

# *The Fragility of Organizational Trust:* Lessons From the Rise and Fall of Enron

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Recent headlines have been filled with stories about the collapse of Enron Corp. After its evolution in the 1980s from an old-style gas pipeline company to an aggressive energy trading and marketing leader, Enron filed for bankruptcy in December of 2001. Congressional hearings, Securities and Exchange Commission (SEC) investigations, and lawsuits from shareholders, employees, and customers will keep Enron in the news for years. Although there is plenty of blame to go around, perhaps the most important lesson from the Enron collapse is both the centrality and fragility of organizational trust. The profound implications of the loss of trust can be seen in other corporate collapses as well, such as WorldCom Inc., Tyco International, Global Crossing, and Adelphia Communications Corp. Here, there is certainly a critical lesson for all senior corporate managers regarding the importance of corporate accountability.

Recently, Marc Epstein and Bill Birchard described a model for organizational accountability that relies on four elements: improved corporate leadership and governance; improved and broader measurement of corporate financial, operational and social impacts; an integrated system of internal and external reporting and disclosure; and the management systems to implement these elements throughout an organization. Central to this entire discussion of increased corporate accountability is the issue of trust—its importance, how to build it, and

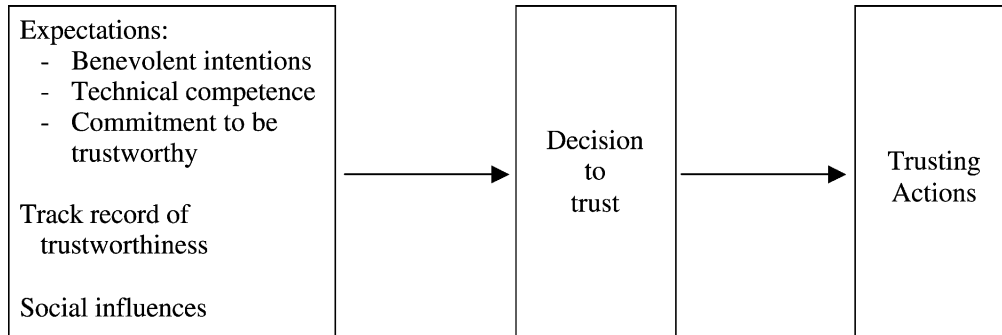
how to maintain it. Organizational and individual trust is critical to organizational performance and success. Trust is at the core of analyses of Enron and the closely related case of the fall of the prominent global auditing firm Arthur Andersen.

In this article, we develop a generic framework of the factors that lead to organizational trust and discuss the importance of trust to the success and failure of companies and their managers. We then show that excessive trust by some corporate stakeholders is a fundamental concept explaining the rise and fall of Enron, and we discuss why trust is so slow to build—yet can collapse so quickly. Although we focus on the Enron case, our model is generalizable across companies and can be used to explain trust dynamics in corporate disasters, as well as in strong companies where trust has been cultivated as a key source of competitive advantage. Last, we provide specific guidance on how companies and managers can build and maintain trust to enhance success.

## THE PSYCHOLOGY OF TRUST

Trust is the decision to rely on another party under a condition of risk. That is, trust has two principal components: reliance and risk. Risk refers to the possibility that the trusting party will experience costs or damage if the other party proves untrustworthy. Risk,

**FIGURE 1 THE DETERMINANTS OF TRUST, DECISION TO TRUST, AND TRUSTING ACTIONS**



therefore, creates an opportunity for trust. Reliance involves one's fate being determined by another's actions. Under a condition of risk, one's trust is signified by a decision to engage in action (i.e., reliance) that allows one's fate to be determined by another party. It also is possible that a decision not to take action can signify trust (e.g., a decision not to maintain surveillance over another party). The trust decision is based on positive expectations of, or confidence in, the trustworthiness of another party. Therefore, trust arises from judgments we make about the likelihood that another party will behave in a trustworthy manner as well as assessments we make about the possible costs we will suffer if the other party turns out to be untrustworthy.

We find it useful to distinguish between the "trustor," the trusting party, and the "trustee," the trusted party. Take, for example, investors who often purchase stock on the advice of stockbrokers. The investor (trustor) operates under a condition of risk because of the possible loss of funds if the stock declines. The investor assesses the stockbroker (trustee) and, if a certain level of confidence is reached, the investor acts on the decision and purchases the stock. The investor's financial fate is therefore a function of reliance on the stockbroker's recommendation. Applying this to Enron, many investors and Enron employees placed their

financial futures in the hands of Wall Street firms, many of whom made poor recommendations based on inadequate research or recommendations that were inappropriately influenced by their investment banking relationships with Enron.

A decision to trust is based on three main considerations:

- Expectations about another's trustworthiness
- Track record of another's trustworthiness
- Social influences

These determinants of trust are the basis of the mental calculus behind the decision to trust, which leads to trusting actions. This framework is depicted in Fig. 1.

### **Expectations About Another's Trustworthiness**

An expectation involves a prediction about whether another person will behave in a trustworthy or untrustworthy manner. We normally think about an expectation in terms of a probability. Although we may not assign an actual numerical probability, such as a "70% chance of trustworthiness," we make approximate judgments about whether it is likely or unlikely that another person will behave in a trustworthy manner.

There are three primary criteria used in forming expectations. First, does the person

have *benevolent intentions*? In other words, does the person aim to help us and guard our interests, even perhaps at his or her own personal cost? Individuals who are sensitive, empathetic, and unselfish are typically seen as having benevolent intentions. We tend to have confidence that these individuals will act in a trustworthy manner, and so we are inclined to rely on them. But, we all know those who are selfishly oriented and have agendas that may put their own interests ahead of ours. So, if we have suspicions that the other person might put his or her interests ahead of ours, we predict that the person is likely to be untrustworthy. As a result, we decline to trust.

In economic transactions, another dynamic can impact our perceptions of a person's intentions—namely, the financial incentives under which he or she operates. In a relationship such as the one between a stockbroker and client, the client may have little interest in the stockbroker's empathy or sensitivity. Rather, the client may be more interested in assessing the financial compensation system under which the stockbroker operates and whether this maximizes the alignment of the stockbroker's performance and the client's financial returns. If we are convinced that the compensation system focuses the stockbroker on maximizing our economic benefit we are more likely to trust him or her.

A second consideration impacting expectations is whether the person has *technical competence*. There are many well-intentioned individuals who do not have the skills to guard our interests. Take, for example, the choice of a tax preparer. One desires a tax preparer who will complete tax returns in compliance with tax laws, and in a way that minimizes the probability that the Internal Revenue Service will perform an audit. If the prospective tax preparer has only a superficial knowledge of the tax law, we are unlikely to select him or her to prepare our returns. So, a tax preparer with the best of intentions is a necessary but not sufficient condition for trust. If the tax preparer does not have extensive familiarity with the tax laws, no amount of good intentions will lead

us to hire her. The same logic can be applied to our stockbroker example. If we do not believe that he or she possesses solid knowledge of financial markets, we will not rely on his investment recommendations.

A third consideration impacting expectations is whether the person is *committed* to protecting our interests. Commitment to be trustworthy refers not to whether another party has unselfish intentions or is technically competent—rather, commitment to be trustworthy refers to whether the person is sufficiently motivated to protect our interests. Individuals may have benevolent intentions and be technically competent, but if we believe that they are unwilling to expend sufficient effort to guard our interests, we will lack confidence that they will behave in a trustworthy manner. Consider our tax preparer example. If the preparer's intentions are to ensure that we are in compliance, and he or she has deep knowledge of the tax laws, we still may not expect trustworthiness if he or she is unwilling to work diligently on our returns or is distracted by other tasks.

### **Track Record of Trustworthiness**

Because trust tends to be a very evidentiary decision, most of us behave as if we are from the "Show Me" state of Missouri; we wish to *see* the evidence that someone is trustworthy. We are heavily influenced by past experience because trust involves reassurance when it is upheld yet suffering when it is violated. Because the consequences of trust or distrust are personal and dramatic, we have long lasting memories of another person's track record of trustworthiness or untrustworthiness. We remember who has been trustworthy and may recall even more clearly who has violated our trust. There is yet another reason why we are so sensitive to another's track record of trustworthiness or untrustworthiness: because trust typically involves significant decision-making uncertainty. Often, our information is imperfect regarding someone's intentions, competence, or commitment. As a result of this uncer-

tainty, we recall our past experience with their trustworthiness or untrustworthiness as our best guide. Indeed, we are particularly impacted by evidence of trustworthiness when the person was not obligated to behave in a trustworthy manner—or did so at cost to him or her.

### Social Influences

Because it involves such personal consequences, trust is a largely solitary decision. Yet under certain conditions, our decision to trust also may be influenced by what family or friends do or urge us to do. Indeed, it is common for us to be swayed to trust someone by what others tell us about him or her. Furthermore, although trust is an evidentiary decision, we may use family members' or friends' experience as a proxy for our own. And, because trust decisions are often made in the context of incomplete information, we may even seek out the advice of others as a supplement to our own information.

The determinants of trust depicted in Fig. 1 combine to form the decision to trust, or not. Recall our stockbroker example. The client faces a decision whether or not to trust the advice of the stockbroker to buy or sell investment instruments. As our model indicates, the client forms expectations about the probability of trustworthy behavior by considering the benevolence of the stockbroker's intentions, his or her level of technical competence, and the stockbroker's commitment (effort) to maximize the financial gains of the client. The client also will weigh the track record of past trustworthiness of the stockbroker (i.e., has the stockbroker's past advice to us resulted in financial gain?). Finally, the client may be swayed by a friend's or family member's past experience with the stockbroker. Based on all these considerations, the client then makes a decision either to take the advice of the stockbroker, signifying trust, or to ignore the recommendation of the stockbroker, signifying the absence of trust. Based on a decision to trust, the resulting trusting action is to purchase or sell investments based on the stockbroker's advice. The

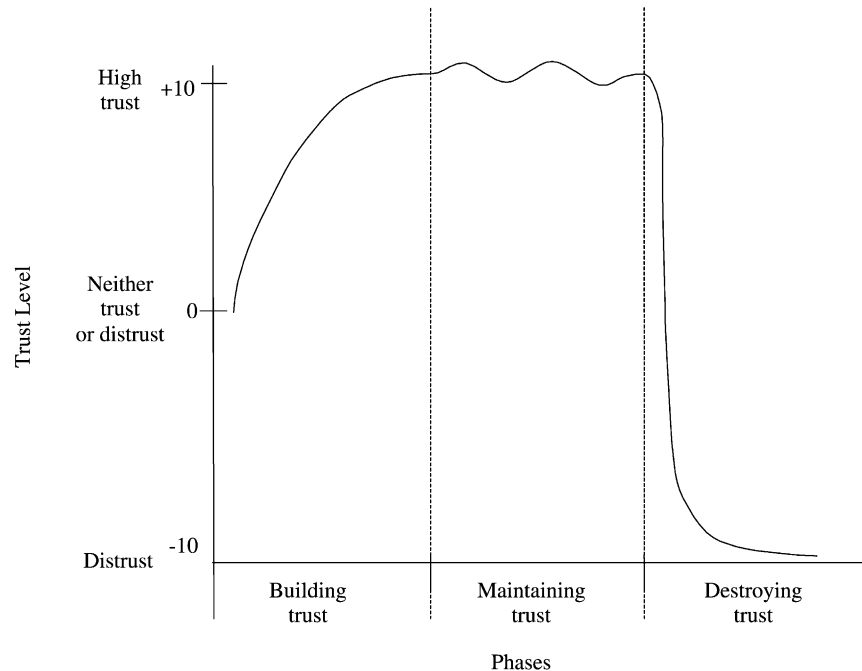
future financial consequences to the client are, of course, then a function of the advice received, and the resulting financial consequences thereby constitute a feedback loop to the determinants of trust.

### BUILDING, MAINTAINING, AND DESTROYING CORPORATE TRUST

Trust has evolutionary phases, as shown in Fig. 2. The pattern depicted shows that early in a relationship trust starts around the zero point because the parties lack information about the trustworthiness of their counterpart. Over time, if trust-building actions are taken, the overall level of trust grows until it begins to level off during the maintenance stage. During this stage, the level of trust stays constant, albeit with some minor variations, as long as neither party takes actions that erode trust. If, however, trust-destroying events occur, then the overall level of trust plummets quickly into the domain of distrust. Once distrust exists, significant trust-building efforts must take place just to return to the zero point of neither trust nor distrust. Even further efforts are required to then move into positive trust domain. Below, the evolutionary phases of trust are discussed in more detail.

In the trust-building stage, one builds trust by providing evidence of *benevolence*, *technical competency*, and *commitment* to be trustworthy, as well as by creating a *track record* of trustworthiness and leveraging *social influences* that favor trust. Building trust, however, is often slow because people tend to be reticent about trusting. This is especially true of those whom we do not know or about whom we have uncertainty. Trust building therefore follows an incremental pattern; one may trust in small ways first, observe whether trust is upheld or violated, and then proceed with caution in trusting one step at a time. This is why development of a track record of trustworthiness is so fundamental to the development of trust.

**FIGURE 2** EVOLUTIONARY PHASES OF TRUST



It should be noted, however, that a track record of trust might have a dark side as well. Unscrupulous individuals or companies may seek to create the illusion of a track record of trustworthiness and then exploit it for their own gain. For example, in most financial frauds and stock market bubbles, companies may entice investors to begin investing slowly and then increase the size of their investments as positive returns are demonstrated. But if the firm's business model is based on a house of cards, once weaknesses emerge, investors realize the tenuous nature of their investment and pull out their money as fast as possible. This phenomenon applies to Enron, which we will discuss later.

Once trust has been built, the demands lessen for evidence of trustworthiness. Yet even during the trust maintenance stage, there must be a continuous supply of information that keeps trust afloat. Once the maintenance phase has been reached, however, trust may become more and more resistant to information that implies untrustworthiness.

Indeed, once trust has been reached, we may cognitively discount new information that implies that the other party is not trustworthy. This is a somewhat peculiar aspect of the psychology of trust—namely, that once trust is built, we may actively reject evidence suggesting that a party whom we trust is actually untrustworthy. As we will explain shortly, some of those who developed trust in Enron were later resistant to information suggesting that Enron executives should not be trusted.

If solid evidence of untrustworthiness emerges, trust is destroyed quickly and distrust emerges. The speed with which trust can be destroyed depends on the magnitude of damage from untrustworthiness, plus the perceived intentionality of the untrustworthiness. In cases when the loss is particularly great, trust can evaporate almost immediately. If untrustworthiness is seen as intentional, the destruction of trust is particularly severe, because intentional untrustworthiness reveals malevolent intentions,

which are seen as highly probable of predicting future untrustworthiness. Technical mistakes or untrustworthiness due to lack of commitment, on the other hand, may be less damaging to trust because they can be more easily rationalized and do not reveal malevolent intent. Once distrust is created, it demands even more compelling evidence of trustworthiness, compared with the evidence required during the initial trust-building stage.

### **APPLYING THE TRUST FRAMEWORK TO ENRON: THE DYNAMICS OF EXCESSIVE TRUST**

Although there are some industries and companies that are relatively more dependent on trust (e.g., the service sectors), the importance of trust to all companies cannot be overstated. Trust was at the core of Enron's rise during the 1980s and 1990s and is central to explaining its collapse in 2001. Beginning with the 1986 merger of Houston Natural Gas and InterNorth, chief executive officer (CEO) Kenneth Lay was seen as taking an "old economy" company—with its origins as a traditional gas pipeline—and transforming it into Enron, a modern energy and commodities trading dynamo. We now draw upon our trust framework to analyze how trust in Enron evolved and the ways that Ken Lay and other executives built trust in Enron.

Lay's speeches to business and community groups conveyed a vision of a transformed company that would be the leader of the "new energy" industry. This vision resonated with both the energy industry and those on Wall Street who longed for increased productivity and profitability in an industry that was in a rut. Because Lay's vision was aligned with theirs, many industry observers began to develop trust in him. Lay was also perceived as trustworthy because he was seen as *benevolent*, due to his significant philanthropic activities in the state of Texas and nationally. Further contributing to the perceived benevolence

of Lay was his modest upbringing as a preacher's son in the Midwest. Given the perception of Lay's business acuity and civic benevolence, he came to be seen by many as highly trustworthy. Furthermore, Lay's persona created the sense that he was a highly *competent* executive, because he took a leadership role in the development of new business models for the energy industry. Lay also was seen as highly competent because he was able to accomplish what many energy industry executives had not. Finally, Lay's personal *commitment* was seen as completely focused on his vision because he had placed his company and his own personal career on the line in pursuing the new energy paradigm.

Further contributing to the perceived competence of its executives was Enron's willingness to take risks on innovations. Enron's reputation as an innovator was buoyed, for example, by *Fortune* magazine, which listed Enron as the most innovative company in the country for several years running. New programs such as EnronOnline, an Internet-based tool for trading commodities, also fueled Enron's reputation as an innovator. Enron's ability to take risks by embracing new innovations cemented the perceived competence of its executives.

In addition to Lay, other Enron executives were seen as technically competent because of their skills in business strategy and finance. Jeffrey Skilling, for example, was a highly touted former McKinsey & Co. consultant who aimed to revolutionize the energy industry by using highly sophisticated financial engineering and risk management tools, as well as by the use of the latest information technology. Andrew Fastow, Enron's chief financial officer (CFO), was a former Continental Bank in Chicago employee—known as a finance "whiz kid." Additionally, Lay, Skilling and Fastow surrounded themselves with graduates of the elite business schools. The perception was, therefore, that Enron's top echelons were populated with individuals who had strong academic pedigrees and track records of success with previous companies.

As Enron's stock demonstrated its dramatic run-up during the 1990s, Enron executives developed a *track record* of trustworthiness in the eyes of investors, analysts and employees, because the executives were perceived as truly delivering on the promise of a new vision of the energy industry. Because of their success and the growing confidence in Lay by investors, analysts, and employees, *social influences* also emerged—whereby the “true believers” in Enron exerted pressure on anyone who doubted Enron's vision and record. The mutual support of the bankers, investors, and employees provided further social reinforcement that any concerns about Lay's trustworthiness should be muted.

How did Enron build and maintain such a high level of trust among its other corporate constituents?

### **Board of Directors**

Corporate boards of directors recently have been criticized for lax oversight of corporate activities generally, and CEOs in particular. Enron was no exception. Indeed, the Enron board appeared to have excessive trust in Enron's top executive team. This included giving Enron executives wide latitude; for instance, the board twice suspended its conflict of interest policy when Andrew Fastow proposed to the board his role as a partner in off-balance-sheet financial entities. Belief in Ken Lay's business acumen and his prominence in the business and civic communities, combined with Enron's stellar financial performance in the 1990s, may have led some board members to place too much trust in Enron leadership and relax their scrutiny of the company and its financial statements.

Further, Enron's impressive financial performance indicated that it could be relied upon to deliver increasingly high returns, thereby leveraging the *track record* element of trust. Many Enron directors had served on the board for numerous years and observed a significant run-up in Enron's stock, which provided additional validation of Enron's

business practices. Furthermore, Wall Street's support for Enron was confirmation of what Enron was doing, despite any private reservations directors might have had about Enron's activities. In short, Enron's stock provided superior returns to investors in general, which further validated directors' trust in Enron's leadership and their business model.

### **Investor Community**

Based on four factors, Enron sold the story to the investor community (analysts, shareholders, and lenders) that its stock would continue to increase. First, Enron emphasized the competence of its leadership and the strength of its business model. The run-up of Enron's stock during the 1990s provided evidence that the company would continue to produce continued profitability, liquidity, and solvency. Many analysts acknowledged that they did not fully understand Enron's businesses, but confidence in Enron's management allayed analyst's uncertainty. Second, Enron demonstrated extraordinary confidence that inspired additional trust in the eyes of Wall Street analysts. Enron pressured analysts to “get behind” the Enron vision; any failure to do so implied that the analyst's hesitance was due to lack of sophistication and failure to understand Enron's business. Third, in communications with investors, Enron executives used the rapid rise in Enron's stock to provide additional validation of the company's vision and performance. The rapid rise was the basis for projections that the stock might eventually reach \$120 per share. Last, and perhaps most important, Enron withheld information on its business practices, such as special purpose entities, so that financial analysts (along with many others) did not have full information on Enron's finances. Thus, Enron leveraged the trust that it had fabricated, rather than financial transparency, to create the confidence necessary to support its stock price. When a lack of substance exists and there is an attempt to fool the public—as with many of the current stock market failures—

the lack of disclosure and transparency is necessary to mask company financial performance and buoy trust.

### **Employees**

For Enron to succeed, it needed to obtain the trust of its current and prospective employees. The company developed a reputation of being innovative and hiring top professional staff. As we have discussed, the company's leaders were seen to have a high level of *technical competence* and an excellent *track record*. Moreover, the employees were convinced that both the *intentions* and the *commitment* of the company executives were aligned with the employees' interests. Thus, if there were ever doubts about the company's actions, the employees' high level of trust provided assurance that the senior managers knew what they were doing.

### **Customers**

Enron relied on a high level of trust with its customers. As with most customer and supplier relationships, the company needed to develop trust that it was able to deliver promised goods on time. Both the company's *commitment* to its business model and *track record* influenced the customers' decision to trust Enron. The nature of the energy trading business (like many financial transactions) provided an additional demand for a high level of trust. As with banks, whenever customers deposit funds with the expectation of a future delivery of products or services, a high level of trust is required. Bank customers expect the bank to return deposits upon customer demand; energy-trading customers expect that energy will be provided at the agreed price and at the agreed time. As soon as a customer doubts the competence or commitment of the supplier to provide the agreed products or services, trust evaporates quickly and the business quickly collapses. Enron was able to convince its customers that it would be able to deliver energy products in the future, which enticed the customers to enter into the energy contracts.

### **Members of Local Communities and Government Regulators**

Because the energy business typically involves either regulated or quasi-regulated customers, Enron had a significant need to have a strong, positive relationship with government regulators and the communities in which Enron operated. Although this is the case with most large companies, it is particularly true in an energy company, because community members can have substantial *social influence* on the company's ability to obtain contracts. Further, it was critical that regulatory agencies were making rulings favorable to the industry in general and to Enron in particular. Indeed, many government rulings in favor of deregulation were seen as highly beneficial to Enron's business model. To build trust with regulators and local communities, Enron developed extensive political connections at both the local and national levels. Ken Lay was a major contributor to political campaigns and was friendly with government leaders. His actions demonstrated that both his *intentions* and *commitment* were aligned with political and community leaders that he was supporting. He had a powerful public image and was in the press often supporting charitable, community, and public interests.

### **Auditors**

Just as it was important to develop a high level of trust with other stakeholders, a trust relationship with its external auditor, Arthur Andersen, was a critical pillar on which the Enron business paradigm was built. The audit function involves certain standards and representations that are dependent on the auditor's assessment of a client's risk. This will then affect the audit scope and procedures to be used. Thus, a lower level of trust will normally encourage a higher level of scrutiny on the part of auditors as well as with other constituents. These decisions are affected by the auditor's perception of the trustworthiness of its clients and, in particular, the *technical competence* and *track*



*record* determinants of trust, which we have previously discussed. Over time, Enron built trust with Andersen, which lowered Andersen's scrutiny of Enron's finances. Arthur Andersen's trust in Enron was further bolstered by the fact that Enron employed many former employees of Andersen.

### **FURTHER COMPLEXITIES REGARDING TRUST IN ENRON**

Although Enron was adept at manufacturing trust among the investor community, the dynamic between Enron and Wall Street was complex, because many financial analysts *wanted* to trust that Enron could deliver superior returns on its stock. In other words, Wall Street was "co-dependent" with Enron; analysts tended to embrace the good news about Enron's growth and to ignore or minimize the bad news. Indeed, Wall Street appears to have ignored some information, such as the March 5, 2001 *Fortune* magazine article "Is Enron Overpriced?" by Bethany McLean, suggesting that Enron was over-valued and that it was engaging in improper financial reporting.

The *social influence* aspect of trust had its most pernicious effect on Wall Street analysts. Many have criticized Wall Street for operating with a "herd mentality." Because nearly all analysts had issued "buy" recommendations on Enron, a social norm emerged in favor of supporting Enron. The operation of this majority opinion concerning Enron created powerful pressures to stay in line with other analysts and a disincentive for any one analyst to buck the trend and criticize Enron. Incentives existed in favor of issuing buy recommendations, and disincentives existed for issuing negative comments. Furthermore, with the stock price rising, it became difficult for any analyst to make recommendations against the company.

Herd-mentality dynamics also applied to many of the other constituents. Customers, employees, and others all wanted to be a part of the Enron juggernaut that appeared to be leading the energy industry into the 21st

century. Moreover, the various constituents were affected by the "halo effect" that surrounded everything that Ken Lay and Enron did. Enron was seen as very successful and the model for a leading business. Because of Ken Lay's prominence in the business community, as well as his visibility as a civic leader, many saw him as beyond reproach.

Enron's board of directors and the investment community appeared to contribute to the mythology surrounding Enron that led to the extraordinary run-up of its stock. Because Enron stock had a stellar track record, many investors suspended their scrutiny of Enron's accounting and failed to fully investigate its business model; they did not wish to miss out on the gains derived from investing in Enron. The combination of Enron's record of delivering very attractive financial returns, the ability of Enron's leadership to fabricate trust among the investor community, and the social pressures among analysts in favor of supporting Enron, created a system that was largely impregnable to negative information about Enron.

### **THE FRAGILITY OF TRUST: WHY DID ENRON SINK SO FAST?**

Throughout its history, Enron was devoted to presenting an image of a firm that represented an outstanding investment opportunity. Yet, Enron did not exhibit financial transparency or responsiveness to queries of financial analysts. Nor did it have a well-functioning audit committee on its board. As things started to go poorly (e.g., financial losses, the public relations debacle of the Dabhol power plant in India, and the collapse of Azurix, an Enron spin-off water company), investors demanded more certainty about Enron's financial fitness. When Enron responded with arrogance (e.g., Skilling resorting to name-calling when an analyst challenged him during a conference call) and continued to withhold information, the investment community became more and more suspicious. Indeed, increased investor

demand for additional financial information was a key factor in Enron's downfall.

This involves another dynamic at play across the three evolutionary phases of trust depicted in Fig. 2, namely, the *confidence threshold*. This idea refers to the minimum level of certainty required for a decision to trust. The confidence threshold is the minimum bar that must be cleared with respect to the predictability of the other party. At the beginning of the trust building phase, the confidence threshold is relatively high—the demands are stringent for information that enhances confidence in predicting another party's future actions. As trust is built over time, however, the confidence threshold is lowered because a track record of trustworthiness has been established. Similarly, once trust has been established, as in the maintenance phase, demands for information about the predictability of the other party are relaxed.

If significant evidence emerges showing the other party to be untrustworthy, however, then the confidence threshold is drastically increased. That is, there is an inverse relationship between the degree of trust and the required level of certainty about the other party's future actions such that, if trustworthiness becomes questionable, the confidence threshold is correspondingly increased. If the threshold increases, scrutiny increases—because more information is required in making predictions about a company's future performance. If such scrutiny uncovers further information implying the untrustworthiness, trust can quickly turn to distrust.

When a firm's stock develops a track record of delivering high returns, as it did for Enron, then investors' confidence threshold relaxes (i.e., less scrutiny is required). Indeed, during the trust maintenance phase of Enron's evolution in the late 1990s, its stock reached a high of nearly \$90. Yet, once meaningful questions were raised within the investor community about Enron's business model and the appropriateness of its financial reporting procedures, then an inflection point was reached in Enron's evolution. Scrutiny swelled due to an increasingly stringent investor confidence threshold (i.e.,

demand for more information). As concerns about Enron began to snowball, investors required more and more information in order to assess Enron's financial health. Because information about Enron failed to reassure the investor community, confidence in Enron plummeted and investors came to deeply distrust Enron's ability to be a going concern. This created what many have referred to as the "run on the bank" at Enron.

The collapse of Enron could have been prevented if some constituents had adequately fulfilled their duties. In better-managed corporations, the fulfillment of responsibilities by, for example, the board would have caused the fundamental problems to surface earlier. This would have enabled the firm to deploy time and resources to mitigate the problems. To the contrary, the excessive trust by its constituents permitted Enron to survive significantly longer than might be expected. The lack of transparency aided the company in hiding the fundamental failures for months or years.

Why did constituent groups react so strongly to the collapse of Enron? Many suffered tremendous financial losses. And the employees lost jobs. That alone, however, does not account for the extent of the anger. Shareholders often lose money and employees do lose jobs. But, in the case of Enron, the trust of shareholders and employees was violated. They trusted Enron's management, board of directors, analysts, and auditors. This led to feelings of injustice, which has fueled the tremendous media attention that Enron garnered.

## THE APPLICABILITY OF THE TRUST MODEL

The fragility of organizational trust can be seen in companies other than Enron. Many of these same trust issues have played out recently at WorldCom, Tyco, Global Crossing, and Adelphia. Executives at these firms fabricated trust with their various constituents by manipulating expectations, social influences, and perceptions of the company's

track record. Shareholders and board members were willing to permit excessive compensation, related party transactions, and executive loans based on the same trust dynamics that were evident at Enron. Thus, the same destruction of trust seen at Enron also has been observed at these other companies that have recently collapsed.

The decline of trust has even been seen in traditionally strong companies. For example, General Electric Co.'s stock price fell by more than half as a result of the departure of CEO Jack Welch and renewed concerns regarding the management of earnings. Shareholders were willing to pay a premium for the stock based on an expectation of continued increasing stock price. Trust in GE's leadership propped up a price that exceeded competitor companies. As soon as trust in GE waned, the stock price fell.

Members of the investment community have experienced a similar pattern of lost trust. Stockbrokers Henry Blodget at Merrill Lynch & Co. and Jack Grubman at Salomon Smith Barney Inc. were held in high esteem in the profession of financial analysts. They garnered a high level of trust until many questioned whether their recommendations were based on independent analysis and decisions or tainted by financial incentives. As soon as trust was lost, their careers as investment advisers were severely tarnished.

The success of some industries is more dependent on organizational trust. The constituents are sometimes different. But the determinants of trust, the decision to trust, and the trusting actions are applicable across companies. The consequences of poor management of the trusting process can be disastrous. Organizational trust is fragile, and companies must carefully consider how they can better build and maintain trust to improve long-term organizational performance.

## **THE LESSONS FOR MANAGERS**

Corporations that are successful find ways to build and maintain trust. Some are built on

strong foundations, and others are shams. But in both cases, the operation of trust is critical. Our model of trust provides managers with a way to systematically think about what they can do to cultivate and maintain trust with their various constituents in their industry and company. The analysis of the rise and fall of Enron demonstrates both the centrality and fragility of organizational trust. If properly developed, trust can propel companies to greatness. Improperly used, it can plant the seeds of collapse. Trust has enabled strong companies to survive crises. In Enron's case, excessive trust permitted a weak company to survive longer than it should have.

The collapse of Enron is partly a story of inadequate scrutiny by stakeholders. Inappropriately high levels of trust lead to suspension of scrutiny by analysts, auditors, regulators, and the board of directors. It is a story of excessive hubris and inadequate transparency. It is a case of excessive trust by accountants, analysts, and board members.

Everyone wanted to be part of this new dynamic company. Ken Lay did a terrific job of manufacturing trust. The company lasted longer (or grew faster) than it should have. He bet on a lack of careful scrutiny, on inadequacies in corporate governance, and on confusing the accountants and analysts with new financial instruments. He also bet on the herd mentality to carry him forward. He carefully built trust on the part of all of his constituents, including government regulators and local community members.

Unfortunately, there was insufficient substance to the company to warrant this trust. Trust feeds on itself, as does distrust. When a company is rising, all of the determinants of trust provide fuel for the engine. The expectations of constituents (including perceptions of intentions, competence, and commitment), track record, and social influence all lead to increased trust. When trust is lost, however, the collapse is dramatic. As we look at recent headlines of other corporate debacles—including WorldCom, Tyco, Global Crossing, and Adelphia—the loss of trust was central. Indeed, Arthur Andersen did

not need the government action alone to destroy it. When Andersen lost the trust of its clients and the public, its fate was sealed. Almost a century of notable accounting and auditing practice was destroyed when the public no longer trusted the reliability of Anderson's audits.

Trust is typically built slowly and takes substantial organizational time and effort to maintain, but the benefits can be substantial. Successful companies build, treasure,

preserve, and nurture trust. They recognize that it helps them in good times as well as bad. They also recognize that if trust is lost, companies almost never recover. Building trust is critical for all companies—and is a critical element of successful corporate leadership.



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Our trust framework builds on the "decision model" of I. Ajzen and M. Fishbein, *Understanding Attitudes and Predicting Social Behavior* (Englewood Cliffs, NJ: Prentice-Hall, 1980) and is discussed in detail in S. Currall and T. Judge, "Measuring Trust Between Organizational Boundary Role Persons," *Organizational Behavior and Human Decision Processes*, 1995, 64, 151–170. The logic of our framework is supported by research literature on trust involving the role of expectations in trust (M. Deutsch, "Trust and Suspicion," *Conflict Resolution*, 1958, 2, 265–279), the influence of social pressures on trust (J. Adams, "The Structure and Dynamics of Behavior in Organizational Boundary Roles," in M. Dunnette, ed., *The Handbook of Industrial and Organizational Psychology* (Chicago: Rand-McNally, 1976, 1175–1199), and Stricklin's (L. Strickland, "Surveillance and Trust," *Journal of Personality*, 1958, 26, 200–215) work concerning past trustworthiness (i.e., the degree to which a trustee has behaved in a trustworthy manner in the past).

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