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A PRIMER ON ENRON: LESSONS FROM A *PERFECT STORM* OF FINANCIAL REPORTING, CORPORATE GOVERNANCE AND ETHICAL CULTURE FAILURES

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I. INTRODUCTION

As the stories of the collapse of Enron Corporation (Enron)¹ and the travails of its outside auditor, Arthur Andersen (Andersen), emerged² the usual

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1. Enron, as Part II details, was a Houston energy firm that had reported \$100 million in revenues. However, near the end of 2001, it suffered losses approaching \$1 billion; had to restate its earnings (they were \$600 million less than had been reported over the 1991-2001 time frame); and because of the impact on its stock price, ability to raise capital, and trading capacity, was forced to declare Chapter 11 bankruptcy. Edward Iwata, *Enron Faces "Hornet's Nest" of Charges*, USA TODAY, June 17, 2002, at 1B. The bankruptcy was listed as the largest bankruptcy in the history of the United States. Elizabeth L. Sanchez, *Special Report: Anniversary Report 2002 (Litmus Test of Leadership: Agenda for Governance)*, BUS. WORLD, July 27, 2002, at 34. However, the ranking was based on Enron's own numbers, which, as we will see, were not always the most reliable in the world.

WorldCom jumped on the scene by declaring not just bankruptcy, but that it was now the largest bankruptcy in the history of the United States. Simon Romero & Riva D. Atlas, *WorldCom's Collapse: The Overview*, N.Y. TIMES, July 22, 2002, at A1. But, then again, just days before declaring themselves king of the bankruptcy world, WorldCom confessed to booking \$3.3 billion in expenses in the wrong accounting column. Barnaby J. Feder & Seth Schiesel, *WorldCom Finds \$3.3 Billion More in Irregularities*, N.Y. TIMES, Aug. 9, 2002, at A1. By the time WorldCom was done, that number had crept up a bit, to \$9 billion, give or take a half-a-billion here and there. Kurt Eichenwald and Seth Schiesel, *SEC Files New Charges on WorldCom*, N.Y. TIMES, Nov. 6, 2002, C1, at C2. So, not to put too fine a point on things, Enron is somewhere in the top twenty, bankruptcy-wise, between \$9 billion and \$63 billion, give or take a billion. Richard A. Oppel, Jr. & Andrew Ross Sorkin, *Enron's Collapse: The Overview; Enron Corp. Files Largest U.S. Claim for Bankruptcy*, N.Y. TIMES,

questions arose:³ Where were the auditors? Where was the audit committee? Where were the lawyers? Where was the Board?⁴

However, the story of Enron and its ripple effect on Andersen is far too complex of a tale to enable a simple point of the finger and clear placement of blame.⁵ The more accurate question is, "What went wrong here?"⁶ The

Dec. 3, 2001, at A1. While the author recognizes that this piece focuses on the Enron collapse, the WorldCom debacle will be worth another 300-footnote piece. How on earth does a company hide \$9 billion in expenses? A walk-in closet won't even hold the receipts. Andersen was also the auditor for WorldCom and it is safe to say that Andersen auditors were not the sharpest tools in the shed when it came to ballpark figures on earnings and expenses. "Close enough" was apparently their model.

2. Between the period of September 2001 and June 2002, when Andersen was convicted of obstruction of justice, the number of Enron stories was remarkable. Simply take a gander at the sources in the footnotes in this piece. *See infra* all my footnotes.

3. *See generally* Daniel Kadlec et al., *Power Failure: As Enron Crashes, Angry Workers and Shareholders Ask, Where Were the Firm's Directors? The Regulators? The Stock Analysts?*, TIME, Dec. 10, 2001, at 68.

4. Additionally, many have asked post-bankruptcy, as they realize that the earnings were not only unrealized, but unrealistic and largely nonexistent, "Where was the money?" Another frequent question is, "Where were the analysts?" The analysts generally pose that question because they have become generically confused about where they are supposed to be and what they are supposed to do; apparently no one was aware of this confusion regarding analysts' roles prior to Enron. At any rate, the New York Attorney General, Eliot Spitzer, found the analysts, or, more relevantly, found the analysts' e-mails to each other. Mr. Spitzer summarized the emails saying, "[A]t the very moment they were telling us to buy this stock, invest more of your money in it, they were saying internally, there is absolutely no reason to own this stock. . . [.] It's a dog." *Now with Bill Moyers* (PBS television broadcast, May 31, 2002). Mr. Spitzer continued, "This correspondence shows that the people writing stock reports at times functioned essentially as sales representatives for the firm's investment bankers." Patrick McGeehan, *Merrill Lynch Under Attack as Giving Out Tainted Advice*, N.Y. TIMES, Apr. 9, 2002, at C1. Mr. Spitzer not only found the analysts, he extracted a rather tidy sum from Merrill Lynch. Merrill Lynch settled its case for \$100 million, an apology to investors, and disclosure of any investment bank fees it received during the past twelve months for companies whose stock its analysts had recommended. Charles Gasparino, *Merrill Lynch to Pay Big Fine, Increase Oversight of Analysts*, WALL ST. J., May 22, 2002, at A1. Other firms are under investigation for analyst behaviors and the SEC has joined Mr. Spitzer in the investigations. Charles Gasparino, *New York Attorney General Turns up Heat on Wall Street*, WALL ST. J., Apr. 10, 2002, at C1; *see also* Charles Gasparino, *SEC Launches Inquiry into Wall Street Research*, WALL ST. J., May 1, 2002, at C3. The negotiations over a settlement, liability and issues for the Wall Street firms continue. Gregory Zuckerman, *Wall Street's Settlement Will be Less Taxing*, WALL STREET J., Feb. 13, 2003, C1.

5. Apparently, the tale of Enron was far too complex for even its directors to understand. *See infra* section III for discussion, including charts and graphs, of the Enron complexity. The author is reminded of a quote from a Wall Street investment banker who left the room as some young hotshots were making a pitch for a company with derivatives, leasebacks, SLOBS, SWATS, FICAS, FUTAS and RUBES. His partners said as he departed, "A little too complex for you?" to which he responded, "The fact that I don't understand one thing that has been said in this room does not make this a good investment."

6. Oh, for the days of the 1980s and Gordon Gekko, *see* WALL STREET (Twentieth Century Fox 1987), when the activity was just insider trading, the motivation was just greed and we could understand what the heck they were doing. Heck, we understood preppie Dan Akroyd's (Louis Winthrop's) plan to get even with the Duke Brothers in TRADING PLACES (Paramount Pictures 1983) for giving him Eddie Murphy's (Billy Ray Valentine's) life as a street hustler. He got the citrus crop report in advance, lied about its content, had the Dukes

answer to that question is detailed and layered. No singular aspect of corporate governance, audit rules, or corporate compliance programs is responsible. For an Enron to collapse, or for that matter, for any of the companies that collapsed since Enron's bubble burst,⁷ required a confluence of events and behaviors, a sort of *Perfect Storm*⁸ of Board shortcomings; audit lapses,

bet the wrong way while he bet the right way on the price of citrus and he bankrupt the Dukes whilst winning Ophelia's (Jamie Lee Curtis') hand. *Id.* Trading on inside information, selling short: those are things Hollywood and we understand. "Complexity allowed Enron to hide the true picture from the capital markets," was the assessment from Professor Henry T.C. Hu at the University of Texas. Daniel Altman, *Contracts So Complex They Imperil the System*, N.Y. TIMES, Feb. 24, 2002, § 3, at 1. Enron's executives were daft, diabolical or stupid. But, there was a great deal going on here besides greed and selling short. These seem to be easy concepts next to Enron's offshore layers. See *infra* section II.B and accompanying charts.

7. Since the time of Enron, WorldCom filed for bankruptcy and it claimed that it is the world's largest bankruptcy. Simon Romero & Rita D. Atlas, *WorldCom Files for Bankruptcy: Largest U.S. Case*, N.Y. TIMES, July 22, 2002, at A1. Sure, and I have some broadband worth a billion I'd like to sell you and you can capitalize the cost, so no impact on earnings. Wait a minute, that line worked during most of the 1990s. At this point, it is hard to believe it could matter which of these companies is indeed the world's largest bankruptcy. Who knows, there may be other surprises out there. WorldCom had to restate its earnings by several billion; Xerox had to restate its earnings yet another time; and Martha Stewart is making soufflés under a cloud of suspicion related to insider trading because she dumped \$223,000 of ImClone stock the day before the company, (headed by Martha's boyfriend, formerly her daughter's boyfriend), announced that the FDA was not going to approve its new and highly touted anticancer drug, Erbitux. Constance L. Hays & Patrick McGeehan, *The Media Business: Advertising; Stewart Broker Handled Shares for Her Friends*, N.Y. TIMES, July 3, 2002, at C1. Martha missed her calling—it's soap opera for which she has a flair, not cranberry root and moss cobbler. When asked on *The Early Show* on CBS (a show on which Martha has a regular cooking gig) about the allegations and investigations, Ms. Stewart replied, "I just want to focus on my salad." *Id.* (citing *The Early Show* (CBS television broadcast, June 25, 2002)). She appeared to be poised to claw the eyes from Jane Clayson's head. CBS executives had made Ms. Clayson's questions, about the insider trading allegations, a precondition of Martha's regular appearance on the show. Ms. Stewart cancelled her next appearance on the show, which was to involve the preparation of icebox desserts. *Id.* One can distract an audience from insider trading questions with a salad, but icebox desserts just don't have near the draw.

The former CEO of ImClone Systems, Inc., Samuel Waksal, has been indicted by the U.S. Attorney for fraud and has entered a not guilty plea. Jerry Markon, *ImClone Ex-CEO Waksal Pleads Not Guilty to Charges of Fraud*, WALL ST. J., Aug. 13, 2002, at A6. Ms. Stewart is under investigation by Congress, the Justice Department and the SEC, who, reportedly, are not happy with inconsistencies and holes in the story that her broker sold merely under a stop-loss order. Constance L. Hays, *Investigators Said to Be Frustrated in Stewart Case*, N.Y. TIMES, Aug. 12, 2002, at C4.

8. *THE PERFECT STORM* (Warner Bros. Pictures 2000) based on the book SEBASTIAN JUNGER, *THE PERFECT STORM* (1998), starred George Clooney as the determined skipper of the Andrea Gail, a swordfish boat. Clooney, crew and the Andrea Gail wind up in the intersection of three major weather fronts, one of which was Hurricane Grace. The result was the "greatest storm recorded in history." Everyone aboard the Andrea Gail is presumed dead. They pushed the envelope in search of fertile waters (please excuse mixed and inappropriate metaphors) and destroyed themselves. Judging from the charts depicting Enron's not-so-fertile offshore investments, the executives mixed assets and commingled funds destroying their company, careers and a good chunk of Houston, Texas. Even the Houston Astros no longer play in Enron Field; it is now the "Minute Maid Park." Michael McCarthy, *Sports Sponsorship Game Heating Up*, USA TODAY, June 12, 2002, at B3. Robin Williams refers to

including the assumed watchful eyes of auditors, analysts and business media; and a corporate ethical culture that left those who saw the massive storm front moving in at the last minute, with few or no options, as it were, for shelter.

Litigation and prosecutions related to both Enron and Andersen will continue with the usual goals of assessing blame.⁹ However, the quest for

it as "Fifth Amendment Field." Robin Williams, Interview on *Late Night with David Letterman* (CBS television broadcast, July 10, 2002).

9. As of July 2002, the following steps occurred regarding criminal, civil and legislative investigations: Arthur Andersen, LLP, which served as Enron's outside auditors, was charged by the U.S. Department of Justice with one felony count of obstruction of justice for destruction of documents related to its Enron work. Jonathan Weil et al., *Editor's Ruling: Andersen Win Lifts U.S. Enron Case*, WALL ST. J., June 17, 2002, at A1. Following a six-week jury trial, Andersen was convicted. *Id.* A federal grand jury was impaneled in March 2002 to investigate Enron and its officers for possible criminal conduct including "fraud, perjury and obstruction of justice." *Id.* Financial institutions, including commercial banks, are also part of the federal investigation, as well as an independent inquiry by the Manhattan District Attorney's office. Kurt Eichenwald & David Barboza, *Enron Criminal Investigation is Said to Expand to Bankers*, N.Y. TIMES, June 26, 2002, at A1. Three British bankers were charged with criminal fraud for their involvement with South Hampton L.P., a partnership with Andrew Fastow, Enron's former CFO, as a principal. Kurt Eichenwald, *3 British Bankers are Accused of Fraud in Offshoot of Enron Case*, N.Y. TIMES, June 28, 2002, at C1. Connecticut's investigation into its \$200 million deal with Enron is sputtering because, as some theorize, there is no heart for looking at corruption in the state. Paul Zielbauer, *Bureaucratic Finger-Pointing Impedes Connecticut's Inquiry into Enron Deal*, N.Y. TIMES, June 20, 2002, at B1. Apparently corruption is as corruption does in Connecticut and it is a classic case of the following conclusion, "Let's not go there." Congress has been conducting ongoing hearings. The Senate Commerce Committee held hearings, beginning in January 2002. Greg Hitt & Kathryn Kranhold, *Internal Probe of Enron Finds Wide-Ranging Abuses*, WALL ST. J., Feb. 4, 2002, at A3; see also Stephen Labaton & Richard A. Opiel, Jr., *Enron's Many Strands: The Overview; Testimony from Enron Executives is Contradictory*, N.Y. TIMES, Feb. 8, 2002, at A1.

In fact, by the end of January 2002, six Senate committees, including: Banking; Commerce; Energy and Natural Resources; Finance; Governmental Affairs; and Health, Education, Labor and Pensions had all announced their own hearings on Enron. Jayne O'Donnell & Jim Drinkard, *Agencies, Panels Set Hearings on Enron*, USA TODAY, Jan. 21, 2002, at 3B. In the House, the following committees announced hearings: Education and Workforce, Energy and Commerce, and Financial Services. *Id.*; see also Don Van Natta Jr., *Enron's Collapse: The Politicians; Enron Spread Contributions on Both Sides of the Aisle*, N.Y. TIMES, Jan. 21, 2002, at A13. Andersen and Enron both face shareholder litigation. Jonathan D. Glater, *Rivals and Lawyers Vie over Andersen Remains*, N.Y. TIMES, June 18, 2002, at C4; Eric Berger, *\$680 Million Paid to Enron Execs in '01; Lay, Skilling Together Topped \$ 109 Million*, HOUS. CHRON., June 17, 2002, at A1. States such as Texas are also conducting probes. *The Fall of Enron*, HOUS. CHRON., Jan. 25, 2002, at A19. The FBI has been investigating insider-trading issues. Kurt Eichenwald, *U.S. Inquiry Tracks Insiders at Enron*, N.Y. TIMES, Apr. 15, 2002, at A1. The Justice Department is focusing on the company and its officers via a criminal probe and the Labor Department investigates Enron's retirement plans. Julie Mason, *Concerned Ex-Worker Was Sent to Human Resources*, HOUS. CHRON., Jan. 31, 2002, at A11. The SEC has, of course, also investigated. Jayne O'Donnell & Jim Drinkard, *Agencies, Panels Set Hearings on Enron*, USA TODAY, Jan. 21, 2002, at 3B. When a company collapses, can the SEC be far behind? The author realized too late that it would have been easier to list those agencies and committees that are *not* currently investigating Enron. The Department of Parks and Recreation in Mankato, Minnesota has declined prosecution.

In a major break-through, Michael J. Kopper, the former financial executive under Andrew Fastow, Enron's CFO, entered a guilty plea to money laundering and conspiracy to commit

blame is not a helpful exercise to implement the type of checks and balances that could have provided shelter from the storm or at least created some warning systems so that the collapse was not so sudden as to leave so many with no protection. Enron could not have happened without complicity on many fronts. The examination of that complicity proves helpful in prevention.

An examination of the confluence of these three separate storms provides insight into the types of reforms, regulatory and otherwise, that might prevent other unprecedented collapses or perhaps provide the means of intervention before the three components merge. As in *The Perfect Storm*, an Enron, with its full creative accounting scenario could not have occurred if just one of the three legs of the stool had functioned differently.¹⁰ There are prevention techniques, both minor and those requiring systemic change, applicable in each of the three legs that could serve to halt what otherwise is an inexorable march to destruction.

This analysis proceeds, in Part II with the story of Enron, what happened and when, and the resulting impact on the stakeholders of Enron. Part III examines the events and system flaws that had to come together at one time for Enron to collapse as it did, including the complicity of the parties, the flaws in the various systems created to prevent what happened to and within Enron, including internal audit, external audit, the Board, the audit committee, analysts, underwriters, and the business press. Finally, Part IV offers the prevention tools from the lessons of Enron with a detailed list of changes companies should make in order to prevent the havoc that befalls those whose checks and balances might otherwise fail simultaneously for the creation of the *perfect storm*.

II. THE STORY OF ENRON: WHAT REALLY HAPPENED HERE

When people speak of Enron, they do so quite easily with catch phrases such as, “You mean like Enron?” or “There are hundreds of other Enrons out there.”¹¹ Yet, just as when Enron was in business, it is not at all clear that

fraud. Jonathan Weil et al., *Guilty Plea by Enron's Kopper Increases Scrutiny of Ex-CFO*, WALL ST. J., Aug. 22, 2002, at A1. He surrendered \$12 million and agreed to cooperate fully with investigators. *Id.* It doesn't look good for the rest of the boys because Kopper knew a great deal. *See infra* notes 100-104 and accompanying text for specifics on Kopper.

10. The author recognizes that she once again mixes metaphors, but *Perfect Storm, Perfect Stool*, close enough.

11. Post-Enron collapse, one compensation expert summed up Enron as follows, “I am dissatisfied with using fuzzy numbers in doing accounting.” Matt Kranz & Del Jones, *Enron's Fall Fuels Push for Stock Option Law*, USA TODAY, Feb. 8, 2002, at B3. As the discussion following shows, Enron involved a bit more than fuzzy numbers and option reforms won't fix another Enron. One *Fortune* writer said the collapse of Kmart for mismanagement was the real scandal. Geoffrey Colvin, *It Ain't All About Enron*, FORTUNE, Feb. 18, 2002, at 44. Mr. Colvin understands Kmart's collapse was no surprise. *Id.* Martha Stewart caused that. She's trying to hawk glazed acorn napkin rings to folks who shop at Kmart, who don't use napkins. Kmart failed because of strategic errors, not knaves running the corporation. There is a differ-

those who reference Enron are able to explain exactly what Enron was doing and why it collapsed.¹² Enron's story is necessarily complex because its complexity is at least a partial explanation as to why it was able to continue in such grandeur for so long with so little in terms of performance and so few realizing, or at least saying aloud, that there were serious issues with a company that could implode at any time.¹³

A. *The Initial Years*

Enron, Corp. was incorporated in Oregon in 1985, as a simple gas company as a result of a merger of Houston Natural Gas and Internorth of Omaha.¹⁴ With its principal offices in Houston, Texas, it became the "world's largest energy company."¹⁵ While Kenneth Lay, one of the com-

ence between failure due to ineptness in business and failure due to financial shenanigans. Actually, we remain unsure even about Kmart, for, as they say in business these days, investigations are underway regarding Kmart's accounting practices. Stephanie Armour, *Grand Jury Impaneled in Kmart Probe*, USA TODAY, Aug. 12, 2002, at B1.

12. Indeed, when he testified before a House Subcommittee, former CEO Jeffrey Skilling, assured that even he, as CEO, had no idea what was going on, "[t]his was a very large corporation. . . . It would be impossible' to know everything going on." Stephen Labaton & Richard A. Oppel, Jr., *Enron's Many Strands: The Overview; Testimony from Enron Executives is Contradictory*, N.Y. TIMES, Feb. 8, 2002, at A1. Representative Edward J. Markey (D., Mass.) accused Mr. Skilling of using the "Sergeant Schultz defense of 'I see nothing, I hear nothing.'" *Id.* Sergeant Schultz was the officer in charge of POWs in the show *Hogan's Heroes* in which the POWs had the run of the camp. Schultz suspected something was awry, but who could argue with his record? No one had ever escaped from Stalag 13. The record spoke for itself. Of course, the POWs were out through a tunnel doing U.S. espionage work, stealing furs, diamonds and silk stockings and generally winning the war for the Allies. *Hogan's Heroes* (CBS television broadcast 1965-1971). Likewise, Enron's traders, accountants and financial officers were using all manners of creative accounting and while suspicions were there, who could argue with double-digit earnings growth and a stock price of \$83 per share? *Southeast Market Players Abandon Faltering Enron as Dynegy Steps in*, SE. POWER REP., Nov. 12, 2001, at 8. Sixty to eighty times Enron's earnings (or alleged earnings as the case may be). *Id.* See also *supra* note 5, in which the author raised the possibility of daftness and/or stupidity.

13. See Bethany McLean, *Is Enron Overpriced?*, FORTUNE, Mar. 5, 2001, at 122.

14. Kurt Eichenwald, *Enron's Collapse: Audacious Climb to Success Ended in a Dizzying Plunge*, N.Y. TIMES, Jan. 13, 2002, at A1; Greg Farrell & Del Jones, *How Did Enron Come Unplugged?* USA TODAY, Jan. 14, 2002, at B1 [hereinafter *Enron Unplugged*]; see also Jeff Gerth & Richard A. Oppel, Jr., *Regulators Struggle with a Marketplace Created by Enron*, N.Y. TIMES, Nov. 10, 2001, at C1.

15. The author acknowledges that the source for this claim is Enron. www.enron.com (last visited end of 2001; not on site as of Nov. 2002 because Enron stopped making this claim). However, support for this claim by Enron can be found in CEO, Jeff Skilling's license plates, which held the acronym "WLEC" for "World's Largest Energy Company." Kevin Whited, *Once the World's Largest Chutzpah Company*, KEVIN WHITED'S REASON F. v. 4.0: REFLECTIONS—THE J. (Feb. 9, 2002) at <http://www.publiustx.net/journal/archives/000056.htm>. Being "the world's largest energy company" means someone has looked at the numbers and then leapt to that conclusion. See *supra* note 1 and *infra* notes 45-51 for thoughts on reliance on Enron's numbers. A banner in the company's lobby read, "The World's Leading Company." Bethany McLean, *Why Enron Went Bust*, FORTUNE, Dec. 24, 2001, at 58, 60 [hereinafter *Why Enron Went Bust*].

pany's founders, was an innovator in the energy field, popularizing utilities' involvement in hedging activities to cover fluctuations in weather and energy pricing, it was not until Harvard MBA, Jeffrey Skilling was hired in 1990 that Enron began its descent (or ascent followed by descent) into leveraged energy trading.¹⁶

By the end of 2001, Enron held twenty-five percent of all of the world's energy trading contracts.¹⁷ Enron's public relations materials describe it as "one of the world's leading electricity, natural gas and communications companies, which markets electricity and natural gas, delivers physical commodities and financial and risk management services to companies around the world, and has developed an intelligent network platform to facilitate online business."¹⁸ Enron held interests and operated companies on all continents except Antarctica.¹⁹ By 2001, it was called the "most innovative company" in America by *Fortune*, and with \$100 billion in annual revenues, it was number seven of the Fortune 500.²⁰

Enron was also one of the world's most admired corporations, appearing consistently in listings of the "100 Best Companies to Work For," an annual analysis done by *Fortune* magazine of companies and their treatment of em-

16. Mr. Skilling came in contact with Enron as a management consultant during his time at McKinsey & Co. John Schwartz, *Enron's Many Strands: The Former C.E.O.; Darth Vader, Machiavelli, Skilling Set Intense Pace*, N.Y. TIMES, Feb. 7, 2002, at C1. His first position at Enron, in 1990, was director of trading operations. *Id.*

17. Noelle Knox, *Enron to Fire 4,000 from Headquarters*, USA TODAY, Dec. 4, 2001, at B1. One of the things you quickly learn in exploring Enron is that all of its rankings were based on the numbers management generated internally, which, as we know now, were spun out of whole cloth. So, when Enron says that it held twenty-five percent of the world's energy contracts, it is important to understand the concept of restatement. The author refers not to the RESTATEMENT OF CONTRACTS, but rather, to the new activity of most companies, which is restatement of earnings. Enron has restated its earnings, its assets, its equity, ergo the numbers upon which these were based, i.e., contracts for the sale of energy, were, perhaps, bogus, or the stated returns from those contracts were fictitious. The problem with the accuracy of the numbers is exacerbated by the problem of the contracts themselves that no one really understood. In fact, many folks who were parties to Enron contracts were not actually sure what they had purchased or what Enron was offering for sale. See David Barboza, *Ex-Executives Say Sham Deal Helped Enron*, N.Y. TIMES, Aug. 8, 2002, at A1; Tom Fowler, *Broadband-unit Hype Didn't Match Reality*, HOUS. CHRON., Jan. 18, 2002, at A1; Rebecca Smith & John R. Emshwiller, *Running on Empty: Enron Faces Collapse as Credit, Stock Dive and Dynegy Bolts*, WALL ST. J., Nov. 29, 2001, at A1. Like the dot-coms, Enron sold a great deal of air, but with nice margins, at least as originally reported.

18. Plaintiff's Complaint at 1, Kaufman v. Enron Corp., No. 4:01-3682 (S.D. Tex., filed Oct. 25, 2001) (on file with *California Western Law Review*). Enron staked its ground with this description as opposed to the rest of the world that has developed really stupid network platforms.

19. See ENRON 10-K (2000) available at <http://www.sec.gov/Archives/edgar>. See also *infra* notes 29-31 and section II.A.2.

20. *Running on Empty: Enron Faces Collapse as Credit, Stock Dive and Dynegy Bolts*, *supra* note 17. That ranking put it ahead of IBM and AT&T, as far as we knew at that time. *Id.*; see also *supra* note 1 for discussion of Enron's bankruptcy.

ployees.²¹ Enron's outside auditors, from the beginning of the aggressive financial techniques, were Arthur Andersen, with partner David Duncan out of the Houston office assigned to the Enron account.²² Mr. Duncan had a ten-year relationship with Enron; during the last five he was the partner in charge.²³ As will be noted later, Mr. Duncan played a critical role in Enron's growth and preparation of earnings statements.²⁴

Enron was positioned strategically in the 1980s and 1990s to take a first-mover position and advantage in the energy markets that were moving toward deregulation.²⁵ Enron seized the opportunity to become an energy

21. Shelly Branch, *The 100 Best Companies to Work for in America*, FORTUNE, Jan. 11, 1999, at 118. Enron appeared for the first time in the top 100 in 1997. In 2000, it was ranked as #24, and in 2001 it was #22. Robert Levering & Milton Moskowitz, *The 100 Best Companies to Work for: These Employers Show No Signs of Cutting Back on Their Commitment to Employees*, FORTUNE, Jan. 8, 2001, at 148. Employees had a "[h]ealth club, doctor's office, subsidized Starbucks coffee, concierge, massages, and car wash" on site. Alexei Barrionuevo, *Your Career Matters: Jobless in a Flash, Enron's Ex-Employees are Stunned, Bitter, Ashamed*, WALL ST. J. Dec. 11, 2001, at B1. The key to the options program was running for your life from the company. *Fortune* was duped for a time, but its writer Bethany McLean eventually came through. *Why Enron Went Bust*, *supra* note 15. See *infra* notes 293-298 and accompanying text for discussion. Enron was, in reality, one of the "100 Best Companies to Work For," as far as we knew. The company had opulent headquarters and was gearing up to build even bigger and better headquarters when its bubble burst. Of course, Enron was doing the square footage computation on the new company headquarters so it might well be that the square footage was overstated as well. Employees at company headquarters were also able to enjoy one of the many concierges, a masseuse for relieving tension and a service to have their cars washed while they were at work. Workout rooms, generous retirement plans, you name it, and Enron employees had it. Barrionuevo, *supra*. Actually, the retirement plans also had to be restated because they included large amounts of Enron stock. Enron employees, current and former, now have retirement plans that consist, on average, of about 10,000 shares of Enron stock, valued at \$0.67 cents per share. Julie Mason, *Former Enron Workers Air Complaints on CNN*, HOUS. CHRON., Jan. 21, 2002, at A10. It's not a posh retirement, just about enough to have your car washed once or twice. Enron Broadband employees got Palm Pilots, cell phones and wireless laptops. Barrionuevo, *supra*. Enron International employees had authorization for \$5,000 bar tabs. *Id.*

22. Anita Raghavan, *Accountable: How a Bright Star at Andersen Fell Along with Enron*, WALL ST. J., May 15, 2002, at A1. By all accounts, David Duncan, 43, was a hard-working family man, committed to his local church, and a fast-tracker at Andersen. After graduating from Texas A&M, he became one of Arthur Andersen's youngest partners and earned \$1,000,000 per year, as the managing partner for Enron's audits. However, as attorney Rusty Hardin, the lead defense lawyer for Andersen in its obstruction of justice case noted, "No question David Duncan was a client pleaser." *Id.* Mr. Duncan's pastor said Enron put the pressure on him, "[h]e basically said it was unrelenting. It was a constant fight. Wherever he drew that line, Enron pushed that line—he was under constant pressure from year to year to push that line." *Id.*

23. *Id.* Mr. Duncan's office was in the Enron building in Houston and he was a close friend of Enron's chief accounting officer, Richard Causey—they traveled together, lunched together, golfed together, and now after Duncan's guilty plea, apparently cooked the books together. *Id.*; see also Cathy Booth Thomas & Deborah Fowler, *Will Enron's Auditor Sing?* TIME, May 20, 2002, at 44. Duncan was bringing in \$50 million per year in audit fees from Enron. *Id.*

24. See *infra* section III.A.1 and accompanying text and footnotes.

25. The first mover position is one of those "stratagery" terms that, restated, as it were, in lay terms (pun intended), "No one has thought of your idea yet, so move on in and make as

trader at a time when the federal and state governments opened the doors for utilities to participate in an open market for the wholesale, and eventually retail, purchase and sale of electricity. Just beginning at the time of Enron's initial seizure, were the creation of national power grids, the spot pricing of electricity, and long-term contract commitments with locked in prices.²⁶ Enron became a new and critical player in this open market because its trading operations allowed electric utilities to hedge risk with futures contracts for energy.²⁷ Enron dominated the market; in fact, utilities around the country often used "the Enron model" as a basis for their strategic discussions and plans.²⁸

much money as you can before they do." One Enron executive phrased it this way—Enron created a "regulatory black hole . . . [Its] core management philosophy . . . was to be the first mover into a market and to make money in the initial chaos and lack of transparency." Jeff Gerth & Richard A. Oppel, Jr., *Regulators Struggle With a Marketplace Created by Enron*, N.Y. TIMES, Nov. 10, 2001, at C1.

26. *Enron Unplugged*, *supra* note 14. Enron was forced to move, because of the heavy debt from the merger that created it and the stiff competition that soon appeared in the industry, from a simple gas and electric company into the role of a broker, middle-man for utilities, in the buying and selling of electricity. "Think of it as an energy eBay with algorithms," was one description of Enron. *Id.*

27. Enron did not limit its hedging activity to electricity. It was hedging telecommunications wire load, bandwidth, lumber, and even television ad times. If there were anything that sounded like a bet, Enron would take by creating contracts that went both ways and selling them both ways. Enron was AC/DC on electricity and all forms of futures. For example, it created a market for snowfall, that is, ski lodges could hedge their risk on snowfall. If the snow fell, Enron made money. If the snow didn't fall, the ski lodge got paid by Enron and was covered for its lost season. *Id.* Actually, Enron probably sold contracts the other way to people who were betting there would be snow and so Enron was covered no matter what happened with the snowfall. If this all sounds made-up and risky, it was. Bankruptcy at the largest level the U.S. has ever seen, "don't come easy," as Ringo Starr would say. RINGO STARR, *It Don't Come Easy*, on BLAST FROM YOUR PAST (Apple 1975). See generally *Enron Unplugged*, *supra* note 14; see also *supra* note 1 for an important caveat on bankruptcy rankings.

28. McKinsey & Company, specifically a young consultant, named Jeffrey K. Skilling, was the mastermind of the Enron model. He piloted Enron through the new waters it had charted (note apropos and consistent metaphor for *The Perfect Storm* theme). *Audacious Climb to Success Ended in a Dizzying Plunge*, *supra* note 14.

The Enron model included some market tactics that California and the Federal Energy Regulatory Commission are investigating. Richard A. Oppel, Jr. & Jeff Gerth, *Enron Forced Up California Prices, Documents Show*, N.Y. TIMES, May 7, 2002, at A1. For example, "ricochet" or "megawatt laundering" are names for some trading activities of which regulators now question the legality. *Id.* Enron would buy power in California, transport that power to the national market, and then bring it back into California at a higher price. Enron also used a "Get Shorty" strategy, which employed the sale of power commitments. *Id.* They would sell the commitments at a high price and then buy its own commitments at a low price. In effect, it was making money selling a service to provide power it knew it would never be forced to provide. Enron also used the "Death Star" strategy of scheduling power it didn't need to drive up the price and force others to pay the premium prices required to have them forgo use of backed-up transmission lines in periods of high volume (congestion, as they say in the trade). *Id.* The names are courtesy of Enron traders. The disclosure of the strategies comes from ongoing investigations. See Oppel & Gerth *supra*; Kathryn Kranhold & Rebecca Smith, *Energy Sellers Teamed up in Profit-Boosting Scheme: Role of White's Unit Raised*, WALL ST. J., May 9, 2002, at A1. See generally John Swartz, *Daschle: Somebody Ought to Go to Jail*, USA TODAY, May 10, 2002, at 5B.

By 1995, Enron was the country's largest national gas purveyor.²⁹ In fact, Enron became "the biggest e-commerce company in the world."³⁰ Revenues topped \$100 billion and Enron began pursuing investments in hard assets, such as power plants and water companies.³¹ Enron still sold natural gas, but in long-term contracts that were hedged by other instruments, with Enron taking a cut in all contracts.³² Enron's niche, combined with creative and aggressive trading in the boom of the 1990s, saw the company's share price soar to \$83 per share in January 2001³³ with 20,000 employees and earning nearly \$100 billion per year.³⁴

As other utilities entered the market for national and international wholesale sales of electricity, however, Enron lost its dominant position and its ability to post the double-digit earnings growth and resulting share price increases its investors, employees, officers, and Board had come to expect.³⁵ It was during 1999, when Enron executives began to feel the crunch of the market; as a result, multifarious forms of financial creativity were begun as a

29. *Enron's Collapse: Audacious Climb to Success Ended in a Dizzying Plunge*, *supra* note 14. These numbers appear to be real, verifiable and verified, and occurred in 1995, which was before Enron began making things up, again not to put too fine a point on things.

30. *Id.* By the time Skilling became COO in 1997, Enron was even selling weather derivatives; utilities could purchase hedges against hot and cold weather, depending on which way their risk was. And Enron would hedge its risk the other way with those who were willing to be that the weather would do something just the opposite of the original hedge. *Id.*

31. *Id.* It had \$10 billion in such assets, but they produced very little in terms of earnings. *Id.* Enron's executives knew how to trade, but they did not know how to manage. By the time the company collapsed, these plants and companies were in utter chaos. Enron's foray into India for construction of a power plant, found it asking Vice President Dick Cheney to dun India for payment of the \$64 million it was owed. Bennett Roth, *The Fall of Enron: Enron Project was Raised With India*, HOUS. CHRON., Jan. 19, 2002, at A20. *See generally* Melita Marie Garza, *Cheney Discussed Plagued Enron Project in India*, CHI. TRIB., Jan. 19, 2002, at A12.

32. *Enron's Collapse: Audacious Climb to Success Ended in a Dizzying Plunge*, *supra* note 14.

33. *The Enron Scandal: By the Numbers*, USA TODAY, Jan. 22, 2002, at 3B. These numbers are verifiable via independent sources that are more independent than the independent auditors Enron used.

34. *Enron's Collapse: Audacious Climb to Success Ended in a Dizzying Plunge*, *supra* note 14. The number of employees is verifiable. The earnings, well, see *supra* notes 1, 17 and 24.

35. Bob McNair, a Houston entrepreneur who sold his company to Enron in 1998 stated, "If they had been going a slower speed, the results would not have been disastrous. . . . It's a lot harder to keep it on the track at 200 miles per hour. You hit a bump and you're off the track." John Schwartz & Richard A. Oppel, Jr., *Enron's Collapse: The Chief Executive; Foundation Gives Way on Chief's Big Dream*, N.Y. TIMES, Nov. 29, 2001, at C1. Between mid 1998 and the end of 1999, Enron's stock price tripled from \$20 to over \$60 per share. Peter Behr & April Witt, *Visionary's Dream Led to Risky Business*, WASH. POST, July 28, 2002, at A1. By the middle of 2000, the share price was over \$80. *Id.* By October 2001, that price dropped seventy-eight percent. Floyd Norris, *Enron Tries to Dismiss Finance Doubts*, N.Y. TIMES, Oct. 24, 2001, at C1. The 1997-2001 earnings were ultimately restated and reduced by \$586 million, 20 percent of its earnings for those four years. John R. Emshwiller et al., *Enron Slashes Profits Since 1997 by 20%*, WALL ST. J., Nov. 9, 2001, at A3 [hereinafter *Enron Slashes Profits*].

means of bolstering earnings and maintaining or increasing the market price of Enron's shares.³⁶

B. The Creative Years: The Data Behind Enron's Financial Statements

Enron followed two strategies for maximizing revenue growth. During the late 1990s, Enron expanded itself from energy trader to highly leveraged hedge fund through a series of structural changes.³⁷ Enron transitioned from stodgy energy trader to leveraged hedge fund dealer without alarming shareholders or even analysts because hedge funds have so little regulation in terms of disclosure requirements when run by a power trading company.³⁸ The second strategy involved complex structures that technically complied with the Financial Accounting Standards Board (FASB) rules and therefore, not subject to the long arm of the law.

36. See *Enron's Collapse: Audacious Climb to Success Ended in a Dizzying Plunge*, supra note 14. The period between 1999 and Enron's bankruptcy in December 2001 represented fertile times for officer trading: "Mr. Lay sold Enron stock 350 times, trading almost daily, receiving \$101.3 million. In all, Mr. Lay sold 1.8 million Enron shares between early 1999 and July 2001, five months before Enron filed for bankruptcy." Leslie Wayne, *Before Debacle, Enron Insiders Cashed in \$1.1 Billion in Shares*, N.Y. TIMES, Jan. 13, 2002, at A1. The sales were at prices ranging from \$31 to \$86 per share. *Id.* Beginning in December 2000, Mr. Skilling sold his shares at a rate of 10,000 every seven days. *Id.* A suit by Amalgamated Bank of New York documents what its lawyers call, "the most massive insider bailout that we've ever seen. . . . The overall size of this case is unprecedented." *Id.*

Interestingly, Enron began marketing its earnings management techniques to other companies, including AT&T, Eli Lilly & Company, Owens-Illinois, Lockheed Martin, and Qwest Communications. David Barboza, *Enron Offered Management Aid to Companies*, N.Y. TIMES, Apr. 10, 2002, at C1. One of the techniques touted was "swap[s]", an area of investigation for Qwest. *Id.*

37. Gregory Zuckerman, *Enron Quietly Ran a Risky Hedge Fund That Did Well*, WALL ST. J., Apr. 11, 2002, at C1. Mr. Skilling created the hedge-fund operations in 1996 through an Enron subsidiary called ECT Investments. *Id.* The benefit of the hedge fund was two-fold: (1) large returns (20%); and (2) regulatory no-man's land. *Id.* The result was the ECT could bet high and with leveraged funds with little disclosure required. *Id.* ECT was an autonomous trading unit and had the highest R01 of any of Enron's subsidiaries. *Id.* It was responsible for 40 percent of Enron's earnings. *Id.*

38. *Id.* "They [Enron] didn't hide it, but there was not a lot of financial disclosure about the hedge-fund group." *Id.* Of course, no one referred to Enron as such until after the collapse despite the obvious revelations that basic financial report analysis would have provided. A safety tip on companies is that when they have income through the roof but nonexistent cash flow and returns lower than their cost of capital, something might be amiss. The Enron team quickly mocked those who asked such basic finance and financial reporting questions. *Fortune* magazine's editors had to accept a tongue lashing from Jeffrey Skilling because one of its reporters, Bethany McLean, had the nerve to raise the basic question, "How are these guys doing this?" Actually, she asked an even better question, "What exactly are these guys doing?" Ms. McLean indicates that she obtained her insights and questions from a short-seller, one of those risky market types (although no more risky than an Enron investor, as we know now) who bets that a company's stock will go down. It seems short-sellers really do their homework. See *Why Enron Went Bust*, supra note 15; see also Cassell Bryan-Low & Suzanne McGee, *What Enron's Financial Reports Did and Didn't Reveal: Enron Short Seller Detected Red Flags in Regulatory Filings*, WALL ST. J., Nov. 5, 2001, at C1.

Two critical FASB rules enabled Enron to make the transition from energy company to hedge fund with minimal disclosures. The first rule dealt with disclosures on special purposed entities (“SPEs”).³⁹ Direct disclosures about these entities were not required on Enron’s financial reports if these SPEs were structured a certain way. To even understand the scope and breadth of these off-the-books entities required great expertise and significant outside research. Without this significant outside research, it was impossible to understand or evaluate Enron’s true financial situation.⁴⁰

Enron also used the flexibility FASB provided on the booking of revenues for contracts that will be performed in the future, known as mark-to-market accounting. Under FASB rules, management was charged with the duty and discretion of valuing those contracts and Enron management used that discretion liberally.

Enron rode the wave of double-digit earnings and a booming economy by taking advantage of the flexibility of the FASB rules and the even greater flexibility of auditors charged with their application to their clients’ financial

39. ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Financial Accounting Standards No. 140 (Financial Accounting Standards Bd. 2000) [hereinafter ACCOUNTING FOR TRANSFERS], a replacement of FASB 125, governs the consolidation of financial statements with regard to SPEs. The rule provides that until the company owns fifty percent or more of the voting shares, consolidation reporting with the parent is not required. Enron’s Accounting Issues—What Can We Learn To Prevent Future Enrons Statement Before the House Energy & Commerce Comm., 107th Cong. (Feb. 6, 2002) (prepared statement of Bala G. Dharan, Ph.D., C.P.A., Professor of Accounting at Rice University)(available through Federal News Service)[hereinafter Dharan testimony]. See *infra* section II.B for further explanation of Enron’s use of SPEs to manipulate the FASB rules.

40. Note, once again, the use of the water metaphor. For example, one of Enron’s 10-Ks (1999) simply disclosed that officers of the company were the principals in organizations that were doing business with Enron. The mandatory “related party transactions” disclosures revealed the following, a senior officer of Enron “is the ‘managing member’ of [LJM] with which Enron had entered into series of transactions.” *What Enron’s Financial Reports Did and Didn’t Reveal: Enron Short Seller Detected Red Flags in Regulatory Filings*, *supra* note 38. This one-line disclosure was a signal to some analysts, i.e., “Dad gum, these guys are doing business with themselves and taking commissions from each other to do it.” However, few analysts actually took the time to investigate Enron’s true structure and debt exposure. Actually, given the revelations on analysts post-Enron and Merrill Lynch’s plea agreement, it would seem analysts were doing very little except touting the shares of companies in which their firms had an underwriting interest. Hear no evil, see no evil, speak no evil, and don’t say anything about the financials or 881 Enron subsidiaries, 700 of which are in the Cayman Islands. Professor Alan Bromberg notes, “[t]he heart of disclosure is intelligibility. . . . If the people to whom it’s addressed can’t understand it, it hasn’t been adequately disclosed. There’s clearly a qualitative, as well as a factual, component to disclosure.” Jonathan Weil, *What Enron’s Financial Reports Did and Didn’t Reveal: Auditor Could Face Scrutiny on Clarity of Financial Reports*, WALL ST. J., Nov. 5, 2001, at C1.

Those who did question Enron were met with the wrath of Khan, or at least Skilling. A short seller who criticized Enron for not providing a balance sheet was called an “ah” by Jeffrey Skilling in April 2001. *What Enron’s Financial Reports Did and Didn’t Reveal: Enron Short Seller Detected Red Flags in Regulatory Filings*, *supra* note 38.

statements.⁴¹ The confluence of the effects of these two accounting rules permitted Enron's managers to paint a picture of Enron's financial condition that neither reflected the exposure investors held in terms of risk nor the true amount of earnings the company had.

1. "Mark-to-Market Accounting"

Enron utilized "mark-to-market accounting," in full compliance with accounting rules for the reporting of income from futures contracts. These rules apply not just to energy contracts, but to all types of transactions that are entered into presently, but will realize revenue over long periods of time. The right to receive those revenues or the present value of those contracts is a critical part of a company's, especially one such as Enron, financial picture. Under FASB 133, for example, energy traders are permitted to include in current earnings those profits they expect to earn on energy contracts and related derivative estimates.⁴² Accordingly, many energy companies were posting non-cash earnings that they expected to realize some time in the future.⁴³

Mark-to-market accounting was an integral part of the electric industry, but was used by all companies that had any form of long-term contracts, future and otherwise.⁴⁴ By the time of its collapse, Enron had eighty percent of its earnings from "wholesale energy operations and services" or contracts for sales of power it was not generating but purchasing from others, then hedging, then leveraging and then hedging again, all based on its valuation of its contracts using mark-to-market accounting.⁴⁵ For some analysts, understand-

41. For examples of their flexibility, see *supra* notes 1, 17 and 24, and *infra* notes 65-126. Flexibility was everywhere. Even the flexibility was flexible.

42. ACCOUNTING FOR TRANSFERS, *supra* note 39, no. 133. See generally Paul Krugman, *Cronies in Arms*, N.Y. TIMES, Sept. 17, 2002, at A29. We are still waiting on many Enron contracts to deliver, and will be waiting until 2015, in some cases. Of course, they need not deliver the cash if Enron doesn't deliver the power, yet another story.

43. Accounting is a heck of a field. You get to book as revenues sales that have not yet and may never occur and you can carry money you are owed as receivables if the contract is performed, but there is some delay on the payment. You can also carry money you are owed as an asset, i.e., a loan for money you are owed, but don't have is a positive thing. A safety tip to avoid accounting mumbo jumbo: ask to see the cash. Enron, however, also defied this rule because despite its earnings being future takes from contracts, it was awash in cash because it was selling assets right and left, using cash that it had obtained from lenders who were loaning money advanced by other Enron entities and who had Enron stock as their security for the loan, see *infra* notes 65-126 and accompanying text.

44. For example, Pinnacle West Capital Corporation, parent company to electric utility, Arizona Public Service, has twenty-seven percent of its earnings in mark-to-market contracts. Matt Krantz, *Accounting Rule Eyed*, USA TODAY, Dec. 3, 2001, at B4. American Electric Power was at twenty-three percent and Duke Energy has promised to disclose its percentage of earnings that are attributable to such contracts. Williams Energy was at forty percent at the close of 2001. See Jonathan Weil, *After Enron, 'Mark to Market' Accounting Gets Scrutiny*, WALL ST. J., Dec. 4, 2001, at C1 [hereinafter *Mark to Market Gets Scrutiny*].

45. *Why Enron Went Bust*, *supra* note 15, at 58. Other companies with mark-to-market contracts in earnings include El Paso Energy and American Electric Power. *Mark to Market*

ing mark-to-market accounting was the key to picking Enron apart, even in its hay-day.⁴⁶ The additional complexity in mark-to-market contracts and revenues is that those who depend on earnings levels of the company for compensation are assigned the task of valuating the contracts. Mark-to-market accounting requires that company managers develop the formulas used for the valuation of future contracts. The numbers are subjective, both as a function of human error and as a result of the vacillating nature of the value of the contracts because of their direct ties to the fluctuating prices of energy.⁴⁷ Contract values carried in earnings depended upon assumptions management made about market factors and the resulting impact on the value of the contracts.⁴⁸ Such assumptions, used in computing future earnings booked presently, are not revealed in the financial reports and investors have no way of knowing the validity of those assumptions or even whether they are conservative or aggressive assumptions about energy market expectations.⁴⁹

Gets Scrutiny; *supra* note 44. Once again, accounting is a heck of a field. Remember, you get to book as revenues sales that have not and may never occur, and you can carry the money you are owed under these elusive contracts as receivables assuming the contract is performed and the only problem is some delay on the payment part. You can also carry money you are owed as an asset, i.e., a loan for money you are owed but don't actually yet have is a positive thing. *Id.* The term "mumbo jumbo" springs to mind more and more as the accounting analysis of Enron unfolds.

46. Here is an analysis of Enron stock that might have tipped an open-minded soul, even at \$80/share:

- The company stock was selling at 60 times earnings, but
- Its cash flow was negative despite ever-increasing revenues
- It had a very low return on equity (7% even in 2000) (off-the-balance sheet debt not counted)
- It was burning through cash as if there were no tomorrow (who doesn't with a concierge at company headquarters?)
- Its operating margins were 5% in 2000 and 2% in early 2001.

Gleaned from ENRON 10-K (2000) available at <http://www.sec.gov/Archives/edgar>.

47. See *Mark to Market Gets Scrutiny*, *supra* note 44. ABN Amro Analyst Paul Patterson, a specialist in energy trading firms, offered the following insight, "[w]henever there's a considerable amount of discretion that companies have in reporting their earnings, one gets concerned that some companies may overstate those earnings in certain situations where they feel pressure to make earnings goals." *Id.* For example, many of Enron's futures contracts were for contracts in states that had not yet deregulated electricity. Those contracts could not be performed until deregulation occurred, but Enron indicated that it had factored in the risk regarding deregulation in the valuation of those contracts. Floyd Norris & Kurt Eichenwald, *Enron's Many Strands: The Accounting; Fuzzy Rules of Accounting and Enron*, N.Y. TIMES, Jan. 30, 2002, at C1.

48. Further, the void in regulation permits very little disclosure about the assumptions. *Mark to Market Gets Scrutiny*, *supra* note 44.

49. The assumptions that can be all over the maps, weather and otherwise, are the prices of the commodities such as oil, gas and electricity, and, get this, the weather. Whether it will be hot or cold, long winter or short, hot summer or not, controlled the value of these energy contracts. In fact, the volatility of the pricing and value of these contracts was so great that Enron often hedged its contracts with what amounted to bets on the weather. *Enron Unplugged*, *supra* note 14. In lay terms (no CEO pun intended), Enron's contracts bet one way on the weather and then it went into the derivatives and hedge markets to bet the other way

A simple example illustrates the diversity of opinion. Suppose that an energy company has a contract to sell gas for \$1.00 per gallon, with the contract to begin in 2004 and run through 2014.⁵⁰ If the price of gas in 2002 is \$0.80 per gallon, then the value of that contract can be booked accordingly and handsomely, with a showing of a 20 percent profit margin. However, suppose that the price of gasoline then climbs to \$1.20 per gallon during 2003. What is the manager's resolution and reconciliation in the financial statement of this change in price? The company has a ten-year commitment to sell gas at a price that will produce losses. Likewise, suppose that the price of gas declines further to \$0.50 per gallon in 2003. How is this change reflected in the financial statements, or does the company leave the value as it was originally booked in 2002?

Investors have difficulty cross-comparing financial statements of energy companies because they are comparing apples and oranges because of market changes and adjustments or non-adjustments to financial statements, are mostly not disclosed.⁵¹ It is nearly impossible to view earnings as something definitive when firms have a substantial percentage of earnings from mark-to-market accounting.

For example, the unrealized gains portion of Enron's pretax profit for 2000 was about 50 percent of the total \$1.41 billion profit originally reported.⁵² That amount was one-third in 1999.⁵³ Dynegy, another Houston energy company was poised to buy Enron until it realized the extent of the financial issues, also had about one-half of its \$762 million in pretax profits in

just in case it was wrong on its assumptions in the weather, the contracts and the pricing. Then Enron management had to assess a value for the weather bets. So, the validity of income statements, as you can see, is all tied to barometric pressure under FASB rules.

50. The wisdom of these ten-year agreements for commodities such as gas and electricity is a stand-alone question. Further, the courts are not particularly generous in forgiving errors made in entering into the long-term contracts. For example, in a line of cases concerning long-term contracts entered into by Westinghouse Electric Corporation, the courts were reluctant to relieve the company of its liability simply based on changes in expectations. Westinghouse committed to deliver uranium to twenty-two utilities under twenty year supply contracts at prices ranging from \$3 to \$10 per pound. The contracts were entered into in the late 1960s and early 1970s. When the nation's energy picture changed substantially in 1974 with the Arab oil embargo, prices for uranium went to \$45 to \$75 per pound, with availability being a substantial question. Westinghouse sought to be excused from performance under the agreements under U.C.C. § 2-615, commercial impracticability. While many of the suits brought by the utilities for performance under the contracts were settled, the eventual decision of the federal judge in the case was that while the fundamental assumptions of the parties had changed and there was some grounds for releasing Westinghouse from the agreements, Westinghouse had also oversubscribed in its contract commitments and was, therefore, at least partially liable. *See, e.g.,* Tenn. Valley Auth. v. Westinghouse Elec. Corp., 429 F. Supp. 940 (E.D. Va. 1977); Tenn. Valley Auth. v. Westinghouse, 69 F.R.D. 5, 6 (E.D. Tenn. 1975); *In re* Westinghouse Electric Corp. Uranium Contracts Litig., 405 F. Supp. 316, 317 (1975).

51. For example, while an outsider could examine quoted market prices, there is no way to determine timing, inclusion and other discretionary factors in a company's booking of revenues on futures contracts.

52. *Mark to Market Gets Scrutiny*, *supra* note 44.

53. *Id.*

unrealized gain.⁵⁴ The two companies settled litigation following Dynegy's withdrawal of its offer to purchase a percentage of Enron's mark-to-market earnings.⁵⁵

2. Related Party Transactions and Disclosures

The General Accepted Accounting Principles ("GAAP") and FASB standards for disclosure of a company's transactions with related entities (FASB 125), or those entities in which the company holds an interest, apply

54. *Id.* Dynegy backed out of the deal to acquire Enron, its major competitor, on November 29, 2001 and Enron filed for bankruptcy on December 2, 2001. Alex Berenson, *Deal is Over but Not Dynegy's Troubles*, N.Y. TIMES, Nov. 30, 2001, at C7. Dynegy through due diligence learned that Enron had only about one-half of the cash it had expected to find. Dynegy had offered \$9 billion for the company and it backed out when Enron's market cap went to \$270 million. Neil Weinberg & Daniel Fisher, *Power Player*, FORBES, Dec. 24, 2001, at 52. Dynegy had its own problems by May 2002, CEO Chuck Watson resigned confessing to "wash trades" or "swaps" or "round trip trades" or offsetting sales of power to other energy companies just to pump up the volume of trading and illusion of earnings. Holman W. Jenkins, Jr., *Energy CEOs Fall Victim to Bubbleconomics*, WALL ST. J., May 29, 2002, at A21. Dynegy is under SEC scrutiny. Paul Beckett & Jonathan Sapsford, *Dynegy Probe by SEC Widens to Citigroup*, WALL ST. J., May 31, 2002, at C1.

55. The litigation alleged that Dynegy already understood Enron's business and accounting methods and that it failed to negotiate in good faith. Chuck Watson, however, Dynegy's chairman, stated at an investors' meeting on November 12, 2001, when the acquisition of Enron was still pending that Dynegy understood Enron's accounting because Dynegy used similar methods. "There just may be an exaggeration of the problem in the press and the market. We're not anticipating any revelation other than what's been disclosed." *Deal is Over but Not Dynegy's Troubles*, *supra* note 54. However, Dynegy had encouraged FERC to clamp down with more regulation, as in the following quote from one of its filings: "[a]buses abound because of financial windfalls, difficulty of detection, lengthy investigations and increased complexity of the market." Jeff Gerth & Richard A. Oppel, Jr., *Regulators Struggle with a Marketplace Created by Enron*, N.Y. TIMES, Nov. 10, 2001, at C1. Enron filed suit against Dynegy, causing Watson to complain to a Forbes reporter with the following result reported at the end of December 2001:

"I was very disappointed," Watson says in characteristic, laconic understatement. He also was furious: Enron had tumbled into turmoil by misleading investors, and now it was misrepresenting its finances yet again—so says Watson—and laying the blame on Dynegy. "I just hope the other side doesn't think all this spinning, which got them into trouble to begin with, is going to let them out of it," he fumes.

Neil Weinberg & Daniel Fisher, *Power Player*, FORTUNE, Dec. 24, 2001, at 53-54. Dynegy unraveled in the six months following the failed merger with the litigation of questionable value. Most observers agree that Dynegy was using the same processes and accounting as its rival, Enron, but that it touted its differences as earnings based in assets. Dynegy's long-term (mark-to-market accounting) were \$133 of the company's \$167 million in earnings for the first quarter of 2002. Neela Banerjee, *Disclosing Long-Term Contracts, Dynegy Worries Some Investors*, N.Y. TIMES, June 14, 2002, at C1.

The suit asked for \$10 billion and alleged that Dynegy wrongfully terminated the contract and "consistently took advantage of Enron's precarious state to further its own business goals." *Why Enron Went Bust*, *supra* note 15, at 68. Dynegy settled the suit with Enron by agreeing to pay \$25 million. *Dynegy to Pay Enron a \$25 Million Settlement*, N.Y. TIMES, Aug. 16, 2002, at C1.

only when the company owns at least 50 percent of the related entity.⁵⁶ If a company owns 49 percent or less of an entity, any debt obligations the related entity carries need not be listed as debt on the company's balance sheet.⁵⁷

While Enron's efforts at transferring debt off the books began with the creation of Whitewing in 1997, its complex network of subsidiaries and special purpose entities (SPEs) did not begin in earnest until the end of 1999.⁵⁸ By the time of its collapse, Enron had created 881 to more than 3,000 SPEs,⁵⁹ with many of them located in the Cayman Islands with their offshore status designed to eliminate the need for the payment of U.S. federal income tax by the entities and other business ventures.⁶⁰

Whitewing started Enron down the broad road to destruction with what was originally conceived as a fairly narrow pathway and proposed to the Board. Whitewing and its related entities known as Nighthawk and Osprey, was run by Enron employees, did business only with Enron, and was owned fifty percent by Enron and fifty percent by Nighthawk with the remainder of Nighthawk owned by outside investors.⁶¹ Enron guaranteed Whitewing's credit lines for the fifty percent that Enron owned⁶² and then, Whitewing purchased, in 11 transactions, nearly \$2 billion in Enron assets,⁶³ leaving Enron with a passel of cash, investors enormously happy with an eight percent immediate return, and everyone none the wiser for owning stock in a company that was pledged to banks for an SPE's debt even as the SPE owned nearly half of Enron's assets.⁶⁴

56. Dharan testimony, *supra* note 39. Related FASB rules are covered in detail *infra* notes 65-126 and accompanying text.

57. Dharan testimony, *supra* note 39.

58. PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE, S. REP. NO. 107-70, at 39-40 (2002), *available at* http://www.senate.gov/%7Egov_affairs/070902enronboardreport.pdf [hereinafter PSI REPORT].

59. *The Enron Scandal: By the Numbers*, *supra* note 33. The discrepancy in the numbers is due to the complexity in counting the multifarious entities. Many had the same name, but a Roman numeral following them, while others used an Arabic sequential numbering system while others were part of a single umbrella entity. It is impossible to know the exact number although the exhibits to Enron's 10-Ks for 1999 and 2000 do list about 3,000 SPEs. ENRON 10-Ks (1999, 2000) *available at* <http://www.sec.gov/Archives/edgar>. See *infra* note 215 and accompanying text for more information on this disclosure. Not until the government unfolds its criminal case or the shareholders get rolling on their suits can we really know how many, where and what. The why may never be discoverable. Indeed, if there is one consistent theme in the entire Enron debacle it is that no number is ever certain.

60. There were "about 900" partnerships based offshore. *The Enron Scandal: By the Numbers*, *supra* note 33.

61. PSI REPORT *supra* note 58, at 39.

62. *Id.*

63. *Id.* at 40.

64. For those of you who have reached the conclusion that everyone was investing in air, you are correct—air with razor-thin margins. Interestingly, Whitewing has not made its way into the business press. Business coverage and analysis generally begins with the 1999 transactions in SPEs, but Whitewing established a precedent and provided management with a pat-

Whitewing, however, was only the beginning of the SPEs and their maximum utilization by Enron for moving its debt off the books. The massive numbers of transactions are the subject of Congressional, criminal, and shareholder litigation. A shareholder class action lawsuit filed in November 2001, includes the following descriptions of Enron's practices:

One of Andrew Fastow's "innovative" accounting techniques was to create entities (trusts) to which Enron would issue millions of dollars in mandatory convertible debentures or depreciated assets. The trust would then use the assets as collateral to receive billions of dollars in financing for Enron projects, including Broadband. Although Enron Corp. officially owned less than fifty percent of these entities, Enron controlled them. Defendants, improperly, did not consolidate these entities into Enron's disclosed financials; rather, Defendants hid the true nature of all of these transactions from the public. This meant Enron was engaged in business deals, risky hedging, self-dealing transactions that were never disclosed to the SEC.⁶⁵

While it would be impossible to review all of the "off-the-books" transactions, there are several illustrative examples of the complexity, debt exposure, and involvement of Enron management in these SPEs. One series of complex, but fruitful transactions that publicly emerged were the so-called "Raptor" transactions.⁶⁶ The Raptor transactions were an ongoing series of transactions that involved the LJM transactions.⁶⁷ But, the LJM transactions were the impetus for the Raptor transactions and necessary to avoid prob-

tern to begin using with the Board. *See infra* notes 186-216. The Senate Permanent Subcommittee on Investigations covered Whitewing in detail as it discussed the issue of laxity on the part of Enron directors. *See infra* notes 178-245 and accompanying text for a discussion of the Enron Board's supervisory role, or lack thereof, as the case may be and as the shareholder suits play out.

65. Complaint, Shareholder Class Action (N.D. Cal., Nov. 5, 2001)(on file with author).

66. Floyd Norris, *Enron's Many Strands: The Bookkeeping: Too Clever by Half: Enron's Doomed Triumph of Accounting*, N.Y. TIMES, Feb. 4, 2002, at A18 [hereinafter *The Bookkeeping: Too Clever by Half*]. There was Raptor I, II, III, and IV and LJM 1, 2 and 3. *See generally* PSI REPORT *supra* note 58, at 37-45. *See infra* notes 87-126 and accompanying discussion. Are you like me? Do you just no longer care what Enron was doing? *See infra* notes 87-126, again, and accompanying text.

67. *The Bookkeeping: Too Clever by Half*, *supra* note 66. LJM are the initials of the first names of Mr. Fastow's wife and children. Mary Flood, *The Fall of Enron*, HOUS. CHRON., Nov. 7, 2002, at A1. Lea is his wife's name, but the children's names have not been revealed in public. *Id.* LJM3 was never used for any types of transactions, as far as we know.

The Powers Report, commissioned by the Enron Board, reveals the same information. The Powers Report is a 217-page indictment of the officers, the accountants, and Enron's law firm, as completed by Dean William C. Powers, Jr. of the University of Texas Law School. In describing the underlying transactions, Dean Powers wrote that they were "a flawed idea, self-enrichment by employees, inadequately designed controls, poor implementation, inattentive oversight, simple (and not so simple) accounting mistakes, and overreaching in a culture that appears to have encouraged pushing the limits. Our review indicates many of those consequences could and should have been avoided." Kurt Eichenwald, *Enron's Many Strands: The Overview; Enron Panel Finds Inflated Profits and Self-Dealing*, N.Y. TIMES, Feb. 3, 2002, at A1.

lems with FASB rules.⁶⁸ The names, as well as the complexity of these layers of transaction, provide insight into the nature of Enron's business, its culture, and the hubris that engulfed its senior management. Further, no one seemed aware of the risks these complexities created until after Enron's downward spiral began with the revelation of earnings reversals and debt that had heretofore been off the books.⁶⁹ That examination is akin to peeling a genetically mutated onion in which the layers themselves have their own layers as well as spots and each layer cannot be peeled back until one reaches the inner layers, but the inner layers cannot be reached without first penetrating the outer layers.⁷⁰

The Raptors were really four off-the-books finance vehicles created as the holding companies for Enron's high-risk assets, including technology stocks and some of its foreign investments.⁷¹ In short, the Raptors were hedging vehicles. The Senate Report on Enron's Board concludes:

These documents establish that, step by step, the Enron Board allowed the establishment of Whitewing, supported it with Enron stock, restructured it as an off-the-books entity, approved its use as an off-balance sheet vehicle to purchase Enron assets, monitored billions of dollars in Enron asset sales

68. The Enron Board minutes also document an LJM transaction in which LJM participated in an "Osprey Add-On" which was apparently a means for Osprey to provide additional capitalization for Whitewing, of which Osprey was a subsidiary. PSI REPORT *supra* note 58, at 40-41 (internal citations omitted). How did these guys sleep at night with birds and raptors dancing through their heads at levels I, II, III and IV and 1 and 2, but not 3. Trying to keep track of all the incestuous financial relationships among the SPEs reminds the author of trying to survive those fire worlds in the original Mario Brothers. Things were flying at you everywhere even as the floor fell out from beneath you and the elevators kept moving.

69. John R. Emshwiller & Rebecca Smith, *Scandals Shake Public Trust*, WALL ST. J., Dec. 5, 2001, at A1. "It was vintage Enron: minimal disclosure of financial information that, in retrospect, was central to understanding the complex company." *Id.* "Many Wall Street analysts admitted to not fully understanding chunks of Enron, a company that had 3,500 subsidiaries and affiliates across the globe." *Id.* See *infra* note 232 for other figures on numbers of subsidiaries. "But to analysts and investors seeking to understand it, Enron was uninformative. Emshwiller & Smith, *supra*. The press release for the \$618 million loss and the reduction of shareholder equity occurred on October 16, 2001. *Why Enron Went Bust*, *supra* note 15, at 66.

70. Matt Krantz, *Peeling Back the Layers of Enron's Breakdown; a Look Inside a House of Cards*, USA TODAY, Jan. 22, 2002, at B1 [hereinafter *Peeling Back the Layers*]. See *supra* note 64.

71. The Raptors were numbered in sequence and inspired by the film JURASSIC PARK (Universal Studios 1993), in which the raptors ended up eating everyone and everything and controlling the Jurassic Park Island. David M. Boje, *Enron is Metatheatre*, at <http://cbae.nmsu.edu/~dboje/enron/dialogs.htm> (last visited Mar. 7, 2003). Enron was not unlike Richard Hatch in the first *Survivor* television series on CBS. Mr. Hatch's diabolical conduct with his colleagues found him with all the money. Enron did the same, but without the nudity. Kathryn Kranhold et al., *Following the Trail: As Enron Inquiry Intensifies, Mid-level Players Face Spotlight*, WALL ST. J., Apr. 30, 2002, at A1 [hereinafter *As Inquiry Intensifies, Midlevel Players Face Spotlight*].

to Whitewing, and monitored Whitewing's impact on Enron's financial statements and its claims on Enron stock.⁷²

To satisfy FASB 125, the Raptors were required to have at least three percent equity ownership by outsiders.⁷³ The basic theme of the Raptors and all other Enron partnerships was as follows:

- Enron creates a partnership (an SPE)
- Enron recruits an outside owner to cover the 3% rule⁷⁴
- The SPE purchases Enron assets (the riskier ones such as broadband width, shares in subsidiaries in high tech fields) but the sale is simply for an IOU from the SPE⁷⁵
- Enron can show a profit on its books for the sale
- The debt (IOU) of the SPE is not carried on Enron's books
- If the value of the sold asset falls, the SPE can't pay the IOU
- Enron would issue its stock to the SPE
- The SPE sells the shares of stock to raise cash
- The entire scenario is dependent upon Enron's share price remaining high⁷⁶
- If the share price falls, as it did beginning in the summer of 2001, then all of the SPEs have no assets and no value
- Although Enron told analysts it was non-recourse, Enron was the guarantor for SPE's IOUs—it was the only way to recruit the outside investor⁷⁷
- Andrew Fastow, Enron's CFO, was the principal in many of the partnerships and would net more than his Enron salary in serv-

72. PSI REPORT *supra* note 58, at 41.

73. Dharan testimony, *supra* note 39, at 6. As time went by, the definition of "outsiders" became flexible as the labyrinth web of Enron finances grew. For example, Andrew Fastow, Enron's CFO, proposed using his wife's family as the outside investors. When Andersen nixed the idea, he used Michael Kopper, a mid-level employee, who could avoid SEC disclosure because he was not an officer. Joshua Micah Marshall, *Talking Points Memo*, at <http://www.talkingpointsmemo.com/feb0201.html>, (Feb. 6, 2002.)

74. Dharan testimony, *supra* note 39, at 6. Some of Enron's SPE investors were GE Capital and Credit Suisse First Boston (CSFB). Rebecca Smith & John R. Emshwiller, *Enron CFO's Partnership Had Millions in Profit*, WALL ST. J., Oct. 19, 2001, at C1.

75. Acronyms and movie names abounded among the Enron off-the-books empire. See *infra* notes 79-104 and accompanying discussion.

76. For diagrams of more details on this process, see *Peeling Back the Layers*, *supra* note 70. Several Board members have noted that they felt, during the countless presentations and approval processes for these transactions that there would be no impact on the company and that what they were doing were simply "accounting gimmicks." PSI REPORT *supra* note 58, at 46. However, the Board meeting documents also show that the directors were told that the key to all of the transactions was maintenance of Enron's share price, which as we now know was determined by the tides and/or barometric pressure. See *supra* note 49 and accompanying text.

77. They were making this up—they were not non-recourse notes. In fact, no one has given non-recourse notes since 1929. See *infra* note 113.

ing as broker for the various deals between the SPEs and Enron⁷⁸

Walking through examples of these partnerships illustrates how complex Enron's finances were, perhaps too complex to grasp.⁷⁹ The Raptor transactions began with the Raptors created by Enron providing stock in exchange for a promissory note (or some form of IOU as noted in the general model).⁸⁰ LJM2, with outside funding, invested \$30 million in Raptor in exchange for a promised rate of return of thirty percent.⁸¹ But, Raptor had to recover LJM2's \$30 million investment, so Enron paid Raptor \$41 million for the right to sell Raptor Enron stock at a fixed price at some time in the future.⁸² Raptor took the \$41 million and repaid LJM2 its \$30 million plus \$11 million, thus meeting the thirty percent ROI and providing Fastow with his earnings.⁸³ Once LJM2 was repaid for its investment, Enron used Raptor

78. Rebecca Smith & John R. Emshwiller, *Enron CFO's Partnership Had Millions in Profit*, WALL ST. J., Oct. 19, 2001, at C1. Mr. Fastow realized \$7 million in management fees and \$4 million in investment yields from the LJM2Co-Investment LP, created in 1999 to do business with Enron, in the year 2000. *Id.* There was also an interesting transaction in which Mr. Fastow and five other Enron employees formed Southampton, L.P., and purchased a subsidiary of LJM1. For those of you still keeping score, (indeed, for any of you still following along,) Mr. Fastow was buying partnerships he owned that owned assets of the company for which he was the CFO and for which he received management fees for both the buying and the selling inasmuch as he was batting for both sides. Bring in his Enron role and he had a triple play each time a deal to transfer assets occurred. Not bad work if you can get it. The downside is pleading the Fifth Amendment at Congressional hearings.

79. In a "Top 10" list written by Enron employees entitled "Top Ten Reasons Enron Restructures so Frequently," #7 on the list was "[b]ecause the basic business model is to keep the outside investment analysts so confused that they will not be able to figure out that we don't know what we're doing." #1 was "[f]orget all the hype about being Fortune's #1—congratulations to Enron for having broken a Guinness [B]ook of [W]orld [R]ecord with 942 reorganizations in one year!" *Peeling Back the Layers*, *supra* note 70.

80. Frank Partnoy, *Testimony of Frank Partnoy at the Senate Enron Hearings*, FUTURES & DERIVATIVES L. REP. 1, 4 (Feb. 2002).

81. *The Bookkeeping: Too Clever By Half*, *supra* note 66. The author does not want to mislead, the transaction could have involved LJM1. Frankly speaking, the SPEs are more confusing than the financials. But we know that the LJMs did interbreed with Raptors and the interbreeding netted Fastow and others in the company tidy sums because they were the principals of the Raptors and LJMs, but as far as we know, not of the Whitewings and Ospreys and the add-on rooms to the Ospreys. We are also unclear as to how much Fastow actually made on the transactions because he was most resistant, even to Board members, about disclosing his compensation from LJM, Raptors and even the little-known Southampton. One Board member, assigned the task to go and face the dragon CFO, wrote in his notes that Fastow acknowledged receiving \$45 million from the various SPEs and the transactions he negotiated both for Enron and the SPEs. PSI REPORT *supra* note 58, at 36. For more discussion of these fees and Fastow's reticence, see *infra* section III.D.3.

82. *The Bookkeeping: Too Clever By Half*, *supra* note 66. For those of you with finance background, we have the use of warrants, options, puts and calls going on here. Most of you have probably realized that Enron had issued stock to Raptor to start and was now issuing the right to buy stock as Raptor's second asset. So, even non-finance types are able to see that the price of Enron's stock was important to the success of Raptors, Enron, Fastow, shareholders and just about everyone in the Greater Houston area.

83. *Id.* Andrew Fastow is an interesting character study, although "character" is not used in the integrity sense. He graduated from Tufts University and then received his MBA from

for contracts with itself that provided Enron with hedges for any potential losses on investments (including the volatile high tech areas).⁸⁴ The benefit to Raptor was that it would enjoy the gains if the assets increased in value. The downside was that Raptor had to cover any losses in values, but it could do so with Enron stock so long as the share price remained stable or increased.⁸⁵

It seems that most Board members understood the Raptor transactions' overall effect. Notes from Enron's corporate secretary at an Enron Board committee meeting reads "[d]oes not transfer economic risk, but transfers P&L volatility."⁸⁶

While "The Raptors" collectively referred to the many SPEs created for risk transfer, there are several examples that illustrate the extent of other SPEs and the different types of transactions. For example, in 1999, Enron announced that it had transferred, by private agreement, 1,999,999 shares from its affiliate, Sundance Assets, to another affiliate, SE Thunderbird.⁸⁷En-

Northwestern. He started at Enron in 1990, fresh from his work as a "troubled loan" specialist at Continental Bank. Oh, the Shakespearean foreshadowings! He began using off-the-books partnerships immediately upon his arrival. By age 36, he was CFO of Enron and in 1999 was honored by *CFO Magazine* for his innovative financing structures. *Finest in Finance*, CFO, Oct. 1, 1999, at 45. Memo to *CFO Magazine*: we really need to talk. He told the interviewer for that story that he kept Enron's credit rating high by keeping debts off the balance sheet. Memo to Wall Street and analysts: the man confessed three years ago and you missed it. At the time of Enron's collapse, Mr. Fastow was in the process of building an 11,500 square-foot house. David Barboza & John Schwartz, *Enron's Many Strands: The Financial Wizard Tied to Enron's Fall*, N.Y. TIMES, Feb. 6, 2002, at A1. Again, see *supra* notes 65-126 for information on the extent of restructuring and off-the-books debt; and *infra* note 238-245 on the taciturn Mr. Fastow when it came to Board requests for interviews.

Disclosure of Mr. Fastow's interest in LJM came in the 1999 10-K with a cryptic reference, "[a] senior officer of Enron is the managing member of LJM's general partner." Enron 10K, Filed December 31, 1999, at 16 available at <http://www.sec.gov/edgar>. For those of you who are curious, the LJM1 partnership sold an Enron power plant located in Brazil and followed the same *modus operandi* as LJM2. Kurt Eichenwald & Diana B. Henriques, *Enron's Many Strands: The Company Unravels; Enron Buffed Image to a Shine Even as It Rotted From Within*, N.Y. TIMES, Feb. 10, 2002, at A1[hereinafter *Enron Buffed Image to a Shine Even as It Rotted From Within*].

84. PSI REPORT *supra* note 58, at 44.

85. *The Bookkeeping: Too Clever By Half*, *supra* note 66.

86. *Id.* In fact, in a chilling touch of arrogance, the Raptor transactions were referred to collectively as Hawaii 125-0, a play on Jack Lord's old show as well as a fist of defiance to accounting standards and FASB 125 on its three percent ownership requirement coupled with the fifty percent rule. Rebecca Smith, *Short Circuit: How Enron's Plan to Market Electricity Nationwide Fizzled*, WALL ST. J., Mar. 25, 2002, at A1. Interestingly, that corporate secretary, Rebecca Carter, received a proposal of marriage from Mr. Skilling in July 2001, just after Mr. Skilling informed Mr. Lay that he was leaving the company. Ms. Carter and Mr. Skilling were married shortly thereafter. To no one's surprise, this allowed the marital privilege to prevent testimony from the former corporate secretary about which officers knew what and said what and explained what at Board meetings. David Barboza, *Enron's Many Strands: The Former Chief; Friends Say Ex-Chief Despairs, Seeking Someone to Believe Him*, N.Y. TIMES, Aug. 22, 2002, at C1.

87. Complaint of Shareholder Class Action Members at 7, *Kaufman v. Enron Corp.*, Civ. Action No. 4:01-3682 (S.D. Tex. Filed Oct. 25, 2001)(on file with *California Western Law*

ron did not, however, disclose that Sundance Assets was partially owned and controlled by Enron's unconsolidated subsidiary, New Power.⁸⁸ Enron owned forty-five percent of New Power and New Power had been created to sell electricity and natural gas to residential and small load customers throughout deregulated markets in the United States.⁸⁹ None of these ownership interests or Enron's contracts with these companies was disclosed in Enron's financial statements.⁹⁰

Enron also did a substantial amount of business with LJM Cayman, L.P., a private investment company that specializes in energy futures contracts and which was also managed by Andrew Fastow,⁹¹ a principal in New Power.⁹² These complex interrelationships and the lack of a required disclosure enabled Enron to transfer assets into LJM, thereby increasing Enron's equity position and its market worth. For example, in June 2000, Enron transferred, through Mr. Fastow, sufficient shares to LJM2 to permit Enron to report an increase in its equity of \$171 million while also reporting the assets that LJM transferred in exchange for the shares represented \$500 million in proceeds.⁹³ Also during that quarter in 2000, Mr. Fastow facilitated the sale of Enron's "dark fiber cable" to LJM2 for \$30 million in cash, a \$70 million note, and a gross margin of \$53 million reported earnings for the quarter.⁹⁴ These earnings were subsequently reduced in October 2001 in the now infamous press release that was the beginning of Enron's end.⁹⁵ However, the LJM2 partnership reported that the company earned \$7 million in management fees and "about \$4 million in capital increases" in 2000.⁹⁶

Review). These transactions marked the second layer of protections created to retain Enron's balance sheet, earnings and share price. *Id.*

88. *Id.*

89. *Id.* These secondary layers are referred to as the "restructuring of the Raptors." The special report commissioned by the Enron Board concludes the following, "[t]he creation, and especially the subsequent restructuring, of the Raptors was perceived by many within Enron as a triumph of accounting ingenuity by a group of innovative accountants. . . . We believe that perception was mistaken. Especially after the restructuring, the Raptors were little more than a highly complex accounting construct that was destined to collapse." *The Bookkeeping: Too Clever By Half*, *supra* note 66 (quoting a Special Report of the Enron Board Committee).

90. See Plaintiff's Complaint at 7, Kaufman, No. 4:01-3682 (on file with *California Western Law Review*).

91. Plaintiff's Original Petition, Application for Temporary Restraining Order and Temporary Injunction at 16, Jose v. Arthur Andersen, L.L.P., Cause No. 2002-CI-01906 (Dist. Ct. Bexar County, Tex. 2002).

92. Plaintiff's Complaint at 7, Kaufman v. Enron, No. 4:01-3682 (on file with *California Western Law Review*).

93. See *id.* at 8. For the period of the third quarter of 2000 through the third quarter of 2001, not using the Raptor scheme would have made profits \$429 million, or 72%, lower. *The Bookkeeping: Too Clever By Half*, *supra* note 66.

94. ENRON ANNUAL REPORT 2000 at 49, at www.enron.com/corp/investors/annuals/2000/at2000.pdf (last visited Mar. 7, 2003).

95. See *Enron Slashes Profits*, *supra* note 35.

96. *Enron CFO's Partnership Had Millions in Profit*, *supra* note 74.

Often, Enron was using other SPEs to hedge and raise cash for partners who wanted to recoup their investments and withdraw. For example, the California Public Employees' Retirement System's (Calpers) formed a joint venture with Enron called, Joint Energy Development Investments, LP (JEDI).⁹⁷ Calpers and Enron formed the joint venture to make energy-related investments.⁹⁸ Both the partners are believed to have put in \$250 million each into JEDI.⁹⁹

In 1997 when Calpers wanted out of JEDI, Enron could not simply buy back Calpers' share because it would have been required to reflect a debt load of \$1.6 billion on its balance sheets because of its resulting 100 percent ownership of JEDI that would have occurred and triggered the application of the FASB consolidation rule. Further, it was critical to Enron's survival that any outside company involved in a joint venture not become dissatisfied with its involvement or investment because Enron would be unable to recruit new outside partners to assume the stake necessary to keep the transactions of the SPEs off the Enron books.

To avoid such a disclosure in the Calpers situation, Kopper and Fastow formed Chewco (believed to be named after Chewbacca of "Star Wars" fame)¹⁰⁰ to purchase Calpers' share. In March 2001, a senior officer who reported to Mr. Fastow, Michael Kopper, facilitated a \$35 million deal between Enron and Chewco Investments, LP.¹⁰¹ Mr. Kopper was also listed as a principal in LJM2 and described "manag[ing] the general partner of Chewco, an investment fund with approximately \$400 million in capital commitments that was established in 1997 to purchase from Enron an interest in a defined pool of Enron assets."¹⁰² No one has been able to determine how Enron paid the \$35 million to Chewco and exactly how much Chewco or Mr. Kopper benefited from the transaction in which Calpers sold its share to Chewco for \$375 million.¹⁰³ The government has at least submitted a chart establishing its theories on amounts and furthermore, Mr. Kopper's

97. *Enron Slashes Profits*, *supra* note 35. These and other transactions were part of a series of *Star Wars*-named covert partnership operations. Those in Fastow's area were proud of their ability to keep the balance sheet healthy and the earnings rising. Whenever a successful new SPE was launched or a transaction closed, those responsible would receive "plaques with chrome replicas of *Star Wars* light sabers." *Peeling Back the Layers*, *supra* note 70. Others received plaques with R2D2 replicas. *Id.*

98. John R. Emshwiller, *Enron Transaction Raises New Questions*, WALL ST. J., Nov. 5, 2001, at A3.

99. *Id.* Mr. Kopper reported to Mr. Fastow. It is believed he was chosen because no SEC disclosures would be required regarding his role or compensation, because he was not a "16-b" officer. See PSI REPORT *supra* note 58, at 34. This is the level at which stock transactions and other reporting requirements arise under the Securities Exchange Act of 1934. 15 U.S.C.A. § 78p (2001); PSI REPORT *supra* note 58, at 12 n.16.

100. *Enron Transaction Raises New Questions*, *supra* note 98.

101. *Id.*

102. *Id.* (quoting a 1999 offering memorandum of the LJM2 partnership).

103. *Id.*

guilty plea adds a truckload of evidence to the case against Enron and certainly Fastow.¹⁰⁴

The relationships were actually far more complex with resulting liability exposure for Enron. Enron was advancing the funds for the outside party to invest in the SPEs or the money being used to finance transactions with the SPEs were borrowed from syndicates of lenders who accepted Enron stock as security for the loan.¹⁰⁵ Additionally, Enron often served as the guarantor for loans to the SPEs and there was no disclosure in Enron's financial statements about its potential exposure as a guarantor, one of the factors that did cause some discussion between company executives and Andersen auditors.¹⁰⁶ All of these transactions depended on Enron being able to maintain its share price, a price that was tied directly to the volatility of prices in the energy market.¹⁰⁷

These relationships also revealed a loophole in the FASB rules on SPEs that permitted nearly one hundred percent exposure by the company in an SPE without the need for disclosure. For example, in the Calpers relationship, Enron and Calpers formed a joint entity, an LLP, known as New Power.¹⁰⁸ Calpers would front three percent of the capital necessary for the creation of New Power in order to give it operating funds.¹⁰⁹ The reason

104. *Editor's Ruling: Andersen Win Lifts U.S. Enron Case*, *supra* note 9; see also Kurt Eichenwald, *Enron's Many Strands: The Overview; Ex-Enron Official Admits Payments to Finance Chief*, N.Y. TIMES, Aug. 22, 2002, at A1. No one has been able to determine what the heck was going on here generally, let alone how Chewbacca got \$35 million from an underlying finance guy. However, and this is not humor, the Enron executives who closed the Chewco deal did get a life-size Chewbacca head to commemorate their success. *Following the Trail: As Enron Inquiry Intensifies, Midlevel Players Face Spotlight*, *supra* note 71.

The author increasingly gets the feeling that Enron was ANIMAL HOUSE (Universal Studios 1978) with hedge funds and STAR WARS toys instead of beer and togas. However, Mr. Kopper's guilty plea is one that guarantees that he sings like a canary in exchange for leniency in his sentencing. And Mr. Kopper is in a position to hold a great deal of information. What we did know is that he was chosen for this particular deal because he was not at a level in the company that required that his role with the SPE be disclosed in the SEC reporting documents. Kopper has already indicated that some of the money in these transactions went to Mr. Fastow. Eichenwald, *supra*. And, implicitly from the plea terms, some of the money must have come to him because he agreed to pay back \$12 million. See *id.* Kopper says he and a Mr. Dodson split \$7 million from the Chewco arrangement and that Mr. Fastow's family got at least \$121,000. *Id.* He also maintains that he and Fastow each got \$4.5 million from the Southampton deal, with some of Fastow's distribution going to his wife and children, as theorized. *Id.*

105. See *As Inquiry Intensifies, Midlevel Players Face Spotlight*, *supra* note 71.

106. See John R. Emshwiller & Rebecca Smith, *Joint Venture: A 1997 Enron Meeting Belies Officers' Claims They Were in the Dark*, WALL ST. J., Feb. 1, 2002, at A1. There were numerous discussions about whether there was "sufficient equity at risk" in the Raptors to permit the continuation of carrying the SPEs off the books. *As Inquiry Intensifies, Midlevel Players Face Spotlight*, *supra* note 71.

107. See *Enron Meeting Belies Officers' Claims They Were in the Dark*, *supra* note 106.

108. See Diana B. Henriques, *Enron's Many Strands: A Big Investor; Even a Watchdog is not Always Fully Awake*, N.Y. TIMES, Feb. 5, 2002, at C1.

109. See Matt Krantz, *Trouble Grew in Enron's Interlinking Partnerships*, USA TODAY, Jan. 22, 2002, at B2.

Calpers, and others in similar joint ventures with Enron, would front only 3 percent is because under FASB Rule 125, it was the minimum requirement for protection of the non-consolidation rule.¹¹⁰ In other words, an outside party, other than lenders and particularly those whose investment was guaranteed by the company had to own at least three percent of the SPE that their joint venture created.¹¹¹ However, in some cases, Enron advanced the funds to the outsider for the three percent investment.¹¹²

A consortium of lenders who were given a guarantee on the loan by Enron was the remaining ninety-seven percent of the investment in New Power.¹¹³ The guarantee was only of value to the extent that Enron was able to maintain the market price of its shares.¹¹⁴ Enron then used the minimal in-

110. See Dharan testimony, *supra* note 39, at 6.

111. See *id.*

112. See *As Inquiry Intensifies, Midlevel Players Face Spotlight*, *supra* note 71.

113. See *Short Circuit: How Enron's Plan to Market Electricity Nationwide Fizzled*, *supra* note 86. However, Enron continued to assure analysts and investors that the loans were non-recourse loans. Mr. Fastow did so as late as October 23, 2001, although he was fired the next day. John R. Emshwiller & Rebecca Smith, *Corporate Veil: Behind Enron's Fall, A Culture of Operating Outside Public's View*, WALL ST. J., Dec. 5, 2001, at A1.

114. Interestingly, litigation against the lenders focuses on their involvement in Enron loans and the timing of their analysts' recommendations on Enron stock. For example, the following scenario, as described in the *Wall Street Journal*, is included as part of the foundation for a class action suit against lenders:

However, by June 2001, the lawsuit says, at least some bank executives knew of Enron's tenuous financial situation. The lawsuit claims that CSFB managing directors were meeting with Enron executives to discuss the structure of one of Enron's partnerships.

One CSFB manager "commented to an Enron manager, 'how can you guys keep doing this?' referring to Enron's repeated statements to the market that its stock was undervalued," the lawsuit states.

The CSFB manager told the Enron executives that the stock was "overvalued" at \$40; it was trading at \$48.50 at the time. According to the lawsuit, the CSFB manager warned the Enron executive that if the stock fell to \$20 a share, "things are going to come falling down and you guys are gonna be fed."

Despite those comments in June by one CSFB manager, a CSFB analyst came out with a "strong buy" rating on Enron's stock on Aug. 14 with a price target of \$84 a share. There is no evidence in the lawsuit that CSFB's bankers and research analysts ever colluded or had conversations about Enron's finances, but Mr. Lerach claims that the CSFB manager had the obligation to tell the analyst about Enron's potential problems.

"The 13th floor had the responsibility to tell the 10th floor that it's a fraud," Mr. Lerach said.

Kathryn Kranhold & Jonathan Weil, *Enron Holders' Suit Adds New Defendants*, WALL ST. J., Apr. 8, 2002, at A3 (quoting class-action lawsuit filed Oct. 2002). See *infra* notes 274-290 and accompanying discussion for issues related to the role of banks, analysts, and conflicts in the Enron collapse.

In addition, there are some questions about how the banks such as J.P. Morgan Chase, Citigroup and Credit Suisse First Boston provided their loans to Enron. For example, J.P. Morgan Chase made its loans to Enron through a shell company called Mahonia, a subject of litigation. See Jonathan Sapsford & Anita Raghavan, *Trading Charges: Lawsuit Spotlights J.P. Morgan's Ties to the Enron Debacle*, WALL ST. J., Jan. 25, 2002, at A1. And Citigroup lent

vestment SPEs to transfer Enron assets in exchange for cash; something that Enron needed more and more as its share of the energy market dwindled. In the case of Calpers, Enron created New Power, a spin off of Enron and a vehicle for raising capital.¹¹⁵ New Power would hold the power plant and the problems associated with the plant while Enron would be paid the funds to aid in the financial problems Enron was facing.¹¹⁶

Knowing that it had the exposure of the loan guarantee in New Power and other similar transactions with third parties, Mr. Fastow then developed a process, repeated many times throughout the web, whereby it would take warrants from New Power and sell them to yet another SPE in exchange for cash. Not only was this secondary layer of SPEs used as means of hedging, it was also yet another source of cash flow.¹¹⁷ For example, in the case of New Power, Enron created Raptor III, part of the umbrella of Hawaii 125-0, that was utilized in order to create, without disclosure on Enron's financial statements, this complex extra-structure that provided the cash flow and financial façade necessary for Enron to continue.¹¹⁸

Raptor III would be financed by, again, a consortium of lenders.¹¹⁹ Raptor III had a consortium of sixteen banks providing its financing, including a group of Canadian banks.¹²⁰ While Enron guaranteed the Raptor III LLP, it

\$2.4 billion via prepaid swaps. Daniel Altman, *Enron's Many Strands: Finances; Enron Had More Than One Way To Disguise Rapid Rise in Debt*, N.Y. TIMES, Feb. 17, 2002, at A1. With a prepaid swap, two parties shift their future ROIs. *Id.* One party pays a small amount for a fixed return in exchange for uncertain gains another party is willing to forgo, *id.*, and we can assume has probably hedged anyway. Finally, Credit Suisse Boston's arrangement with Enron was a loan tied to the price of oil. *Id.* The bank called it a loan while Enron called it an asset of risk management. *Id.*

Congress has not been kind to the bankers in the Enron matter. An internal e-mail Congress uncovered in J.P. Morgan Chase documents from a bank executive, George Serice, responsible for the Enron account, read, "Enron loves these deals because they are able to hide funded debt from their equity analysts because they at the very least book it as deferred revenue or, better yet, bury it in their trading liabilities." Lydia Adetunji & Peter Spiegel, *Banks "Actively Helped" Enron to Disguise Debt*, FIN. TIMES, July 22, 2002. The e-mail is dated November 1998. *Id.* The bank referred to "pre-pays" in its e-mails which apparently were complex financial transactions with Enron (were there any other kind?) that purported to be commodities trades but were really loans. *See id.* One e-mail from a Chase employee to George Serice, the executive who wrote the "Enron loves these deals" e-mail, read, "\$5 billion in pre-pays!!!!!!!" Serice responded, "Shutup and delete this e-mail." Paul Beckett et al., *How Energy-Trading Boom Went Bust*, WALL ST. J. EUROPE, Dec. 31, 2002 at A2.

115. *See A Big Investor; Even a Watchdog Is not Always Fully Awake*, *supra* note 108.

116. Senior Enron employees told a Board committee meeting in March 2001 that Mr. Skilling was "intensely interested" in the Raptor credit problems and that solving those problems was "one of the company's highest priorities." *Enron Buffed Image to a Shine Even as it Rotted From Within*, *supra* note 83.

117. *See David Barboza, Enron Examiner Raises More Questions*, N.Y. TIMES, Sept. 22, 2002, at 38.

118. *See id.*

119. *Short Circuit: How Enron's Plan to Market Electricity Nationwide Fizzled*, *supra* note 86.

120. *Id.*

did not guarantee the actual loan, Enron was not required to disclose its relationship to Raptor III in its financial statement, so it was 100 percent financed by lenders. Hence, the three percent rule did not apply. Accordingly, Enron was not required to disclose its relationship with Raptor III in its financial statement.¹²¹

Enron benefited in other ways from this layered transaction. Fastow served as the principal for Raptor III and when the bank consortium loaned it \$500 million, Fastow was entitled to a commission because of his success in arranging for the funding.¹²² New Power pledged warrants for Enron stock to the bank consortium as security for the loan to Raptor III.¹²³ New Power would then sell the warrants to Raptor III and Raptor III would turn over the cash to New Power, which also netted officers running that SPE a commission and New Power was awash in cash that it could use to purchase more Enron assets, which Enron would sell to maintain cash flow.¹²⁴

Realizing its exposure on this guarantee of the Raptor III LLP, Enron then purchased total return swaps as a way of hedging and affording itself protection in the event of changes in the stock price.¹²⁵ The following three diagrams depict the relationships between and among Enron, Calpers, New Power and Raptor III, as well as their lenders.¹²⁶

121. *See id.*

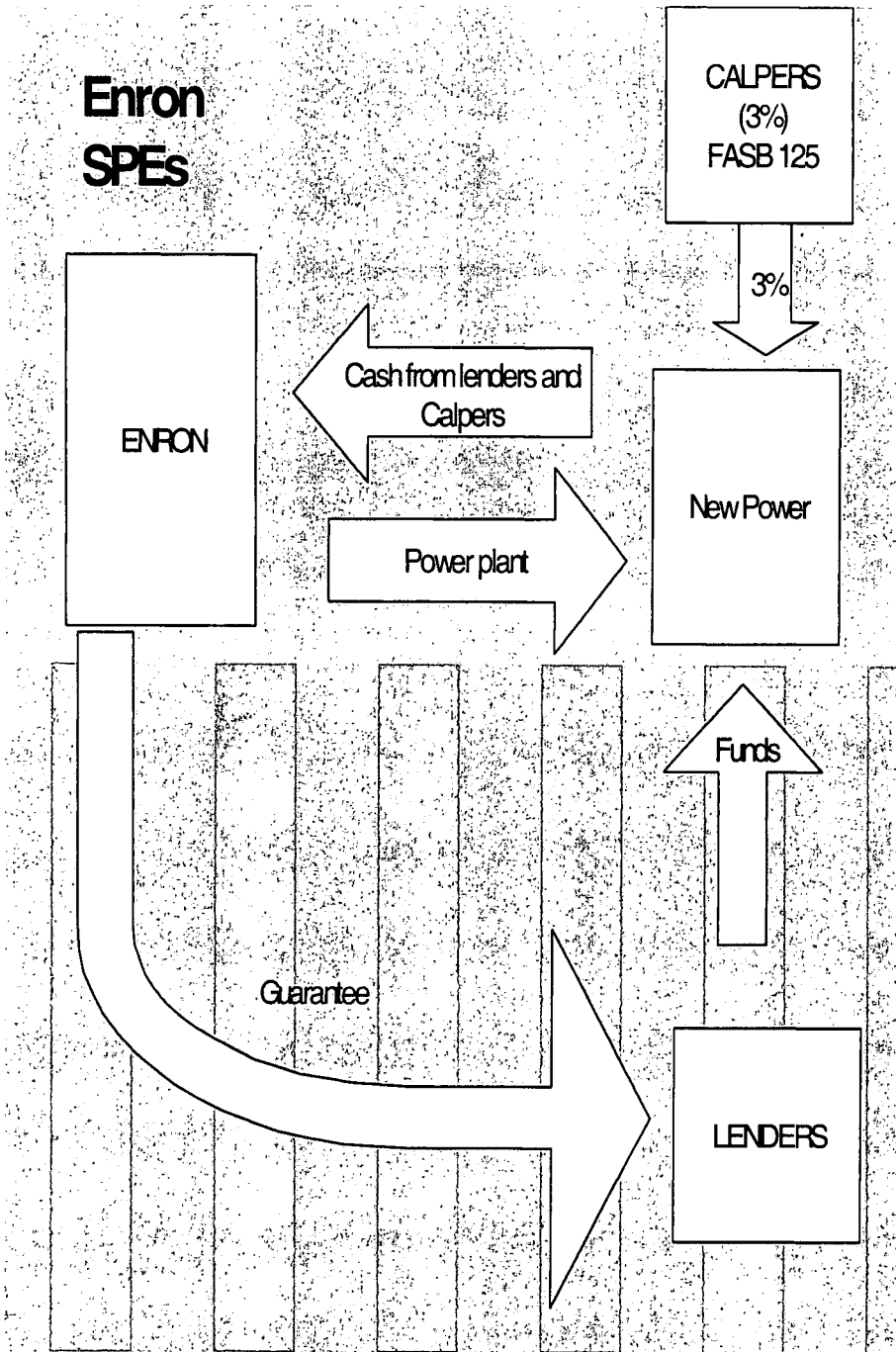
122. *Id.*

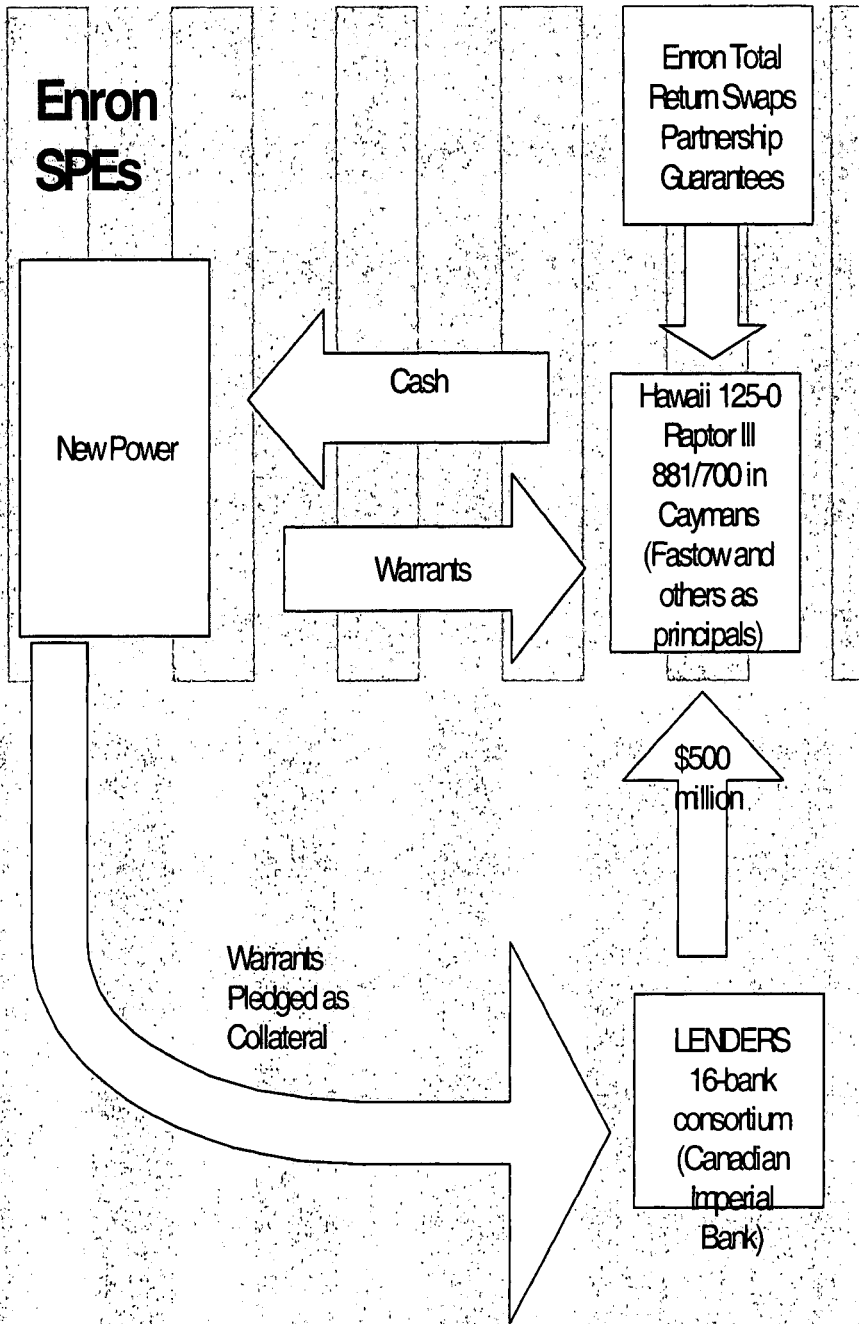
123. *Id.*

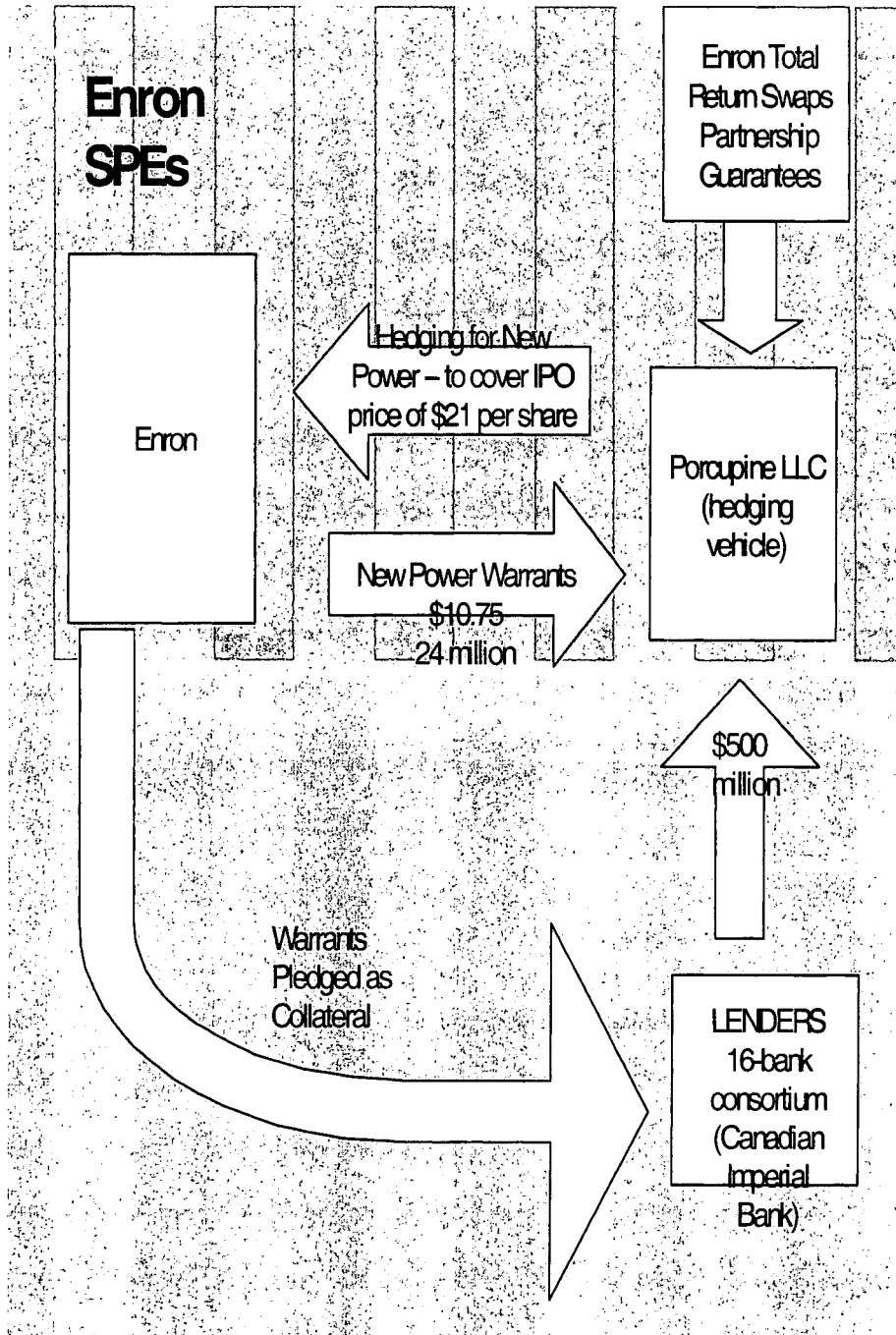
124. *See id.*

125. *Id.*

126. *Id.* There was an additional layer to the New Power/Raptor III transactions in which Fastow created an LLP known as Porcupine, which was a hedging vehicle for New Power. *Id.* For example, if New Power was to go public with an IPO, Fastow would be protected against any share price drop in New Power with warrants sold to Porcupine. *See id.* Fastow protected Enron no matter what happened to the transactions with the SPEs. However, that protection was only as good as Enron's share price, something he was trying to buoy with the transactions he was entering into with the SPEs even as he hedged the SPEs.







As complex as these transactions were, there were still other accounting mirages that contributed to Enron's collapse. One such venture illustrates a combination of FASB 125 with mark-to-market accounting and was known as the "Braveheart" transaction.¹²⁷ In this scenario, Enron signed a contract with Blockbuster Video to provide videos for delivery over Enron's broadband.¹²⁸ With only a few customers in place for the video contracts,¹²⁹ Enron sought to find a means to obtain the cash/profits in advance of sales it expected later of this new product. The Braveheart/Blockbuster partnership followed the classic Enron formula: a little bit of cash from outsiders for the three percent rule and Enron stock. An investment bank fronted \$115 million to Braveheart,¹³⁰ thus Enron scored cash and was able to record as earnings all those funds advanced because the willingness of a lender to invest that much was a valid measure of the value of future contracts for Enron on Braveheart deals.¹³¹

There were other partnerships in which more Enron employees became involved. For example, in the Southampton Place Partnership, Enron lawyer Kristina Mordaunt and corporate treasurer Ben Gilsan, invested \$5,800 in the Fastow partnership and just months later they had a little over \$1 million wired to each of their checking accounts.¹³²

In sum, Enron had created a Byzantine empire of financial layers that were impenetrable by investors until the company's collapse when all documents were made public. The documents dribbled out over a period of months as Enron finally came to grips with the fact that it could not pay the debts it had created via the SPEs. While Enron tried mightily to find a cash

127. Floyd Norris & Kurt Eichenwald, *Enron's Many Strands: The Accounting: Fuzzy Rules of Accounting and Enron*, N.Y. TIMES, Jan. 30, 2002, at C1. The movie theme continues although no one has been able to discern why the name "Braveheart" was chosen for this transaction.

128. *Id.*; see also Rebecca Smith, *Show Business: A Blockbuster Deal Shows How Enron Overplayed Its Hand*, WALL ST. J., Jan. 17, 2002, at A1.

129. See *The Accounting: Fuzzy Rules of Accounting and Enron*, *supra* note 127; *Show Business: A Blockbuster Deal Shows How Enron Overplayed Its Hand*, *supra* note 128. Documents indicate only a few apartment complexes had signed up, on a test basis, for the videos via broadband. One Enron employee said when the revenues were booked, "I was just flooded. . . . I mean, I couldn't believe it. . . . How can they monetize this asset when we're still putting it together? It didn't make any sense to me." *Id.* (quoting former Enron employee).

130. *The Accounting: Fuzzy Rules of Accounting and Enron*, *supra* note 127.

131. For those of you still attempting to keep score, Enron parleyed a couple of contracts with apartment complexes into \$110.9 million and did so all within accounting rules. See *Show Business: A Blockbuster Deal Shows How Enron Overplayed Its Hand*, *supra* note 128. Further, the *Wall Street Journal* reported that the lender for Braveheart's \$115 million had a guarantee from Enron. Norris *The Accounting: Fuzzy Rules of Accounting and Enron*, *supra* note 125. Paul Brown, chair of the Accounting Department at NYU adds, "[t]hey were extremely clever." *Id.* One more thought to contemplate: Enron paid income taxes in only one year from 1996-2000. David Cay Johnston, *Enron's Collapse: The Havens; Enron Avoided Income Taxes in 4 of 5 Years*, N.Y. TIMES, Jan. 17, 2002, at A1. It received a refund of \$105 million in 1999 and \$278 million in 2000. *Id.*

132. *As Inquiry Intensifies, Midlevel Players Face Spotlight*, *supra* note 71.

infusion or buyer, any potential savior in just the beginnings of due diligence bolted because of the revelations minimal due diligence unveiled.¹³³ By November 2001, Enron had been downgraded to “junk” grade.¹³⁴ Enron’s CEO, Kenneth Lay, left the company shortly after the collapse. Mr. Lay waived any rights to his parachute payoff, reportedly worth \$60 million,¹³⁵ and also agreed to repay millions he borrowed from the company.¹³⁶

A number of Wall Street analysts complained from 1995 through 2001, that Enron’s financial statements were difficult to read and that its disclosures on officer relationships were not clear.¹³⁷ Another said that Enron managed to operate as a “giant hedge fund” without disclosing that risk in its SEC documents.¹³⁸

The fallout from Enron’s collapse has been pervasive by December 2, 2001. Enron fired 5,100 of its 7,500 employees.¹³⁹ Each employee will receive a \$4,500 severance package, if the bankruptcy court approves it.¹⁴⁰ However, the employees are more concerned about their financial futures. Many held Enron stock and were compensated with Enron stock options. The stock, which was valued at nearly \$85 per share in the prior year, was trading at \$0.40 per share on December 3, 2001.¹⁴¹ Enron employees’ 401(k) plans, funded with Enron stock, lost \$1.2 billion as of December 3, 2001.¹⁴² “Almost everyone is gone. . . . Upper management is not talking. No managing directors are around, and police are on every floor. It’s so unreal,” said one departing employee.¹⁴³ Another employee, Gary Kemper, a maintenance foreman, who is part of a suit filed against Enron related to the employees’ 401(k) plans, plan was once worth \$225,000 and is now worth less than

133. See Richard A. Oppel Jr. & Riva D. Atlas, *Hobbled Enron Tries to Stay on Its Feet*, N.Y. TIMES, Dec. 4, 2001, at C1.

134. *Id.*

135. *Visionary’s Dream Led to Risky Business*, *supra* note 35.

136. See PSI REPORT, *supra* note 58, at 53. Mr. Skilling left the company in the summer of 2001, just six months after becoming CEO, a departure that some find Machiavellian. See *Darth Vader. Machiavelli, Skilling Set Intense Pace*, *supra* note 16. Others attribute it to his true understanding of what was happening and others label his departure a bail-out. Mr. Skilling was the only one of the Fastow and Lay triumvirate who did not take the Fifth Amendment when subpoenaed by Congress. Stephen Labaton & Richard A. Oppel Jr., *Testimony From Enron Executives is Contradictory*, N.Y. TIMES, Feb. 8, 2002, at A1. Mr. Skilling testified defiantly that he knew nothing. *Id.* Michael J. Kopper refused to testify. *Id.* Jordan Mintz, a former Enron lawyer who worried about the Fastow conflicts, did testify. *Id.*

137. *What Enron’s Financial Reports Did and Didn’t Reveal*, *supra* note 40.

138. *Id.*

139. *Hobbled Enron Tries to Stay on Its Feet*, *supra* note 133.

140. *Id.*

141. *As Investors Worry About Mideast and Enron, Shares Fall*, N.Y. TIMES, Dec. 4, 2001, at C11.

142. *Hobbled Enron Tries to Stay on Its Feet*, *supra* note 133.

143. *Id.*

\$10,000, said, “[h]ow am I going to retire now? Everything I’ve worked for the past 25 years has been wiped out.”¹⁴⁴

Enron had a matching plan for its employees on the 401(k). However, sixty percent of their plan was invested in Enron stock. Between October 17 and November 19, 2001, when the issues surrounding Enron’s accounting practices and related transactions began to surface, the company put a lock down on the plan so that employees could not sell their shares.¹⁴⁵

In addition to the impact on Enron, its employees, and Houston, there is a worldwide ripple effect. Enron has large stakes in natural gas pipelines in the United States and around the world and interests in power plants everywhere from Latin America to Venezuela. It is also a partial owner of utilities including telecommunications networks.

Representative Billy Tauzin of Louisiana, heads the House investigation into Enron noted through his spokesman, Ken Johnson, “[h]ow a company can sink so far, so fast, is very troubling. . . . We need to find out if the company’s accounting practices masked severe underlying financial problems.”¹⁴⁶ Senator Jeff Bingham, chairman of the Senate Energy Committee said, “I believe that our committee is keenly aware of the need for enhanced oversight and market monitoring.”¹⁴⁷

Enron’s bankruptcy filing included a list of creditors fifty-four pages long. While the bankruptcy filing showed \$24.76 billion in assets and \$13.15 billion in debt, these figures do not include those off-the-balance-sheet obligations, estimated to be about \$27 billion.¹⁴⁸ Among the creditors exposed in the Enron bankruptcy, because of derivative transactions on energy contracts are JP Morgan Chase and Chubb.

Enron’s energy customers, including PepsiCo, the California State University system, JC Penney, Owens-Illinois, and Starwood Hotels & Resorts, now scramble to replace energy commitments. Enron had contracts with 28,500 customers. These customers are now revisiting their contracts for loopholes on both sides and ensuring that they have contingency plans in place.¹⁴⁹ California’s State Universities were in negotiations for renewal of their 1998 contract with Enron, but those talks are now in a stalemate.¹⁵⁰ Trammell Crow halted the groundbreaking ceremony for its planned con-

144. Christine Dugas, *Enron Workers Sue Over Retirement Plan*, USA TODAY, Nov. 27, 2001, at 3B.

145. *Id.*

146. Richard A. Opiel, Jr. & Andrew Ross Sorkin, *Ripples Spreading from Enron’s Expected Bankruptcy*, N.Y. TIMES, Nov. 30, 2001, at C1.

147. Nancy Dunne et al., *Financial Threat from Enron Failure Continues to Widen*, FIN. TIMES (London), Dec. 1, 2001, at 1.

148. Rebecca Smith, *Enron Files for Chapter 11 Bankruptcy, Sues Dynegy*, WALL ST. J., Dec. 3, 2001, at A3.

149. Rhonda L. Rundle, *Enron Customers Seek Backup Suppliers*, WALL ST. J., Dec. 3, 2001, at A10.

150. *Id.*

struction of new Enron headquarters; a building that would have been thirty-four stories high and included offices, apartments and stores.¹⁵¹

The ripple effect even stretches into unrelated investments. Five major Japanese money market funds with heavy Enron investments fell below their face value by December 3, 2001.¹⁵² These losses will have an impact primarily on retirees because the five funds were seen as “safe haven” funds for investors. The banks that financed Enron SPEs are in litigation to recoup funds with the recovered funds also going to partners they had in their funding entities.¹⁵³

Enron’s collapse also appears to be raising concerns among state regulators about deregulation in the utility industry. Several members of Congress have noted that lawmakers and regulators cannot leave energy products in the regulatory shadows if the companies involved in the industry are harming both consumers and investors.¹⁵⁴ In addition, there are investigations at several levels into Enron’s energy trading practices.¹⁵⁵

III. WHAT HAD TO COME TOGETHER FOR ALL OF THAT TO HAPPEN

For an Enron to occur there had to be a confluence of events and weaknesses.¹⁵⁶ The discussion of the factors that were required to come together for an Enron to occur provides the keys for the prevention of another such mighty collapse. This segment of the paper offers a discussion of those factors.

A. A Weak Board

It is important to note, particularly in light of calls for reform in corporate governance, that Enron’s Board was a model judging by the standards of those who urge strong corporate governance.¹⁵⁷ A business school dean, sev-

151. Allen R. Myerson, *With Enron’s Fall, Many Dominoes Tremble*, N.Y. TIMES (Magazine), Dec. 2, 2001, § 3, at 1.

152. Ken Belson, *Enron Causes 5 Major Japanese Money Market Funds to Plunge*, N.Y. TIMES, Dec. 4, 2001, at C9.

153. Mary Kelleher, *J.P. Morgan Sues Enron Over \$2.1 Billion*, YAHOO NEWS, Dec. 11, 2001, at www.dailynews.yahoo.com/h/nm/20011211/.

154. Joseph Kahn & Jeff Gerth, *Collapse May Reshape the Battlefield of Deregulation*, N.Y. TIMES, Dec. 4, 2001, at C1.

155. Edward Iwata, *Probe of California Power Crisis Grows*, USA TODAY, July 17, 2002, at 1B. Those involved in the investigation are the SEC, the Justice Department, Federal Energy Regulatory Commission (FERC), Commodities Futures Trading Commission, the California Attorney General and several other state regulators there. *Id.*

156. In fact, judging from the diagrams, a confluence of arrows and boxes was also required.

157. William Powers, an Enron Board member, was assigned the task of evaluating the performance of the Enron Board and issued, in February 2002, the so-called Powers Report, that constituted a scathing indictment of the company’s management as well as the lack of oversight from the Board. Mr. Powers is the dean of the University of Texas School of Law

eral CEOs from other companies, an economist, a woman (for diversity), and limited insiders is a characterization of Enron's Board's composition. However, a closer look at the individuals illustrates not just the flaws in Enron's Board, but the flaws in the assumptions made as governance authorities created the ideal Board profile. Kenneth Lay handpicked Enron's Board and it was not a Board trained in the ways of FASB 125.¹⁵⁸ The Board members were selected for the appearance of depth and possible connections that they brought for Enron.¹⁵⁹ For example, Wendy Gramm, an economist and wife of Senator Phil Gramm was there for political connections.¹⁶⁰ Other members of the Board included Dr. John Mendelsohn who not only served on the Enron Board, but also on its audit committee.¹⁶¹ The other Board members and their titles are listed below.

Kenneth L. Lay, Chair and CEO, *Enron*

Robert A. Belfer, CEO, *Belfer Management*

Norman P. Blake, Jr., Chair, President and CEO, *Comdisco*

Ronnie C. Chan, Chair, *Hang Lung Group*

John H. Duncan, Former Chair Exec. Committee, *Gulf & Western Ind.*

Robert K. Jaedicke, Professor of Accounting, *Stanford University*

Charles A. LeMaistre, Emeritus, *University of Texas MD Anderson Cancer Ctr.*

Paulo V. Ferraz Periera, Exec. Vice President, *Group Bozano*

William C. Powers, Jr., Dean, *University of Texas, School of Law*

and called the number of partnerships Enron entered into as "dizzying." David Hechler, *Report Criticizes V & E's Enron Work*, NAT'L L.J., Feb. 11, 2002, at A1.

158. It does give one pause that an entire Board of directors found nothing odd about partnerships named after STAR WARS, JURASSIC PARK and FASB rules. The Enron SPEs were evidence of the frat boys running the hedge fund and the irony escaped the Board.

159. Mr. Lay was bright enough to follow corporate governance standards, but also savvy enough to understand that Enron needed a certain deregulation strategy to survive.

160. Interestingly, Dr. Gramm owned no stock because she and Senator Gramm decided in 1998 not to own stock as a means of avoiding conflicts of interest. She was paid some of her Enron Board fees in stock, but it was placed in a deferral account. Reed Abelson, *Enron Board Comes Under a Storm of Criticism*, N.Y. TIMES (Magazine), Dec. 16, 2001, § 3, at 4.

161. Joann S. Lublin, *Inside, Outside Enron, Audit Panel is Scrutinized*, WALL ST. J., Feb. 1, 2002, at C1. Mr. Mendelsohn is a leading cancer researcher and president of the University of Texas M.D. Andersen Cancer Center in Houston. Interestingly, Dr. Mendelsohn also served on the Board of ImClone Systems, the company whose anti-cancer drug was not given FDA approval, whose former CEO had been indicted and which is the subject of the Martha Stewart insider trading investigation in which she is alleged to have sold \$224,000 of ImClone stock the day before the public announcement of the FDA rejection. Daniel Kadlec, *Sam's Club; ImClone's Waksal Is Accused of Trying to Dump Company Stock Ahead of Bad News*; Jerry Markon, *Martha Stewart Sale of Stock Under Inquiry*, WALL ST. J., June 14, 2002, at C1; *He Couldn't, but His Friend Martha Stewart Unloaded Hers. Did She Do a Bad Thing?* TIME, June 24, 2002, at 48. Jerry Markon, *Martha Stewart Sale of Stock Under Inquiry*, WALL ST. J., June 14, 2002, at C1; Andrew Pollack & David Cay Johnston, *Former Chief of ImClone Systems Is Charged with Insider Trading*, N.Y. TIMES, June 13, 2002, at B1. It is perhaps safe to conclude that Dr. Mendelsohn either lacks business savvy or is a horrible judge of character and/or savvy in others. *Id.*

Frank Savage, CEO, *Savage Holdings*
 Raymond Troubh, Financial Consultant
 John Wakeham, Chair, *Press Complaints Commission*
 Herbert S. Winokur, Jr., Chair, CEO, *Capricorn Holdings*¹⁶²

While Ken Lay and Jeffrey Skilling, prior to his August 2001 departure, were the only insiders on the Board, there were problems with conflicts of interest. The first inherent conflict of interest was that Enron's directors were the seventh highest paid directors among public companies in the U.S., with a total compensation package of \$380,619.¹⁶³ The reality is that it is tough for directors to be defiant or walk away from such an amount of money. The other inherent conflict was that the directors were selling off their stock even as they continued to serve and collect it as compensation.¹⁶⁴

Other conflicts existed in terms of the nature of Houston's business and political community. The following chart shows various familial, political, and financial connections of various Board members and others with Enron ties. Lawyers and accountants are also included in this chart.¹⁶⁵

*B. The Interconnection of Conflicts in Enron and Houston*¹⁶⁶

NAME	CONNECTION	ACTIVITY
Kenneth L. Lay	CEO, Chairman of Board	\$100,000 to Bush 2000
Wendy L. Gramm	Enron Board member	Husband – Senator Phil Gramm; As former Bush official, supported legislation put forward by Enron ¹⁶⁷
Joseph C. Dilg	Attorney with Vinson & Elkins. Enron was his	Significant Enron stock holdings; paid by Enron

162. ENRON 10-K (2000) available at www.sec.gov/Archives/edgar.

163. *Enron Board Comes Under a Storm of Criticism*, *supra* note 160. Of course, since 85% of the compensation was in Enron stock, that "7th highest paid" comes into doubt. The top six are Oracle, Cisco Systems, United Health Group, Sun Microsystems, Dell Computer and GE. *Id.*

164. Dean Jaedicke, who sat on the audit committee, sold about \$841,000 in Enron shares, \$500,000 of it in 2001. *Id.* Norman P. Blake, Jr. sold \$1.7 million of his Enron shares in 2000. *Id.* Charles A. LeMaistre, who had Dr. Mendelsohn's job and Enron Board seat prior to his retirement, sold \$842,000 in 1999 and in 2001. *Id.*

165. The issues surrounding the accountants and lawyers are covered *infra* at notes 219, 246-273 and 439.

166. Don Van Natta, Jr. et al., *Enron's Collapse: Backdrop; in Houston, The Lines Dividing Politics, Business and Society are Especially Blurry*, N.Y. TIMES (Magazine), Jan. 20, 2002, § 1, at 25. The issues with the auditors and lawyers are covered *infra* at notes 246-273 and 439 and accompanying text.

167. But, in fairness to Dr. Gramm, she and her husband were very critical of legislation and rules Enron put forward. Jeff Gerth & Richard A. Oppel, Jr., *The Power Couple; Senate Bill Showed Complexities of Power Couple's Ties to Enron*, N.Y. TIMES, Jan. 18, 2002, at C1.

	firm's biggest client (\$30 million in revenue for 2001)	
Joe B. Allen	Attorney with Vinson & Elkins (see above) Also, Enron lobbyists advised Board	\$100,000 to Bush campaign; paid by Enron; significant Enron stock holdings
Thomas P. Marinis, Jr.	Attorney with Vinson & Elkins (see above), Advised Board	Boyhood friend of George W. Bush; \$100,000 to Bush campaign; significant Enron holdings; paid by Enron
Ray Hutchison	Attorney with Vinson & Elkins; advised Board	Married to Senator Key Bailey Hutchison; \$100,000 to Bush campaign; significant Enron stock holdings; paid by Enron
Lawrence B. Lindsey	Economic advisor to George W. Bush	Formerly on Enron payroll
Karil Rove	Chief strategist for George W. Bush	Significant Enron holdings
Thomas E. White	Secretary of the Army	Significant Enron holdings; formerly on Enron payroll
Robert B. Zoellick	U.S. Trade Representative	Formerly on Enron payroll
James A. Baker	Handled Gore v. Bush litigation PR in Florida in November 2000	Formerly on Enron payroll
D. Stephen Goddard, Jr.	Managing partner of Houston office of Arthur Andersen (\$52 million in fees for 2001)	\$100,000 contributor to George W. Bush

There were additional individual conflicts among Board members that would not require any form of SEC disclosure, but nonetheless created the beholden nature of the Enron Board. Mr. Mendelsohn, again a member of the audit committee, received a donation of \$1,564,928¹⁶⁸ for his cancer center from Enron and \$240,250 from Ken Lay and his wife Linda since joining the Enron Board in 1999.

168. *Inside, Outside Enron, Audit Panel is Scrutinized*, *supra* note 161.

Herbert S. Winokur, Jr., one of Enron's original directors from its founding in 1985, serves on the Board of Natco Company, a firm that did business with Enron subsidiaries.¹⁶⁹ Disclosure of directorships is not required for privately held companies.

Since Enron's collapse, other conflict issues arose. For example, Frank Savage, a senior executive at Alliance Capital Management, was a Board member and even when investors were beginning to sell Enron stock in droves as questions arose. Alliance was in an aggressive buying stance with Enron.¹⁷⁰

Lord John Wakeham, a member of the audit committee, served as a consultant for Enron's European unit for \$72,000 per year since 1996.¹⁷¹ Wendy Gramm, also on the audit committee, is the director of the Mercatus Center Regulatory Studies Program at George Mason University, to which Enron donated \$50,000.¹⁷²

Two audit committee members raise issues of independence with their conduct. Ronnie C. Chan missed over one-fourth of the Enron Board and Committee meetings in 1996, 1997 and 2000. And, Dean Robert K. Jaedicke, professor emeritus at Stanford, had been chair of the audit committee since 1985.¹⁷³

One-half of the audit committee members were from outside the U.S.,¹⁷⁴ a category of directors that raises two issues. The first issue is the problem of attendance, as the previous discussion indicates. International members of Boards of U.S. companies have lower attendance rates for both Board and committee meetings.¹⁷⁵ The second issue is that there are significant differences in financial report transparency and audit standards in other countries.¹⁷⁶

Like other aspects of Enron, while the Board appeared to fit the definition of "outsiders of interdependency," the Board was, in fact, a closely connected community and company, the conflicts present and the more subtle issues of quality governance made it more difficult to Board members to raise the issues that were percolating for some time.¹⁷⁷ The failure of the Board to catch obvious "red flags" is perhaps the best evidence of its com-

169. *Enron Board Comes Under a Storm of Criticism*, *supra* note 160. The total amount of business for Natco was \$1.5 million. *Id.*

170. Reed Abelson & Kenneth N. Gilpin, *2 Enron Roles Raise Questions of Allegiance*, N.Y. TIMES, Dec. 7, 2001, at C1.

171. *Inside, Outside Enron, Audit Panel is Scrutinized*, *supra* note 161.

172. *Id.*

173. *Id.* Such a long tenure is unusual with most governance experts in agreement that such a long tenure impedes independence.

174. *Id.*

175. *Id.*

176. *Id.* The only member of the audit committee not discussed was Paulo V. Ferraz Pereira of Group Bozano in Brazil. *See id.* There were no apparent conflicts here, although there was the international factor of attendance.

177. *See supra* chart at 136.

plicity. At the Senate hearings conducted by the Permanent Subcommittee on Investigations (PSI), Exhibit 1 was a chart entitled "Red Flags Known to Enron's Board."¹⁷⁸ Those red flags consisted of the following:

- At the February 1999 Audit Committee Meeting, Andersen partner, David Duncan, told the Board members that Enron's accounting practices tended to "push limits" and were "at the edge" of generally accepted accounting principles (GAAP).¹⁷⁹
- The Board was alerted to the issue of Fastow's involvement with the SPEs because its approval was required, but it nonetheless agreed to waive company policy in order to facilitate not just the company doing business with an entity headed by one of its officers (the CFO), but that it was acceptable that the CFO earn substantial fees and returns while serving in that capacity.¹⁸⁰
- In September 1999, the Board approved the removal of Whitewing, an Enron affiliate, from the company's consolidated financial statements despite that fact that \$1.4 billion in Whitewing debt was guaranteed by Enron stock and that Enron had served as financier for Whitewing's asset purchases.¹⁸¹
- Throughout the period of 1999-2001, the Board was informed that gross revenues had more than doubled and that these funds were generated by the LJM SPE operated by Fastow, but the curious rise in revenues involving an off-the-books relationship with an entity run by its CEO did not give the directors pause.¹⁸² The Senate Subcommittee investigating Enron's collapse found no evidence of any director questioning these odds-defying numbers and performances.¹⁸³

178. PSI REPORT, *supra* note 58, at 12. See also *Accountable: How a Bright Star at Andersen Fell Along with Enron*, *supra* note 22 (explaining that even Mr. Duncan's pastor was aware that Enron was pushing Mr. Duncan to go beyond his self-imposed accounting limits).

179. PSI REPORT, *supra* note 58, at 12.

180. Andrew Fastow's conflict of interest waivers were approved on June 28, 1999 and again on October 12, 1999. *Inside, Outside Enron, Audit Panel is Scrutinized*, *supra* note 161. The audit committee conducted the review and Chairperson, Robert Jaedicke approved the motions. *Id.*

181. PSI REPORT, *supra* note 58, at 12 (explaining how these asset, debt, and guarantee swaps worked).

182. *Id.*

183. *Id.* To paraphrase Brookings Institute Scholar Martin Mayer's take on astronomical numbers that defy explanation (Lawrence Parks, *What the President Should Know About our Monetary System* (1999), available at <http://www.fame.org/HTM/President16.htm>) this would be like your child coming home one day and saying, "Mom, I made \$1 million dollars at the lemonade stand today." Most parents would respond, "How on earth is that possible?" and then begin a Ward and June Cleaver-like investigation into what exactly the child was doing that day, beginning with a visit to the local video poker machines. However, Enron's Board, were it in the position of the informed parents simply responded, "Isn't that nice dear! Bully for you!"

- From October 1999 through October 2000, the Enron Board was asked to approve all of the Raptor I, II, III, IV¹⁸⁴ and LJM2 and LJM3, including two additional waivers of the conflicts of interest rules for Fastow to serve as principal operating officers for these SPEs.¹⁸⁵

Unlike the subcommittee's analysis of the "red flags" for the Board, it is perhaps fair to halt the analysis there. The report includes additional "red flags" for the Board, but, with due respect to the committee and its staff, it is counting red flags that occurred after the horse had left the barn.¹⁸⁶ Perhaps the Board could have spoken up earlier with the following events, but there was little that could have been done at these junctures to save the company. The company was too highly leveraged for recovery, even assuming the continuation of the irrational exuberance of the 1990's economy.

Bethany McLean's "Is Enron Overpriced?" article appears in the March 5, 2001 issue of *Fortune* magazine.¹⁸⁷ The committee refers to the article as "prominent" however, as noted earlier, despite the article's dead-on questions and assessments, it fell flat.¹⁸⁸ As will be noted in the discussion of reforms, Enron had become such a phenomenon that few dared question its achievements. Ms. McLean was tilting at windmills and only she and some short-sellers, who pocketed a handy twenty-four percent ROI on their bets against Enron, believed in March 2001 that there was something fundamentally wrong at Enron.¹⁸⁹

In April 2001, the Enron Board was told that sixty-four percent of the company's assets were "'troubled' or performing 'below expectations.'"¹⁹⁰ Prior to this report they were told that sixty-seven percent of the company's

184. Unlike Sylvester Stallone's *ROCKY* (20th Century Fox) series, Enron never made it to Raptor V, although it was certainly not due to any lack of financial imagination on Andrew Fastow's part.

185. PSI REPORT, *supra* note 58, at 60.

186. The author once again mixes metaphors of flags and barn doors, but perhaps the reader gets the point that any red flags after this point were irrelevant because Enron had already painted itself into a financial corner from which there was no salvation. This is particularly evidenced by the general economic downturn followed by the post 9-11-01 fallout. Painting into corners and salvation are two thoughts that generally do not run together, but perhaps the reader understands what really is a critical point: once Enron went down the Raptor and LJM paths, there was no turning back. Alas, a metaphor that matches.

187. PSI REPORT, *supra* note 58, at 12 n.15. See *Is Enron Overpriced?*, *supra* note 13.

188. PSI REPORT, *supra* note 58, at 12.

189. John Olson, vice president and director of research at the Houston-based Sanders Morris Harris, publicly expressed his doubts about Enron. While every other firm and analyst had a strong "Buy" for Enron, Olson stated that "no analyst worth his salt can seriously analyze Enron." *Why John Olson Wasn't Bullish on Enron*, (Feb, 2, 2002), at http://www.knowledge.wharton.upenn.edu/013002_ss3.html. Olson added that Enron was "not very forthcoming" with information and he defied other analysts with recommendations against Enron. John Schwartz, *Man Who Doubted Enron Enjoys New Recognition*, N.Y. TIMES, Jan. 21, 2002, at C8. For more discussion of the role of analysts, see *infra* notes 274-289 and accompanying discussion.

190. PSI REPORT, *supra* note 58, at 12 (citation omitted).

assets were “underperforming.”¹⁹¹ The significance of the April 2001 meeting is that an additional thirty-five percent of the “troubled” assets were tossed into another ten percent of that total group to create a new subtotal of forty-five percent of Enron’s “troubled” assets.¹⁹² For those of you still following along, and it is an irony that it is even difficult to understand the way Enron computed its nonperforming and underperforming assets, forty-five percent of the original sixty-seven percent were now totally worthless. That figure translated to a \$2.3 billion overstatement of assets on the company’s balance sheet.¹⁹³ Either March or April would have been a good time for the Board to come clean even if it couldn’t fix the problems. Indeed, by this point there were too many Raptors for anyone to even send in Jeff Goldblum, Laura Dern or Sam Neill to the rescue.¹⁹⁴

The summer of 2001 saw things cooking with gas at Enron. The Board was informed that Andrew Fastow transferred his interest in LJM, ending the need for a review of financial transactions; they were not informed the transfer was to former Enron employee, Michael Kopper.¹⁹⁵ The Board was also informed of the JEDI and CHEWCO partnerships.¹⁹⁶ If the squirreling about of company assets among employees for an international shell game involving SPEs with goofy names was not enough excitement for the Board in the summer of ‘01, it soon found itself coping with the resignation of CEO Jeffrey Skilling and the internal investigation of a whistle-blower memo sent

191. *Id.* at 12 n.16.

192. *Id.*

193. *Id.*

194. The author here employs cinema similes again. JURASSIC PARK the original, not II or III (Universal Studios 1993) had Jeff, Laura and Sam play the independent scientists (although they were about as independent as Wall Street analysts because they came to Jurassic Park as independent scientist whose work was going to be funded by Sir Richard Attenborough for the next ten years—Sir Richard, of course, played the creator and developer of Jurassic Park) who are to certify Jurassic Park as safe for investors and insurers. Seeing as how they were chased about the island by one too many raptors for them to handle, they decided not to sign off on the safety and risk statements. They confront only three raptors in the final dramatic scenes. You will recall the discussion *supra* II.B.2., that Enron had four Raptors, three LJMs, and a Fastow in the catbird seat on all of them.

195. PSI REPORT, *supra* note 58, at 34. Kopper resigned from Enron in June, 2001, before most of Enron’s problems became generally known outside the company. *Former Enron Executive Pleads Guilty*, at http://www.pbs.org/newshour/updates/kopper_08-21-02.html. Kopper has proved to be the weak link in the stonewall. The author apologizes for the mixed metaphor, but clearly Kopper failed to stand tall when the going got tough. Fifteen years is the maximum sentence for his two charges. *U.S. v. Kopper*; Cr. No. H-02-0560(S.D. Tex. filed Aug. 21, 2002)(Cooperation Agreement). See *supra* note 104 and *infra* notes 299-334 for more discussion of this transfer and the surrounding culture at Enron.

196. PSI REPORT, *supra* note 58, at 13. While the recommendations for reform are some pages and footnotes away, the author believes an important safety tip for Board members is best placed here. Should anyone ask you, as a Board member, to approve transactions involving names such as Raptor, JEDI, Chewco or anything employing the numbers of accounting rules, refuse and run like the dickens the other way for it is certain that a *perfect storm* is on its way. The PSI missed the red flag of goofy names altogether when discussing what should have put the Board on notice.

anonymously, and later revealed to be the work of Sherron Watkins. The Board was assured the concerns expressed in the memo were nothing and it formally closed as an internal investigation in October 2001.¹⁹⁷

In their testimony before the PSI and in subsequent interviews with staff members conducting the Enron investigation, Board members¹⁹⁸ insisted that both management and Enron's outside auditor, Andersen, were not forthcoming with information about SPEs and the company's accounting practices.¹⁹⁹ However, at the February 1999 Enron Board meeting held in London as part of a multi-city international tour that the Board was taking to understand Enron's extensive holdings and investments, the Audit Committee minutes reveal substantial discussion by David Duncan and other Andersen representatives of the nature of Enron's accounting and business practices.²⁰⁰ In fact, David Duncan provided the audit committee with a one-page summary called, "Selected Observations 1998 Financial Reporting."²⁰¹ The format of the one-page summary was one in which Duncan highlighted the key accounting issues including "[h]ighly [s]tructured [t]ransactions," "[c]ommodity and [e]quity [p]ortfolio," "[p]urchase [a]ccounting," and "[b]alance [s]heet [i]ssues."²⁰² These issues were then part of a matrix in which Duncan evaluated three categories of risk for the audit committee. The three categories of risk were: "[a]ccounting [j]udgments," "[d]isclosure [j]udgements [sic]," and "[r]ule [c]hanges."²⁰³ Duncan assigned one of three letters to each of the three categories: "H" for High risk, "M" for Medium risk, and "L" for Low risk.²⁰⁴ Each of the issues had at least one "H", mean-

197. *Id.* at 12. While discussion of the ethical culture issues at Enron and recommendations for future reforms among companies is forthcoming, another brief safety tip for Board members is in order. Should you receive a memo with this language, "Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues. . . . The spotlight will be on us, the market just can't accept that Skilling is leaving his dream job" know that all is not OK in Dodge. *Id.* (quoting Letter from Sherron Watkins, Vice President for Corporate Development, Enron, to Kenneth Lay, Chairman of the Board of Directors, Enron (Aug. 15, 2001)).

198. The present and past Board members who appeared before the PSI or were questioned include: Norman P. Blake, Jr., John H. Duncan, Herbert S. Winokur, Jr., Dr. Robert K. Jaedicke, and Dr. Charles A. LeMaistre. *Id.* at 1-2.

199. *Id.* at 14. Mr. Winokur, who served as chair of the Enron Board Finance Committee said, "We cannot, I submit, be criticized for failing to address or remedy problems that have been concealed from us." *Id.*

200. *Id.* at 16 (citing *Hearing Exhibit 2b*, Enron Audit Committee Minutes (Feb. 7, 1999)).

201. *Id.* at 16. This summary sheet qualified as a red flag because in early 1999, the Board still had the opportunity to follow up on issues, halt certain transactions and prevent the further deterioration of the company's financial position. (This deteriorating financial position resulted from Fastow's continuing domination of financial strategy, both within and outside the company via the SPEs, courtesy of the conflict rules waived by the Board.) *Id.*

202. *Id.* Duncan also included sub-issues within these issues with more details on the general categories.

203. *Id.*

204. *Id.*

ing it was high risk.²⁰⁵ Apparently the reconciliation of the subcommittee's assertion that the Board knew and did nothing, with the Board's insistence that it did not know, is that while the Board may have been told of the risk, it was relying on management's and auditors' judgment in permitting such risk to continue.²⁰⁶

If judged by simplistic standards for good corporate governance, Enron met and exceeded those standards.²⁰⁷ Mr. Lay and Mr. Skilling were the only

205. *Id.*

206. The obvious debate is whether a Board so inclined to go along with high-risk operations is performing its role of independent overseer sufficiently and whether it has satisfied its fiduciary duty without further investigation.

Further, the question arises, in the review of the minutes from the audit committee and Board meetings, whether the picture presented was somewhat sanitized. For example, the PSI Report raises the following from the minutes from the Enron Audit Committee in May 2000, "Mr. Duncan discussed the financial reporting areas that [Andersen] had determined to be high priorities due to inherent risks that were present. He stated that the ongoing high priority areas included structured transactions, the merchant portfolio, commodity trading activities, project development activities and intercompany and related party transactions." *Id.* at 18 (citing *Hearing Exhibit 7c*, Enron Audit Committee Minutes 2 (May 1, 2000)).

In fairness to the Board, these discussions sounded like code and/or cover for the auditor. There is nothing in the hearings or the PSI REPORT that finds Duncan standing and screaming, "This is a gigantic fraud. These numbers are all air and we are all going down here if barometric pressure changes." *See supra* note 49 (more information on the role of barometric pressure in Enron's collapse).

207. For a review of guidelines on corporation governance, *see Statement of the Business Roundtable on Corporate Governance Principles Relating to the Enron Bankruptcy*, (Feb. 11, 2002), at <http://www.brtable.org/document.cfm/650> (last visited July 24, 2002). The Business Roundtable has issued a number of public statements calling on corporate officers to change their ways and regularly participated in the debates on Capitol Hill over Enron. Immediately following the President's request for a return to ethics, John T. Dillon, the chairman of the Business Roundtable issued this statement:

The Business Roundtable actively supports the proposals put forth by the President to improve the transparency of corporate financial statements, to deal harshly with corporate wrongdoers, and to promote strong and independent governance and oversight.

In May, The Business Roundtable called for a majority of a company's directors to be truly independent, and the audit, compensation and governance committees to be made up entirely of independent directors. We have supported CEO certification of financial statements, and endorse the President's proposal for personal certification of true and transparent reporting in annual reports. And we have urged that violators of the law must be prosecuted immediately and severely.

John T. Dillon, *The Business Roundtable Statement Following The President's Call For A "New Ethic of Responsibility,"* at <http://www.brtable.org/press.cfm/734> (last visited July 9, 2002).

While its guidelines on corporate governance are extensive, the Business Roundtable issued the following summary in a press release (the full guidelines are available at its Website): "Independence: Boards of directors must exercise independent judgment and a substantial majority of Board members must be independent of management, as advocated in our Principles of Corporate Governance. The three key committees of the Board—the audit, compensation and governance committees—must be made up entirely of independent directors." *The Business Roundtable Statement on Restoring Investor Trust*, available at <http://www.brtable.org/press.cfm/728> (last visited July 8, 2002). The statement was also pub-

insiders on the Board. Directors were independent on the surface; by a paper examination of credentials they all appeared to be independent. And qualifications such as a former business school dean did not appear to be lacking.²⁰⁸ However, as noted earlier, they had significant indirect conflicts that created a beholden type of atmosphere among Board members. At least one member of the audit committee, Dr. Mendelsohn, had limited familiarity with accounting principles, along with the substantial conflict with receiving donations to his cancer center from the Enron Foundation, as well as from Ken and Linda Lay.²⁰⁹

It is perhaps impossible to know what the directors really understood about Enron's situation. But, it is clear that the Board had given fairly wide latitude and *carte blanche* supervisory controls to a financially sophisticated team of managers. Those sophisticated business people on the Board, who might have had the insight and ability to raise issues and questions about the extensive SPEs and the accounting for such, were not always full participants in Board meetings and discussions because of travel issues.

The Board appeared to be well informed with regard to the rules that applied to Enron's approach to accounting for those vulnerable areas noted in the Duncan one-page memo.²¹⁰ However, it was in the recognition of the level of risk, where the auditors and directors may have had a breakdown in communications, which may or may not have been attributable to management. The Board accepted assurances from the auditor that it was within accounting rules, albeit aggressive in its approach.²¹¹ It is possible that the entire interconnected aspects of the Raptor and LJM SPEs may not have been clear, even as Duncan provided the technical language and briefing. The scope and magnitude of the off-the-books debt plus the extent of the quality of Enron's assets may not have been brought together into one global view until it was too late for Enron's salvation.²¹² This acknowledgment of per-

lished in major newspapers around the country as a full-page ad on July 8, 2002. *See, e.g.* WALL ST. J., July 8, 2002, at A5. For a summary of the judicial view on corporate governance, *see* Gearheart Indus. v. Smith Int'l, 741 F.2d 707,720 (5th Cir. 1984) (including the duty of care as part of a director's fiduciary duty. The court defined due care as exercising diligence and prudence in "managing the corporation's affairs"). For discussion of more recent theories on management and director liability when there is deepening insolvency, *see* Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340 (3rd Cir. 2001).

208. ENRON ANNUAL REPORT 2000, at 54-55, at <http://www.enron.com/corp/investors/annuals/2000/board.html>.

209. David Lawrence, *Enron Doctor*, PEOPLE'S WEEKLY WORLD NEWSPAPER (Mar. 2, 2002), at <http://www.pww.org/article/articleprint/712>.

210. *See supra* note 201 and accompanying discussion.

211. Lord Wakeham is what is known as a "chartered accountant" in Great Britain, the equivalent of a CPA, and the chair of an audit committee at another publicly held company. He referred to Enron's structure as "relatively new" and "not done by many companies in the world," but within the bounds of accepted accounting principles, something Lord Wakeham says he obtained in the form of assurance from Arthur Andersen. PSI REPORT, *supra* note 58, at 20 (discussing and quoting interviews conducted by the PSI staff).

212. As noted earlier, it was not until the spring of 2001 that the Board was informed of the poor asset quality, something that followed within two months of the March 2001, Beth-

haps some merit in the directors' claims is critical because meaningful reform mandates that those reforms be effective even in the face of a diabolical management team.²¹³

However, having noted that the directors' claims may have some merit, however, it is critical to note an overarching problem in the directors' conduct as to why they did not have full information from the management team about the nature of these transactions; it is in answering the "why" question that the directors may be liable for the breach of their fiduciary duties. For example, all the directors signed Enron's 10-K filings for 1999 and 2000.²¹⁴ In both years, there were nearly 3,000 separate entities listed, including some 600 entities with the same PO Box address in the Cayman Islands.²¹⁵

The continuing laxity in the approval of the waiver of the conflicts of interest policy for Mr. Fastow, so that he could operate the SPEs, is a critical issue in the ability of Enron management to continue its operations as a highly leveraged and complex hedge fund. Under Enron's "Code of Ethics," the CEO could waive the company's conflict of interest rules, so that an employee could obtain personal financial gain from dealing with the company. The Enron Code of Ethics has both a general and a specific policy on conflicts of interest. The general ethical principle provides as follows:

Employees of Enron Corp., its subsidiaries, and its affiliated companies (collectively the "Company") are charged with conducting their business affairs in accordance with the highest ethical standards. An employee shall not conduct himself or herself in a manner which directly or indirectly would be detrimental to the best interests of the Company or in a manner which would bring to the employee financial gain separately derived as a direct consequence of his or her employment with the company.²¹⁶

any McLean article, *Is Enron Overpriced?*. Again, the horse may have already been out of the barn by the time the directors were able to put two and two together. The author recognizes that we have come to expect more of directors than the simple task of adding two and two together. However, the sheer complexity of Enron's Byzantine finances (*see supra* Figures and accompanying notes 65-126) may not have been presented with sufficient clarity or with a global view. The Board deserves criticism for its cavalier waiver of the conflicts of interest rules. However, the Board's defense that it neither knew nor could know of the events at the company until it was too late for salvaging may have a kernel of truth. Now, whether the directors should have known is a question juries will grapple with in the numerous suits pending by shareholders, pension holders and just about everyone in the Houston area.

213. Enron's management team may have been sorely lacking in ethics and now appear to be a taciturn crowd, but we are forced to acknowledge that they were positively brilliant in their financial structuring and exploitation of loopholes in FASB and the law. Knives and rogues they may have been, but they did know their FASBs, SLOBS, SPEs, swaps, leverage and, apparently, popular movies.

214. ENRON 10-Ks (1999,2000) available at www.sec.gov/Archives/edgar.

215. *Id.* In fairness to the directors, however, it is possible that they would have only been given the body of the 10-K reports and not the extensive exhibits that companies must attach to the 10-K.

216. ENRON, CODE OF ETHICS, EXECUTIVE AND MANAGEMENT 12 (July 2000). Author in possession of this code (which, by the way, she was able to obtain unopened from e-Bay for a none-of-your-business price; the author viewed it as a donation to the pitiful retirement plan

The specific provisions that appear later in the code provide:

[T]he employer is entitled to expect of such person complete loyalty to the best interests of the Company. . . . Therefore, it follows that no full-time officer or employee should:

(c) Own an interest in or participate, directly or indirectly, in the profits of another entity which does business with or is a competitor of the Company, unless such ownership or participation has been previously disclosed in writing to the Chairman of the Board and Chief Executive Officer of Enron Corp. and such officer has determined that such interest or participation does not adversely affect the best interests of the Company.²¹⁷

While the CEO could approve a waiver of the policy for everyone except himself, the Board nonetheless, ran the waiver for Fastow at least three times.²¹⁸ Despite this knowledge, that the Board members did not dispute, no one on the Board hesitated in his or her approval for the waiver of the conflicts rule, as well as the increasing role of Andrew Fastow in SPEs.²¹⁹ Even as it was approving the waiver of the conflict policies for Fastow, the Board was not devoting a great deal of time to understanding the underlying transaction that found Fastow in need of a waiver of the conflicts policy.²²⁰ At the first meeting on the LJM1 partnership, the Board approved the conflicts waiver, authorized a major stock split for Enron, voted to increase the number of shares for employees in the company's stock compensation program, approved the purchase of a new corporate jet, authorized an investment in a

of the Enron employee who was quite industriously auctioning off codes of his failed company)(on file with *California Western Law Review*).

217. *Id.* at 57.

218. PSI REPORT, *supra* note 58, at 24. Technically, the Board Minutes provide that the Board was asked to ratify the waiver that Mr. Lay had already granted to Mr. Fastow. Dr. Jaedicke said that the ratification was not actually a waiver but an enforcement of the Code of Ethics. This is because the Code permitted the waiver in the discretion of the CEO and the effect of the Board's ratification was simply to state unequivocally that the conflicts policy and the waiver policy were valid. *Id.* at 25 n.59. There are those who theorize that the Board ratification was at the suggestion of Andersen and David Duncan. In a May 28, 1999 e-mail to David Duncan, Benjamin Neuhausen, a member based out of Chicago of Andersen's Professional Standards Group, wrote, "[s]etting aside the accounting, idea of a venture entity managed by CFO is terrible from a business point of view. Conflicts galore. Why would any director in his or her right mind ever approve such a scheme?" *Id.* at 25. David Duncan replied on June 1, 1999, "[O]n your point 1 (i.e., the whole thing is a bad idea), I really couldn't agree more. Rest assured that I have already communicated and it has been agreed to by Andy that CEO, General [Counsel], and Board discussion and approval will be a requirement, on our part, for acceptance of a venture similar to what we have been discussing." *Id.* at 25-26 (alterations in original). Andersen appeared to be counting on the Board catching it and saving them, but the Board either saw the request differently or did not see its significance or the potential conflicts, three times into the ratification. *Id.* at 25 n.59. Yet another important safety tip for directors emerges: if the CEO asks you to waive provisions in the Code of Ethics, you perhaps, have a problem.

219. *Id.* at 26-27.

220. *Id.*

Middle Eastern power plant, discussed a reorganization/restructuring at Enron that Mr. Lay had planned, and approved the LJM1 creation.²²¹ The minutes of the meeting show that the meeting lasted one hour, that there was little discussion or debate, and that the directors had received the information on LJM only three days prior to the meeting.²²² In terms of fiduciary responsibility, the argument can be made, that the breach of duty is the Board's failure to devote the time necessary for understanding and debating the LJM plan.²²³ This was a timid Board pitted against aggressive accounting managers, a volatile combination.

There were moments, however, when the Board perhaps realized that there were issues in and among Fastow, his initialed LLPs, and the Raptors. By October 1999, when additional approvals for LJM2 and Fastow waivers were requested, the proposals were first presented to the Finance Committee.²²⁴ Board members agree that the committee held a "vigorous discussion."²²⁵ No one on the Finance Committee or the Board asked to see or ever read the private placement memoranda for the LJM series.²²⁶ In fact, one Board member received information on the LJM2 series as a potential investor, but confessed that he tossed it before even reading it.²²⁷ In an indication of how powerless Enron management perceived the Board, Mr. Fastow, prior to the October Board meeting in which LJM2 was approved, had already completed negotiations with Merrill Lynch for the marketing of the LJM2 partnerships.²²⁸

The LJM3 partnership was approved in October 2000 in a perfunctory fashion. The approval was requested at the same time LJM issued its first annual report, but the Board neither requested the report nor did management offer it.²²⁹ In addition, the Board received assurances that that there would be sufficient internal controls in place to manage the potential con-

221. *Id.* at 27 (citing ENRON BD. OF DIRS., MIN. (6/28/99)).

222. *Id.* at 27.

223. Some Board members indicated in interviews with staff members that their approval of LJM and the Fastow waiver was based on their understanding that they were approving a one-time transaction, not a steady stream of asset movements and manipulations. *Id.* at 26 n.63. However, it is interesting to note that these approvals took place via conference call, in an emergency meeting called just two days before the end of the reporting period for that quarter (June 28, 1999). *Id.* at 26-27.

224. *Id.* at 28.

225. *Id.*

226. *Id.*

227. *Id.* The Board members also never reviewed the Annual Reports from LJM that included the compensation paid to Mr. Fastow and others in their roles as principals of those companies. *Id.*

228. *Id.*

229. *Id.* Many Board members expressed the view that they were relying on the opinions of both Andersen and Enron's legal counsel, Vinson & Elkins, in permitting such a smooth approval process. In other words, these Board members trusted auditors and legal counsel. *See id.* Big mistake.

flicts of interest.²³⁰ With each requested LJM approval, there were additional controls.²³¹ By the time the Board faced LJM3, it had assurances that all Enron and LJM transactions would be approved by Causey, Mr. Skilling, and that the Audit Committee would conduct an annual review of all of the transactions involving, among, and, as we now know, between the firms.²³²

By the request for LJM3 in October 2000, the Board was getting testy and imposed a requirement of quarterly reviews of LJM transactions and a one-time look at Mr. Fastow's compensation, with the Finance Committee conducting the transaction review and the Compensation Committee conducting the Fastow review.²³³ The Finance Committee reviews, as well as the standing reviews by the Audit Committee proved to be cursory.²³⁴ Management furnished all the information; it consisted solely of a list of the Enron/LJM transactions and did not include supporting documentation. The presentation and lasted from 15-30 minutes in terms of committee and Board discussion time.²³⁵ No director was struck, then or when interviewed by the Congressional staff members, by the sheer magnitude of the LJM deals.²³⁶ In the 1999 report on LJM transactions, the Board was told that LJM had generated \$200 million in earnings in eight days and had an internal rate of return of eighteen percent.²³⁷

230. In the original LJM proposal, the Board was told that Richard Causey, the company's Chief Accounting Officer, would be required to approve all transactions between Enron and LJM. *Id.* at 29. However, we now know that Mr. Causey and Mr. Duncan were very cozy. *See supra* note 23.

231. PSI REPORT, *supra* note 58, at 30.

232. *Id.* at 29-30. In the special report commissioned by the Enron Board (again, after the horse was out of the barn), there was a finding that there was a failure of the proposed internal controls in that LJM transactions occurred without the necessary routing and approvals that had been promised to the Board. *Id.* at 30. For example, the process required that a Deal Approval Sheet (DASH) be completed and circulated among the necessary officers for approval of LJM transactions. *Id.* There were some transactions with no DASH sheets, some with DASH sheets without signatures and some transactions were completed before the DASH sheets had the authorized signatures. *Id.* There is testimony from staff members that they experienced pressure from Mr. Fastow on these deals to get better terms for LJM. The PSI found internal memos expressing concern about lax compliance with the DASH policies. Enron legal counsel Jordan Mintz wrote, "[T]he Company needs to improve both the *process* it follows in executing such transactions and implement improved procedures regarding *written substantiation* supporting and memorializing the Enron/LJM transactions." *Id.* at 30 n.81 (alteration and emphasis in original). Mr. Mintz also emphasized the need for "more rigorous testing of the fairness and benefits" of these transactions. *Id.*

233. *Id.* at 30.

234. *Id.* at 32.

235. *Id.*

236. *Id.* at 33.

237. *Id.* The PSI REPORT notes that during 2001, the Finance Committee did not ask any questions when informed that Fastow had sold his interest in LJM and did not inquire as to why the quarterly reports had ended. *Id.* (citing *Hearing Record* at 175, 179). These lapses can be viewed as evidence of breach of fiduciary duty. Well, that may be, but in August 2001, when the Fastow sale occurred, there was nothing the Board could have done to save the company. Back when Fastow asked for LJM was when the Board should have been proactive.

It is on the issue of Fastow's compensation that the Board has its greatest vulnerability and is evidence of the deferential nature of the Enron Board. When the one-time review of Fastow's compensation was announced as a precondition for approval of another LJM transaction, Dr. LeMaistre, as head of the Compensation Committee requested information on his compensation from Mary Joyce, Enron's senior Compensation Officer.²³⁸ His request applied to all "16(b)" officers.²³⁹ One year would pass and he would still not have the information from Ms. Joyce.²⁴⁰ At this point the Board directed Dr. LeMaistre and John Duncan to personally approach Mr. Fastow, to obtain the information.²⁴¹ Understanding the fearful task ahead, of actually confronting the CFO of a company on whose Board they sit, these two directors asked legal counsel for Enron to draft a set of questions that they could take with them to meet Mr. Fastow.²⁴² For those of you still keeping score, this was a Board that had to send a delegation with a script from legal counsel to get information from the company's Chief Financial Officer about how much money he was making from deals with the company and how much his family members were also making from these deals.

The directors did get some information from Mr. Fastow, that he had made \$45 million from LJM 1 and 2, but Mr. Fastow never did return phone calls providing the directors with his return on investment.²⁴³ When Dr. LeMaistre and Mr. Duncan asked Mr. Fastow whether any other Enron employees were involved in financial relationships and transactions with the

238. *Id.* at 34-35.

239. "16(b)" refers to those levels of officers in a company to whom Section 16 of the 1934 Securities Exchange Act applies. Securities Exchange Act, § 16(b), 73 P.L. 291, 73 Cong. Ch. 404, 48 Stat. 881 (1934). These are the officers subject to the six-month, in effect, holding period on their company shares, a timing prohibition to curb acting on inside information. 15 U.S.C. A. § 78p(b) (West 2003).

240. PSI REPORT, *supra* note 58, at 35.

241. *Id.* The rich comedic possibilities here abound. One Board member approaches a staff member and asks for all full compensation disclosures on all Officers so as not to irritate Mr. Fastow. Nothing happens for a year so the Board, timidity abounding, sends two Directors to meet the troll to find out money figures.

242. *Id.* The film OLIVER (RCA COLUMBIA 1968) comes to mind with the two directors approaching Mr. Bumble, "Please, sir, could I have some more information?" Could this Board have been any more obsequious? Take a gander at the script legal counsel drafted for these two directors and keep this deferential tone in mind as we explore the culture of Enron *infra* at notes 299-323 and accompanying text:

We very much appreciate your willingness to visit with us. Andy, because of the current controversy surrounding LJM I and LJM II, we believe it would be helpful for the Board to have a general understanding of the amount of your investment and of your return on investment in the LJM entities. We understand that a detailed accounting of these matters will be done in connection with the response to the SEC inquiry. In responding to our questions with respect to your interest in the LJM entities, we would appreciate your including any interest . . . that the members of your family may have had in the entities.

PSI REPORT, *supra* note 58, at 36 (citation omitted).

243. PSI REPORT, *supra* note 58, at 36.

company, he responded that there were not.²⁴⁴ A short time later, during the Powers investigation that the Board commissioned, they discovered that Fastow and other employees had created the Southampton partnership, which consisted of a group of employees investing in LJM.²⁴⁵

While it is possible that the Board did not understand the scope of extent of these off-the-books companies and the transactions, their lapse occurred in the failure to ask for more information despite a series of “red flags.” The question for their liability as well as the focus of reforms is not whether they knew, but whether they should have known and how they could have found out.

C. Auditors, Analysts and Business Press

Leg two of the three-legged *perfect storm* that allowed an Enron to happen, is best characterized by failure of external controls. Auditors, analysts, and the business press are, at least in theory, independent outsiders who should be able to detect an Enron house of cards, and then say so publicly. However, Enron was able to create its complex financial scheme, only with a complicit Board accompanied by complicit auditors, complicit analysts, and a complicit business press. Any one of these four groups, the outsiders plus the Board could have brought the Enron train to a screeching halt. That none did, or even raised sufficient questions to cause the investing public to withdraw its support, also warrants examination if meaningful reforms are to take hold. Even with Board weaknesses or failures, investors have traditionally had the resource of third parties to turn to for candid evaluation of a company’s performance and the veracity of its financial statements and claims. In this *perfect storm*, the auditors, analysts, and business press joined Enron, as a sort of cheering section for its ongoing, odds-defying success.

1. Weak Auditors

One of the first weaknesses that consumed the auditors in Enron and other companies was the issue of conflicts of interest. Enron paid Arthur Andersen \$25 million for its audit work and \$27 million for non-audit work, including both tax and consulting services.²⁴⁶ Andersen indicated that it did not feel its audits were compromised by the consulting work and Andersen

244. *Id.*

245. *Id.* at 36-37. Southampton was quite a deal for employees. They pumped in \$5,800 and received \$1 million in immediate returns. Not bad work if you can get it without going to jail. Bill Saporito, *Speak No Evil*, TIME, Feb. 18, 2002, at 34. The estimated total return to Fastow and fellow employees who invested was \$43 million. *Id.*

246. Deborah Solomon, *After Enron, a Push to Limit Accountants to . . . Accounting*, WALL ST. J., Jan. 25, 2002, at C1.

joins all of the other accounting firms in their assurances that consulting and auditing do mix.²⁴⁷

But, Andersen had more subtle conflicts. The staffs of Enron and Andersen were inextricably intertwined. As noted earlier, David Duncan was a close friend with Mr. Causey, the company's Chief Accounting Officer and the man responsible for approving the SPE transactions that Mr. Fastow handled as both CFO and principal in the off-the-books entities.²⁴⁸ Further, the employees at Enron were not sure who the Andersen employees were and who worked for Enron; because many Andersen staff had permanent offices at Enron, were often then hired by Enron, and also were beneficiaries of office parties, just as Enron employees were.²⁴⁹

One of the reasons for the staffs of the auditor and the client to be so inextricably intertwined is that Andersen performed and reviewed both the internal and external audit functions.²⁵⁰ The two were originally separated because independence is compromised when those reviewing the work and judgment calls, did the work and made the calls.²⁵¹

In addition, for Enron to continue for as long as it did with so many intricate accounting issues, the auditors had to buy into "aggressive accounting."²⁵² While Andersen has used its employees since the fall of Enron as a

247. *Id.* The Council of Institutional Investors does, however, beg to differ. Press Release, Council of Institutional Investors, Council of Institutional Investors Calls for Auditor Reforms, (Feb. 4, 2002), at <http://www.cii.org/pressreleases/pressrelease1.asp>. It is urging unions and other investors in their shareholder proposals at the following corporations to urge companies to voluntarily adopt conflict-of-interest policies that restrict the companies' audit firms to performing either audit services or consulting services, but not both. *Id.* Following each company's name is a number in parenthesis that indicates the ratio of the company's non-audit fees to its audit fees: Allegheny Energy (3.1:1); Ameren (2.3:1); American Power Conversion (5.1:1); Apple Computer (12.6:1); Avon (2.9:1); Best Buy (4.4:1); Boston Properties (4.8:1); Bristol Myers Squibb (4.5:1); Constellation Energy Group (4.1:1); Delphi Automotive Systems (7.7:1); Dominion Resources (1.2:1); Duke Energy (3.5:1); Equitable Resources (3.9:1); First Energy (5.9:1); Gap (13.5:1); Halliburton (1.1:1); John Hancock Financial (9.75:1); Johnson & Johnson (4.6:1); Kmart (10.4:1); Lafarge North America (3.1:1); Liz Claiborne (2.2:1); Manpower (3.6:1); Marriott International (4.7:1); McGraw-Hill (2.2:1); Motorola (16:1); PG&E (3.6:1); Reliant (5.1:1); TXU (3:1); VF (5.2:1); and Walt Disney (4.1:1). ED DURKIN, UNITED BROTHERHOOD OF CARPENTERS PENSION FUND, ANALYSIS OF COMPANY PROXY STATEMENTS (2001). Some companies, such as Disney, have already halted the dual relationship. Disney dropped PricewaterhouseCoopers from its dual role with the company. Gary Strauss, *Companies Take Action to Regain Investor Trust*, USA TODAY, July 17, 2002, at 1B.

248. PSI REPORT, *supra* note 58, at 8, 29.

249. Thaddeus Herrick & Alexei Barrionuevo, *Were Auditor and Client Too Close-Knit?*, WALL ST. J., Jan. 21, 2002, at C1. Seven former Andersen accountants became Enron employees in 2000 alone. John Schwartz & Reed Abelson, *Enron's Collapse: The Partner; Auditor Struck Many as Smart and Upright*, N.Y. TIMES, Jan. 17, 2002, at C11.

250. Burton Malkiel, *Watchdogs and Lapdogs*, WALL ST. J., Jan. 16, 2002, at A16.

251. *Id.* Professor Malkiel likens giving the internal and external audit functions to the same firm as akin to having the students grade their own papers and then handle appeals on their grades. *Id.*

252. *Id.* Continuing long-standing tradition in law and ethics, accountants refer to "cooking the books" as "earnings management" or "aggressive accounting." Shantan Pesaru, *Tech*

sympathetic public relations campaign to save the company and there are indeed employees at Andersen who were not involved in cooking books, the hard facts illustrate that Andersen developed a reputation and peculiar skill for “aggressive accounting.” In addition to Enron, Andersen’s audit clients include: Global Crossing (in bankruptcy with questions about its accounting practices),²⁵³ WorldCom (in bankruptcy with the admission that it understated expenses by \$4 billion), Qwest Communications (now the subject of an SEC inquiry), Level 3 Communications (issues with restatements of financial information),²⁵⁴ Waste Management (just now recovering from issues surrounding its financial reports), Baptist Foundation of Arizona (in bankruptcy with Andersen recently settling suit with investors for \$100 million), and Sunbeam (in litigation over accounting and restatement issues).²⁵⁵

The audit rules themselves permit the complicity that David Duncan and Andersen provided Enron, because they were able to take the approach of absolute compliance with the letter of the auditing laws while failing to acknowledge the overall financial picture of the company, as presented in their certified statements for the company, was not accurately portrayed.²⁵⁶ In other words, Andersen was able to sign off on the Raptors I, II, III, IV and V and other SPEs because, technically, Enron was in compliance with accounting rules. The question that now emerges is whether those accounting rules are fundamentally flawed and require modification, to a less detailed and

Profs Expose Fuzzy Accounting, (Aug. 23, 2002), at <http://www.cyberbuzz.gatech.edu/technique/issues/fall2002/2002-08-23/21.html>. But accountants’ creative labeling in order to avoid addressing the fundamental ethical or legal issue involved is not unique to accountants. For example, the youngsters who download music from the Internet do not refer to it as “copyright infringement,” it is “peer-to-peer file-sharing.” Simon Lim, *Share No More*, NANYANG CHRONICLE (2002), at <http://www.ntu.edu.sg/studorgn/chronicle/digital3.html>. Taking the answers into an exam is not “cheating,” it is “using memory pegs.” Marianne M. Jennings, *Morality beyond the Excuses*, MERIDIAN (Jan. 12, 2001), available at <http://www.meridianmagazine.com/ideas/991231moralexexcuse.html>. One of the non-quantifiable causes of Enron and other companies’ collapse is the unwillingness of those involved to place a bright light of reality on the practices, decisions and financial reports of the company.

253. Dennis K. Berman, et al., *Global Crossing Ltd. Files for Bankruptcy*, WALL ST. J., Jan. 29, 2002 at A3; Dennis K. Berman & Deborah Solomon, *Questioning the Books: Analysts Fault the Accounting at Global Crossing*, WALL ST. J., Jan. 30, 2002, at A8.

254. Deborah Solomon, *Accounting for Enron: Andersen Also Audited Qwest, Accounting Questions Surfaced*, WALL ST. J., Jan. 22, 2002, at C7.

255. Ken Brown, *Andersen Memo Urged Caution with Risky Clients*, WALL ST. J., Apr. 12, 2002, at A14. The issues in Global Crossing and WorldCom are the same—cooking the books.

256. See Andy Serwer, *Dirty Rotten Numbers; Enron has Made us Shine a Light on the Books of America’s Public Companies*, FORTUNE, Feb. 18, 2002, at 74 (auditor’s compliance with letter of the law can be misleading); and Steve Liesman, et al., *When Rules Keep Debt Off the Books: Enron Crisis Puts Spotlight on the FASB*, WALL ST. J., Jan. 18, 2002, at C1 (inaccurate representation of financial condition).

more British approach of the overall accuracy of the financial statements, not compliance with individual and highly technical rules.²⁵⁷

However, in addition to the rules and the conflicts, there is the reality that David Duncan and Andersen were willing to accommodate Enron and its executives with their desires when it came to accounting for both the company's contracts, the SPEs, and the related debt.²⁵⁸ While Mr. Duncan regularly met with the Audit Committee and pointed out, Enron was embarking into uncharted accounting territory because of the nature of its business, and that management had a great deal of discretion in its reporting of the numbers, in areas such as Enron's energy contracts; he did not halt the steam engine's progress toward the brick wall.²⁵⁹ In fact, on one single sheet of paper used as Mr. Duncan's briefing paper for the February 1999 Enron Audit Committee meeting, Mr. Duncan wrote, "[o]bviously, we are on Board with all of these, but many push limits and have a high 'others could have a different view' risk profile."²⁶⁰ Mr. Duncan conveyed the message of risk at the insistence of Andersen legal counsel.²⁶¹ While Mr. Duncan pled the Fifth Amendment and declined to testify at the Congressional hearings on Enron and Andersen's role,²⁶² Andersen's legal counsel confirmed that Mr. Duncan had, in fact, communicated what was written on his one page of briefing notes to the Enron Audit Committee in February of 1999.²⁶³

257. Cf. Serwer, *supra* note 256, at 74 (mentioning differences in British accounting regulations).

258. See Ken Brown & Henny Sender, *When Rules Keep Debt Off the Books: Did Andersen Act Properly? Firm is Fired*, WALL ST. J., Jan. 18, 2002, at C1. Enron fired Andersen as its auditor on Jan. 17, 2002. Andersen had fired Duncan two days earlier because he led an expedited shredding of documents related to Andersen's engagement work with Enron. *Id.*

259. The author has mixed metaphors again, uncharted waters being coupled with steam engines and train tracks. However, the mixed metaphor makes the point that David Duncan was not exactly falling on his sword at the audit committee meetings. Now the author has injected the battlefield into the mix. Perhaps it would serve literature better if we said that David Duncan did not lie down on the tracks to stop the train. Perhaps it would be better for literature if the author would wrap this up, at 200 or so footnotes or sooner. The documentation on the non-sword audit committee meetings can be found at PSI REPORT, *supra* note 58, at 15-18. See also *supra* note 200 for a discussion of Mr. Duncan's matrix analysis of risks and issues related to Enron's accounting.

260. PSI REPORT, *supra* note 58, at 17.

261. See *id.* This was different legal counsel than Nancy Temple, the Andersen lawyer whose e-mail to David Duncan about document destruction policies that was the "smoking gun" in the verdict against Andersen for impeding justice. Peter Martin, *Subject: Wrecking the Company: The Andersen Verdict Shows that Even an E-mail that Seems Innocuous May End up Destroying a Business*, FIN. TIMES (LONDON), June 18, 2002, at 23. And here also is another important safety tip: If the company you are auditing is the subject of an SEC investigation, is having difficulty securing loans, and has a share price hovering around nine cents, you may want to look into it when the audit partner assigned to the client company calls and asks about document destruction. Just another safety tip.

262. John R. Wilke & Richard B. Schmitt, *Andersen Ex-Partner Might Aid U.S. Case: Fired and Blamed in January, Enron Auditor Duncan Meets With Prosecutors*, WALL ST. J., Mar. 25, 2002, at A3.

263. PSI REPORT, *supra* note 58, at 17. Legal counsel for Tom Bauer at Arthur Andersen wrote to the committee:

Internal Andersen documents also reveal that the auditor was concerned. In 2000, Mr. Duncan and four other Andersen partners prepared what they referred to as the “[r]isk [d]rivers” for Enron.²⁶⁴ Included in their list were “[m]anagement [p]ressures” and “[a]ccounting and [f]inancial [r]eporting [r]isk,” with the following comments about these drivers:

- “Enron has aggressive earnings targets and enters into numerous complex transactions to achieve those targets.”²⁶⁵
- “The Company’s personnel are very sophisticated and enter into numerous complex transactions and are often aggressive in structuring transactions to achieve derived financial reporting objectives.”²⁶⁶
- “Form over substance transactions.”²⁶⁷

Despite clear recognition of the accounting issues and concerns, neither Duncan nor anyone at Andersen chose to offer Enron an ultimatum or allow the media to resolve the issue.²⁶⁸ Andersen and Duncan saw the issues in accounting at Enron, reviewed their substantial risk, but still refused to take the steps necessary to reveal the issues to the auditor.²⁶⁹ It was not until October of 2001 that this admission came, when Enron was just two months away from bankruptcy, that Duncan says he realized that the way and structure had been created violated GAAP.²⁷⁰ Andersen served as Enron’s auditor through-

As you requested, on behalf of Tom Bauer, a partner in Arthur Andersen, I am responding to your inquiries To the best of Mr. Bauer’s knowledge, the handwriting on the document . . . is the handwriting of David Duncan. It reflects what Mr. Duncan and others discussed at an Enron Audit Committee meeting held on February 7, 1999 The risk profile of Enron as reflected in the document was discussed at that meeting with and among the members of the Audit Committee and the representatives of the Company who attended Certain risk areas were described as “pushing the limits,” [sic] as reflected in Mr. Duncan’s notes, or as being “at the edge.”

PSI REPORT, *supra* note 58, at 17 (omissions in original) (citing Hearing Exhibit 3, *Selected Observations 1998 Financial Reporting* (David Duncan talking points or Audit Committee Presentation, Feb. 7, 1999)). The minutes of a May 2000 Audit Committee meeting provide: “Mr. Duncan discussed the financial reporting areas that [Andersen] had determined to be high priorities due to inherent risks that were present. He stated that the ongoing high priority areas included structured transactions, the merchant portfolio, commodity trading activities, project development activities and intercompany and related party transactions.” PSI REPORT, *supra* note 58, at 17 (alteration in original) (quoting *Hearing Exhibit 7c* (Audit Committee Minutes from May 1, 2000) at 2).

264. PSI REPORT, *supra* note 58, at 18.

265. *Id.*

266. *Id.*

267. *Id.* The clear communication in these documents is that Andersen believed that Enron was pushing limits, engaged in aggressive accounting and constituted a risk for the company.

268. *Id.* at 19.

269. *Id.*

270. Tom Fowler & Todd Ackerman, *The Andersen Verdict; Andersen Guilty; Outcome Viewed as Final Blow for Firm*, HOUS. CHRON., June 16, 2002, at A1.

throughout its evolution and, despite briefings to the Audit Committee, it could not bring itself to veto any new partnership, book revenues differently or simply admit that Enron may have pushed the envelope too far.²⁷¹ Forensic accountant, Howard Schilit, has noted that Andersen's relationship with Enron represented the worst of complicity "[a]uditors should be like referees in football. Sometimes you don't like the zebras, but that's just too bad."²⁷² A cartoon in the *Wall Street Journal* in early 2002, showed two executives sitting in a prison cell with one saying to the other, "[I]et's just say, with accounting, it's best to think inside the box."²⁷³

2. Analysts Who Said Nothing or the Opposite of What They Knew to be True

Even if the Board and the auditors failed in their roles of outsiders, with the ability to change the practices, and hence destiny of a company and its shareholders, there should have been the presence of analysts with sufficient skills to point out the deficiencies in Enron's financial statements and its levels of disclosure. The analysts during this era, however, were also suffering from conflicts of interest issues.

In the four-month period following Enron's bankruptcy, there were significant questions raised about why analysts had been "go-go" on Enron when there were, fundamentally, so many problems with it. At least a partial answer came through the revelations in an investigation by New York's Attorney General, Eliot Spitzer.²⁷⁴ In April 2002, Mr. Spitzer announced that he conducted a ten month investigation into the practices of Wall Street analysts and charged Merrill Lynch with several violations of New York laws that focused on a series of e-mails his office had uncovered.²⁷⁵

271. PSI REPORT, *supra* note 58, at 19.

272. *Dirty Rotten Numbers*, *supra* note 256, at 80.

273. *Pepper . . . and Salt*, WALL ST. J., Jan. 22, 2002, at A21. Because of the felony conviction on the obstruction of justice charge, Andersen can no longer serve as an auditor. Andersen Case Conviction, SEC Statement No. 2002-89 (June 15, 2002). It is banished from government contracts. *Id.* The litigation settlement talks with Enron shareholders have not gone well. Andersen initially proposed \$750 million as a settlement in February, which the shareholders rejected. Mitchell Pacelle & Cassell Bryan-Low, *Andersen Worldwide Sets Likely Deal: Under Tentative Settlement, Parent of U.S. Partnership is to Pay \$60 Million in Enron Lawsuits*, WALL ST. J., Aug. 28, 2002, at C1. That offer decreased slowly, but steadily, because as Andersen explained, it doubted its viability. *Id.* Its last offer was in April 2002 for \$300 million and the settlement negotiation talks were declared dead in May 2002. *Id.* A tentative settlement was, however, reached on August 27, 2002, for \$60 million. *Id.* The shareholders agreed to the settlement amount because an examination of Andersen's books revealed that the American operation of Andersen is completely shut down and that there is no revenue. *Id.*

274. Charles Gasparino, *New York Attorney General Turns up Heat on Wall Street*, WALL ST. J., Apr. 10, 2002, at C1.

275. *Id.*

The e-mails revealed that analysts for Merrill Lynch often felt very differently in private about the companies that they were recommended to clients, but made the recommendations publicly because either their compensation was tied to the success of an offering or company that was a Merrill client or they were prohibited from candidly discussing any Merrill clients.²⁷⁶ Following a \$100 million settlement with Merrill, Mr. Spitzer continued his pursuit of the conflicts issues among analysts,²⁷⁷ which offers a partial explanation, as to their taciturn behavior on certain stocks such as Enron, which were clearly courting disaster in terms of their share prices vis-à-vis performance and actual cash flow.

Mr. Spitzer was able to uncover yet another source of conflicts for analysts, the so-called “bonus memo.” The “bonus memo” is written by analysts at the end of the year and is used as a means of touting for management, as it makes its bonus determination for analysts, the achievements of the analyst over the past year.²⁷⁸ Mr. Spitzer found evidence that in the bonus memos, analysts revealed that their positive recommendations were the impetus for obtaining and retaining certain clients for purposes of public offering business.²⁷⁹ The year-end memos, according to initial disclosures from Spitzer’s investigations, reveal that:

[M]any of the major firms on Wall Street during the bull market of the late 1990s wooed analysts with multimillion-dollar contracts based on their ability to generate investment-banking fees. And many firms, in evaluating analysts during bonus time, scrutinized the analysts’ roles in helping their firms win banking business.²⁸⁰

There is other evidence of significant ties and conflicts between firms that are brokers, investment bankers, and the resulting relationship conflicts of their in-house analysts, to the buying and consulting/investing side of the house. For example, Salomon Smith Barney is under scrutiny for its rela-

276. Patrick McGeehan, *Merrill Chief is Apologetic Over Analysts; One Dismissed*, N.Y. TIMES, Apr. 27, 2002, at C1. The initial investigation focused on Henry Blodget, Merrill Lynch’s Internet analyst. *New York Attorney General Turns up Heat on Wall Street*, *supra* note 273. While issuing buy-buy recommendations publicly on certain Internet stocks that were Merrill clients, Mr. Blodget said privately in e-mails that those same stocks were a “dog,” or “crap.” *Id.* In July 2000, one Merrill analyst called InfoSpace stock “a piece of junk” to friends even though he had given it the firm’s highest rating publicly. *Merrill Lynch Deal Won’t Restore Investors’ Trust*, USA TODAY, May 23, 2002, at A10. Merrill settled one case brought by an investor who followed the recommendation on InfoSpace because the analyst said the stock would reach a target of \$100 per share. *New York Attorney General Turns up Heat on Wall Street*, *supra* note 274. Shortly after the investor purchased, the stock plummeted to \$1.45 per share. *Id.*

277. Charles Gasparino, *Latest Fuel in Analyst Probe: ‘Bonus’ Memos*, WALL ST. J., May 30, 2002, at C1. Mr. Spitzer also extracted a significant number of promises from Merrill. Those promises are covered as part of the reform discussions in Section IV *infra*.

278. *Id.*

279. *New York Attorney General Turns up Heat on Wall Street*, *supra* note 274.

280. *Latest Fuel in Analyst Probe: ‘Bonus’ Memos*, *supra* note 277.

tionship with WorldCom because it was so intertwined with the company that its employees attended Board meetings of WorldCom and offered ideas, as it was offering the company its highest rating, knowing the issues of debt and accounting that ultimately were the company's demise.²⁸¹ Salomon's Jack Grubman was asked to appear before a House committee conducting an investigation into WorldCom to discuss his role in WorldCom and hesitation to downgrade the stock despite clear and evolving troubles.²⁸²

Another conflict issue that arose also with Salomon is the possibility that firms and analysts were allocating shares of IPOs to certain individuals in order to win their business in the future.²⁸³ This activity involved holding back IPO stock for favored clients such as Bernard Ebbers, formerly the CEO of WorldCom, with the hope that their investments in lucrative dot-com shares that Salomon was handling would win future WorldCom business for Salomon.²⁸⁴

Apart from the conflicts that existed with regard to client and customer relations, Enron appeared to enjoy a sort of deference from analysts for there seemed to be an unwillingness to point to any chinks in the armor or declare that the emperor had no clothes, despite odds-defying performance by the company and incongruent financial statistics.²⁸⁵ Why analysts were so differential and unwilling to buck the trend toward Enron worship remains unclear. Some have attributed it to the distance that Andrew Fastow kept between himself and Wall Street: "[t]he CFO never came to analyst conferences; he'd always be buried somewhere with his financiers. Analysts were duped. They were never able to see the off-the-balance-sheet partnerships; they never saw how earnings were being puffed up by mark-to-market accounting."²⁸⁶ One analyst who did see and state the Enron problem long before its collapse, John Olson, gleaned his information from talking with former employees who described the company as doing everything "on the edge."²⁸⁷

Interestingly, executives from Enron quickly dogged those who did voice concerns. When Mr. Olson issued his cautions to clients about Enron, Ken Lay wrote a letter to Mr. Olson's employer saying, "John Olson has been wrong about Enron for over 10 years and is still wrong. [B]ut he is con-

281. Andrew Backover & Jayne O'Donnell, *WorldCom Scrutiny Touches on E-mail*, USA TODAY, July 8, 2002, at 1B.

282. *Id.*

283. Charles Gasparino, et al., *Salomon Faces Questions on IPO: Two Congressmen Want to Know if WorldCom Executives Received Hot Shares in Bid to Curry Favor*, WALL ST. J., July 10, 2002, at C1.

284. *Id.*

285. See *supra* III.A. for discussion of the surface clues that should have been obvious to those with just minimal financial reading skills.

286. *Why John Olson Wasn't Bullish on Enron*, *supra* note 189.

287. *Id.*

sistant [sic].”²⁸⁸ Mr. Olson maintains that too many Wall Street analysts in search of the fame and glory are “schnuckels,” a Yiddish word for dupe.²⁸⁹ Olsen, like Bush, may have limited understanding of foreign languages; the Yiddish word is likely “schnook.”²⁹⁰

3. *The Business Press*

If the Board, auditors, and analysts failed in their role as outsiders, with the responsibility of examining companies and their practices thoroughly and with skepticism, there still remained the possibility that an independent business media could offer insight and revelations on a company like Enron. Again, however, there were conflicts. It was not until well into the bull market that networks such as CNBC, CNN and MSNBC adopted conflicts policies for their on-air talent and for guests appearing on their shows. Many were using the media outlets for purposes of pumping and dumping shares, which they held even as they appeared on the shows, to tout their excellence as an investment.²⁹¹ Even following the Enron collapse, Lou Dobbs of CNN’s Moneyline failed to disclose, even as he adamantly defended Andersen, that it was the auditor for a company in which he holds a substantial interest.²⁹²

Even when conflicts did not exist, the business media were not particularly aggressive in picking up issues or stories. For example, the issues surrounding Enron should have been obvious using just basic financial analysis, but only one reporter picked up on these issues, and her story fell flat.²⁹³ Peter Eavis of TheStreet.com also raised questions about Enron, including that of how Enron’s profit may have been added by deals related to LJM.²⁹⁴ He

288. John Schwartz, *Enron’s Collapse: The Analyst; Man Who Doubted Enron Enjoys New Recognition*, N.Y. TIMES, Jan. 21, 2002, at C8. Mr. Olson explains that when his boss showed him the note from Lay, he responded, “[y]ou know that I’m old and worthless, but at least I can spell ‘consistent.’” *Why John Olson Wasn’t Bullish on Enron*, *supra* note 188.

289. *Enron’s Collapse: The Analyst; Man Who Doubted Enron Enjoys New Recognition*, *supra* note 288. Mr. Olson adds that too many analysts were not kicking the tires and really trying to find out what was going on at Enron.

290. *Id.*

291. Noelle Knox, *TV Stock Analysts May Soon Need Disclaimer*, USA TODAY, Dec. 8, 2000, at 3B.

292. Mr. Dobbs defended Andersen on his show as he maligned its indictment. Matthew Rose, *Lou Dobbs Defends Andersen and Raises Eyebrows*, WALL ST. J., Apr. 3, 2002, at B1. He has accepted speaking fees in the past from the company and was promised an exclusive interview with Joseph Berardino, the former Andersen CEO. *Id.* Andersen has also been a CNN sponsor in the past. *Id.*

293. Felicity Barringer, *Enron’s Many Strands: Early Scrutiny; 10 Months Ago, Questions on Enron Came and Went with Little Notice*, N.Y. TIMES, Jan. 28, 2002, at A11. *Fortune*’s managing editor, Rik Kirkland said Bethany McLean’s March 2001 story on Enron was “prescient, but it kind of went out and sank.” *Id.*

294. *Id.*

wrote of his concerns about Fastow's dual roles, but no mainstream media outlets picked up on his observations or questions.²⁹⁵

One observer explained that the reason the story was ignored was, "[t]he whole thing was so opaque and so difficult to conceive and so well hidden that it was just beyond the tools of journalism."²⁹⁶ Inasmuch as Ms. McLean gained her insight and story from a short seller,²⁹⁷ there is perhaps a safety and prevention tip for the future—check with the shortsellers to see what's really going on in the market.²⁹⁸

D. *The Enron Culture*

When all else fails, meaning the Board, auditors, analysts, and press have not taken hold of a company and questions surrounding it; there is the possibility that an employee or former employee might take the issues affecting the company to the public. The Enron culture was not one that was conducive to open feedback. In fact, the Enron culture was a contributing cause to the ethical collapse of the company.

1. *A Culture of Conflicts*

As noted earlier in the discussions regarding Mr. Fastow's role in the SPEs, the issue of conflicts of interest took a bit of a back seat at Enron. Further, the Fastow issues were not the only conflicts problems. Mr. Lay's son, Mark, with his father's help, created two privately held technology firms, and within months after the companies were created, Enron signed contracts to do business with both of these Lay companies and even invested in one of

295. *Id.*

296. *Id.* Still, as Enron's stock price was plummeting, the analyses did not improve and there was little additional coverage of these questions raised by a few reporters who were clearly not in the mainstream business popular press.

297. *Id.*

298. And another important safety tip: If the CEO of the company leaves suddenly, as Jeffrey Skilling did in August 2001, and the share price is dropping, it is a good time to begin asking questions. There were similar lapses of coverage with regard to WorldCom. A federal judge dismissed a shareholder lawsuit against WorldCom filed on June 1, 2001 on March 29, 2002. The lawsuit included affidavits from 100 employees describing the aggressive accounting practices that they had witnessed at WorldCom. Despite the suit appearing in newspapers and the complaint available for anyone to examine along with the list of affiants and their addresses, no members of the press pursued the issue. Neil Weinberg, *Asleep at the Switch: WorldCom Book-Cooking was Laid Out a Year Ago: Too Bad No One Listened*, FORBES, July 22, 2002, at 38. In dismissing the suit, the federal judge noted that the numbers are so large and the magnitude of the alleged fraud so expansive that it was impossible to believe. *Id.* The judge and the media apparently fell into the trap of the bigger the fraud, the easier it will be to perpetrate.

them.²⁹⁹ In addition, Enron hired Mark Lay as a consultant for a salary of \$1,000,000 for a three-year contract and 20,000 options for Enron stock.³⁰⁰

Enron used an agency that was co-owned by Mr. Lay's sister as its travel agent.³⁰¹ Sharon Lay was an owner of Alliance Worldwide Travel which booked more than \$10 million in travel for Enron and its employees.³⁰²

2. The "Culture of Arrogance:" Sycophants, Autocrats and Fear

A sense of the Enron culture emerges through the testimony of the anonymous internal memo, later found to have been authored by Vice President for Corporate Development, Sherron Watkins.³⁰³ Ms. Watkins used the term "arrogance" in her testimony as well as "intimidating."³⁰⁴ The arrogance that Ms. Watkins referred to was manifest in the spending. At the executive meeting in January 2001 at the Hyatt Regency Hill Country Resort in San Antonio, there was flowing champagne, an open bar, fistfuls of free cigars, a company-sponsored racecar, and executives boasting three Ferraris in their garages.³⁰⁵

What she documents in that memo and later testified regarding in the Congressional hearings is an ongoing pattern among companies involved in complete ethical collapse. When companies implode, generally because of financial reporting issues undertaken because of an inability to sustain outstanding financial performance, there is a clear pattern in terms of the culture that consists of: an autocratic CEO, and perhaps many of his or her immediate reports; fear among employees so expansive that they will not raise even the most obvious issues; and punishment for employees who question company processes or procedures.³⁰⁶

299. David Barboza & Kurt Eichenwald, *Enron's Many Strands: Ex-Chief's Family; Son and Sister Of Enron Chief Secured Deals*, N.Y. TIMES, Feb. 2, 2002, at A1.

300. *Id.*

301. *Id.*

302. *Id.*

303. Michael Duffy, *What Did They Know and . . . When Did They Know It?*, TIME, Jan. 28, 2002 at 16.

304. Tom Hamburger, *Enron's Watkins Describes "Arrogant" Culture; Hearing Provides New Details on Efforts to Warn Lay; That is the Smoking Gun*, WALL ST. J., Feb. 15, 2002, at A3.

305. *Enron Buffed Image to a Shine Even as It Rotted From Within*, *supra* note 83. The picture of Enron's internal culture emerges in dribs and drabs. The chief of Enron Broadband Services drove his car in Ferrari Challenge races. Anita Raghavan, et al., *Full Speed Ahead: How Enron Odd Bosses Created a Culture of Pushing Limits*, WALL ST. J., Aug. 26, 2002, at A1. Even local strippers benefited, with one noting that she made \$1,200 in one afternoon from Enron executives celebrating closing a deal. *Id.*

306. For background on these companies, see MARIANNE M. JENNINGS, BUSINESS ETHICS 249-61 (4th ed). For information on Charles Keating, *see infra* note 346.

Ms. Watkins was a former Andersen employee who had been hired into the executive ranks by Enron.³⁰⁷ Ms. Watkins wrote a letter to Kenneth Lay on August 15, 2001, that included the following,

I am incredibly nervous that we will implode in a wave of accounting scandals. I have heard from one manager-level employee from the principal investments group say, "I know it would be devastating to all of us, but I wish we would get caught. We're such a crooked company."³⁰⁸

While she zeroed in on Mr. Skilling and Mr. Fastow as responsible for the accounting improprieties she believed existed, she also warned that Mr. Skilling's swift departure would raise questions.³⁰⁹ She urged Mr. Lay to simply "come clean" and "point the finger" at these two, describing them as follows, "[t]here were swindlers in the emperor's new clothes discussing the fine materials that they were weaving."³¹⁰ She concluded that because of the accounting improprieties, "[I]t sure looks to the layman on the street that we are hiding losses in a related company."³¹¹

In her memo, she listed Cliff Baxter as someone Mr. Lay could talk to in order to verify her facts and that her concerns about the company were legitimate.³¹² Ms. Watkins wrote the memo anonymously, on August 15, 2001, because she feared repercussions from raising the issues.³¹³ However, by August 22, and after discussing the memo with former colleagues at Andersen, she told her bosses that she was the one who wrote the memo.³¹⁴ Ms.

307. *What Did They Know and . . . When Did They Know It?*, *supra* note 303, at 16-27.

308. *Id.*

309. *Id.*

310. *Enron's Watkins Describes "Arrogant" Culture*, *supra* note 304.

311. *Text of Letter to Enron's Chairman After Departure of Chief Executive*, N.Y. TIMES, Jan. 16, 2002 at C6.

312. Mr. Baxter left the company shortly thereafter and sold most of his Enron stock. Mr. Baxter sold 577,000 shares of Enron stock between October 1998 and early 2001, for a total of \$35.2 million. Mark Babineck, *Deceased Enron Executive Earned Respect in the Ranks*, HOUS. CHRON.COM Jan. 26, 2002, at <http://www.chron.com/cs/CDA/printstory.htm/special/enron/1228097>.

The company indicated he had taken early retirement to spend more time with his family. However, Mr. Baxter was found dead in his 2001 Mercedes of a self-inflicted gun wound to the head at an area just a few miles from his suburban Houston home. Jim Yardley, *Enron's Many Strands: An Executive's Death; Critic Who Quit Top Enron Post Is Found Dead*, N.Y. TIMES, Jan. 26, 2002, at A1.

313. *What Did They Know and . . . When Did They Know It?*, *supra* note 303, at 16.

314. Ms. Watkins had obtained a briefing from Rick Buy, Enron's Chief Risk Officer. *Enron's Watkins Describes "Arrogant" Culture*, *supra* note 303. And isn't Buy a great last name for a risk officer? She focused on the Raptor partnerships and wrote in the margins next to her description of the Raptors, "There it is! That is the smoking gun. You cannot do this! My understanding as an accountant is that a company can never use its own stock to generate a gain or avoid a loss on its income statement." *Id.* At her Congressional testimony, Ms. Watkins indicated that she believed Mr. Lay really did not understand clearly the problems with the Raptors and the other accounting issues. After Vinson & Elkins, the law firm for Enron, conducted its investigation into the allegations it concluded, "[b]ased on the findings and conclusions set forth with respect to each of the four areas of primary concern discussed above,

Watkins testified before Congress that she did not turn to Mr. Skilling or Mr. Fastow because she said, “[i]t would have been a job-terminating move.”³¹⁵

Other employees within the company were also trying to alert management and others to pending problems. For example, Margaret Ceconi, an employee with Enron Energy Services, wrote a five-page memo to Kenneth Lay on August 28, 2001, stating that losses from Enron Energy Services were being moved to another sector in Enron in order to make the Energy Service arm look profitable.³¹⁶ One line from her memo read, “[s]ome would say the house of cards are falling.”³¹⁷ Mr. Lay did not meet with Ms. Ceconi, but she was contacted by Enron Human Resources and counseled on employee morale.³¹⁸ When she raised the accounting issues in her meeting with HR managers, she was told they would be investigated and taken very seriously, but she was never contacted by anyone about her memo.³¹⁹ Her memo remained dormant until January 2002, when she sent it to the U.S. House of Representatives’ Energy and Commerce Committee,³²⁰ the body conducting a series of hearings on the Enron collapse.

Even after Enron’s travails began to trickle out to the public, employees remained in a culture of intimidation and fear. Clayton Vernon was fired after he posted a question on company internal online discussion that was directed at Mr. Lay and asked whether Enron had used aggressive accounting to overstate its profits.³²¹ Another employee was fired for questioning the payment of \$55 million in retention bonuses paid to officers in early December 2001.³²² Both employees were fired for postings that were deemed “offensive.”³²³

the facts disclosed through our preliminary investigation do not, in our judgment, warrant a further widespread investigation by independent counsel and auditors.” The report by the law firm was issued in the fall of 2001. Peter Behr & April Witt, *Concerns Grow Amid Conflicts; Officials Seek to Limit Probe, Fallout of Deals*, WASH. POST, July 30, 2002 at A1.

315. *Enron’s Watkins Describes “Arrogant” Culture*, *supra* note 303. While there was no evidence beyond her testimony, Ms. Watkins indicated that once Mr. Fastow heard of her memo, he wanted her fired and her computer seized. *Id.* However, additional documents do reveal that Fastow felt that the criticisms in the memo were an attempt by Watkins to get his job. Rebecca Smith, *Fastow Memo Defends Enron Partnerships and Sees Criticism as Ploy to Get His Job*, WALL ST. J., Feb. 20, 2002, at A3. Mr. Fastow was not a friendly sort. On his desk was a cube with the company’s values, one of which was communication. Inscribed beneath the “communication” value was the following: “[w]hen Enron says it’s going to ‘rip your face off,’ it will ‘rip your face off.’” Raghavan, *Full Speed Ahead: How Enron Odd Bosses Created a Culture of Pushing Limits*, *supra* note 305.

316. *Concerned Ex-Worker Was Sent to Human Resources*, *supra* note 9.

317. *Id.*

318. *Id.*

319. *Id.*

320. *Id.*

321. Alex Berenson, *Enron Fired Workers for Complaining Online*, N.Y. TIMES, Jan. 21, 2002, at C1.

322. *Id.*

323. *Id.* Mr. Vernon acknowledges that he got carried away with his language in the note and says he will not litigate: “I was using their equipment. I was in their building, and it was a

3. *A Culture of Wizards and Hubris*³²⁴

In addition to the other cultural factors at Enron, there was an underlying cultural profile that perhaps contributed to those factors. The senior officer group of Enron was a collection of well-trained MBAs, given the hyper-technical tools typical of financial education in MBA programs in the 1980s. The credentials for the Enron executive team were as follows: Jeffrey K. Skilling, the former CEO of Enron, held an MBA from Harvard;³²⁵ Andrew Fastow, the former CFO, held a Northwestern MBA;³²⁶ Clifford Baxter, a former vice chairman, who killed himself shortly after the Enron revelations became a daily media event, was a Columbia MBA.³²⁷

The MBA curriculum since the 1980s has focused on financial models designed to smooth earnings and produce double-digit returns for interminable stretches, things history tells us are not possible.³²⁸ The mandates of the curriculum contain no specific references to issues such as honesty, disclosure and fairness. To the extent ethics is a part of the curriculum it is considered to be social responsibility and a focus on issues such as environmental, health and safety issues and corporate philanthropy. Msrs. Skilling, Fastow, and Baxter emerged as well trained in financial models from MBA programs and equally well trained in terms of social responsibility, particularly with regard to their roles in the philanthropic community. All had extensive presence in the Houston community with regard to philanthropic activities.³²⁹

flagrant violation of company policy to do what I did. I'm not going to litigate it. I don't think it was unfair." He indicated that the cancellation of the company Christmas party, coupled with the loss of value in his stock and the lack of any work to do at the office were the contributing factors for his messages and use of vulgarity therein. *Id.*

324. The author understands that she runs the risk of sounding a bit Harry Potterish here, but she is referring to financial wizardry and pride, not non-muggles and Hogwarts. *See generally*, HARRY POTTER AND THE SORCERER'S STONE (Warner Bros. 2000).

325. *Darth Vader. Machiavelli. Skilling Set Intense Pace*, *supra* note 16.

326. *The Financial Wizard Tied to Enron's Fall*, *supra* note 83. Mr. Fastow graduated from Tufts University and then the Kellogg School of Management of Northwestern University. *Id.* He began his work at Enron at age 29 and quickly rose through the ranks to become the CFO at age 36; although he functioned as second in command from the time he was 31. David Ivanovich, *Center of the Storm: Aggressive, Driven, Fastow has Many Faces*, HOUS. CHRON., Jan. 20, 2002 at A1. After being fired, Mr. Fastow and his wife, an heiress, continued to build their 11,500-square foot home and his friends say that the amount of money someone made was his only measure of a person's worth and success. *The Financial Wizard Tied to Enron's Fall*, *supra* note 83.

327. Jim Yardley & Shelia K. Dewan, *Enron's Many Strands: The Suicide; Despite His Qualms, Scandal Engulfed Executive*, N.Y. TIMES, Jan. 27, 2003, at Mr. Baxter's undergraduate degree was from NYU and his MBA was from Columbia. *Id.*

328. *See infra* notes 335-344 and accompanying discussion for more information on business school curricula.

329. For example, in 2000, Enron raised \$525,000 in a Houston bike race to raise money for Multiple Sclerosis research and sponsored a race to raise money for the Holocaust Museum, Houston. ENRON CORPORATE RESPONSIBILITY ANNUAL REPORT 26 (2000), available at <http://www.enron.com/corp/pressroom/responsibility/CRANNUAL.pdf>. The report also highlights Enron's employee giving and matching gift programs. *Id.* at 26-27.

Mr. Fastow, for example, was prominent in Houston's Jewish community, active in the art museum, and had been a voracious fundraiser for the city's Holocaust museum.³³⁰ One friend who knew Mr. Fastow personally for years and worked with him on community projects said, "[t]he person I know bears absolutely no relation to the person who has been characterized in some reports within the walls of Enron."³³¹ Mr. Baxter was involved in Junior Achievement, a friend said ironically, to help make sure that young people "understood the values of the free enterprise system."³³² Enron paralleled FINOVA, American Continental Corporation (Charles Keating) and now WorldCom with regard to philanthropic activity. All of these companies had officers heavily involved in community and philanthropic activity, yet all of these companies imploded from accounting improprieties.³³³ In their minds, and based on their training it was quite easy for them to conclude, as Jeffrey Skilling did that, "we are on the side of angels."³³⁴

The following paraphrased excerpt from an analysis by *Across the Board*, the magazine of the Conference Board, provides a view of the MBA curriculum:³³⁵

4. *The Curriculum as Mandated by the AACSB*

The American Assembly of Collegiate Schools of Business (AACSB) is the national accrediting body for business schools. In an attempt to escape the academic stigma of being the least scholarly units on campus, business schools created an accrediting body to dictate courses, content and rigor.

The AACSB has been an active regulatory body for colleges of business. It has also managed to change the atmosphere and philosophy of business schools in the process. When one thinks of business school curriculum, one thinks of accounting, marketing, management, finance and business law. But the AACSB guidelines set a rain forest tone with the preamble to the guidelines offering the following as the four significant challenges businesses face:

- Strong and growing economic global forces
- Conflicting values
- Changing technology in products and processes; and
- Demographic diversity among the employees and customers

330. *The Financial Wizard Tied to Enron's Fall*, *supra* note 83.

331. *Id.*

332. *The Suicide; Despite His Qualms, Scandal Engulfed Executive*, *supra* note 327.

333. *See supra* notes 331-32 and accompanying text.

334. *Enron Buffed Image to a Shine Even as It Rotted From Within*, *supra* note 83. Mr. Skilling's full quote was, "[w]e are the good guys. We are on the side of angels." *Id.*

335. Marianne M. Jennings, *Are Business Schools Antibusiness?* 38 *ACROSS THE BOARD* 29 (2001).

The preamble goes on to add, "In this environment, management education must prepare students to contribute to their organizations and the larger society and to grow personally and professionally through their careers."

There is a slight subversiveness to that simple preamble and the stated goals for business education. Those goals represent a philosophy that businesses exist to serve larger society. While all good Adam Smith apostles understand that economic self-interest does, indeed, benefit society, the issue of whether such a goal supercedes responsibility to shareholders is a topic of debate. Milton Friedman has questioned this premise of businesses serving society since 1970 and there are those of us who adhere to his theory that no one is well served if businesses fail to concentrate on business, not social goals.

Even the description of an appropriate curriculum reflects a newfound focus:

- Ethical and global issues
- The influences of political, social, legal and regulatory, environmental and technological issues; and
- The impact of demographic diversity on organizations

If it sounds a bit like the school of sociology, it is perhaps because there has been so much influence by social scientists. Management departments hire from schools of psychology and increasingly those from other areas of the campus are hired for business faculty positions because although those from around the campus may be anti-business, they are not anti-maximizers and they know where the highest salaries abound. At a recent meeting of the Society for Business Ethics, one of the professors lamented, "Let's face it. We are all in colleges of business because we wanted more money. We sold out years ago."

Only as a subset of these listed content areas do the guidelines mention the topics of accounting, behavioral science, economics, mathematics and statistics. Only at the MBA level are the topics of financial reporting, market analysis and human behavior in organizations mentioned. . . . The lack of practical skills for business or even business history and operations is striking. One finance syllabus described the goal of the course as follows: "In microeconomics we rely heavily on optimization—specifically: maximizing utility subject to a production possibilities frontier an subject to budget constraint."³³⁶

The MBA curriculum is a sterile curriculum with an emphasis on financial models and doing well through volunteer work. However, there is a disconnect in the curriculum between the financial skills and ethics and in understanding that social contributions are not a substitute for candor in financial reports and honesty in company transactions. Enron is not unique in its structure or the attitudes or standards of its MBA officers. For exam-

336. *Id.*

ple, WorldCom's CFO, Scott Sullivan, is not an MBA,³³⁷ but a business school graduate with a penchant for the deal that piloted a multinational corporation into new waters with regard to financial reporting.³³⁸ Following WorldCom's phenomenal earnings restatement that staggered even an Enron-jaded Wall Street, Mr. Sullivan along with WorldCom's controller, David Myers were charged with securities fraud, conspiracy to commit securities fraud, and making false filing with the SEC.³³⁹

The MBA curriculum that produced these Enron executives and many other ticking bombs out there carries a certain disdain for traditional business principles of low cost, quality, service and real profits. It is a curriculum that convinces its charges that they are better, smarter, and above the proletarian notion of reporting debt and expenses. Managing earnings is taught as a means of delivering shareholder value.³⁴⁰

The notion of spinning debt off the balance sheets is neither new nor unique to Enron. Most MBAs will study the Harvard Business School case on Marriott Corporation in which Marriott split itself into two pieces, spinning off its debt and bondholders into one corporation, with a resulting

337. *High Profiles in Hot Water*, WALL ST. J., June 28, 2002, at B1.

338. Deborah Solomon & Susan Pulliam, *U.S., Pushing WorldCom Case, Indicts Ex-CFO and His Aide*, WALL ST. J., Aug. 29, 2002, at A1.

339. Simon Romero & Alex Berenson, *WorldCom Says it Hid Expenses, Inflating Cash Flow \$3.8 Billion*, N.Y. TIMES, June 26, 2002, at A1; Kevin Maney & Jon Swartz, "A Stellar Reputation" *Shattered*, USA TODAY, Aug. 1, 2002, at 1B. Interestingly, Mr. Sullivan not only served as CFO, he was on the Board and served as secretary of the corporation. A bit of a recipe for disaster with one person having that much executive and Board control. WORLD COM, INC., 2001 ANNUAL REPORT 77-78 (2002), http://www.worldcom.com/global/investor_relations/annual_reports/2001/2001annual.pdf (last visited Nov. 19, 2002); WORLD COM, INC., 2000 ANNUAL REPORT 145 (2000). http://www.worldcom.com/global/investor_relations/annual_reports/2000/2000annual_report+proxy.pdf (last visited Nov. 19, 2002); WORLD COM, INC., 1999 ANNUAL REPORT 65 (2000), http://www.worldcom.com/global/investor_relations/annual_reports/1999/1999_wcom_annual.pdf (last visited Nov. 19, 2002). The two were also indicted along with Buford Yates, the former director of general accounting at WorldCom. At the time the indictments were announced, the Justice Department also announced the cooperation of Betty Vinson, an accounting employee who made the changes on the expenses, and Troy Normand, a former accounting employee who gave directions to property accounting to make the changes related to the capital expenses. Mr. Yates was charged with the same charges as Mr. Sullivan. Mr. Myers is said to be cooperating with investigators and expected to enter a guilty plea. All four are business school graduates. *U.S., Pushing WorldCom Case, Indicts Ex-CFO and his Aide*, *supra* note 338.

340. Charles A. Nichols, III & Lynn Sharp Paine, *MARRIOTT CORPORATION (A)*, 9-394-085 (Harvard Business School 1997) (1993). Professors James Stearns of Miami University and Shaheen Borna of Ball State University interviewed 300 incarcerated inmates at three minimum security prisons and compared their responses with those of students at 11 MBA programs. The inmates showed just as much integrity, or more, when presented with ethical dilemmas. Inmates were more concerned about customer service while MBAs were more concerned about pleasing shareholders. Inmates were also less likely to pirate employees from other companies than the MBAs. Study available from THE CHRONICLE OF HIGHER EDUCATION, Feb. 9, 1999 at www.chronicle.com.

ninety percent debt-to-equity ratio.³⁴¹ The executives landed safely in the other corporation with its boosted stock price because, well, it had no debt. They endured some squawking and litigation from bondholders, but lived to tell about it.

There are generally three reactions to the Marriott case among MBA students. Reaction one is, "What exactly is the ethical issue here?" Reaction two is: "So, they screwed the bondholders. It's the shareholders who count." Reaction three comes from the poor souls who raise the issues of reputation, fairness, and the long-term. If not hooted from the room, they are overpowered by those who assure them that these brilliant financial techniques are why they are earning an MBA.

This environment and the types of executives in Enron run parallel to other organizations that have met similar fates in an implosion sense. Charles Keating was surrounded by an executive team a full generation younger, with some of the executives being Keating's sons or sons-in-law. FINOVA and WorldCom also had their youthful MBA profiles at the top of the company. While it is impossible to know cause and effect on these acts of earnings manipulation, management and fraud, it is clear that the presence of MBAs at the top of an organization does not provide any checks and balances for bringing a halt to the "aggressive accounting."

The problem may be much more insidious. Again, as noted in the Conference Board review of business school curricula:

There is a feeling among these students that they have sold their souls by going into business. So indoctrinated are they upon arriving from their undergraduate programs that they are convinced that they have chosen a path of wrongdoing by even being associated with business. Some will be convinced otherwise during the course of the semester, but many will not and they become a particularly dangerous combination. They combine their having sold their soul theory with an odd sort of nihilism and the result is an ethically toxic group headed out into business.

Worse, the notions from the rest of the campus on moral relativism and there being no absolute truth have invaded business ethics discussions as well as courses in management and marketing. The prevailing ethical theory of stakeholderism is not an ethical theory at all but a convenient tool of analysis that permits the justification and rationalization of any business decision so long as the business is acting in the best interest of some stakeholder group. Teaching a value system with shifting accountability could not be more subversive. These students are sent out with theories that teach them that the shareholder is but one group to whom they are accountable. They must use their power in business to improve communities, make charitable contributions, change public policy and advance civi-

341. The author has been harping on earnings management since 1996. See generally Marianne M. Jennings, *The Slippery Slope From "Hold to Pay in 45 Days" to Phantom Inventory*, 1 CORPORATE FINANCE REV. 39 (1996); Marianne M. Jennings, *Earnings Management: The Ethical Issues Remain*, 3 CORPORATE FIN. REV. 39 (1999).

lization. The goals are lofty. It's just that corporations are perhaps not equipped to do all of that and meet quarterly sales goals.³⁴²

A recent study demonstrates the impact of the MBA on judgment. Seventy-five percent of MBAs said the primary role of a company is maximizing shareholder value, 71% said satisfying customers was the goal of a business and only 33% said producing a quality product was the goal of a company. Those numbers differ prior to business school as 68%, 75% and 43% respectively demonstrating that there is some change brought about by business school training.³⁴³

Without definitive rules, the judgment to spin the debt of Enron off the books was quite an easy one to justify because the end result was, that at least for time, shareholders were pleased, employees were treated well, Houston and other communities benefited from Enron's generosity and a general feeling of euphoria overcame the officers as they realized their complex financial models were ideal for serving stakeholders.³⁴⁴

IV. PREVENTION OF ANOTHER ENRON: TOOLS FOR COMPANIES TO USE TO HALT ETHICAL IMPLOSION AND RESOLVE THE CRISIS OF CONFIDENCE

The prevention tools and fixes are self-evident because of the detailed discussion of what happened at Enron. Despite the inherent obvious corrections that might have prevented the *perfect storm* at Enron, the reforms to date are neither well thought out nor directed at the root causes. This section reviews the reforms established presently at both the public and private levels and then provides suggestions for voluntary actions on the part of businesses that would be more effective in addressing the gaps and the failures in checks and balances that led to the Enron *perfect storm*.

A. The Reforms

Perhaps the easiest reform proposal to cover is that of the *Wall Street Journal* and other free-market disciples who believe that the decline in the market is not due to a loss of trust, Enron or any other scandal, and that the market is capable of adjusting without any type of regulatory reform. Leave them alone and they will take care of things themselves. To some extent there is some merit in their approach, for this is the third great reform effort of one score and two years. There were the prison terms and reforms following Ivan Boesky and Michael Milken's insider trading and "junk" bond fi-

342. Jennings, *supra* note 335, at 39; see also Marianne M. Jennings, *What's Happening in Business Schools?*, 137 THE PUB. INT. 25 (1999).

343. Mica Schneider, *How An MBA Can Bend Your Mind*, BUS. WK., Apr. 1, 2002, at 12.

344. Marianne M. Jennings, *Teaching Stakeholder Theory: It's For Strategy, Not Business Ethics*, 16 J. LEGAL STUD. EDUC. 203 (1998).

nancing on Wall Street.³⁴⁵ Then there were the prison terms and reforms following the savings and loans crisis and Charles Keating.³⁴⁶ Presently there are similar cries for prison terms, greater penalties, and reforms from the Enron and WorldCom debacles.

However, the resistance from the business community to any type of change or reform is not helpful in the restoration of trust. Several of the opinion pieces on Enron are of the type that induce flinching in their callousness toward the scope of the problem.³⁴⁷ On the day following WorldCom's declaration of bankruptcy, rumor had to be the largest bankruptcy in the history of the United States, depending of course, on the testimony of three former accounting department employees at WorldCom who have been singing like canaries, Ben Stein wrote in the *Wall Street Journal* of the need for recognizing how good and honest the vast majority of businesses and CEOs are.³⁴⁸ Mr. Stein may be absolutely correct, but perception is everything, and the failure to recognize the need for change and take steps in that direction is not helpful for restoring public trust. A look at the year in review gives an indication of how pervasive the issues related to ethics in business are.

345. Janet Novack, *Almost Makes Boesky a Saint*, FORBES, Dec. 10, 2001, at 54; Gary Strauss, *How Did Business Get so Darn Dirty?*, USA TODAY, June 12, 2002, at 1B.

346. Kathleen Kerwin, *For Charlie Keating, The Best Defense is a Lawsuit*, BUS. WK., May 1, 1989. See also Richard W. Stevenson, *The Justice Department's S. & L. Learning Curve*, N.Y. TIMES, Dec. 15, 1991, at E4. For information on his prison sentence, see Eric Schine, *Charlie Keating Gets A Taste of L.A. Law*, BUS. WK., Oct. 8, 1990, at 46. Some trivia for you: Lance Ito was the trial judge in the state prosecution of Mr. Keating in California. *Id.*

347. For example, The *Wall Street Journal* has had pieces entitled, "What Enron Did Right," "Enron May be Dead but the New Economy Isn't," and "Enron: A Wake-Up Call," a piece by Andersen's CEO that seems to be a justification for its conduct and not seeing it coming. Samuel Bodily & Robert Bruner, *What Enron Did Right*, WALL ST. J., Nov. 19, 2001, at A20; Joe Berardino, *Enron: A Wake-Up Call*, WALL ST. J., Dec. 4, 2001, at A18; Don Tapscott, *Enron May be Dead but the New Economy Isn't*, WALL ST. J., Dec. 3, 2001, at A18. And then there are those who accuse New York Attorney General, Eliot Spitzer, of caring only about politics in finding out that analysts were lying to their companies' clients. Rob Norton, *The Problem with Eliot Spitzer*, FORTUNE, July 8, 2002, at 44. I daresay that the problem does not lie with Mr. Spitzer. If he makes a little political hay, more power to him. He was the only public official in the country willing to say aloud what analysts were really doing. Bully!

348. Ben Stein, *They're Not All Crooks*, WALL ST. J., July 22, 2002, at A14. One phrase that was particularly irritating is, "I keep thinking that if we subjected journalists or actors or producers to the temptations we offer to CEOs, with as little supervision as they get, how many of us would be able to keep our paws out of the cookie jar as well as most CEOs." And the point is that we can't blame them because they had the opportunity to steal??? With this type of editorial in the *Wall Street Journal*, there appears to be little hope for the self-reform and control needed. Indeed, Thomas E. White, the secretary of the Army, and formerly the vice chairman of Enron Energy Services, is a millionaire many times over because of his service at the company and seventy-seven calls from government phones to former Enron colleagues. While he said he was "ashamed" of Enron accounting practices, he assured Congress in testifying that he knew nothing and would retain his earnings from his shares and work there. James Dao, *Senators Question Credibility of Army Secretary on Enron*, N.Y. TIMES, July 19, 2002, at A13.

The following chart is adapted from a piece in *Corporate Finance Review*.³⁴⁹

THE LAPSES OF THE 2001-2002

COMPANY/ PERSON	ISSUE	STATUS
Adelphia Communica- tions	Company guaranteed loans to another entity controlled by the Rigas family. John Rigas and his sons held the top executive spots at Adelphia. The result was \$2.7 billion in guarantees and \$1 billion in off-the-balance-sheet debt ³⁵⁰ with an overstatement of number of customers and cash. ³⁵¹	Annual report delayed. Shares lost 70% of value from March 2002 to April 2002. Ongoing grand jury investigations ³⁵² in Chapter 11 bankruptcy. ³⁵³ The largest shareholder resigned from Board. Rigas family that founded company indicted and arrested and charges of "looting" the company of more than \$1 billion in one of the largest corporate frauds ever. ³⁵⁴ John Rigas and his sons were indicted. ³⁵⁵
Arthur Andersen	Auditor for Sunbeam;	Found guilty of one

349. Marianne M. Jennings, *Why Regulation Won't Fix the Problems Plaguing Corporations: Moral Clarity as a Resolution*, 7 CORP. FIN. REV. 39 (2002).

The chart does not include coverage of Merrill Lynch despite issues there because reforms there are somewhat different from the reforms of an Enron *perfect storm* and these other companies with financial reporting issues.

350. David Lieberman, *Adelphia's Woes "A Total Shock" to Many*, USA TODAY, Apr. 5, 2002, at 3B.

351. Robert Frank & Deborah Solomon, *Adelphia Inflated Customer Base*, WALL ST. J., June 7, 2002, at A3.

352. Geraldine Fabrikant & Andrew Ross Sorkin, *New Questions are Turning up in the Inquiry into Adelphia*, N.Y. TIMES, May 18, 2002, at C1.

353. Bill Bergstrom, *Adelphia Boss Took in \$67 Million: Agents Document Hefty Advances from Cable Firm*, CHI. TRIB., July 29, 2002, at 6.

354. Andrew Ross Sorkin, *Founder of Adelphia and 2 Sons Arrested*, N.Y. TIMES, July 25, 2002, at C1. Because we are relying on government numbers here, the claim "largest corporate fraud case ever" could be right. Count on the Rigas family to use the defense, "It wasn't \$1 billion because, remember, we were cooking the books and what we embezzled was not near what the government alleges because those earnings were always unrealized, pro forma, marked-to-market and all manner of Ebitda."

355. Jerry Markon and Robert Frank, *Five Adelphia Officials Arrested on Fraud Charges*, WALL STREET J., July 25, 2002, A3

	Enron; Global Crossing; Dynegy; WorldCom; Qwest	felony count of obstruction of justice in Enron matter for destruction of documents ³⁵⁶
Dynegy	Accounting issues surrounding: Project Alpha which reduced taxes and inflated cash flow; adequacy of disclosures; ³⁵⁷ questionable partnerships; ³⁵⁸ issues on "round-trip" trading of energy ³⁵⁹	CFO replaced; ³⁶⁰ has halted online energy trading, citing poor credit; ³⁶¹ CEO quit when subpoenas from federal government regarding energy trading was announced ³⁶²
Enron	Earnings overstated through mark-to-market accounting. Off-the-book/special purpose entities carried significant amounts of Enron debt not reflected in the financial statements. Significant off-shore SPEs (770 of 881 SPEs were offshore – primarily in Cayman Islands)	Company is in bankruptcy (touted as the largest bankruptcy in the history of the US). Shareholder litigation is pending. Congressional hearings held. Justice Department and U.S. Attorney offices handling criminal investigations. One guilty plea from Michael Kopper's on money laundering and wire fraud.
Andrew Fastow, former Enron CFO	Multimillion dollar earnings from serving as principle in SPEs of Enron created to keep debts off the company books; significant sales	Resigned as CFO. Multi-million dollar home under construction in Houston. Appeared before Congress and pled the Fifth

356. Jonathan Weil, et al., *Andersen Win Lifts U.S. Enron Case*, WALL ST. J., June 17, 2002, at A1.

357. *Dynegy Probe by SEC Widens to Citigroup*, supra note 54.

358. Riva D. Atlas, *Dynegy Faces New Questions Over "Debt" of Partnership*, WALL ST. J., May 14, 2002, at C1.

359. Chip Cummins, *CMS's Longtime CEO Resigns Amid Probe of "Round-Trip" Trades*, WALL ST. J., May 28, 2002, at A3.

360. Chip Cummins, *Dynegy Replaces Financial Chief*, WALL ST. J., June 20, 2002, at C1.

361. Mitchell Benson, *Dynegy Halts Online Trading, Citing Poor Credit Environment*, WALL ST. J., June 21, 2002, at B7.

362. Noelle Knox, *Dynegy CEO Quits Amid Scrutiny*, USA TODAY, May 29, 2002, at 1B.

	of shares in the time frame preceding company collapse.	Amendment. Indicted by federal government. ³⁶³
Kenneth Lay, former Enron chairman	Significant sales of shares in time frame preceding Enron collapse; warning memo from one financial executive about possible implosion of company due to accounting improprieties.	Resigned as CEO. Appeared before Congress and pled the Fifth Amendment.
Jeffrey Skilling, former Enron CEO.	Resigned just prior to company's collapse.	Testified before Congress; offered assurances that he did not understand what was happening at Enron and that he resigned when he became aware
Global Crossing	Deals with CEO's son's companies, ³⁶⁴ accounting questions surrounding booking of revenues (Andersen was auditor), ³⁶⁵ also questions on booking of long-term leases. ³⁶⁶	Filed for bankruptcy, ³⁶⁷ fourth largest bankruptcy in U.S. history. ³⁶⁸ Investigation of related party transactions and sales of shares by officers and an investigation into analysts' role by NY Attorney General. ³⁶⁹

363. Mr. Fastow faces 78 felony charges. One of his direct reports, Lawrence M. Lawyer entered a guilty plea and has agreed to provide information to prosecutors on Mr. Fastow's activities at Enron. Kurt Eichenwald, *Ex-Executive of Enron Enters A Plea of Guilty*, N.Y. TIMES, Nov. 27, 2002, C1.

364. Geraldine Fabrikant & Saul Hansell, *Deals With Son of an Executive Raise Questions on Governance*, N.Y. TIMES, Feb. 18, 2002, at C1.

365. Simon Romero, *S.E.C. Scrutinizing Another Company*, N.Y. TIMES, Feb. 9, 2002, at A1.

366. Dennis K. Berman, *Global Crossing Faces SEC Probe of Accounting Practices on Leases*, WALL ST. J., Feb. 4, 2002, at B5.

367. Dennis K. Berman et al., *Global Crossing Ltd. Files for Bankruptcy*, WALL ST. J., Jan. 29, 2002, at A3.

368. Jim Hopkins & Matt Kranz, *Global's Troubles Shouldn't Surprise Anyone*, USA TODAY, Feb. 27, 2002, at 1B.

369. Laurie P. Cohen & Dennis K. Berman, *How Analyst Grubman Helped Call Shots at Global Crossing*, WALL ST. J., May 31, 2002, at A1.

		Acknowledges shredding documents ³⁷⁰
ImClone	Questions surrounding the timing of disclosure of action by the FDA relating to the company's anticancer drug, Erbitux, and its less-than-touted effectiveness.	SEC notified the company that it will file a civil suit. Shares dropped significantly after announcement of FDA action on December 28 and dropped again upon revelations of possible insider trading (see below). ³⁷¹
Dr. Samuel Waksal, former ImClone CEO	Sold \$50 million in ImClone shares prior to releasing to public information that FDA had rejected marketing for Erbitux.	Charged with insider trading and arrested by FBI at his SoHo residence. Pled the Fifth Amendment before Congress. Other investigations pending. ³⁷² Entered guilty plea. ³⁷³
Martha Stewart, CEO of Martha Stewart Living Omnimedia, Inc.; close friend of Dr. Waksal	Sold \$227,000 in shares of ImClone one day before public announcement of negative FDA action on Erbitux. ³⁷⁴	SEC investigation pending. Her Merrill Lynch broker and the broker who sold the shares have been suspended with pay. ³⁷⁵
Rite-Aid	Earnings reporting issues that resulted in the largest restatement of earnings in the history	Chapter 11 restructuring. The company is functioning but recent indictments of former

370. Simon Romero, *Global is Said to Admit Files Were Shredded*, N.Y. TIMES, June 24, 2002, at C1.

371. Andrew Pollack & David Cay Johnston, *Former Chief of ImClone Systems is Charged with Insider Trading*, N.Y. TIMES, June 13, 2002, at C1. The share price was over \$70 in December, 2001. By the middle of January it was selling at a little above \$20 per share. In June 2002, it was selling at \$7.83 per share. *Id.*

372. Andrew Pollack, *Ex-Chief of ImClone Refuses to Testify To Congress About Testing of Drug*, N.Y. TIMES, June 14, 2002, at C1.

373. Kara Scannel, *Waksal Made Money Betting Against ImClone*, WALL STREET J., March 12, 2003, at C1.

374. Alessandra Stanley & Constance L. Hays, *Martha Stewart's To-Do List May Include Image Polishing*, N.Y. TIMES, June 23, 2002, at A1.

375. Charles Gasparino & Susanne Craig, *Merrill Worker Questions Pact in Stewart Sale*, WALL ST. J., June 24, 2002, at C1.

	of the U.S. ³⁷⁶	executives do not help market price.
Sunbeam	Revenues overstated. \$62 million of \$189 million were mythical. Income had to be restated for a several year period.	Company is in bankruptcy. Shareholder suits pending. SEC actions pending for “fraudulent financial reporting.”
Al Dunlap, former Sunbeam CEO	Fired by Board in 1998.	Settled shareholder suits by agreeing to pay \$15 million. ³⁷⁷ Charged with fraud by SEC. ³⁷⁸ Andersen, as auditor, settled shareholder suits for \$110 million. ³⁷⁹
Tyco International	Questions about accounting practices, particularly with regard to the booking of mergers and acquisitions; ³⁸⁰ clandestine deals between CEO and Board members for closing deals (one commission to Board member was \$20 million). ³⁸¹	Stock dropped from almost \$60 per share to around \$20 upon announcement of accounting issues. Lost 27% value in one day following announcements on CEO—see below. Shareholder suits pending as well as other investigations. Top lawyer for company fired for allegedly impeding probe on

376. Kenneth N. Gilpin, *Ex-Rite Aid Officials Face U.S. Charges of Financial Fraud*, N.Y. TIMES, June 22, 2002, at A1. Note, however, that the amount was only \$1.6 billion and Xerox (*see infra* notes 397-99 and chart) has now tripled that figure, twice.

377. Kelly Greene, *Dunlap Agrees to Settle Suit Over Sunbeam*, WALL ST. J., Jan. 15, 2002, at A3.

378. Jonathan Weil, *Five Sunbeam Ex-Executives Sued by SEC*, WALL ST. J., May 16, 2001, at A3.

379. Floyd Norris, *S.E.C. Accuses Former Sunbeam Official of Fraud*, N.Y. TIMES, May 16, 2001, at A1.

380. Mark Maremont, *Tyco Made \$8 Billion of Acquisitions Over 3 Years but Didn't Disclose Them*, WALL ST. J., Feb. 4, 2002, at A3; *see also* Herb Greenberg, *Does Tyco Play Accounting Games?* FORTUNE, Apr. 1, 2002, at 83-86.

381. Laurie P. Cohen & John Hechinger, *Tyco Suits Say Clandestine Pacts Led to Payments*, WALL ST. J., June 18, 2002, at A3.

382. Mark Maremont et al., *Probe of Ex-Tyco Chief Focuses on Improper Use of Company Funds*, WALL ST. J., June 6, 2002, at A1; Alex Berenson, *Tyco Cleared to Sell Unit to*

		Board payments. ³⁸² Both top counsel and CFO indicted ³⁸³
L. Dennis Kozlowski	Former CEO, accused of improper use of company funds. ³⁸⁴	Indicted in New York for failure to pay sales tax on transactions in fine art. ³⁸⁵ Indicted on fraud charges by New York and the SEC ³⁸⁶
WorldCom	Accounting issues centering around swaps—selling to other telecommunications companies and hiding expenses, thereby overstating revenue. ³⁸⁷	Work force cut by 17,000 employees. Revenues reversed for 2 years to reflect losses and not profits. ³⁸⁸ Ongoing and new SEC investigations. CEO Bernard Ebbers resigned with \$366 million in loan forgiveness. ³⁸⁹ Share price dropped from over \$60 per share in 1999 to less than \$10 in 2002. ³⁹⁰ CFO Scott Sullivan (40) fired. ³⁹¹ Mr. Sullivan was indicted and several WorldCom employees

the Public, N.Y. TIMES, June 13, 2002, at C1; Alex Berenson, *Tyco Turmoil Deepens as it Fires Lawyer*, N.Y. TIMES, June 11, 2002, at C1.

383. Andrew Ross Sorkin, *2 Top Tyco executives Charged With \$600 Million Fraud Scheme*, N.Y. TIMES, Sep. 13, 2002, A1, C3.

384. *Probe of Ex-Tyco Chief Focuses on Improper Use of Company Funds*, *supra* note 382.

385. Alex Berenson, *Ex-Tyco Chief, a Big Risk Taker, Now Confronts the Legal System*, N.Y. TIMES, June 10, 2002, at B1. Mr. Kozlowski is challenging the charges and has moved for their dismissal. David Armstrong, *Former Chief at Tyco Moves to Dismiss Charges*, WALL ST. J., Aug. 29, 2002, at A3.

386. Alex Berenson, *Ex-Tyco Chief, a Big Risk Taker, Now Confronts the Legal System*, N.Y. TIMES, June 10, 2002, at B1.

387. *WorldCom Says it Hid Expenses, Inflating Cash Flow \$3.8 Billion*, *supra* note 339.

388. *Id.*

389. *Id.*

390. Seth Schiesel & Simon Romero, *WorldCom Out of Obscurity to Under Inquiry*, N.Y. TIMES, Mar. 13, 2002, at C1.

391. Shawn Young & Evan Perez, *Finance Chief of WorldCom Got High Marks on Wall Street*, WALL ST. J., June 27, 2002, at B1.

		have entered guilty pleas. ³⁹² Congressional investigation began. ³⁹³ WorldCom declares bankruptcy. ³⁹⁴
Merck	Recorded \$12.4 billion in revenue it never collected by counting co-pays received by pharmacies for drugs, even though that money is not actually received by Merck. The amount was 10% of Merck's overall revenue between 1999 and 2001. ³⁹⁵	Stock price dropped 5% on its announcement. SEC has not announced any investigation or requested changes in accounting treatment. ³⁹⁶
Xerox	Improper booking of revenues (\$6.4 billion). ³⁹⁷	Settled charges with SEC in April for \$10 million. ³⁹⁸ Inquiry expanded to KPMG. ³⁹⁹

392. Kurt Eichenwald and Seth Schiesel, *S.E.C. Files New Charges on WorldCom*, N.Y. TIMES, Nov. 6, 2002, at C1.

393. Michael Schroeder et al., *WorldCom Executives are Hit with Subpoenas by House Panels*, WALL ST. J., June 28, 2002, at A3. Inextricably intertwined in the Global Crossing collapse and the WorldCom investigation, because of the business interrelationships, is Qwest, another telecommunications giant. The author predicts that its revelations on accounting are forthcoming.

394. Simon Romero & Riva D. Atlas, *WorldCom Files for Bankruptcy; Largest U.S. Case*, N.Y. TIMES, July 22, 2002, at A1. And as noted, Mr. Sullivan, Mr. Myers and others have now been indicted for securities fraud. See *supra* note 339.

395. Barbara Martinez, *Merck Booked \$12.4 Billion it Never Collected*, WALL ST. J., July 8, 2002, at A1.

396. Alex Pham, *Xerox Adds to Scandals with Huge Restatement*, L.A. TIMES, June 29, 2002, at B1.

397. James Bandler & John Hechinger, *SEC Says Xerox Misted Investors by Manipulating its Earnings*, WALL ST. J., Apr. 12, 2002, at A3.

398. Claudia H. Deutsch & Floyd Norris, *S.E.C. Expands Xerox Inquiry to Ex-Auditor*, N.Y. TIMES, Apr. 11, 2002, at C1.

399. Harvey L. Pitt, *Auditing Reform Can't Wait for Congress to Act*, WALL ST. J., June 19, 2002, at A18. The problem with this recommendation is that the SEC has not been particularly zealous in its oversight role. In 1992, the SEC's chief accountant indicated that the peer review process in accounting was ineffective leading to the staff studying ways to improve oversight of the profession. However, the staff work was halted and a report on flaws in accounting practices and oversights was put on hold when Harvey Pitt became chairman of the SEC. Jonathan Weil & Scot J. Paltrow, *Peer Pressure: SEC Saw Accounting Flaw*, WALL ST. J., Jan. 29, 2002, at C1.

The following were the suggestions that surfaced through various sources as each of the above business stories has emerged and evolved:

- The Harvey Pitt plan of private regulation goes through a Board called the Public Accountability Board (PAB), which will be dominated by members of the public, not accountants, with independent funding, SEC oversight, the responsibility for setting audit standards and the authority to discipline;⁴⁰⁰
- The Robert A.G. Monks plan of institutional investors taking charge in corporations and seeing to it that through shareholder activism the books and records of the corporation are accurate;⁴⁰¹
- Changes in accounting rules that were used and abused by the companies now in financial trouble;⁴⁰²
- Eliminate the conflicts of interest by prohibiting auditors from also being consultants and brokers and analysts and from touting stocks while having an interest in the company or using the touting to obtain business or giving potential customers preferences on IPOs;⁴⁰³
- More independence on Boards, especially on audit and compensation committees;⁴⁰⁴

400. See Marc Gunther, *Investors of the World, Unite!*, FORTUNE, June 24, 2002, at 78. To some extent, some investors are doing so. New York and North Carolina's pension plans have told Wall Street firms that they will do business only with firms that reduce conflicts of interest. Charles Gasparino, *Two Big States Tell Wall Street: Reform, or Else!*, WALL ST. J., June 7, 2002, at C1.

401. Cassel Bryan-Low & Ken Brown, *And Now, the Question is: Where's the Next Enron? Accounting Textbooks will Get Rewritten, but Few Practices in the Industry Might Change*, WALL ST. J., June 18, 2002, at C1. One suggestion includes requiring companies to fill their pro forma numbers with their GAAP numbers so that investors could see the side-by-side comparison. *Dirty Rotten Numbers*, *supra* note 256, at 78 (taking idea from Jack Ciesielski, publisher of *Analyst's Accounting Observer*).

402. *Watchdogs and Lapdogs*, *supra* note 250. NASD has announced investigation into the activities of Salomon Smith Barney's research analyst, Jack Grubman, for his touting of Winstar, a Salomon investment bank client, knowing that the firm was experiencing deep financial difficulties. Charles Gasparino, *NASD Prepares Action Against a Star Analyst*, WALL ST. J., July 22, 2002, at A1.

403. Adam Shell, *NYSE Calls for More Independence on Boards*, USA TODAY, June 7, 2002, at 1B.

404. *Id.*; see also Judith Burns, *SEC Seeks Improvement In Reports*, WALL ST. J., June 13, 2002, at C13. Effective July 1, 2002, the SEC requires CEOs and CFOs to sign under oath the financial statements of the company. *Id.* The immediacy of the new requirement was achieved by making the change through an SEC order that was deemed necessary as part of an ongoing staff investigation into the accuracy and transparency of corporate financial reports. The order applies to companies with \$1.2 billion or more in assets and thus affects 947 companies. PBS, *Taking the Oath: Companies Subject to SEC Order 4-460*, WALL ST. WK., http://www.pbs.org/wsw/news/certifying_companies.html (last visited Jan. 16, 2003).

- Make CEOs sign off on financial statements, which the SEC adopted and which has President Bush's support;⁴⁰⁵
- Allow shareholders to vote on all stock compensation programs;⁴⁰⁶
- More rules on stock options;⁴⁰⁷
- Increased penalties for violations of securities laws, including false financial statements;⁴⁰⁸

SEC Order #4-460 provides:

The officers are required to file their written statements with the Commission no later than the close of business on the first date that their company is required to file a Form 10-K or Form 10-Q with the Commission on or after Aug. 14, 2002. The certifications are available to the public on the SEC website.

The certifications apply to the following financial reports:

- the company's most recent Annual Report on Form 10-K filed with the Commission;
- all of the company's reports on Form 10-Q, all reports on Form 8-K and all definitive proxy materials filed with the Commission subsequent to the filing of the most recent Form 10-K; and
- any amendments to any of the above.

U.S. SEC. & EXCH. COMM'N., Statement Under Oath of Principal Executive Officer and Principal Financial Officer Regarding Facts and Circumstances Relating to Exchange Act Filings, <http://www.sec.gov/rules/other/4-460a.htm> (last visited Mar. 13, 2003)[hereinafter SEC Required Attestation].

The attestation language under the Order is:

(1) To the best of my knowledge, based upon a review of the covered reports of [company name], and, except as corrected or supplemented in a subsequent covered report:

- no covered report contained an untrue statement of a material fact as of the end of the period covered by such report (or in the case of a report on Form 8-K or definitive proxy materials, as of the date on which it was filed); and
- no covered report omitted to state a material fact necessary to make the statements in the covered report, in light of the circumstances under which they were made, not misleading as of the end of the period covered by such report (or in the case of a report on Form 8-K or definitive proxy materials, as of the date on which it was filed).

(2) I [have/have not] reviewed the contents of this statement with [the Company's audit committee] [in the absence of an audit committee, the independent members of the Company's Board of directors].

Id.

405. Adam Shell, *NYSE Calls for More Independence on Boards*, USA TODAY, June 7, 2002, at 1B.

406. *Id.*

407. Stephanie Strom, *S.E.C. Widens Rule Covering Stock Options*, N.Y. TIMES, Dec. 20, 2001, at C1. President Bush has asked for CEOs to make voluntary and complete disclosures. "I challenge every CEO in America to describe in the company's annual report, prominently and in plain English, details of his or her compensation package, including salary and bonus and benefits. And the CEO, in that report, should also explain why his or her compensation package is in the best interests of the company he serves." *The November Markets*, WALL ST. J., July 10, 2002, at A14. Due to a "withering lobbying campaign," the proposals for reforms on stock option accounting have fallen flat. Jim Drinkard & Kathy Kiely, *Stock-Option Rule Change Blocked*, USA TODAY, July 12, 2002, at 1A.

408. Known as the Sarbanes legislation because of its drafter, Senator Paul S. Sarbanes, a Maryland Democrat. The Senate version of additional penalties increases prison sentences to

- The Goldman Sachs proposal of requiring CEOs to hold stock in their companies for certain extended periods and return any gains made on sales of shares within one year of bankruptcy;⁴⁰⁹ and
- Longer tenure for CEOs so that they are not as tempted to produce quarterly results at any cost⁴¹⁰

B. A Critique of Sarbanes-Oxley and the Other Proposals for Reform

The problem, generically, with all the proposals is that they are technical rules in response to buses of other technical rules by corporate officers. Additional signatures, additional jail sentences, additional oversight Boards, and additional rules for Boards are the types of changes that seem logical, punitive and satisfying for an investor class hungry for the restoration of

ten years. S. REP. NO. 107-205 (2002). The legislation passed unanimously in the Senate with little debate. Richard A. Oppel Jr., *Senate Backs Tough Measures To Punish Corporate Misdeeds*, N.Y. TIMES, July 11, 2002, at A1.

The House version for reforms differed. H.R. CONF. REP. NO. 107-418 (2002).

On July 24, 2002, a joint bill made its way through joint committees, is assumed "signable" by President Bush, and contains the following:

Creation of a regulatory board of accountants

Prohibitions on most types of consulting activities when accountants are also serving as auditors

Lead partner on audit client must be changed every 5 years

Increased penalties on obstruction of justice, up to 20 years

Specific fraud statute related to shareholder fraud with 10-year penalty

CEOs and CFOs must certify financials and imposes 20-year penalties for "knowingly and willfully" allowing materially misleading financial statements to be issued

No loans for executives that outsiders can't get

Prevents executives' use of bankruptcy laws to escape liability

Prohibits retaliation against research analysts who issue negative reports on their firms' clients

Lengthens statute of limitations for securities fraud

New protections for whistle-blowers

Jonathan D. Glater and David Leonhardt, *Both Sides Say Bill Addressing Business Fraud Is a First Step*, N.Y. TIMES, July 25, 2002, at C1.

409. Patrick McGeehan, *Goldman Chief Urges Reforms in Corporations*, N.Y. TIMES, June 6, 2002, at A1. A recent study shows that in those companies in which officers hang on to their stock, there are significantly higher returns for investors and those companies' shares outperform the market when officers buy shares in the company. Jeremy Kahn, *Insider Trades—Exposed!*, FORTUNE, May 27, 2002, at 164.

410. Professor Harvey Goldschmid, a nominee for an SEC commissioner position, notes, "Previously the CEO's job was much more secure. Today, with CEOs that [are] much more accountable for their stocks' performance, they are under greater pressure to keep the share price up." *Dirty Rotten Numbers*, *supra* note 256, at 75. Another facet to this proposal is requiring CEOs and directors to hang onto their stock and not be selling out while still officers and directors. The president favors this although he did sell Harken stock while he was on the Board of Harken. Do what I say, not what I did. Elisabeth Bumiller & Richard A. Oppel Jr., *Bush Defends Sale of Stock and Vows to Enhance S.E.C.*, N.Y. TIMES, July 9, 2002, at A1.

trust. However, these mob solutions born of outrage often have unintended consequences. For example, in response to shareholder outcry over excessive CEO compensation, Congress passed reforms that limited the tax deductibility of compensation to executives to \$1,000,000.⁴¹¹ Companies avoided the regulation by traipsing down the path of stock options, an issue that is an issue in financial transparency today because options are not booked as an expense and shareholders are often taken aback when they are exercised, particularly at the prices granted and in the volumes awarded. Proposed reforms can backfire and, in the case of these reforms, it is not clear that they address the root cause of the problems that gave rise to Enron's *perfect storm*, a storm that has now found its way into the bellies of other companies.

3. The SEC Certification

One of the first changes in the law occurred through an expedited rule change on the part of the SEC. Under a new rule, the SEC mandated that the financial officers of 947 companies headquartered in the United States affix their signatures to the mandatory SEC certification for their financial reports.⁴¹² As the deadline approached, there was much posturing for there was the underlying assumption that the fear of certification would begin a flood of earnings restatements, delays and corrections. The August 14, 2002 deadline has come and gone and companies did not drop like flies. While there has been an increase in the number of earnings restatements over the past year, there was no flurry of last-minute activity regarding the certifications. As of August 23, 2002, the SEC announced that only 16 companies were not in compliance with the certified statements requirements.⁴¹³

2. Sarbanes-Oxley⁴¹⁴

The key elements of this legislation are: (1) an accounting oversight Board;⁴¹⁵ (2) regulations on the independence of auditors;⁴¹⁶ (3) corporate

411. Nancy L. Rose & Catherine Wolfram, *Regulating Executive Pay: Using the Tax Code to Influence CEO Compensation*, NBER WORKING PAPER No. w7842 (Aug. 2000). Public outcry on CEO pay was cooking in the 1995-1997 period. There was a 54% increase in 1996, following a 30% increase in 1995. *More Than CEO Pay*, 6 ETHICAL MANAGEMENT 1 (1997); see also *Executive Pay: It's Out of Control*, BUS. WK., Apr. 21, 1997, at 58.

412. The SEC order was #4-460 and it was issued pursuant to Section 21(a) of the 1934 Securities Exchange Act, 15 U.S.C. Section 78 *et seq.* The certification language is attached as Appendix A. See *SEC Required Attestation*, *supra* note 404.

413. U.S. Securities and Exchange Commission, *Statements by Company CEOs and CFOs*, at <http://www.sec.gov/rules/extra/ceocfo.htm> (last modified Jan. 23, 2003) (on file with *California Western Law Review*).

414. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (enacted in scattered sections of 15 & 18 U.S.C.) (codified as amended in scattered sections of 11, 18, 28, & 29 U.S.C.) (enacted provisions set out as notes in scattered sections of 15, 18, & 28 U.S.C.) (amended provisions set out as notes in 28 U.S.C. § 994) [hereinafter Sarbanes-Oxley Act].

415. Sarbanes-Oxley Act § 101.

responsibility and governance issues including the structure of audit committees,⁴¹⁷ certification of financial statements⁴¹⁸, forfeiture of bonuses and options,⁴¹⁹ codes of ethics for senior financial officers⁴²⁰, and professional responsibility rules for attorneys working with companies on certification of financial statements⁴²¹; (4) analysts' conflicts of interest⁴²², and (5) increased criminal penalties for fraud in financial reporting.⁴²³

Everyone who proposed reforms got a little something in Sarbanes-Oxley.⁴²⁴ Both the SEC rules changes on certification of financial statements by CEOs and CFOs and the Sarbanes-Oxley legislation are touted as major reforms. However, a closer examination of the legislation reveals that both the new SEC rules and the Congressional package change very little except the penalties for financial fraud and other white-collar crime. In fact, a list of the key provisions demonstrates the absence of meaningful change.

SARBANES-OXLEY AND SEC CERTIFICATION REQUIREMENTS VS. STATUS QUO

NEW RULE/LAW	STATUS QUO
1. SEC certification of financial statements—"untrue statement of a material fact"	The standard for financial reporting is, and always has been: are these financial statements materially true? ⁴²⁵ Currently, auditing standards do not address the key elements of qualitative vs. quantitative materiality; The quantitative standard for most auditors is 5-10%. However, numbers as low as 1% can be

416. *Id.* § 103.

417. *Id.* § 301.

418. *Id.* § 302.

419. *Id.* § 304.

420. *Id.* § 406.

421. *Id.* § 307.

422. *Id.* § 501.

423. *Id.* at Titles VIII, IX and XI.

424. The Public Company Accounting Reform and Investor Protection Act of 2002, passed in the Senate by a vote of 97-0 and in the House by a vote of 423-3. 148 CONG. REC. S6779 (dated ed. July 15, 2002), available at www.senate.gov; 148 CONG. REC. H5480 (daily ed. July 25, 2002). It was eventually codified as P.L. 107-204.

The various names given during its passage included: Corporate Accountability Bill, Accounting Industry Reform Bill, and Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002. Corporate Accountability Bill, 148 CONG. REC. E1452 (daily ed. July 29, 2003)(statement of Edward J. Markey); Accounting Industry Reform Bill, 148 CONG. REC. H5474 (daily ed. July 25, 2002)(statement of Mr. Etheridge); Corporate and Auditing Accounting Responsibility, and Transparency Act of 2002, 148 CONG. REC. H5467 (daily ed. July 25, 2002).

425. For a complete discussion of the standards of materiality, still applicable today, see Marianne M. Jennings, Philip M. Reckers & Daniel C. Kneer, *A Source of Insecurity: A Discussion and an Empirical Examination of Standards of Disclosure and Levels of Materiality in Financial Statements*, 10 J. CORP. L. 639 (1985).

	qualitatively material if they reveal a creative and struggling management (in an accounting and viable entitle sense) ⁴²⁶
2. SEC certification of financial statements— ” the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not mis-	Inasmuch as all reports (10-K; 8-K; 10-Q) must be filed with the SEC and require the signatures of the CEO and financial officer as well as those of the Board

426. For example, the recent unraveling of the Sunbeam Corporation through both SEC charges and its restructuring, demonstrate how quantitatively immaterial financial information can carry significant qualitative materiality weight. Eventually, the SEC required Sunbeam to restate its income by reducing the \$189 million report by what it referred to as \$62 million in mythical income. One of the examples provided by the SEC related to the booking of contracts that were not firm, but were quantitatively immaterial. Sunbeam, Inc., as a maker of home appliances such as electric blankets, the Oster line of blenders, mixers, can openers and electric skillets, has a rather large inventory of parts it needs for the repair of these appliances when they are returned by customers while they are still under warranty. Sunbeam used a warehouse owned by EPI to store the parts, which were then shipped out as needed. Sunbeam proposed selling the parts to EPI for \$11,000,000 and then booking an \$8,000,000 profit. However, EPI's appraisal of the parts came in at only \$2,000,000. EPI and Sunbeam, therefore, just entered into an "agreement to agree. EPI would agree to buy the parts for \$11,000,000, Sunbeam would be able to book the contract as revenue of \$11,000,000 and then EPI could simply back out of the deal after the first of the year when the financial statements were already completed. Sunbeam's auditor, Arthur Andersen, approved of the booking of the agreement despite full information about the nature of the "agreement to agree" because the \$11,000,000 was quantitatively immaterial. The Andersen partner, Philip Harlowm was, of course, perfectly correct in the application of the materiality standard. However, that booking of a sham \$11,000,000 contract represents qualitative materiality that would provide investors and shareholders with substantial insight about management as well as the status of the company.

The SEC did charge Sunbeam with fraud in relation to the booking of these transactions. The SEC director of enforcement called the fraud accusations part of the SEC's ongoing efforts to prevent "fraudulent earnings-management practices."

Mr. Harlow did hire another set of eyes and standards for Sunbeam. PricewaterhouseCoopers was hired to go over Sunbeam's books. However, they simply concluded as Harlow did and the financial statements went forward with little accuracy, but great comfort on materiality and his judgment calls and those auditors agree that Mr. Harlow certified "materially accurate financial statements." See generally, *Why Regulation Won't Fix the Problems Plaguuing Corporations: Moral Clarity as a Resolution*, supra note 349; Martha Brannigan, *Sunbeam Audit to Repudiate '97 Turnaround*, WALL ST. J., Oct. 20, 1998, at A3; Michael Schroeder, *Dunlap Settles Fraud Charges with the SEC*, WALL ST. J., Sept. 5, 2002, at C1; Floyd Norris, *Justice Dept. Starts Inquiry at Sunbeam*, N.Y. TIMES, Sept. 9, 2002, at C1.

leading; . . . as of, and for, the periods presented in the report” ⁴²⁷	
3. SEC certification of financial statements—officer signatures ⁴²⁸	CEO, Chairman and CFO sign everything anyway, from credit lines to SEC reports
4. Sarbanes-Oxley Sec. 203. Audit partner rotation. Provides for audit partner rotation once every 5 years. ⁴²⁹	Most companies were already rotating audit partners and many were doing so on less than-a-five-year basis; For some companies, 5 years is too long to go without switching the partner; An additional issues is whether the company should switch audit firms, something not required under these new laws
5. Sarbanes-Oxley Sec. 204. Auditor reports to audit committees. ⁴³⁰	Most companies with good Board processes and audit committee charters followed this process anyway. The problem is that, as in Enron, no one was capable of understanding what David Duncan’s charts were really telling them or they were afraid to speak up and challenge the numbers. ⁴³¹
6. Sarbanes-Oxley Sec. 206. Conflicts of interest. Strict prohibitions on consulting activities beyond financial statement certification. Exceptions	This is a major and much-needed change because the conflicts in being a consultant while certifying financial statements are inherent. It is one of the few actual prohibitions in the Code.

427. Sarbanes-Oxley Act, *supra* note 408, § 302.

428. *Id.*

429. *Id.* § 203.

430. Section 204 provides:

(k) Reports to Audit Committees.—Each registered public accounting firm that performs for any issuer any audit required by this title shall timely report to the audit committee of the issuer—

(1) all critical accounting policies and practices to be used;

(2) all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and

(3) other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.

Id. § 204.

431. *See supra* notes 157-165 and accompanying text for more information.

require Board approval. ⁴³²	
7.Sarbanes-Oxley Sec. 301. Public company audit committees. Requires members to not be employed by the company or have family members employed at the company; cannot be hired as consultants; restric-	Again, while many companies followed this process, Enron had far too cozy a Board with no on-the-surface conflicts, but a percolating set of conflicts once one dug deeper into the interrelationships

432. Sarbanes-Oxley Act, *supra* note 408, § 201.

SERVICES OUTSIDE THE SCOPE OF PRACTICE OF AUDITORS provides as follows:

(g) Prohibited Activities—Except as provided in subsection (h), it shall be unlawful for a registered public accounting firm (and any associated person of that firm, to the extent determined appropriate by the Commission) that performs for any issuer any audit required by this title or the rules of the Commission under this title or, beginning 180 days after the date of commencement of the operations of the Public Company Accounting Oversight Board established under section 101 of the Sarbanes-Oxley Act of 2002 (in this section referred to as the ‘Board’), the rules of the Board, to provide to that issuer, contemporaneously with the audit, any non-audit service, including—

- (1) bookkeeping or other services related to the accounting records or financial statements of the audit client;
- (2) financial information systems design and implementation;
- (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- (4) actuarial services;
- (5) internal audit outsourcing services;
- (6) management functions or human resources;
- (7) broker or dealer, investment adviser, or investment banking services;
- (8) legal services and expert services unrelated to the audit; and
- (9) any other service that the Board determines, by regulation, is impermissible.

(h) Preapproval Required for Non-Audit Services.—A registered public accounting firm may engage in any non-audit service, including tax services, that is not described in any of paragraphs (1) through (9) of subsection (g) for an audit client, only if the activity is approved in advance by the audit committee of the issuer. . . .”

Id.

tions on business with the company ⁴³³	
8. Sarbanes-Oxley Section 407—Audit committee must have at least one “financial expert” as defined by the SEC ⁴³⁴	Common sense requirement that the law has now imposed.
9. Sarbanes-Oxley Sec. 304. Forfeiture of certain bonuses and profits. If the company must restate a financial statement, the officers responsible lose their bonuses for any 12-month period surrounding the original financial statement and they must return any profits realized on sales of	The new law imposes a penalty for what should have been done. The simple rule is no buying or selling stock so long as you are running the company.

433. *Id.* § 301.

434. The SEC will define “financial expert,” but the statute instructs the SEC as follows:

In defining the term ‘financial expert’ for purposes of subsection (a), the Commission shall consider whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer, or from a position involving the performance of similar functions—

- (1) an understanding of generally accepted accounting principles and financial statements;
- (2) experience in—
 - (A) the preparation or auditing of financial statements of generally comparable issuers; and
 - (B) the application of such principles in connection with the accounting for estimates, accruals, and reserves;
- (3) experience with internal accounting controls; and
- (4) an understanding of audit committee functions.

Id. § 407.

435. *Id.* § 304. Section 304 states:

If an issuer is required to prepare an accounting restatement due to the material

stock. ⁴³⁵	
10. Sarbanes-Oxley Sec. 306. Insider trades during pension fund blackout periods. Officers and directors cannot trade in stock during this black-out period any stock or interests acquired through company affiliation. ⁴³⁶	The law attempts to move officers, directors and other insiders to a standard of absolute accountability in which trading in the company's shares becomes the exception, not the norm. ⁴³⁷
11. Sarbanes-Oxley Sec. 307. Rules of	This rule already exists in both the language of professional responsibility as well as various interpre-

noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for—

(1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and

(2) any profits realized from the sale of securities of the issuer during that 12-month period.

Id.

436. *Id.* § 306. Section 306 states:

Except to the extent otherwise provided by rule of the Commission pursuant to paragraph (3), it shall be unlawful for any director or executive officer of an issuer of any equity security (other than an exempted security), directly or indirectly, to purchase, sell, or otherwise acquire or transfer any equity security of the issuer (other than an exempted security) during any blackout period with respect to such equity security if such director or officer acquires such equity security in connection with his or her service or employment as a director or executive officer.

(2) Remedy.—

(A) In General.—Any profit realized by a director or executive officer referred to in paragraph (1) from any purchase, sale, or other acquisition or transfer in violation of this subsection shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such director or executive officer in entering into the transaction.

Id.

437. *Fortune* magazine has reconstructed the securities trading activities of the CEOs of companies now experiencing regulatory issues or financial setbacks. Even as these CEOs were selling shares through a private or public offering, they were dumping their shares onto the market at substantial profit. Mark Gimén, *The Greedy Bunch: You Bought—They Sold*, *FORTUNE*, Sept. 2, 2002, at 64.

<p>professional responsibility for attorneys. Attorneys must report financial fraud or misdeeds to CEO of chief counsel and if they fail to act, must report such to the audit committee. If the audit committee is not independent with regard to the issue, then the attorney must report the issue to another committee or the Board itself.⁴³⁸</p>	<p>tations of that language. The law codifies the ethical standards that attorneys were to follow in corporate work, of representing the company, and not the officers or Board. The responsibility to report misconduct is expanded because several of these high-profile cases involved lawyers who said nothing about their concerns surrounding various transactions.⁴³⁹</p>
<p>12. Sarbanes-Oxley Sec. 402. Enhanced conflict of interest provisions.⁴⁴⁰</p>	<p>Absolute prohibitions on officers and Board members entering into transactions with the company through entities that the officers own or operate as principals; only shareholder approval in some com-</p>

438. Sarbanes-Oxley Act, *supra* note 408, § 307. This section states:

[Corporate counsel must] report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and (2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the Board of directors of the issuer or to another committee of the Board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the Board of directors.

Id.

439. *Id.* Section 307 of the Act further requires the SEC to develop minimum standards of professional conduct for company in-house counsel within 180 days from passage that address the absolutes quoted *supra* in note 432. The Act asks for the regulatory codification of what was an interpretation under the existing ethical standards of the profession for corporate counsel. However, the new law takes the duty out of the realm of interpretation and into mandatory territory.

440. This could be nicknamed the “Bernie Ebbers” law because it prohibits loans to officers and directors by the company. It provides that:

It shall be unlawful for any issuer (as defined in Section 2 of the Sarbanes-Oxley Act of 2002), directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer. An extension of credit maintained by the issuer on the date of enactment of this subsection shall not be subject to the provisions of this subsection, provided that there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after

Sec. 403. Disclosures of transactions involving management and principal stockholders.	panies would permit such a transaction; Board could not waive conflict of interest policy; many companies did not loan money to officers and directors
13. Sarbanes-Oxley Sec. 406. Code of ethics for senior financial officers. Officers must certify along with financials that the company has a code of ethics. ⁴⁴¹	Data indicate that most companies have codes of ethics in place; training in the code; ⁴⁴² strong statement of values to go along with the compliance aspect of the code of ethics; interaction of senior management with employees and meetings in which employees can discuss issues and concerns; anonymous hotline for reporting issues; compliance officers and/or ombudspersons for disclosure and discussion; enforcement of code; uniform application of code principles to all employees; penalties for violations, including losses of bonuses; investigation of all tips and complaints; resolution of all tips and complaints; compliance is included but the code goes beyond just compliance and provides employees with simple language and strong values; companies will need to add some provisions on financial reporting to be in compliance with the law
14. Sarbanes-Oxley Sec. 806. Protection for employees of publicly traded companies who provide evidence of fraud.	Of those companies with a hotline (30% as noted in note 315, most provide a promise of no retribution for good-faith reports of wrongdoing (even if employee turns out to be wrong); encouraging employees to come forward with issues, even anonymously; investigation of all complaints; no

that date of enactment.

Id. § 402.

441. A Code of Ethics is defined as follows:

In this section, the term “code of ethics” means such standards as are reasonably necessary to promote—

- (1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- (2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and
- (3) compliance with applicable governmental rules and regulations.

Id. § 406.

442. 80% of all publicly-traded companies have a Code of Ethics; 55% provide training for their employees; and 30% say they have a hotline for reporting concerns. Ethics Resource Center 2000 Survey, www.ethics.org at *Ethics Today Newsletter* archives. The reader may recall that Enron had a fabulous Code of Ethics. *See supra* note 216.

Amends Federal Whistleblower Protection Act to provide coverage for employees who report financial fraud internally or to federal agencies ⁴⁴³	retaliation
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The legislation, in effect, codifies what were known to be the best practices of companies in terms of avoiding ethical collapse. Because of the new specifics in the statute, there are changes all companies will be required to make, even those firms following the best practices that already implemented the statutory changes. For those companies following best practices, the only significant issues they face with the enactment of this reform legislation is that their code of ethics must contain a provision that deals specifically with financial reporting. Companies will be required to add programs, training and distributions that establish for the SEC, as well as for use should it become necessary under the Federal Sentencing Guidelines, that all employees have been told and/or trained to understand the importance of full and fair disclosure in financial reports and the critical role of honesty in fi-

443. Sarbanes-Oxley Act, *supra* note 408, § 806. Section 806 states:

No company with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l), or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)), or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee—

(1) to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by—

(A) a Federal regulatory or law enforcement agency;

(B) any Member of Congress or any committee of Congress; or

(C) a person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct); or

(2) to file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or about to be filed (with any knowledge of the employer) relating to an alleged violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders.

Id. § 806.

financial reporting. To make the notion of “full and fair disclosure” clear to employees, and to satisfy the SEC, companies should develop and provide examples and training for employees that walk through the specific types of concerns regarding financial reporting. Generic training of employees discussing the simple proposition that financial reports must be complete and accurate will not suffice under the provisions of Sarbanes-Oxley. Companies must be able to demonstrate that employees understand that if they are asked to book expenses differently, spin debt off the company books, or even include overly optimistic figures in earnings, then they are in a situation that requires some form of internal reporting on their part.

Sarbanes-Oxley is also a two-by-four to the heads of management executive teams because of the strict penalties that are now imposed for securities crimes and all other financial types of crimes and fraud. The penalty for securities fraud has increased to twenty-five years.⁴⁴⁴ The White-Collar Crime Penalty Enhancement Act of 2002,⁴⁴⁵ enacted as part of the Sarbanes-Oxley bill, increases the penalties for mail and wire fraud from five to twenty years.⁴⁴⁶ Violations of ERISA now carry greater penalties with \$5,000 fines for individuals increased to \$100,000,⁴⁴⁷ one-year imprisonment increased to ten years;⁴⁴⁸ and company fines of \$100,000 increased to \$500,000.⁴⁴⁹ The new provisions for certification of financial reporting impose penalties of \$1,000,000 and/or ten years and for willful violations, \$5,000,000 and twenty years.⁴⁵⁰ Another statute that was part of the Sar-

444. *Id.* § 807. This section of the Act provides, in pertinent part:

Whoever knowingly executes, or attempts to execute, a scheme or artifice—

(1) [T]o defraud any person in connection with any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934; or

(2) [T]o obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934; shall be fined under this title, or imprisoned not more than 25 years, or both.

Id. (internal citations omitted).

445. 18 U.S.C.A. § 1341 (West 2003).

446. Sarbanes-Oxley Act, *supra* note 408, § 903.

447. *See id.*; *Id.* § 904(1).

448. *See id.* § 904(2).

449. *See id.* § 904(3).

450. 18 U.S.C.A. § 1349 (West 2003) provides:

(c) Criminal Penalties.—Whoever—

(1) [C]ertifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than \$1,000,000 or imprisoned not more than 10 years, or both; or

banes-Oxley Bill, the Corporate Fraud Accountability Act of 2002, imposes penalties for the concealment or destruction of documents related to the financial reports of a company.⁴⁵¹ The penalty is a hefty twenty years and would have increased David Duncan's, the Andersen audit partner for Enron, punishment from a mere obstruction charge to one of financial fraud.⁴⁵²

Penalties under the Securities Exchange Act of 1934 are increased substantially.⁴⁵³ The existing \$1,000,000, and/or ten years is increased to \$5,000,000 and/or twenty years and Company penalties are increased from \$2,500,000 to \$25,000,000. CEOs also have exposure under the Internal Revenue Code provisions for they must also now sign the corporate tax returns.⁴⁵⁴

The new legislation also makes the new stiffer fines largely inescapable because debts that arise as a result of financial fraud are now non-dischargeable in bankruptcy.⁴⁵⁵ There is no longer a bankruptcy loophole for officers of companies that have defrauded shareholders and are found guilty. Any orders of restitution continue until paid. Further, the Act makes it easier for litigation on securities fraud in that it increases the statute of limitations from 1 year from the time of discovery but no later than three years after the prospectus is issued to a two year/five year combination.⁴⁵⁶

(2) [W]illfully certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than \$5,000,000, or imprisoned not more than 20 years, or both.

Id.; See Sarbanes-Oxley Act, *supra* note 408, § 906.

451. 18 U.S.C.A. § 1512(c) (West 2003). The section states:

Whoever corruptly (1) alters, destroys, mutilates, or conceals a record, document, or other object, or attempts to do so, with the intent to impair the object's integrity or availability for use in an official proceeding; or (2) otherwise obstructs, influences, or impedes any official proceeding, or attempts to do so, shall be fined under this title or imprisoned not more than 20 years, or both.

Id.

452. See *id.* This provision would then be called the "David Duncan Law" because the penalty was so light for the auditor Congress proposed to nab everyone with a prison sentence that hurts should they take it upon themselves to destroy evidence.

453. 15 U.S.C.A. § 78ff(a) (West 2003).

454. Sarbanes-Oxley Act, *supra* note 408, § 1001. "It is the sense of the Senate that the Federal income tax return of a corporation should be signed by the chief executive officer of such corporation." *Id.*

455. The Act adds this new non-dischargeable debt category to 11 U.S.C.A. § 523(a) as category (19). See *id.* § 803.

456. See *id.* § 804, amending 28 U.S.C.A. § 1658 to provide that securities fraud suits:

"[M]ay be brought not later than the earlier of—

(1) 2 years after the discovery of the facts constituting the violation; or

(2) 5 years after such violation."

28 U.S.C.A. § 1658 (West 2003).

More changes could be forthcoming, because the bill also mandates a plethora of studies to be conducted over the next few years with substantial funding from Congress, including studying the consolidation of public accounting firms, credit reporting agencies, and the Federal Sentencing Guidelines.⁴⁵⁷ The Act also forms new oversight bodies with the audit profession, now governed by an Accounting Oversight Board.⁴⁵⁸ Those analysts who were so terribly conflicted during the boom economy will now be required to disclose their conflicts of interest in terms of research reports and compensation structures with clients and customers.⁴⁵⁹

The key factor in Sarbanes-Oxley is for companies and their officers to understand that, for the most part, companies do not operate as Enron or WorldCom did. Sarbanes-Oxley is the codification of moral standards for businesses, while providing the teeth for ensuring that those morals are understood and followed.

Now that the reforms have arrived, there are many still struggling with new corporate requirements. The elimination of auditor conflicts, in that an auditor cannot serve as the company's auditor while providing consulting services, is critical. However, the accounting industry has been resistant to

457. Title VII of the Act provides the funding authorizations as well as the descriptions of the areas to be studied. Sarbanes-Oxley Act, *supra* note 408, §§ 701-705.

458. Section 101 of the new legislation provides:

There is established the Public Company Accounting Oversight Board, to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors. The Board shall be a body corporate, operate as a nonprofit corporation, and have succession until dissolved by an Act of Congress.

Id. § 101.

459. Sarbanes-Oxley amends 15 U.S.C. § 78a by adding Section 15D with provisions on protecting analysts from pressure through the following changes in analysts' relationships with their employers:

(1)(A) [R]estricting the prepublication clearance or approval of research reports by persons employed by the broker or dealer who are engaged in investment banking activities, or persons not directly responsible for investment research, other than legal or compliance staff;

(B) [L]imiting the supervision and compensatory evaluation of securities analysts to officials employed by the broker or dealer who are not engaged in investment banking activities; and

(C) [R]equiring that a broker or dealer and persons employed by a broker or dealer who are involved with investment banking activities may not, directly or indirectly, retaliate against or threaten to retaliate against any securities analyst employed by that broker or dealer or its affiliates as a result of an adverse, negative, or otherwise unfavorable research report that may adversely affect the present or prospective investment banking relationship of the broker or dealer with the issuer that is the subject of the research report

Id. § 501.

such reforms and mandatory elimination of the conflicts may be required.⁴⁶⁰ The same is true of brokers and analysts with regard to their relationships and financial arrangements, both with clients, and in their compensation systems. There are two ways to eliminate a conflict of interest: “don’t do it” or “disclose it.” In the case of auditors, “don’t do it” is the only option because the inherent conflict is not eliminated by disclosure.

The *perfect storm* is a systemic crisis. Different from the rogue traders and the occasional corrupt corporate officer, these are crises in which the systems inside and outside the companies failed to provide the checks and balances. Fundamentally, the companies and the executives running them lied.⁴⁶¹ Accounting rules, interpretations, and legal opinions meant that their actions were in compliance, the standard form of corporate ethics, overall, they understood that their share prices were not justified given their true internal financial picture.⁴⁶² Still, they continued this public deception, all while making significant salaries and returns on their own options.⁴⁶³

That people lie is hardly new to this era or business.⁴⁶⁴ What may be different is the personal interest in the diabolical activities, the challenge is

460. While serving as a consultant to Arthur Andersen, in the initial days following the Enron collapse, Paul Volcker recommended the elimination of these conflicts, as well. Seth Sutel, *As Andersen Edges Toward Extinction, Volcker Team Trots Out Ways to Reform it*, THE COM. APPEAL, Mar. 12, 2002, at B8.

461. At Enron, some have labeled the activities as being more serious than lying. Robert L. Bartley, editor of the *Wall Street Journal* has described the Enron conduct as follows, “So it would appear, at least at this stage of the events that the chief financial officer and a few partners were stealing from shareholders. Someone might even call it embezzlement, in the broad sense of theft of company assets by those with fiduciary obligations.” Robert L. Bartley, *Thinking Things Over: Enron: First, Apply the Law*, WALL ST. J., Feb. 11, 2002, at A23.

462. There are more accounting tools and tricks out there that companies can employ to keep debt off the books, thereby increasing their share value and risk while decreasing their cost of capital including “synthetic leases,” a means of getting back the now verboten tool of selling company headquarters and then leasing it back to avoid carrying the debt. Some of the companies with synthetic lease issues, disclosed and not disclosed to shareholders, are Krispy Kreme, Cisco, Lexicon Genetics, and Dollar General. Seth Lubove & Elizabeth MacDonald, *Debt? Who, Me?; Enron is Hardly Alone When it Comes to Creative Off-Balance-Sheet Accounting*, FORBES, Feb. 18, 2002, at 56.

463. The reaction of some portions of the business community to even just the SEC’s new requirement on certification (see earlier discussion in Part IV) is not encouraging in terms of meaningful reform. One lawyer advised his business clients to resist the change because he doubted the SEC’s authority to take these steps. See Paul Beckett, *SEC Order Forces Executives to Swear by Their Numbers*, WALL ST. J., July 5, 2002, at A1. And Scott Sullivan, CFO of WorldCom, Gary Winnick of Global Crossing, and Martha Stewart have all continued with multi-million dollar renovations or constructions of mansions, with Sullivan’s in Boca Raton because bankruptcy exemptions there for homes are unlimited. See Jon Swartz, *Homes of the Rich and Infamous*, USA TODAY, July 15, 2002, at 3B.

464. For example, Middle West Utilities collapsed in the years following the 1929 stock crash precisely because it too had an astounding amount of off-the-books debt accomplished through the use of interconnected companies and interlocking boards. Its structure was so complex that it took the Federal Trade Commission seven years to unravel its financial structure. When it did collapse, Samuel L. Insull, its CEO, was very much a Ken Lay, someone who had been generous with political donations and someone who quickly became a target for

finding the means for curbing the diabolical activities of educated, and experienced business people, and those who reported to them because they were able to perpetuate longstanding deception of a magnitude that continues to stun an already stunned investor class.⁴⁶⁵ Incentive plans, stock options, bonuses, the unforgiving demands of quarterly results that meet announced goals, and not one penny less, served as both temptations and rationalizations.⁴⁶⁶

Still, the root cause is not solely these carrots, nor will the sticks of fines, criminal charges and imprisonment solve the systemic crisis.⁴⁶⁷ While there is presently a crisis in ethics in business, there is also a crisis in the perceived fundamentals of business. What Andrew Fastow and WorldCom's CFO, Scott Sullivan, and a host of executives at Xerox believed was that if they could just hang on and keep the earnings coming using various FASB stretches, their pro formas would become reality and they would reign as the wizards of finance and business.⁴⁶⁸

The crises in ethics are partially a function of longstanding rationalizations justified by unrealistic finance theories and even investor expectations in returns from those applied theories. Such a crisis cannot occur without the acquiescence of investors who were all too willing to believe that these astronomical share prices and earnings were possible on a continuing and regular basis. Investors, because of the increased sophistication, will need to

vilification. He was tried for fraud and embezzlement, left the country as lawsuits from shareholders were litigated and died of a heart attack while waiting for a subway in Paris. He had only 85 cents in his pocket. Mr. Insull "went down with his ship," even as Enron executives continue to enjoy a millionaire's life. Middle West's collapse was responsible for the passage of the 1934 Securities Exchange Act (15 U.S.C. § 78), the Public Utility Holding Company Act, and the Federal Power Act, the last two of which were federal laws in which Enron found loopholes. Rebecca Smith, *Enron's Rise and Fall Gives Some Scholars a Sense of Deja Vu*, WALL ST. J., Feb. 4, 2002, at A1.

465. Incredibly, there seems to be little shame or remorse over Enron. For example, when Mr. Skilling left Enron to "spend more time with his 3 children," having "missed too many soccer games over the years," he engaged in a short sale on August 24, 2001 against an Enron competitor, AES. Estimates put the value of the sale, because AES shares did indeed decline, at between \$15 and \$30 million. Ken Brown, *Enron Ex-CEO Made Sideline Bet vs. Rival*, WALL ST. J., Jan. 14, 2002, at C1.

466. In a recent piece in *Forbes* magazine, the chairman of Hypercom commented that he was reluctant to fire the company's top salesman even though there were charges of sexual harassment, abuse and at least one settlement of a case brought against the company for the salesman's behavior, "He was bringing in \$70 million a year. Do you fire your number one rock star because he's difficult?" Daniel Lyons, *Bad Boys*, FORBES, July 22, 2002, at 99, 102.

467. This position is supported by Federal Reserve Chairman, Alan Greenspan who stated in testimony before Congress that Congress could not "effectively legislate morality or character." Mr. Greenspan did acknowledge that additional criminal penalties for CEOs could "have profoundly important effects" on corporate behavior. George Hager, *Fed Chief Expresses Guarded Optimism*, USA TODAY, July 17, 2002, at A1.

468. And we must not forget "Ebitda" (Earnings before interest, taxes, depreciation and amortization), a figure that was worshipped by many as a true indicator of firm performance. It's just that taxes and interest are real expenses and as it turns out with WorldCom, they were faking the real expenses anyway. Martin Peers & Robin Sidel, *Days May be Numbered for Ebitda Numbers*, WALL ST. J., July 5, 2002, at C1.

be savvy. Fortunately, that investment savvy is guided by a simple and overarching principle: if it sounds too good to be true, it is too good to be true. Investors will need to examine not just earnings, but the quality of earnings. If companies are reporting significant revenues and revenue increases, investor should check earnings quality, by comparing revenues with cash flow. Even when Enron's share price was still at \$63 in May 2001, a simple look at its lack cash and mounting debt would have been a tip to a relatively unsophisticated investor that there was something significant behind the financial statements.⁴⁶⁹

The fundamentals of sound business are not difficult: the business makes a product or offers a service that customers want they make the product or provide the service and keep costs down; they sell the product or service and they have earnings. Just a glance at the chart of misdeeds demonstrates that this fundamental along with very simplistic philosophies were ignored. Investors were duped because they dismissed the old adage, if it sounds too good to be true, it is too good to be true. These companies were operating in such a leveraged fashion that when a rainy day came, i.e., in Enron's case, a downturn in the economy post September 11, they had no cushion (savings) for a rainy day. The booking of revenues in advance of when they were earned was a violation of the sage advice: Don't count your chickens before they are hatched. There is so much of common sense that has been ignored in business operations and financial reporting that this crisis has caused the complexities of regulatory reform to consume the discussions without acknowledging that there are far deeper problems, than whether auditors have an independent Board supervising them.

The behaviors at Enron included lavish spending, and executives who used their company as a means of self-enrichment or even as a bank for loans with enormously favorable terms.⁴⁷⁰ Some of these companies were carrying inventory, as in the case of the telecoms with their capacity, so large that there could never be a market of buyers large enough to use all the capacity that they had. The wisdom, art, and science of doing business is lost among the wizardry that is the substitute.

The crisis in confidence among investors has left them with the conclusion that there is no need to invest in companies, when the government can provide a financial return on instruments with lower rates of return but, which have clear terms, and a transparency that gives them comfort.⁴⁷¹ Man-

469. Matt Krantz, *Avoiding the Next Enron*, USA TODAY, Feb. 1, 2002, at B3.

470. In some situations, the enormously favorable terms for the loans meant not having to pay it back, the nirvana of all possible loan terms. The loan to WorldCom's Bernie Ebbers was \$366 million and has not been collected as yet. Rebecca Blumenstein & Jared Sandberg, *WorldCom CEO Quits Amid Probe of Firm's Finances*, WALL ST. J., Apr. 30, 2002, at A1.

471. Given the performance of the market over the past two years, investors have realized that there is only a tiny additional gain to be made by investing in the market as opposed to Treasury bonds. One calculation puts the difference between an investment of \$100,000 in 1987 in Treasury bonds vs. a \$100,000 investment in the market to be only \$40,000 less "and the investor would have been spared much of the angst of the 1987, 1998 and current market

agers once used skills of strategy, quality, and sales to bring about the higher returns for investors. Now companies, in all industries, have become financial service organizations that investors have difficulty understanding and which fundamentally carry more risk, both in terms of the structure of the financial instruments and trustworthiness. That investors no longer trust is evidenced both by survey attitudes, with seven out of ten believing that CEOs cannot be trusted,⁴⁷² and in their behavior. During June 2002, withdrawals from domestic mutual funds exceeded investments by \$19 billion according to Banc of America Securities.⁴⁷³ From July 9, 2002 through July 23, 2002, the Dow dropped 1393 points and declined eleven of the twelve trading days during that period.⁴⁷⁴

Some internal changes could help curb reporting abuses in companies. Enron's Audit Committee represented a case study in what not to do on a corporate Board. In order to perform that function effectively, members of the audit committee need the following:

- Expertise in reading financial statements (Sarbanes-Oxley gets at this requirement, but only with regard to one person and an audit committee needs financial expertise around the table, particularly because there should be robust disagreement about financial reporting issues and singular expertise will not provide that debate)
- Business experience that is applicable to the company business
- No financial ties to the company other than director compensation fees
- No conflicts of interest in the performance of the director/audit committee role (Again, Sarbanes-Oxley now requires something that should have been inherently obvious prior to this legislation and Enron. The statute provides a list of activities that constitute a conflict of interest by definition, such as bookkeeping. Also, as noted, conflicts can be more complex than simply relationships with the company or company employees and the statute is not broad enough to cover these types of conflicts)

downturns." *What to Do When the Conventional Wisdom is Wrong: Market's Fall Discredits Many Investing Rules; How to Respond*, WALL ST. J., July 23, 2002, at D1.

472. *Scandals Shake Public Trust*, *supra* note 69. Additionally 8 out of 10 investors believe that CEOs "will take 'improper actions' to help themselves at the expense of their companies." *Id.* 69% indicate that they will rely less on the advice of a broker or analyst. *Id.* Even the General Services Administration, the purchasing agent for the federal government, has indicated it may not continue to do business with WorldCom because of its concerns about its viability and ability to deliver service. Andrew Backover, *SEC 'Disappointed' by WorldCom Report*, USA TODAY, July 2, 2002, at B1.

473. *Scandals Shake Public Trust*, *supra* note 69.

474. The Dow closed at 9096.09 on July 9, 2002, and at 7702.34 on July 23, 2002. E.S. Browning, *Nasdaq Stocks Sustain Biggest Loss of Year*, WALL ST. J., July 24, 2002, at C1; E. S. Browning, *Stocks Drop Amid Earnings Fears*, WALL ST. J., July 10, 2002, at C1.

- No excessive compensation and caution in using golden handcuffs as a mean of retaining officers because of their tendency to manipulate stock price to satisfy their desires upon departure in terms of share price.

The performance of the audit committee work requires the following, a set of factors not addressed by Sarbanes-Oxley:

- Regular meetings
- Familiarity with company internal auditors and internal controls
- Knowledge of the policy debates that are ongoing among managers, internal auditors and external auditors about the financial reporting issues of the company⁴⁷⁵
- Contact apart from management with both internal and external auditors; best practices indicate that the audit committee should interact regularly at each meeting with the internal auditors outside the presence of management and with the external auditors outside the presence of both the internal auditors and management. Again, Sarbanes-Oxley specifies this type of meeting, but not with the delineation outlined here for these independent meetings.
- Consultation with industry experts on key accounting issues in the industry⁴⁷⁶

While the various rules on audit committee independence have been in place since the early 1990s, the definition of independence appears to be somewhat fluid. A conflict of interest occurs, not just when a member of the audit committee is an insider or is an outsider with extensive consulting or contract ties to management and the company. A conflict occurs when there is self-interest in going along with management. As noted in the discussion of Enron's Board, conflicts can come in the form of excessive compensation, non-profit connections, consulting contracts, and political connections.⁴⁷⁷

475. Warren Buffett proposed his three questions for audit committee members three years ago and continues to adhere to them as a means of curbing some of these problems:

If the auditor were solely responsible for preparation of the company's financial statements, would they have been done differently, in either material or nonmaterial ways? If differently, the auditor should explain both management's argument and his own. (2) If the auditor were an investor, would he have received the information essential to understanding the company's financial performance during the reporting period? (3) Is the company following the same internal audit procedure the auditor would if he were CEO? If not, what are the differences and why?

Dirty Rotten Numbers, *supra* note 256, at 74.

476. It is interesting to note that the Corporate Library, an investor consulting company, does not put much stock in credentials in Board members, pointing to the presence of former Stanford business dean, Robert Jaedicke, on the Enron Board and noting what happened to that company. The Corporate Library, run by Nell Minow and Robert Monks publishes grades for both the quality of Boards and their decisions. In addition, they counsel investors on how to oust poor CEOs as well as get through resolutions on reporting and accountability. Dyan Machan, *I Am Watching*, FORBES, Mar. 4, 2002, at 68.

477. See *supra* notes 165-166 and accompanying discussions.

But the remainder of the repairs for the crisis in confidence comes from an unequivocal return to honesty. Arthur Levitt was successful in obtaining more public disclosures from companies including Web broadcasts,⁴⁷⁸ yet because of the technical compliance with accounting rules we now have less information about the true financial status of companies than ever. Regulation, additional disclosures, and more widespread disclosures have not solved the problem, nor will the new legislation and SEC mandates prove to be solutions. Honesty cannot be legislated and the return of honesty is no small task because dishonesty is so pervasive. For example, eighty-two percent of executives confess that they cheat at the game of golf.⁴⁷⁹ Yet ninety-nine percent of those same CEOs believe that they are honest in business.⁴⁸⁰ The straightforward answer is something still evaded, despite the ongoing crisis. When WorldCom declared bankruptcy, its new CEO, John Sidgmore, appeared on the *Today* show to reassure. When asked, as a Board member, whether he voted to approve the \$400 million loan to former CEO Bernie Ebbers, he was hesitant to answer. When pressed by Mr. Lauer, he responded that the Compensation Committee approved the loan. As a Board member, he only “ratified” the contract.⁴⁸¹

Apparently before we can demand honesty, we must define honesty. The demands of honesty will force businesses to focus on the basics of business, rather than the wizardry of complex financial instruments and estimates of future returns. A simple definition of honesty in financial reporting could consist of the following:

- If we didn’t earn it, we don’t report it.
- If we don’t earn it for awhile, wait to report it.
- If it cost us, it’s an expense.⁴⁸²
- When in doubt, report, record, and book.
- No creating new companies without a product, a purpose, and an independent management team.
- Your bonus is tied to your honesty in your numbers, not just the numbers themselves, and if the numbers are inflated, the bonus is returned.

478. Joseph McCafferty, *The Whole World is Listening*, CFO, June 1, 1999.

479. Del Jones, *Many CEOs Bend the Rules (of Golf)*, USA TODAY, June 26, 2002, at A1.

480. *Id.*

481. Creditors, run for your lives or get rid of this new CEO. This guy is slick and can’t admit that the loan was wrong or at least own up to having made the loan.

482. Coca-Cola has already taken a step in this direction with its announcement that it would book options as an expense. Coke follows Boeing and Winn-Dixie in this regard. Floyd Norris & Sherri Day, *Coke to Report Stock Options as an Expense*, N.Y. TIMES, July 15, 2002, at A1. “I think you will see other companies doing this,” was Warren Buffett’s response. *Id.* Mr. Buffett is on the Board of Coca-Cola and called the decision a “classy move.” Alex Pham, *Coca-Cola to Treat Options as Expenses*, L.A. TIMES, July 15, 2002, at B3. The change will cost Coke a penny a share in earnings in 2002 and 3 cents per share in 2003. Kathleen Pender, *Is Coke’s Big Move Real Thing?*, S.F. CHRON., July 16, 2002, at B1.

- We have goals we want to reach, but we do not lie to meet the goals.
- If we miss a goal, we say so, clearly, with an explanation and with a promise to do better.
- We disclose when we know.
- We don't trade in stock before others are told.
- We remember the following – if I were a shareholder on the outside would I want to know this information?⁴⁸³
- Why am I doing what I am doing? Am I hiding something? Am I hoping things will get better?

Boards should send a clear signal to employees that if there is something in the earnings reports or operations that are troubling, they want to know, and should provide employees with an outlet for reporting, including anonymous reporting systems such as hotlines. With definitions of honesty, a means for expressing concerns and reporting dishonesty, the ethical culture of a company can change. Boards entrench that culture when they act on employee concerns and follow through.

These reforms assume not just an independent Board, but also a fiercely independent, indeed crotchety Board, not afraid of management and experienced enough to ask the right questions. The fix for the crisis in confidence is honesty, defined and the reinforced by a Board that is intolerant of one whit of departure from that definition.

The current crisis in confidence in the markets is one that springs from moral issues. Moral issues are resolved, not through additional Boards, independent Boards, or new regulations. Moral clarity offered by business leaders committed to honesty and a return to business fundamentals is necessary. The only issue is whether companies have the courage to return to not just sound moral ground, but the sound business practices that high ground demands. If that move falters, we stand vulnerable, on the low ground, to more *perfect storms*.

483. One anecdote about Enron characterizes the notion of the false impression art that it had perfected:

One senior Wall Street official recalls recently asking Enron officials whether the company had retained bankruptcy counsel. He was told no. He later found out that while the company hadn't formally retained such representation, it had met with bankruptcy lawyers. "If you don't ask the absolute right question, you don't get the right answer," he says. "Enron does that a lot."

Scandals Shake Public Trust, *supra* note 69.