

## Enron Too Shall Pass

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By Tom Jacobs (TMF Tom9)

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Rather than add to the din over accounting horrors, I'm going to take a different tack. The sky is not falling, the world is not coming to an end. We will survive this and prosper -- whatever Congress and the Executive do.

No, I am not Pollyanna. We must and will tweak or beat laws and regulations, after enough lawmakers have speechified, but the big picture is that our current messes are not unique or unprecedented. **Accounting scandals appear every decade or so and are very definitely short term.** So for everyone except Enron employees -- who are entitled to lack whatever perspective they darn well please -- the big picture is required.

There's no way that criminal law, government regulation, or auditor independence will ever ensure a just and fair society or a squeaky-clean stock market. Any tax expert, investment banker, ambitious exec or teenager will, given enough time, find loopholes in any rules big enough to drive an SUV through. Things work pretty well, though. We plug the biggest holes in the ship, and watch and wait while the rats gnaw other ones.

There will always be rats. Given enough motivation, any one of us can become a rat. I learned this as a teen, when my second stock investment turned sour and my then best friend's father went to jail.

### Housing for everyone

Rochester, New York in 1970 was the company town of **Eastman Kodak**([NYSE: EK](#)), **Xerox Corp.**([NYSE: XRX](#)), and **Bausch & Lomb**([NYSE: BOL](#)). The go-go 1960s had infected Rochester as much as anywhere else, and the town's ambitious people wanted their share of the era's riches too. **They embraced two Toronto brothers named Stirling who were going to use hydraulic jacks to raise low-cost housing modules and build inexpensive high-rises. The visionary David Stirling spun a tale of making money helping governments solve the housing crisis.** Investors lined up, and Stirling Homex was born.

### New economy seduction

One convert was my best friend's dad, we'll call him Mr. East, who owned the biggest house on Rochester's signature main drag, the same street as George Eastman's mansion. Compared to my modest middle class life, the Easts were gods, with their pool, horses, eight bedrooms, cleaning women, trips to New York and vacations in Puerto Rico.

The brothers tapped Rochester-born East as their top lawyer, and he was their conduit and official representative. They raised money, put their assembly line in action, and recruited future millionaires. Eleanor Dienstag recounts in her out-of-print memoir *Whither Thou Goest* how the company lured top people -- including her New York lawyer husband. Mr. East told them, "None of you will have any regrets... Believe me, this is a great moment, a great opportunity." He said to one wife, "You mark my words... Your husband will be a millionaire one day." That talk enticed not only a slew of New Yorkers **but also Boston Bruins' head coach [Harry Sinden](#) to exchange job security for a shot to be a millionaire.**

Execs and engineers camped out in hotels and spare bedrooms, working round the clock, with families coming later. Though profitable, the company burned through cash, flying execs on company jets to meet the government officials and politicians essential to the contracts Homex wanted. The magnitude of money required could only come from stock sales, and the company raced towards its initial public offering.

When the SEC questioned the parts of the prospectus, East's powers of persuasion prevailed. Dienstag's husband silenced the underwriter's young employee who asked about all the uninstalled modules surrounding the plant. Homex flew the prospectus to Washington in a company jet flown by ex-astronaut Frank Borman, encouraged to invest by friend Ross Perot, whose **Electronic Data Systems**([NYSE: EDS](#)) company went public with the same underwriter.

**I snared ten pre-IPO friends-and-family shares for \$150 through Mr. East, though he clearly warned that it was a speculation.** The first trade in Feb. 1970 was at \$33.00, and despite the bear market it hit \$51.75 in a month, **for a price-to-earnings ratio of 250.** *Forbes* dubbed David Stirling "the Henry Ford of the housing industry," and his company "the salvation of the housing crisis."

### Home job

Inside the company, East controlled the information flow to and from David Stirling, and everything was on a need-to-know basis. As secrecy grew, Dienstag's husband began to suspect trouble because of the **cash burn**. The \$6.5 million IPO proceeds went quickly, and a year later, the company needed another \$20 million to feed a \$35 million credit line and still-growing expenses. With the stock in the \$20s, Merrill Lynch Pierce Fenner & Smith stepped up to underwrite the secondary offering of over one million shares, while Peat, Marwick & Mitchell -- precursor of today's KPMG -- continued as auditor.

**The hype machine whirred full tilt.** The company's first high-rise built with the hydraulic jack method graced the cover of *House and Garden* magazine. Glossy photos of HUD Secretary George Romney festooned the annual report, promising deals. Homex execs shmoozed with politicians relentlessly, and in 1972 the company jet even flew John Mitchell and Frederick LaRue to the Key Biscayne, Florida meeting where they approved the plan to break into Democratic headquarters.

### Premature revenue

The SEC found the prospectus wanting and demanded that earnings be chopped by a third because of a fishy land sale. **Worse, the Commission questioned the company's policy of prematurely recognizing revenue.** According to Dienstag and the Harvard Business School case study, "Homex recorded a sale when a module came off the assembly line and assigned it to a specific housing contract." This was not only before one dwelling in a housing project had gone up or before the sewers and water and power lines were installed -- it was before the project had even obtained building permits.

At the same time, under government contracts Homex received no cash until buildings were ready for occupancy. **The amount of these "unbilled receivables" ballooned to over \$30 million and was the only basis for Homex's profitability.** Astonishingly, when Homex agreed to drop the land sale revenues and make some other minor changes, the SEC changed its view of the revenue recognition.

But even a new \$20 million, now from preferred shares rather than common, couldn't keep up with managements' wild spending on executive perks and quirks, such as retreats with mind-control gurus. With up to 10,000 built but unsold modules, the receivables were a total sham, and the signature hydraulic jack building system failed.

### Moment of truth

Facing a 10-Q filing in early 1972, Dienstag's husband went to management with a memo detailing the receivables problem. He became persona non grata. The company reported a small loss, but nothing like the millions Dienstag recommended. The dominoes fell. In half a year, debt overwhelmed the company, the banks extended no more credit, a bond issue collapsed, and the company was in bankruptcy, where Dienstag's memo surfaced. (Somehow, I got \$50 back. Never happens.)

**It took a little over a year, but in 1974 the Stirlings and East were indicted for giving money and stock to labor officials.** In 1975 the SEC charged them civilly for their role in Stirling Homex's "creating phantom sales, making illegal political contributions, using illegal bugging equipment, and making payoffs to union officials." Eventually, the Stirlings and East received one-year sentences. East fled to London but returned to do his time.

The auditors? According to **Professors Abraham Briloff and Robert Anthony**, Peat, Marwick & Mitchell "was subjected to an elaborate [SEC] tongue lashing, made to do some brief penance and to forswear future violations" for failures with Stirling Homex and four others, including Penn Central. Small beer, but new SEC rules made it easier to sue auditors.

### What you can do

Stirling Homex is but one of the go-go years' examples, joining Leasco, Equity Funding, and Saul Steinberg's Reliance Group. Better historians than I can make lists for every decade. The world creates Mr. Easts and company as soon as they get knocked down, so we should always follow a few principles -- not just in the Enron Era. If you invest in individual stocks, diversify in a basket of 6-12 or so established businesses you can understand with solid track records of growing revenues, earnings, and most importantly, free cash flow.

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