluff his way out of his dilemma; if other traders knew what trouble Enron Oil was in, they were likely to bid the price of oil even higher, then demand payment. To fool them, Muckleroy pretended that Enron had crude oil in hand; he even bought some to sell into the market. The bluff bought him time. Within a few days, oil prices began to decline. Or at least they fell enough that Muckleroy and his team were able to close down Enron Oil's positions, reducing the damage to the company to around $140 million. That still hurt, but it was no longer life-threatening. "If the market moved up three more dollars Enron would have gone belly up," Muckleroy later said. "Lay and Seidl never understood that."

After almost a year of pretending in the face of overwhelming evidence that nothing was awry at Enron Oil, Ken Lay and the other Enron executives now had to pretend the opposite: that they were shocked—*shocked!*—by the actions of these rogue traders. The company announced that it would take an $85 million after-tax charge to 1987 earnings and blamed it on "losses from unauthorized trading activities by two employees in its international crude oil trading subsidiary." As rumors of the fiasco had trickled out, Enron's stock began to fall; by the time of the October announcement it was down 30 percent. But now Lay insisted to Wall Street analysts that this was a freak event that would have no long-term effect: "I would not want anyone to think at any time in the future this kind of activity would affect our other businesses," he said.

At an all-employee meeting in late October, Lay told the crowd that he had been blindsided by Borget. "If anyone could say that I knew, let them stand up," he said. Two people had to physically prevent Muckleroy from standing. At a board meeting held to discuss the loss, Lay again denied any responsibility, according to one person who was there. Lay also played dumb with Enron's bankers, who were infuriated when they learned of the trading losses. As well they should have been. For at the same time the scandal was unfolding internally, Enron was in the midst of raising money from its banks. The deal closed just before Enron announced the $85 million charge but well after the company knew about the problem. “Everyone went apeshit,” recalls one banker. “They felt like they were lied to.” Well, they *had* been lied to.

The most ironic part of the aftermath was a massive suit Enron filed against Borget, Mastroeni, and a handful of others alleging a conspiracy to “defraud” Enron through what it now called “sham trades” with entities like Isla, Southwest, and Petropol, among others. Nobody at Enron was calling trades with these entities “unusual transactions” anymore. Defense lawyers for other trading companies argued that Enron was merely playing the victim to cover up its own complicity. “Any honest competent management, confronted with the conduct of Borget and Mastroeni, as revealed to Enron’s senior management in January 1987, would have fired these gentlemen without delay,” wrote one lawyer. (The suits were eventually settled.)

There were also investigations by both the SEC and the U.S. attorney’s office, but it seems that Enron got lucky once again. The investigations focused on the phony transactions Borget and Mastroeni had concocted to shift profits from quarter to quarter, transactions that several Enron executives had encouraged and that several others, including Ken Lay, had condoned after the fact. Yet for reasons that mystify many lawyers involved in the case, the government chose not to prosecute the company. In early 1988 Enron restated its financials for the previous three and a half years, blaming “unauthorized activities . . . designed to shift income.”

In addition to charging both Borget and Mastroeni with fraud and personal income tax violations, the U.S. attorney charged Borget with “aiding and assisting the filing of a false corporate income tax return” by hiding income with “sham transactions.” But, said the government, “there is no indication that Enron knew the information supplied by Borget and contained in the consolidated tax return was false.” Of course, anyone who poked around could have found plenty of indications. In early 1990 Borget pled guilty to three felonies and was sentenced to a year in jail and five years’ probation. (When reached by telephone, he said, “My memory is fading, and I don’t have much to say about an episode that is painful.”) A month later, Mastroeni pled guilty to two felonies. He received a suspended sentence and got two years’ probation. But by then, the Enron Oil scandal had long been forgotten.

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Inside Enron, there was a second, less public kind of aftermath: the scandal marked the rise of Rich Kinder as a force inside the company. Mick Seidl had become the company’s number two man largely on the strength of his friendship with Lay. He had much in common with Lay: he was a former academic with a Ph.D. in economics and a former government policy maker who had worked with Lay at the Interior Department in the early 1970s. But Seidl also shared other tendencies with Lay. He had a terrible time making decisions that might anger somebody. And he was far more interested in the glamour of being a corporate executive than in the hard work of making the company profitable.
He wanted to be Mr. Outside, but Enron already had a Mr. Outside: Ken Lay himself.

Kinder was the opposite. Where Seidl was weak, Kinder was tough. Where Seidl was forgiving, Kinder was demanding. Where Seidl was easily flustered, Kinder was decisive. Even though his title was only general counsel, Kinder had a natural authority that other Enron executives lacked. Unlike Seidl, Kinder was the perfect complement to Lay. “Ken isn’t the kind of guy to take people to the woodshed the way he needed to,” says one former executive. Nobody ever said that about Kinder.

Like Seidl, Kinder had known Ken Lay a long time, since college, in fact, where their girlfriends (later their first wives) were sorority sisters and best friends at the University of Missouri. But after graduation, their paths diverged. Kinder earned a law degree, served a stint in the army, and returned to the small Missouri river town where he was raised, Cape Girardeau, to practice law (in a firm run by Rush Limbaugh's father). He also had an entrepreneurial streak. By the late 1970s he was a partner in a local racquet club and owned a bar called the Second Chance, as well as a Howard Johnson's Motor Lodge and some apartment buildings. But his real estate investments proved disastrous: in late 1980 Kinder was forced to file for Chapter 7 bankruptcy protection; he listed $2.14 million in debts and just $130,750 in assets. Kinder and his wife Anne claimed to have just $100 in cash.

Bill Morgan, a third University of Missouri buddy who had gone to work for Lay at Florida Gas, rescued his old college friend, hiring him as an in-house lawyer. When Lay bought Florida Gas's pipeline business shortly after becoming CEO of Houston Natural Gas, he also brought Kinder to Houston and soon named him Enron's general counsel.

There was no secret why Kinder stood out: he got things done. He had rough edges—one person who worked with him called him "smart, rough and tumble, and selfish"—but they worked to his advantage. People were afraid of him. "You didn't mess with Rich Kinder," recalls another former executive. "If you messed with Rich Kinder, he was going to cut you to shreds." Another adds, "Rich was a mean son of a bitch. You didn't want to cross him. But he imposed the kind of discipline we didn't have before, which we really needed." A Churchill fanatic and history buff, Kinder would walk around the office chomping on an unlit cigar, striking fear into the hearts of Enron executives.

In August 1987 Lay moved Kinder out of the general counsel's office and gave him the title chief of staff. In effect, he was designating him the company's chief problem solver. And though it was another three years before Kinder became chief operating officer, replacing Seidl, who'd left the company in 1989, he took unofficial charge of Enron well before then. There is one meeting in particular that everyone at Enron remembers as marking the moment Kinder became the boss. In the Enron mythology, it came to be known as the Come to Jesus meeting.

The meeting took place in 1988. The Enron Oil scandal was no longer on the front burner, but the company was still plagued with problems. After the InterNorth-HNG merger, Lay had hired lots of his old cronies. They had ill-defined jobs and a line straight to the man who had hired them. Morale was terrible. Backbiting had become part of the Enron culture. Power plays were a daily occurrence. And it was nearly impossible for the company to act decisively, because executives felt they could always get Lay to reverse a management decision. All the politicking had practically paralyzed the company.

Lay was also at the Come to Jesus meeting. He made a few tepid remarks about how the company needed to embrace gas deregulation. But mostly this was Rich Kinder's show. *"Enough of this!"* he declared, and then he lit into the group. He was tired of the chaos, tired of people going behind his back to Lay, tired of the constant complaints and excuses about why the company wasn't doing better. And it was going to stop. The company's problems were like alligators, he growled. "There are alligators in the swamp," he said. "We're going to get in that fucking swamp, and we're going to kick out all the fucking alligators, one by one, and we're going to kill them, one by one." And on that note, the meeting ended.

CHAPTER 3

"We Were the Apostles"

In the aftermath of the Come to Jesus meeting, things did settle down at Enron, thanks largely to Rich Kinder. He took on the tough job of paring costs, he found ways to pay down some of the crushing debt, and he helped Enron negotiate its way out of the take-or-pay crisis with surprisingly little financial pain. By the end of 1988 Enron was even back in the black, earning $109 million.

But it wasn't a sustainable profit. In fact, without onetime gains from selling assets and stock it held in other companies, Enron would have declared another loss. The big problem still remained, and it wasn't going to go away no matter how many alligators Kinder killed. Enron was still a company in search of a future. Ken Lay had gotten into the pipeline business in the first place because he believed deregulation was inevitable and felt sure there was money to be made in a deregulated industry. He was right about the first; by the late 1980s, wholesale deregulation had largely arrived. But neither he nor Kinder nor anyone else at Enron had the foggiest idea how to create a brand-new business model, one that could make a big profit in this new world. What Enron needed—indeed, what the entire natural-gas industry needed—was someone who could show them the way.

And, lo and behold, there he was.

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For better or worse—and over the years it would be both—Enron found its visionary in Jeffrey Skilling. When Skilling looked at the natural-gas industry, he didn't see natural gas. Instead, he saw the needs of customers on one side and the needs of suppliers on the other—and the gaps in between where, he believed, serious money could be made. To put it another way, he saw the ways in which the natural-gas industry resembled commodity businesses like wheat and pork bellies and especially financial services, where money itself is the commodity. That no natural-gas executives shared his vision didn't bother Skilling in the least; other energy executives, he believed, were hidebound, unimaginative, and hemmed in by the past. Never having worked in the industry before joining Enron—never having run *any* business before joining Enron—Skilling felt no such constraints. He fervently believed that he saw the way the industry should operate, and for him, "should" and "would" were pretty much the same. Over time, his way of thinking not only reshaped Enron, it helped revolutionize the entire natural-gas industry.

In part, Skilling's influence can be explained by his particular brand of intelligence. When people describe Skilling they don't just use the word "smart"; they use phrases like "incandescently brilliant" or "the smartest person I ever met." Skilling in the late 1980s wasn't a physically striking man—he was smallish, a little pudgy, and balding—but his mental agility was breathtaking. He could process information and conceptualize new ideas with blazing speed. He could instantly simplify highly complex issues into a sparkling, compelling image. And he presented his ideas with a certainty that bordered on arrogance and brooked no dissent. He used his brainpower not just to persuade but to intimidate.

Without question, Skilling's formidable intelligence had a lot to do with turning Enron into a company that was successful—at least for a while. But he also had qualities that were disastrous for someone running a big company. For all his brilliance, Skilling had dangerous blind spots. His management skills were appalling, in large part because he didn't really understand people. He expected people to behave according to the imperatives of pure intellectual logic, but of course nobody does that (including, it should be said, Skilling himself). One former top executive recalls arguing with him constantly, struggling to explain, "Jeff, people will do things just because they're people."

Skilling also had a tendency to oversimplify, and he largely disregarded—indeed, he had an active distaste for—the messy details involved in executing a plan. What thrilled Skilling, always, was the intellectual purity of an idea, not the translation of that idea into reality. "Jeff Skilling is a designer of ditches, not a digger of ditches," an Enron executive said years later. He was often too slow—even unwilling—to recognize when the reality didn't match the theory. Over time his arrogance hardened, and he became so sure that he was the smartest guy in the room that anyone who disagreed with him was summarily dismissed as just not bright enough to "get it."

And there was one other thing about Skilling. For all his analytical abilities, he was a gambler at heart and had been from an early age. He always assumed that he could beat the odds. In the end, that was Skilling's most dangerous blind spot of all.

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Like many of the other major players in the Enron saga, Jeff Skilling made his way to the top of American business by sheer force of will. He wasn't poor the way Ken Lay was poor, but his family lived on the thin line that separates the working class from the middle class. He grew up feeling that he couldn't ask his parents for money, because they didn't have much. As a result, making his own way financially was always important to him.

Born in Pittsburgh in 1953, when that city was still the heart of America's industrial economy, Skilling was the second of Betty and Thomas Skilling's four children. His father was a salesman for a company that made large valves for heavy machinery. When Skilling was just a baby, the family moved to Westfield, New Jersey, where his father had been transferred and where he later bought a lovely house that was beyond his means. In 1965 his father changed jobs, and the family moved again, this time to Aurora, Illinois, a blue-collar town at the end of the Chicago commuter rail line. For the children, who had loved the woods behind their New Jersey home, the move was traumatic, all the more so because their father was already working in Aurora and couldn't come back to help them move. So the four children and Betty drove across the country. His younger sister, Sue, remembers Skilling sitting in front of the Rambler station wagon, helping his mother read the map, and filling water bottles at gas stations to keep the old car from overheating.

To a surprising degree, considering that he became a business celebrity, Skilling was a wallflower in high school. Aurora was a quintessentially midwestern football town, and he was a smart kid, not a jock. He has described himself as a "bit of a loner," and apart from brief stints on the school paper and the student council, Skilling wasn't actively involved in the life of the school. Today, former classmates remember his older brother, Tom, far more vividly; the older Skilling boy, who used to do weather updates over the PA system in grade school and by age 15 on local radio, is now a Chicago TV weatherman. Though Skilling made National Honor Society his junior and senior years and graduated sixteenth of a class of 600, he later told friends that school was "sheer boredom." His childhood was unhappy; one friend describes him as "a tortured soul."

He found his solace in work. Soon after moving to Aurora, he got a job at a start-up local TV station. His first duties were cleaning out 40-odd years of accumulated debris from the old Moose Lodge, where the new station was housed. He painted the walls. Then, as each piece of equipment arrived, Skilling learned to operate it. When the production director quit, Skilling took his job. He was 14 years old. After school, his mother would drive him to the TV station, where he would stay until midnight. Throughout his high school years, he worked upward of 50 hours a week.

When Skilling was applying to college, his father took him to see his alma mater, Lehigh University, in Bethlehem, Pennsylvania. From the school, Skilling could stare down into the valley upon acre after acre of aging, decrepit steel mills, many of them boarded up and abandoned. Skilling had an immediate visceral reaction to the sight: this, he thought, was what he was trying to get away from. Not long afterward, he visited Southern Methodist University in Dallas, which dangled the prospect of an engineering scholarship in front of the young midwesterner. The sun was shining, the campus was neat, and the girls were out in their bathing suits. Perhaps most important, there were no aging steel mills anywhere. “They’re going to pay me to go here?” he thought. At a place like SMU, a person could start fresh. Though he was only 17, that’s what Jeff Skilling wanted to do.

Even though he had a scholarship, Skilling still had to work in college;
despite all the money he’d made in high school, he was flat broke. The problem wasn’t that he’d spent it; no, he’d lost it playing the stock market. Today, of course, that’s hardly likely to raise eyebrows. Lots of people, including teenagers, got caught up in the market in the late 1990s and lost money as the bull market soured. But it was different in the 1960s and early 1970s. The stock market had not yet become part of daily life in America, and a teenager putting his money in the market was almost unheard of. Skilling, though, poured all the money he’d made at the TV station—more than $15,000—into shares of his father’s employer, a company called Henry Pratt. He got in at $8 to $9 a share, and for a while, the stock was a winner, going as high as $25 a share. Convinced that the stock was headed even higher, Skilling borrowed thousands against his stake to buy a car. But then came the bear market of the 1970s, and before long Henry Pratt was at $2; and because he’d borrowed against the stock, Skilling had to liquidate his holdings to pay off the loan. He was soon wiped out.

Most kids would have been chastened by such an experience. Not Skilling. The summer between his freshman and sophomore years, he had a bad accident while working a summer job: a truckload of heavy equipment fell on him, crushing his back. He was in a full body cast for three months, but he came out of it with a $3,500 workers’ compensation check. And once again, he plunged the money into the market, this time the bond market. But he didn’t buy low-risk bonds. Instead, he leveraged his money almost three to one and bought $10,000 worth of deep-discount bonds. Interest rates were sky-high, and Skilling was betting that they’d soon drop. Instead, they kept going up. Skilling started getting margin calls and finally had to sell just two weeks before the rates began to fall. For the second time in less than a year, he was wiped out.

Despite the losses, Skilling’s interest in the market did have one benefit: it led him to business classes. That’s when the lightbulb switched on; once he discovered business, Skilling knew he’d found his intellectual passion. Though he’d dutifully taken his engineering classes, he found them “mind-numbing.” By contrast, business was fun, engaging, even creative. He also thought his engineering background could help him: he could apply scientific logic to business and thereby gain an edge. His GPA in engineering was 2.6. In his senior year, he concentrated on business and got a 4.0. For his entrepreneurship class, he had to read a thesis written by a Ph.D. candidate at the University of Chicago on the subject of converting commodities contracts into tradable securities. To Skilling, it was a thrilling idea, and he never forgot the paper.

Skilling graduated in 1975 but skipped the ceremony to drive to Chicago to marry Susan Long, a fellow midwesterner who was his college sweetheart. Three days later, he returned to Texas and began a job at First City National Bank in Houston. Assigned to the bank’s operations center, he was soon moved to corporate planning. His starting salary at the bank was $800 a month. By the time he left First City, he was making $22,000 a year and was the youngest officer at the bank.

What changed the course of his life—and Enron’s history—was Skilling’s next big gamble. He decided to apply to the country’s most prestigious business finishing school: Harvard Business School. The gamble wasn’t so much that he’d set his sights on Harvard but that he applied nowhere else. It was going to be Harvard or nothing; if he didn’t get in, he thought, he’d just stay in his job and get his MBA at the University of Houston at night. Despite his middling college grades, though, he did get in—because he acted like Jeff Skilling. An interview at Houston’s Hyatt Hotel with the dean, who was meeting candidates about whom the school was on the fence, was going nowhere fast. Then the dean asked, “Skilling, are you smart?” “I’m *fucking* smart,” he replied. Skilling rented a U-Haul truck, drove to Cambridge, and entered the business school in the fall of 1977.

Here at last Skilling was in his element. At Harvard he became a star. He stood out in part because of his brilliance and in part because of his harshly libertarian view of business and markets. The markets, he believed, were the ultimate judge of right and wrong. Social policies designed to temper the market's Darwinian judgments were wrongheaded and counterproductive. And that wasn't all. John LeBoutillier, a Skilling classmate (and later a one-term congressman), remembers one class in which the students were discussing a product that might be—but wasn't definitively—harmful to consumers. The question for the class: what should the CEO do? "I'd keep making and selling the product," replied Skilling. "My job as a businessman is to be a profit center and to maximize return to the shareholders. It's the government's job to step in if a product is dangerous." (Skilling has always denied this story.)

Skilling graduated a Baker Scholar, a coveted honor bestowed upon the top 5 percent of the class. He decided that his talent was "pattern recognition," which meant that he thought he was good at seeing how the techniques used in one industry could be applied to another. Degree in hand, Skilling did one of the appropriately prestigious things that Baker Scholars often do, probably the one thing that best matched his mental proclivities. He joined the nation's bluest-chip consulting firm, McKinsey & Company.

McKinsey was founded in 1926 by a University of Chicago accounting professor named James McKinsey, and the firm has dominated the business of corporate strategic consulting ever since. McKinsey has always had a special aura about it, a sense that it employs only the best of the best, that its management advice is smarter and better than anyone else's, and that its theories are a little akin to tablets handed down from on high. It's a coveted place to work—overachievers who go to work at McKinsey can be comfortable that they will continue to overachieve—and it can also be a stepping stone to other enviable perches. Lou Gerstner, the recently retired CEO of IBM, is one of many former McKinseyites who went on to lead major corporations. The 1982 book *In Search of Excellence*, perhaps the best-selling management tome of all time, was written by two McKinsey partners.

Operating on the belief that intellectual brawn is more important than practical experience, McKinsey prefers to hire new consultants straight out of places like Harvard Business School rather than from industry itself. In fact, it's hard to think of a place that believes in the value of brainpower more than McKinsey. The firm spends a great deal of time sorting out stars from the merely superbright; perhaps not surprisingly, those who prosper there often develop a smug superiority. A McKinsey partner once told *Forbes*: "We don't learn from clients. Their standards aren't high enough. We learn from other McKinsey partners." A McKinsey alum described the firm to a new recruit as a place where "the smartest people in business tackle the most important and challenging issues of the world's leading corporations." Indeed, the firm likes to think of itself as bringing enlightenment to the business world. McKinsey ideas often sound incredibly compelling, even pure, in a way that makes it impossible to believe they could ever be corrupted. But like Skilling himself, McKinsey partners tend to be designers of ditches, not diggers of ditches. When it comes to executing their lofty theories, well, consultants lean toward leaving those messy realities to the companies themselves.

Even by McKinsey standards, Skilling was phenomenally successful, rising through the extremely competitive ranks with almost surreal speed. He started his career in Dallas. Six months later he moved to the Houston office, where he was the third employee. (The Houston office is now one of McKinsey's biggest.) It normally took a successful McKinsey consultant seven years to become a partner and another dozen or more to become a director. Skilling made partner in five years and director in ten; by 1989, he was overseeing the worldwide energy and North American chemical practices. He is still proud of the fact that only a handful of people (they include Lou Gerstner) rose through the ranks faster than he did.

It would be hard to imagine a place that suited Skilling more perfectly. The McKinsey thought process reduced a chaotic world to a series of coolly clinical, logical observations. That's precisely how Skilling thought. McKinsey valued sheer brainpower; he had it to spare. It favored people who were quick on their feet and who could “present well.” That was Skilling through and through. He had a way of turning practical disagreements into abstract arguments and could outdebate just about anyone. “It was difficult to disagree with Jeff because he would elevate the disagreement to an intellectual disagreement, and it was hard to outsmart him,” says a former partner who worked with him.

But McKinsey also played to his weaknesses. Working at McKinsey only heightened his natural arrogance. McKinsey could be a cold place, ruthless in sorting out the stars from the also-rans. Skilling embraced that ruthlessness. The culture rewarded individual achievement, as opposed to teamwork. Skilling was never much of a team player. If he thought he was smarter than someone—and he usually did—he would treat him harshly if he had the temerity to disagree with him. Other McKinsey partners began saying of Skilling, “Sometimes wrong, but never in doubt.”

Ultimately, though, McKinsey was the formative experience of Jeff Skilling’s business life. Though McKinsey has since sought to distance itself from Skilling and Enron, much of what he brought to Enron—not only ideas about how to reshape the natural gas industry but ideas about what companies should value and how they should be run—came out of his experience at McKinsey.

His first goal, upon arriving in Houston as an up-and-coming consultant, was to start a financial services practice. But within a few years, the price of oil, which had skyrocketed during the energy crisis of the 1970s, began to decline, hurting not only the companies that drilled for oil but all the big Texas banks that had loaned them money. Clearly a financial services practice was not going to fly. So he did other kinds of consulting work. According to the *Houston Chronicle*, a study Skilling did of the Houston Fire Department so thoroughly impressed the fire chief that he told Skilling, “You could be the best fire chief in the nation if you ever need a job.” And he did occasional consulting for InterNorth, work that continued after the company changed its name to Enron.

By the late 1980s Skilling was spending about half his time on Enron work. In the process, he was also learning about the natural-gas business; not surprisingly, he was appalled at what he saw. It was, he has said, “the screwiest business I’d ever seen in my life. All the rules were written in Washington. It was like *Alice in Wonderland*.” All true, of course. But it was also true that the industry had to change, and Skilling reveled in that opportunity. “It was fabulous,” he has said. “It was like starting from scratch.” By the late 1980s Skilling was convinced that he had devised an answer—nay, *the* answer—to the industry’s problems. He saw one of those patterns he so liked to recognize. Put simply, he believed the natural-gas business could get out of its predicament by becoming more like the financial-services industry. He called his idea the Gas Bank, and it soon catapulted Skilling into Enron for good.

The biggest single issue facing the entire natural-gas industry was astoundingly basic: the interaction between buyers and sellers. It wasn’t all that long ago, you’ll recall, that gas was sold under long-term contracts between producers, pipelines, and local utilities, with the price set by the government. But by the late 1980s, with the onset of deregulation, some 75 percent of all the natural gas sold in the country changed hands on the spot market during a frantic few days of deal doing at the end of every month.

The problem with such a system was its inherent uncertainty. A sudden cold spell in the Northeast could cause prices to rise overnight, hurting consumers. A wave of warm weather could depress prices, causing the gas producers to lose money. Even though there was a glut of natural gas, big industrial customers couldn’t be sure that they would always be able to lock up as much supply as they needed from one month to the next. And it was a risky bet for a pipeline company to guarantee a long-term supply at a fixed price to a customer because the pipeline couldn’t count on being able to secure a steady supply of gas at a price that would ensure a profit. No wonder many industrial users of natural gas were switching to oil and coal. No wonder they no longer viewed natural gas as a reliable fuel. As for the pipelines, they were struggling to make profits, because the margins on spot-market deals were so low. Indeed, by the late 1980s, Enron was trying to convince the industry to move back to longer-term contracts—just like in the old days, except the price would be negotiated between the parties rather than set by the government.

Enron took the first steps in that direction by setting up a new division called Enron Gas Marketing, which tried to get customers to sign up for long-term deals. In March 1988, for example, Enron signed a 15-year contract with Brooklyn Union to supply 21 million cubic feet of gas a day to a plant being built in Bethpage, New York. The deal was a coup for several reasons. Brooklyn Union agreed to pay a hefty premium to the market price of gas because Enron was willing to guarantee the supply for so many years. Second, Brooklyn Union was not one of Enron's old-line natural-gas customers; in fact, it wasn't even connected to Enron's pipeline system. Enron would have to contract with another pipeline to get the gas to Brooklyn Union. Although deregulation had mandated such "open access" a few years earlier, this was one of the first deals that took advantage of the new rules. But while such a deal diminished the uncertainty for Brooklyn Union, it actually *increased* Enron's risk. If gas prices rose and the contract became unprofitable, that was Enron's problem, not Brooklyn Union's. And Enron was assuming the transportation risk as well; if, for some reason, the Houston company couldn't get the gas to the New York utility, Enron would be liable.

Enter Skilling's Gas Bank. It was nothing less than the first serious effort to diminish the level of risk for everybody involved in natural-gas transactions. The basic idea was this. Producers (acting as depositors) would contract to sell their gas to Enron. Gas customers (the borrowers) would contract to buy their gas from Enron. Enron (the bank) would capture the profits between the price at which it had acquired the gas and the price at which it had promised to sell the gas, just as a bank earns the spread between what it pays depositors and what it charges borrowers. Everybody would be happy. So long as Enron had a balanced portfolio of contracts—that is, contracts to sell gas at a specific price were matched by contracts to acquire gas at a specific price—the spot-market price of natural gas could go crazy and it wouldn't matter. Enron would already have locked in the profits. Just as important, for both sellers and buyers, the uncertainty of the spot market would be replaced by the contractual certainty that Skilling's Gas Bank offered. "The concept was pure intellectually," Skilling has said. "It made all the sense in the world."

In late 1987 Skilling pitched his idea to a meeting of 25 top Enron executives, including Lay and Kinder, in a conference room on the forty-ninth floor of Enron's headquarters in downtown Houston. In classic Skilling fashion, he used just one slide in his presentation—which shocked the Enron executives, who were expecting dozens—and he spoke for less than a half hour. When he had finished, an executive named Jim Rogers declared the idea dumb, and virtually all of the others agreed. In the elevator afterward, Skilling apologized to Kinder for not explaining his concept well. Kinder, chomping on his unlit cigar, replied that when he had heard Rogers call the idea stupid, he knew it was the right move.

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