

Introduction to: McLean, B, and P. Elkind. The Smartest Guys in the Room. New York: Penguin Group, 2004.

Background

Crime takes many forms. Too often in courses like this we concentrate largely on violent and property FBI Part I “serious” crimes. The volume and costs to society of white collar crime, however, are far greater.

White collar crime is different in many ways from street crime. The criminal act itself is sometimes more complex making it harder to understand than a robbery, shootings, or burglary; the time gap between when the offending takes place and the victimization impact occurs is often longer; the difficulties in identifying the number and range of victims are sometimes greater; the certainty with which specific criminal acts can be connected to specific harmful outcomes is often lower; and the allocations of criminal responsibility are much more challenging given a broader institutional structure and regulatory framework within which these crimes often take place.

All of these factors make it more difficult to decide several key matters: how much harm occurred?; how guilty were the perpetrators?; was *mens rea* present?¹

Examples of white collar crimes include defrauding investors and stockholders, as in the Enron case; violations of environmental regulations, sometimes leading to serious health or mortality impacts,² or even community-wide impacts;³ violations of safety regulations;⁴ and much much more.

In past years, I have placed the discussion of white collar crime at the end of the semester. Students have generally disliked the topic, either because of its placement, or because of the readings. So this year, in the perennial quest for improvement, we address the topic at the beginning of the semester, and we use new readings. You will tell me if this was a good idea or a bad idea.

Although the volume of scholarship and research funding on white collar crime as compared to street crime is small in comparison, bear in mind that the study of white collar criminality has a long and distinguished pedigree. In the last century, eminent criminologist Edward Sutherland, one-time president of the American Sociological Association, the author of differential association theory, and of one of the best selling criminology texts of the last century, addressed white collar criminality in his 1939 ASA presidential address. It is highly recommended.⁵

McLean & Elkind start us with an extensive case study of the Enron debacle. At the time of the filing, the Enron bankruptcy was the largest ever in U.S. history. Thousands of Enron employees lost their jobs and their retirement funds. It the backwash Arthur Anderson, one of the most respected accounting firms in the world, shut down, costing thousands more of employees their jobs.

¹ Schlegel, K. Just Deserts for Corporate Criminals. Boston: Northeastern University Press, 1990.

² Harr, J. A Civil Action. New York: Random House, 1996;

³ Bullard, R. D. Dumping in Dixie: Social Justice, Race and the Environment. Second ed. Boulder, CO: Westview Press, 1994; Edelstein, M. Contaminated Communities: The Social and Psychological Impacts of Residential Toxic Exposure. Boulder, CO: Westview Press, 1988.

⁴ Hawkins, K. Law as Last Resort: Prosecution Decision-Making in a Regulating Agency (Oxford Socio-Legal Studies). Oxford: Oxford University Press, 2003.

⁵ Sutherland, E.H. "White-Collar Criminality." American Sociological Review 5.1 (1940): 1-12.

The purpose of starting with a case study is so that you can see how the crimes developed, and the criminal culture deepened, up close and over time, and how others inside and outside the company perhaps aided in this development.

The case study is dizzying in its detail, especially if you were not an econ major as an undergrad, so one of the purposes of this memo is to help orient you to some of the key background and regulatory background.

This book is different from all the other ones we will be reading. All of the other ones develop one specific theoretical model about why crime occurred. This one does not. It is descriptive reporting.

Therefore, in addition to hopefully clarifying some of the relevant economic and regulatory matters, this memo also suggests a broader framework, developed within economic sociology, to help frame the relevant dynamics taking place here.

The piece ends with some key things to think about and write about.

The Economics of Enron

Enron started out as a **natural** gas pipeline company. Companies such as this had assets: pipelines. They could charge producers for moving gas to customers. That required them to negotiate with both producers and customers.

At the time Skilling came to Enron, the natural gas industry was being deregulated. This allowed him to propose innovative business solutions, starting with the **gas bank**.

Not only were the 1980s and 1990s, thanks to Reagan-Bush I, a time of deregulation, the 1990s was also a time of a climbing stock market, also called a bull market. Stock prices went up, sometimes very fast.

Stock shares in publicly traded companies are owned by investors. They buy stock, literally a piece of the company, on the presumption that the company will pay dividends on the stock. Those dividends are called earnings. It is like collecting interest on a loan. You loan the company your money by buying their stock, you get it back with interest, here called a dividend. If you are also lucky the stock price goes up. Your investment in the company climbs in value. That means you can sell it at a profit. Publicly traded stocks are traded through stock exchanges like the NY Stock Exchange.

Regulations and regulatory agencies at the exchange and federal level oversee publicly traded companies. Their job at the exchange is to preserve market integrity, and at the federal level to protect shareholders.

Gas bank

Skilling's first great innovation was the gas bank. It was like a normal bank in some respects. Producers were depositors; they were expected to place gas produced into the bank, in return for a certain rate of return. Their deposits would earn interest. Gas customers would play the role of bank customers applying for a loan. They would ask to "use" the gas in return for a certain price. If the gas price paid by the customers, like utilities or major manufacturing plants or municipalities, exceeded what the bank paid to the producer for the gas, including the interest the bank paid to the producer, then the bank made a profit. This is analogous to a bank being able to borrow money at a cheaper rate than they lend it. It was intended to be less chaotic, and more profitable to Enron, than the spot market processes currently in place.

Skilling at first had a tough time creating a market – getting producers to deposit their gas, and customers to request "loans" – gas for cash.

This touches on a key point in economic sociology, as discussed by Abolafia: markets are made. They are **social constructions**. If a lot of people want to trade something, like baseball cards, there is a market. If people do not want to trade them, there is no market. People need to be interested and to see them as markets.

So there were two types of deals to be made. On the production side, to get things rolling, Skillings got them to buy in by underwriting, with Enron funds, their exploration efforts. The equivalent would be if a local bank offered you an incentive for you to open a savings account like giving you money to help you start a new business.

Skilling made deals. On the customer side, he made it work by promising them very long term, multi-decade contracts at fixed prices.

Trading

The second innovation came with trading. He realized that rather than hold these contracts and actually deliver the gas for 20 years, he could sell them to someone else. He could trade them. In short, Enron became a commodities trader and a futures trader.

Commodities and futures trading has been well established in the U.S. for over a century, and much of it happens through mercantile exchanges. These have their own regulatory bodies, as well as informal controls operating among the traders themselves. There is also a Federal oversight committee, the Commodities Futures Trading Commission (CFTC).⁶

Much of this futures trading involves short term contracts: people buying or selling potatoes or silver three or six or nine months in the future. With such short term frameworks, issues of supply and demand can be estimated with some degree of certainty.

Here is an illustration from “Trading Places” where
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One of the different things Enron did was to enter into contracts for extremely long time periods. With such time frames issues of supply, demand, and pricing became extremely difficult, and thus subject to arbitrary solutions. Arbitrary solutions also were called “tilting” or “fixing” the supply or demand curves. By making certain long term projections they could make the contract look extremely profitable, and thus, given M2M (mark-to-market) accounting, make the company look extremely profitable.

Commodities traders do not want commodities in the future, rather they want to trade contracts and make money on the contracts they buy and sell..

A futures contract is

An agreement to buy or sell a fixed quantity of a particular commodity, currency, or security for delivery at a fixed date in the future at a fixed price. Unlike an option, a futures contract involves a definite purchase or sale and not an option to buy or sell; it therefore may entail a potentially unlimited loss.⁷

It represents a particular type of derivative, because it is related to or derived from the commodity itself, and is related to the price of the commodity, but is a separate entity.

If you are stuck holding the contract when the delivery date arrives, and prices have skyrocketed far above the price at which you agreed to sell the commodity, you are in deep sushi.

On the other hand, prices have plummeted far below the price at which you agreed to sell the commodity, and you have not yet acquired the commodities you will be selling, you will make a lot of dough.

Traders can trade contracts because they are assignable. According to Investopedia.com’s (not Wikipedia!), if the futures contract is **assignable** it is:

⁶ Abolafia (2006): 38-63.

⁷ "futures contract" A Dictionary of Finance and Banking. John Smullen and Nicholas Hand. Oxford University Press 2005. Oxford Reference Online. Oxford University Press.

A futures contract with a provision permitting the contract holder to convey his or her rights of assignment to a third party. This enables the contract holder to assign the rights and obligations of a contract to another to perform and receive the benefits of that contract before it closes. For example, if an investor holds a futures contract and the holder finds that the security has appreciated by 1% at or before the contract is closed, then the contract holder may decide to assign the contract to a third party for the appreciated amount, thus making a profit on the contract before it even closes.

EXAMPLE

Dr. Ratcliffe has 100 bottles of 2001 Chateau de Beaucastel Chateau neuf de Pape. Current street value = \$80 / bottle.

I ask him to let me borrow the 100 bottles for 6 months. Will pay him \$5 / bottle for the loan. He will get 100 comparable bottles back in 6 months. He agrees.

I have industry information leading me to believe the price of this vintage will drop drastically in the near future. (An Emir of the UAE has a stock of 5,000 bottles but he is going to be forced to sell these soon due to being disinherited.)

Dr. Rengert, who is a big fan of this vintage, is planning a huge extended family party and would really like to acquire some Chateau Neuf de Pape.

I offer to sell him Dr. Ratcliffe’s bottles for \$80 each. He agrees. I deliver the bottles to him. He has a great party.

A few months goes by, the Emir dumps his stock as anticipated, the price drops to \$40 / bottle. I buy 100 bottles.

I deliver the 100 bottles to Dr. Ratcliffe. He is happy. He has his wine back plus some of lending fee.

Cost of borrowing bottles	- \$500
Profit from sale	\$8,000
Cost of replacement bottles	\$4,000
NET PROFIT	\$3,500

I am in the middle, I am just a **trader**. My profits are based on how good my speculations are about the future. I am **speculating**. Being a speculator creates opportunities for tremendous gains, and tremendous losses.

Pay close attention to the Enron oil fiasco in the late 1980s for an excellent example.

Most companies will have corporate limits on how big a “position” a trader may have – how much total speculation he is permitted to commit to – the total value of the contracts he/she may hold – at any one time. A “rogue trader” is someone who has ignored those limits and potentially placed the company in jeopardy.

Once Skilling got the gas bank going, he was able to trade contracts on the gas itself, pipeline rental costs, delivery, and many other details. All aspects of natural gas trading became a central activity of the

company. Because they knew so much about the industry through excellent information sources, they were able to make a lot of money.

Much of Enron's profits came from trading, i.e., speculating. Do you see why he kept insisting Enron was a logistics company to the analysts and shareholders?

Trading and Manipulating

Enron started trading electric power. In the California electric power scandal, the traders went wild.

Traders are by definition a wild group. They just want to make a lot of money for the company in the shortest time.

Because of the way deregulation was structured in California, traders could make enormous money in a short period of time by "cornering" the market – buying such a large fraction of the available commodity that they became a dominant player in the buying and selling of electricity. "Cornering the market" is often considered a regulatory violation..

Regulatory agencies not to mention the public frown on market manipulation. It creates unstable and wildly fluctuating prices, distorting "natural" supply/demand/pricing variations, and creates enormous profits for the manipulators.

But when can you determine that market manipulation has happened? When does "aggressive trading become market manipulation?"⁸

Despite considerable effort by legal scholars, no formal definition of manipulation has been established. Neither the Commodities Exchange Act, the Commodity Futures Trading Commission regulations, nor any exchange by-laws contain a definition. There are, however, several characteristics that the courts have associated with with manipulation. Manipulations are usually alleged to include **(1) a dominant or controlling position in either futures of deliverable supplies; (2) a distorted price; and (3) manipulative intent.** Each of these characteristics is difficult to define. Their definitions are situation specific, constructed by those who have been harmed or feel threatened.⁹

Abolafia goes on to maintain that describing a market as manipulated amounts to a "social construction."¹⁰

There is no fixed point beyond which all actions are manipulative. Rather, the definition is situationally determined according to whose interests are at stake and the amount of influence they can muster. It is for this reason that most accusations of manipulation are made after the fact, once the consequences of the struggle can be assessed by the interested parties.¹¹

Often it is the most powerful parties who have the most say in defining what happened.¹²

As you read about the California situation, you want to decide:

- Did the three conditions described above obtain?
- Can you specifically back up your view on each of these conditions?
- At what point did aggressiveness become manipulation?

⁸ Abolafia (1996): 69.

⁹ Op cit.

¹⁰ Berger, P.L., and T. Luckmann. *The Social Construction of Reality: A Treatise in the Sociology of Knowledge.* New York: Free Press, 1967.

¹¹ Abolafia (1996): 69.

¹² Berger & Luckmann (1967): 121.

Securitization

Another of Skilling's innovations was to turn debts into securities, oftentimes through funny deals. The goal was to get a debt – an obligation – off of the company's balance sheet so that the company would not look burdened with debt, and thus in a stronger position to better impress its investors.

In finance, at the time of the Enron story, securitization was spreading into previously uncharted territories. Securitization is the process of turning assets, or in Skilling's and Fastow's case, debt, into securities. These were new financial instruments at the time, and regulatory rules were not clear. Securitization is "the process of creating a tradeable financial instrument (a security) from a non-tradeable financial asset, such as a bank loan."¹³

So an example would be if a bank takes a large number of mortgages it holds, and bundles them into securities, and sells them to someone as an investment like a bond. If the mortgage rates in the bundle average 6 percent, and the bank promises the securities purchasers 4.5 percent interest, and the securities are backed by the actual mortgages, an asset, everyone is happy. The investors make money, the bankers make money on the spread (1.5%), and the bankers make money on having sold the securities. The latter is often split with the investment banking firm that created and helped sell the offering. Further, the bank is no longer required to hold a certain percentage of its assets to "cover" the loan, freeing up more of its capital.¹⁴

Everything is fine until many mortgages start defaulting. Then the values of the securities fall, because the assets backing them are disappearing. People are no longer paying their mortgages. The securities, often in the form of bonds, become worthless.¹⁵

Oops.

Enter the sub-prime mortgage lending crisis.¹⁶

¹³ "securitization" A Dictionary of Finance and Banking. John Smullen and Nicholas Hand. Oxford University Press 2005. Oxford Reference Online. Oxford University Press.

¹⁴ For example, this is what is happening with Fannie Mae and Freddie Mac. Over the weekend Sept 6, 2008) the government announced it was taking over and bailing out the two FMs, in the largest government bailout of any financial institution ever in the history of the U.S. Total cost to taxpayers is estimated to be around \$50 billion. The U.S. government had to step in because Fannie and Freddie were government-backed, quasi-public private corporations.

¹⁵ Investment grading companies like Standard & Poor or Moody's lower the "rating" on a firm's securities. This is what happened to Fannie & Freddie in late August. That made it harder for the firms to get loans.

¹⁶ In the words of The Insurance Journal:

In the simplest of terms, subprime mortgages were provided to high risk borrowers with less than stellar credit histories. They generally were offered at higher rates of interest than those presented to more financially stable customers and carry a greater risk for both borrowers and lenders. However, in the past few years, many such loans were offered as adjustable rate mortgages with low interest rates at the outset and no money down. Apparently in some cases, little or no documentation was required to determine whether or not the borrower could afford to make the payments, especially as interest rates adjusted to higher levels.

Through a series of financial transactions, the mortgages were sold by the original lenders to other financial institutions. In many cases, the loans were packaged as mortgaged-backed securities and sold on the bond market.

The double whammy of rising interest rates and a cooling housing market caused the house of cards to come tumbling down. As interest rates rose, customers were unable to continue making their loan payments. Mortgage defaults and foreclosures soared, lenders were forced out of

But I digress.

In the book, cross-check the index for entries on securitization, and read those carefully.

Being Short and Being Long

Throughout there are situations where traders' positions are described as being "long" or "short." This is confusing, but is important to understand in at least two key situations: when Muckleroy got involved in straightening out the Enron Oil trading group in the late 1980s, and when the bull market turned into a bear market at the end of the 1990s.

Enron's oil traders were making a lot of money for Enron because they were taking positions that were larger than they should have been – they were getting obligated for a greater volume of contracts than the company had authorized.

Muckleroy hears that the traders are on the "wrong side" of the oil market. He finds out that they had been expecting the oil price to go down, and had been buying contracts for future oil deliveries, at certain prices. The traders, Borget and Matroeni, hoped that if the price of oil went down they would be able to sell these contracts, because someone could buy the oil at a lower price than its delivery had been promised, as stated in the contract.

They held a "short position" which is

A contract to sell, for future delivery, goods or securities in excess of the amount a firm or individual actually holds. The holder of a short position relies on being able to produce or buy sufficient goods or securities to be able to fulfill the contract. When the time for delivery arrives, if spot market prices are lower than the contract price, the holder of the short position will be able to buy the goods at this lower price, and will make a profit. If the spot market price is higher than the price agreed in the contract, however, the result can be a loss, with no finite limit to its size. A short position is thus extremely risky.¹⁷

Go back to the wine example. If the Emir had not dumped his stock, his cousins having reconciled the Emir and his father, and instead the price went up, then I am in trouble. I sold the bottles I borrowed from Dr. Ratcliffe to Dr. Rengert for \$80 a bottle, but now it is going to cost me \$105 dollars to buy each new bottle.

In a situation like this, if I cannot sell the contract to someone else, and must buy and deliver the commodity at the higher price, then I will lose money.

Accounting Issues

Also important for you to understand are the creative or aggressive accounting practices of Enron. In particular pay attention to

- mark to market accounting
- special project entities
- how to move debt off the balance sheet

business, and bond funds were rendered worthless. Lawsuits ensued, with companies hoping to recover from some of their losses.

Jones, S. K. (September 3, 2007). The Blame game and the subprime mortgage lending meltdown. The Insurance Journal. [ONLINE: <http://www.insurancejournal.com/magazines/west/2007/09/03/features/83533.htm>; retrieved 8/18/08]

¹⁷ "short position" A Dictionary of Economics. John Black. Oxford University Press, 2002. Oxford Reference Online. Oxford University Press.

- Fastow’s conflict of interest in setting up LJM and LJM2, and how he bullied banks into backing them

and the like.

Be sure you understand how these practices related to **quarterly profit targets**.

Broader Conceptual Background

Following on Polanyi, Abolafia recommends thinking about systems of self interest, and systems of regulation, how they are constantly in opposition to one another, and how at certain specific historical points in certain locations, one force will be more powerful than another.¹⁸

Markets are inherently self destructive, because each party tries to maximize its profit. The public must be protected, through regulatory agencies, against such excesses. So there is a constant tension between “unfettered market relations” and “interventionism.”¹⁹ As this balance shifts, markets are altered.

Polanyi argued that over time there are periods of excessive deregulation and trader excess, followed by periods or more intervention and more regulation.²⁰ He called these variations “cycles of opportunism.” See the figure below.²¹

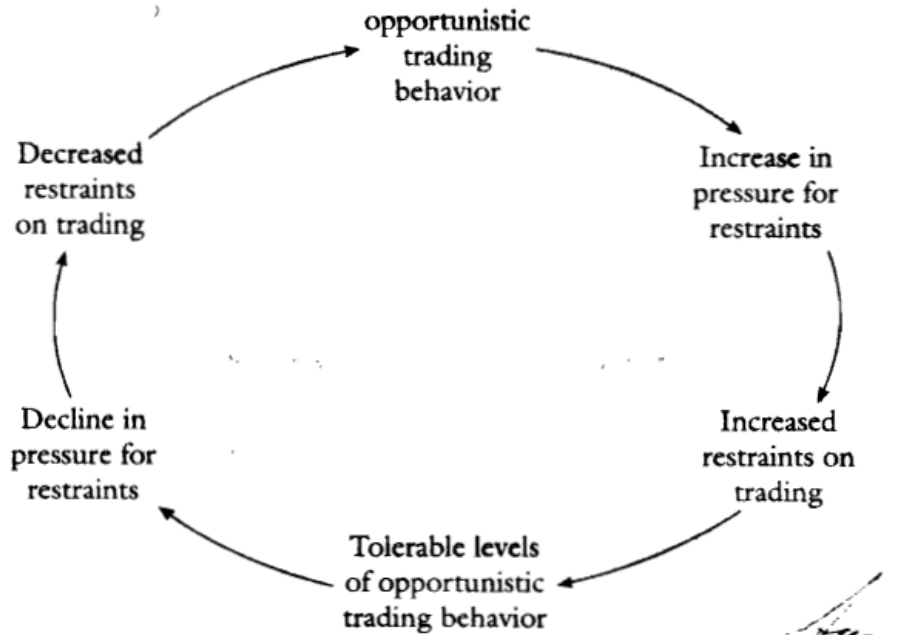


Figure 4. The cycle of opportunism

Bear in mind that

- deregulation had been promulgated at the national level since 1980;
- this period witnessed the emergence of relatively novel financial instruments;
- during the bull market of the 1990s Wall Street loved high growth companies.

¹⁸ Abolafia (1996): 168-181.

¹⁹ Ibid, p. 178.

²⁰ Polanyi, K. (1944). The Great Transformation: The Political and Economic Origins of Our Time. Boston: Beacon Press.

²¹ From: Abolafia (1996): 179.

If we have this dynamic, what you want to understand is: how if at all, and if so in what ways, did the actions of the different regulatory actors **at all levels** contribute to the cycle of opportunism, and why did they act this way?

Key Things to Think About and Maybe Write About

You can find a series of detailed questions about the reading.²² In addition to these questions you want to be thinking about some broader issues.

1. Expanding on the last point, try and think systematically about the levels of review that were supposed to be operating both within Enron, in its business and accounting partners, and in the relevant state and federal regulatory agencies. The purpose is not to assign blame to each party. McLean and Elkind handle that in the epilogue. Rather the purpose is to understand how the actions and inactions of each of these parties facilitated engaging in criminal behavior. What elements contributed to the criminogenic environment or culture and how. **Try and write a paragraph addressing the most important contributors, how they contributed, and why you think they were the most important.**
2. What common features of key Enron personnel contributed most strongly to making Enron a place ripe for abuse and fraud? Look carefully at the profiles the authors give you for key players (Lay, Skilling, Fastow, Mark, Whalley, the AA partners). Do you see any common characteristics that facilitated abuse? **Write a short paragraph.**
3. There were specific practices, internal to Enron itself, and which evolved over time, that made it more likely that fraud and abuse would result. **Write a short paragraph about those practices and how they contributed. Pick just a couple you think are the most important.**
4. If you have watched “The Wire,” you know that Avon Barksdale and Stringer Bell are major West Baltimore drug dealers, ruling an empire. They have fancy houses, nice clothes, fancy cars, fine liquor. They take care of their relatives. In what ways are they different from the Enron kingpins (Lay, Skilling, Fastow)? In what ways are they the same? **Write a short paragraph.**

²² http://www.rbtaylor.net/406_fa08_q_mclean.htm