

INTRODUCTION: CONFERENCE ON ENRON, WORLDCOM, AND THEIR AFTERMATH

Linda O. Smiddy*
Melissa Innat**

During the waning months of 2002, photographs of handcuffed executives vividly portrayed the depths of the U.S. business crisis.¹ In those images, we saw the lowered heads and averted eyes of alleged criminals—not common thieves, these accused, but former captains of industry or, as author Tom Wolfe would put it, Masters of the Universe.² Were we to compare those images with photographs of the same executives taken only a few months before the business scandals erupted, we would have seen the steady gaze, squared shoulders, and assured stance (arrogant to some) of U.S. capitalism and an unflinching and abiding confidence that the U.S. way of doing business was setting the right course for the future. Now much has changed, and for some, the support for these firmly held beliefs have all but come tumbling down.

As a nation, we are still reeling from the domestic aftershocks of the economic quake triggered by the collapse of Enron and others. What's more, we are shaken by the international impact of Enron's demise on investor confidence in U.S. markets and companies, on the strength of the U.S. dollar, and on the direction of the development of international forms of capitalism.³

Stunned, we feel compelled to ask not only what happened, and why, but, more importantly, to explore the complex nature and dimensions of the problems before us. This conference is intended to begin that exploration.

We will begin our consideration by reviewing important events in Enron's history, including those leading to the company's collapse. To be sure, similar tales could be told about other companies, but Enron has become the symbol for all that went wrong. The following chart tracks key

* Director of International and Comparative Programs and Professor of Law, Vermont Law School; Doctorat Honoris Causa, 2002, University of Paris North; LL.M 1983, Yale Law School; J.D. 1979, Vermont Law School; M.A.T. 1965, Harvard University; B.A. 1964, Northwestern University.

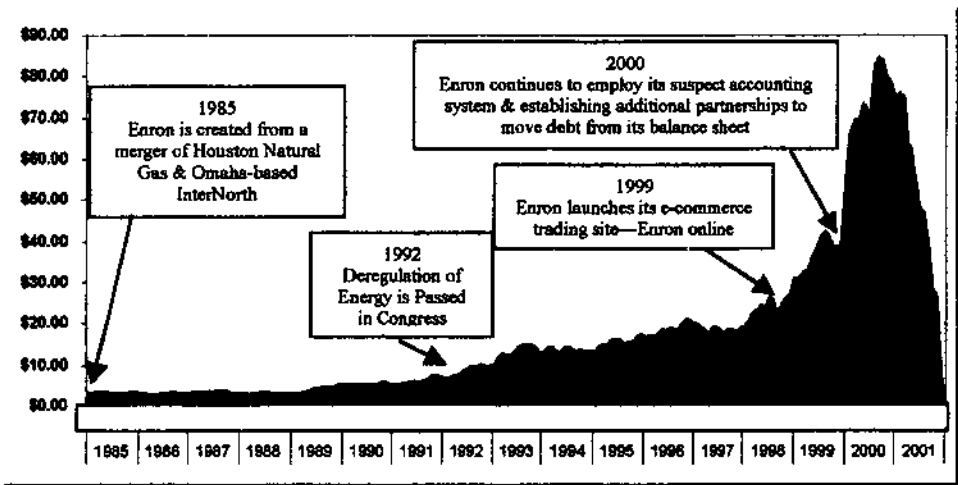
** J.D. 2003, Vermont Law School; B.S. 1993, Michigan State University.

1. See, e.g., *Fastow Charged with Enron Fraud* (Oct. 2, 2002), at <http://www.cnn.com/2002/BUSINESS/asia/10/02/us.fastow.biz/index.html> (last visited May 12, 2003).

2. TOM WOLFE, *BONFIRE OF THE VANITIES* 12 (1987) ("[O]ne fine day, in a fit of euphoria, after he had picked up the telephone and taken an order for zero-coupon bonds that had brought him a \$50,000 commission, *just like that*, this very phrase had bubbled up into his brain. On Wall Street he and a few others . . . had become precisely that . . . Masters of the Universe. There was . . . no limit whatsoever!")

3. See BBC News, *Enron Timeline* (providing estimates for the amount international financial institutions lost as a result of the Enron collapse), at http://news.bbc.co.uk/1/hi/english/static/in_depth/business/2002/enron/timeline/default.stm (last visited May 13 2003).

events in Enron's short life and the influence these events had on the price of the company's stock.



Enron Stock Values from 1985 to 2001⁴

Enron was formed in Texas in 1985 from the merger of two companies: Houston Natural Gas, located in Texas, and InterNorth, an Omaha, Nebraska company.⁵ When Enron was first formed, the company was in the business of providing energy.⁶ Early on, however, it positioned itself to take advantage of the deregulation of the utilities industry if and when that should occur.⁷ Congress did deregulate the utility industry in 1992, and Enron was ready.⁸ It began to transform itself from an energy provider to an active player as an energy trader.⁹ By 1997, Enron had redirected its focus from its traditional utility business to dealing in energy futures.¹⁰ These, and other of Enron's responses to deregulation, stimulated

4. This particular graph was compiled for the conference by Melissa Ihnat. It is based on the work of Professor Murdoch. Charles Murdoch, *Lessons from Enron* (2002 Powerpoint presentation, Loyola University Chicago) (on file with author). For a similar graph, see BBC News, *supra* note 3.

5. *Id.*

6. *Id.*

7. *Id.*; see also Jeffrey D. Watkiss & Douglas W. Smith, *The Energy Policy Act of 1992—A Watershed for Competition in the Wholesale Power Market*, 10 YALE J. ON REG. 447, 450–56 (1993) (discussing the history of the energy industry up to 1992).

8. See Energy Policy Act of 1992, Pub. L. No. 102–486, 106 Stat. 2776 (1992). See generally Watkiss & Smith, *supra* note 7.

9. BBC News, *supra* note 3.

10. Liz Harper, Online Newshour, *Enron: After the Collapse*, at <http://www.pbs.org/newshour/bb/business/enron/whatisenron.html> (last visited, May 13, 2003).

a gradual, but steady rise of the price of Enron's stock.¹¹ In 1999 Enron launched its e-commerce trading site, EnronOnline.¹² During the following year, the company's stock price doubled.¹³ Soon Enron was heralded for having a management culture that encouraged creativity without limitation. Enron became the symbol of what was good about business in the United States.¹⁴

The year 1997 was also significant because it was the year that Enron executives began to falsify the company's financial statements.¹⁵ Instead of serving the legitimate business goals of the company as a whole, Enron's much heralded creativity was used to fill the personal coffers of certain, high level individuals. Creativity became technical cleverness, financial wizardry became fraud, and business success was corrupted by unchecked greed. Enron used financial legerdemain to transfer Enron debt to off-balance-sheet partnerships and other entities.¹⁶ The effect of these and other related transactions was to convert Enron's liabilities into assets.¹⁷

In one instance, Enron created an off-balance-sheet partnership for which Enron stock provided collateral.¹⁸ Other, unrelated companies also became equity investors in the partnership, providing a small amount of the capital.¹⁹ The partnership then raised additional money by issuing debt backed by Enron stock. Because the partnership had at least 3% ownership other than Enron, it qualified as an independent company and did not have to appear on Enron's financial statements.²⁰

Subsequently, the partnership formed a joint venture in which Enron acquired an equity interest by transferring debt-laden assets to the joint venture.²¹ The joint venture then paid off the debt on the assets transferred by Enron, thus improving the company's balance sheet.²² In addition,

11. *Id.*

12. PBS, Online Newshour, *Enron: After the Collapse*, at <http://www.pbs.org/newshour/bb/business/enron/timeline.html> (last visited, May 15, 2003).

13. Harper, *supra* note 10.

14. *Id.*

15. Plaintiffs' Complaint, *Amalgamated Bank v. Lay*, at 16 ¶ 39 (S.D. Tex. Dec. 4, 2001), available at <http://www.enronfraud.com/pdf/complaint.pdf> (last visited May 13, 2003).

16. *The Amazing Disintegrating Firm—Enron*, THE ECONOMIST, Dec. 8, 2001, at 61; Murdoch, *supra* note 4.

17. Peter Behr, *Enron Says Profit Was Overstated*, WASH. POST, Nov. 9, 2001, at E11; Murdoch, *supra* note 4.

18. BBC News, *supra* note 3; Murdoch, *supra* note 4.

19. Peter Behr, *How Chewco Brought Down an Empire*, WASH. POST, Feb. 4, 2002, at A1; Murdoch, *supra* note 4.

20. Behr, *supra* note 19, at A1; Murdoch, *supra* note 4.

21. Allen Sloane, *Tangle of Transactions Fueled Enron's Crisis*, WASH. POST, Dec. 11, 2001, at E3.

22. *Id.*

Enron's equity interest in the joint venture appeared as an asset on Enron's financial statements.²³ The former Enron debt was ultimately transferred to the partnership, technically an independent entity. If the partnership was unable to pay the debt, Enron, as the partnership guarantor, would have to assume responsibility for the payment.²⁴ As a result, in 1997 Enron's financial statements overstated the company's assets by \$258 million and underreported its debt by \$771 million.²⁵ These practices continued until a few months before Enron's collapse.²⁶

In 2001, when the energy business began to falter, the off-balance-sheet partnership was unable to pay the debt and Enron had to reassume liabilities no longer reflected in its financial statements.²⁷ These practices and others ultimately led to Enron's financial ruin. Enron's fall was sudden and precipitous. Only two and a half years ago, it would have been hard to imagine the economic world we find ourselves in today.

There were Cassandras,²⁸ to be sure, during the go-go years of the 1990s. Predictably, their warnings were ignored. Arthur Levitt, former Chair of the SEC, raised questions, as did a few financial analysts who, in some cases, were fired for their trouble.²⁹ Occasionally, a company executive would resign after insisting, to no avail, on the application of GAAP to pro forma financial statements showing mounting debt and no foreseeable revenues.³⁰ The community of business, accounting, and legal professionals turned a blind eye to serious conflicts of interest.³¹ Accounting firms provided both auditing and consulting services to the

23. *Id.*

24. Allen Sloane, *Who Killed Enron?*, NEWSWEEK, Jan. 21, 2002, at 21–22.

25. See *id.* at 22 (noting that keeping the partnerships off the books “inflated Enron’s 1997 profits by 75%”).

26. *Id.*

27. *Id.*

28. Cassandra, of course, was King Agamemnon’s cursed mistress from Aeschylus’s *Orestea*. Cassandra’s curse was rather unique. She had the ability to foretell the future with frightening accuracy, but the kicker was no one ever believed her prophecies.

29. See Michael Schroeder, *Fall of an Energy Giant: Arthur Levitt Says Enron Case Shows Need for More*, WALL ST. J., Jan. 11, 2002, at A4 (describing how Mr. Levitt argued for tougher accounting standards during his tenure as SEC chief); Rebecca Smith, *The Analysts Who Warned About Enron*, WALL ST. J., Jan. 29, 2002, at C1 (providing examples of financial analysts who were “forced out” of their firms after warning clients about Enron stock months prior to the collapse).

30. See, e.g., Paul Duggan & Peter Behr, *Ex-Enron Executive Found Dead in Car*, WASH. POST, Jan. 26, 2002, at A1 (“[Enron executive J. Clifford] Baxter reportedly complained to other Enron officials about the company’s questionable financial practices before his resignation.”).

31. See Daniel Kadlec, *Power Failure*, TIME MAG., Dec. 10, 2001, at 68 (“Enron’s fatal flaw was management hubris, tacitly encouraged by board members, regulators, politicians, and stock analysts—many with financial ties to Enron—who looked the other way as warning lights began to flash.”).

same client.³² Brokerage companies provided both investment banking services and retail brokerage services for the same companies.³³ Lawyers did not question transactions that the accountants had approved, even when there were indications of improper conflicts of interest, as for example, when Enron executives assumed key management roles in allegedly unrelated entities.³⁴

Attempts by the Financial Standards Accounting Board to introduce new regulation were thwarted.³⁵ Investors demanding ever-higher short-term returns ignored wise cautions. Shareholders were having the ride of their lives, pursuing an American dream of financial well-being in a culture that too often measures success by material wealth. Hubris also played a role. After the end of the Cold War, the triumph of the West was seen by many as a triumph of capitalism and, in this country, as a triumph of the American form of capitalism.

Questions about Enron's activities began to emerge in the year 2000. The Texas edition of the *Wall Street Journal* published an article naming Enron as one of several Texas based companies using suspicious accounting practices.³⁶ Hedge fund manager James Chanos began to take a close look at Enron's financial statements.³⁷ Having substantial questions about Enron's practices, reports, and disclosures, Chanos alerted *Fortune* magazine to the possibility of irregularities at the energy company.³⁸ In March 2001, *Fortune* published an article alluding to Enron's questionable accounting practices.³⁹ Later that year, the *Wall Street Journal* ran a three-day series detailing the suspicious nature of Enron's off-balance-sheet partnerships.⁴⁰

32. *Id.*

33. *Id.* at 72.

34. See *Standing Up to Corruption and Greed*, N.J. LAW., Apr. 2003, at 42 ("Any number of lawyers performed badly, with shocking disregard to their fiduciary duties and the rights of third parties.").

35. See Greg Hitt & Michael Schroeder, *Questioning the Books: Enron Hoped to Sway Accounting Group*, WALL ST. J., Feb. 14, 2002, at A8 ("Despite requests for decades, the domestic accounting rule-maker, FASB, has failed to clarify the rules for [special-purpose entities].").

36. Jonathan Weil, *Energy Traders Cite Gains, But Some Math Is Missing*, WALL ST. J., Sept. 20, 2000, at T1.

37. Scott Sherman, *Enron: Uncovering the Uncovered Story*, COLUM. JOURNALISM REV., Mar.-Apr. 2002, available at <http://www.cjr.org/year/02/2/Sherman.asp> (last visited May 16, 2003).

38. *Id.*

39. *Id.*; Bethany MacLean, *Is Enron Overpriced?*, FORTUNE, Mar. 5, 2001, at 122.

40. Sherman, *supra* note 37; see e.g., Rebecca Smith & John Emshwiller, *Enron Jolt: Investments, Assets, Generate Big Losses*, WALL ST. J., Oct. 17, 2001, at C1.

During the year 2001, Enron was subjected to other types of pressures. Some questioned the company's role in the California energy crisis.⁴¹ With the general down-turn in the dot.com industry, the price of the company's stock began to decline from a high of over \$80 per share. Jeffrey Skilling, the company's CEO, resigned and Kenneth Lay assumed the position once again.⁴² The company temporarily froze its employee pension fund, preventing Enron employees from selling their shares, although Enron executives were not subject to the same constraints. In October and November of 2001, Enron announced a series of accounting "mistakes" amounting to \$1.2 billion and disclosed that more than four years of earnings would have to be recalculated.⁴³ A final-hours merger with Dynergy failed to materialize, and Enron ended the year by filing for bankruptcy.⁴⁴

The impact of Enron's decline and demise has been broad and deep. For the average person, the world of business and finance is now, painfully, no longer remote. Significant numbers of individuals and businesses tell tales of personal loss: shareholders whose stock has become worthless; creditors left with valueless claims; employees looking for other jobs; retirees and former employees bereft of pensions; suppliers whose bills were not paid; and customers whose needs were not met. Nationally and internationally, investment banks and other large, financial enterprises, such as J.P. Morgan, Citigroup, Credit Lyonnais, and Nikko Cordial to name just some, have reportedly lost a total of almost \$3.6 billion.⁴⁵

This brief history of Enron's relatively short life—it was only sixteen when it collapsed—provides a chronological context for the discussion that follows. As panelists explore the complexity of the problems caused by Enron's failure, and the failure of many other U.S. companies, it will become clear that the failure is systemic.

This afternoon's conference has convened three panels of distinguished professionals from multiple disciplines—business, law, economics, and accountancy—to begin the inquiry of what went wrong and why. The purpose of this gathering is to begin to examine the context and nature of the failure and the legal responses to the problem, and to raise questions

41. See Kathleen Day & Susan Schmidt, *U.S. to Probe Enron Tie to Energy Prices*, WASH. POST, Jan. 30, 2002, at A6 ("The nation's top energy regulators promised . . . to investigate whether Enron Corp. manipulated long term energy prices in western states until the day it declared bankruptcy last month.").

42. *The Amazing Disintegrating Firm*, *supra* note 16, at 61

43. *Id.*

44. *Id.* at 62.

45. See BBC News, *supra* note 3 (providing estimates for the amount financial institutions lost in the Enron collapse).

about the international implications of the events of the recent months. All this in a short afternoon.

The first panel has been asked to address three types of influences on corporate decision-making and behavior: corporate culture, business ethics, and the structure of economic institutions. Mr. David Collins was asked to discuss the influence of corporate culture on business decision-making. He uses Johnson & Johnson's response to the Tylenol poisoning episodes of the 1980s as a case study to explore the role played by the firm's credo in shaping the company's willingness to act on its view of its broader mission, rather than shaping a response driven by short-term financial interests. Dean John W. Hennessy, Jr. explores the links between the ethical failures of Enron's management and the environment in which those lapses occurred, including the Enron business culture, a resurgent stock market, an executive compensation explosion, and the actions and inactions of the accounting and legal professions and the Enron Board of Directors. Considering the problem from a different vantage point, Professor William L. Baldwin suggests that reforming the conduct of individuals will not, by itself, reform corporate conduct in a significant way. Corporate reform requires changes to be made to economic institutions and to the economic environment in which corporations operate.

The second panel addresses specific issues of reform. Questions concerning the use of stock options as executive compensation and the recently enacted Sarbanes-Oxley Act have become the centerpieces of such discussions. On the topic of executive compensation, Professor Rajesh Aggarwal uses empirical data to investigate the extent to which stock options have been used for management enrichment rather than as a substitute for other forms of compensation. He also explores the connection between the quality of corporate governance at selected enterprises and their use of stock options. Attorney Bernard Carrey discusses the impact of the new Sarbanes-Oxley Act on the attorney-client relationship and client confidentiality and addresses the complexities facing an attorney having to decide whether a proposed corporate action is now subject to a reporting requirement.

The issues addressed by the final panel concern the international impacts of the U.S. business scandals, the relationship of culture to those scandals, and the lessons we may learn from corporate reform abroad. Professor Linda Smiddy asks whether there is a cultural basis for the fact that almost all of the many companies now restating their earnings and acknowledging "mistakes" in their accounting practices are U.S. companies. She also describes some recent corporate reforms in France and considers to what extent the reforms should be adopted in the United States.

Professor Karin Thorburn presents a comparative approach to the legal and market-based governance forces influencing corporate conduct in Western Europe and considers whether the system failure in the United States could happen in Europe. She also identifies major areas of corporate reform in Europe. The final speaker, Professor David Kang, shifts the focus to Asia for an examination of the impact of the recent scandals on the emerging Asian markets. Professor Kang concludes that Asian countries have improved their corporate governance structures during the past five years and that such reform necessarily involves a long-term process of institutionalizing the larger democratic and economic structures within which companies operate.

Inquiries such as those made by today's panelists are first steps in our efforts to understand the origins and structure of the problems we now face. The next phase will present a more difficult challenge—charting the course to accomplishing meaningful and lasting reform.