Untimely Problems from Valhalla' Halls

"This environment is hardly giving us room to breath. The last thing we need is a public scandal."

It was the end of the business day, February 1, 1987. Ken Lay, CEO of Enron Corporation sat at his desk examining his agenda for the following day. Tomorrow's schedule showed a morning meeting with Internal Audit and two top officers from the Enron oil-trading unit (EOT). Louis Borget, President of EOT and Tom Mastroeni, the Treasurer, were coming down from their headquarters in Valhalla, New York. They were coming to answer charges of opening undisclosed bank accounts to engage in unauthorized transactions.

Lay had already heard a bit about the controversy. He again skimmed a memo (Attachment 1) from Internal Audit that summarized the issues. The essence of the matter concerned an account opened by EOT at the Eastern Savings Bank. Borget and Mastroeni were the authorized signatories on the account, but had failed to report its existence to Enron's Houston headquarters. Millions of dollars from EOT trades had found their way into this account. More worrisome, some $2 million had then been transferred into Mastroeni's personal account at the same bank. Internal Audit suspected that Borget and Mastroeni had EOT engaging in unauthorized and/or fictitious trading, through which they were skimming money for personal gain.

Houston oversight of EOT was the responsibility of John Harding and Steve Sulentic. Lay had sought out their views upon first receiving Audit's report. Eventually they got back to Lay with the story that the undisclosed account pertained to transactions which were legitimate and in Enron's interests. These transactions involved 'twinned trades' that were used to move profits from one accounting quarter to another; such trades, they observed, were not uncommon in the trading business. Borget and Mastroeni would come to Houston, bring their bank records and explain everything. Lay had pressed lightly on the point of EOT not reporting the Eastern Savings account to Houston, and gotten the answer that 'perhaps some unfortunate shortcuts had been taken, but the underlying motives and transactions were ok.'

Ken Lay strongly hoped that this would turn out to be true. As he ruminated about how to run tomorrow's meeting, Lay's mind wandered back over Enron's recent history and its current predicaments.

Natural Gas Pipelines in Crisis

Ken had only joined Enron in June 1984. It was not then known as Enron; the company which Ken Lay took over as Chairman and CEO was then called Houston Natural Gas (HNG). Lay had assumed the helm at a moment of difficult transition for the Natural Gas pipeline industry. Longstanding players like HNG were finding the industry business model evolving rapidly. Prior to the mid-1980's, natural gas producers sold their gas to pipeline owners under long term contracts. In order to induce producers to commit their gas, pipeline owners customarily provided long term contracts with floor prices and a commitment to 'take or pay', i.e. take a minimum volume of gas at a stipulated price or pay the cash equivalent of having taken the volume. Two things happened in

the 1980's to destabilize this model. The first concerned the price of newly discovered natural gas; it was falling to rock-bottom levels, below $2/million BTU's. The second was a regulatory change. No longer would pipeline operators be able to 'lock out' producers who didn't commit to ship through their line. Instead, producers were now able to sell gas directly to end users and require pipelines with available capacity to ship their volumes for a simple transport tariff.

These changes rocked the gas pipeline industry. Major carriers found themselves burdened with gas purchased at above-market prices and contractual commitment to 'take it or pay'. Pipeline company financial conditions deteriorated and debt ratings were downgraded as the carriers labored to work their way out from under disadvantageous contracts. HNG was not an exception.

Ken Lay's assessment was that natural gas market deregulation would continue to progress; from this he concluded that future profitability would become a function of scale – simply put, the biggest pipeline companies with the most extensive networks would become low-cost providers - dominating a market of spot natural gas seeking low cost logistics. As if on cue, the gas pipeline industry began to consolidate. Again, HNG was not an exception. In April 1985 Lay a call came from Omaha-based Inter-North suggesting a merger. Inter-North was approximately three times the size of HNG. However, its senior management was aging, and its board was divided and uncertain about how to cope with the deregulated market. A corporate raider, Irwin Jacobs, was also stalking the company. Immediately prior to the merger talks, HNG stock was trading at $45/share. In just eleven days, Lay was able to extract both a $70 per HNG share price (a 56% 'control' premium) and a commitment that he would move up to CEO after a couple of years. The Inter-North/HNG merger closed within the year, and the new entity was christened Enron in 1986.

Unfortunately, the merger did little to alleviate the pipeline company's economic straits. Profitability was miserable. The natural gas glut produced even lower prices. Enron had to face this deteriorating price environment with over $1 billion in take-or-pay contract liabilities. Enron reported a $79 M loss for 1985, its first year of operation. Attachment 2 details Enron's financial performance for the years 1985-86. Although Enron reported net profits of $556 M for the year 1986, the bulk of that reflected recoveries of past income taxes. Its financial condition was more accurately reflected by the following: Earnings before Interest and Taxes (EBIT): $230 M; Interest Expense: $421 M.

Clearly, Enron was now heavily debt laden, the product of Inter-North having to finance the premium price for HNG's stock. In January 1987, Moody's Investors Service downgraded the company's long term rating to below investment grade, i.e. 'junk' status.

To some extent, this 'leveraging up' of the company had been intentional. Irwin Jacobs' group was been paid $350 M to hand over its Inter-North stake and 'go away'. Inter-North thus reckoned that a heavy debt burden would act as shark repellant for future raiders; however, high debt levels also hamstrung the newly merged entity. Ken Lay found that his firm's bank loans contained covenants requiring quarterly interest expense to be covered 1.2 times by EBIT; failure to do so would mean an event of default. Enron would be especially exposed in such case, as the firm also had over $1 billion of commercial paper outstanding. These unsecured short term promissory notes had to be 'rolled over' continuously. A 'hiccup' on bank loan covenants could thus spark a full-fledged financial crisis if it led commercial paper buyers to flee from Enron's paper.

This perilous financial condition meant Ken Lay spent much of 1986 focused on maintaining liquidity and avoiding the default triggers in Enron's bank loans. Lay froze senior executive pay and sold some pipeline assets. Enron stayed afloat but the company was barely scrapping by.

In fact, a good portion of the company's razor-thin margin for error was being contributed by a little known and even less well understood entity, EOT. Inter-North had created the subsidiary back in 1984. Oil commodities' trading was a relatively new business at that time. Inter-North chose to enter the business by hiring an established trader, Louis Borget, away from Gulf States Oil and Refining, where Borget had set up a similar unit three years earlier. The package to induce Borget to move included bonuses tied to the profits produced by the trading operation; and, EOT immediately began to report profits. In 1985, when the merged Inter-North/HNG lost $79 M, EOT made $10 M. In 1986, when Enron couldn't cover interest expense with operating earnings, EOT reported profits of $28 M.

Ken Lay still wasn't sure what to do to 'fix' Enron's financial problems. Long term, he believed deregulation would reward his company. For the immediate future, Enron seemed bogged down in a bad business environment comprised of low prices, intense competition and the burdens of high debt. One thing he did know was that EOT's contribution was helping the company cope in the short run while it waited for the longer run to bring improved conditions.

Lay also had other, more political problems closer to home. The Board of Inter-North had rebelled against his predecessor, Sam Segnar, concluding that he had caved in to HNG's demands during the merger negotiations. Segnar had ended up 'paying with his [corporate] head'. Lay had faced bitter resistance from former Inter-North directors on a series of secondary, but highly symbolic issues: i.e. the appointment of auditors and the relocation of Enron's headquarters to Houston. The issues eventually were resolved, with Lay getting his way on the relocation. He had also begun to replace former Inter-North directors with selections more supportive of his leadership. Still, at the outset of 1987, Ken Lay was a CEO under the microscope, facing a Board that was divided and in some cases personally bitter towards him.

None of this was lost on Ken Lay as he finished skimming over Audit's memo yet another time.

Considering the Options

"What do I do to resolve this issue? I'd better walk into this meeting with some idea of what answer we want at the end.

What really matters here? What issues take priority over others? I have to give preference to the financial condition of the Company. That means EOT's profit generating capability needs to be preserved. Moreover, a financial scandal right now could be devastating. Not only might EOT's profit contributions be affected, but Enron's past financial results might have to be restated. Accounting restatements are 'yellow flags', signs that something major is amiss inside a company. It wouldn't be long before Enron's equity analysts and lenders got wind of unreported bank accounts, transactions and funds flows. They'd assume the worst and wonder what else they didn't

know. The result could be a major crisis of confidence in the financial markets, possible leading to a liquidity crisis for Enron.

Borget and Mastroeni have undoubtedly broken some rules. That's not a total surprise coming from traders and their culture. We have to find some means to limit abuses while leaving EOT's risk-taking culture intact.

What exactly are the allegations of wrong-doing here? It seems that Borget and Mastroeni either received, or thought they'd received signals from their Houston's superiors to manage the timing of EOT's reported profits. They responded by doing some of what is commonly done in their industry – twinned trades that give a third party profits in one period to be offset by profits returned to the other party in the subsequent period. Such trades are not illegal. They alter quarterly results, but that's not uncommon – everybody 'manages' earnings one way or another. The worst that can be said is that they executed these trades in a fashion that was less than above-board. Clearly, they must have assumed that not everyone in Houston was 'on board' with managing earnings – why else would they have not reported the new bank accounts? And what's this about company money going into Mastroeni's personal account? Whatever the reason, and I'm sure they'll have one, that's got to stop.

What to do about it all? How best to keep the big picture in mind but still send a message that excess won't be tolerated?"

With this, Ken Lay picked up a pen and began to outline a set of options. He began by listing categories of possible remedial actions:

- Immediate Issue Management
- Personnel discipline
- Organizational reform
- Transactional rules
- Process reform
- Organizational oversight

He then expanded each bullet point with possible options to consider:

- Immediate Issue Management
    - Define the transgressions associated with EOT bank accounts, trades, and the mingling of corporate money with personal accounts, and the mitigating circumstances
    - Assure Enron's financial constraints are considered when resolving the incident
    - Determine 'materiality' of accounting issue and need for any restatement of public financial reports
- Personnel discipline
    - Terminate Borget, or Mastroeni, or both
    - Terminate Harding, or Sulentic, or both
    - Discipline some or all of the above in terms of:
        - Compensation, responsibilities, title

- Organizational reform
  - Revise Houston's oversight of EOT, either changing out current Management and/or intensifying oversight in terms of stewardship reviews and/or oversight of controls
  - Embed new management at EOT
    - New trading personnel loyal to Houston management, charged to learn EOT's business model
    - New financial management loyal to Houston, charged to ensure controls are sound and rules are respected
    - Assign a Financial Controls advisor to EOT for the indefinite future
- Transactional rules
  - Have Audit recommend new/clarified rules for authorizing and reporting bank accounts, trades, unit financial results
  - Have the Chief Accounting Officer and/or Arthur Anderson opine on the acceptability of 'matched trades' done solely for the purpose of managing earnings; consider whether such trades might have other economic rationales
- Process reform
  - Consider established EOT trading limits and Enron's process for obtaining exceptions; assure limits are proportionate to unit profit objectives
- Organizational oversight
  - Decide whether EOT merits an full-time Internal Audit presence; determine also the frequency and timing of audits and the role of Arthur Anderson as external auditor
  - Review who should be EOT's legal counsel and whether that presence should be in Houston or Valhalla

"Well, I clearly have a range of options available. Possibly I can blend a couple of different actions to not upset the apple cart while still making it clear to EOT that there are boundaries."

It flitted through Lay's mind that the meeting's outcome would go some distance towards 'setting the tone' on financial control for the newly merged company. There had been whispers in Houston that EOT was not respecting its trading limits. The division's open position was not supposed to exceed 8 million barrels and if losses exceeded $4 million, the open position was to be liquidated. Some of Enron's Houston-based traders were questioning how EOT could generate the profits it was reporting without breaching these boundaries – after all, trading limits worked to contain the magnitude of gains as well as losses. Still, nothing hard had surfaced. Perhaps this was only professional jealousy at work.

"Whatever I decide, it will have to be smoothly executed. Enron is in no position to absorb public scandal. This will have to be carefully handled."

It also occurred to Lay that this episode could contain an opportunity. Sometimes rule breaches were expressions of pressures that needed to be solved, but managers were choosing the path of least resistance rather than a course more likely to yield fundamental improvement. Was there a way he could somehow deliver a message to EOT that might also reverberate with positive impacts throughout the struggling pipeline business?

Lay packed up his notes without making a firm decision regarding a course of action. He found himself leaning towards correcting the abuses without firing anybody. However, he would reserve judgment on the severity of corrective actions until he heard the full story. Lay also reflected that the oil-trading business was something of a mystery. It was relatively new, not a heritage HNG business; profits seemed be closely tied to the quality of the individuals doing the trading. In 1986, Borget himself had told the Enron Board that 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…"*

Lay resolved to listen carefully to what emerged between the lines at tomorrow's meeting. What 'vibes' might emerge regarding how EOT was generating its profits? Would there be anything more to the auditors' allegations than what he had already seen in writing and heard from Harding and Sulentic? If so, he might have to adjust his rough plan of action right there at the meeting.

The Meeting with Audit

The meeting convened with Borget and Mastroeni present, along with Enron General Counsel Rich Kinder, plus Harding and Sulentic. David Woytek and John Beard represented Internal Audit. Lay opened the meeting, calling upon EOT President Lou Borget to address audit's concerns.

Borget and Mastroeni laid out the following facts. EOT had been highly profitable in 1986. As this became known, company managers requested that they find a way to shift some profits into 1987. They were told to do this by 'whatever legitimate business practice we could.' As a result, EOT resorted to matched or 'twinned' trades that would net out over the period 1986-87. Borget observed that such trades were commonly used by other trading companies. Mastroeni stated that EOT next identified three firms interested in boosting their 1986 profits: Isla Petroleum, Southwest Oil and Commodities and Petropol Energy. EOT then entered into trades selling oil at prices which delivered profits to those three entities during December 1986; the plan was for EOT to buyback oil and recoup equal gains during the first part of 1987. Mastroeni explained that they opened the Eastern Savings Bank account as a place to hold proceeds from the 1986 sales. However, because this account was in Enron's name, Mastroeni stated that he had moved money to his personal account with the intention of returning it to Enron in 1987.

Sulentic then added that it was all a misunderstanding, that Borget and Mastroeni believed they were acting in Enron's best interests; he added:

> *"I say we accept that mistakes were made, do what needs to be done to correct them, and move on to a profitable 1987."*

Ken Lay then spoke, making it clear that he disapproved of the methods EOT used to accomplish their goals. He asked if anyone else at the meeting had anything to add.

David Woytek spoke up, pointing out that the bank statements which EOT had brought to the meeting had been altered. Transactions showing funds transfers into and out of the accounts had

been removed. Woytek had the actual statements provided by the Eastern Savings Bank to document the point.

Mastroeni then explained that the deleted transactions referred to a disputed bonus paid to a trader. The individual in question had been fired near the end of 1985. He had retained a lawyer and threatened to sue the company if his anticipated year-end bonus was not paid. After some discussion, a 'close-out' settlement of $250,000 had been agreed upon. Woytek asked Mastroeni why, if that were so, there was any need to alter the bank records. Mastroeni replied that the incident had nothing to do with the transactions under discussion at this meeting, so they just took them out of the bank statements to avoid confusing the issues.

Lay listened to the conversation as in surged back and forth. What he had just heard amounted to new information; Borget and Mastroeni had brought doctored bank records to the meeting. They had made a decision not to 'confuse' the issues, in the process attempting to prevent some transactions from coming under scrutiny.

It was getting close to the moment when Lay would need to end the discussion and focus the meeting on what actions should be taken. Lay had now heard Borget/Mastroeni's stories 'explaining' the opening of the unreported bank account, the origins of the funds transfers into the account and the outflow of money to Mastroeni's account. How much could he take those stories at face value? And, how should this new information, that EOT's managers altered bank records, influence the perspectives and options he had mulled over the night before?

Attachment 1

January 25, 1987

To: Mr. David Woytek

From: John Beard

SUBJECT: Possible Irregularities at Enron Oil Trading

This memo intends to summarize our findings so far regarding potential financial irregularities at Enron Oil Trading (EOT) and to lay out the issues requiring further investigation.

On January 23, Internal Audit was contacted by an officer at the Eastern Savings Bank. The bank officer had identified unusual activity involving an Enron bank account and wanted to verify with Company officials that certain transactions were legitimate and authorized.

The officer reported that Tom Mastroeni, Treasurer of EOT, had recently opened an account at the bank. Mastroeni and EOT President Louis Borget are listed as signers on the account. Immediately following the account opening, several transfers totaling $5 M flowed into the account from a bank located in the Channel Islands, a European tax haven location. Subsequently, funds in excess of $2 M left the account and were transferred to another account registered in Tom Mastroeni's name. Eastern Savings has cooperated by sending us statements document both the account opening and the funds transfers into and then out of this new account.

We have checked Enron's corporate registry of bank accounts and can find no evidence of the Eastern Savings Bank account having been recorded on the Company's books.

We have interviewed, Steve Sulentic and John Harding, EOT's contact executives in Houston. They advise that at their request, EOT has since 1985 engaged in 'twinned trade' transactions for the purposes of moving accounting profits from one reporting period to another. These executives indicate that such transactions are not unusual among oil traders. Essentially, one entity agrees to sell oil to another at a price which allows the buyer to profit; the understanding is that the initial buyer will then sell the oil back in a subsequent period at a price which returns an equivalent profit to the initial seller. Sulentic and Harding believe that the transactions which led to funds transfers into the Eastern Savings account may have resulted from EOT entering into year-end 1985 'twinned trades'. They also indicate that Borget and Mastroeni are available to come to Houston to clarify this matter.

As of this moment, we do not know whether the funds transfers represent legitimate EOT business transactions or irregular activity. It is certainly a concern that funds flowed through the Eastern Savings account and into the personal account of a company officer – such activity involving an amount over $2 M is highly irregular. It is also a 'red flag' that this activity took place in a new

account set up in circumvention of clear corporate guidelines requiring the reporting of all new bank accounts to corporate headquarters. To the extent that these transactions are irregular, they may represent misappropriation and even theft of corporate funds. To the extent that the transactions are found to be legitimate, their 'off-the-books' nature could require restatement of financial records and reported results for the year 1986.

The issues requiring further investigation are thus the following:

- For what purpose was the new account at Eastern Savings Bank opened?
- Why was the opening of this account not reported to Houston, in direct violation of company control standards?
- Was there a substantive business purpose associated with the cash transfers that entered the Eastern Savings Bank account?
- What justification can be provided for corporate funds being transferred to the personal account of an employee?
    - Are all corporate funds accounted for?
    - When will the funds be returned? If not immediately, why not?
- If the underlying transactions were entered into solely for the purposes of altering EOT's reported earnings, do Enron's 1986 financial statements need to be re-stated?

In conclusion, the facts known to date are of grave concern and warrant a full investigation. The potential implications include loss of corporate funds as well as misstatement of records, deliberate manipulation of records and the creation of fictitious losses with impact on Enron's financials for the year ending 12/31/86.

Cc. R. Kinder, General Counsel

Attachment 2

Enron Corporation

Summary Financial Statements, 1985-86*

$ M Year	1985	1986
Revenue	9,767	7,454
Earning Before Interest & Taxes (EBIT)	554	230
Interest Expense	(337)	(421)
Taxable Income	234	(191)
Income Taxes, net	(109)	565
Income from Continuing Operations Before Extraordinary Charges	163	374
Net Income	(79)	557
Total Debt	4,356	3,538
Net Worth	1,492	1,203
Debt/Total Capital %	74	75
EBIT/Interest Expense %	164	55
Operating Cash Generation	682	478
Investment/Acquisitions, net	(2,357)	756
Financing, net	1,641	(963)
Change in Cash	(35)	270

* Figures may not be additive because of other items, charges and rounding

Author's Note

This case relies principally on the accounts of the Valhalla financial control issues provided in *The Smartest Guys in the Room* and *Conspiracy of Fools.* Both books treat the episode in detail and with minor discrepancies provide accounts which are consistent as to the facts.

Each offers some details not provided by the other. For example, *The Smartest Guys in the Room* provides details of the trading limits in existence at EOT, the financial condition and bank covenants of Enron at that time, and the fact that David Woytek sent a memo to Ken Lay describing the EOT twinned trades as creating 'fictitious losses'. *Conspiracy of Fools* provides a detailed account of the meeting among EOT's Borget and Mastroeni, Enron Internal Audit, and Enron management. This work also confirms that Lay attended that meeting and gave explicit instructions as to what remedial actions were to be taken.

Several portions of the case are created for purposes of surfacing the issues and options facing Ken Lay. Lay's 'stream of consciousness' (in italics) on the night before the meeting has been crafted for these purposes. This applies also to the list of options he outlines while sitting in his office. This portrayal is however, consistent with a) the fact that he received a memo from David Woytek on the possible irregularities and b) Lay's actions taken at and right after the meeting. It is also apparent from the content of David Woytek's memo that Lay had heard at least a preliminary version of the 'twinned trade to move accounting profits' story that Harding and Sulentic articulated at the actual meeting. Lay's options list has obviously been expanded beyond the actions he actually endorsed in order to provide students with a full range of choices to consider. The account of the meeting with Internal Audit is consistent with versions reported in the two sources cited.

Attachment 1, Beard's memo to Woytek, is a creation intended to summarize the facts known to the auditors prior to the meeting with Borget and Mastroeni. However, it is factually based, being grounded in not only the general accounts provided in the sources, but also in: a) the fact that Woytek did provide a memo to Lay and other senior managers; b) published comments from Beard's notes and c) a published quote from Woytek's memo describing the twinned trades as creating 'fictitious losses'.

Attachment 2 is drawn from Enron's restated public financial filings.

Untimely Problems from Valhalla' Halls

Teaching Note

Introduction: This case concerns the priority given to financial control when it competes with other corporate concerns. It raises the following specific questions which bear on this general theme:

- Do certain employee actions merit severe discipline and/or termination irrespective of the potential consequences for the business?
- How can effective action on a controls issue be reconciled with conflicting business requirements?
  - What options are available to senior managers for crafting composite solutions?
- How far do investigations need to be progressed before senior executives take action on potential irregularities?
  - How does management distinguish a 'cover-up' involving multiple executives from legitimate explanation?
  - What are the reasons to, and the complexities involved in 'following the facts to their final conclusions?'

When teaching this case, instructors should keep the following objectives in mind:

1. To get students to put themselves in Ken Lay's shoes and feel the weight of the pressures bearing down upon Enron and on him personally as a new CEO 'under the microscope'.
2. To define the case's corporate ethics/controls issues in isolation, that is without allowing the pressures affecting Enron and Lay to influence this definition.
3. To take note of the full panoply of options available to Lay, out of which he could fashion an action plan that might correct the financial control issues without destabilizing Enron's precarious financial condition.
    a. Students should be encouraged to consider whether Lay's option list, outlined in the case, is complete
4. To ask whether the incident investigation has progressed far enough to enable an effective action plan to be developed; if not, what issues need further investigation and exposition?
5. To consider whether Lay can employ this controls incident as an 'opportunity' to upgrade and align Enron's organization, the better to focus on resolving then-pressing core business problems
6. To develop their version of Lay's 'guidance' to the meeting, one which takes into account the 'new information' on bank statements which surfaces at the meeting.

Case analysis pertaining to each of these teaching objectives will not be provided in more detail.

Pressures facing Ken Lay

At the outset of 1987, Lay has multiple problems on his plate.

Students should note the facts of the case and the Enron financials in Attachment 2. These show that the company's operations are having troubling generating sufficient cash to pay interest on Enron's debt.

These weak operating results underscore that Enron is vulnerable to having lenders toughen terms and/or withdraw financing. In particular, Enron is vulnerable to being unable to rollover its $1 billion+ in commercial paper, which event could spark a liquidity crisis. One concern for Lay is to have weak profitability trigger default under Enron's bank loan covenants, news of which could spark redemptions by commercial paper holders. Another is to have a restatement of prior year financial results produce a confidence crisis on the part of lenders, leading to the same result. Lay had spent much of 1986 working to keep the company solvent, so these concerns would be in the front of his mind.

The Valhalla incident holds the potential for both of these outcomes. If EOT has to be restructured or dismantled, its trading profits could be lost. This will put more pressure on the rest of the business to meet the bank loan covenants. Lay may also have quietly guessed that EOT's ability to move reported profits from one quarter to the next has been playing a role in meeting the quarterly covenant tests, i.e. Houston calls for EOT to take action when they know loan coverage is either comfortably loose or likely to be a close call.

Worse yet, if past 'twinned trades' are deemed to be inappropriate, this likely would require restatement of reported results. Not only might the restatement trigger confidence problems in the financial markets, it might also reveal Enron to already have been in violation of its loan covenants.

Students should also note that Lay has opponents on the Enron Board. Current company performance is not helping Lay disarm, neutralize or move out these opponents. A major controls scandal with accompanying financial crisis would provide opponents with fresh ammunition to criticize Lay's leadership and perhaps attempt to have him replaced.

All of these pressures point in the same direction – towards avoiding public scandal and preserving EOT's profit generating capacity intact. They also create a disincentive to know facts which would make it difficult to justify leaving EOT intact.

Ethics/Controls Issues raised by the Valhalla Incident

Seen in isolation, the facts of the Valhalla incident raise the issues identified by Internal Audit in Attachment 1: possible loss of corporate funds, misstatement of records, deliberate manipulation of records and the creation of fictitious losses with impact on Enron's financials for the year ending 12/31/86

Several of the Borget/Mastroeni actions are normally 'termination events', i.e. the employee perpetrators get fired. These would include moving corporate funds into a personal account and altering company records. The former involves an obvious risk of corporate funds being stolen and the latter not only suggests a cover-up but cuts against the whole legal framework surrounding the accurate recording of company business. Such actions are considered so extreme from a controls

perspective that only an extraordinary justification could serve to prevent termination. Even if just a justification were found to exist, Borget and Mastroeni would merit severe discipline, and possibly termination, for not seeking policy exceptions at the proper level of authority.

Not reporting company bank accounts to proper authorities normally merits severe discipline and possible termination. Since bank account openings and closings are closely associated with potential for fraud, controls are normally intensive in this area; consequently, discipline for failure to follow proper procedure is typically strong to severe.