ENRON, FRAUD, AND SECURITIES REFORM: AN ENRON PROSECUTOR'S PERSPECTIVE

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INTRODUCTION

From June 2002 to July 2003, I took a leave of absence from teaching to serve as a prosecutor with the United States Justice Department's Enron Task Force.[1] When people ask me about the case, their focus is almost always on questions of individual criminal liability. They want to know, for example, if Ken Lay is likely to be convicted at trial, and if so, how much time he might serve in prison.[2] These are important ques-

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1. My status as a former prosecutor in the Enron case places limits on the information presented in this article. Most importantly, I am bound by Rule 6(e) of the Federal Rules of Criminal Procedure, which prohibits me from disclosing matters that occurred before the Enron Special Grand Jury sitting in Houston. More generally, I have not disclosed in this essay any non-public confidential information that I obtained in my role as a participant in the Enron case. As a member of the Connecticut bar, I am also bound by Rule 3.6 of the Connecticut Rules of Professional Conduct. Rule 3.6 provides, in relevant part, that a lawyer who has participated in the investigation or litigation of a matter may not make extrajudicial statements that a reasonable person would expect to be disseminated publicly if the lawyer knows or reasonably should know that that the statements will have a substantial likelihood of materially prejudicing an adjudicative proceeding in the matter. CONN. R. PROF'L ETHICS 3.6(b)(2) (2004). Rule 3.6(b)(2) provides, however, that such a lawyer may repeat, inter alia, information in a public record. *Id.* Pursuant to Rule 3.6, I have avoided any significant discussion of individual criminal liability in this article—aside from conduct of persons who have already pleaded guilty—so as to avoid having any impact on the ongoing criminal litigation. Instead, I focus on structural legal and regulatory issues raised by the Enron case. I also generally write about "Enron's" actions rather than the actions of particular Enron executives. In addition, I have based my analysis of the Enron collapse on information disclosed in public records or otherwise in the public domain.

2. Though I am obviously biased, I believe the Enron Task Force has achieved very significant results in the Enron case. As of the date this article was sent to press, thirty-two Enron and Wall Street executives had been charged with federal crimes related to Enron's financial collapse. Of those persons, fifteen have pleaded guilty, five have been convicted at trial, and one has been acquitted. This includes several very senior Enron executives, including Enron

tions: if persons who commit crimes in highly publicized financial scandals are not held responsible for their actions, our efforts to deter similar criminal conduct in the future will suffer a serious blow. But for me, the significance of individual questions of guilt or innocence pales when compared to what seems to be the more pressing structural issue: could an Enron-style collapse happen again?[3]

When Enron went bankrupt on December 2, 2001,[4] after stunning revelations about the company's insider deals and faulty accounting, some 4,500 Enron workers had lost their jobs in Houston alone.[5] Enron's employees, who had been encouraged to place their retirement savings in Enron stock, lost some $1.3 billion in 401(k) accounts.[6] Nationwide, Enron's countless investors, who had seen the stock price decline over the course of the year from $84 to mere pennies per share, lost some

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CFO Andrew Fastow, Enron Treasurer Ben Glisan, the chief and deputy chief of Enron's investor relations department, several senior Enron energy traders, and the CEO and COO of Enron Broadband Services, Enron's telecommunications division. In addition, the Task Force obtained the conviction of the Arthur Andersen accounting firm on the charge of obstruction of justice. Eleven other executives, including Enron Chairman Kenneth Lay and CEO Jeffrey Skilling, have pleaded not guilty and are currently awaiting trial. For a summary of the investigation's results, see the frequently updated "Prosecution Scorecard" maintained by the Houston Chronicle, *at* http://www.chron.com/content/chronicle/special/01/enron/index.html.

3. Scholarly commentary on Enron is already quite extensive. Among the articles I have found most insightful are: Neil H. Aronson, *Preventing Future Enrons: Implementing the Sarbanes-Oxley Act of 2002*, 8 STAN. J.L. BUS. & FIN. 127 (2002); Douglas G. Baird & Robert K. Rasmussen, *Four (or Five) Easy Lessons from Enron*, 55 VAND. L. REV. 1787 (2002); George J. Benston, *The Regulation of Accountants and Public Accounting Before and After Enron*, 52 EMORY L.J. 1325 (2003); John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403 (2002); Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233 (2002); Anthony J. Luppino, *Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense*, 2003 COLUM. BUS. L. REV. 35; David Millon, *Who "Caused" The Enron Debacle?*, 60 WASH. & LEE L. REV. 309 (2003); Deborah L. Rhode & Paul D. Paton, *Lawyers, Ethics and Enron*, 8 STAN. J.L. BUS. & FIN. 9 (2002).

4. On December 2, 2001, Enron Corp. and certain Enron affiliates filed voluntary petitions for relief under Chapter 11, Title 11, of the United States Code. The petition was filed in the United States Bankruptcy Court for the Southern District of New York, apparently because that court allows for electronic filing of petitions on Sundays. Enron continues to operate as debtors in possession pursuant to 11 U.S.C. §§ 1107 and 1108.

5. Patty Reinert, *The Fall of Enron: Watkins to Discuss Now-famous Memo, Enron Exec Plans to Bring More Documents to Hearing*, HOUSTON CHRON., Feb. 13, 2002, at A19 (claiming that 4500 Enron employees in Houston lost their jobs after Enron's bankruptcy).

6. James K. Glassman, *Diversify, Diversify, Diversify*, WALL ST. J., Jan. 18, 2002, at A10 (noting that Enron stock price plummeted from $84 to practically zero; the average Enron employee had 60 percent of their 401(k) assets in Enron stock); Michael Lietdke, *Proud "Papa" Recognizes Some Faults in 401(k)s*, HOUSTON CHRON., Sept. 23, 2002, at B3 (noting that Enron employees lost $1.3 billion in retirement accounts).

$61 billion.[7] This disaster occurred largely because of a troubling gap between perception and reality.

Throughout the 1990s and up to late 2001, most investors and commentators believed Enron was one of the most successful, innovative and profitable companies in America. *Fortune*, for example, rated Enron "The Most Innovative Company in America" for five straight years, from 1997 to 2001.[8] At its peak, Enron traded at a price-to-earnings ratio of fifty-five to one, four times higher than comparable energy and trading firms.[9] In 2001, in the midst of the dot.com implosion, *Fortune* even identified Enron as one of the most reliable "10 Stocks to Last the Decade."[10] These assessments were horribly inaccurate. In truth, Enron was a deeply troubled company, well on its way to financial collapse.

The extent of the gap in the Enron case between outsider perceptions and company reality inevitably draws our attention to the role of Enron's senior management, who created and profited from this gap. We must not let our concern with individual conduct distract us, however, from the larger issue. The next time senior management of a major American company tries to mislead investors by making their company appear more successful than it truly is, will we catch the problem before it explodes, or will we be fooled again?

Since the 1930s, America has relied on a complex and evolving public-private system of checks and deterrents to prevent companies and their executives from misleading investors.[11] This regime relies on four primary institutional watchdogs to prevent and deter misconduct before it happens and to catch and disclose actual misconduct when it occurs: independent auditors, corporate boards of directors, private securities analysts, and securities regulators at the Securities and Exchange Commission ("SEC"). Behind this initial line of defense lies a fifth institutional

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7. Glassman, *supra* note 6 (Enron stock price plummeted from $84 to "practically zero"); Floyd Norris, *After Two-Year Drop in Markets, Calendar Turns on Note of Hope*, N.Y. TIMES, Jan. 1, 2002, at A1 (Enron's market value fell $61 billion).

8. *America's Most Admired Companies*, FORTUNE, Feb. 19, 2001, at 64, 104; *America's Most Admired Companies*, FORTUNE, Feb. 21, 2000, at 108, 110; *America's Most Admired Companies*, FORTUNE, Mar. 1, 1999, at 68, 70; *America's Most Admired Companies*, FORTUNE, Mar. 2, 1998, at 70, 86; *America's Most Admired Companies*, FORTUNE, Mar. 3, 1997, at 68, 74.

9. Baird & Rasmussen, *supra* note 3, at 1790.

10. David Ivanovich, *Everybody Knows Enron's Name, But Pop Icon Status Probably Won't Last*, HOUSTON CHRON., Oct. 21, 2002, at A1.

11. One area requiring increased study in the future is the relative efficiency of the various public and private tools we use to check fraud. In an important recent article, James Cox and Randall Thomas make an important contribution in this area by conducting an empirical analysis of the relationship between and relative impact of SEC enforcement actions and private securities fraud class action suits. *See* James D. Cox & Randall S. Thomas, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737 (2003).

force, the criminal prosecutors with the United States Department of Justice ("DOJ") who enforce the federal criminal laws. Though motivated by disparate goals, these five players collectively work to protect investors from false and misleading information and to ensure that our securities markets function in a safe, reliable, and efficient manner.[12] If we are going to prevent more Enron-style disasters in the future, it is these five institutional players that will do it.

Does our regulatory system work? Are investors safe? Analysis of the Enron case suggests, unfortunately, that the answer to these questions is "no." Enron sought to mislead investors about its financial position and commercial success, and it got away with this deception from 1997 to late 2001 because all five institutional players failed massively in their tasks. Enron's board of directors was apparently clueless, possessing no idea it was presiding over a sinking ship;[13] Arthur Andersen's accountants helped perpetuate the fraud rather than work to stop it;[14] Wall Street's securities "analysts" were more interested in pumping up Enron's stock price and repeating Enron management's inaccurate claims than they were in analyzing the company's actual business performance;[15] the SEC was asleep at the wheel, not even bothering to review Enron's publicly filed quarterly financial statements;[16] and the federal criminal laws ultimately proved to be no real deterrent at all.[17]

The Enron case provides us with a very useful map of the shortcomings in our regulatory scheme, and those shortcomings are clearly enormous, calling for serious reform. Since Enron's collapse, Congress, the

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12. Lawyers who work at businesses, auditing firms, and law firms retained by businesses are a critical sixth watchdog. Deborah Rhode and Paul Paton suggest that in the Enron case, "[t]oo many members of the legal profession were part of the problem, rather than the solution." Rhode & Paton, *supra* note 3, at 9. These authors also decry the fact that "lawyers' roles and rules too often have been absent from the discussion" about the case and needed reforms. *Id.* at 10. Alas, I add to this problem by declining to discuss the role of lawyers in the Enron case in this article because I believe I could not adequately address the subject without disclosing confidential nonpublic information I obtained as an Enron prosecutor. For excellent discussions of the role of lawyers in the Enron case, see *id.* *See also* John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293 (2003); Michael L. Fox, *To Tell or Not to Tell: Legal Ethics and Disclosure after Enron*, 2002 COLUM. BUS. L. REV. 867. Many commentators also view credit rating agencies as a securities investment watchdog. I do not analyze performance of the credit agencies in this article, largely because I think their views have a less significant impact on the investment decisions of ordinary Americans than those of equity analysts. For a first rate analysis of the conduct of the credit rating agencies in the Enron case, see STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 76–99 (Comm. Print 2002).

13. *See infra* Part III.B.

14. *See infra* Part III.A.

15. *See infra* Part III.C.

16. *See infra* Part III.D.

17. *See infra* Part III.E.

SEC, and other securities and accounting regulators have worked hard to fix these problems. Recent reforms, such as the 2002 Sarbanes-Oxley Act, have made several significant improvements to our securities laws. These reforms did little, however, to combat some of the most significant problems evident in the Enron case. As a result, another Enron could happen tomorrow. Given the importance of the United States securities market to the international economy and our own national retirement system, we have to do better.

In this Article, I call for three significant changes in the way we regulate the sale of securities issued by publicly traded companies: an organizational and institutional overhaul of the SEC, criminalization of negligent conduct by executives of publicly traded companies, and implementation of mandatory auditor rotation. These proposals would change our current regulatory scheme in fundamental ways, and I do not advocate them lightly. Indeed, I expect resistance to these ideas to be intense, particularly from Wall Street, the Big Four accounting firms, and the corporate and white collar defense bars. To overcome this resistance, policy makers, practicing lawyers, academics, and the general public need to be aware of how poorly our current regulatory scheme protects investors. To assist in this educational process, this Article uses the Enron financial collapse as a case study in the operation of our current regulatory scheme.

This case study revolves around two fundamental questions—the same questions I asked myself almost every day I worked on the Enron investigation. First, how did Enron convince the public that a failing company, heavily in debt and hemorrhaging cash, was actually one of the most profitable and innovative companies in the world? Second, how is it possible that none of the frontline institutional players that collectively serve to protect investors—Arthur Andersen, the Enron Board of Directors, stock analysts, the SEC, and the federal criminal justice system—prevented this deception from taking place or caught and disclosed it before it was too late? Answering these two questions will help us identify the precise problems with our current securities regulation regime. This, in turn, will help us understand areas where further reforms are necessary.[18]

Part I of this Article discusses Enron Corp.'s business operations in the years before its bankruptcy. During this period, Enron was engaged in a costly and ultimately disastrous diversification strategy, starting a series of business initiatives in water, telecommunications, energy, and other sectors of the economy that cost the company billions but failed to

18. This approach assumes that the Enron case was not an anomaly or aberration. I briefly discuss this issue in Part IV, *infra*.

produce significant revenue. To meet its rapidly escalating costs, Enron had to raise billions of dollars in capital markets but it needed to do so quietly, so as not to alarm banks and investors. Faced with this quandary, the company resorted to deception.

Part II explains how Enron's deception worked. Enron wanted to appear profitable, raise billions of dollars in cash, and keep its reported debt low. To accomplish this legerdemain, Enron employed a series of schemes to manipulate its financial statements. These techniques helped Enron dramatically inflate its reported revenue and hide billions of dollars in debt. They also misled investors and violated both federal criminal laws and relevant accounting rules.

In Part III, I discuss what may be the most alarming aspect of the Enron case—the failure of Arthur Andersen, the Enron Board of Directors, Wall Street equity analysts, and the SEC to catch and disclose Enron's deception before it was too late, despite some critical warning signs. I analyze the performance of each of these institutions in the Enron debacle and try to assess what went wrong. I argue that the existence of systematic conflicts of interest, lack of incentives for diligent work performance, and the absence of meaningful checks on or reviews of institutional performance made protection of investors a low priority for the Enron board, auditors, and stock analysts. In the case of the SEC, I suggest that its performance was derailed by poor management and a misplaced sense of priorities.

Since Enron's collapse, we have seen a period of intense reform. In Part IV, I briefly discuss and assess some of these efforts to improve securities laws and regulatory practices, including the Sarbanes-Oxley Act, amendments to the United States Sentencing Guidelines, rule changes by the SEC and Financial Accounting Standards Board ("FASB"), and reforms that resulted from litigation brought by New York's Attorney General, Elliot Spitzer. I argue that many of these changes are useful, but that others are actually counterproductive. I also address the most critical practical issue: where do we go from here? Are the reforms implemented since 2002 adequate? Do they sufficiently address and correct the problems with our system of securities regulation evident in the Enron debacle and similar cases? I argue that Sarbanes-Oxley and related reforms, though very useful in many respects, fail to mitigate sufficiently some of the major problems in the securities market, leaving investors extremely vulnerable to fraud and deception.

Finally, in Part V, I discuss my three reform proposals to improve securities market oversight, protect investors, and prevent more Enrons in the future. These measures will improve the accuracy of information provided to investors and ensure that our equity markets continue to function in a safe, reliable, and efficient manner.

I. ENRON'S BUSINESS OPERATIONS: A STUDY IN FAILURE

A. Enron: Background

When I was a child growing up in Houston, there was no Enron.[19] Instead, we had good old Houston Natural Gas ("HNG"). HNG started as our local natural gas utility, providing gas to retail customers for home and business energy needs. In the 1980s, HNG sold off its retail business and focused instead on natural gas production and transportation.[20] It soon became a major regional gas powerhouse.

In 1985, a large midwestern gas pipeline company called InterNorth, headquartered in Omaha, Nebraska, acquired HNG.[21] The Inter-

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19. This section contains a brief analysis of Enron's business operations from roughly 1980 to 2001. This section draws upon, among other sources, three excellent books on Enron: ROBERT BRYCE, PIPE DREAMS: GREED, EGO, AND THE DEATH OF ENRON (2002); BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON (2003); and REBECCA SMITH & JOHN R. EMSHWILLER, 24 DAYS: HOW TWO WALL STREET JOURNAL REPORTERS UNCOVERED THE LIES THAT DESTROYED FAITH IN CORPORATE AMERICA (2003). Another significant source for this and subsequent parts of this article is the four public reports filed by Neal Batson, the examiner appointed by the United States Bankruptcy Court, Southern District of New York, to assist the Court in untangling Enron's complicated accounting and finance schemes. Batson filed his First Interim Report on September 21, 2002. First Interim Report of Neal Batson, Court-Appointed Examiner, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. Sept. 21, 2002). This first preliminary report investigated six suspect Enron transactions. Batson filed his Second Interim Report on January 21, 2003. Second Interim Report of Neal Batson, Court-Appointed Examiner, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. Jan. 21, 2003). This report, perhaps the most significant, investigates virtually all of the Enron "special purpose entity" or "SPE" transactions the examiner could identify. The report concludes that Enron manipulated its financial statements, in violation of Generally Accepted Accounting Principles, to dramatically overstate its reported income and funds flow and understate its debt. Batson filed his Third Interim Report on June 30, 2003. Third Interim Report of Neal Batson, Court-Appointed Examiner, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. June 30, 2003). The Third Report examined whether certain individuals and companies were responsible for Enron's accounting abuses. The Third Report concluded, inter alia, that there was sufficient evidence to conclude that Enron executives violated their fiduciary duties and that certain financial institutions knew of this wrongdoing and assisted in it. Batson filed his Final Report on November 4, 2003. Final Report of Neal Batson, Court-Appointed Examiner, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. Nov. 4, 2003). The Final Report examined the responsibility of Arthur Andersen, in-house and retained counsel, senior Enron executives, the Enron Board of Directors, and certain financial institutions in the Enron debacle. In addition to these sources, Baird and Rasmussen's *Four (or Five) Easy Lessons from Enron*, which discusses significant bankruptcy issues raised by the Enron case, provides a brief but very useful analysis of Enron's business successes and failures that reaches many of the same conclusions I have reached during the two years I have spent thinking about Enron as a business. *See* Baird & Rasmussen, *supra* note 3.

20. BRYCE, *supra* note 19, at 23.

21. For excellent discussions of the HNG-InterNorth merger, see *id.* at 31–33. *See also* MCLEAN & ELKIND, *supra* note 19, at 10–13.

North acquisition is something of a legend in Houston business circles. Though InterNorth thought it was buying HNG, within a short period of time it became clear that HNG's management was calling all the shots for the newly merged company. HNG-InterNorth was based in Houston, not Omaha, and the CEO of HNG ran the newly merged company. His name was Ken Lay, and he renamed the company "Enron."[22]

Enron was a company built on deregulation. From the 1930s to the 1980s, natural gas was heavily regulated by the federal government, which set the price for both the sale and transportation of the product.[23] In the mid-1980s, however, the Reagan Administration began to eliminate price controls and give gas producers and pipeline companies the ability to contract freely.[24] Some major companies like Columbia Gas Transmission could not adjust to the rapidly changing market and perished.[25] Others thrived, and none more so than Enron. Enron understood that the newly deregulated market was grossly inefficient, with a large number of producers struggling to identify and contract with an even greater number of customers. Enron exploited these inefficiencies, stepping into the middle between producers and users and rationalizing the entire market. It bought huge quantities of gas from producers at steep discounts, often obtained by financing gas exploration and production in the tight 1980s Texas credit market, and then delivered that gas to wholesale customers through its own nationwide pipeline system.[26] Soon, both producers and users gave up trying to enter the market on their own, preferring simply to deal with Enron. Within a few short years, Enron's strategy totally transformed the gas sector. The company captured a huge percentage of the market and pocketed substantial profits. By the early 1990s, Enron was the leading natural gas company in the United States.

Ironically, Enron's success in the rapidly deregulating natural gas sector held the key to the company's ultimate demise. Success built on exploiting a rapidly deregulating market is inevitably short-lived. Other companies watch the market leader's operations, copy its innovations, and compete for the same business. As the market becomes more efficient, opportunities decline, competition stiffens, and profit margins shrink. This happened rapidly in natural gas. Companies like El Paso and Dynegy monitored Enron closely and based their own business mod-

22. HNG-InterNorth's selection of the name "Enron" is equally legendary in Houston. Originally, the company selected the name "Enteron," only to abandon it at the last moment when the company learned that "enteron" is a term for the intestines or alimentary canal.

23. BRYCE, *supra* note 19, at 52; MCLEAN & ELKIND, *supra* note 19, at 2.

24. BRYCE, *supra* note 19, at 53; MCLEAN & ELKIND, *supra* note 19, at 9.

25. BRYCE, *supra* note 19, at 53; MCLEAN & ELKIND, *supra* note 19, at 34–36.

26. BRYCE, *supra* note 19, at 54–56.

els on Enron's. As early as 1993, Enron's profit margins in gas began to decline.[27]

As the low-hanging fruit in the natural gas market disappeared, Enron's management faced a difficult business strategy decision: it could remain a natural gas company and grow content with a smaller return on its capital, or it could diversify into other sectors of the economy and try to replicate its great success in natural gas. Enron was a confident and aggressive company. It chose to diversify.

B. Enron's Diversification Strategy and Cost Structure

Over the course of the 1990s, Enron rapidly diversified into an enormous array of new business areas in the United States, Europe, and the developing world: energy derivatives trading, water, power generation, coal, paper and forest products, telecommunications, retail electricity, and metals.[28] This diversification strategy was asset heavy. Enron, for example, built or purchased pipelines in Brazil, steel mills in Thailand, newsprint mills in Canada, and power plants in the United Kingdom, the Philippines, Guatemala, India, and Guam.[29] These investments cost tens of billions of dollars. Enron paid out approximately $1 billion to construct its Dahbol power plant in India;[30] some $2.4 billion for purchase of the Wessex water utility in the United Kingdom;[31] $3.2 billion for Portland General Electric;[32] $2 billion in cash and debt for metals trading company MG;[33] $1.3 billion for an electricity company in Brazil;[34] and $300 million for a paper mill in Quebec.[35] The rate of investment was dizzying. In July 1998, Wall Street equity analysts from Donaldson, Lufgren, & Jenrette noted that Enron had spent some $3.5 billion to purchase water and electricity assets within a few short weeks alone.[36]

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27. *Id.* at 137; MCLEAN & ELKIND, *supra* note 19, at 105.

28. *See* Second Interim Report of Neal Batson, Court-Appointed Examiner at 15–16, *In re* Enron Corp., No 01-16034 (AJG) (Bankr. S.D.N.Y. Jan. 21, 2003) (describing Enron's diversification strategy in the 1990s).

29. BRYCE, *supra* note 19, at 136, 154; MCLEAN & ELKIND, *supra* note 19, at xxiv, 74, 225.

30. BRYCE, *supra* note 19, at 288.

31. *Id.* at 179, 359; MCLEAN & ELKIND, *supra* note 19, at 246.

32. MCLEAN & ELKIND, *supra* note 19, at 107.

33. BRYCE, *supra* note 19, at 218; MCLEAN & ELKIND, *supra* note 19, at 225.

34. MCLEAN & ELKIND, *supra* note 19, at 258–59.

35. BRYCE, *supra* note 19, at 154.

36. Second Interim Report of Neal Batson, Court-Appointed Examiner at 15 n.42, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. Jan. 21, 2003) (quoting Donaldson, Lufkin & Jenrette, Comment, *Acquisition of U.K. Water Company Adds to EPS and Opportunities for Growth* (July 24, 1998)).

Enron's diversification strategy should serve as a case study for business students for years to come, for it teaches important lessons. As Enron expanded into new areas, it did not generally hire experienced senior managers from these sectors of the economy to guide its business operations. Instead, Enron dispatched senior natural gas and energy trading executives to drive its new businesses. Enron assumed that success in natural gas and trading could be replicated in other fields because markets are markets, functioning in more or less the same manner. Enron failed to understand that its success in natural gas was the direct result of its superior knowledge about the market, and knowledge gained through decades of experience as a gas producer, transporter, and retail marketer. When Enron's extremely successful gas executives were plugged into new industrial sectors, they failed virtually across the board, often through sheer ignorance, producing very little or no revenue for the company.[37]

Consider, for example, the effort of Enron's water subsidiary, Azurix, to enter the water market in Latin America.[38] In 1999, Azurix made a sealed bid of $439 million to take control of Buenos Aires' water utility.[39] Azurix won the auction, but its bid was nearly three times higher than the next largest offer.[40] Once Azurix took control of its prize, it discovered that the utility was crumbling and that Azurix's purchase did not include critical assets like the utility's billing system. The bid ultimately resulted in enormous losses.[41] This example is typical of Azurix's performance over the course of its short life. As a result of management errors and outrageous overhead, Azurix, journalist Robert Bryce has commented, "didn't burn cash, it incinerated it."[42]

By decade's end, Enron's costly diversification strategy had put the company in a very vulnerable position. Though the energy trading business may have been prospering,[43] virtually every other major new Enron initiative—international power, retail electricity, water, telecommunica-

37. BRYCE, *supra* note 19, at 289.

38. For a discussion of Azurix, see *id.* at 175–89.

39. *Id.* at 184; *see also* MCLEAN & ELKIND, *supra* note 19, at 252.

40. BRYCE, *supra* note 19, at 184; MCLEAN & ELKIND, *supra* note 19, at 253.

41. BRYCE, *supra* note 19, at 184; MCLEAN & ELKIND, *supra* note 19, at 253–54.

42. BRYCE, *supra* note 19, at 176. Bryce notes that Azurix's executives spent $60 million per month on hotels, consultants, and airfare alone during the company's short existence.

43. There is serious question whether Enron's energy trading business was profitable or not. *See* MCLEAN & ELKIND, *supra* note 19, at 412; *see also* BRYCE, *supra* note 19, at 220; SMITH & EMSHWILLER, *supra* note 19, at 378. Even if the trading business was profitable, those profits may have been derived, in part, from fraud. *See, e.g.*, United States v. Timothy Belden, Cr. No. 02-0313-MJJ (N.D. Cal.) and United States v. Jeffrey Richter, Cr. No. 03-0026-MJJ (N.D. Cal.) (defendants, who traded electricity from Enron's office in Portland, Oregon, pleaded guilty to fraudulent manipulation of the California electricity market).

tions—was failing. [44] The true extent of Enron's losses in these years may never be known with precision, but informed estimates are staggering. In India, Enron's Dabhol power plant never became operational, with an ultimate cost to Enron of almost $1 billion.[45] Enron's telecommunications division, Enron Broadband Services, lost at least another $1 billion within two short years.[46] Metals accounted for at least $400 million in losses.[47] These losses were matched or exceeded in other areas. *Fortune*'s Bethany McLean and Peter Elkind, two of Enron's most savvy observers,[48] have estimated Enron's total business losses in the late 1990s at "well over $10 billion in cash"[49]—a figure that boggles the mind.

Enron's difficulties were exacerbated by a cost structure that was totally out of control.[50] In the first half of the 1990s, Enron kept a tight lid on personnel costs, with virtually no employment growth during a five-year period of increasing revenue and profits.[51] In the second half of the decade, however, Enron abandoned serious cost controls. Employment payrolls skyrocketed as Enron diversified, from 7,500 employees in 1996 to over 20,000 in 2001.[52] Employee compensation also went through the roof. In 2000, for example, some 200 Enron executives made $1 million or more in compensation, and twenty-six made over $10 million.[53] A new office tower in Houston added another $200 to $300 million in costs.[54]

C. Enron's Need for Capital

How do you stay in business if, like Enron, you are spending billions of dollars each year to buy expensive new assets and hire more well-paid staff, but none of your new business ventures are generating sufficient profit to meet these costs? There is really only one answer:

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44. BRYCE, *supra* note 19, at 9; MCLEAN & ELKIND, *supra* note 19, at 78, 104, 184, 260; SMITH & EMSHWILLER, *supra* note 19, at 320.

45. MCLEAN & ELKIND, *supra* note 19, at 83.

46. *Id.* at xxiv.

47. *Id.* at 131.

48. McLean was the first business journalist to publicly suggest that Enron was significantly overvalued. *See* Bethany McLean, *Is Enron Overpriced?*, FORTUNE, Mar. 5, 2001, at 123.

49. MCLEAN & ELKIND, *supra* note 19, at 412.

50. *Id.* at 119.

51. BRYCE, *supra* note 19, at 115.

52. *Id.* at 115, 134. Enron's decision to abandon serious cost controls was related to the resignation of Enron Chief Operating Officer Rich Kinder in 1996 and his replacement by the new COO, Jeff Skilling. *Id.* at 115.

53. MCLEAN & ELKIND, *supra* note 19, at 241.

54. BRYCE, *supra* note 19, at 216, 304; MCLEAN & ELKIND, *supra* note 19, at 239.

you meet your costs by raising money in capital markets—by issuing equity or going into debt. Enron chose debt, borrowing some $30 billion over a few short years. What made Enron unique was the way it borrowed those sums.

Corporations that precipitously increase their debt load take a serious risk. Publicly traded companies are required to report their debt positions to the SEC, and this can have a huge impact on the company's fortunes. For example, if a company raises billions of dollars in the capital market over a very short period of time, credit rating agencies will lower the company's credit rating. This, in turn, will increase the company's cost of capital and, in extreme situations, cause access to capital to dry up altogether. When, for example, lenders got an accurate picture of Enron's true debt position in late November 2001, they immediately cut off access to funds and Enron went bankrupt.

Raising capital is particularly tricky for companies like Enron that engage in substantial derivatives trading. Over the course of the 1990s, Enron had become a major player in energy futures markets, and though this may have been profitable, it increased Enron's vulnerability. When companies sell futures, they are promising to deliver a commodity to their customer at a future date. This entails risk for the customer, since there is no guarantee that the selling company will be in a position to meet its obligation when the future delivery date arrives. As a result, only companies with solid credit ratings and a reputation for reliability can play in the derivatives markets in any substantial way. If one's credit rating declines, counterparties demand more collateral before entering into trades, making extensive trading prohibitively expensive. Unfortunately for Enron, nothing drives down one's credit rating faster than large-scale borrowing. Thus, Enron's cash hungry diversification strategy posed enormous risks to Enron's critical energy trading business.[55]

In summary, poor management put Enron in a very difficult position by the late 1990s. Enron needed to raise billions of dollars to meet its costs, but it needed to do this in a manner that would not spook capital markets and jeopardize its trading business. Surprisingly, Enron managed to pull this trick off, quietly borrowing over $30 billion to meet its costs without a significant impact on its credit rating. The company accomplished this miracle through deception.

55. For a discussion of this problem, see Second Interim Report of Neal Batson, Court-Appointed Examiner at 18–19, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. Jan. 21, 2003); SMITH & EMSHWILLER, *supra* note 19, at 78, 162.

II. ENRON'S DECEPTIONS

A. Enron's Financial Statements: An Introduction

How do you know if a company is successful or not? In the past, you could actually use a company's product or service, or talk to persons who did, and judge for yourself. If, for example, you were considering investing in a toothpaste company, you could try the toothpaste and see if it was an effective product. Indeed, the first time I read a book on investing, back in the 1980s, investment guru Peter Lynch recommended just this approach. In today's world of multinational conglomerate corporations with radically diverse product and service offerings, this method is useless for all but the smallest companies. Today, investors trying to decide whether or not to invest in a company have only one real option: to search for and read as much information about a company as possible. Interestingly, however, there are very few objective sources of information available to investors about any particular company. Instead, investors, stock analysts, and business journalists are forced to base their judgments largely upon the company's own statements—its press releases, annual meeting statements, stock analyst presentations, and, above all, the financial statements it files with the SEC. The fact that we now rely almost exclusively on information provided by large companies themselves to judge their operations is a dangerous development. In the Enron case, investors were not aware that Enron was heavily in debt and losing money fast for a very simple reason: Enron did not tell them.

The most important way in which companies communicate with investors is through the mandatory securities reporting system established by the Securities Exchange Act of 1934 and overseen by the SEC. Under this system, publicly traded companies file mandatory financial statements with the SEC at the end of each quarter, and these reports are then made available to investors and analysts.[56] These reports, referred to by investors and securities lawyers as "10-Qs" and "10-Ks,"[57] inform investors about a company through two different mechanisms. First, companies provide a narrative description of their operations and new initiatives during the relevant reporting period in a "Management's Discussion

56. 15 U.S.C. § 78o(d) (2000). For a primer on securities reporting requirements, see LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 471–477 (4th ed. 2001).

57. Companies file SEC Form 10-Q at the conclusion of the first three quarters of the year, and a Form 10-K, covering the entire year, at the conclusion of the fourth quarter. Companies must also file Form 8-Ks after the occurrence of specified events of an extraordinary character that have not been previously reported.

and Analysis of Financial Condition and Results of Operations," or "MD&A."[58] Second, the company supports this narrative by disclosing hard financial data covering basic performance metrics, such as the amount of the company's debt, revenue, and cash flow.[59] Companies are required to report information accurately and in compliance with "generally accepted accounting principles," or "GAAP."[60] They are also required to report any additional "material" information needed to ensure that their disclosures in the MD&A or metric sections are not misleading.[61] The materiality requirement means, in practice, that companies

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58. *See* Management's Discussion and Analysis of Financial Condition and Results of Operations, 17 C.F.R. § 229.303 (2004). According to the SEC, the MD&A is necessary because:

> a numerical presentation and brief accompanying footnotes alone may be insufficient for an investor to judge the quality of earnings and the likelihood that past performance is indicative of future performance. MD&A is intended to give the investor an opportunity to look at the company through the eyes of management by providing both a short and long-term analysis of the business of the company.

Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Securities Exchange Act Release No. 33,6835, 54 Fed. Reg. 22,427, 22,428 (May 18, 1989), *available at* http://www.sec.gov/rules/interp/33-6835.htm.

59. *See generally* SEC Regulations S-K and S-X, 17 C.F.R. §§ 210, 229 (2004) (detailing requirements for financial statements).

60. LOSS & SELIGMAN, *supra* note 56, at 471, 474. The SEC has statutory authority to set accounting principles. *See, e.g.*, Securities Exchange Act of 1934 § 13(b)(1), 15 U.S.C. § 78m(b)(1) (2000); Securities Act of 1933 §19(a), 15 U.S.C. § 77s(a) (2000). The SEC has delegated this task since 1973 to the Financial Accounting Standards Board, or FASB, whose members are appointed by an oversight body comprised of major stakeholders, including business executives, investors, and accountants. FASB promulgates standards which serve as the basis for GAAP. For a discussion of this process, see *Concerning Recent Events Relating to Enron Corporation: Hearing Before the Subcomm. on Capital Mkts., Ins., & Gov't Sponsored Enters. of the House Comm. on Fin. Servs.*, 107th Cong. 93–94 (2001) [hereinafter Herdman Testimony] (testimony of Robert K. Herdman, Chief Accountant of the SEC); STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 17 (Comm. Print 2002). For an excellent critique of FASB's performance in this task, see *Concerning Accounting and Disclosure Reform and Oversight: Hearing Before the House Comm. on Fin. Servs.*, 107th Cong. 458–59 (2002) [hereinafter Breeden Testimony] (testimony of Richard C. Breeden, former Chairman of the SEC).

61. Securities Exchange Act of 1934 § 12b-20, 17 C.F.R. § 240.12b-20 (2004). Compliance with disclosure requirements is policed by the SEC pursuant to the antifraud provisions set forth in section 10(b) of the Securities Exchange Act and Rule 10b-5, codified at 17 C.F.R. § 240.10b-5. Section 10(b) provides, in relevant part, that "it shall be unlawful for any person directly or indirectly . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance. . . ." 15 U.S.C. § 78j(b). Rule 10b-5 provides, in relevant part, that:

> [i]t shall be unlawful for any person, directly or indirectly . . . (a) [t]o employ any device, scheme or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or

must disclose all major developments, both good and bad. The importance of these publicly filed financial statements to equity and debt markets cannot be overestimated. Ultimately, virtually all business news and analysis available to lenders and investors is based on these quarterly SEC reports.

In the Enron case, the investing public did not know Enron was falling apart because from 1997 onward, its 10-Qs and 10-Ks were grossly inaccurate.[62] In late 2001, William Powers, Dean of the University of Texas Law School, joined the Enron Board of Directors and began to investigate the true condition of the company. What he found, he later testified before Congress, was "appalling": a "systematic and pervasive attempt by Enron's Management to misrepresent the Company's financial condition."[63]

Enron bankruptcy examiner Neil Batson reached the same conclusion. According to Batson, Enron's narrative descriptions of company operations in its 10-Q and 10-K MD&A disclosures were misleading. Enron, Batson found, kept important "bad news" to itself, hiding the corporation's growing economic vulnerability, its reliance on structured finance transactions for liquidity, and the extent of its financial obligations to lenders. This was accomplished through both simple nondisclosure and by "incomplete and uninformative" footnotes that were virtually incomprehensible.[64]

Ultimately, however, a company's narrative disclosures are less important than the hard financial data included in the financial statements. Even if a company wants to put a positive spin on its setbacks, numbers do not lie, right? Alas, the Enron case demonstrates conclusively that if a company wants to deceive investors, it can easily do so by manipulating its publicly disclosed financial data. This is the crux of the Enron case.

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would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

62. STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 30 (Comm. Print 2002) ("Enron's financial statements back to at least 1997 contain inaccurate, and likely fraudulent, information.").

63. *The Enron Collapse: Implications to Investors and the Capital Markets: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. of the House Comm. on Fin. Servs.*, 107th Cong. 211 (2002) (testimony of William C. Powers, Chairman, Special Investigative Committee of the Board of Directors of Enron Corp.) [hereinafter Powers Testimony].

64. Second Interim Report of Neal Batson, Court-Appointed Examiner at 55–56, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. Jan. 21, 2003).

From a financial reporting perspective, Enron faced two "challenges." First, the company was making very little money the old fashioned way, by selling a product or service, particularly from its new business initiatives. To state the obvious, revenue and cash shortfalls matter to investors and lenders. Revenue and cash flow are two of the most important metrics that companies report in their 10-Qs and 10-Ks, and if a company reports bad numbers, or numbers that are positive but lower than expected, investors and lenders will head for the hills. Second, Enron desperately needed cash—billions of dollars of cash—to meet the company's exploding costs, compensate for its poor business performance, and fuel its diversification strategy. If, however, the company met these cash needs through traditional means, such as additional stock offerings or loans, investors reading Enron's financial statements would quickly realize that Enron was not making enough money to pay for its operations and the company's stock price and credit rating would decline accordingly. Enron, then, faced a conundrum. It could either report its financial condition accurately and take its lumps in the market, with potentially disastrous results for its credit rating and trading business, or it could try to conceal its true financial position.

Enron, fatefully, chose the second option.[65] In the late 1990s, senior Enron executives set out to manipulate Enron's reported financial data to improve the company's apparent financial success. As Enron CFO Andrew Fastow explained in his guilty plea allocution to federal securities fraud charges, "While CFO, I and other members of Enron's senior management fraudulently manipulated Enron's publicly reported financial results. Our purpose was to mislead investors and others about the true financial position of Enron and, consequently, to inflate artificially the price of Enron's stock and maintain fraudulently Enron's credit rating."[66] Enron Treasurer Ben Glisan confirmed these facts in his own guilty plea allocution, stating: "I and others at Enron engaged in a conspiracy to manipulate artificially Enron's financial statements."[67]

How did this fraud work? In a rudimentary securities fraud case, a company wishing to mislead investors simply reports inaccurate financial data to the SEC and to investors. This, for example, is what happened at

65. Neal Batson, the Enron bankruptcy examiner, has reached the same conclusion about the factors that motivated Enron's efforts to manipulate its financial statements. *See id.* at 15 (stating that Enron manipulated its financial statements as a result of need for cash and to maintain credit rating).

66. Plea Agreement Exhibit A, United States v. Fastow, Cr. No. H-02-0665 (S.D. Tex. Jan. 14, 2004) (statement of defendant, dated January 4, 2004).

67. Plea Agreement Exhibit I, Glisan Statement—Count Five, United States v. Glisan, Cr. No. H-02-0665, (S.D. Tex. Sept. 10, 2003), *available at* http://news.findlaw.com/hdocs/docs/enron/usglisan91003dstmnt.pdf.

WorldCom. There, the company took billions of dollars in costs and improperly reported them as capital expenditures, a simple mechanism that transformed a $662 million loss in 2001 into a reported $2.4 billion profit.[68] Enron's deception was significantly more sophisticated.

B. Enron's Pre-Pay Transactions

Let's begin with Enron's biggest problem in the late 1990s: it needed to borrow billions of dollars without reporting the loans to investors. How do you borrow billions of dollars without disclosing that fact? One of Enron's methods of accomplishing this trick was to create a financial transaction called a "pre-pay."[69] Say, for example, that Enron needed to borrow $1 billion from a bank to meet its expenses or buy a steel mill in Thailand. Enron could simply borrow the money from a lender, but this debt, once reported on the company's 10-Q and 10-K statements, would lower the company's credit rating and alarm investors.[70] To avoid this outcome, Enron would offer to sell to major financial institutions energy futures for $1 billion.[71] At the same time, Enron would offer to buy back the same energy futures in one year for, say, $1.2 billion. The bank would agree to this proposal because for all intents and purposes the proposed transaction was a loan: the bank would provide Enron $1 billion for one year, and in return would receive the principal back plus $200 million in interest once the term of the loan was over.

For Enron, too, the pre-pay transactions were loans, functionally and practically: it borrowed money for a period of time and in return as-

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68. Kathleen F. Brickey, *From Enron to WorldCom and Beyond: Life and Crime After Sarbanes-Oxley*, 81 WASH. U. L.Q. 357, 369 (2003).

69. The pre-pay transactions are discussed in Second Interim Report of Neal Batson, Court-Appointed Examiner at 44–45, 58–66, *Enron Corp.*, No. 01-16034 (AJG). Because the structure of the pre-pays and other Enron-structured finance transactions was immensely complicated, I have simplified the transactions to a degree in order to make them comprehensible to persons lacking a background in structured finance. Thus, in the pages that follow, I typically conduct a functional analysis of the described transactions rather than describing all of the formal transactions steps taken by Enron and its counterparties. For example, most of Enron's finance deals were typically structured through use of multiple Special Purpose Entities, or SPEs, Enron affiliates created specifically to facilitate preferable accounting treatment. In my summaries, I have treated SPEs functionally, as a part of Enron itself, rather than formally, as technically quasi-independent entities. My effort to explain these and other Enron transactions in a straightforward manner has not, in my estimation, resulted in inaccuracy. For those interested in details of these and other Enron finance transactions, I recommend the four Bankruptcy Examiner's Reports.

70. Third Interim Report of Neal Batson, Court-Appointed Examiner at 14, *Enron Corp.*, No. 01-16034 (AJG); Second Interim Report of Neal Batson, Court-Appointed Examiner at 15, *Enron Corp.*, No. 01-16034 (AJG).

71. The figures in my example are made up to serve an illustrative purpose.

sumed obligations to pay the money back with interest. Since, however, Enron structured and labeled these debt transactions as "trades of energy futures," it would record the $1 billion it borrowed as cash flow from trading operations, and the $1.2 billion it owed as a "price risk management liability"—a derivative trading liability.[72] As a result, $1.2 billion that should have been reported to the SEC and investors as debt was hidden in the corporation's enormous multi-hundred billion dollar derivatives trading budget. Investors reading Enron's financial statements would have no way to learn that Enron was going further into debt.

How important were these pre-pays to Enron? According to the bankruptcy examiner, pre-pay transactions, primarily conducted with Citibank and JPMorgan,[73] became "the quarter-to-quarter cash flow lifeblood of Enron."[74] From 1992 to 2001, Enron borrowed at least $8.6 billion through pre-pays—money, according to the examiner, that should have been reported as debt.[75] Pre-pays increased in importance to Enron as the company headed toward bankruptcy. In 2000 alone, for example, pre-pays provided over fifty percent of Enron's reported cashflow funds from operations.[76] By June 2001, Enron was keeping over $5 billion in debt improperly hidden on its balance sheet as "price risk management liabilities."[77] These transactions violated GAAP, because they resulted in substantial underreporting of Enron's true debt position.[78]

C. Mark-to-Market Manipulation and Accounting Hedges

Pre-pays brought in badly needed cash, but the transactions led to a revenue loss. This would not have been a problem if Enron had substantial real revenue to report to investors and the SEC, but unfortunately, it did not. Thus, Enron faced another tough question: how do you find revenue to report to investors when you do not have cash coming in from sales of products and services? Enron's answer was, in part, to manipulate mark-to-market accounting.

Under traditional accrual accounting, a company typically records revenue when cash comes in the door from its customers in return for delivered goods and services. Not so under mark-to-market accounting

72. Second Interim Report of Neal Batson, Court-Appointed Examiner at 59, *Enron Corp.*, No. 01-16034 (AJG).

73. *Id.* at 59, 65. According to the bankruptcy examiner, Citibank and JPMorgan helped Enron structure the pre-pays, provided the funds, and helped create the SPEs designed to improve accounting treatment.

74. *Id.* at 45.

75. *Id.* at 58, 66.

76. *Id.* at 45.

77. *Id.* at 59, 66.

78. *Id.* at 66.

("MTM"). Under MTM, a company's assets are carried on the books not at purchase price, but at "fair value." Each quarter, companies using MTM value their assets and record quarterly changes in the fair value of those assets as gains or losses.[79] So, for instance, if a company using MTM originally bought ten units of a commodity at a unit price of $1, and the price of the commodity shot up to $2 in a particular quarter, the company would record $10 in revenue in that quarter, even though it had not sold the commodity in question. If the price subsequently dropped back to $1, and the company still owned the commodity, the company would report a $10 loss. Companies that are engaged almost exclusively in the trading of stocks, commodities or their derivatives often use MTM accounting because it arguably provides a more accurate picture of the company's true financial position. Unfortunately, the Enron case shows that in the wrong hands, MTM can be severely misused.

In 1992, after extensive lobbying, Enron received approval from the SEC to use MTM to value its natural gas trading business.[80] This made good sense at the time, for the value of natural gas, at least in the short-term, is not based on speculative estimates, but is set daily by the market. Over the course of the 1990s, however, and without SEC approval, Enron gradually began to use MTM to value much of its non-trading operations.[81] This led to chronic accounting abuses.[82]

MTM allowed Enron to record estimated future profits from transactions as current operating revenue long before the transactions actually generated any cash earnings.[83] For example, if Enron signed a long-term energy contract, it would estimate how much the contract might be worth over the lifetime of the deal and then record the estimated long-term profit as current revenue in the quarter the deal was signed. This situation created a strong incentive for Enron employees to enter into long-

79. For a brief discussion of MTM, see *id.* at 23.

80. *Id.* at 22–23; STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 31–32 (Comm. Print 2002); BRYCE, *supra* note 19, at 66–67; MCLEAN & ELKIND, *supra* note 19, at 41–42. Significantly, Enron promised during this lobbying effort that its MTM valuations of assets would not be based on subjective analysis, a promise which Enron violated repeatedly. *Id. See also infra* note 89 and accompanying text (analysis of Mariner investment).

81. Second Interim Report of Neal Batson, Court-Appointed Examiner at 23, *Enron Corp.*, No. 01-16034 (AJG); BRYCE, *supra* note 19, at 67–68.

82. For a brief but useful discussion of the ways in which MTM's emphasis on estimation of potential future profits leads to easy accounting manipulation, see George J. Benston, *The Regulation of Accountants and Public Accounting Before and After* Enron, 52 EMORY L.J. 1325, 1347–48 (2003). Perhaps one reason the SEC did not seek to curb Enron's unapproved expansion of MTM accounting is that it was not closely reviewing Enron's 10-Q and 10-K filings. *See infra* Part III.

83. This problem is discussed in Second Interim Report of Neal Batson, Court-Appointed Examiner at 26, *Enron Corp.*, No. 01-16034 (AJG).

term deals regardless of whether those deals would actually make money or not, as long as the employees could, through use of overly optimistic estimates, claim the deals would make money.[84] The fact that Enron bonuses were tied to the size of the estimated future profits, and not to a deal's actual performance over time, only made matters worse. In one case, Enron actually paid a customer $50 million up front in cash to induce the party to sign a long-term energy contract. This made sense for Enron, from a financial statement perspective, because it could use MTM to immediately record enormous revenue far in excess of the $50 million expense.[85] Indeed, since Enron used MTM to book all of its expected future revenue in the quarter a large transaction was signed, Enron employees often viewed making real profit as deals went forward as irrelevant.[86] This focus on generating paper revenue for reporting purposes, rather than generating actual cash flow and actual profits, exacerbated Enron's need to find cash elsewhere, through, for example, its pre-pays.

MTM abuses did not end when the initial "earnings" from a deal were recorded. Many of Enron's physical and contractual assets were *sui generis* and non-fungible or had value based on necessarily speculative assumptions about the long-term price of commodities. Since there was no clear and definitive market price for these assets, Enron was forced to "estimate" fair market value for MTM purposes.[87] Inevitably, Enron "estimated" that its assets were rising in value.[88] This allowed Enron to report the subsequent "gain" in estimated fair value as revenue on its financial statements. For example, Enron marked up its investment in Mariner Energy, a private oil and gas exploration company, from $185 million in 1996 to $367 million in 2001, and reported the difference as revenue. Later, after bankruptcy, Enron conceded that this figure was inflated by some $256 million.[89]

Of course, some of Enron's assets did have definite concrete market prices, and these posed another MTM "challenge": what do you do if the value of these assets declines? The correct answer, from an MTM accounting perspective, is simple: you record the decline in value as a loss. Enron had another idea. In 2000, Enron and LJM 2, a private investment

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84. STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 44 (Comm. Print 2002).

85. BRYCE, *supra* note 19, at 209.

86. *See id.* at 131, 134.

87. *See* Herdman Testimony, *supra* note 60, at 103–05, for a discussion of this process under MTM.

88. STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 33–34 (Comm. Print 2002).

89. MCLEAN & ELKIND, *supra* note 19, at 129.

fund created and run by Enron executives, created four special purpose entities—companies that exist only as names on transaction documents—called the "Raptors."[90] Enron then entered into hedging transactions with the Raptors, pursuant to which the Raptors would be obligated to pay Enron one dollar for every dollar in the decline in the price of certain highly speculative Enron investments.[91] This would allow Enron to offset any MTM losses from the investments with corresponding MTM gains from the increase in value of the Raptor obligations.

Not surprisingly, the assets covered by the Raptor hedges plummeted almost $1 billion in value in 2000, an enormous loss indicative of Enron's poor diversification strategy. Pursuant to the hedging agreements, however, the Raptors were obligated to pay Enron the same amount to offset the loss. This allowed Enron to convert some $954 million in losses into a reported $1.1 billion in income from the third quarter of 2000 through the third quarter of 2001.[92] As Enron board member William Powers later stated to Congress, the result of these transactions was that "more than 70 percent of Enron's reported earnings for this period were not real."[93]

Unfortunately, the Raptors did not provide a true economic risk hedge, but only an accounting hedge.[94] In setting up the Raptors, Enron had capitalized them using its own stock. Thus, the Raptors' ability to compensate Enron for its investment losses was tied directly to Enron's own stock price.[95] The scheme would "work" as long as Enron's stock price remained sufficiently high to ensure that the Raptors were solvent. If, however, Enron's stock price declined, the Raptors would become insolvent and Enron would have a serious problem on its hands.[96] The transactions inevitably ended in disaster in the fall of 2001 when Enron's stock price dropped rapidly, leaving the Raptors insolvent and Enron with no choice but to write off the entire mess with a $710 million pretax

90. For a discussion of the Raptor transactions, see First Interim Report of Neal Batson, Court-Appointed Examiner at 3–4, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. Sept. 21, 2002); Powers Testimony, *supra* note 63, at 213–14.

91. First Interim Report of Neal Batson, Court-Appointed Examiner at 3, *Enron Corp.*, No. 01-16034 (AJG).

92. Second Interim Report of Neal Batson, Court-Appointed Examiner at 106, *Enron Corp.*, No. 01-16034 (AJG); First Interim Report of Neal Batson at 3, *Enron Corp.*, No. 01-16034 (AJG); Powers Testimony, *supra* note 63, at 213–14.

93. Powers Testimony, *supra* note 63, at 214.

94. Third Interim Report of Neal Batson, Court-Appointed Examiner at 12, *Enron Corp.*, No. 01-16034 (AJG); Powers Testimony, *supra* note 63, at 212–13.

95. First Interim Report of Neal Batson, Court-Appointed Examiner at 3–4, *Enron Corp.*, No. 01-16034 (AJG).

96. This fact gave Enron's senior management a strong incentive to ensure that Enron's reported financial data looked strong, so that the stock price would remain high.

loss.[97] Disclosure of these facts by Enron on October 16, 2001—even remarkably hazy and partial disclosure—ultimately helped kill off the company.

The Raptor hedges violated GAAP. As Enron Treasurer Ben Glisan explained as part of his guilty plea, "this transaction violated existing accounting principles in that its form was misleading and was accounted in a manner inconsistent with its economic substance."[98] The transactions also violated federal criminal securities laws. Indeed, Enron CFO Andrew Fastow admitted in his guilty plea that the entire Raptors scheme was criminal, because the accounting hedge was "set up as a way to conceal the poor performance of certain Enron assets" and "misled investors by fraudulently improving the appearance of Enron's financial statements."[99]

D. Monetizations

Mark-to-market manipulations generated revenue on paper, but the company needed cash. Instead of relying exclusively on the pre-pays to meet this need, Enron began in 1998 to enter into another type of structured finance transaction, known as "monetizations," that generated both cash and reportable revenue. These transactions were, in essence, simple sales of financial assets. Enron, however, gave these "sales" a new twist.

Let's start with a simple example. Assume that Enron signed a contract with another company pursuant to which Enron agreed to sell the company energy over a twenty-year period. Using MTM, Enron could record the estimated future profits as revenue at the time of the deal, and then retain the contract and slowly try to collect its payments. This course produced good financial statement results but no immediate cash. Alternatively, Enron could try to "monetize" the contract—sell the expected revenue stream from the contract for a price calculated by totaling the estimated future profits and then subtracting a discount representing the time value of money and execution/performance risk. For example, if the contract was estimated to be worth $40 million in profit over the course of the contract's life, Enron might try to sell the contract to another energy company for, say, $25 million. If Enron could find a buyer, then Enron would get both badly needed cash and a nice boost for its fi-

97. First Interim Report of Neal Batson, Court-Appointed Examiner at 4 n.12, *Enron Corp.*, No. 01-16034 (AJG).

98. Plea Agreement Exhibit I, Glisan Statement—Count Five, United States v. Glisan, Cr. No. H-02-0665, (S.D. Tex. Sept. 10, 2003).

99. Plea Agreement Exhibit A at 3, United States v. Fastow, Cr. No. H-02-0665 (S.D. Tex. Jan. 14, 2004) (statement of defendant, dated January 4, 2004).

nancial statements, for it could record the $25 million as cash flow from operations.[100]

There is nothing wrong with monetizations—they are simply discounted sales of financial assets that transform future prospects into ready cash. Unfortunately, Enron's poorly managed expansion left it with few valuable assets to sell, and this led to serious monetization abuses. Enron, as we have seen, liked big deals, because big deals produced large and immediate reportable revenues under MTM accounting. Unfortunately, many of those "big deals" were actually revenue losers, and it is hard to find buyers for contracts or assets that lose money. How, then, do you get a buyer to buy something like an energy contract that may be, and probably is, ultimately worthless?[101] The answer? You provide the buyer a guarantee.[102]

In 2000, for example, Enron and Blockbuster, the video rental company, agreed to develop a home video-on-demand business.[103] This "business" never left the testing phase, generating only several thousand dollars in revenue after hundreds of millions of dollars in development costs.[104] Nevertheless, Enron was able to "sell" this business to the Canadian Imperial Bank of Commerce ("CIBC") in late 2000 and early 2001 for approximately $110 million dollars.[105] Why, one wonders, would a bank buy a highly speculative media delivery business for $110 million?

For one thing, Enron agreed to continue to control and operate the business through a subsidiary—CIBC would not have to do anything. More important, CIBC was guaranteed not to lose money. Under Enron's interpretation of the relevant accounting rules, Enron believed it

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100. This was managed through the fiction that Enron was in the business of buying and selling assets, so that the sale of such an asset was a normal business operation.

101. *See* First Interim Report of Neal Batson, Court-Appointed Examiner at 15–16, *Enron Corp.*, No. 01-16034 (AJG) (explaining that in many asset sale transactions, Enron needed to provide repayment guarantees because assets provided "insufficient cash flow to support the financing or may have been difficult to sell to third parties on acceptable terms").

102. *See* Plea Agreement Exhibit A at 2, *Fastow*, Cr. No. H-02-0665 (admitting that Fastow and others secretly agreed that LJM would not lose money when entering into transactions with Enron); Plea Agreement Exhibit I, Glisan Statement—Count Five, *Glisan*, Cr. No. H-02-0665 (admitting that LJM was guaranteed a prearranged profit); Second Interim Report of Neal Batson, Court-Appointed Examiner at 37–39, *Enron Corp.*, No. 01-16034 (AJG) (explaining that Enron retained obligation to repay substantially all of financing in its asset sale transactions); First Interim Report of Neal Batson, Court-Appointed Examiner at 14, *Enron Corp.*, No. 01-16034 (describing Enron obligation to pay back money received in asset sale transactions).

103. The Blockbuster transaction is discussed in Second Interim Report of Neal Batson at 29–32, *Enron Corp.*, No. 01-16034 (AJG).

104. *See id.* at 29 ("Enron did not have the technology to deliver [video-on-demand] on a commercially viable basis and Blockbuster did not have the rights to movies to be delivered.").

105. *See id.* at 30–32.

could treat the transfer of an asset to another business entity as a "sale" as long as the other entity took three percent of the ensuing business risk. Based on this interpretation, Enron guaranteed in writing that CIBC would receive at least ninety-seven percent of its money back after a specified term of years through a mechanism called a total return swap.[106] Still, why would a bank risk losing even three percent of its money? Again, the answer is another guarantee, this time orally and in secret, that CIBC would get all of its capital back plus interest, regardless of whether the "sold" asset made any money in the future or not. In short, the transaction, like the pre-pays, was a loan.[107] CIBC gave Enron $110 million, and Enron agreed to pay the money back with interest. Because, however, Enron treated the loan as an asset sale, it recorded the proceeds of the transaction—$110 million in the Blockbuster deal alone—as revenue from Enron Broadband Services ("EBS"), Enron's telecommunications division. The transaction thus served multiple purposes: it reassured Enron's investors that EBS had significant cash flow when in fact it did not; it boosted reported revenue for the company as a whole; it brought in actual cash to meet spiraling costs; and it kept $110 million in debt from being reported as debt.[108] Brilliant? Alas, the bankruptcy examiner has concluded that the Blockbuster deal and similar monetizations violated GAAP, the relevant accounting rules, because the outcomes reported to investors did not accurately reflect the substance of the transactions and because Enron did not report to investors the existence of its secret guarantees to repay lenders the capital Enron received from the "sales."[109] In short, loans must be accounted for as loans.

Interestingly, Enron discovered that even with guarantees, it could not convince lenders to "buy" certain assets. Starting in 1997, Enron solved this problem by creating its own investment funds to buy Enron's underperforming assets. These funds had names like "Chewco,"[110] "Whitewing," "LJM Cayman," and "LJM2."

The LJM transactions were deceptively simple. As Enron Treasurer Ben Glisan explained in his guilty plea to federal securities charges, "LJM enabled Enron to falsify its financial picture to the public; in re-

106. *See id.* at 109–10.

107. *See id.* at 107–08.

108. Enron split the $110 million over the fourth quarter of 2000 and the first quarter of 2001. The Blockbuster "revenue" was important to perceptions about EBS's business performance. In the fourth quarter of 2000, for instance, $53 million of EBS's reported $63 million in revenue came from the Blockbuster monetization—though investors were not told this fact. *See id.* at 31.

109. *Id.* at 39.

110. For Chewco, see BRYCE, *supra* note 19, at 137–143.

turn, LJM received a prearranged profit."[111] Here is how it worked. In the LJM transactions,[112] Enron executives raised money on Wall Street by promising that LJM would be able to cherry-pick the best investment opportunities from Enron, due to the close relationship between fund executives—including Enron's own CFO—and Enron.[113] LJM then bought underperforming assets from Enron with the money it had raised, giving Enron a badly needed infusion of cash.[114] Enron, in return, provided LJM with a secret oral promise that Enron would eventually buy the assets back from LJM for the purchase price plus a profit, regardless of whether the "sold" assets retained their value or not.[115] Enron liked these deals because it allowed Enron to "sell" assets that were otherwise unmarketable and report the resulting proceeds as cash flow from operations, giving its financial statements a badly needed illicit bump.[116] LJM and its investors liked the deals as well, because they resulted in enormous risk free profits. Indeed, Enron's CFO pocketed some $30 million from the deals.[117] The only persons who lost were Enron's investors, who had no idea what was happening.

Whitewing worked in a similar fashion.[118] Enron raised money for its Whitewing fund by secretly promising that Enron itself would repay the raised funds at a future date.[119] Enron then "sold" assets of limited or decreasing value to the Whitewing fund.[120] Enron was, in practice, both the buyer and the seller in the deals, and it remained the true equitable owner of the "warehoused" assets. However, it treated the transactions as sales. This allowed Enron to move valueless assets off its books while hiding substantial debt. The size of these "sales" was ultimately staggering. According to the bankruptcy examiner, Enron ultimately

111. Plea Agreement Exhibit I, Glisan Statement—Count Five, United States v. Glisan, Cr. No. H-02-0665, (S.D. Tex. Sept. 10, 2003).

112. For the LJM partnerships, see BRYCE, *supra* note 19, at 223–39.

113. *Id.* at 224 (noting that LJM2, the second and largest LJM fund, received investments from Merrill Lynch and Merrill Lynch executives, JPMorgan, Lehman Brothers, Citicorp, CSFB, and other major Wall Street firms); SMITH & EMSHWILLER, *supra* note 19, at 50.

114. MCLEAN & ELKIND, *supra* note 19, at 202–03.

115. Plea Agreement Exhibit A at 2, United States v. Fastow, Cr. No. H-02-0665 (S.D. Tex. Jan. 14, 2004) (statement of defendant, dated January 4, 2004); Plea Agreement Exhibit I, Glisan Statement—Count Five, *Glisan*, Cr. No. H-02-0665.

116. As Enron CFO Fastow recently stated in his guilty plea allocution, "[t]he purpose of these [LJM] transactions was to improve the appearance of Enron's financial statements by (1) generating improper earnings and funds flow; (2) enabling Enron to set inflated 'market' prices for assets; and (3) improperly protecting Enron's balance sheet from poorly performing and volatile assets." Plea Agreement Exhibit A at 2–3, *Fastow*, Cr. No. H-02-0665.

117. Powers Testimony, *supra* note 63, at 18.

118. Whitewing is discussed in Second Interim Report of Neal Batson, Court-Appointed Examiner at 73–75, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. Jan. 21, 2003).

119. *Id.*

120. BRYCE, *supra* note 19, at 156.

"sold" some $1.6 billion in underperforming assets to its own Whitewing fund.[121]

Monetizations with independent financial institutions like CIBC and Enron-created funds like LJM, Chewco, and Whitewing effectively disguised loans as sales. They allowed Enron to raise billions of dollars in capital markets and report that cash infusion as revenue or cash flow, not debt. The transactions violated GAAP because, among other things, Enron used the transactions to improperly overstate its "earnings" and never disclosed that it was ultimately obligated to repay the sums.[122]

Enron did an enormous number of these deals, and they had a significant impact on Enron's financial statements. The bankruptcy examiner concluded, for example, that in 2000, monetizations with outside parties like CIBC increased Enron's reported revenue by over $351 million, comprised thirty-six percent of Enron's reported revenue, and kept $1.4 billion in debt off Enron's balance sheet.[123] Similarly, the examiner concluded that "related party" deals with Chewco and the LJM funds alone helped Enron overstate its income by nearly $1.5 billion from 1997 to June 2001 and understate its debt by almost $900 million.[124]

E. Results of Enron's Financial Statement Manipulations

Pre-pays, MTM manipulation, and fraudulent "assets sales" were only the tip of the iceberg at Enron. Enron also engaged in many additional types of transactions designed, like those discussed above, to mislead investors into thinking that that the company had less debt, more

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121. Second Interim Report of Neal Batson, Court-Appointed Examiner at 42–43, *Enron Corp.*, No. 01-16034 (AJG). The proceeds from these asset transfers were declared as cash flow from operations even though Enron guaranteed that Whitewing would be made whole and that Enron retained all control, risk, and potential rewards from the assets before and after transfer. *Id.* at 75–78.

122. Plea Agreement Exhibit A at 2, *Fastow*, Cr. No. H-02-0665; Second Interim Report of Neal Batson, Court-Appointed Examiner at 43, 77, *Enron Corp.*, No. 01-16034 (AJG); Powers Testimony, *supra* note 63, at 18 (Enron's related party rules violated accounting rules). Enron's accounting treatment of its monetizations turned on the rules governing deconsolidation of SPEs, which results in off-balance sheet treatment. Prior to recent changes in FAS standards, a company could take an SPE off its balance sheet as long as it did not control the entity, an outside party made at least a three percent capital investment in the SPE, and the outside party possessed the risks and rewards of owning the SPE's assets. *See* Herdman Testimony, *supra* note 60, at 33–34. Enron violated these rules by, among other things, secretly guaranteeing outside parties that they would not lose money, so that the outside party did not have any true economic risk. As Herdman testified before Congress, "[i]f the investor's return is guaranteed or not 'at risk,' the transferor would be required to consolidate the SPE in its financial statements." *Id.* at 12.

123. Second Interim Report of Neal Batson, Court-Appointed Examiner at 38, *Enron Corp.*, No. 01-16034 (AJG).

124. *Id.* at 104.

revenue, and greater cash flow than it actually did.[125] Enron's efforts to manipulate and "improve" its financial statements had an enormous impact on investors' perceptions about the company. As bankruptcy examiner Neal Batson concluded,

> through pervasive use of structured finance techniques involving SPEs and aggressive accounting practices, Enron so engineered its reported financial position and results of operations that its financial statements bore little resemblance to its actual financial condition or performance. This financial engineering in many cases violated GAAP and applicable disclosure laws, and resulted in financial statements that did not fairly present Enron's financial condition, results of operations or cash flows.[126]

This manipulation was driven not only by Enron's desire to raise cash without issuing equity or incurring debt, but also by "the need to mask Enron's business failures."[127] The cumulative impact of these schemes on Enron's financial statements is almost unbelievable. For 2000, 96 percent of Enron's reported net income and 105 percent of its reported funds flow were the direct result of accounting manipulation. Using these same accounting schemes, Enron managed to keep almost $12 billion in debt off its books.[128] Financial data manipulation, in short, transformed Enron from a dog into a Wall Street champion.[129]

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125. *See id.* at 40–41, 43, 79–94, 95–103, 113–28. For example, Enron engaged in tax manipulation schemes, minority share financing designed to improperly boost reported net income while decreasing reported debt, and a host of additional transactions designed to improve Enron's reported financial position.

126. *Id.* at 15. *See also id.* at 39, 44, 77–78. Special purpose entities ("SPEs") are off-balance sheet vehicles that Enron used to hide the true nature of many of the transactions discussed above. For a discussion of SPEs, see Herdman Testimony, *supra* note 60, at 33–34.

127. *See* Third Interim Report of Neal Batson, Court-Appointed Examiner at 14, *Enron Corp.*, No. 01-16034 (AJG).

128. Second Interim Report of Neal Batson, Court-Appointed Examiner at 47, *Enron Corp.*, No. 01-16034 (AJG). The examiner's conclusions about Enron's manipulation of its reported financial data are probably conservative. On November 19, 2001, amidst swirling rumors and a growing scandal, Enron executives flew to New York to meet with bankers in a private meeting at the Waldorf to beg for additional credit to keep the company from imploding. There, the Enron executives admitted that Enron was actually over $38 billion in debt: this suggests that the company managed to hide over $25 billion in loans from investors by keeping those loans off its balance sheet. *Id.* at 9–10. The examiner reached a lower number by highlighting only the amount of debt kept off the books by manipulations it believed clearly violated GAAP.

129. *Id.* at 15.

III. GETTING PAST THE WATCHDOGS: WHY ENRON'S DECEPTION SUCCEEDED

Enron was a failing company propped up by accounting games, deceptive transactions, and financial statement manipulation. How is it possible that one of the ten largest companies in America could engage in serious financial deception for years without this fact being discovered and disclosed? The answer lies in the total failure of the watchdog institutions that collectively deter, detect, and disclose fraud in the securities market.

In the United States, investors rely on a complex and evolving public-private system of checks and deterrents to prevent companies and their executives from misleading the investing public. Independent auditors are supposed to review the company's financial statements to ensure they comply with GAAP and accurately reflect the company's business operations and financial position. Corporation boards of directors are supposed to monitor management's conduct and make sure that the company runs on a sound, legal, and profitable basis for the benefit of its stockholders. Securities analysts with major brokerage firms are supposed to watch the company closely and provide investors with an insightful, independent, objective assessment of the company's value and profitability. Securities regulators at the SEC are supposed to oversee the entire process, to make sure that companies play by the rules and provide investors with the complete and accurate information they need to make wise investment decisions. And finally, if all else fails, the federal criminal laws are supposed to deter serious fraud.

In the pages that follow, I want to examine the role of the watchdog institutions in the Enron debacle. I have two goals. First, I want to assess the degree to which the watchdogs met their responsibilities to shareholders and the investing public. I conclude that in the Enron case, all five watchdogs failed miserably, resulting in the deception of millions of investors and the ultimate loss of some $61 billion. Second, I want to try to understand *why* these institutions failed in their assigned tasks. This requires diagnosis, a process that is speculative to some degree, but necessary nevertheless if we want to understand what is actually happening in securities markets.

A. Independent Auditors: Arthur Andersen

As noted above, publicly held corporations are required to file annual financial statements, or 10-K forms, with the SEC.[130] These reports must be audited by an independent certified public accountant ("CPA").[131] The auditor is required to examine the corporation's books and determine whether the annual reports have been prepared in accordance with GAAP. The auditor then issues an opinion as to whether the financial statements, taken as a whole, fairly present the financial position and operations of the corporation for the relevant period.[132] Enron, of course, employed the now-defunct Arthur Andersen firm to perform this vital function.

An independent CPA auditing a publicly held company holds a position of unique responsibility. As the Supreme Court has explained,

> [b]y certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.[133]

How adequately did Andersen perform this "public watchdog" function? The answer is grim. Though Enron's financial statements violated GAAP in numerous ways and were fundamentally misleading,[134] Andersen issued Enron an "unqualified opinion" every year, the most favorable

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130. Securities Exchange Act of 1934, §§ 13(a)(2), 13(b) (2000), 17 C.F.R. §§ 249.310, 249.460 (2003). My discussion of Arthur Andersen's conduct in the Enron case draws extensively on BARBARA LEY TOFFLER, FINAL ACCOUNTING: AMBITION, GREED, AND THE FALL OF ARTHUR ANDERSEN (2003). Toffler, a former business professor at Boston University, Harvard, and Columbia, is an expert on corporate ethics and was an Andersen partner from 1995 to 1999. As a result, she is extremely well placed to discuss the cause of Andersen's performance failures in audits at Enron and other major companies in the decade before its prosecution for obstruction of justice and subsequent collapse. I should also note that my sister was a partner at Arthur Andersen before its demise. Because of the existence of this potential conflict of interest, I was not involved in the Andersen case brought by the Justice Department's Enron Task Force.

131. Qualifications of Accountants, 17 C.F.R. § 210.2-01.

132. The classic statement of these requirements and process is in United States v. Arthur Young & Co., 465 U.S. 805, 810–811 (1984).

133. *Id.* at 817–18.

134. *See* Third Interim Report of Neal Batson, Court-Appointed Examiner at 2, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. June 30, 2003).

report an auditor can give.[135] This suggests, obviously, that Andersen failed horribly in its duty to Enron shareholders and the investing public.[136]

To some degree, the Enron disaster was not Andersen's fault. Both the bankruptcy examiner and Grand Jury in the Southern District of Texas investigating the Enron collapse, speaking through its indictments, concluded that in numerous transactions, Enron executives deceived Andersen auditors about the nature and material terms of the deals in question in order to obtain favorable accounting treatment. For example, in some of Enron's related party deals and monetizations, Enron failed to disclose to Andersen the existence of secret agreements by which Enron guaranteed its transaction partners that they would not lose money, even if the assets Enron was selling ultimately lost their value. This deception is incredibly important: it suggests that Andersen was, to some degree, more sinned against than sinning.[137]

Nevertheless, Andersen's transgressions were extraordinarily serious in the Enron case. Neil Batson, the bankruptcy examiner, closely scrutinized the role of Andersen in Enron's demise. Batson determined, among other things, that Andersen auditors helped design the accounting manipulation schemes Enron used to mislead investors about its income, cash flow and financial position; that Andersen failed to use due care to investigate whether Enron's counterparties in monetization transactions actually had any money at risk in the transactions; and that Andersen failed in its duty to flag unusual transactions and controversial account-

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135. As the Supreme Court explained in *Arthur Young*, an unqualified opinion "represents the auditor's finding that the company's financial statements fairly present the financial position of the company, the results of its operations, and the changes in its financial position for the period under audit, in conformity with consistently applied generally accepted accounting principles." *Arthur Young*, 465 U.S. at 818 n.13.

136. For analyses which reach the same conclusion, see STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 27 (Comm. Print 2002) ("Andersen appeared to have failed miserably in its responsibility as Enron's auditor."); WILLIAM C. POWERS, JR. ET AL., REPORT OF THE INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 24 (2002) [hereinafter POWERS REPORT] ("Andersen did not fulfill its professional responsibilities in connection with its audits of Enron's financial statements, or its obligation to bring to the attention of Enron's Board (or the Audit and Compliance Committee) concerns about Enron's internal controls over the related-party transactions").

137. *See, e.g.*, Third Interim Report of Neal Batson, Court-Appointed Examiner at 41–42, *Enron Corp.*, No. 01-16034 (AJG); United States v. Rice, Cr. No. H-03-93-01 (S.D. Tex. June 30, 2003) (seven Enron executives charged with fraud relating to Enron's telecommunications unit; certain executives misled Arthur Andersen auditors). This deception may also foreclose the ability of Enron executives involved in the deception to assert professional reliance defenses in any criminal trials.

ing decisions for Enron's board.[138] Batson also noted that although Andersen was fully aware of the extent to which Enron's reported financial results were the product of accounting manipulation,[139] it did not insist on disclosure of these facts to investors and the SEC in Enron's 10-Ks.[140] For these reasons, Batson concluded that Andersen gave "substantial assistance" to Enron officers seeking to disseminate misleading financial information.[141] Andersen's failure, then, appears to have been comprehensive.[142] If Andersen had not assisted and enabled Enron's deception, Enron would have been caught years before 2001. Indeed, if Andersen had done its job, Enron would not have been able to deceive the investing public in the first place.[143]

Andersen's failure to protect Enron investors was not an isolated incident. Throughout the 1990s, prior to Enron's bankruptcy, Andersen auditors certified false or misleading financial statements for the management of a number of major American companies, including Sunbeam, Waste Management, and Baptist Association.[144] From 1992 to 1997, for example, Andersen helped Waste Management, the trash conglomerate, improperly inflate its earnings by $1 billion.[145] After Enron collapsed, we learned that Andersen was also involved in deceptive accounting at McKesson-HBOC (earnings inflated by $300 million),[146] Qwest (earnings inflated by $1.2 billion),[147] and WorldCom (earnings inflated by $9 billion) as well.[148] This pattern of misconduct—Assistant Attorney General Michael Chertoff, chief of DOJ's criminal division, called An-

138. Third Interim Report of Neal Batson, Court-Appointed Examiner at 40–41, *Enron Corp.*, No. 01-16034 (AJG). For example, Andersen helped structure deceptive transactions like the Raptor accounting hedges that had no economic purpose other than improving the company's reported financial position. *Accounting Reform and Investor Protection: Hearing Before the Senate Banking, Hous., and Urban Affairs Comm.*, 107th Cong. 375 (2002) (testimony of John H. Biggs) [hereinafter Biggs Testimony]; STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 22 (Comm. Print 2002).

139. Final Report of Neal Batson, Court-Appointed Examiner at 41–42, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. Nov. 4, 2003).

140. *Id.* at 41, 44–45.

141. *Id.* at 46–47.

142. *See id.* at 39–47.

143. *Id.* at 41. ("Without Andersen's certification of Enron's financial statements and various other approvals provided by Andersen, Enron would not have been able to employ those transactions to distort Enron's reported financial condition, results of operations and cash flow.").

144. TOFFLER, *supra* note 130, at 150–52.

145. The Waste Management case is discussed in BRYCE, *supra* note 19, at 234.

146. TOFFLER, *supra* note 130, at 156.

147. *Id.* at 142.

148. Rebecca Blumenstein et al., *After Inflating Their Income, Companies Want IRS Refunds*, WALL ST. J., May 2, 2003, at A1; Susan Pulliam & Jared Sandberg, *Leading the News: WorldCom to Revise Results Again*, WALL ST. J., Sept. 19, 2002, at A3.

dersen a "recidivist"—suggests that Andersen's failures in the Enron case were not an anomaly or the action of one or two rogue auditors, but were the result of a pervasive firm culture that repeatedly valued the interest of management in positive earnings statements over the interest of the shareholders and investing public in accurate information.

Auditing firms have a concrete incentive to place management interests before those of investors: auditors are running a business, and management pays their bills.[149] Traditionally, however, we have turned a blind eye to this problem, on the questionable ground that no reasonable auditor would risk damaging his or her reputation in return for mere auditing fees. This view received its classic expression in *DiLeo v. Ernst & Young*, a 1990 case from the Seventh Circuit. In *DiLeo*, the plaintiffs alleged that Ernst & Whinney, a precursor to Ernst & Young, had assisted banking giant Continental Illinois Bank in understating its nonperforming loans by $4 billion. Writing for the Court of Appeals, Judge Easterbrook opined that the plaintiff's suit was properly dismissed because it offered no basis to infer that Ernst & Whinney had knowingly assisted the fraud.

> The complaint does not allege that E & W had anything to gain from any fraud by Continental Bank. An accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work. Fees for two years' audits could not approach the losses E & W would suffer from a perception that it would muffle a client's fraud. And although the interests of E & W's partners and associates who worked on the Continental audits may have diverged from the firm's, covering up fraud and imposing large damages on the partnership would bring a halt to the most promising career. E & W's partners shared none of the gain from any fraud and were exposed to a large fraction of the loss. It would have been irrational for any of them to have joined cause with Continental.[150]

Would it be "irrational" for an auditing firm to risk its reputation by certifying misleading financial statements in return for auditing fees?

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149. As Roman Weil, Professor of Accounting at the University of Chicago Graduate School of Business, testified before the House Energy and Commerce Committee, "The basic conflict occurs because the audited pays the auditor and, in practice, selects the auditor." *Lessons Learned from Enron's Collapse: Auditing the Accounting Industry: Hearing Before the House Comm. on Energy and Commerce*, 107th Cong. 86 (2002) [hereinafter *Lessons Learned*] (statement of Roman Weil, Professor of Accounting, University of Chicago Graduate School of Business).

150. DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990) (citation omitted). Other courts have followed Easterbrook's reasoning, viewing the idea that auditing firms would assist in fraud in return for fees "irrational." *See, e.g.*, Melder v. Morris, 27 F.3d 1097, 1103 (5th Cir. 1994) (Jones, J.).

Easterbrook's conclusion is based on two assumptions: that the risk of a rogue auditing firm getting caught and damaging its reputation is relatively high, and that the financial incentive to engage in misconduct is relatively low. These assumptions may have been true in the past. Arthur Andersen, for example, voluntarily chose not to audit savings and loan associations long before the S&L crisis broke in the 1980s because of concerns about potential misconduct in that sector of the economy.[151] The Enron case, however, suggests that both of these assumptions may be false in the current market.[152]

Let's start with an assessment of the incentive: the need for auditing firms to earn fees in a competitive marketplace. In the 1990s, corporations were under increasing pressure to report positive quarterly financial numbers to Wall Street, and this may have created a demand at companies like Enron for "flexible" auditors.[153] At the same time, competition exploded in the auditing business, putting immense pressure on auditing firms to retain business.[154] This fact may have been critical in the Enron case, for the Enron audit fee alone was worth $25 million per year to Andersen, and thus represented an important revenue stream for the auditing firm.[155]

Arthur Andersen partners may have felt this competitive pressure more keenly than other auditors because of the firm's recent history. By 1999, Andersen had the smallest auditing business of the Big Five ac-

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151. TOFFLER, *supra* note 130, at 19.

152. The force of reputational constraints in the auditing field is analyzed in depth in Robert A. Prentice's excellent article, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. REV. 133 (2000) (arguing that reputational constraint is often insufficient to check auditor misconduct).

153. This desire for "flexible auditors" may also have stemmed from increased use of stock options to compensate management, which gave management increased interest in inflating earnings so as to keep the company's stock price high.

154. TOFFLER, *supra* note 130, at 48; Prentice, *supra* note 152, at 206.

155. As former SEC Chairman Richard C. Breeden testified before Congress:

> [H]ad Arthur Andersen not been performing any consulting work, its pure audit fee of $25 million per year would have been more than large enough to create powerful incentives for the managers at Andersen to give the client the accounting treatment it wanted for its SPEs. Unlike consulting fees, which are one time assignments, the audit is generally viewed as a long-term engagement. On average, audit engagements at Coopers & Lybrand when I was there lasted nearly twenty years. Thus, the $25 million annual audit fee would have a present value much greater than $25 million in one time consulting business. Therefore, even if firms performed no consulting work whatever, there would still be issues of the willingness of the auditors to antagonize a big client determined to use accounting games to overstate income.

Breeden Testimony, *supra* note 60, at 469. *See also* Joseph F. Morrissey, *Catching the Culprits: Is Sarbanes-Oxley Enough?*, 2003 COLUM. BUS. L. REV. 801, 840 (auditing fees alone are strong incentives for auditing firm to compromise objectivity); Prentice, *supra* note 152, at 204–07 ("the client's economic clout greatly influences the [auditing] firm's judgment").

counting firms, with the slowest rate of growth.[156] Andersen partners had also recently taken a major revenue hit. In 1997, Andersen Consulting, now Accenture, split off from Arthur Andersen, stripping Arthur Andersen partners of a major source of profits and forcing them to try to expand their own consulting business.[157] Obviously, auditing clients like Enron were a major source of potential consulting revenue for Andersen. As a result, Andersen auditors might have reasonably concluded that if they alienated Enron management by insisting on strict application of accounting rules, Enron might decline to provide lucrative consulting fees.

Barbara Ley Toffler, a former business and management professor at Harvard and Columbia business schools and an expert on business ethics, worked as a partner at Arthur Andersen from 1995 to 1999. Toffler watched the impact of increased competition and the Andersen Consulting split on Arthur Andersen's firm culture. Her conclusion? Because of the pressure to retain major auditing clients and increase consulting fees, "clients had become too valuable to defy."[158] As a result, Andersen was transformed into "a place where the mad scramble for fees had trumped good judgment."[159]

For Andersen, Enron represented over $52 million per year in auditing and consulting billing.[160] Indeed, Enron was Andersen's largest client in 1999, with a phenomenal eighty-eight percent fee growth rate.[161] These facts gave Andersen a very strong incentive to keep Enron happy.[162] Did this effect Andersen's auditing judgment? The case of Carl Bass is instructive. Bass was an Andersen partner and a member of Andersen's Professional Standards Group, which provided guidance to Andersen auditors working on difficult issues. Bass opposed Enron's proposed accounting treatment of certain high impact transactions, including the Raptor accounting hedges discussed in Part II above, which converted approximately $1 billion in losses into $1 billion in gains. In response, Enron complained to Andersen and had Bass removed from the Enron audit.[163] The fact that Andersen succumbed to this pressure and

156. TOFFLER, *supra* note 130, at 98.

157. *Id.* at 93.

158. *Id.* at 62.

159. *Id.* at 6.

160. STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 22 (Comm. Print 2002).

161. Third Interim Report of Neil Batson, Court-Appointed Examiner at 39, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. June 30, 2003).

162. *See* Prentice, *supra* note 152, at 210 (discussing a study showing that "auditors were more likely to violate professional norms when dealing with a large client").

163. BRYCE, *supra* note 19, at 238; TOFFLER, *supra* note 130, at 212.

removed Bass clearly suggests that pleasing clients was more important to Andersen than providing accurate and principled auditing services. In sum, the financial incentives for accountants to help firms mislead investors currently seems, *contra* Easterbrook, quite strong.

Easterbrook may also have overestimated the risk to auditors of getting caught if they engaged in misconduct. In *DiLeo*, Easterbrook assumed, without analysis, that this risk is sufficiently high to outweigh auditor incentives to place the interests of management before that of shareholders and the investing public. If this is correct, why, one wonders, was Andersen not deterred from misconduct in Enron, WorldCom, Sunbeam, Waste Management, Qwest, and other major Andersen-related auditing fraud cases? The answer, put bluntly, is that the deterrents in place in the 1990s actually provided no real deterrence at all.

Prior to 2002, auditors faced potential investigation, disclosure and punishment from four sources: criminal prosecutors, the SEC, the now-defunct Public Oversight Board, and individual investors. An auditing firm assessing the "threat" from these sources in the late 1990s, when Enron began to manipulate its financial statements, might have reasonably concluded that the risk of discovery and disclosure from these sources was minimal. The potential risk of criminal prosecution was and remains almost nil.[164] SEC enforcement action was and remains slow, the penalties imposed minimal.[165] And self-regulation and oversight by the accounting profession itself—an idea we have now abandoned in the wake of Enron and WorldCom—was, unfortunately, a bad joke.[166]

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164. To my knowledge, no major accounting firm has ever been charged criminally for helping a corporation manipulate its financial statements. (Arthur Andersen was prosecuted, of course, but for obstruction of justice, not for securities fraud). My sense is that this prosecutorial caution stems from three related aspects of auditing cases: (1) prosecutors believe auditors can easily hide behind "professional judgment" in auditing fraud cases, making convictions difficult to obtain; (2) in most financial statement fraud cases, the government is more interested in prosecuting management than auditors, because management is typically viewed as being more at fault; and (3) when prosecuting management, prosecutors do not want to alienate auditors—potentially very important witnesses—by seeking indictments against individual auditors or the auditing firm.

165. *See generally* Benston, *supra* note 3, at 1344–47 (attributing recent auditing scandals to, inter alia, absence of punishment of auditors committing misconduct by SEC). Even when the SEC does act, it does so in a manner unlikely to produce any deterrent effect. In the Waste Management case, for example, the company began to manipulate its earnings statements in 1992, but Andersen was not forced to settle the case with the SEC until June 2001, and then it only paid $7 million without admitting fault. There is no evidence that this settlement damaged Andersen's reputation in any significant way: there was, for example, no measurable flight from Andersen by major auditing clients. Moreover, the $7 million Waste Management agreement was much lower than the fees Andersen had gained for being Waste Management's auditor in the first place.

166. Prior to 2002, the accounting profession regulated its own performance through the now-defunct Public Oversight Board ("POB"). The POB was created in 1977 to supervise peer review of accounting firms. Under the peer review program, accountants from one firm

Because the threats posed by prosecution, SEC action, and professional discipline were and are so remote, the only real functional deterrent to auditor misconduct has traditionally come from shareholder lawsuits. In the 1990s, however, at the same time that pressures on auditors to cave in to management were increasing, Congress and the judiciary were making it much more difficult for shareholders to bring these suits. Acceptance of Judge Easterbrook's reasoning in *DiLeo* by other courts[167] meant that plaintiffs suing auditing firms were generally required to show that the auditors had profited in some way from aiding company fraud beyond the mere reception of auditing fees—even though these fees may, in fact, have been all the incentive a firm needed. In 1994, the Supreme Court made matters worse. In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,[168] the Supreme Court reversed twenty-five years of practice and precedent in eleven federal circuits and held that auditors could not be held liable in private causes of action for aiding and abetting securities fraud.[169] And in 1995, after extensive lobbying by the accounting profession, Congress passed the Private Securities Litigation Reform Act ("PSLRA") over President Clinton's veto. PSLRA tightened securities fraud pleading requirements, limited discovery prior to summary judgment, and eliminated the ability of plaintiffs in securities fraud cases to seek treble damages through civil Racketeer Influenced and Corrupt Organizations Act ("RICO").[170] Collectively, these actions by the judiciary and Congress significantly decreased lawsuits against auditors, and thus decreased the potential deterrent effect of private litigation.

Two additional factors may have also impacted Andersen's integrity at Enron. Enron's financial statement manipulation increased in intensity

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would assess another firm's quality control systems. *See* Herdman Testimony, *supra* note 60, at 95. John Biggs, a former trustee of POB, testified before Congress that peer reviews are "a weak self-regulatory tool, and they appear to be universally criticized as inadequate." Biggs Testimony, *supra* note 138, at 376. Biggs also noted that the accounting profession was unwilling to change its practices in response to POB initiatives. Biggs stated, in summary, that "[n]o one will really miss us." *See id.* at 376–77. According to Toffler, the peer review process was merely a "backslapping exercise." TOFFLER, *supra* note 130, at 176. Deloitte & Touche, for example, gave Arthur Andersen a clean bill of health just weeks before Enron went bankrupt. Richard C. Breedon, former Chairman of the SEC concurred, testified before Congress that "[t]he POB was never an effective body." Breeden Testimony, *supra* note 60, at 480. For a discussion of poor performance of self-regulation by the accounting profession, see David S. Hilzenrath, *Auditors Face Scant Discipline, Review Process Lacks Resources, Coordination, Will*, WASH. POST, Dec. 6, 2001, at A1.

167. *See* cases cited in Prentice, *supra* note 152, at 133, 136–37, 137 n.24.

168. 511 U.S. 164 (1994).

169. For a good discussion of the *Central Bank* case, see Morrissey, *supra* note 155, at 815–20.

170. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995). For a brief discussion of PSLRA, see Morrissey, *supra* note 155, at 804–05, 825–34.

in the late 1990s as the company's financial problems increased.[171] This might have led to a "boiled frog problem." According to popular legend—I cannot say that I have tried this myself—a frog thrown into boiling water will jump out of the pot, but a frog placed in tepid water and subjected to slow but steady increases in heat will calmly boil to death before it understands what is happening. At Enron, the boiled frog may have been Andersen. Faced with a strong need to keep Enron's management happy, Andersen may have agreed to ignore a small amount of earnings management in the mid-1990s. As time went on, and Enron's management gradually increased its use of accounting gimmicks to pump up its financial statements, Andersen auditors may have been insensitive to the degree to which this gradual escalation of earnings management had led to the creation of totally misleading 10-Ks. Alternatively, Andersen auditors may have been aware that Enron's manipulation was increasing, but having agreed to ignore a small number of unprincipled transactions, they may have found it difficult to find a principled basis to object when Enron expanded its use of such transactions. In short, like frogs in a hot pot, auditors in Andersen's shoes may have real trouble preventing slow but gradual increases in accounting abuses by management.[172]

Second, most auditing firms retain clients for decades.[173] Indeed, Fortune 1,000 corporations currently retain their auditors for an average of twenty-two years.[174] This meant that Andersen auditors had little fear that another auditing firm was going to be reviewing their work for many years to come. This fact, in turn, may have decreased Andersen's concern that its "compromises" with management would ever be discovered.

Andersen's misconduct at Enron, in sum, was not an aberrant act.[175] Rather, it occurred as part of a pattern of recurrent deception and ac-

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171. STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 24 (Comm. Print 2002).

172. For a discussion of this problem, more commonly referred to as "commitment bias," see Donald C. Langevoort, *Seeking Sunlight in* Santa Fe's *Shadow: The SEC's Pursuit of Managerial Accountability*, 79 WASH. U. L.Q. 449, 486 (2001).

173. *See* Breeden Testimony, *supra* note 60, at 469 (when he served at major accounting firm, average auditing engagement was close to twenty years).

174. United States General Accounting Office, Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation, GAO-04-216, 6 (2003), *available at* http://purl.access.gpo.gov/GPO/LPS42491.

175. Nor, it is important to state, was Andersen the only major accounting firm responsible for major audit failures. PricewaterhouseCoopers audited Microstrategy; Ernst & Young audited Cerdant; KPMG audited Rite-Aid and Xerox (restatement of five years of revenue by $6.4 billion); and Deliotte & Touche audited Adelphia. *See* STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 27 (Comm. Print 2002). On Xerox, see Kathleen Day, *Xerox*

counting abuse. That pattern of misbehavior was the result of market forces and regulatory trends. As competition increased in the auditing market, providing greater incentives for auditors to compromise their standards, Congress and the courts concurrently decreased deterrence by limiting the ability of shareholders to sue. Given this regulatory and competitive context and Andersen's own market position and firm history, Andersen's poor auditing performance at Enron and other companies should, perhaps, have been expected.

B. The Enron Board of Directors

Though the American public generally thinks of the CEO as the ultimate authority within a corporation, the law actually imposes this duty on the corporation's board of directors.[176] Directors are charged with monitoring management's performance on behalf of the corporation's investors.[177] Like embedded auditors, they can monitor a company from the inside. Unlike auditors, however, they occupy an empowered position. As we have seen, auditors may desire to avoid confrontation with their clients because of market pressure and the fear of losing fees. The board of a major company, in contrast, is generally filled with powerful people possessing a right to have management answer their questions.

The Enron board's performance is best judged through an analysis of its role in the LJM transactions. In 1999, Enron decided to expand the use of asset sales to manipulate its financial statements by creating the LJM funds. The LJM funds were capitalized by Wall Street but managed by Enron's own CFO. Over the next few years, the LJM funds would engage in a large volume of deals with Enron, puffing up Enron's financial statements and enriching both Enron's CFO and LJM's Wall Street investors. The LJM funds played a critical role in the Enron collapse. As noted above, the related party transactions with the LJM funds

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Restates 5 Years of Revenue: '97–'01 Figures Were Off By $6.4 Billion, WASH. POST, June 29, 2002, at A1; Claudia H. Deutsch, *Xerox Revises Revenue Data, Tripling Error First Reported*, N.Y. TIMES, June 29, 2002, at C1.

176. *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (Del. 1986) ("The ultimate responsibility for managing the business and affairs of a corporation falls on its board of directors.").

177. Corporation directors are fiduciaries and owe shareholders and the company itself duties of care and loyalty. The duty of loyalty requires directors to place the interests of the corporation before the interests of others, and to be independent and objective when reviewing corporate policy. The duty of care requires directors to act in good faith, with the diligence that an ordinarily prudent person in a similar position would exercise under similar circumstances. *See, e.g.*, Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367 (Del. 1993) (duty of care and loyalty imposed on fiduciaries); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (defining duty of care); Guth v. Loft, Inc., 5 A.2d 503, 511 (Del. 1939) (defining duty of loyalty).

radically altered Enron's apparent financial position and operational performance, and disclosure of the nature, purpose and terms of the deals in October 2001 by the *Wall Street Journal* ultimately triggered the company's collapse.[178] If, then, one wanted to identify one primary culprit in Enron's demise, creation of the LJM funds would be a leading candidate.

The most significant fact to keep in mind as one assesses the performance of the Enron board of directors is that the board was the only watchdog institution with both a clear duty and a clear opportunity to stop the LJM transactions before they took place. Related party transactions inherently involve potential conflicts of interest. The LJM transactions, for example, posed a conflict because they involved negotiations and subsequent payments between Enron and investment funds created and managed by Enron's own CFO.[179] As a result of this arrangement, the CFO occupied a position in which his fiduciary responsibilities to Enron and its shareholders frequently conflicted with his duties to maximize returns to LJM's investors. Because of this conflict, which violated Enron's code of ethics, Enron's management was required to present the unusual LJM arrangement to Enron's board of directors for approval.[180] Had the board declined to approve the deals and the necessary ethics waiver, Enron might never have gone bankrupt. Alas, the board signed off on the deals, putting Enron firmly on the path toward bankruptcy.[181]

The board of directors made two fatal mistakes in their review of the LJM arrangement. First, the board should never have approved self-dealing between the corporation and a fund led by the corporation's CFO: the conflict of interest was simply too severe. As former SEC Chairman Richard Breeden later testified before Congress, "[a]ny conflict of interest on the part of the CFO is inherently extremely dangerous, as this is the person who has the institutional capability to circumvent review by the board and the outside auditor."[182] Even Arthur Andersen thought the LJM setup was crazy. A 1999 e-mail from one Arthur Andersen partner to another says it all: "[w]hy would any director in his or her right mind ever approve such a scheme?"[183] The Powers Report, which was issued by a special investigative committee of the Enron

178. *See* First Interim Report of Neil Batson, Court-Appointed Examiner at 9, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. Sept. 21, 2001) (disclosure of related party deals precipitated crisis in public confidence that led to bankruptcy).

179. POWERS REPORT, *supra* note 136, at 8–9, 71.

180. *See id.* at 69, 72.

181. *Id.* at 9.

182. Breeden Testimony, *supra* note 60, at 472.

183. SMITH & EMSHWILLER, *supra* note 19, at 293.

board of directors after Enron's bankruptcy, concurs in this judgment.[184] The LJM transactions, the report notes, were "fundamentally flawed" and "should not have been undertaken in the first place."[185] Significantly, the board's decision to approve the LJM arrangement was not the product of deception by Enron's management. As the Powers Report notes, the "Board approved [the CFO]'s participation in the LJM partnerships with full knowledge and discussion of the obvious conflict of interest that would result."[186]

After the board approved the LJM arrangement, it had a duty to carefully monitor the situation to ensure that the deals with LJM were appropriate, that the substance and purpose of the deals were disclosed to shareholders, and that no one profited from the deals at Enron shareholders' expense. Here, too, the board failed miserably. The board assigned its own Audit and Compliance Committee to conduct an annual review of all LJM transactions. This review, however, was meaningless—a rubberstamp. The board, according to Powers, never conducted "any meaningful examination of the nature or terms of the transactions," and it "did not give sufficient scrutiny to the information that was provided to it."[187] Worse, the board completely ignored one of the central problems inherent in the LJM transactions: the fact that Enron's own CFO was profiting from the deals at the expense of Enron shareholders. The Powers Report notes that though the board's Compensation Committee was supposed to review the CFO's profits from the LJM deals, the board never asked the CFO how much he was making from the arrangement until the *Wall Street Journal* broke the LJM story in October 2001.[188] This error was critical, for the CFO, it turns out, had fraudulently pocketed at least $30 million from the deals.[189] Had the board asked about

184. In late 2001, as the company crumbled, Enron asked William Powers, Jr., Dean of the University of Texas Law School, to join the Enron board and supervise an investigation into transactions between Enron and its "related parties." Powers, together with long time board members Herbert "Pug" Winokur and Raymond Troubh, hired the Washington, D.C. law firm of Wilmer, Cutler & Pickering and went to work. On February 1, 2002, almost two months after Enron filed for Chapter 11 protection, Powers delivered the "Report of the Special Investigation Committee," generally referred to as the "Powers Report." Though the Powers Report focuses primarily on the "related party" transactions between Enron and the LJM partnerships and Chewco, the report also addresses the quality of the oversight provided by Enron's board. *See* POWERS REPORT, *supra* note 136.

185. *Id.* at 9.

186. *Id.*

187. *Id.* at 11.

188. *Id.*

189. Plea Agreement Exhibit A, United States v. Fastow, Cr. No. H-02-0665 (S.D. Tex. Jan. 14, 2004) (statement of defendant Fastow: "I also engaged in schemes to enrich myself and others at the expense of Enron's shareholders and in violation of my duty of honest services to those shareholders."); Powers Testimony, *supra* note 63, at 211.

compensation and discovered this fact, they might have terminated the LJM transactions long before they threatened the company with destruction. In short, the Enron board's performance of its oversight duties was, as Powers laconically concluded in his report, "inadequate."[190] Powers was more blunt when he appeared before Congress. The Enron board, he testified, "failed in its duty to provide leadership and oversight."[191]

Why did the board perform its duties so poorly? Some commentators think the Enron board was particularly incompetent, a collection of Ken Lay cronies more interested in picking up fat checks and flying to exotic locales than looking out for investors.[192] There is a grain of truth to this view. The Directors received approximately $350,000 per year in compensation for their very limited service, about twice the national average,[193] and they did, in fact, fly to nice locales for some board meetings.[194] But overall, I think this conclusion overstates the case against the Enron board and, paradoxically, understates the ultimate significance of the problem. My sense is that Enron possessed at least an average or above average board in terms of two classic measurements of board quality, independence and experience. Indeed, before Enron's collapse, *CEO* magazine named Enron's board one of the top five in America, and there was a reasonable basis for this view.[195]

If, as I believe, Enron had a reasonably good board prior to its bankruptcy, the implications for securities regulation are significant, for it suggests that even an independent and competent board has a very limited ability to catch fraud or deception. In short, the performance of the board of directors in the Enron case may indicate that boards in general are highly ineffective fraud watchdogs.

Four institutional factors limit the ability of boards to protect investors from deceptive management practices. First, the task of the directors of a Fortune 500 company like Enron—to oversee the performance of a major company with thousands of employees, complicated financing,

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190. POWERS REPORT, *supra* note 136, at 10.

191. Powers Testimony, *supra* note 63, at 214. A Report by the Senate Permanent Subcommitte on Investigations, SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS, 107TH CONG., REPORT ON THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE 70 (Comm. Print 2002), goes farther, concluding that the Enron Board violated its duty of care to Enron shareholders. *See id.* at 11–14.

192. *See, e.g.*, BRYCE, *supra* note 19, at xii, 162–67.

193. SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS, 107TH CONG., REPORT ON THE ROLE OF BOARD OF DIRECTORS IN ENRON'S COLLAPSE 11 (Comm. Print 2002).

194. BRYCE, *supra* note 19, at xii, 162–67.

195. MCLEAN & ELKIND, *supra* note 19, at 239. As Jeffrey Gordon has noted recently, Enron's board "was a splendid board on paper, fourteen members, only two insiders. Most of the outsiders had relevant business experience, a diverse set including accounting backgrounds, prior senior management and board positions, and senior regulatory posts." Gordon, *supra* note 3, at 1241.

and multiple product and service lines—is inherently difficult. Second, the amount of time the directors have to commit to this difficult task is extraordinarily limited, particularly when compared to the time devoted to the same general task by management. Directors, after all, typically have time consuming careers of their own to pursue, and devote only a handful of days per year to the corporation they oversee. Third, most independent directors have little personal stake in the direction of the corporation. Their reputations will not be seriously affected by corporate performance, and they typically have insurance to indemnify them for any liability stemming from their actions.[196] As a result, they approach their tasks dispassionately and neutrally, and not with the ardor and deep concern that someone with a greater personal stake in the outcome might have. Fourth, it appears that individual directors tend to become less critical and more trusting of management over time. Collectively, these four factors result in boards that lack both the desire and the capability to carefully scrutinize management performance and look for potential problems unless someone else—auditors, the SEC, or, as at Enron, the *Wall Street Journal*—identifies an issue and brings it to the board's attention.

The Enron board fits this profile. Enron was performing excellently, according to management, analysts and investors. Given this fact, a board of persons who were honest and capable, but also busy, trusting, and relatively disinterested, saw little need to pay attention to details or analyze management recommendations with a skeptical eye. Even if the board had been so motivated, it had little time to do so. Enron's board typically met only five times per year, and typically devoted less than one hour to review even the most complicated issues.[197] Given the manner in which we elect boards, the size of the tasks we ask them to perform, and the limited time we expect them to devote to their task, the result—a board that was tragically out of the loop—should not surprise us.

C. Wall Street's Stock Analysts

Every major Wall Street brokerage firm and investment bank has a team of equity analysts who monitor the performance of major companies and report on their potential investment value.[198] These analysts

196. For a discussion of liability issues, see STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 14 (Comm. Print 2002).

197. SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS, 107TH CONG., REPORT ON THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE 9, 32 (Comm. Print 2002).

198. These analysts are known as "sell-side" analysts because they work for firms that offer brokerage services. In contrast, "buy-side" analysts work for institutional clients like

typically issue reports and, more importantly, make concrete and specific investment recommendations: buy, sell, or hold.[199] Throughout the country, millions of investors rely on this advice, in part, I think, because they believe that the recommendations of the big Wall Street players represent a more sophisticated and informed view than an ordinary investor could possibly reach on her own.[200]

Analysts play a critical role in the monitoring of corporate performance for one very important reason: access. Ordinary investors have no chance to question corporate management about a company's performance or financial condition. In contrast, Wall Street equity analysts typically have numerous opportunities to question management about their corporations, through quarterly management conference calls, annual analyst meetings, and frequent interactions with the corporation's investor relations staff. This access gives analysts with major Wall Street firms a privileged position in the investor community.[201]

Enron was seventh on the Fortune 500 list, and thus it was the subject of scrutiny from hundreds of equity analysts from major brokerage firms. From an analyst's perspective, Enron posed an interesting challenge. On the one hand, there were several powerful reasons to recommend the stock to investors: explosive revenue growth, a good "story" from management to explain that growth, and wide market approval, a fact reflected in Enron's very high price-to-earnings ratio and stock price.[202] Nevertheless, analysts also had access to serious warning signs and red flags signaling that something might be wrong with the stock.

The most important warning signs came in Enron's 10-Qs and 10-Ks. Though Enron reported rapidly increasing revenue figures, it declined to disclose the percentage of its reported revenue that came from

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hedge funds and mutual funds. The discussion below is limited to the performance of Wall Street sell-side analysts.

199. The most common scale has five tiers: strong buy, buy, hold, sell, and strong sell. Less common, but also in use, are three- and four-tier rating systems. *See Enron Collapse: Impart on Investors and Financial Markets: Joint Hearing Before the House Subcomm. on Capital Mkts., Ins., & Gov't Sponsored Enters. and the House Subcomm. on Oversight & Investigations of the Comm. on Fin. Servs.*, 107th Cong. 127 (2001) (testimony of Charles L. Hill, Director of Research, Thomson Financial/First Call) [hereinafter Hill Testimony].

200. The idea that ordinary investors follow Wall Street analysts' recommendations because they believe these recommendations are the product of more sophisticated and informed analysis is supported by testimony before the Senate Governmental Affairs Committee. *See* STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 52 (Comm. Print 2002).

201. *Id.* at 55; Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1042 (2003).

202. During the 1990s, Enron's stock price rose three times faster than the S&P 500 index. SMITH & EMSHWILLER, *supra* note 19, at 16.

changes in MTM valuation of Enron assets as compared with "real" revenue: cash received or otherwise accrued from customers.[203] This made it difficult, though not impossible, for analysts to judge whether Enron was actually making money or not. Indeed, this problem was evident to many observers. In 2000, for example, the *Wall Street Journal*'s Texas edition ran a story suggesting that if one set aside unrealized MTM future revenue, Enron would have lost money in the second quarter of 2000.[204]

A second major issue was Enron's opaque segment reporting. Publicly held companies with multiple business lines break out separate numbers in their financial statements for each business division, or "segment," a practice known as "segment reporting." A company, for example, that manufactures both cars and boats will provide Wall Street and the SEC with separate information about both its car and boat divisions, so that investors will understand how each separate business is performing. Enron followed this practice, but in a very peculiar manner. Though Enron was divided into distinct divisions, Enron constantly renamed these divisions and reallocated particular businesses among the divisions. In spring of 2001, for example, Enron moved significant commodity risk activities from its Enron Energy Services ("EES") division to its Wholesale Services division, a move that made the failing EES look profitable.[205] By changing the definitions of its segments on a regular basis, Enron made it impossible for analysts to track business unit performance from quarter to quarter. Because of these two factors, one witness testified before Congress, that it became "increasingly difficult to understand how Enron was achieving its revenue growth and profitability."[206]

Enron's disclosures of its related party transactions with entities like LJM should have also alarmed Wall Street analysts. These disclosures showed that Enron was engaging in a large and ever-increasing volume

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203. Herdman Testimony, *supra* note 60, at 105. Analysts could try to calculate the percentage by analyzing Enron's cash flow reporting, but this method would not have produced an accurate picture of the degree to which Enron's revenue was "real," because the reported cash flow figures were artificially inflated by the pre-pay transactions.

204. Jonathan Weil, *Energy Traders Cite Gains, But Some Math Is Missing*, WALL ST. J., (Tex.), Sept. 20, 2000, at A1. Since many of the analysts who tracked Enron were energy analysts, many of them worked in Houston, and thus had access to paper editions of the Texas Wall Street Journal. Weil's important article is discussed in STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 35 n.158 (Comm. Print 2002); SMITH & EMSHWILLER, *supra* note 19, at 78–79.

205. STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 34 (Comm. Print 2002).

206. Hill Testimony, *supra* note 199, at 126.

of related-party deals with business associations it controlled. The disclosures also showed that Enron was not interested in providing investors with a straightforward explanation of these transactions. On the contrary, the disclosures were incredibly opaque: the names of the "related parties" were not revealed, the identities of the "senior Enron executives" involved in the transactions were not provided, the purposes of the deals were not disclosed, and the descriptions of the deals themselves were so convoluted, no one would be able to understand what the transactions actually involved.[207]

In sum, Enron's earnings statements were, as one expert on Wall Street equity research later testified, "inscrutable," not just to laypersons, but to sophisticated analysts as well.[208] This was not a secret. *Fortune*, for example, ran a story in early 2001 calling Enron's financial statements "impenetrable." In the story, credit analysts openly joked about Enron's opacity, labeling the company a "black box."[209] This should have sent a chill up the spines of careful analysts. As one financial expert later testified before the Senate Governmental Affairs Committee, "for any analyst to say there were no warning signs in the public filings, they could not have read the same public filings I did."[210]

Faced with incomprehensible earnings statements, how did elite players in the investment community react? In spring of 2001, major investors holding large blocks of Enron stock, like Janus, Fidelity, and American Express, began to quietly dump millions of Enron shares on the market.[211] At the same time, many independent equity research firms—those not associated with major Wall Street brokerages and banks—began to recommend that investors sell their stock. In contrast, the major Wall Street analysts remained totally bullish on Enron. Faced with confusing financial statements, shifting segment metrics, and alarming quasi-disclosures of self-dealing, analysts should have demanded that Enron provide more transparent financial statements and disclose more information about the nature and purpose of its related party deals. If Enron declined, as the company might well have done, analysts should have refused to recommend that investors buy Enron stock. Unfortunately, analysts did none of these things. Though some analysts groused to Enron about the complexity of Enron's financial statements, none

207. Second Interim Report of Neil Batson, Court-Appointed Examiner at 56, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. Jan. 21, 2003).

208. Hill Testimony, *supra* note 199, at 128.

209. McLean, *supra* note 48, at 123–24.

210. STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 60 (Comm. Print 2002).

211. MCLEAN & ELKIND, *supra* note 19, at 340.

chose to hold Enron accountable or declined to recommend the stock as a result. Instead, they heartily recommended that investors buy the stock despite the lack of clear information.

The facts are stunning. In fall of 2001, all fifteen of the largest Wall Street firms covering Enron's stock had "buy" recommendations in place.[212] By late October 2001, ten of the fifteen continued to recommend Enron, though by this point, the *Wall Street Journal* was running almost daily stories about Enron's earnings management problems, Enron's CFO had resigned, and the SEC had announced an Enron investigation.[213] Any investors following Wall Street's advice on Enron lost heavily. So much for "sophisticated" and "informed" analysis. As the *Wall Street Journal* commented, "[r]arely have so many analysts liked a stock they concede they know so little about."[214]

How, one wonders, could sophisticated Wall Street analysts fail to understand the significance of the warning signs so evident to Janus, Fidelity, and the independent research firms? One tempting answer is incompetence. On August 14, 2001, Enron CEO Jeff Skilling resigned after only a few short months on the job.[215] This was, of course, another red flag indication that Enron might have serious but concealed problems. Despite this fact, Wall Street analysts continued blithely to recommend Enron's stock. In contrast, *Wall Street Journal* reporters trying to understand why Skilling resigned began to look at the company's 10-Qs, and there they quickly discovered that Enron was engaging in a large number of very confusing and poorly described transactions in the billion-dollar range with an unidentified "related party." The *Journal*'s John Emshwiller later wrote that although he was not sure what the related party disclosure meant, he knew it was a big issue; though he had covered Wall Street for years, "[h]e'd never seen a disclosure quite like this before."[216] Excited, Emshwiller began to call equity analysts to see what they thought about the related party transactions. To his shock, it quickly became clear to him that the analysts knew "little or nothing" about Enron's related party deals, despite the bulk of the disclosures, which took up numerous pages in Enron's financial statements, and the

212. STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 5 (Comm. Print 2002).

213. *Id.*; BRYCE, *supra* note 19, at 255. *See also* Hill Testimony, *supra* note 199, at 128. As late as October 26, 2001, fifteen of seventeen top Wall Street analysts surveyed by the *Wall Street Journal* still had buy recommendations on the stock, even after the forced resignation of the company's CFO. SMITH & EMSHWILLER, *supra* note 19, at 173.

214. SMITH & EMSHWILLER, *supra* note 19, at 173.

215. *Id.* at 3–4.

216. *Id.* at 18.

enormous dollar value of the transactions themselves.[217] This ignorance was due, Emshwiller concluded, to the fact that the analysts were simply not reading Enron's financial statements, or reading them carefully.[218] Had the analysts done so, they might not have understood what they were reading, and they might not have questioned their enthusiasm for the stock, but at the very least, they would have been aware that Enron was entering into some very large and very curious deals, providing fodder for questions the next time they spoke to Enron management.

Incompetence, unfortunately, is not a very satisfying explanation for the failure of Wall Street analysts to do their jobs, for it begs the question: why? Why weren't the analysts reading Enron's financial statements? Why weren't the analysts looking for problems? Why, as *Fortune*'s Bethany McLean and Peter Elkind have noted, had many analysts "stopped doing anything that resembled serious securities analysis"?[219]

Two major factors contributed to the failure of analysts to perform adequately as watchdogs in the Enron case; both involve significant conflicts of interest.[220] Banks and brokers, one must remember, fund equity research not as a public service, but because it helps the banks make money. There is, however, no real direct market for equity research. Big Wall Street banks, for example, do not make money by selling their research and recommendations to analysis consumers.[221] Instead, banks and brokers make money from research indirectly, in two ways: research leads to increased equity transactions for firm brokers, and it helps firm investment bankers sell their financial services to major corporations.

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217. *Id.* at 34.

218. *Id.* at 34.

219. MCLEAN & ELKIND, *supra* note 19, at 231.

220. In addition to the explanations for analyst failure discussed above, two additional potential causes might be relevant. One is what Fed Chairman Alan Greenspan once termed "irrational exuberance"—a fatal lack of skepticism. During the bull market of the 1990s, stock values shot skyward, apparently without limit. One popular investment guide from the period was titled "Dow 36,000." In this overheated atmosphere, many of the analysts, typically in their twenties and thirties, had never experienced a bear market. As a result, market decline, let alone the implosion of major blue chip companies, may simply have been beyond the imagination of many analysts. Recommending stocks may have felt like a job with no significant consequences. Another potential issue specific to Enron analysis was the background of the Enron analysts themselves. Since Enron had started as a natural gas company, most of the Enron analysts were persons with natural gas or, at best, general energy analysis backgrounds. The analysts did not, as a general rule, have the background or experience to understand and come to terms with the Enron's efforts in new areas such as water or telecommunications, or the implications of Enron's complex structured finance transactions. These analysts were generally impressed with Enron's prowess in energy markets, and thus were natural prey to Enron's line that since all markets are the same, Enron could prosper in any market. Analysts with more experience in non-energy sectors of the economy might have been more skeptical.

221. Fisch & Sale, *supra* note 201, at 1045.

First, brokerage firms disseminate research reports because these reports, once placed in the hands of investors, help stimulate the trading of stocks.[222] When, for example, an influential bank or broker recommends that investors buy a particular stock, transactions in that stock increase.[223] This results, of course, in increased brokerage transaction fees and commissions for the firm. Since, however, there are always more potential buyers for a particular stock than there are potential sellers of the same stock, "buy" recommendations, on average, generate much larger fees and commissions for the firm than do "sell" recommendations.[224] Thus, from a business perspective, brokerage firms have a direct financial incentive to issue "buy" recommendations.

The second and potentially more significant conflict arises from the fact that large corporations are hesitant to provide an investment bank with significant banking fees if the bank's research division is publicly panning the company's stock.[225] Indeed, some large corporations put pressure on banks to issue upbeat analysis reports about their stocks and may threaten to stop using a bank's financial services products if the bank declines to push the company's stock.[226] Some banks, in turn, have adjusted to this pressure and view their equity analysis programs not as a way to educate investors, but as a method of generating and retaining clients for their firms' investment banking and financial services divisions.[227] As SEC Chairman Arthur Levitt stated in 1999, before Enron collapsed, bankers expected their analysts "to act more like promoters and marketers than unbiased and dispassionate analysts."[228] Banks, for example, have used overly rosy equity reports as a way of ingratiating themselves with the management of major companies with significant financial services needs, in the hopes of gaining business for their firms.

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222. Fisch and Sale provided a good discussion and analysis of this problem in their excellent article. *Id.* at 1045–46.

223. *Id.*

224. *Id.* at 1045.

225. STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 64 (Comm. Print 2002); Fisch & Sale, *supra* note 201, at 1047.

226. *See* example of relation between Merrill Lynch and Enron, *infra* notes 237–241 and accompanying text. Some corporations also restrict the access of analysts to corporate executives if the analysts file negative research reports. *See* STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 88 (Comm. Print 2002).

227. This problem is discussed in STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 64 (Comm. Print 2002); MCLEAN & ELKIND, *supra* note 19, at 233–35; Aronson, *supra* note 3, at 131–32, 145–46.

228. Mark Maremont & Deborah Solomon, *Missed Chances: Behind SEC's Failings: Caution, Tight Budget, '90s Exuberance*, WALL ST. J., Dec. 24, 2003, at A1.

In 1992, Morgan Stanley's managing director of corporate finance instructed his firm's analysts that "the practical result needs to be 'no negative comments about our clients.'"[229] More recently, Merrill Lynch, another major malefactor in this area, publicly touted client stocks in positive research reports even though the firm's analysts privately described the companies in e-mail as "junk," "shit," and "crap."[230] Analysts also share the profits from the gains in investment banking fees.[231] Obviously, this dynamic has a huge impact on Wall Street equity analysts. It provides them with very little incentive to care about research accuracy or to examine carefully any given company's pronouncements about its current success or future prospects. Instead, it encourages analysts to simply repeat whatever story the company's management wants to deliver to investors.

Given these two enormous conflicts of interest,[232] it is not surprising that for Wall Street analysts, optimism about the stocks one analyzes is generally a good career move, while pessimism is often punished.[233] Indeed, according to John Coffee, who testified about these matters before the Senate Banking Committee, one survey found that sixty-one percent of analysts had suffered some form of retaliation for writing a negative report at some time in their career.[234] Equally unsurprising: Wall Street analysis of stocks is extremely positive overall. In 2002, for example, a Wall Street director of research informed Congress that analysts typically rate approximately sixty-six percent of stocks as "strong

229. Fisch & Sale, *supra* note 201, at 1049 (quoting *The Rohrbach Memo: "No Negative Comments,"* WALL ST. J., July 14, 1992, at A6).

230. STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 62 (Comm. Print 2002) (quoting Affidavit in Support of Application for an Order Pursuant to General Business Law Section 354, by Eric Dinallo, Spitzer v. Merrill Lynch, No. 02-401522 (N.Y. Sup. Ct. Apr. 8, 2002)).

231. STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 66–67 (Comm. Print 2002) (based on filings in Spitzer v. Merrill Lynch, No. 02-401522); Fisch & Sale, *supra* note 201, at 1052–53; Julie Creswell, *Banks on the Hot Seat*, FORTUNE, Sept. 2, 2002, at 79.

232. In addition, some analysts own stock in the companies they cover. *See* Fisch & Sale, *supra* note 201, at 1044.

233. *See* STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 67–68 (Comm. Print 2002) (discussing an academic study by economists Harrison Hong of Stanford and Jeffrey Kubik of Syracuse finding that analysts are more likely to be promoted if their recommendations are optimistic, and that optimism is rewarded more than accuracy). *See also id.* at 88 (discussing survey finding retaliation against analysts for filing negative research reports common); Fisch & Sale, *supra* note 201, at 1054–56.

234. STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 68 (Comm. Print 2002).

buys" or "buys," compared with only one percent rated as "strong sells" or "sells."[235]

Enron was a major user of lending, underwriting and M&A services, and thus a very attractive potential client for major investment banks. Indeed, Enron burned through some $230 million in banking fees in 1999 alone.[236] Did Enron put pressure on Wall Street to praise its stock? The case of John Olson is instructive.

In the 1990s, John Olson was a respected energy stock analyst with Merrill Lynch. Olson tracked Enron, but unlike virtually every other major sell-side analyst, he had significant concerns about Enron's financial health. In 1997, Olson wrote a research report raising concerns with Enron's performance and changed his short-term Enron recommendation to "neutral."[237] In reaction, Enron executives complained to Merrill Lynch's management and threatened to withhold banking fees in the future unless Merrill upgraded Enron's stock rating by 1998.[238] Merrill Lynch, in return, forced Olson out of the firm and replaced him. Merrill Lynch's new Enron analyst changed Enron's rating to "buy."[239] Olson later told Texas journalist Robert Bryce that "analysts had to be very encouraging, or provide strong buy recommendations for current or prospective banking clients, so the firm-wide bonus would be unusually generous. And if you didn't do that, you'd get whacked."[240] Needless to say, actions like this, and the climate surrounding Wall Street equity analysis in general, deterred other analysts from raising similar concerns about Enron's stock. [241]

D. The Securities and Exchange Commission

The SEC is responsible for preventing securities fraud and protecting equity investors. The SEC had access, of course, to most of the information about Enron available to Wall Street analysts. Thus, the SEC

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235. Hill Testimony, *supra* note 199, at 50.

236. MCLEAN & ELKIND, *supra* note 19, at 163.

237. SMITH & EMSHWILLER, *supra* note 19, at 35.

238. STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 83 (Comm. Print 2002).

239. MCLEAN & ELKIND, *supra* note 19, at 234–35; SMITH & EMSHWILLER, *supra* note 19, at 35–36.

240. BRYCE, *supra* note 19, at 252.

241. One should note, for what it is worth, that in testimony before the Senate Governmental Affairs Committee on February 27, 2002, a group of analysts from major Wall Street firms all denied that their banks' significant relationships with Enron affected in any way their analysis of Enron's stock. *See* STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 65, 69 (Comm. Print 2002).

knew or should have known that Enron's financial statements were confusing; that it kept rearranging its business divisions, making it impossible to follow business segment performance from quarter to quarter; that it was engaging in a huge volume of related party transactions; that the disclosure of these related party transactions was disturbingly opaque; and that the CEO had resigned suddenly in the summer of 2001 under unusual circumstances. On a more basic level, the SEC knew or should have known that Enron was spending billions to diversify without going deeply into debt or issuing more equity. The SEC, in other words, had plenty of reasons to examine Enron closely. At the very least, SEC lawyers and accountants reading Enron's perplexing financial statements could have demanded that the company provide more clear and detailed disclosures in the future. Alas, the SEC did nothing.

The most alarming part of Enron's collapse was the failure of the SEC to see the warning signs before the collapse and open an inquiry. In our analysis of the performance of Arthur Andersen, the Enron board of directors, and Wall Street analysts, we have to speculate to some degree about why these institutions failed to do their jobs. But for the SEC, we know the definitive explanation for institutional failure, and that answer is shocking. The SEC did not know what was happening at Enron because the SEC did not review any of Enron's 1998, 1999, 2000, or 2001 10-K and 10-Q filings.[242] I have immense respect for the frontline attorneys and accountants at the SEC, and I am sure that if they had been reading Enron's financial statements in 1999, 2000, or 2001, they would have spotted serious issues demanding an informal inquiry. After all, reporter John Emshwiller of the *Wall Street Journal* spotted the problems in just a few minutes after pulling up Enron's publicly filed financial statements on his computer.[243] Unfortunately, no one at the SEC was reading the filings, and Enron's financial manipulations went unquestioned.

The SEC has an excuse for failing to read Enron's 10-Qs and 10-Ks, and it is not a bad one, in some ways. SEC leadership notes that in the 1990s, the number of regulated companies and financial filings increased dramatically, while SEC resources grew at a much more modest rate. As a result, the SEC was forced to prioritize. Faced with this tough decision, the SEC claims that it decided to devote its resources to reviewing initial public offerings, and not the filings of supposedly reliable blue chip firms of the Fortune 500.[244]

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242. *Id.* at 25–27.

243. SMITH & EMSHWILLER, *supra* note 19, at 18–19.

244. STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 11 (Comm.

The SEC is correct when it asserts that it needs more resources to adequately police the securities market. Nevertheless, I find the proffered explanation for the Commission's failure to review Enron's 10-Qs and 10-Ks from 1998 to late 2001 totally unacceptable. The Fortune 500 companies play a critical role in the American securities market, for a huge percentage of American stock investment goes into our largest companies. As a result, the SEC has a particular duty to ensure that these behemoths are playing by the rules. More significantly, policing the financial statements of the Fortune 500 takes minimal resources. Assume for a moment that it takes one week for a lawyer to make a careful review of a 10-Q or 10-K—a very conservative estimate.[245] That means that an SEC attorney could review fifty such forms per year. Since the Fortune 500 companies submit 500 annual reports per year, ten SEC attorneys working slowly could review all of their 10-K filings every year. Alternatively, forty persons could review all of the 10-Ks and 10-Qs. This resource commitment is obviously very small. Given that the SEC has over 3,000 employees,[246] it is amazing that it failed to devote this minimal amount of manpower to such a basic and fundamental task. The SEC's problem was not lack of resources: it was poor management and poor prioritization.

This fact was revealed most clearly in a post-Enron study of SEC management practices conducted by the consulting firm McKinsey & Company. Though the McKinsey report has not been released publicly, portions of the study were leaked to the *Wall Street Journal* in December 2003. According to the *Journal*, the McKinsey study found that SEC management gave SEC employees reviewing corporation filings numerical targets to meet. As a result, SEC employees began "gaming the system," reviewing "smaller, easier-to-review filings rather than more complex ones" taking more time.[247] Given these incentives, it is not surprising that SEC staff decided not to review Enron's long, difficult SEC filings.

Print 2002). The SEC abandoned reviewing all filings in 1980. *See* Herdman Testimony, *supra* note 60, at 98. In 2001, as a result of prioritization, the SEC reviewed only sixteen percent of 10-K forms filed. *See* STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 10 (Comm. Print 2002). I do not question the SEC's belief that IPOs needed close attention. I reject, however, the idea that emphasis on review of IPOs required them to abandon all serious review of Fortune 500 company filings.

245. I make this claim on the basis of personal review of SEC filings.

246. STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 7 (Comm. Print 2002).

247. Maremont & Solomon, *supra* note 228 (quoting McKinsey and Co. study).

Even if one accepts the claim that the SEC lacked the resources to review all Fortune 500 financial statements, it should still have reviewed Enron's under any rational set of prioritization procedures. When a company files a 10-Q or 10-K with the SEC, the SEC conducts a preliminary screening to determine how carefully it will review the filing. Some filings are prioritized for full review by SEC staff; some get a more limited review; and others are not reviewed any further at all.[248] The SEC keeps its screening criteria secret, in order to prevent companies from gaming the system.[249] As a result, we do not know precisely why Enron's filings were not selected for review. It is clear, however, that if the SEC had sound procedures in place, considering all of the relevant factors, Enron's statements would not have slipped through the cracks.[250]

One factor that should have been relevant to the SEC was Enron's history of fraud. In 1987, Enron Oil, the company's oil trading division, was caught cooking its books and engaging in fraudulent fake trades designed to enrich Enron traders at shareholders' expense.[251] Enron caught the misconduct, but amazingly, Enron's management initially declined to fire the traders, apparently because the trading operation was so profitable.[252] Indeed, one senior executive sent the rogue oil traders an e-mail ending: "[p]lease keep making us millions."[253] Even more alarming, Enron's board agreed with and approved management's decision.[254] Despite Enron's lackadaisical reaction, the Department of Justice prosecuted two of the traders, and in 1990, both pleaded guilty to felonies.[255] This track record of fraud by Enron executives, and the failure of the

248. STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 9–10 (Comm. Print 2002). The SEC has four levels of monitoring beyond the initial screening. Some filings are not read at all; some receive "monitoring," pursuant to which the SEC reviews a limited number of items in the filing; some receive a "financial statement review," pursuant to which the SEC reads and reviews the financial metrics and MD&A; and a few select filings receive a "full review," in which the entire filing is scrutinized. *See id.* at 10.

249. Herdman Testimony, *supra* note 60, at 8; STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 10 (Comm. Print 2002).

250. As the Senate Governmental Affairs Report noted, "there is little evidence that this relatively informal system has been particularly successful, and a more sophisticated means of risk analysis appears to be needed." *See* STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 63 (Comm. Print 2002).

251. For discussions of fraud in Enron's oil trading business, see BRYCE, *supra* note 19, at 37–43; MCLEAN & ELKIND, *supra* note 19, at 15–24.

252. BRYCE, *supra* note 19, at 39; MCLEAN & ELKIND, *supra* note 19, at 20.

253. MCLEAN & ELKIND, *supra* note 19, at 19–20.

254. *Id.* at 20–21.

255. BRYCE, *supra* note 19, at 42; MCLEAN & ELKIND, *supra* note 19, at 24.

board and management to take these crimes seriously, should have been a signal to SEC regulators that they needed to keep an eye on Enron. If, as the SEC claims, it had to set priorities, it seems that examining companies with recent past records of fraud might be a useful factor to take into account.

Second, the SEC was aware by the late 1990s that Arthur Andersen's auditors were helping major companies like Sunbeam and Waste Management file misleading financial statements, since the SEC was already pursuing enforcement actions in these cases. Given this fact, the SEC should have identified the Fortune 500 companies relying on Andersen to audit their books and given those companies extra scrutiny. Again, if prioritization is necessary, prioritized review of companies audited by a potentially unreliable accounting firm should have been implemented.

Third, and finally, the SEC's Chief Accountant has admitted in testimony before Congress that because Enron never disclosed the percentage of its reported revenue that came from changes in MTM valuation of Enron assets, as compared with "real" revenue, Enron's true profitability was "unclear."[256] The Chief Accountant failed to acknowledge the obvious conclusion that should have been drawn from this fact. If Enron's financial statements were unclear in such a fundamental respect, the SEC had an obligation to inform Enron that it needed to make more complete disclosures or face an SEC investigation.

The SEC, in short, was a slumbering watchdog. Had the SEC done its job, the Enron collapse might never have occurred.[257]

E. Deterrence: Federal Criminal Laws

When all other safeguards do not work, the only remaining protection for investors is to hope that the possibility of criminal sanctions will deter securities fraud. In the Enron case, the prospect of criminal prosecution clearly failed to provide any deterrence whatsoever. I expect this was because prosecuting and punishing white collar crime has never been a priority in the United States. Historically, white collar fraud has

256. Herdman Testimony, *supra* note 60, at 115.

257. In its excellent report on Enron, the staff of the Senate Governmental Affairs Committee suggest that Enron's explosive growth and the large number of affiliate entities listed on Enron's reports—some fifty pages worth in the 2000 10-K—should have put Enron on the SEC's radar screen. The Senate Governmental Affairs Report also notes that the SEC erred when it approved Enron's use of MTM and then failed to provide any follow-up review to ensure Enron was not violating the conditions imposed by the SEC as part of its approval process. *See* STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 65 (Comm. Print 2002).

been punished less severely than so-called "blue collar" theft and property destruction cases causing equivalent economic loss to victims.[258] The federal sentencing guidelines institutionalized and validated the practice of giving white collar defendants low sentences. Under the initial version of the guideline's fraud provisions, for example, the Commission predicted that the average fraud defendant would serve only eight months in prison.[259]

This light-handed approach to sentencing in white collar cases can be seen in the sentences imposed in the major white collar cases of the late 1980s. Michael Milken and Ivan Boesky served only two years in prison,[260] and Kidder Peabody's Martin Siegel served only two months.[261] Similarly, the felons in the 1990 Enron Oil fraud cases received slaps on the wrist for committing a multimillion dollar scam: one year in jail and five years probation for one defendant, two years probation for another.[262] The sentences imposed in these cases were substantially lower than the sentences routinely handed out in low-level federal immigration and narcotics cases.[263]

Wall Street clearly got the message that white collar crime is not serious. A 2003 *Wall Street Journal* article, for example, carried a disturbing but revealing title: "A Rare Headline: Wall Streeter Could Face Jail."[264] Given these facts, it is not surprising that Enron executives were not deterred from misconduct.

F. Conclusion: Watchdog Performance

In the Enron case, all five major watchdog institutions responsible for protecting investors totally failed to meet their responsibilities. Of course, Enron's bad deeds were ultimately discovered and publicized, primarily because of actions of the *Wall Street Journal*, but that offers little consolation. Enron's financial statement manipulation began, at the very latest, in 1997, the time of the Chewco deal. By the time Enron's misdeeds were disclosed in November 2001, it was too late.[265] Hun-

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258. John R. Steer, *The Sentencing Commission's Implementation of Sarbanes-Oxley*, 15 FED. SENTENCING REP. 263, 263 (Apr. 2003) (discussing the conclusion reached by Sentencing Commission after research of historical practices in American sentencing). Steer is the Vice-Chair of the Sentencing Commission, and thus speaks with authority here.

259. *Id.*

260. *A Rare Headline: Wall Streeter Could Face Jail*, WALL ST. J., Apr. 24, 2003, at C1.

261. *Id.*

262. MCLEAN & ELKIND, *supra* note 19, at 24.

263. I have based this conclusion on my personal experiences as a federal prosecutor.

264. *A Rare Headline: Wall Streeter Could Face Jail*, *supra* note 260.

265. We should also be cognizant of the fact that Enron's misdeeds might never have been uncovered but for the fact that: (a) Jeff Skilling resigned as CEO under peculiar circumstances,

dreds of Enron executives had pocketed their misbegotten millions, most of which will never be recovered; thousands of their employees had lost their jobs and their retirement savings; and millions of investors had lost their invested sums, much of which, again, represented retirement savings. This kind of delayed disclosure is better than nothing, but it is simply not acceptable in a country that encourages millions of its citizens to rely on equity investments for their retirement.[266]

IV. REFORMS SINCE THE ENRON COLLAPSE: A BRIEF ASSESSMENT

The Enron case suggests that our securities regulatory system performs poorly in a critical area: prevention and disclosure of fraud. The case demonstrates that executives of one of America's largest companies can mislead investors for years without detection, even if no one understands how the company makes its money, the company has a history of fraud, and the company files increasingly opaque financial statements involving large-scale related party transactions. The case indicates that boards of directors, independent auditors, financial analysts, the SEC, and the criminal laws will not always prevent or catch serious fraud in a timely fashion, even when the fraud involves billions of dollars, affects millions of investors, and occurs over several years.

The Enron case, standing alone, does not necessarily suggest that significant structural reforms to our securities regulation regime are necessary. Indeed, after Enron's collapse, Congress and the SEC made no significant legislative or regulatory changes: everyone treated Enron as an anomaly. Within six months, however, investors discovered that Enron's collapse was not an isolated event. McKisson, Tyco, WorldCom, and HealthSouth were also engaged in massive accounting deception, and these frauds were disclosed publicly. At the same time, regulators began to pay attention to the very large and steadily increasing number of major American companies that were restating their earnings.[267] Policy

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with an incoherent explanation, and (b) the *Wall Street Journal* began to investigate Enron to figure out why Skilling had actually departed. Had Skilling stayed in his job, been a less high profile executive, or provided a more compelling explanation for his resignation, the *Journal* would not have been interested in Enron, no muckraking stories would have followed, and Enron might have continued to mislead investors for years. In the future, we cannot rely on such fortuitous events to protect investors. *See generally* SMITH & EMSHWILLER, *supra* note 19.

266. Currently, 48 million citizens participate in 401(k) plans. Josh Friedman, *Curbs on Late Trades Could Hurt Investors*, L.A. TIMES, Dec. 3, 2003, at C1.

267. In 1980, there were three restatements of earnings. In 2001, there were 270. STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 3 (Comm. Print 2002). On the increase in restatements, see GENERAL ACCOUNTING OFFICE, FINANCIAL STATEMENT

makers quickly concluded—correctly, I think—that the problems seen in Enron are relatively common.[268]

In reaction to these developments, Congress, the United States Sentencing Commission, the SEC, and state regulators initiated and implemented a series of significant reforms to our securities regulation system in 2002 and 2003. These reforms included major legislation like the Sarbanes-Oxley Act,[269] changes to the federal sentencing guidelines, changes to accounting rules, changes in SEC enforcement practices, and changes to Wall Street behavior imposed through litigation settlements. In the following pages, I provide a brief assessment of some of the most significant of these reforms.[270] I believe that many of the changes made

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RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES, AND REMAINING CHALLENGES, GAO-03-138, 17–19 (2002), *available at* http://www.gao.gov/new.items/d03138.pdf (annual rate of restatements increased dramatically between 1997 and 2002). Congress and the SEC were well aware of these problems long before Enron collapsed. In 1998, then-SEC Chairman Arthur Levitt stated in a now famous speech at New York University: "I fear that we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting. Managing may be giving way to manipulation; [i]ntegrity may be losing out to illusion." STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 3 (Comm. Print 2002). Assessing why Congress and the SEC failed to act on these problems back in the 1990s falls outside the scope of this article. Clearly, the cause was some combination of (a) excellent lobbying by Wall Street interests and (b) the desire of Congress to avoid killing the bull market goose that laid the golden campaign contribution egg.

268. *See, e.g.*, STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 46 (Comm. Print 2002) ("In the case of Enron—and the corporate collapses that have since followed—we have witnessed a fundamental breakdown in this system."); John C. Coffee, Jr., *Limited Options*, LEGAL AFF., Dec. 2003, at 52 (problems seen in Enron and WorldCom pervasive).

269. The Sarbanes-Oxley Act of 2002 was passed by the United States House of Representatives by a vote of 423–3 and the United States Senate by a vote of 99–0. It was signed by the President on July 30, 2002. Sarbanes-Oxley is a remarkably complex piece of legislation. In this article, I have made no effort to provide an exhaustive analysis of Sarbanes-Oxley. Instead, I have only discussed those Sarbanes-Oxley provisions that I believe will have the most significant impact on the securities market and in particular, on the prevention and disclosure of fraud. Accordingly, there are numerous provisions of the Act, some of them quite significant, that I have not discussed here. For more comprehensive discussions of Sarbanes-Oxley, see, for example, Aronson, *supra* note 3; Brickey, *supra* note 68 (providing an excellent discussion of impact of Sarbanes-Oxley whistleblower protection measures on future cases); Brian Kim, *Sarbanes-Oxley Act*, 40 HARV. J. ON LEGIS. 235 (2003); Luppino, *supra* note 3, at 155–64.

270. It may be appropriate here to situate my views about securities regulation within the context of the current debate in the academy over the value and efficiency of our current regulatory scheme. In recent years, that debate has been shaped primarily by scholars whose faith in the efficient capital markets hypothesis has led them to advocate dismantling the current federal mandatory disclosure system that governs securities markets. *See, e.g.*, Stephen J. Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279 (2000) (calling for regulation and limits on investor freedom to replace current regulatory system); Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997) (arguing for

since 2002 are extremely positive. Other reforms, unfortunately, are counterproductive. I also conclude that our latest wave of securities regulation reform has failed to sufficiently address and rectify a number of major problems in securities regulation evident from the Enron case.

A. Six Positive Developments

Since the Enron collapse, Congress, the United States Sentencing Commission, and federal and state securities regulators have made six significant positive changes to our securities regulation regime.

1. Increased Prison Sentences for White Collar Crime

The most important development has been in the area of criminal punishment. As noted above, white collar crimes have historically been punished very lightly in the United States. This scandalous practice has come to an end. Since late 2001, Congress and the United States Sen-

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reducing current enforcement efforts in favor of regulation by stock exchanges); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998) (advocating replacement of federal securities regulation with competitive state regulation). The general thrust of these works, as Stephen Choi and A. C. Pritchard recently explained, is the conclusion that the "implication of the efficient market hypothesis is that government regulation of financial intermediaries and companies' financial disclosures may be unnecessary and potentially wasteful." Stephen J. Choi & A. C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 3 (2003). In turn, behavioral economics scholars operating in the realist tradition have argued, based on empirical investigation into the problems of bounded rationality, that deregulation would be a costly error. *See, e.g.*, Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135 (2003); Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L.J. 1397 (2002). I do not have a foot solidly in either theoretical camp. Nevertheless, my work as a prosecutor has taught me, if nothing else, to have little faith in the efficient market hypothesis. I think allowing firms to select the degree of regulation to which they will be subject would result in massive fraud and deception targeted at our most vulnerable citizens. As Jeffrey Gordon commented recently, the Enron case alone "provides another set of reasons to question the strength of the efficient market hypothesis . . . ." *See* Gordon, *supra* note 3, at 1235–37. I am also persuaded that companies, if left unregulated, will not disclose the socially optimal amount of financial information. *See generally* Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999). As a result, I remain, as do the behavioralists, an advocate of the mandatory disclosure system and an opponent of balkanizing our securities regulation regime. Perhaps Choi and Pritchard would respond, as they have done recently to behavioral critics, that the problem with SEC regulatory action is that "the SEC usually focuses on the stereotypical 'widows and orphans' in crafting protections." Choi & Pritchard, *supra*, at 35. I am not really sure what to make of this claim, other than to note that some 60 million ordinary Americans are currently investing in the market, few of these investors are widows or orphans, and the vast majority of them want to keep basic disclosure and fraud rules in place. This reflects, I take it, the efficiency of the democratic marketplace for ideas.

tencing Commission have radically increased criminal penalties for persons convicted of white collar fraud. In Sarbanes-Oxley, Congress quadrupled the statutory maximum penalties for wire and mail fraud from five to twenty years.[271] Since, however, statutory maximums merely affect the legal parameters of sentences, and not the length of actual sentences themselves, the promulgation of major amendments to the federal sentencing guidelines are of greater importance. The United States Sentencing Commission has completely rewritten the sentencing guidelines applicable to fraud cases in the last several years.[272] The new provisions essentially double the penalties imposed on defendants who commit large-scale securities fraud.[273] The first major fruit of this change can be seen in the sentence of former Imclone CEO Samuel Waksal to seven years in prison for insider trading—a much higher sentence than those imposed in similar cases in the past.[274] The importance of these changes in sentencing laws cannot be overstated. For the first time, our society has recognized that white collar crimes pose a threat to the country's social and economic fabric as significant as that of organized crime and narcotics trafficking.[275]

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271. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 § 903, 116 Stat. 805.

272. The Sentencing Commission promulgated the first set of significant fraud amendments on November 1, 2001, before Enron collapsed. These amendments, known collectively as the "Economic Crime Package," consolidated the old, separate fraud, theft and property destruction guidelines into one unified guideline, 2B1.1. The new unified guideline significantly increased recommended sentences for fraud offenders, particularly those who committed frauds resulting in large financial losses to victims. The Commission also provided a sentence enhancement for cases involving large numbers of victims. Following the passage of Sarbanes-Oxley, the Commission revisited the punishment of fraud. The Commission promulgated new amendments in January 2003 increasing punishment once again for, among other things, crimes involving large numbers of victims, that endanger the solvency of publicly traded companies, or that result in large dollar losses. For an excellent discussion of the 2001 and 2003 amendment, see Steer, *supra* note 258. For a discussion of the 2001 amendments, see Mary Kreiner Ramirez, *Just in Crime: Guiding Economic Crime Reform After the Sarbanes-Oxley Act of 2002*, 34 LOY. U. CHI. L.J. 359, 376–81 (2003).

273. For an excellent calculation example, see Steer, *supra* note 258, at 267–68.

274. Matthew Rose & Kara Scannell, *Martha Stewart Likely Won't Take the Stand*, WALL ST. J., Feb. 23, 2004, at C1.

275. Sarbanes-Oxley also creates four new federal crimes relating to securities fraud or obstruction of justice in the securities fraud context. These new laws are largely duplicative of statutes already on the books and thus are unlikely to have any significant impact. *See* Recent Legislation, *Corporate Law—Congress Passes Corporate and Accounting Fraud Legislation*, 116 HARV. L. REV. 728, 730–33 (2002). For an excellent summary of all of Sarbanes-Oxley's criminal provisions, see William S. Duffey, Jr., *Corporate Fraud and Accountability: A Primer on Sarbanes-Oxley Act of 2002*, 54 S.C. L. REV. 405 (2002).

2. Creation of PCAOB

Congress has also recognized that the accounting profession can no longer be trusted to regulate itself. In Sarbanes-Oxley, Congress created a new public regulatory body, the Public Company Accounting Oversight Board ("PCAOB").[276] The PCAOB is a five member board charged with supervising the accounting profession on behalf of investors and the general public under the general supervision of the SEC. To keep the board independent of the accounting profession, only two of the board members may be CPAs. Once it is fully operational, the PCAOB will register, inspect and discipline public accounting firms and establish standards for auditor ethics, independence, and quality control. Hopefully, PCAOB will also play a major role in reviewing GAAP as well, identifying problematic rules and plugging loopholes that might lead to the filing of essentially misleading but arguably GAAP-compliant disclosures.[277]

3. New Ban on Accounting Firms Providing Most Consulting Services

Sarbanes-Oxley also bans auditing firms from providing auditing clients with most consulting services.[278] This new prohibition will force auditors to concentrate first and foremost on the auditing business, eliminate a major incentive for auditors to skew their audit results in an effort to please management, and prevent companies from trying to "discipline" principled auditors by reducing or eliminating their consulting fees. The ban does not extend to tax consulting, and thus does not completely resolve this problem, but it represents a sound step toward enhanced auditor independence.

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276. Sarbanes-Oxley Act § 101.

277. There is a very strong argument that in the past, FASB has allowed the interests of management to override the interests of investors and accuracy in general when promulgating rules such as FAS 140, which gave a green light to many of the SPE manipulations seen in the Enron case. For this reason, as Anthony Luppino has argued, "history suggests that government regulators should consider taking a more active role than in the past in shaping the rules and standards that ultimately result in the disclosures required in public company financial statements." Luppino, *supra* note 3, at 153. The PCAOB is obviously well-placed to serve in this role. Richard Breeden, former Chairman of the SEC, has also called for the PCAOB to be directly involved in formulating accounting standards. *See* Breeden Testimony, *supra* note 60, at 462.

278. Sarbanes-Oxley Act § 201. SEC Chairman Arthur Levitt proposed this same reform during the Clinton Administration, but was unable to overcome intense lobbying by the accounting industry. *See* Peter H. Stone, *Accounting Angst*, 34 NAT'L J. 793 (2002).

4. New Rules Governing Use of SPEs

In a long overdue development, FASB has tightened the rules regarding the proper accounting of transactions with special purpose entities like the Raptors. In January 2003, FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities," which requires companies to consolidate and report SPE results on their financial statements if the reporting company is, as a matter of substance, the "primary beneficiary" of the SPE arrangement and absorbs the majority of the entity's profits or losses.[279] This new rule supersedes the prior FASB rulings on this topic, which resulted in companies like Enron taking massive amounts of debt off their books by engaging in transactions with entities owned and controlled almost totally by the company. In a related development, Congress and the SEC now require companies to disclose their off-balance sheet arrangements in their 10-Q and 10-K filings.[280] Had these two new rules been in effect from 1997 to 2001, they would have stopped many of the particular accounting manipulation gimmicks used by Enron—though I suspect Enron might have concocted different types of transactions to exploit different loopholes to achieve the same misleading results.

5. New Efforts to Limit Analysts' Conflicts of Interests

Regulators have also taken some steps to mitigate the disastrous conflicts of interest that render much of Wall Street's disseminated sell-side equity analysis meaningless at best and often actually pernicious. The most important development in this area came through litigation, not legislation. In April 2003, ten major Wall Street firms agreed to pay $1.4 billion to settle charges from New York Attorney General Elliot Spitzer

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279. For an excellent discussion of the new rule, see Luppino, *supra* note 3, at 79–83.

280. Sarbanes-Oxley Act § 401(a); Disclosure in Management's Discussion about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Exchange Act Release No. 33-8182 (Jan. 28, 2003). This is just one of a host of new reporting and disclosure requirements imposed on companies since Enron's collapse. For a list, see STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 50 (Comm. Print 2002). I do not oppose increasing disclosure requirements. For example, I believe that the new requirements for off-balance sheet entities are needed. However, I am skeptical that increasing reporting and disclosure requirements, on its own, will do much to deter or disclose fraud. As the Senate Governmental Affairs Report notes, more disclosures will not do much good if no one at the SEC is reading the disclosures. *See id.* Or, I might add, if analysts are not reading them either. More profoundly, the problem in the Enron case was generally not lack of relevant disclosure requirements, but the poor or nonexistent quality of disclosures made pursuant to relevant requirements. This suggests that mandating additional disclosure, while tempting to Congress and the SEC, may have largely been a waste of time, resulting in unnecessary costs.

and the SEC that the firms had manipulated their stock research to gain fees for their investment banking divisions.[281] As part of the settlement, the ten firms agreed to significant changes to their practices in this area, including, most notably, their agreement to provide their clients with independent research in addition to the firm's own research.[282] In addition, Title V of Sarbanes-Oxley prohibits investment banking executives from setting compensation for their firms' equity analysts and prohibits banking firms from retaliating against their analysts if their analysts criticize client companies or potential clients in their reports.

Spitzer's litigation and Title V will probably encourage Wall Street to provide more objective, independent research. Their usefulness, however, has probably been overestimated. If the reforms (and fears of future law suits by regulators) achieve their intended result, it will be harder for banks to use research to generate banking fees. But if that is the case, banks will lose their primary incentive for funding research programs in the first place.[283] As a result, banks may simply cut their research budgets.[284] In addition, the new rules do not address the fundamental bias of brokerages in favor of buy recommendations that boost transaction volume. For this reason, it would be naïve to think that these reforms will bring biased analysis to an end.[285] The only way Wall Street will abandon biased research is if the investing public comes to distrust its recommendations so strongly that research fails to move the equity markets at all. This outcome is unlikely.[286]

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281. SMITH & EMSHWILLER, *supra* note 19, at 376.

282. *Wall Street Firms Hit Hard*, ORLANDO SENTINEL, Apr. 29, 2003, at A1.

283. Thus, if one believes that Wall Street analysis leads to dramatically more efficient markets—an idea I doubt—then these reforms might actually be counterproductive.

284. My prediction appears to be coming true. *See* Ann Davis, *Increasingly, Stock Research Serves the Pros, Not "Little Guy,"* WALL ST. J., Mar. 5, 2004, at A1 (noting substantial reductions in the research budgets of major Wall Street firms since the Spitzer settlement).

285. It certainly will not solve the problem entirely. A recent *New York Times* story covering an Intel quarterly earnings conference call is instructive. Gretchen Morgenson reports:

> Proving that the more things change, the more they stay the same, Wall Street analysts have their pompoms out again. Yes, cheerleader analysts are not quite as prevalent as they were in 2000. But as the Intel earnings conference call last Tuesday showed, too many analysts still seem to think it is part of their job to high five the companies they are supposed to be assessing for the benefit of their clients.

Gretchen Morgenson, *Fawning Analysts Betray Investors*, N.Y. TIMES, Oct. 19, 2003, § 3, at 1. Morgenson went on to repeat some of the analyst comments during the call. Dan Niles, Lehman Brothers: "Another nice quarter, guys!"; Eric Gomberg, Thomas Weisel Partners: "Nice quarter!"; Mark Edelstone, Morgan Stanley: "Congratulations on a truly phenomenal quarter!" *Id.*

286. *See* Fisch & Sale, *supra* note 201, at 1048 ("One might predict that the market would discount for this excessive analyst optimism; however, empirical studies suggest that, at least in the past, the market has failed to do so.").

6. Increased Resources for the SEC

Finally, Congress has dramatically increased the resources of the SEC. The SEC, in turn, has decided to devote some of its resources to providing more careful review of the 10-K filings of the Fortune 500 companies.[287] Obviously, both of these changes are long overdue. The SEC's decision to start reading Fortune 500 filings—announced in December 2001, shortly after Enron filed for bankruptcy—is a little bit like barring the barn door after the cow has already escaped. Nevertheless, provision of more resources, and devoting some of those resources to reviewing the SEC filings of the Fortune 500 corporations, are necessary and useful steps.[288]

B. Counterproductive "Reforms"

Though many of the changes since Enron have been useful, several measures represent a step in the wrong direction. I will provide two important examples.

1. New Responsibilities for Audit Committees

A major goal of Sarbanes-Oxley is to increase auditor independence. To achieve this, Sarbanes-Oxley now requires, inter alia, that auditors report directly to boards of directors' audit committees, and not to management. The goal here is laudable: decreasing the ability of management to skew audit results. But the solution invites further disasters. It provides management with a new factual defense when accused of accounting fraud: they can argue to juries that supervising the auditors and audit results was the board's job, not management's. Decreasing man-

287. Section 408(c) of the Sarbanes-Oxley Act requires the SEC to review a company's periodic reports at least once every three years. Over and above this requirement, the SEC has committed to annual "monitoring" of Fortune 500 filings. Monitoring is a process by which the SEC reads some portion of a filing to determine whether there are issues calling for more detailed analysis. STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 9–10 (Comm. Print 2002); *Program to Monitor Annual Reports of Fortune 500 Companies*, SEC NEWS DIG., 245, Dec. 21, 2001.

288. In addition to the significant measures discussed above, Sarbanes-Oxley contains numerous reforms that I believe will make a positive, though probably less significant, impact on the securities market. For example, § 203 of Sarbanes-Oxley obligates lawyers to report material violations of securities law or breaches of fiduciary duty to a company's general counsel, CEO and Boards of Directors; §§ 302 and 906 require CEOs and CFOs to certify the accuracy of financial statements; § 306 prohibits certain insider sales of stock during blackout periods due to the likely existence of inside material information; and §§ 806 and 1107 create certain whistleblower protections.

agement's apparent accountability is, I suggest, a step in the wrong direction. Second, and more important, we have seen that boards of directors have neither the time nor the inclination to supervise audits closely, and are extraordinarily poor fraud and deception watchdogs. Indeed, given time constraints, the board audit committee may not even be able to understand the company's financial statements, let alone provide careful review of the auditing process.[289] Thus, assigning the board even greater oversight responsibilities without taking any steps to make boards more effective makes very little sense.

2. New Corporate Ethics Code Requirements

A second major blunder concerns corporate ethics codes.[290] As we have seen, Enron's Board of Directors agreed to waive the company's code of ethics so that Enron's CFO could participate in the LJM-related party transactions, conflict of interest notwithstanding. In direct response to these events, Section 406 of Sarbanes-Oxley requires companies to disclose any waivers of their codes of ethics.[291] The theory here is that if Enron had been forced to notify the market that it had waived its code of ethics, the market might have investigated the LJM transactions more closely. I am skeptical about this conclusion. As we have seen, investors, market analysts, and regulators were not paying any real attention to the company's financial statements in the first place, so placing an additional ethics waiver footnote in those statements would probably not have caused any additional analyst inquiry. More to the point, neither Section 406 nor its implementing regulations set forth standards with which company codes of ethics must comply. In particular, there are no rules governing what types of ethical issues require waivers and what types do not.[292] As a result, one suspects that all corporate lawyers worth their salt will advise clients to write and promulgate ethics codes that require very few waivers, or none at all. As a result, this provision may actually lower corporation ethical standards and decrease board

289. For a concurring view, opposing the provision of more responsibilities to audit committees, see *Corporate Governance and Executive Compensation: Hearing Before the Senate Comm. on Fin.*, 107th Cong. 178 (2002) [hereinafter Pozen Testimony] (Testimony of Robert C. Pozen, former Vice Chairman of Fidelity Investments, wherein he stated that "[t]he typical audit committee of a large corporation is hard pressed to understand and monitor the auditing of the company's financial statements.").

290. My analysis here is indebted to the first-rate analysis in Notes, *The Good, the Bad, and their Corporate Codes of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behavior*, 116 HARV. L. REV. 2123 (2003).

291. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 § 406, 116 Stat. 805.

292. Notes, *supra* note 290, at 2135.

oversight of corporation ethics, a perverse consequence Congress could not possibly have intended.

C. Are the Reforms Implemented to Date Adequate?

The reforms noted above address several major problems evident in the Enron debacle. Boosting criminal penalties is long overdue. Eliminating most auditor consulting fees should have a positive impact on auditor independence. Also, steps taken in Sarbanes-Oxley and through the Spitzer settlement to decrease analyst conflicts of interest seem useful, though the jury is out on whether this will truly improve the quality of Wall Street analysis. That said, I think the reform measures implemented since the Enron collapse do not adequately address a number of major concerns I have after working on the Enron case.

1. Concerns about the SEC

First, Sarbanes-Oxley assumes that throwing more money at the SEC will make the SEC an effective regulatory body. I disagree. I support providing the SEC with more resources, but the SEC will never adequately police the securities market unless it radically changes its culture and practices as well. As we saw in the Enron case, the SEC had sufficient resources to review Fortune 500 filings but simply failed to do so. The SEC did not need more money to stop Enron, it needed managers to set better priorities and implement better screening criteria. The SEC's substandard performance in the Enron case is not an isolated incident. Since the Enron bankruptcy, regulators have uncovered three major examples of securities sector misconduct involving fraudulent practices on the floor of the New York Stock Exchange,[293] Wall Street analyst conflicts of interest, and trade timing abuses in the mutual fund industry.[294] In the first case, the SEC began to investigate only after the fraud was disclosed in the *Wall Street Journal*.[295] In the second and third cases, the abuses were caught and disclosed by New York Attorney General El-

293. *See* Deborah Solomon & Susanne Craig, *Market Discipline: SEC Blasts Big Board Oversight of "Specialist" Trading Firms*, WALL ST. J., Nov. 3, 2003, at A1 (discussing violations of exchange rules by specialist firms on NYSE trading floor over three years resulting in approximately $155 million in losses to investors).

294. *See* John Hechinger & Tom Lauricella, *Sun Life Unit Reaches Pact in Fund Probe*, WALL ST. J., Jan. 27, 2004, at C1. *See also* Editorial, *Spitzer's Fee*, WALL ST. J., Jan. 5, 2004, at A14 (noting that Spitzer brought mutual fund scandal to light while SEC "snoozed on the job"); Tom Lauricella et al., *Spitzer Gambit May Alter Fund-Fee Debate: Alliance Capital Offers Fee Cut As Part of Proposed Settlement; Terms of Deal Split SEC, Spitzer*, WALL ST. J., Dec. 11, 2003 at C1 (same).

295. Solomon & Craig, *supra* note 293.

liot Spitzer, not the SEC. Indeed, at a time when abuses in the mutual fund industry were commonplace, SEC Chairman William Donaldson was opposing stricter mutual fund oversight.[296] Interestingly, Spitzer's securities fraud staff in New York has approximately fifteen people.[297] How, one wonders, can a staff of fifteen out-think and out-muscle the entire SEC? The answer, of course, is that the New York AG sets priorities carefully, follows good leads, and is not afraid to challenge Wall Street on Wall Street's home turf. The SEC, in contrast, appears to have little sense of what is happening in the market, frequently fails to identify and stop problems before they explode, and is reluctant to challenge the major Wall Street firms, even when their practices are clearly unethical.[298]

The SEC's problems are not limited to its inability to proactively uncover fraud. The Commission also suffers from bureaucratic complacency. I will provide two examples. How long did it take the SEC to review Enron's 1997 10-K form once it was filed? Answer: almost a year.[299] What happened when Congress provided the SEC with increased resources in 2003? Answer: the SEC returned $130 million of the increase to the Treasury.[300] If we want a well-policed securities market, the SEC must change its ways.[301]

2. Failure to Use Criminal Laws to Increase Accuracy of Financial Information

Second, the basic cause of the Enron debacle was the company's provision of inaccurate and misleading financial information to the securities market. Sarbanes-Oxley seeks to combat this problem indirectly by enhancing auditor independence, increasing criminal punishments for intentional fraud, and boosting SEC resources. This effort to address the problem of information accuracy indirectly is odd, since we could have attacked the issue directly. What we want, in the end, is not just to mar-

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296. Deborah Solomon, *Fund Industry Faces Overhaul of Rules*, WALL ST. J., Feb. 4, 2004, at C3.

297. Monica Langley, *The Enforcer: As His Ambitions Expand, Spitzer Draws More Controversy*, WALL ST. J., Dec., 11, 2003, at A1.

298. For concurring assessments of SEC performance, see Choi & Pritchard, *supra* note 270, at 24–25 (SEC has "inability to assess all market risks and prioritize among them"); Laurie P. Cohen & Kate Kelly, *NYSE Turmoil Poses Question: Can Wall Street Regulate Itself?*, WALL ST. J., Dec. 31, 2003, at A1 ("The SEC, for its part, has a poor record of spotting risks to investors before they worsen . . ."); Maremont & Solomon, *supra* note 228 (describing poor SEC performance).

299. STAFF OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 26 (Comm. Print 2002).

300. *See* Maremont & Solomon, *supra* note 228.

301. I present several ideas for reforming the SEC below. *See infra* Part V.A.

ginally increase deterrence of intentional fraud or marginally enhance auditor independence, but to improve as much as possible the accuracy and usefulness of the information management provides to the market. This could be done very efficiently and directly by placing an enforceable legal duty on corporation managers to be careful when they talk about their companies to analysts or file financial statements. Currently, senior corporate executives can be sued for securities fraud civilly only if they commit fraud with scienter: knowingly or recklessly, with a conscious disregard of the risk of inaccuracy. Similarly, executives cannot be prosecuted criminally unless they make false statements to the market knowingly and intentionally. If we are really interested in improving the quality of the information flow to the equity market, we should use the criminal laws to impose a duty of care on management to take all reasonable steps to ensure that their disclosures are accurate.[302]

3. Failure to Adequately Address Auditor Misconduct

Finally, Arthur Andersen's conduct in the Enron case strongly suggests that increasing deterrence of auditing misconduct and fraud should be a priority. Sarbanes-Oxley, however, did not ease criminal prosecution of auditors in any way, and it did not reverse the Supreme Court's 1995 decision prohibiting civil aiding and abetting suits against auditors who assist management in commiting fraud.[303] Instead, Congress decided to rely on the newly formed PCAOB, restriction of auditor consulting fees, and the enhancement of responsibilities of board audit committees to deter auditor misconduct. This reliance is misguided.

Though I support the creation of the PCAOB, I have little faith that the PCAOB will do much to deter fraud and misconduct. The board is likely to have only three hundred employees to review the work of tens of thousands of auditors and thousands of publicly audited companies. What reason do we have to believe that this review will be any more effective than the haphazard oversight provided generally in the securities market by the PCAOB's parent organization, the SEC? Indeed, the enormous disparity between board resources and the size of the task will likely render the PCAOB ineffective as a monitor of auditor fraud and misconduct.[304]

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302. This idea is fleshed out in detail below. *See infra* Part V.B.

303. Morrissey proposes that we roll back the Supreme Court's *Central Bank* decision and the PSLRA. *See* Morrissey, *supra* note 155, at 852–56. This is a reasonable proposition, but my sense is that we can fight fraud more efficiently through improved government policing of the market than we can by taking steps to incentivize private enforcement, which might easily lead to frivolous litigation.

304. For a concurring judgment, see *id.* at 838–39.

In addition, restricting the ability of auditors to provide most consulting services does not eliminate the basic incentive auditors have to please their clients: the clients pay their auditing fees. As former SEC Chairman Richard Breeden testified before Congress,

> had Arthur Andersen not been performing any consulting work, its pure audit fee of $25 million per year would have been more than large enough to create powerful incentives for the managers at Andersen to give the client the accounting treatment it wanted for SPEs. Unlike consulting fees, which are one time assignments, the audit is generally viewed as a long-term engagement. On average, audit engagements at Coopers & Lybrand when I was there lasted nearly twenty years. Thus, the $25 million annual audit fee would have a present value much greater than $25 million in one time consulting business. Therefore, even if firms performed no consulting work whatever, there would still be issues of the willingness of the auditors to antagonize a big client determined to use accounting games to overstate income.[305]

Thus, simply eliminating most consulting fees will not eliminate the incentive auditors have to placate their largest clients. Likewise, reliance on boards of directors to deter or detect auditing fraud in the few days per year they devote to company business seems extremely naïve, given what we know about board performance. We need to try something more effective to prevent more Andersen-style misconduct in the future.[306]

V. PROPOSED REFORMS

As noted above, the latest round of securities regulation reform in 2002 and 2003 failed to address three critical issues: fundamental reform of the SEC; creation of direct legal incentives to improve the quality of the information management provides to the market; and effective deterrence of auditor misconduct. In the pages that follow, I provide concrete proposals to deal with all three issues, recommending an overhaul of the SEC, criminalization of negligent conduct by corporate executives, and

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305. Breeden Testimony, *supra* note 60, at 469. Morrissey reaches the same conclusion. "In many cases," Morrissey writes, "the audit fees themselves would still typically be sufficient for an accounting firm to compromise its objectivity in order to retain the audit business. In fact, the auditing fees themselves might even be all the more important if fees from other types of services are reduced or eliminated." Morrissey, *supra* note 155, at 840. *See also* Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited*, 8 STAN. J.L. BUS. & FIN. 39, 47 (2002).

306. I propose imposing mandatory auditor rotation as a way of addressing this problem in Part V.C, *infra*.

implementation of mandatory auditor rotation on at least a limited basis. These reforms are necessary if we are to plug the gaps in our securities regulation regime, protect ordinary investors, and ensure that our equity markets function in a safe and efficient manner.

A. Reform the SEC

In the Enron case, the SEC's performance as a fraud and deception watchdog was totally inadequate. As we have seen, Congress has attributed the SEC's failure to a lack of resources. Unfortunately, more money will not solve the SEC's problems unless we also make the Commission more efficient, more effective, and more diligent. To accomplish this task, I propose an overhaul of the SEC. This overhaul should include, at the very least, improvements in the SEC's litigation and settlement practices, changes in SEC attorney recruiting, passage of legislation providing the SEC with the right to hold public hearings, and improvements in the SEC's ability to proactively investigate and uncover widespread and systematic securities violations.

1. Reform SEC Litigation and Settlement Practices

First, we must reform SEC litigation and settlement practices. The SEC is currently trial averse.[307] Indeed, the SEC litigation paradigm for a "successful" case is "file-and-settle." Under this paradigm, the SEC typically works out a deal with a malefactor beforehand, and then files and settles the civil complaint on the same day. The eagerness with which the SEC pursues file-and-settle cases is profoundly disturbing.[308] Wall Street defense lawyers know that the SEC wants to avoid trial at all cost, and they use this fact as leverage to obtain light settlements. Moreover, the fact that the case starts and ends on the same day, usually without any acknowledgement of fault by the malefactor, ensures that the negative publicity for the company is limited, undercutting the deterrence

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307. *See* Langevoort, *supra* note 172, at 477 (noting that SEC fears losing in court and thus prefers administrative actions and settlements). Langevoort attributes this problem to low pay and difficulty in retaining experienced personnel, though as I state below, the experience of DOJ in this area suggests that morale and institutional culture may have at least as much to do with this outcome as resources.

308. The latest example of this practice was the SEC's hasty and controversial decision to reach a quick settlement with Putnam Investments, a major target in the mutual fund scandal. The SEC was in such a rush, it did not even bother to work out a settlement fine amount, agreeing with Putnam to put off determination as to an appropriate penalty, if any, to a later date. *See* Deborah Solomon, *SEC Chairman Defends Decision to Quickly Settle Putnam Charges*, WALL ST. J., Nov. 18, 2003, at D9; Deborah Solomon & John Hechinger, *SEC Takes Heat for Quick Deal with Putnam*, WALL ST. J., Nov. 17, 2003, at C1.

force of SEC action. As a result of this approach to litigation, Wall Street firms and other securities law violators can typically avoid imposition of penalties high enough to deter misconduct in the future. In short, running afoul of the SEC has become nothing more than a minor and acceptable cost of doing business for many major Wall Street players.

To reverse this trend, the SEC needs to push for larger settlements in the billion dollar range when dealing with major Wall Street institutions, and to show that it is willing to take cases to trial if defendants will not pay up. This is the only way to make the SEC a powerful and effective deterrent force in today's securities marketplace.

As part of this drive to become less trial averse, the SEC enforcement division needs to eliminate the investigation-litigation staff divide. Currently, in many large SEC cases, one group of SEC attorneys and accountants works on a case through the investigation phase, and then, once a suit is filed, hands the case over to the litigation staff for trial or settlement. The problem here is twofold. First, the litigation staff member that receives a newly filed SEC case for disposition starts the case with very limited knowledge about the case. Like prosecutors in similar situations, they may fear that the cases they inherit possess hidden traps, legal defenses or charging mistakes that will come back to haunt them—and embarrass them—if they approach the case confrontationally. In contrast, their counterparts on the defense side, who typically have been representing their clients since the SEC opened its inquiry, tend to know their cases backward and forward from day one. Wall Street litigators take advantage of this disparity in knowledge to obtain better settlements than they could get if they were up against SEC staff who had lived with their cases for months and were truly confident, as only an investigator can be, that they know all of a particular case's strengths and weaknesses in detail. Second, I know from experience that when prosecutors receive a case for disposition that another prosecutor has investigated and indicted, they are often less personally invested in the outcome than they would be if they had spent months, or even years, putting the case together themselves. Such cases—known to prosecutors as "dumps"—often result in pleas to lower sentences than could have been obtained had the same prosecutor stayed with the case from start to finish. Many prosecutorial offices, like my own former office in the Eastern District of New York, recognize this problem and try, as an institutional matter, to ensure that the same prosecutor is responsible for investigating, indicting, and disposing of a particular case as often as possible. The SEC, in contrast, institutionalizes the "dump" mentality through its staffing plan. The SEC needs to eliminate the investigation-litigation split if it is serious about obtaining adequate penalties from persons and companies who violate the securities laws. Instead, unified teams of lawyers and ac-

countants should stick with cases from the moment the inquiry opens to the day the case is completed.[309]

2. Improve SEC Recruiting Practices

We also need to change SEC recruiting practices. Though the SEC has some excellent lawyers on its staff, the institution as a whole needs to hire more talented lawyers. In my generation of lawyers—I graduated from law school in 1996—going to work for the SEC is rarely a goal for top graduates of our best law schools. Apologists for the SEC claim that the SEC has difficulty hiring top job candidates because the SEC cannot compete with the salaries offered by top law firms. This explanation rings hollow. United States Attorney's Offices throughout the country pay the same or less than the SEC yet routinely have their pick of the best young litigators in their cities. The SEC's inability to recruit and retain top talent is not due to low salaries, but because many see the SEC as a backwater—a "timid, poorly managed bureaucracy," as the *Wall Street Journal* recently put it[310]—where the chance to pick up real litigation skills and experience is limited.[311] To improve SEC hiring, the Commission's senior staff need to make a greater effort to appear personally at law firms and law schools to talk about the SEC's mission and generate more interest in the Commission among young and prospective lawyers. The SEC also needs to promise young litigators that if they join the SEC, they will work on cutting edge cases and take those cases to trial, and then deliver on this promise. This will provide the incentive to draw top trial lawyers back to the SEC, as was the case in the past.

3. Give SEC Power to Hold Public Hearings

We need to pass legislation giving the SEC power to conduct public hearings to discuss financial statements with corporate executives. To-

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309. These comments are based on my observations of SEC practices and on my own experience as a federal prosecutor in the Eastern District of New York, where I spent much of my time trying large cases indicted by others.

310. Maremont & Solomon, *supra* note 228.

311. SEC personnel identify low pay as a primary reason for leaving the SEC, but I think this reflects low morale more than pay. United States Attorney's Offices do not have similar problems retaining experienced staff despite disparities between private and public salaries. My comments on the SEC may seem unduly harsh, and I know I run the risk of alienating my friends who work at the SEC. Nevertheless, I think we need to be brutally honest about the SEC as a first step toward improving the institution. As a prosecutor, I was often shocked by the incredibly disrespectful manner in which Wall Street defense lawyers spoke about SEC efforts to police the securities market. Ignoring this problem rather than speaking out about it seems irresponsible.

day, a company like Enron can bury bad news in opaque or deceptive financial statements and get away with it because Wall Street analysts simply will not ask executives tough questions about their disclosures. The SEC should be empowered to step into the breach. When the SEC staff reviews 10-Q and 10-K forms, they should identify filings that raise as many questions as they answer, either because they are unclear or because they contain unusual disclosures, such as large-scale related-party transactions, aggressive use of SPEs and off-balance sheet financing, or waivers of ethical standards. The top executives of these companies should then be subpoenaed to appear before the Commission and explain their filings. This would have three positive effects: it would encourage companies to make their disclosures as straightforward as possible, to avoid the risk of a hearing; it would give the investing public, through their SEC proxy, access to ask corporate executives questions that Wall Street analysts have been reluctant to ask; and it would give the SEC a mechanism to try to understand filed financial statements short of opening a formal inquiry. If companies have nothing to hide, they should be eager to appear before the SEC and explain what their 10-Qs and 10-Ks actually mean.

4. Improve SEC's Investigative Ability

We also need to improve the SEC's ability to proactively investigate and uncover widespread and systematic securities violations before millions of investors are harmed, instead of waiting to investigate until the problems have exploded publicly in the headlines of the *Wall Street Journal*. As Chairman Donaldson recently noted, "[f]or too long . . . the commission has found itself in a position of reacting to market problems rather than anticipating them."[312] In the three major securities scandals since the Enron collapse, for example, involving fraudulent practices on the floor of the New York Stock Exchange, Wall Street analyst conflicts of interest, and trade timing abuses in the mutual fund industry, the SEC either knew nothing about the problems until they were publicized by others or, more alarmingly, knew about problems but failed to rectify them. For example, the SEC received tips about problems in the mutual fund industry but failed to act on those leads.[313] In some cases, the SEC's failure to follow up on tips has led tippers to approach other regulators rather than the SEC because the tippers feel the SEC will simply

312. Maremont & Solomon, *supra* note 228.

313. *See id.*; Solomon & Hechinger *supra* note 308 (noting criticism of SEC for failing to act on tip from Putnam employee about mutual fund trading violations).

ignore their information.[314] In contrast, New York Attorney General Elliot Spitzer, with his securities staff of fifteen, has repeatedly been able to proactively identify and bring to light major institutional problems in the securities industry. Spitzer is successful, unlike the SEC, because Spitzer is able to gather intelligence about market problems in an effective manner and then prioritize and attack those problems swiftly.

To improve SEC performance in this area, the SEC needs to create an internal think tank to watch the securities marketplace and try to identify potential problems in the industry. The SEC also needs to implement a more sophisticated method for obtaining and investigating leads it receives from industry professionals.[315] Finally, the SEC needs to link these two processes—market observation and intelligence gathering—and create a more effective risk assessment and enforcement prioritization capability.[316]

We need, in short, to reinvent the SEC for the 21st century. As the number of regulated companies and filings increases, and as the stakes for the investing public grow greater, the SEC needs to become smarter, more aggressive, more efficient, more proactive, and more productive. This will require, above all, leadership. The Bush Administration has twice chosen advocates of the status quo to head the SEC. What we really need is an energetic reformer in that position. Changing the institutional culture at the SEC is a big task. We need a great reform chairman to embrace that task.

B. Criminalize Negligent Behavior

In addition to reforming the SEC, we need to criminalize negligent conduct by CEOs, CFOs and other corporate executives who provide

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314. *See, e.g.*, Maremont & Solomon, *supra* note 228 (tipper approached Massachusetts state regulators after SEC ignored tip); Henny Sender & Gregory Zuckerman, *Behind the Mutual-Fund Probe: Three Informants Opened Up*, WALL ST. J., Dec. 9, 2003, at A1 (noting one informant decided not to approach SEC because "she wasn't confident the agency would follow up on her allegations").

315. The SEC might borrow some techniques from the FBI to accomplish this goal. After the September 11, 2001 attack on the World Trade Center, the FBI and the Joint Terrorism Task Force created an effective system to gather and process an enormous number of leads and tips virtually overnight.

316. After Enron, the SEC hired McKinsey and Co. to provide guidance and advice on how to improve SEC performance. Though the McKinsey study has not been publicly released, key portions were leaked to the *Wall Street Journal*. According to the Journal, one critical finding was that the SEC "lacks the institutional structure and experience needed to systematically identify risks." Maremont & Solomon, *supra* note 228. The SEC is reportedly creating an Office of Risk Assessment to address this problem. *See id.* The Office of Risk Assessment will not be effective, however, unless it includes tip and intelligence processing functions in its operations.

false information to the market.[317] Every legal system in the world criminalizes at least some types of negligent conduct to protect important interests in life, limb and property.[318] The reason for this practice, which dates back to the late Roman Empire,[319] is straightforward: punishing negligent conduct creates incentives for actors to take reasonable care when they engage in conduct that could cause harm to others. In the United States, we currently punish a broad range of negligent conduct through the criminal laws. In California, for example, it is a crime under state laws, punishable by fines and imprisonment, to negligently enter into contracts with uncertified asbestos removers,[320] negligently miscalculate commodity prices,[321] negligently violate medical privacy laws,[322] negligently violate the state's public employee merit system for teachers,[323] negligently mishandle voter registration cards,[324] negligently mishandle pesticides,[325] negligently violate certain adult day care health

317. The scholarly literature regarding use of negligence standards in criminal law is extensive. The classic analysis of the problem is George P. Fletcher, *The Theory of Criminal Negligence: A Comparative Analysis*, 119 U. PA. L. REV. 401 (1971). Fletcher concludes that negligence is a fair ground to impose criminal sanctions. *See id.* at 436. For the classic statement of the opposite viewpoint, see Jerome Hall, *Negligent Behavior Should Be Excluded from Penal Liability*, 63 COLUM. L. REV. 632 (1963). For an excellent analysis of Hall's article, arguing that Hall possessed a "simplistic conception of the relationship between voluntariness and responsibility," and totally misread Aristotle, on whose work he grounded his analysis, see Kyron Huigens, *Virtue and Criminal Negligence*, 1 BUFF. CRIM. L. REV. 431, 440–57 (1998). For important recent work on this topic, see Kenneth W. Simons, *Dimensions of Negligence in Criminal and Tort Law*, 3 THEORETICAL INQUIRIES L. 283 (2002). Though Fletcher notes that theorists have long been "uneasy" about criminalizing negligent behavior, see Fletcher, *supra*, subjecting persons to penal sanctions for conduct which falls below a reasonable standard is not a rarity in criminal law. At least nine states, for example, impose criminal liability on persons who negligently store firearms. *See* Ann-Marie White, Comment, *A New Trend in Gun Control: Criminal Liability for the Negligent Storage of Firearms*, 30 HOUS. L. REV. 1389, 1410–13 (1993) (listing California, Connecticut, Florida, Hawaii, Iowa, Maryland, New Jersey, Virginia, and Wisconsin among states that impose criminal liability for negligently storing firearms). Doctors are increasingly subject in many jurisdictions to criminal prosecution for medical negligence. *See* James A. Filkins, *"With No Evil Intent": The Criminal Prosecution of Physicians for Medical Negligence*, 22 J. LEGAL MED. 467 (2001); Alexander McCall Smith, *Criminal or Merely Human? The Prosecution of Negligent Doctors*, 12 J. CONTEMP. HEALTH L. & POL'Y 131 (1995). The Model Penal Code includes "criminal negligence" as one of the four potential mental states giving rise to criminal liability, though the definition more closely resembles common law gross negligence than simple negligence in tort law. *See* MODEL PENAL CODE § 2.02(d) (1962).

318. *See* Fletcher, *supra* note 317, at 415.

319. *Id.*

320. CAL. BUS. & PROF. CODE §§ 7118.5, 7118.6 (West 1995).

321. 2004 Cal. Legis. Serv. 752 (West).

322. CAL. CIV. CODE §§ 56.17, 56.36 (West 2004); CAL. HEALTH & SAFETY CODE § 120980 (West 1996); CAL. INS. CODE §§ 742.407, 10123.35 (West 2004); CAL. INS. CODE § 799.10 (West 1993).

323. CAL. EDUC. CODE § 88136 (West 2002); CAL. EDUC. CODE § 45317 (West 1993).

324. CAL. ELEC. CODE § 18103 (West 2003).

325. CAL. FOOD & AGRIC. CODE § 12996 (West 2001).

standards,[326] negligently handle flammable materials,[327] negligently start fires,[328] negligently conduct medical experiments without consent,[329] negligently violate rice straw burning regulations,[330] negligently pollute the air,[331] negligently pollute the water,[332] negligently violate worker safety regulations,[333] negligently operate steam boilers,[334] negligently discharge a firearm,[335] negligently cut trees, shrubs or ferns without a permit,[336] negligently harm an animal on another person's lands while hunting,[337] negligently own or control dangerous dogs,[338] negligently make a false statement while soliciting charitable contributions,[339] negligently damage a public highway or bridge,[340] negligently violate forestry or ranger regulations,[341] negligently operate a train resulting in death,[342] and negligently discharge hazardous waste.[343] Negligent conduct, in other words, is widely criminalized in American law, where violation of standards of reasonable care may result in serious social harm or injury. To take a more prosaic example, driving a car negligently is a crime in virtually all American jurisdictions because we recognize that cars can be dangerous and must be driven responsibly and with reasonable care.[344] Similarly, when executives of publicly held companies provide information to the equity marketplace, the potential for harm is great because inaccurate information may lead investors to lose their retirement savings. Accordingly, we need a criminal negligence statute in the securities disclosure area.

I propose that Congress pass a new federal criminal statute making it a misdemeanor, punishable by up to one year in jail,[345] for any person to negligently make any untrue statement of material fact about a pub-

326. CAL. HEALTH & SAFETY CODE § 1595.2 (West 2000).
327. CAL. HEALTH & SAFETY CODE § 13001 (West 1984).
328. CAL. PUB. RES. CODE § 4435 (West 2001).
329. CAL. HEALTH & SAFETY CODE § 24176 (West 2004).
330. 2004 Cal. Legis. Serv. 644 (West).
331. CAL. HEALTH & SAFETY CODE § 42400.1 (West 1996).
332. 2004 Cal. Legis. Serv. 183 (West).
333. CAL. LAB. CODE §§ 2658.1, 6423, 7156 (West 2003).
334. *Id.* § 7770.
335. CAL. PENAL CODE § 246.3 (West 1999).
336. *Id.* § 384a.
337. *Id.* § 384h.
338. CAL. PENAL CODE § 399.5(a) (West 2004).
339. CAL. PENAL CODE § 532d(a) (West 1999).
340. *Id.* § 588.
341. CAL. PUB. RES. CODE § 4021 (West 2000).
342. CAL. PUB. UTIL. CODE § 7680 (West 1994).
343. CAL. WATER CODE § 13265 (West 1992).
344. For a discussion of negligent driving, see Fletcher, *supra* note 317, at 415.
345. Maximum sentence parameters for multiple violations would be aggregated, so that a person committing three offenses could serve up to three years.

licly traded company's operations, performance, or financial condition, or to negligently omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.[346] Thus, if an executive makes a false material statement about her company to analysts, business journalists, or to the SEC in 10-K or 10-Q filings, without exercising reasonable care to ensure the statement is accurate, she could be prosecuted. My model here is 33 U.S.C. § 1319(c)(1)(A), the criminal negligence provision of the Clean Water Act (CWA).[347] Section 1319(c)(1)(A) was passed in 1972 because Congress determined "that the enforcement of federal law regarding water quality had not worked."[348] Section 1319(c)(1)(A) criminalizes negligent violations of CWA permits and negligent discharges or spills of pollutants into waters of the United States. Thus, if companies are negligent in their operations, training, or supervision of personnel, and this negligence results in impermissible water pollution, the negligent company and its executives may be held criminally liable—either fined or sent to prison. Just as persons and companies can and should be held criminally responsible for negligent discharges of pollution into American waterways, corporate executives and their companies should be held criminally responsible for negligently releasing inaccurate information into the equity market.

This new criminal negligence statute would provide four important social benefits. First, it would create a direct incentive for company executives to police their own conduct and ensure that the information they release to the market is accurate. Second, it would provide prosecutors with a badly needed and flexible tool to pursue securities violators. It would, for example, give prosecutors a lesser charging vehicle carrying lower penalties than full blown securities fraud, which might be useful in securities cases involving minor harm, minimal defendant gain, or affecting few victims. At the same time, it would allow prosecutors to charge defendants in cases where the harm caused by release of false information is immense, but proof of intent is hard to find. Third, it would eliminate an important defense to current criminal securities fraud suits:

346. The language here tracks that of Rule 10b-5 so as to avoid creating huge new interpretive issues. *See supra* note 61.

347. For discussion and analysis of 33 U.S.C. § 1319(c)(1)(A), see Truxtun Hare, *Reluctant Soldiers: The Criminal Liability of Corporate Officers for Negligent Violations of the Clean Water Act*, 138 U. PA. L. REV. 935 (1990); Samara Johnston, *Is Ordinary Negligence Enough to be Criminal? Reconciling* United States v. Hanousek *with the Liability Limitation Provisions of the Oil Pollution Act of 1990*, 12 U.S.F. MAR. L.J. 263, 294–300 (1999–2000). Currently, 33 U.S.C. § 1319(c)(1)(A) is the only federal criminal negligence provision, though Hare notes that federal courts use an involuntary manslaughter charge which allows conviction for negligent conduct. *See* Hare, *supra*, at 961.

348. Hare, *supra* note 347, at 946.

the "I did not know what was happening" defense. Finally, it would close the gap between public expectations and legal reality in the area of securities fraud. In the aftermath of the Enron collapse, members of the business press and the public clamored for the prosecution of Enron CEO Ken Lay because he was clearly negligent: even if, these commentators argued, Lay did not intend to defraud the public, he should be held responsible because he was the company's CEO and should have known what was happening at his firm.[349] Of course, no prosecution of Lay for negligence is possible because, under our current securities fraud regime, conduct must be knowing, intentional, or willful before criminal liability attaches. That would not be the case if Congress passed my proposed statute. Over 140 years ago, Henry Maine commented that the happiness of a society depends on the degree to which the gap between social opinion and legal sanction is minimized.[350] Passage of a criminal negligence statute in the securities area would help close the gap that exists today by ensuring that executives who fail to exercise due care in the management of their companies are held responsible for their carelessness.

To understand how useful a negligence statute in the securities area would be, we need only examine thirty-plus years of experience with § 1319(c)(1)(A), the criminal negligence provision of the Clean Water Act (CWA). Federal prosecutors have not abused or misused this important charging provision. In a recent study analyzing use of the negligence statute from 1987 to 1997, Steven Solow and Ronald Sarachan found that prosecutors used the negligence provision in less than seven percent of

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349. In a recent *New York Times* opinion piece, for example, *Fortune* writers Bethany McLean and Peter Elkind write:

> Lay's defense can be summarized in a single word: ignorance.
>
> He says he didn't know about Enron's shaky financial condition. He claims he didn't understand the accounting rules that Enron used to keep billions in debt off its balance sheet. He says he thought the actual businesses were as good as the company was claiming . . . .
>
> Ignorance has often been a legitimate excuse for a corporate executive; under the law, prosecutors must prove intent. But Mr. Lay was chief executive of Enron for all but six months of its existence before it declared bankruptcy. He was chairman of the board the entire time. Most of the important figures in the fraud ultimately reported to him. The actions of people he was responsible for hiring, promoting and overseeing cost many people many millions of dollars.
>
> Shouldn't he have to face a criminal trial for his role in Enron's fraud?

Bethany McLean & Peter Elkind, *Uneven Justice*, N.Y. TIMES, Feb. 4, 2004, at A25. A person interviewed in a recent story in the *Houston Chronicle* had the same reaction. "But as CEO of a company, it's his responsibility to know. If he didn't know, he should have. I feel bad for him, because I truly think he was probably innocent, but because of this job he should have known." Laura Goldberg, *Skilling's Indictment Turns Focus to Ken Lay*, HOUSTON CHRON., Feb. 20, 2004, at A15.

350. HENRY MAINE, ANCIENT LAW 15 (J.M. Dent & Sons 1960).

all environmental crime prosecutions.[351] Prosecutors appear to have used their discretion wisely.[352] According to Solow and Sarachan, prosecutors typically employ the statute to prosecute cases involving extraordinary environmental harm and human injuries, cases of gross negligence, and as a "compromise" disposition where defendants agree to plead guilty.[353] The authors conclude that prosecutors have "exercised considerable restraint in this area."[354]

An anecdotal examination of cases brought pursuant to 33 U.S.C. § 1319(c)(1)(A) also indicates the potential value of federal misdemeanor statutes. Prosecutors, for example, have used the statute to prosecute Rockwell International Corp. for massive water pollution at the Rocky Flats nuclear weapons plant.[355] The Justice Department has also used the statute to charge and convict defendants for negligently dumping large quantities of waste water and pollutants into the Richmond, Virginia sewer system;[356] dumping some twenty-six million gallons of benzene-polluted water into the Los Angeles sewer system;[357] discharging pollutants into the Cahaba River watershed, which provides the drinking water for the residents of Birmingham, Alabama;[358] dumping thousands of gallons of heating oil into Alaska's Skagway River;[359] and negligently destroying wetlands that serve as a habitat for several endangered species, including the American bald eagle.[360] The obvious value of these prosecutions demonstrates how useful a tool criminal negligence statutes can be in the hands of responsible prosecutors.

Consider one more infamous case. In 1989, the "oil tanker *Exxon Valdez* was run aground on Bligh Reef in Prince William Sound, Alaska,"[361] resulting in the discharge of some eleven million gallons of crude oil into an environmentally sensitive but economically crucial fishery, causing immense economic and environmental damage.[362] Joseph

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351. Steven P. Solow & Ronald A. Sarachan, *Criminal Negligence Prosecutions Under the Federal Clean Water Act: A Statistical Analysis and an Evaluation of the Impact of* Hanousek *and* Hong, 32 ENVTL. L. REP. 11,153, 11,156 (2002).

352. *See id.* at 11,158.

353. *Id.* Prosecutors also frequently tag misdemeanor negligence charges onto indictments that also charge felony violations of the CWA. *See id.*

354. *Id.*

355. *See* United States v. Rockwell Int'l Corp., 282 F.3d 787, 794–95 (10th Cir. 2002).

356. *See* United States v. Hong, 242 F.3d 528, 530–34 (4th Cir. 2001) (defendant prosecuted for multiple violations; sentenced to 36 months imprisonment).

357. *See* United States v. Van Loben Sels, 198 F.3d 1161, 1163 (9th Cir. 1999).

358. *See* Burke v. EPA, 127 F. Supp. 2d 235, 236–37 (D.D.C. 2001) (discussing facts of related criminal prosecution).

359. *See* United States v. Hanousek, 176 F.3d 1116, 1119–20 (9th Cir. 1999).

360. *See* United States v. Ellen, 961 F.2d 462, 463–64 (4th Cir. 1992).

361. *In re* The Exxon Valdez, 296 F. Supp. 2d 1071, 1076 (D. Alaska 2004).

362. *Id.* at 1077–78.

Hazelwood, the captain of the vessel, was an alcoholic who had apparently been drinking heavily that day.[363] Exxon, the ship's owner, obviously did not intend that Hazelwood would run his tanker aground. Nevertheless, Exxon had acted negligently, allowing Hazelwood to captain the supertanker even though the company was aware that he had a drinking problem.[364] If the Clean Water Act criminalized only knowing or intentional acts, Exxon could not have been prosecuted. Because, however, prosecutors were armed with § 1319(c)(1)(A), they were able to charge and convict Exxon for multiple negligent CWA violations. The Enron case is the Exxon Valdez of securities fraud. It shows the need to have a similar negligence statute in the securities area. Release of false information into the equity marketplace is at least as harmful to the nation as the discharge of pollutants into our waters. The CWA negligence cases show that if prosecutors are empowered to charge negligence cases criminally, they will do so carefully, sparingly, and responsibly.[365] Immunizing corporate executives from prosecution for negligent conduct makes no sense. This loophole ought to be eliminated.

C. Implement Mandatory Auditor Rotation

Finally, we need to find some way to ensure that auditors place the interest of investors in accurate information before the interest of management in apparent positive financial results. Though Americans have short memories, Enron and WorldCom did not invent deceptive accounting: we experienced a similar wave of major bankruptcies without prior warnings from independent auditors in the 1970s.[366] We failed to do anything significant then to deter and disclose poor auditing, and we have done little to address the problem now. Eliminating auditor consulting fees and creating an oversight board are steps in the right direction, but I think these measures are insufficient. After Sarbanes-Oxley, auditing firms are still subject to pressure from corporations to audit "lightly" because auditors still fear termination of their auditing engagements. Moreover, auditing firms are still allowed to provide tax consulting services, giving corporations an additional stick to encourage "cooperative" auditing.

For these reasons, we need to implement a mandatory auditing rotation scheme. Under mandatory auditing rotation, publicly held compa-

363. *Id.* at 1076–77.

364. *Id.* at 1077.

365. *See supra* notes 351–354 and accompanying text.

366. Luppino, *supra* note 3, at 44. I am indebted to Mr. Luppino's excellent article on the significance of our separate accounting systems for securities disclosure and tax accounting for this point.

nies would be required to change auditing firms periodically. The advantages of a mandatory rotation scheme are twofold. First, it would virtually eliminate the stick that corporations hold over auditing firms. Since, under such a regime, auditing firms would be prohibited from auditing a company's books after a certain number of years, management or board threats to terminate the auditing firm's services would be rendered almost toothless.[367] Second, auditors would be placed on notice that in a few short years, another auditing firm will be looking at their client companies' books. This would give auditing firms a strong incentive to audit strictly.[368] If, for example, Arthur Andersen had known in 1996 that a competitor firm was going to be auditing the Enron books in 1997, they may have been much less inclined to fudge and compromise.[369] As John Biggs testified before Congress,

> Clearly, had Enron been required to rotate its auditors every 5 to 7 years, it is unlikely that misleading financial reporting would have continued or that the Board's Audit Committee would have been kept in the dark, as they claim they were. It is also conceivable that, if they had been confronted by a group of different noncompliant auditors, senior management might have hesitated to engage in some of the financial manipulation they appear to have carried out.[370]

Mandatory auditor rotation was included in H.R. 3118, one of the primary legislative precursors to Sarbanes-Oxley, and was endorsed by numerous experts in House and Senate hearings on securities reform.[371] Rotation was strongly opposed by the Big Five accounting firms,[372] however, and was stripped from the legislation prior to passage. Instead

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367. For a concurring view, see Biggs Testimony, *supra* note 138, at 376 (arguing that mandatory rotation "reduces dramatically the financial incentives for the audit firms to placate management").

368. For concurring view, see Pozen Testimony, *supra* note 289, at 178 (commenting that the subsequent scrutiny of an auditor's decisions is incentive to "adhere to both the letter and spirit of the auditing rules"). *See also* Biggs Testimony, *supra* note 138, at 376.

369. For a concurring view, see Biggs Testimony, *supra* note 138, at 376.

370. *Id.*

371. Biggs Testimony, *supra* note 138, at 376–76 (endorsing mandatory auditing rotation and describing his organization's experiences with voluntary auditor rotation); *Lessons Learned*, *supra* note 149, at 86 (recommending mandatory auditor rotation every five to seven years); Pozen Testimony, *supra* note 289, at 179 (supporting five to seven year mandatory auditor rotation period).

372. *See, e.g.*, *Accounting Reform and Investor Protection: Hearing Before the Senate Banking, Hous., and Urban Affairs Comm.*, 107th Cong. 375, 862–63 (2002) [hereinafter Copeland Testimony] (prepared testimony of James E. Copeland, Jr., CEO, Deloitte & Touche, predicting increased auditing costs and destruction of "vast stores of institutional knowledge" if rotation is imposed); Peter H. Stone, *Accounting Angst*, 34 NAT'L J. 793, 793 (2002) (describing accounting industry lobbying effort and opposition to mandatory auditing rotation).

of requiring rotation of firms, Congress called for a GAO study of auditing firm rotation[373] and imposed, in lieu of true auditor rotation, rotation of firm lead audit partners every five years.[374] This provision is practically meaningless: the problem at Enron, for example, was not the corruption of Andersen partner David Duncan, but Andersen's firm culture. Moreover, the accounting profession already required rotation of lead partners every seven years, so the incremental value of this reform is slight.[375]

Congress's reluctance to adopt auditor rotation in 2002 reveals an important fact: Congress and the SEC are extremely hesitant to impose far reaching reforms in the face of strong opposition by auditing firms and Fortune 500 management. This reluctance is, in part, reasonable—a fear of potential negative unforeseen consequences. To deal with this reluctance, I suggest we impose limited auditor rotation as a test. The SEC should require every company entering into an SEC litigation settlement to agree voluntarily to adopt auditor rotation. Alternatively, we could require corporations registering with the SEC for the first time to adopt the scheme for a term of years. Either way, imposition of limited auditor rotation will provide us with valuable data on costs and benefits of auditor rotation without imposing the scheme universally on corporate America.

CONCLUSION

The Enron case will go down in history as a symbol of an era of immense Wall Street profits and corporate misdeeds. Though the case will always be remembered, the drive to reform our securities system that came as a result of Enron and similar cases has already come and gone. That is a shame, for our opportunity to implement badly needed changes to our scheme of securities regulation appears to have dissipated before the work of reform was completed. Hopefully, someone—a new SEC Chairman, a dogged reformer in Congress, perhaps the new economic team of the second Bush Administration—will pick up the torch and fight for the changes we need to prevent more Enrons in the future.

373. Sarbanes-Oxley Act § 207, 15 U.S.C. § 7232(a) (Supp. 2004).
374. *Id.*
375. Copeland Testimony, *supra* note 372, at 862.