ACCOUNTANTS, ATTORNEYS, AND ENRON: AN ANALYSIS OF THE DEBACLE AND IMPLICATIONS FOR FUTURE CORPORATE PRACTICE UNDER THE SARBANES-OXLEY ACT

> An accountant's duty is to the public, not the client. The lawyer's duty is to the client, and not to the public.[1]
>
> Louis Grumet

I. INTRODUCTION

There were times when Mr. Grumet's statements made perfect sense. People recognized the role of the accountant[2] was to don a green-bill visor, request a mass of seemingly disparate information and lock himself away for a few months of intimate number crunching, interrupted only by additional, meddlesome questions and further requests for documentation. Clients did not particularly *like* having the accountant sniffing around files, probing into the intricate details of corporate life and interrupting settled, daily routine by asking esoteric questions regarding segregation of duties, management characteristics, and other internal controls. Senior officers of the corporation remained guarded in the accountant's presence and suffered through poignant and direct interrogation about the validity of the numbers represented in the financial statements, all the while counting the days until they ultimately received what their troubles would produce—the unqualified opinion of the independent accountant.[3] Armed with this report, the corporation announced to the world that the work of the certified public accountant yielded no findings of material misstatement in its financial

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[1] John Caher, *Corporate Reform Bill Means Changes in Client Relations*, N.Y.L.J., July 29, 2002, at 1. Mr. Grumet, an attorney, is the Executive Director of the New York State Society of Certified Public Accountants.

[2] Although accountants competently perform many different services for their clients (e.g., tax preparation, projections, compilations, due diligence, business structure consulting, internal affairs management, information technology advising, etc.), this note will focus specifically upon the role of the certified public accountant as an auditor for public corporations. In such an external audit, an independent certified public accountant will issue an opinion on whether the public corporation's financial statements are presented fairly in accordance with generally accepted accounting principles (GAAP). A public corporation is a corporation required by the Securities and Exchange Commission to register its securities before transacting with the public.

[3] An unqualified opinion means that, in the opinion of the independent certified public accountant, the company's financial statements at a certain point in time present fairly, in all material respects, the company's financial position, results of operations, and cash flows in conformity with GAAP. CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 69 (Am. Inst. of Certified Pub. Accountants 1992).

statements; therefore, the shareholders were able to rest another night, assured their investments were safe.

Although attorneys in general are widely portrayed as possessing few, if any, morals and frequently selling out to the highest bidder, their work and expertise are invaluable to their clients. Client and attorney work hand-in-hand to resolve the present particular predicament by foraging through the issue in an open, trusting environment. Corporate directors and officers share their information, both good and bad, with their legal counsel to secure a favorable outcome, and the duty of the attorney is to represent the interest of the client zealously to the best of his ability.

While an attorney generally has the best interests of his client in mind, an accountant has a slightly different mindset. Accountants are not necessarily adverse to their clients' interest, but accountants are trained to maintain professional skepticism through the duration of an audit to protect the interests of third parties.

Unlike accounting practices, no law requires a public company to hire attorneys on an annual basis to represent its interests before a court of law or other individuals.[4] Attorneys come only by request, not by statute. Likewise, there is no stipulation mandating legal review of a corporation's records. Former Securities and Exchange Commission Chairman, Richard Breeden, echoed this sentiment when he testified before Congress regarding the collapse of Enron: "Accountants play a unique role as the scorekeepers of the market economy. While companies in the U.S. don't have to employ a law firm, an underwriter, or other types of professionals, federal law requires a publicly traded company to hire an independent accounting firm to perform an annual audit."[5]

The differences between the two professions are many and deliberate. Accountants search for fraud; attorneys are told about fraudulent activities. Accountants publicly report their findings; attorneys do not publicly disclose their clients' indiscretions. Accountants must maintain professional skepticism in dealing with their clients; attorneys attempt to turn skeptics into believers. Accountants are paid well; attorneys are generally paid better. These differences result from the fundamental distinction between the focus and purpose of the accountant and the attorney. The accountant's duty is to the

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[4] *H.R. 3763-The Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002: Hearings on H.R. 3763 Before the House Comm. on Financial Servs.*, 107th Cong. 457 (2002) (statement of Richard Breeden, former Chairman of Secs. and Exchange Comm'n).

[5] *Id.*

public; the attorney is to be a faithful agent for the client by maintaining confidentiality.[6]

The fundamental differences between the two professional practices appear to be great, but the gulf separating them has been considerably diminished under the Public Company Accounting Reform and Investor Protection Act of 2002, more commonly known as the Sarbanes-Oxley Act (SOA or the Act).[7] Due to the roles that both accountants and attorneys played in causing Enron to declare the largest bankruptcy in United States history to that date,[8] Congress was forced to regulate these professions that previously had little federal oversight.

What caused Congress to break from its traditional, *laissez faire* approach? In the case of Enron, Congress found the two professions could not resist the siren's song of seemingly limitless revenue through lucrative consulting fees. In the eyes of the public, both accountants and attorneys apparently lost their perspectives. As Senator John Edwards, an attorney himself, stated, "[Attorneys] get to thinking that playing squash with the CEO every week is more important than keeping faith with the shareholders every day."[9] More directly, Senator Edwards added: "If you are a lawyer for a corporation, your client is the corporation. You work for the corporation and for the ordinary shareholders who own the corporation. That is who you owe your loyalty to. That is who you owe your zealous advocacy to."[10]

Likewise, the accounting profession did not escape public scorn. Many decried the apparent conflict of interest when the same accounting firm provided both auditing and nonaudit-related services to the same corporate client.[11] Although this practice is not usually a problem,[12] a

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[6] Caher, *supra* note 1. Note that accountants have a duty to maintain client confidentiality in a fashion similiar to that of attorneys. CODE OF PROF'L CONDUCT, R. 301 (Am. Inst. of Certified Pub. Accountants 1992) *available at* http://www.aicpa.org/about/code/et301.htm (last visited Feb. 14, 2004). Although auditors are required to maintain client confidentiality, the auditors are charged to render an opinion if there are material misstatements in the financial statements as a result of wrongdoing within the company.

[7] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 & 18 U.S.C.).

[8] John R. Emshwiller & Rebecca Smith, *Corporate Veil: Behind Enron's Fall, a Culture of Operating Outside Public's View*, WALL ST. J., Dec. 5, 2001, at A1. Although currently going through Chapter 11 bankruptcy, Enron was once valued at more than $77 billion. Jonathan Weil, *Double Enron Role Played by Anderson Raises Questions*, WALL ST. J., Dec. 14, 2001, at A4.

[9] 148 CONG. REC. S5652 (daily ed. June 18, 2002) (statement of Sen. Edwards).

[10] *Id.*

[11] As used here, consulting services mean any other service provided by an accounting firm other than the audit, other attestation, and tax services. These types of consulting services are numerous and may include general bookkeeping, financial information systems design and implementation, appraisal or valuation services, human

recent article by the Metropolitan Corporate Counsel condemned this type of relationship: "[It] definitely creates a conflict, because there is a lot more money in consulting than there is in an audit."[13] Indeed, without the additional consulting work Arthur Andersen performed for Enron, that engagement would not have been as profitable. In 2000, Andersen charged Enron $25 million to audit the company; during the same period, Enron paid Andersen an additional $27 million for non-

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resources management, investment adviser or investment banking services, and legal-related and expert services outside the scope of the audit. *See* 15 U.S.C. § 78j-1(g) (2003).

[12] The author would like to comment, as seen from experience, that many law-abiding accountants routinely provide both audit and non-audit services to their clients without sacrificing the least bit of independence or objectivity. In most instances, this type of arrangement only makes economic sense because the auditor, in knowing his client's business, would be able to implement certain services more efficiently than another firm that is not familiar with the workings or structure of the client. Indeed, prior to the SOA, professional conduct rules envisioned such an arrangement and provided rules to regulate that type of practice. *See infra* note 15 and accompanying text. This also includes handling internal audits not associated with the performance of an external audit resulting in the issuance of an opinion. Many companies perform their own internal audits to prevent fraud; in this case, Enron outsourced its internal audit function to Arthur Andersen, its external auditor, in 1994. Weil, *supra* note 8.

> Accounting firms say the double-duty arrangements let them become more familiar with clients' control procedures and that such arrangements are ethically permissible, as long as outside auditors don't make management decisions in handling the internal audits. Under the new SEC rules taking effect next year, an outside auditor impairs its independence if it performs more than 40% of a client's internal-audit work. The SEC said the restriction won't apply to clients with assets of $200 million or less.

Id.

[13] *In-House Counsel Play a Central Role in Preventing Accounting Scandals*, METRO. CORP. COUNSEL, Sept. 2002, at 47, 47. The article further expanded this topic by explaining the following:

> When the firm that is auditing a company's books is simultaneously trying to get as much consulting work from that company as possible, it violates two of the basic tenets of the professional code of ethics for certified public accountants—objectivity and independence. Other rules of professional ethics require that an auditor get sufficient relevant data to satisfy his or her auditing needs. To be effective, an auditor must be skeptical and maintain an inquiring mind. An auditor cannot simply accept what the client says without looking for supporting evidence. If the auditor has a valuable consulting relationship with the client, it is unlikely that, even if the auditor is skeptical, he or she will press as hard for supporting evidence.
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> The culture of corporate America and Wall Street has led some accountants . . . to be more concerned with how much money they can make rather than with serving as watchdogs to protect the public.

Id. Another article succinctly summarized the problem, "Auditors have a hard-to-resist incentive to go easy on companies to avoid jeopardizing lucrative consulting contracts." Edward J. Cleary, *Lessons for Lawyers from the Enron Debacle*, BENCH & B. MINNESOTA, Apr. 2002, at 16.

audit consulting services.[14] Although this type of arrangement between auditor and client is not strictly forbidden by professional accounting standards, auditors are required to evaluate continually how providing non-audit consultation services to audit clients may affect their first and foremost obligation as auditors—independence.[15] Another multi-national accounting firm was recently sued because of an allegedly impermissible conflict of interest.[16] While auditor for a now-bankrupt insurance company, KPMG allegedly assisted disguising a risky product promoted by the company, while also providing other non-audit consultation services, including preparing its client for an initial public offering. As a result, KPMG collected millions in both auditing and consulting fees.[17]

In the wake of Enron's bankruptcy, many people lost their life savings and accused the accountants and lawyers of corruption. After holding numerous hearings regarding the collapse of Enron, Congress had no choice but to regulate these professions that had previously enjoyed the privilege of self-regulation; therefore, the SOA was born.[18]

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[14] Weil, *supra* note 8.

[15] CODE OF PROF'L CONDUCT, R. 101 (Am. Inst. of Certified Pub. Accountants 1988), *available at* http://www.aicpa.org/about/code/sec100.htm (last visited Feb. 14, 2004). Briefly, the independence rule states, "A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council." *Id.* In addition, an auditor must evaluate how providing other services may affect independence:

> A member of his or her firm ("member") who performs an attest engagement for a client may also perform other nonattest services ("other services") for that client. Before a member performs other services for an attest client, he or she must evaluate the effect of such services on his or her independence. In particular, care should be taken not to perform management functions or make management decisions for the attest client, the responsibility for which remains with the client's board of directors and management.

CODE OF PROF'L CONDUCT, R. 101-3 (Am. Inst. of Certified Pub. Accountants 1988) (amended 2003), *available at* http://www.aicpa.org/about/code/sec100.htm (last visited Feb. 14, 2004). Individual State Boards of Accountancy also stress the importance and absolute need for an auditor to be independent. For example, Texas independence rules state auditors of financial statements must be independent with respect to the client *in fact and in appearance*. 22 Tex. Admin. Code § 501.70 (West 2002) (emphasis added). Virginia has a similar requirement. *See* 18 Va. Admin. Code § 5.20-290 (West 2001).

[16] Robin Sidel, *Missouri Sues KPMG, Claiming Connection to Insurer's Demise*, WALL ST. J., Dec. 13, 2002, at B4. The article further explains "[The lawsuit] comes amid scrutiny of the industry for conflicts of interest that arise when accounting firms collect consulting and other advisory fees from clients while also auditing their financial books." *Id.*

[17] *Id.*

[18] In the words of former Securities and Exchange Commission Chairman Harvey Pitt, "the era of self-regulation of the accounting profession is over." Rick Telberg, *Wall Street Scapegoats*, June 24, 2002, *at* http://www.cpa2biz.com/news/telberg/wall+street+scapegoats.htm (last visited Jan. 21, 2004). Mr. Pitt had equally strong words to the legal industry when he warned of possible federal regulation of ethical standards for corporate

This note explores what led to Enron's precipitous fall from glory and how attorneys and accountants both contributed to its eventual demise. The second part discusses the infamous special purpose entities and how attorneys and accountants allowed Enron to keep billions of dollars in liabilities and losses from appearing in its financial statements. The third part investigates the role of inadequate disclosures in Enron's financial statements that further concealed the true picture of Enron's deplorable internal financial affairs. The fourth part analyzes the probable effects the Act will work in the accounting and law professions. The fifth part anticipates how the SOA will change the future corporate practices of attorneys and accountants and how the Act falls pitifully short of the biblical standards outlined for ethical conduct.

II. THE SPECIAL PURPOSE ENTITY AND A LESSON ON HOW NOT TO USE ONE

Enron's use of special purpose entities (SPE) and other similar investment devices eventually led to its collapse. Before this connection can be made, however, it is necessary to understand why Enron used SPEs. Additionally, it is important to appreciate the roles attorneys and accountants played in the creation and subsequent approval of the SPEs.

A. The Rise of Enron

After governmental deregulation of natural gas pipelines in the 1980s, Enron was created by a merger between Houston Natural Gas and InterNorth, a pipeline company located in Nebraska.[19] As a result of the merger, Enron incurred substantial debt and sought new and innovative ways to solve its cash flow problems.[20] Solutions to these problems, however, were not found in the traditional manner of drilling, refining, and selling natural gas.

Rather, Enron delved into a new and revolutionary area: the gas bank.[21] Basically, Enron became a broker or middleman in the natural gas business. Enron "would buy gas from a network of suppliers and sell it to a network of consumers, contractually guaranteeing both the supply and the price, charging fees for the transactions and assuming the

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attorneys: "If the state bars want to preserve their turf, they had better do their job. If it means we have to do the job for them, we will." Peter Spiegel, *SEC Chief Warns of Own Action Against Lawyers*, FIN. TIMES, Sept. 21, 2002, at P7. While many parties rightly share blame for the implosion of Enron (e.g., senior Enron officers, outside investment bankers, financial analysts, etc.), the focal point of this note will be the culpability of attorneys and accountants.

[19] C. William Thomas, *The Rise and Fall of Enron*, J. ACCOUNTING, Apr. 2002, at 41, 41.

[20] *Id.*

[21] *Id.*

associated risks."[22] This new way of doing business was particularly attractive to many natural gas producers, dealers, and consumers because of the volatility that then existed in the natural gas futures market.[23] As a result, Enron "created both a new product and a new paradigm for the industry—the energy derivative."[24] All of this was the brainchild of Jeffery Skilling, who then worked for McKinsey & Co., a consulting company that Enron CEO Kenneth Lay hired to solve Enron's financial woes. In 1990, Lay wooed Skilling from McKinsey & Co., putting him in charge of the newly created Enron Finance Corporation, which quickly had a corner on the market for natural gas contracts.[25] Because of its vast network of suppliers and consumers, Enron became adept at predicting natural gas prices, allowing Enron to reap generous profits.[26]

When Skilling was promoted to chief operations officer in 1996, he successfully convinced Enron's Board of Directors to expand the gas bank theory into other futures markets, including electric energy, coal, paper, steel, and water.[27] Fueled by the frenetic growth of the internet industry in the late 1990s, Enron also launched an electronic commodities trading website dubbed Enron Online (EOL), on which Enron was either the purchaser or seller.[28] Because of the strong name Enron built in the futures market, many traders flocked to this site to process their transactions—in all, EOL handled about $335 billion in various commodity trades in 2000 alone.[29] In addition to the futures market, Enron invested heavily in other areas. A few of these ventures included overseas power companies, a broadband telecommunications network, and pipelines.[30]

B. Enron's Need for SPEs

Because Enron was the broker of many futures contracts and was also simultaneously involved in other capital-intensive ventures that did not produce sufficient cash flow, it was in constant need of capital.[31]

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[22] *Id.*

[23] *Id.* at 43.

[24] *Id.* at 41.

[25] *Id.* at 42.

[26] *Id.*

[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] *Id.* at 42-43; John R. Emshwiller & Rebecca Smith, *Murky Waters: A Primer on Enron Partnerships*, WALL ST. J., Jan. 21, 2002, at C1.

[31] Peter Behr & April Witt, *Visionary's Dream Led to Risky Business*, WASH. POST, July 28, 2002, at A1. The article put it more bluntly by stating "[Enron's] grab bag of pipelines and plants could not produce enough money to drive the growth that Lay and Skilling demanded." *Id.*

Therefore, Enron had two traditional options to raise capital: borrow or issue more equity. Neither, however, was a satisfactory option for various reasons. According to the Powers Report, Enron did not favor issuing more shares of stock "because the earnings in the early years would be insufficient to avoid 'dilution'—that is, reducing earnings per share."[32] Likewise, borrowing money did not present an attractive option. Enron's investment-grade credit was just high enough to ensure that it could get the cash it needed to settle its energy contracts when they came due.[33] Because Enron was already heavily laden with this debt, the accumulation of additional debt would have reduced its credit rating, making it more expensive to borrow capital.[34]

Faced with this dilemma, Skilling turned to Enron's chief financial officer, Andrew Fastow, for a solution. Fastow had extensive experience in complicated financial arrangements through his prior employment at Continental Illinois Bank in Chicago.[35] After failing to convince Enron's credit rating agencies to raise Enron's credit rating, Fastow used other arrangements to bolster Enron's balance sheet.[36]

C. Nature and Purpose of SPEs

Contrary to popular belief, special purpose entities are nothing new in the financial world and are used by many large companies for a myriad of legitimate business purposes.[37] The primary reasons for utilizing an SPE are to hedge risk against loss in the investments of a company or to gain access to capital.[38] In addition, an SPE "may take the legal form of a partnership, corporation, trust, or joint venture."[39]

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[32] *Report of Investigation by the Special Investigative Committee, to the Board of Directors of Enron Corp.*, 36 (Feb. 1, 2002) *at* http://nytimes.com/images/2002/02/03/business/03powers.pdf (last visited Jan. 17, 2004) [hereinafter *Powers Report*]. This report contains over 200 pages detailing the legal insufficiencies of some of Enron's SPEs and financial statement disclosures.

[33] Emshwiller & Smith, *supra* note 30.

[34] *Powers Report*, *supra* note 32, at 36.

[35] Thomas, *supra* note 19, at 42.

[36] *Id.* at 43. The Thomas article further fleshes out this concept by explaining "there were other ways to lower the company's debt ratio. Reducing hard assets while earning increasing paper profits served to increase Enron's return on assets (ROA) and reduce its debt-to-total-assets ratio, making the company more attractive to credit rating agencies and investors." *Id.*

[37] Bob Jensen, *What's Right and What's Wrong with Special Purpose Entities (SPEs)*, *at* http://www.trinity.edu/rjensen/theory/00overview/speOverview.htm#Benston Horizons (last visited Jan. 17, 2004). In addition, another author summarizes "you'd be hard-pressed to find a FORTUNE 500 company that doesn't use one." Jeremy Kahn, *Off Balance Sheet and Out of Control*, FORTUNE, Feb. 18, 2002, at 84, 84.

[38] Thomas, *supra* note 19, at 43.

[39] Jensen, *supra* note 37.

> Like many complex instruments, SPEs were created to perform a straightforward, necessary task—isolating and containing financial risk. Businesses that wanted to perform a specialized task—an airline buying a fleet of airplanes; a company building a big construction project—would set up an SPE and offload the financing to the new entity. For example, a company looking to build a gas pipeline but not wanting to assume all the debt load would set up an SPE—essentially, a joint venture with other investors—to build it. The SPE would own the pipeline and use it as collateral to issue the bonds to finance it. The sponsoring company would still operate the pipeline, with the revenues being used to pay back the bondholders.
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> In theory, SPEs protected both sides of the transaction if something went awry. If the project went bust, the company was responsible only for what it had put into the SPE; conversely, if the company went bankrupt, its creditors couldn't go after the SPE's assets.
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> Over time, SPEs became essential components of modern finance. Their uses expanded wildly—and legitimately. For example, virtually every bank uses SPEs to issue debt secured by pools of mortgages. And companies as diverse as Target and Xerox use SPEs for factoring—the centuries-old practice of generating cash by selling off receivables.[40]

SPEs and their related accounting issues first came into prominence "largely due to pressures from banks and leasing companies to provide a way to avoid capitalization (booking) of special types of leases following [an accounting rule change] that stiffened the requirements for booking of 'capital' leases."[41] While giving a company the flexibility to enter into certain financial transactions, either by reducing the risk of an investment or allowing access to much needed capital, SPEs nonetheless altered the terrain of a company's financial statements by masking the true nature of its operations—for better or for worse.

As stated, SPEs can be used for a number of legitimate business reasons, although they are not usually used in great numbers by the same company. According to Allen Tucci, partner at Tucci & Tannenbaum, a Philadelphia law firm specializing in structuring SPEs, "If a company has four or five of these things, that would be a lot."[42] Enron had over 900 such entities established in international tax havens alone, among its 3,500 subsidiaries and affiliates.[43]

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[40] Kahn, *supra* note 37.

[41] Jensen, *supra* note 37. The financial accounting standard (FAS) at issue was FAS 13.

[42] Kahn, *supra* note 37.

[43] *Id.*; *see also* Emshwiller & Smith, *supra* note 30.

D. Proper Accounting Treatment of SPEs[44]

One simply has to look at the historic and catastrophic fall of Enron, and the subsequent criminal verdict against Andersen, to see that the proper accounting treatment for SPEs is less than intuitive. As Al Hartgraves and George Bentsen noted:

> Until recently, many people in the accounting profession, including accounting educators, never heard of SPEs. Some who heard of these esoteric financing vehicles knew little about how they operated or the accounting standards that guide the accounting and financial reporting by companies who sponsor SPEs. Reports in the popular press that preceded Enron's Chapter 11 filing in December 2001 introduced many accountants for the *first time* to the topic of SPEs and sent many CPAs scrambling to understand the generally accepted accounting principles (GAAP) dealing with these entities.[45]

Generally, the major advantage afforded by an SPE is the ability to exclude certain liabilities or losses attached to an SPE from a company's balance sheet or income statement.[46] General accounting rules, however, favor consolidation of a company's business ventures in its financial statements to provide current and potential shareholders a more complete financial picture of the "extended" company.[47] This presumption to consolidate may be overcome (i.e., the company will not be required to show the liabilities and losses of the SPE in its consolidated financial statements) if two conditions are met.[48] First, there must be a significant investment in the venture by an independent third party that bears the substantive risks and rewards of ownership during the entire life of the SPE.[49] Although it may seem a contradiction

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[44] Due to the complex nature of SPEs and the ambiguous rules regarding the proper accounting treatment of these financing arrangements, it would be beyond the scope of this note, and also unnecessary, to go into the intricate details of SPEs. The author encourages anyone wishing to do further research to see an excellent website with information provided by Bob Jensen of Trinity University, *supra* note 37. This website is a compilation of different sources and statutory authority detailing the proper accounting treatment for SPEs. The website was graciously recommended to the author by Linda Nichols, Professor of Accounting at the Jerry S. Rawls College of Business Administration of Texas Tech University.

[45] Jensen, *supra* note 37 (emphasis added).

[46] Again, this is a gross oversimplification of the rules dealing with only one of many uses of an SPE. For more information, see Jensen, *supra* note 37.

[47] *Powers Report, supra* note 32, at 38. "There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies . . . ." *Id.* (quoting CONSOL. FIN. STATEMENTS, Financial Accounting Standard Bulletin No. 51 (Fin. Acct. Standards Bd. 1959)).

[48] *Id.* at 39.

[49] *Id.*

of terms, a 3% investment by an outside third party satisfies the interpretation of what constitutes a significant investment, thus allowing a corporation to invest the remaining 97% and still not be required to consolidate the SPE's activities into the sponsoring company's financial statements.[50] One possible reason for this low investment threshold is that SPEs usually involve large capital projects, such as pipelines across the Arctic or fiber optic cables throughout the United States; therefore, a 3% investment in such projects still translates into a significant investment.[51] The 3% is based upon the fair market value of the assets at the time of contribution.[52] As discussed below, the minimum 3% was not met in all SPEs in which Enron invested.

Second, to overcome the presumption of consolidation, the investing third party must exercise control over the investment. According to the Powers Report, "[t]his is a subjective standard. Control is not determined solely by reference to majority ownership or day-to-day operation of the venture, but instead depends on the relative rights of investors. Accountants often look to accounting literature on partnership control rights for guidance in making this evaluation."[53] As discussed below, the ambiguity of the control standard allowed Enron to hide in the gray areas regarding business decisions and still maintain ultimate control of the SPEs through related-party transactions.

Before discussing how things went horribly wrong, it will be helpful to understand a basic transaction between Enron and an SPE. The following example is taken from *The Wall Street Journal*:

> Enron used outside partnerships to monetize assets and move debt off its balance sheet. . . . Here is how such transactions in recent years were typically structured:
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> 1. Enron transfers asset to special-purpose entity, or partnership, to move the asset and debt off its balance sheet and to recognize a gain from the transfer.
> 2. Outside investor injects at least 3% [now 10%] of partnership's capital. Under Financial Accounting Standards Board rules, a 3% [now 10%] outside investment allows Enron not to classify the partnership as a subsidiary.
> 3. In some cases it appears Enron helped provide some or all of the 3% of capital injected by the outside investor.
> 4. Banks typically loan up to 97% of capital needed by the partnership. The partnership is expected to repay the loan

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[50] *Id.* However, due to the Enron collapse, the minimum investment necessary has increased to 10%. Jensen, *supra* note 37.

[51] Jensen, *supra* note 37.

[52] *Special Purpose Entities: Understanding the Guidelines*, FIN. EXECUTIVES INT'L, Jan. 2002, *at* http://www.fei.org/download/SPEIssuesAlert.pdf (last accessed on Jan. 17, 2004).

> from cash generated by the Enron assets it acquires or through the sale of the assets upon liquidation of the partnership.
> 5. Enron guarantees bank loan, in some cases with Enron shares or a pledge to make up any shortfall. As the company's fortunes declined [in 2001], these guarantees were sometimes in the form of cash.[54]

Put another way, Enron often "parked" assets, such as overseas power plants declining in value, in SPEs to avoid recognizing any losses associated with those assets.[55] In addition to not recognizing operating losses associated with these troubled assets, Enron would often recognize "gains" on the sale of the assets to the SPE.[56] These activities eventually led to the downfall of Enron because the transactions artificially inflated profits and masked liabilities. When the time came to collect on the liabilities, Enron could not pay and had to fold.

Two red flags emerge, signaling where Enron ran afoul of the proper accounting treatment for SPEs. First, the 3% (now 10%) investment from a third party must actually come from a third party not associated with the sponsoring company—in this case, Enron. As the above example shows, Enron, at times, actually furnished or guaranteed some or all of this 3% that was supposed to be contributed by an independent third party. Enron, under Andersen's guidance, chose not to consolidate these SPEs that were 100% capitalized by Enron. Second, by completely capitalizing an SPE, Enron probably exercised an improper amount of control and assumed the risks and rewards of ownership, instead of the independent third party as required by proper accounting rules. Because of Enron's control of certain SPEs, these SPEs should have been consolidated into Enron's financial statements. The implications of Enron's failure to do so will be explored more fully below.

E. SPEs and Enron: A Troublesome Combination

The major force driving the creation of Enron's SPEs was its chief financial officer, Andrew Fastow. Because of his experience involving highly complicated financing instruments, Fastow became the head of the newly created Enron Global Finance in the summer of 1999.[57] In that

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53 *Powers Report*, *supra* note 32, at 39.

54 Emshwiller & Smith, *supra* note 33.

55 Thomas, *supra* note 19, at 43.

56 Behr & Witt, *supra* note 31. In one such case involving an SPE named LJM, "Enron 'sold' money-losing foreign assets to the partnerships, added the proceeds to its quarterly financial statement and then bought the assets back in the next reporting period." *Id.* In addition, using LJM again, Enron recognized a paper profit of about $300 million due to the increase in value of a company's stock called Rhythms held by LJM. Due to hedging, Enron did not recognize the subsequent decrease in the value of Rhythm's stock, thus capturing the gain and avoiding the loss. *Id.*

57 Bruce Rubenstein, *Structural Damage*, CORP. LEGAL TIMES, Oct. 2002, at 1.

position, he quickly developed a reputation as ruthless, cunning, and self-promoting.[58] He constantly hounded his team to close the next deal to the point of forcing them to make business calls in the middle of the night.[59] Although Fastow was described by Enron's chief operations officer, Jeffery Skilling, as a "prickly guy that would tell you everything wrong about others and everything right about himself," Fastow's position within Enron was secure because of his "financial wizardry" in using SPEs.[60] Those having the fortitude to complain about Fastow's tactics were either ignored or replaced.[61] "The message flashed throughout Enron: Don't mess with Fastow."[62]

Although Fastow was an undeniable presence at Enron, he "was also something of a mystery. He rarely attended the quarterly briefings Enron staged for financial analysts, making him the butt of a Wall Street wisecrack: 'Name Enron's CFO.'"[63] Inside Enron, rumors of Fastow receiving secret profits from undisclosed deals swirled.[64] "People gossiped that Fastow was getting rich, but nobody asked how rich."[65] As one employee quipped, "Next time Fastow is going to run a racket, I want to be part of it."[66] Little did they know what was going on behind closed doors.

Under Fastow's acerbic leadership, Enron exploited the benefits of SPEs, but there is evidence suggesting Enron disregarded even the most basic accounting requirements in creating and maintaining SPEs. This enabled Enron, for a time, to hide liabilities improperly and to recognize gains in transactions with these SPEs. When light was ultimately shed on these shady deals the house of cards came tumbling down.

One would think that the accounting standard of a 3% minimal investment by an independent third party could be easily satisfied; one would be wrong. In one of the larger SPEs, the 3% investment threshold was not met. In 1993, Enron formed a joint natural gas partnership with the California Public Employees' Retirement System (Calpers).[67] The joint venture was named JEDI, which was short for Joint Energy Development Investments.[68] In 1997, Fastow was ready to enlarge JEDI;

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58 Behr & Witt, *supra* note 31.

59 *Id.*

60 *Id.*

61 *Id.*

62 *Id.*

63 *Id.*

64 *Id.*

65 *Id.*

66 *Id.*

67 Peter Behr, *How Chewco Brought Down an Empire*, WASH. POST, Feb. 4, 2002, at A1.

68 Emshwiller & Smith, *supra* note 8.

however, Calpers was a bit more hesitant.[69] Therefore, Fastow and another Enron employee agreed to buy out Calpers' share in JEDI for $383 million.[70] In keeping with the Star Wars theme, Enron replaced Calpers with an SPE called Chewco.[71] Because key details of the transactions were changed at the last minute, the independent third party failed to invest the requisite 3% by contributing only $6.6 million, instead of the obligatory amount of over $11 million.[72]

As a result, both Chewco and JEDI did not qualify for non-consolidation treatment and should have been consolidated in Enron's financial statements. When this fact came to light on November 8, 2001, its impact was devastating.[73] Not only did Enron have to reduce its earnings by more than $405 million for the periods covering 1997-2000, its balance sheet also had to reflect an additional $2.5 billion in debt for the same period.[74] In the understatement of the century, Enron simply stated "its financial statements for those years could no longer be relied upon."[75] As the Powers Report found, "We do not know whether this mistake resulted from bad judgment or carelessness on the part of Enron employees or Andersen, or whether it was caused by [another Enron employee] or others putting their own interests ahead of their obligations to Enron. The consequences, however, were enormous."[76]

As can be imagined, if the objective requirement of making a simple 3% investment by an independent third party could not be met, the subjective control requirement posed even greater risks of manipulation. The independent third party was to exercise full control over the SPE for its operations to remain separate from the sponsoring company's consolidated financial statements. Control is measured by subjective standards often found in a partnership setting.[77] In the case of Enron the person managing the SPE was fully in control; however, the SPE's managing owner was influenced improperly by Enron.

To say the least, the managing owner of several SPEs was not independent of Enron. Take Chewco, for example. Fastow's initial efforts to manage Chewco were denied by Skilling.[78] Fastow's management of this SPE would have created an obvious conflict of interest because Fastow would have been on both sides of the transaction: for Enron, as

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69 Behr, *supra* note 67.

70 *Id.*

71 Emshwiller & Smith, *supra* note 8.

72 Behr, *supra* note 67. Three percent of $383 million is $11,490,000.

73 *Id.*

74 *Powers Report*, *supra* note 32, at 42.

75 Emshwiller & Smith, *supra* note 8.

76 *Powers Report*, *supra* note 32, at 7.

77 *Id.* at 53.

78 Behr, *supra* note 67.

chief financial officer, and for Chewco, as an independent third party manager looking out for the interests of Chewco's investors. Instead, Fastow nominated his friend, Michael Kopper of Enron Global Finance, who invested $115,000 in Chewco, to fill the independent third party manager position.[79] Enron allowed Fastow to "supervise" Kopper's activities.[80] For his role in managing Chewco, Kopper was paid approximately $2 million in management fees.[81] He then shared a huge profit with another investor (who had invested $10,000 in Chewco) when they eventually sold their interests in Chewco to Enron for approximately $10.5 million.[82] From an accounting independence perspective, all of these transactions appear dubious, especially because Kopper received all of these financial gains from Chewco in addition to his regular salary from Enron.[83]

Because Chewco allowed Enron to conceal substantial debt and claim over $405 million in additional profits, Enron, or more specifically Fastow, desired to achieve even better results with another SPE. By waiving any conflict of interest concerns,[84] Enron's Board of Directors allowed Fastow himself, to be the independent third party manager and investor in two SPEs named LJM and LJM2.[85]

Fastow, by virtue of his position within Enron, had considerable influence during any negotiation between Enron and the LJM partnerships. Often, Fastow had direct control over the compensation of the Enron personnel he was negotiating against when he was acting on behalf of the SPE.[86] Additionally, because of his position as CFO of Enron, Fastow knew how badly Enron needed to unload underperforming assets and frequently struck deals that were inherently unfair to Enron and its shareholders.[87]

Enron's Board of Directors defended this arrangement between Fastow and LJM and LJM2. The Board felt that "[b]y having people intimately familiar with Enron's complex operations run the partnerships, the entities supposedly could made much quicker decisions about whether to take part in a particular transaction. This nimbleness, it was argued, could benefit both the company and the partnership . . . ."[88] The world outside Enron called it what it was—a conflict of

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79 *Id.*

80 *Id.*

81 *Id.*

82 *Id.*

83 *Id.*

84 Behr & Witt, *supra* note 31.

85 *See id.*

86 Raphael Grunfeld, *Getting Caught in the Middle*, N.Y.L.J., May 6, 2002, at S1.

87 *Id.*

88 Emshwiller & Smith, *supra* note 30.

interest. After reviewing the arrangement between Enron and these partnerships, one in-house Enron attorney quipped, "Everyone was wearing two hats. The salaries were paid by Enron, but their bonuses were paid by LJM."[89] The conflicts were so egregious that Skilling eventually forced Fastow to make a decision either to remain as CFO or to disassociate from Enron. Fastow, in choosing to keep his CFO position at Enron, transferred his interest in the LJM partnerships to Michael Kopper, Fastow's trusted friend and former manager/benefactor of the Chewco SPE.[90] Before relinquishing control, however, Fastow allegedly pocketed approximately $45 million in management fees and bonuses for being the independent third party investor and manager; this was in addition to his yearly Enron salary of $2.4 million, including bonuses.[91]

F. The Role Attorneys and Accountants Played in Enron's SPEs

The daily mantra of the press in the days after Enron declared bankruptcy was "Where were the accountants?" There is no doubt Andersen played a large role in the implosion of Enron, as evidenced by its being found guilty of obstruction of justice on June 15, 2002.[92] Accountants, however, were not the only parties to blame. The legal profession definitely played some part in pushing Enron into bankruptcy. In particular, attorneys were involved in establishing the legal structure of the many SPEs created by Enron.

Although much finger-pointing between the two professions will undoubtedly continue and the exact roles they played remains to be seen, some evidence has come to light disclosing failures of both industries. In any event, professionals would do well to take the following piece of advice to heart: "Whether you're a lawyer or an accountant or a business person, your actions are at risk of being reviewed after the fact by people that are going to put a different lens on it than mere technicality."[93]

As the auditor of a publicly traded company, Andersen had a responsibility to opine upon whether Enron's financial statements complied with generally accepted accounting principles (GAAP). Regarding the proper accounting treatment for SPEs, it is unclear just what Andersen knew at the time of the creation of the SPEs. For example, the Powers Report indicates Andersen knew of Chewco, but there is insufficient evidence to conclude how much information was given to Andersen or what type of advice Andersen gave regarding the

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89 Rubenstein, *supra* note 57.

90 Behr & Witt, *supra* note 31.

91 *Id.*

92 David Hechler, *Lawyers See Lessons in Trial of Andersen*, NAT'L L.J., June 24, 2002, at A1.

93 *Id.*

proper accounting treatment of the SPE.[94] But two things are known about Andersen's role regarding Chewco. First, Andersen did perform certain "audit procedures" in concluding that Chewco met the 3% independent third party test, when, in fact, it had not met this requirement.[95] Second, it is clear that Andersen charged Enron $80,000 in consulting fees to review the Chewco transaction.[96]

Evidence suggests that Andersen also knew about Fastow's dual role in the LJM partnerships—playing both CFO of Enron and masquerading as LJM's independent third party manager and investor. David Duncan, a partner at Andersen, was the head of Andersen's audit team for Enron.[97] A member of this team brought Fastow's conflicting roles to Duncan's attention by stating, "Setting aside the accounting, [the] idea of a venture entity managed by CFO is terrible from a business point of view. Conflicts galore. Why would any director in his or her right mind ever approve such a scheme?"[98] Duncan's response was priceless: "I really couldn't agree more."[99] Despite this, Duncan conditioned Andersen's acquiescence to this arrangement upon it being approved by Enron's CEO and full Board of Directors, which approval was ultimately given during a teleconference.[100] Unfortunately, due to errors made either in Andersen's audit procedures or in Enron's failure to provide enough information upon which Andersen could base a correct decision, many SPEs were improperly left unconsolidated, painting a very different financial picture of Enron to the outside world.

Although Anderson's accountants erred, did the attorneys working for Anderson also play any role in the Enron debacle? Despite the enormous press coverage concerning the shredding of documents by Andersen, the twelve-member jury that found Andersen guilty of obstruction of justice stated a single Andersen in-house attorney, Nancy Temple, was to blame for the guilty verdict.[101] Despite more than ten days of deliberations and efforts by the prosecution to color a culpable Andersen for its role in shredding evidence, the jury "decided Temple was the 'corrupt persuader' who acted to keep information from the

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94 *Powers Report*, *supra* note 32, at 53.

95 *Id.*

96 *Id.*

97 Behr & Witt, *supra* note 31.

98 *Id.*

99 *Id.*

100 *Id.*

101 Brenda Sapino Jeffreys, *Alteration of Internal Document Led to Finding Against Andersen*, AM. LAW. MEDIA, June 18, 2002, *available at* http://www.law.com/servlet/contentserver?pagename=OpenMarket/Xcelerate/View&c=LawArticle&cid=1024078849643&+lawarticle (last visited Jan. 17, 2004).

[Securities and Exchange Commission]."[102] What did Temple do that warranted labeling her a "corrupt persuader"? Andersen and Enron disagreed over the proper way to disclose a certain $1 billion charge Enron was taking against income. In the end, Temple sent Duncan a single e-mail requesting that her name be removed from an Anderson internal memo that suggested Enron's disclosure of the charge was misleading.[103] To the jury, this sounded like a cover-up. As a result of the conviction, Andersen was no longer allowed to audit public companies and was effectively put out of business.[104] In the words of one observer, "[I]t's just inconceivable to me that a lawyer's decision on one sentence determines whether Andersen is in business or out of business."[105] Inconceivable or not, the actions of one attorney shut down a venerable, eighty-nine-year-old accounting firm.[106]

Enron's outside and in-house attorneys also seem culpable in perpetrating fraud on the public through the use of the SPEs; it, however, appears the blame game is in full force. Vinson & Elkins (V&E), a Houston-based law firm, was Enron's primary outside legal counsel and, along with Enron's in-house counsel, was responsible for reviewing the structure of the now infamous SPEs. Since Enron's bankruptcy, V&E has become the target of a shareholder lawsuit alleging V&E knew the purpose of the SPEs was to inflate revenues artificially and to disguise liabilities.[107] A litigation partner at V&E vigorously denied any wrongdoing and appeared to explain (or shift?) the blame as being a product of esoteric accounting rules that are the responsibility of accountants:

> The plaintiff lawyers are treating off-the-balance-sheet transactions as phony. But that's the way billions of dollars have been handled by corporations across America. I don't think that there is anything mysterious about that except that the accounting is mysterious to most of us. But there is nothing illegal about it. You can argue that it doesn't show debt so it isn't good. But I don't think there is anything we did that is unethical. Companies are entitled to do whatever the law and the SEC allows.[108]

This theme of blame shifting was also found among the in-house attorneys of Enron. "The lawyers worked with the dealmakers from the earliest stages of a transaction to the end and their approval was

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[102] *Id.*

[103] *Id.*

[104] *Id.*

[105] Hechler, *supra* note 92.

[106] Jeffreys, *supra* note 101.

[107] Miriam Rozen, *V&E Reacts to Enron Shareholders' Latest Allegations*, TEX. LAW., June 17, 2002, *available at* http://www.law.com (last visited on Dec. 16, 2002).

[108] *Id.*

required before the deal was made, but, they rarely looked at the numbers."[109]

Nonetheless, there were certain structural aspects of the SPEs beyond the scope and job description of the accountants for which the attorneys held sole responsibility. There is no doubt that Enron's in-house attorneys were involved in the creation of the SPEs from the beginning, and their approval was crucial in closing any deal.[110] Concurrently, outside counsel was often obtained to consult on a particular transaction. In one such case, another law firm based in Houston, Andrews & Kurth (A&K), gave its blessing to a certain securitization deal called Cerberus.[111] In transferring the assets to Cerberus, A&K was hired to draft a "true sales opinion."[112] This opinion is crucial and often demanded by underwriters before outside investors contribute to an SPE. The opinion states the assets transferred have been legally severed by the company and, therefore, become the sole property of the SPE.[113] The opinion from outside counsel is important for two reasons. First, from an accounting perspective, it evidenced that Enron no longer had control over the assets and, therefore, could properly report, according to GAAP, any gain or loss on the sale of these assets to the SPE.[114] Second, if the sponsoring company should go bankrupt, as Enron did, the assets will not become part of the bankruptcy estate used to satisfy creditors.[115]

A&K's work on the Cerberus transactions has been questioned by the court-appointed Enron examiner and others who allege the true sale opinions issued by A&K were nothing more than "artfully lawyered-up loans."[116] If this is true, Enron will be required to reverse a $31 million gain recognized in 2000 from the Cerberus transactions, and the assets

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[109] Rubenstein, *supra* note 57.

[110] *Id.*

[111] Otis Bilodeau, *New Questions Over Lawyering in Enron: "True Sale" Opinions at Issue in Probe of Controversial Deals*, LEGAL TIMES, Sept. 30, 2002, at A1. Securitization allows a company to raise capital without issuing additional stock or debt, but it requires some legal gymnastics. According to the article:

> To "monetize" an asset—like, say, a heap of credit card receivables—through a securitization, a company moves the asset into a specially created corporate vehicle—the now infamous "special purpose entity" or SPE. That SPE in turn issues securities, usually bonds, backed by the assets. The cash proceeds from the bond sale flow back to the company, and the investors' loans get repaid by the SPE.

Id.

[112] *See id.*

[113] *See id.*

[114] *See id.*

[115] *Id.*

[116] *See id.*

would revert back to Enron.[117] In six selected securitization deals, in two of which A&K participated, the value of the assets transferred to SPEs exceeded $500 million, and Enron pocketed approximately $1.4 billion.[118]

III. UNDISCLOSED DISCLOSURES

Whether on purpose or by happenstance, accountants and attorneys alike allowed Enron to use SPEs to cloak the true picture of its financial health. In addition to the creation and maintenance of SPEs, however, the charade continued through obscure disclosures regarding many aspects of the SPEs, including transactions with related-parties and ownership and management of the SPEs. As one senior Wall Street official recalled, "If you don't ask the absolute right question, you don't get the right answer. . . . Enron does that a lot."[119] To highlight how obscure and uninformative the disclosures provided by Enron were, one *Wall Street Journal* article commented, "Enron's disclosure practices stand out, however, because they have been a source of complaints for so long. Even some top-flight accounting professors say they can't make heads or tails of the company's transactions with Mr. Fastow or Enron's motives for entering them."[120] As a result, the Powers Report put the blame for the deficiencies of these disclosures on, among others, both Andersen's and Enron's attorneys.[121]

Enron came under fire for failing to disclose the related-party transactions between the Fastow-managed LJM partnerships and Enron. Public companies have a duty to reveal company transactions with related parties, and the public companies' accountants and attorneys have a duty to ensure the disclosure is proper, primarily because the potential for abuse is greater when not dealing at arm's length.[122] These rules, however, do not provide the clearest guidance and leave room for judgment calls.[123]

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[117] *See id.*

[118] *Id.* The University of California has recently named A&K as a co-defendant in its shareholder suit against Enron alleging A&K "wrote false opinion letters that allowed the transactions to be accounted for as Enron wished . . . ." Trey Davis, *UC Adds Four New Defendants to Enron Fraud Case*, at http://www.ucop.edu/news/archives/2004/jan09.htm (Jan. 9, 2004).

[119] Emshwiller & Smith, *supra* note 8.

[120] Jonathan Weil, *What Enron's Financial Reports Did and Didn't Reveal*, WALL ST. J., Nov. 5, 2001, at C1.

[121] *Powers Report*, *supra* note 32, at 178.

[122] *See, e.g., id.* at 179-80. Per the *Powers Report*, Statement of Financial Accounting Standard 57 requires the following disclosure, which is generally made in the notes to the financial statements when dealing with related parties to be in compliance with GAAP:

> (a) The nature of the relationship(s) involved; (b) A description of the transactions, . . . and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements;

The Powers Report mainly faulted accountants and attorneys for the procedures they followed in approving the content of footnote disclosures in the financial statements. Enron Global Finance, headed by Fastow, was primarily in charge of disclosing pertinent information regarding related-party transactions.[124] Besides the obvious conflict of interest, there was little review of the disclosures either by the accountants or by the attorneys. As the Powers Report sadly revealed, "[W]e were told that, because the related-party transactions were often extremely complex, the Enron Corp. accountants and lawyers responsible for financial reporting relied heavily on—and generally deferred to—the officers and employees in Enron Global Finance who were closer to the transactions and actually knew the details."[125]

While the accountants and attorneys were relying upon Enron employees to ensure the adequacy of the disclosures, Enron's Board of Directors was relying upon Andersen and V&E. "Management and the Board relied heavily on the perceived approval by Vinson & Elkins of the structure and disclosures of the transactions. Enron's Audit and Compliance Committee, as well as in-house counsel, looked to it [V&E] for assurance that Enron's public disclosures were legally sufficient."[126] V&E, however, was relying upon Andersen to ensure the appropriate transparency of the disclosures. Harry Reasoner, a partner at V&E, apparently relied heavily upon Andersen and did not focus on the accounting side of the transaction, admitting his firm never advised Enron regarding any accounting policy or issues.[127] He was quoted as saying "Why on earth would you not trust Arthur Andersen?"[128] So, if the Board of Directors relied on V&E to make sure the disclosures were legally sufficient, and V&E relied upon Andersen, and if both V&E and Andersen greatly deferred to Fastow's group because the transactions were complex, then who was in charge of the content of the disclosures? Basically, it was Fastow.

It is no wonder then that the footnotes disclosed minimal information. As discussed, Fastow's participation in the LJM SPEs

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(c) The dollar amounts of transactions . . . [and] (d) Amounts due from or to related parties.

Id. at 179-80. Likewise, the *Powers Report* notes both accountants and attorneys are bound by SEC rules regarding disclosure of related-party transactions. Per SEC Regulation S-X § 4-08(k), "[r]elated party transactions should be identified and the amounts stated on the face of the balance sheet, income statement, or statement of cash flows." *Id.* at 180.

[123] *Id.* at 180.

[124] *Id.* at 181.

[125] *Id.* at 182.

[126] David Hechler, *Report Criticizes V&E's Enron Work: Firm Could Be Sued, Experts Say*, NAT'L L.J., Feb. 11, 2002, at A1.

[127] *Id.*

[128] *Id.*

rewarded him to the tune of approximately $45 million.[129] This was not revealed until much later, however, because general counsel of Enron Global Finance, Jordan Mintz, narrowly interpreted an SEC rule requiring disclosure.[130] According to Item 404 of Regulation S-K, the compensation of personnel involved in related-party transactions should be disclosed "where practicable."[131] The Powers Report reveals accountants and attorneys alike "accommodate[d] the strong desire of Fastow (and others) to avoid disclosure if there was a legitimate basis to do so."[132] Because there were certain pending transactions between Enron and the LJM entities that would affect Fastow's compensation, a footnote in Enron's 2000 proxy statement merely acknowledged he was entitled to a "share of the profits in excess of its proportional capital investment in the partnership."[133] This "share of profits" happened to exceed $45 million.

As with many disclosures Enron made, "[t]he raw numbers may all be there,"[134] but as accounting professor Douglas Carmichael of New York's Baruch College stated, "any objective person would be hard pressed to understand the effects of these disclosures on the financial statements."[135] It is disheartening when professionals bend the rules for another's profit; it is even more deplorable when they do so for their private gain, as was the case of one Enron in-house attorney, Kristina Mordaunt. Fastow had worked with Mordaunt in the past and often sought her advice on certain transactions.[136] Through her association with Fastow, she became a coveted independent third party investor and manager of an SPE named Southampton.[137] Although the record is still unclear concerning her responsibilities in Southampton, Mordaunt received approximately $1.7 million for her role.[138]

Whether intentionally or otherwise, it seems as if those in a position to correct the financial misrepresentations of Enron turned a blind eye to the malfeasance under their noses. As one Enron employee reflectively stated, "I was right here. How can everyone from the outside think they see it so clearly?"[139] Perhaps they were distracted by the promise of stock

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[129] Rubenstein, *supra* note 57.

[130] *Powers Report*, *supra* note 32, at 188.

[131] *Id.* at 187.

[132] *Id.*

[133] *Id.* at 187-88.

[134] Weil, *supra* note 120.

[135] *Id.*

[136] Rubenstein, *supra* note 57.

[137] *Enron Fallout*, INSIDE F.E.R.C.'S GAS MARKET REP., Aug. 30, 2002, at 3.

[138] *Id.*

[139] David Hechler, *Enron's Legal Staff Battered, Confused*, NAT'L L.J., Feb. 4, 2002, at A1.

options, consulting fees, or a raging bull market that appeared to have no end in sight. In any event, Thomas Gottschalk, general counsel of General Motors, suggested attorneys should have taken more responsibility. "Lawyers should provide objective advice, not assume that auditors are doing what's appropriate. Had lawyers at either Andersen or Enron played more of that role, perhaps some of these questionable accounting practices would not have been adopted."[140] With the introduction of the Sarbanes-Oxley Act, however, attorneys may no longer choose silence.

IV. CORPORATE PRACTICE FOR ACCOUNTANTS AND ATTORNEYS UNDER THE SARBANES-OXLEY ACT

In what have been called "the most far-reaching changes Congress has imposed on the business world since FDR's New Deal,"[141] a new day has dawned for both the accounting and legal professions in corporate practice. Gone are the days of self-regulation as the public has demanded accountability in the wake of corporate scandal after corporate scandal. In response to public outcry, the SOA was born. On its face, the Act is definitely directed at establishing more public oversight for the accounting profession. Without much fanfare, however, the Act also addresses the ethical duties and responsibilities of attorneys working for publicly traded companies, implicitly making attorneys more of a public watchdog. Even though the full implications of the Act on the future practice of accounting and law remain to be seen, there are a few changes in store for those providing accounting and legal services to public companies.[142]

A. New Regulations for Accountants Under the SOA

Under the Act, a new public oversight body, aptly named the Public Company Accounting Oversight Board (PCAOB), became the sole authority for issuing auditing, attestation, and quality control standards for public companies.[143] Nonetheless, the five-member board, comprised of no more than two certified public accountants (CPA), must "cooperate on an ongoing basis" with the professional organizations currently promulgating auditing standards, but the PCAOB has the authority to

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[140] Hechler, *supra* note 92.

[141] Richard I. Miller & Paul H. Pashkoff, *Regulations Under the Sarbanes-Oxley Act*, J. ACCOUNTING, Oct. 2002, at 33, 33.

[142] According to a Senate Report concerning the Act, it applies only to publicly traded companies, i.e., those that are required to register their securities with the SEC. The act leaves unchanged any rules regarding unregistered companies. S. REP. NO. 107-205, at 44 (2002).

[143] Miller & Pashkoff, *supra* note 141, at 33-34.

"amend, modify, repeal or reject any standards suggested by these groups."[144]

Perhaps the most substantive change to the current practice of accounting is the restriction on providing certain non-audit services simultaneously with an audit.[145] This provision was passed primarily to preserve an auditor's independence while performing an audit.[146] The prohibited acts include bookkeeping or other services related to the financial statements of the client, financial information systems, appraisal services, internal audit out-sourcing, management functions, broker-dealer services, and legal and expert services.[147] This provision effectively ends a good deal of consulting work by the same firm performing the audit, thus making audit engagements less lucrative for CPA firms. If this Act had been law during the Enron/Andersen situation, arguably Andersen would not have been allowed to give advice concerning the structure of the SPEs, because this would qualify as a bookkeeping function (i.e., consulting on an entry to be reflected in the financial statements of the company).

The Act also restricts which partners can serve on the audit team of a public company. Section 203 of the Act requires the lead partner and the review partner to be replaced periodically so no one holds such positions in the audit of the same public company for five consecutive years.[148]Another important provision of the Act concerns whom the auditors report to during the course of an audit. The Act imposes standards on an independent Audit Committee.[149] The board of directors of a public company must establish an independent board known as the Audit Committee (Committee). This Committee is "responsible for the appointment, compensation, and oversight of the work of" auditors and requires auditors to "report directly to the audit committee."[150] Therefore, auditors must take their concerns to the Committee instead of

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[144] *Id.* at 34. The idea of leaving the current structure in place, with oversight by the PCAOB, has been touted as the better alternative. According to Senator Phil Gramm of Texas,

> [I]t would be hard to overestimate the importance of maintaining our system of private setting of accounting standards through the Financial Accounting Standards Board (FASB). Neither Congress nor any other agency of the government should be in the business of setting accounting standards. A bad accounting standard set by an independent board is better than a good standard set by Congress.

S. REP. NO. 107-205, at 66 (2002).

[145] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 201(a), 116 Stat. 745, 771-72 (2002) (codified in scattered sections of 15 & 18 U.S.C.).

[146] S. REP. NO. 107-205, at 51 (2002).

[147] Sarbanes-Oxley Act § 201(a).

[148] *Id.* § 203.

[149] *Id.* § 301.

[150] *Id.*

management, and the Committee is charged with addressing those concerns.[151] This allows an auditor more freedom in disclosing questionable transactions to someone other than the culpable person, who is also signing the check for the auditor's fees.

This Act was passed very swiftly, leaving loose ends that need to be resolved before the accounting industry can fully comply with its provisions. Paul Purfield, a partner at PricewaterhouseCoopers and a specialist in SEC-related matters, correctly noted, "You can't write accounting literature in a week."[152]

The Act is fundamentally aimed at making changes in the accounting profession regarding audits of public companies. On the other hand, the legal profession will be forced to grapple with the new rules as well. As discussed below, attorneys would do well to take a more active role in ferreting out corporate malfeasance.

B. What the SOA Means for Attorneys

The provision of the Act regulating the actions of corporate attorneys, both in-house and outside counsel, is actually a small part of the Act. Section 307 simply states that within 180 days of the passage of the Act (July 30, 2002), the SEC is to set forth rules regarding the minimum standards of professional conduct of attorneys working for public companies.[153] This language sounds relatively innocuous and could give attorneys a false sense of security. The Act further requires the SEC, however, to include a rule forcing an attorney "to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof)."[154] Section 307 continues by stipulating that if the CEO or chief legal counsel does not give an appropriate response to the allegations, the attorney is required to bring the matter before the company's Audit Committee;[155] if the issue is not resolved there, the attorney may be required to address the full board of directors. In the words of one observer, "Corporate lawyers are looking at a new job description: corporate informant."[156]

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[151] Miller & Pashkoff, *supra* note 141, at 36.

[152] Rick Telberg, *What Hath Sarbanes-Oxley Wrought?*, Oct. 7, 2002, *at* http://www.cpa2biz.com/news/telberg/what+hath+sarbanes+wrought.htm (last visited Jan. 17, 2004).

[153] Sarbanes-Oxley Act § 307.

[154] *Id.* § 307(1).

[155] *Id.* § 307(2).

[156] Richard Schmitt, *Lawyers Pressed to Report Fraud Under New Law*, WALL ST. J., July 25, 2002, at B1.

The exact details of this rule remain to be enacted at the time of this writing, but the language of the rules has given rise to no small amount of concern and debate. Attorneys have naturally eyed almost every word of the provision with caution. In particular, what constitutes "evidence" of a material violation that would require the attorney to address the company's CEO or chief legal counsel?[157] Beyond that, what is considered a "material violation"? What exactly is a breach of a "fiduciary duty" by the company or the company's agent?[158] What is considered an "appropriate response" by the CEO or chief legal counsel?[159] Is the attorney then relieved from liability if he has brought evidence of what he believes is a material violation of a securities law or a fiduciary duty to the attention of the Audit Committee, and perhaps the board of directors?[160]

The SEC has addressed some of these concerns. According to SEC Final Rule 205.2(b), an "appropriate response" by a company's officer to an attorney's concern about evidence of an apparent material violation is any response that causes the reporting attorney to believe a "material violation" has not occurred or is not going to occur, adopts appropriate remedial measures to address the concern, or involves the retention or direction of another attorney to review the matter.[161] Apparently, the rule defers to the inquiring attorney's discretion regarding what is an appropriate response but gives little guidance to the attorney in making this determination.[162]

Additionally, the SEC has attempted to clarify the meaning of a material violation. The rules provide that a material violation "means a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law."[163] While the definition gives some substance to the context in which the violations may occur, it does little to illuminate the meaning of "material."

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[157] Anthony E. Davis, *Professional Responsibility*, N.Y.L.J., Sept. 9, 2002, at 3.

[158] Regarding breaches of fiduciary duties, the term "agent" could encompass a number of different actors, both within and without the corporation, including "auditors, consultants, investment bankers, insurers, lenders, etc." Stanley S. Arkin, *Corporate Responsibility Legislation: Conflicts, Uncertainties*, N.Y.L.J., Aug. 8, 2002, at 3. If the scope of the term "agent" is not limited by subsequent regulations, corporate attorneys will be quite busy.

[159] Caher, *supra* note 1.

[160] *Id.*

[161] SEC Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.2(b) (2004).

[162] *See id.*

[163] 17 C.F.R. § 205.2(i).

To some attorneys, it is also troublesome that the rules contain no knowledge requirement. As the rule currently reads, an attorney has the duty to report evidence of material violations of security law or breaches of fiduciary duty, regardless of whether the attorney knows about those violations.[164] Richard Painter, law professor at the University of Illinois, put it mildly: "That is a very high standard."[165] Calling it what it is, Lawrence Fox, former American Bar Association ethics committee chair, stated, "It is a lawyer liability act."[166] Another attorney framed it differently but succinctly: "People on the Hill get excited and say, 'We have to do something.' When they say that, they're really likely to screw things up."[167]

The Code of Federal Regulations (CFR) confirms that the attorney need not actually know about a material violation before reporting is required. An attorney must report evidence of a material violation,[168] which the CFR defines as "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur."[169] This objective standard will not permit corporate attorneys to turn a blind eye to corporate malfeasance; rather, it could possibly hold them accountable for the actions of their clients (much like accountants). While there is usually room for interpretation, practicing corporate attorneys do have reason for concern.

Aside from the definitional wrangling over the Act's language, the SEC has postponed implementing a so-called "noisy withdrawal" provision of the Act due to outcry from the legal profession. In the event that an attorney has not received a satisfactory, reasonable response to his concerns of a material violation, the proposed "noisy withdrawal" rule would require the attorney to withdraw from representation, inform the SEC of the withdrawal, and disaffirm any opinions or documents the attorney prepared for submission to the SEC.[170] Attorneys are particularly distressed as to how this noisy withdrawal provision will interfere with their duty of client confidentiality. For example, while the

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[164] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307(1), 116 Stat. 745, 784 (codified in 15 U.S.C. § 7245(1) (2003)).

[165] Schmitt, *supra* note 156.

[166] *Id.*

[167] Anthony Lin, *Law Firms Concerned Over Enron's Impact*, N.Y.L.J., Mar. 15, 2002, at 1.

[168] Sarbanes-Oxley Act § 307(1).

[169] SEC Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.2(e) (2004).

[170] Implementation of Standards of Professional Conduct of Attorneys, 67 Fed. Reg. 71670 (proposed Dec. 2, 2002).

Virginia Rules of Professional Conduct also require withdrawal if the representation will violate "other law,"[171] they neither contemplate nor authorize making such a noisy withdrawal. In fact, the Virginia Rules require an attorney upon withdrawing to "take steps to the extent reasonably practicable to protect a client's interest."[172] Comment 9 to Rule 1.16 supports this position by mandating that "a lawyer must take all reasonable steps to mitigate the consequences to the client" upon withdrawal.[173] One would be hard pressed to interpret compliance with the noisy withdrawal rule by a major law firm, such as V&E, by terminating its long-term relationship with a client like Enron, informing the SEC of its withdrawal, and disaffirming any and all opinions rendered on behalf of Enron to the SEC, as protecting a client's interest. Such a withdrawal is bound to turn the heads of the authorities.

Because of the potential conflicts with the rules of professional responsibility of each state, the SEC pushed back the implementation of the noisy withdrawal requirement and continued to accept comments regarding the prudence of such a rule.[174] Past American Bar Association President, Alfred Carlton, urged reconsideration of this rule stating, "Some of these proposals raise fundamental issues regarding the role of lawyers and the attorney-client relationship."[175] He added, "Congress did not intend for the SEC to impose such requirements."[176] Whether or not Congress meant the Act to extend this far into transforming attorneys from counselors to investigative reporters, the Act has the potential to alter the attorney-client relationship and blur the distinction between attorney and accountant.

V. WILL THE ACT ACCOMPLISH ITS INTENDED GOALS?

A. Historical Perspective

Whatever the final regulations of the Act may be in determining the role of corporate attorneys, one thing appears certain: attorneys will have to take a more active role in ascertaining the legality of their client's work.[177] Even with more public oversight of the accounting

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[171] VA. RULES OF PROF'L CONDUCT R. 1.16(a)(1) (2000).

[172] VA. RULES OF PROF'L CONDUCT R. 1.16(d) (2000).

[173] VA. RULES OF PROF'L CONDUCT R. 1.16 cmt. 9 (2000).

[174] Press Release, Securities and Exchange Commission, SEC Adopts Attorney Conduct Rule Under Sarbanes-Oxley Act (Jan. 23, 2003), *at* http://www.sec.gov/news/press/2003-13.htm (last visited Jan. 15, 2004).

[175] Jenny B. Davis, *Sorting Out Sarbanes-Oxley*, A.B.A. J., Feb. 2003, at 49, 49.

[176] *Id.*

[177] One writer desires to see attorneys embrace, rather than reject, the accounting treatment of their transactions.

industry and the imposition of requirements on attorneys to become more investigative, will the Act put a stop to corporate malfeasance? If history is any guide, the answer is a disheartening "No."

Both accountants and attorneys are hired to give advice upon the issues in question. Often, the issues can be extraordinarily complex, and, as anyone who has dealt with clients on any level knows, the client is not necessarily forthright with all the facts all the time. Congress cannot prescribe regulations covering all possible circumstances that could arise in corporate life; therefore professionals will be required to draw upon their judgment to answer the particular issue addressed.[178]

B. Corporate Practice and the Bible

We are faced daily with a myriad of different choices, albeit some choices have more serious consequences than others. What we base our decisions on, however, seems to be more important than the decisions themselves. This is no less important in the corporate world where professionals are called upon to make many decisions involving a broad range of issues with varying magnitudes, especially when the client needed the answer yesterday. The Bible provides a solid foundation on which to base these difficult decisions. It provides a great deal of wisdom to be considered in making any type of decision, but certain passages are more pertinent to corporate practice.

The Bible encourages us to remember for whom we are working; "Whatever you do, work at it with all your heart, as working for the Lord, not for men, since you know that you will receive an inheritance from the Lord as a reward. It is the Lord Christ you are serving."[179]

Additionally, the book of Proverbs provides cogent, succinct rules of conduct that have stood the test of time, extolling the virtues of fidelity and scorning the transient lure of riches. "The integrity of the upright

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> In order to do their jobs, it is now clear that in-house counsel need to develop the ability to understand these legal implications and the related accounting issues or have access to outside counsel and a neutral accounting expert like a professor or a firm that does not seek audits of public companies . . . that can advise them until they develop the necessary in-house expertise.
>
> Most general counsel are aware of the requirement for disclosing material information to investors even if they do not fully understand all the accounting intricacies. They are in a position to apply common sense to the process as a "double check" on the audits, perhaps with the assistance of independent members of the audit committee.

In-House Counsel Play a Central Role in Preventing Accounting Scandals, METRO. CORP. COUNSEL, Sept. 2002.

[178] One attorney cogently commented, "If it were black and white, you wouldn't need lawyers. You hire lawyers because we are gray." Grunfeld, *supra* note 86.

[179] *Colossians* 3:23.

guides them, but the unfaithful are destroyed by their duplicity."[180] "The man of integrity walks securely, but he who takes crooked paths will be found out."[181] "Better a little with righteousness than much gain with injustice."[182] "The house of the righteous contains great treasure, but the income of the wicked brings them trouble."[183] "Better a poor man whose walk is blameless than a rich man whose ways are perverse."[184] "He whose walk is blameless is kept safe, but he whose ways are perverse will suddenly fall."[185]

These are but a few verses to keep in mind when faced with a decision in the gray area. Accountants and attorneys providing services to corporate clients need to ask themselves two simple questions to stay out of trouble. First, would I want someone else handling my money in this fashion? Second, would I want my actions to be made publicly known? Charles Elson, a law professor at the University of Delaware, had the right idea when he stated, "Everything one does should be viewed as potentially ending up on the front page of the newspaper."[186]

VI. CONCLUSION

The Sarbanes-Oxley Act fundamentally changes the role of corporate accountants and attorneys. Accountants are now subjected to more public oversight than ever before and will be open to increasing scrutiny with every failed audit in the future. Attorneys face an uncertain regulatory future forcing them to disclose various securities violations and breaches of fiduciary duties by not only their client, but also the client's many agents. Only time will tell whether the Act will prevent future catastrophes like Enron; one thing is certain, however: accountants and attorneys working together and exercising sound judgment in the gray areas will leave little place for fraud to frolic. Except for that pay thing, it appears accountants and attorneys are not that different after all.

Justin Kendall

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[180] *Proverbs* 11:3.

[181] *Proverbs* 10:9.

[182] *Proverbs* 16:8.

[183] *Proverbs* 15:6.

[184] *Proverbs* 28:18.

[185] *Proverbs* 28:16.

[186] Hechler, *supra* note 92.