Enron's Ethical Collapse: Lessons for Leadership Educators

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Abstract

Top officials at Enron abused their power and privileges, manipulated information, engaged in inconsistent treatment of internal and external constituencies, put their own interests above those of their employees and the public, and failed to exercise proper oversight or shoulder responsibility for ethical failings. Followers were all too quick to follow their example. Therefore, implications for teaching leadership ethics include, educators must: (a) share some of the blame for what happened at Enron, (b) integrate ethics into the rest of the curriculum, (c) highlight the responsibilities of both leaders and followers, (d) address both individual and contextual variables that encourage corruption, (e) recognize the importance of trust and credibility in the leader-follower relationship, and (f) hold followers as well as leaders accountable for ethical misdeeds.

Introduction

Enron's bankruptcy filing in November 2001 marked the beginning of an unprecedented wave of corporate scandals. Officials at Tyco, WorldCom, ImClone, Global Crossing, Adelphia, AOL Time Warner, Quest, and Charter Communications joined Enron executives as targets of SEC probes, congressional hearings, stockholder lawsuits, and criminal indictments. Enron's troubles, which had been center stage, were soon pushed to the background by subsequent revelations of corporate wrongdoing.

More recent instances of corporate corruption should not diminish the importance of Enron as a case study in moral failure. Enron collapsed in large part because of the unethical practices of its executives. Examining the ethical shortcomings of Enron's leaders, as well as the factors that contributed to their misbehaviors, can provide important insights into how to address the topic of ethics in the leadership classroom.

Moral Failure at the Top

Events leading up to Enron's bankruptcy have been chronicled in a host of magazine articles as well as in such books as *Anatomy of Greed* (Cruver, 2002), *Enron: The Rise and Fall* (Fox, 2003), *What Went Wrong at Enron* (Fusaro & Miller, 2002), *The Enron Collapse* (Barresveld, 2002), and *Pipe Dreams* (Bryce, 2002). The company's collapse was ultimately triggered by failed investments in overseas ventures and the unraveling of a series of dubious limited partnerships called Special Purpose Entities (SPEs). These SPEs , backed by Enron stock and illegally run by company insiders, were designed to keep debt off the firm's balance sheets and helped prop up its share price. However, when the firm's stock price began to slide, the company was unable to back its guarantees. In addition to charges related to shady partnerships, Enron stands accused of:

- borrowing from subsidiaries with no intent to repay the loans (Wilke, 2002, August 5).
- avoiding federal taxes even though some of its subsidiaries, like Portland General Electric, collected tax payments from customers (Manning & Hill, 2002).
- contributing to the California energy crisis by manipulating electricity prices (Fusaro & Miller, 2002; Manning, 2002).
- bribing foreign officials to secure contracts in India, Ghana and other countries (Wilke, 2002, August 7).
- immediately claiming profits for long term projects that would eventually lose money (Hill, Chaffin, & Fidler, 2002).
- switching account balances immediately before quarterly reports to boost apparent earnings (Cruver, 2002).
- manipulating federal energy policy (Duffy, 2002; Duffy & Dickerson, 2002).
- colluding with analysts to project a false image of the firm's financial health (Fox, 2003).

Much of the blame for what happened at Enron (nicknamed the "Crooked E" for its tilted Capital E logo) can be laid at the feet of company founder Kenneth Lay, his successor Jeffrey Skilling, chief financial officer Andrew Fastow, and Fastow's top assistant Michael Kopper. Each failed to meet important ethical challenges or dilemmas of leadership (Johnson, 2001). Their failures included:

Abuse of Power

Both Lay and Skilling could wield power ruthlessly. The position of vice-chair was known as the "ejector seat" because so many occupants were removed from the position when they took issue with Lay or appeared to be a threat to his power. Skilling, for his part, eliminated corporate rivals and intimidated subordinates. Abdication of power was also a problem at Enron. At times, managers did not appear to understand what employees were doing or how the business (which was literally creating new markets) operated. Board members also failed to exercise proper oversight and rarely challenged management decisions. Many were selected by CEO Kenneth Lay and did business with the firm or represented non-profits that received large contributions from Enron (Associated Press, 2002; Cruver, 2002).

Excess Privilege

Excess typified top management at Enron. Lay, who began life modestly as the son of a Baptist preacher turned chicken salesman, once told a friend, "I don't want to be rich, I want to be world-class rich" (Cruver, 2002, p. 23). At another point he joked that he had given wife Linda a $2 million decorating budget for a new home in Houston which she promptly exceeded (Gruley & Smith, 2002). The couple borrowed $75 million from the firm that they repaid in stock. Linda Lay fanned the flames of resentment among employees when she broke into tears on the *Today Show* to claim that the family was broke. This was despite the fact that the Lays owned over 20 properties worth over $30 million (Eisenberg, 2002). During Enron's heyday, some of the perks filtered down to followers as well. Workers enjoyed such benefits as lavish Christmas parties, aerobic classes, free taxi rides, refreshments, and the services of a concierge (*Enron excess*, 2002; *How Enron let down its employees*, 2002).

Deceit

Enron officials manipulated information to protect their interests and to deceive the public, although the extent of their deception is still to be determined. Both executives and board members claim that they were unaware of the extent of the company's off-the-books partnerships created and operated by Fastow and Kopper (Eisenberg, 2002). However, both Skilling and Lay were warned that the company's accounting tactics were suspect (Duffy, 2002). The Senate Permanent Subcommittee on Investigations, which investigated the company's downfall, concluded, "Much that was wrong with Enron was known to the board" (Associated Press, 2002). Board members specifically waived the conflict of interest clause in the company's code of ethics that would have prevented the formation of the most troublesome special partnerships (Cruver, 2002). Employees were quick to follow the lead of top company officials. They hid expenses, claimed nonexistent profits, deceived energy regulators and so on.

Inconsistent Treatment of Internal and External Constituencies

Enron's relationships with both employees and outsiders were marked by gross inconsistencies. Average workers were forced to vest their retirement plans in Enron stock and then, during the crucial period when the stock was in free fall, were blocked from selling their shares. Top executives, on the other hand, were able to unload their shares as they wished. Five-hundred officials received "retention bonuses" totaling $55 million at the same time laid off workers received only a fraction of the severance pay they had been promised (Barreveld, 2002).

Enron treated its friends royally. In particular, the company used political donations to gain preferential treatment from government agencies. Kenneth Lay was the top contributor to the Bush campaign and officials made significant donations to both Democratic and Republican members of the House and Senate. In return, the company was able to nominate friendly candidates for the Security Exchange Commission (SEC) and the Federal Energy Regulatory Commission (FERC). Federal officials intervened with foreign governments to promote Enron projects, and company representatives played a major role in setting federal energy policy that favored deregulation of additional energy markets (Fox, 2003). Anyone perceived as unfriendly to Enron's interests could expect retribution, however. In one instance, Lay withdrew an underwriting deal to pressure Merrill Lynch into firing an analyst who had downgraded Enron stock (Smith & Raghaven, 2002). Skilling called one analyst an "asshole" when he questioned the company's performance during a conference call (Cruver, 2002).

Misplaced and Broken Loyalties

Enron officials put their loyalty to themselves above those of everyone else with a stake in the company's fate — stock holders, business partners, rate payers, local communities, foreign governments, and so on. They also betrayed the trust of those who worked for them. Employees apparently believed in the company and in Lay's optimistic pronouncements. In August 2001, for example, he declared "I have never felt better about the prospects for the company" (Cruver, 2003, p. 91). In late September, just weeks before the company collapsed, he encouraged employees to "talk up the stock" because "the company is fundamentally sound" (Fox, 2003, p. 252). These exhortations came even as he was unloading his own shares. The sense of betrayal experienced by Enron employees only added to the pain of losing their jobs and retirement savings.

Irresponsible Behavior

Enron officials acted irresponsibly by failing to take needed action, failing to exercise proper oversight, and failing to shoulder responsibility for the ethical miscues of their organization. CEO Lay downplayed warnings of financial improprieties and some board members did not understand the numbers or the company's operations. Too often company managers left employees to their own devices, encouraging them to make their numbers by any means possible. After the collapse, no one stepped forward to accept blame for what happened. Lay and Fastow claimed Fifth Amendment privileges against self-incrimination when called before congressional committees; Skilling testified but claimed he had no knowledge of illegal activity.

The unethical behavior of Enron's leaders appears to be the product of both individual and situational factors. Greed was the primary motivator of both managers and their subordinates at Enron (Cruver, 2002). Optimistic earnings reports, hidden losses and other tactics were all designed to keep the stock price artificially high. Lofty stock values justified generous salaries and perks, deflected unwanted scrutiny, and allowed insiders to profit from their stock options. Greed was not limited to top Enron executives, however. Meeting earnings targets triggered large bonuses for managers throughout the firm, bonuses that were sometimes larger than employees' salaries. Rising stock prices and extravagant rewards made it easier for followers as well as leaders to overlook shortcomings in the company's ethics and business model.

Hubris was also a major character flaw at the Crooked E, a fact reflected in the company banner that declared: FROM THE WORLD'S LEADING ENERGY COMPANY — TO THE WORLD'S LEADING COMPANY (Cruver, 2002, p. 3). Skilling, who lacked the social and communication skills of Ken Lay, best exemplifies the haughty spirit of many Enron officials. At the height of the California energy crisis he joked that the only difference between the Titanic and the state of California was that "when the Titanic went down, the lights were on" (Fusaro & Miller, 2002. p. 122).

Even the so-called "heroes" of the Enron debacle failed to demonstrate enough virtue to delay or to prevent the company's collapse. Former company treasurer Clifford Baxter complained about Fastow's financial wheeling and dealing, but then retired without going public with his complaints. Vice-president of corporate development Sherry Watkins outlined her concerns about the firm's questionable financial practices in a letter and in a meeting with Lay (*A Hero*, 2002). Later she discussed the same issues with an audit partner at Anderson. While these are commendable acts, in her letter she recommended quiet clean up of the problems rather than public disclosure. She stopped short of talking to the press, the SEC and other outside agencies when her attempts at internal reform failed (Zellner, 2002).

The destructive power of individual greed and pride was magnified by Enron's corporate culture that encouraged creativity and risk taking. Employees invented a host of new commodity products which earned Enron top ranking six straight years on *Fortune* magazine's list of most innovative companies (Fusaro & Miller, 2002). Ken Lay was fond of telling the story of how Enron employees in London started its on-line trading business (which later carried a quarter of the world's energy trades) without the blessing or knowledge of corporate headquarters in Houston (Stewart, 2001). The cost of freedom, however, was pressure to produce that created a climate of fear. Enron's atmosphere was similar to that of an elite law firm where talented young associates scramble to make partner (Fusaro & Miller, 2002).

Adding to the stress was the organization's "rank and yank" evaluation system. Every six months 15% of all employees were ranked in the lowest category and then had a few weeks to find another position in the company or be let go (Cruver, 2002). Workers in the next two higher categories were put on notice that they were in danger of falling into the lowest quadrant during the subsequent review. This system (a harsher variant of one used at many companies) encouraged cutthroat competition and silenced dissent. Followers were afraid to question unethical and or illegal practices for fear of losing their jobs. Instead, they were rewarded for their unthinking loyalty to their managers (who ranked their performance) and the company as a whole (Fusaro & Miller, 2002).

Lack of controls, combined with an intense, competitive, results-driven culture made it easier to ignore the company's code of ethics which specifically prohibited conflicts of interest like those found in the SPEs and to seek results at any cost (Hill, Chaffin, & Fidler, 2002). Anderson auditors signed off on its questionable financial transactions for fear of losing lucrative auditing and consulting contracts with Enron.

Enron was also a victim of larger social and cultural factors. Publicly traded firms in the United States are judged by their quarterly earnings reports. Obsession with short-term results encourages executives to do whatever they can to meet these expectations. Enron's explosive growth took place during the economic boom of the 90s. All the major stock indices soared and billions were wasted on Internet start-ups that never had a realistic chance to make a profit. During this period the Cult of the CEO emerged. Business leaders achieved rock star status, gracing the covers of national magazines and best selling biographies (Elliott & Schroth, 2002, p. 125). In this heady climate, government regulators and investors felt little need to study the operations or finances of apparently successful companies led by business superstars. The recent spate of corporate scandals and the accompanying market crash may be the penalty that society must pay for the excesses and inattention of the last decade.

Implications for Leadership Educators

The lessons of Enron extend beyond the accounting and market reforms instituted in the wake of the scandal. Leadership educators can gain important insights about how to treat the topic of ethics in the classroom from the moral shortcomings of Enron's top executives. The pedagogical implications of Enron include:

Educators Must Share Some of the Blame

Academics find it easy to distance themselves from the sins of Enron. The college and university classroom seems a world away from the high flying, gun slinging mentality of the former energy giant. Few professors can begin to comprehend the level of privilege and influence enjoyed by the company's C level executives. Those who study and teach ethics believe that they would exhibit the virtues that Lay, Skilling, and Fastow seemed to lack.

Disassociating oneself from Enron may be comforting, but this maneuver conveniently overlooks the fact educators must shoulder at least some of the blame for the company's moral failure (Kavanaugh, 2002). As college graduates, Enron managers undoubtedly enrolled in leadership and ethics courses. Many were also products of Harvard and other top MBA programs. Followers armed with bachelor and masters degrees served as willing soldiers in the army of public relations experts who helped the company maintain its veneer of profitability, lobby government official, and attack its critics. What Enron's top leaders, lower level managers, and front line employees learned in university classrooms was not enough to prevent ethical tragedy.

Strive for Ethical Integration

Enron is a classic example of a company whose ethical pronouncements were "decoupled" from the rest of its operations (Weaver, Trevino, & Cochran 1999). The key values of the company were respect, integrity, communications, and excellence. Enron also had an extensive code of ethics. Unfortunately, these values and policies had little impact on how Lay, Skilling, and their underlings did business. By the time of its collapse in 2001, the company had been manipulating its books and misleading investors for several years.

Unfortunately, the teaching of ethics, like the practice of ethics at Enron, is typically decoupled from the rest of the curriculum. Discussions of ethics often stand alone, limited to a single unit or to one course in the entire leadership curriculum. Further, the placement of ethical material also diminishes its importance. Ethics units and text chapters sometimes appear to be an afterthought, introduced at the end of a course or book and therefore likely to be eliminated if the professor falls behind during the quarter or semester. To be effective, ethical considerations should be part of every unit, class, and set of readings.

Highlight Leadership and Followership Duties and Responsibilities

Many students study leadership in hopes of achieving the kind of heroic stature that, until recently, they saw reflected in press reports about famous business figures and other prominent leaders. Power, perks, financial security, and recognition all seem to come with an executive title. Instructors cater to this motivation when they act as cheerleaders for prominent business leaders like Jack Welch or Kenneth Lay. They overlook the fact that the same qualities and strategies so often praised in business and other leadership literature can lead to disaster. Enron is a case in point. The company's leaders did many things right according to the leadership and management literature. Lay and his colleagues had a clear vision and values, pursued excellence, and fostered an extraordinary degree of creativity and innovation. Sadly, their vision was unrealistic, their stated values took back seat to unstated ones (e. g., make the deal at whatever the cost and generate constant profits and growth), and their drive for innovation led them into a host of unprofitable markets that even their management team did not completely understand. Followers also lost sight of their personal values as well as their commitment to society.

Highlighting leadership duties and responsibilities is one way to address selfish motivation and to demythologize leadership. Altruism, Communitarianism, and Servant Leadership are three ethical perspectives that drive home this point. Each of these approaches emphasizes the duties that leaders have both to followers and to the larger community and can serve as a framework for discussions of leadership and followership ethics.

- *Altruism* is a universal value that is particularly important to leaders who, by virtue of their roles, are to exercise influence on behalf of others. Leaders cannot articulate the concerns of followers unless they first understand their needs (Kanungo & Mendoca, 1996). Leaders driven by altruism pursue organizational goals rather than personal achievement and are more likely to give power away. Leaders seeking self-benefit focus on personal achievements, and control followers through coercion and reward.

- *Communitarianism* emphasizes the need for individual and corporate responsibility (Etzioni, 1993). Citizens and institutions have obligations to the larger community. When making decisions, leaders and followers must look beyond the immediate interests of themselves and their organizations to the needs of the local community and society as a whole.

- *Servant leadership* is a model that puts the needs of followers first (Greenleaf, 1977; Spears, 1998). Servant leaders continually ask themselves what would be best for their constituents and measure their success by the progress of their followers. Driven by a concern for people, they seek to treat others fairly and recognize that they hold their positions in stewardship for others.

Address Both Individual and Contextual Variables

Training can help individuals develop sensitivity to moral issues and improve ethical reasoning skills (Rest, 1993). To prevent future Enrons, faculty must help current and future leaders and followers equip themselves with the values, principles, and skills they need to make reasoned moral choices. Nonetheless, an individual focus does not address organizational forces - group culture, high forced turnover, reward system - that played a significant role in Enron's moral failures. In addition, society's fixation on short term profits and daily market moves also increased the pressure to manipulate results and to hide financial bad news.

Leadership instructors need to help students analyze and respond to contextual forces that encourage ethical misdeeds. These questions should be considered:

- What organizational controls should be put on innovation?
- How can employees be rewarded in a way that promotes ethical behavior?

- What are the dysfunctional consequences of the rank and yank evaluation system?
- What are reasonable limits on executive compensation?
- What is a corporate board's role in overseeing the operations of an organization?
- What should be the composition of a board's membership?
- How should the performance of companies be judged?
- How can society develop a long-term perspective on financial results?

Recognize the Importance of Credibility

Since Aristotle, scholars have examined the factors that make a source believable to an audience, an interest based on the strong correlation between credibility and influence (Hackman & Johnson, 2001, chap. 6). The Enron debacle and subsequent scandals demonstrate that credibility, specifically trustworthiness, is more important than ever. Stock values declined nearly 40% from market highs in July1998 due largely to investors' loss of confidence in the integrity of publicly held corporations. Employees are increasingly skeptical as well. A 2002 survey by the Ethics Resource Center found that 43% of respondents believed that their bosses fail to model integrity and felt pressure to compromise their own ethical standards at work (Wee, 2002). Modern technology, which enables the rapid, worldwide dissemination of information, makes credibility more important now than in the time of Plato and Aristotle. Leadership faculty need to help students consider not only how credibility is built and maintained, but also how trust is destroyed and at what cost to individuals and organizations.

Followers are Also Accountable

Lay, Skilling, Fastow and other high level executives deserve most of the blame for what went wrong at Enron. It was they who created the company's culture, approved dubious partnerships, attacked critics, and, in the end, abandoned employees while enriching themselves. Nevertheless, followers, ranging from second tier officials down to receptionists and mailroom clerks, share some of the blame. Many willingly bought into the get rich quick mentality of the Crooked E. During the company's 15 years of rapid growth, few stopped to question the company's tactics. They were "bought off" by the generous perks and the thrill of being part of one of the most sophisticated and innovative companies in the world. The constant threat of termination undoubtedly convinced others to keep their doubts to themselves and to support their bosses.

According to Chaleff (1995), courage - the willingness to accept a higher level of risk - is the most important virtue for organizational followers. Such courage was sorely lacking at Enron. Few had the courage to challenge authority. Few had the courage to leave when faced with ethical violations. Apparently no member of the firm had the courage to bring the misbehavior of Lay and his subordinates to the attention of the public before the crisis erupted (Cruver, 2002).

Unfortunately, cowardice is not limited to Enron. Nearly two-thirds of those who witness ethical violations in their companies refuse to report them, believing that reporting problems would not do any good (*Chief Executive*, 2002). The final lesson of Enron, then, is that both instructors and students have the responsibility to confront moral failure whenever and wherever it appears, regardless of whether they function in a leadership or in a followership role.

Conclusion

In summary, top officials at Enron abused their power and privileges. They manipulated information while engaging in inconsistent treatment of internal and external constituencies. These leaders put their own interests above those of their employees and the public, and failed to exercise proper oversight or shoulder responsibility for ethical failings. Sadly, the followers were all too quick to follow their example.

Numerous implications for teaching leadership ethics can be gleaned from the Eron situation. Educators must share some of the blame for what happened at Enron. It is important to integrate ethics into the rest of the curriculum. Leadership educators need to highlight the responsibilities of both leaders and followers along with addressing both individual and contextual variables that encourage corruption. The importance of trust and credibility in the leader-follower relationship must be recognized. And, finally, educators must hold followers as well as leaders accountable for ethical misdeeds.

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An earlier version of this paper was presented at the 2002 National Communication Association convention, New Orleans, LA.