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HIGHLIGHTS

ENRON

They're Getting Close

The long arm of the law may finally have Enron's Jeff Skilling and Ken Lay within reach.

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By Bethany McLean and Peter Elkind

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For almost two years one question has dogged every corporate crime-watcher in the U.S.: Will Ken Lay and Jeff Skilling, the men who ran Enron, ever be hauled off in handcuffs? Many thought that day would never come—in mid-October, a New Yorker story by Jeffrey Toobin was headlined: "Why the country's most notorious executives may never face criminal charges."

But then, on Oct. 30, the government scored a major victory when a former top executive named David Delainey, a 37-year-old Canadian, pled guilty to a criminal count of insider trading and agreed to forfeit $8 million he'd reaped from selling Enron stock.

Since Delainey's plea, it has become clear that the government is pursuing a broad case, one that goes to the heart of what was rotten at Enron. And—unlike other approaches that have occupied the feds for months—this one has the potential to lead up the food chain quickly. Delainey, who is cooperating with prosecutors, reported directly to Skilling, and for the past few weeks Houston has been swirling with rumors that Skilling will be indicted soon.

The government's first potential path to Skilling and Lay—through former CFO Andrew Fastow—has so far been a dead end. Fastow's off-the-books partnerships had been widely blamed for Enron's collapse, and the tens of millions he and his friends personally pocketed made them natural targets. Although Fastow has been charged with around 100 criminal counts, he's steadfastly maintained his innocence and refused to cut a deal implicating his bosses—even to avoid the prosecution of his wife, Lea. And it's conceivable that Skilling and Lay, as they have continued to insist, didn't know that of Fastow's alleged scamming of Enron.

What's less conceivable is that Lay, and particularly Skilling, didn't understand the deeper problem at Enron: that the business model didn't work, leaving the company unable to meet the ambitious earnings targets it had promised Wall Street. As a result, Enron executives and accountants resorted to accounting tricks to hit their numbers (including ones using Fastow's partnerships). And as Enron was deceiving investors, Skilling and Lay were selling millions in Enron stock.

What made prosecuting this sort of accounting chicanery tricky was that Enron's outside accountants and lawyers signed off on many of the maneuvers, offering executives the courtroom defense that experts had told them that what they were doing was perfectly legal. (Skilling and Lay

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have always denied wrongdoing.)

Delainey's deal could change all of that. Here was a guy whom Skilling viewed as future Enron CEO material. Delainey had run Enron North America (ENA), which housed the company's vaunted trading operation, and later Enron Energy Services (EES), its much-hyped retail business. And while Delainey (in addition to settling with the SEC) pleaded guilty to only a single criminal count of insider trading, he also admitted that he knew there was widespread fraud at Enron—fraud that totaled in the billions of dollars. As the Department of Justice press release trumpeted: "Delainey knew of and participated in aspects of a scheme by Enron's senior managers from at least 1998 through late 2001 to deceive the investing public about the nature and profitability of Enron's businesses and thereby to inflate the share price of Enron's stock." Houston lawyer Philip H. Hilder, a former federal prosecutor who now represents several onetime Enron employees, says, "They indicted the overall business practices of Enron."

Prosecutors may now have transformed a thorny case that hinged on complex accounting judgments into a fairly simple one in which people sold tens of millions of dollars of stock while knowingly misrepresenting the company's results. "The one thing you need in an accounting fraud is someone saying, 'I was there. I was in the room with Skilling, and we all understood that we were hiding massive losses,' " says John Coffee, a Columbia University law professor.

Indeed, there are damning details in Delainey's indictment. One of the charges against Delainey is that Enron used profits earned by its traders in the California crisis to hide hundreds of millions in EES losses in late 2000 and early 2001. EES was supposed to be a huge success; the revelation that it was losing money would have crushed Enron's stock. The manipulation was hatched in late 2000 and early 2001, when Delainey was taking over as CEO of EES. On his own, he didn't have the authority to sign off on something that gargantuan, meaning that someone else did—presumably Skilling and possibly Lay. (Justice says that the decision to conceal the losses was made by "Enron's senior management.") In addition, the government says that Enron explained its decision to its auditors "deceptively." In other words, the "accountants rubber-stamped this" defense may be tough to invoke.

Another element of fraud Delainey acknowledged involves Mariner Energy, an oil and gas offshore exploration company in which Enron held a controlling interest. Enron used what's known as "fair value" accounting for Mariner, meaning that any increase (or decrease) in its value had to be reflected in earnings. The government alleges Enron took advantage of that approach to make Mariner a tool for manipulating earnings—for example, "during the fourth quarter of 2000 ... Enron corporate management called upon ENA management to provide earnings to help cover a shortfall." And indeed, according to the government, Delainey's division reported a $100 million increase in the value of Mariner.

According to a post-bankruptcy analysis, Enron's in-house risk-management group in 2001 estimated Mariner's value at between $47.3 million and $195.9 million. Yet Enron had it on the books for $367.4 million. Someone in "Enron corporate management" made the call to inflate the Mariner valuation.

Delainey could have continued to use the accounting defense, but one possible reason he agreed to cooperate was that in early October the

SEC charged Wes Colwell, an accountant who reported to Delainey, with fraud for some of the same offenses. Although Colwell was not charged criminally, he too agreed to cooperate.

There's another explanation for why Delainey may give up his bosses. He wasn't part of Skilling's old guard, but rather one of the newer breed of traders who prided themselves on emotionless decision-making. To some it appears that Delainey simply made a trade. "Dave Delainey wants to minimize his downside and cut his losses," says Hilder. It seems as if the cutthroat culture Skilling cherished could come back to haunt him yet.

Bethany McLean and Peter Elkind are co-authors of The Smartest Guys in the Room*, the recently released account of the rise and fall of Enron.*

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