Washington and Lee Law Review

Volume 60 | Issue 1

Article 8

Winter 1-1-2003

Who "Caused" the Enron Debacle?

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I. Introduction

Gregory Van Hoey performs an admirable service in shedding light on a neglected element of the federal securities regulation enforcement regime.[1] He convincingly shows how "causing" liability can provide a viable mechanism for reaching parties who are only secondarily responsible for a securities law violation.[2] Van Hoey's analysis is especially important in light of the United States Supreme Court's elimination in 1994 of private actions for aiding and abetting securities fraud.[3] This Comment explores some of the possibilities of causing liability with reference to the Enron disaster. Consideration of the principal "gatekeepers'" failures graphically illustrates the importance of this form of secondary liability.

At the heart of the Enron scandal was a group of exceptionally ambitious executives seeking to create a new kind of energy company.[4] At its peak, Enron reported annual revenues of $100 billion and employed over 20,000 employees.[5] *Fortune* ranked the company as high as seventh on its "Fortune 500" list.[6] We now know, however, that this edifice was an intricate house of cards built on a foundation of sham transactions and accounting manipulations. When the frauds surfaced during the fall of 2001, the structure quickly collapsed, leaving investors, employees, and customers with billions of dollars in losses. How could a company that was the poster child for innovation and entrepreneurial success fall so far so fast? How could so many people have been deceived?

It turns out that Enron was not unique. Since its fall, revelations of accounting impropriety and insider corruption at WorldCom, Tyco, Adelphia,

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1. Gregory Van Hoey, Note, *Liability for "Causing" Violations of the Federal Securities Laws: Defining the SEC's Next Counterattack in the Battle of* Central Bank, 60 WASH. & LEE L. REV. 249 (2003).

2. *Id.* at 284-87. Congress established causing liability in 1990, adding identical provisions to four major federal securities regulation statutes. The amendments authorize the SEC to apply sanctions to primary violators and to "any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation." 15 U.S.C. §§ 77h-1(a), 78u-3(a), 80a-9(f)(1), 80b-3(k)(1) (2000).

3. *See* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994) (holding that neither antifraud statute nor legislative scheme authorizes private actions for aiding and abetting).

4. For an insightful analysis of Enron's rise and fall and the scandal's law reform implications, see generally William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002).

5. Kurt Eichenwald, *Audacious Climb to Success Ended in a Dizzying Plunge*, N.Y. TIMES, Jan. 13, 2002, at A1.

6. Gretchen Morgenson, *How 287 Turned Into 7: Lessons in Fuzzy Math*, N.Y. TIMES, Jan. 20, 2002, at C1.

and other companies continue to come to light. Major corporations are issuing earnings restatements at a higher rate than ever before, including 270 in 2001 alone.[7]

Enron and other recent scandals reveal astonishing—perhaps unprecedented—levels of executive greed and dishonesty, but there is more to the story than that. Certain features of the current business and legal environment encourage management to raise share prices by any available means. Executive compensation practices heavily rely on stock options, giving top management a direct and immediate stake in price increases. In addition, the still real threat of hostile takeovers creates a powerful incentive on the part of corporate management to boost stock prices in order to placate investors and discourage potential hostile bidders by raising acquisition costs. This culture of shareholder value maximization—currently interpreted to require short-term share price maximization[8]—rewards efforts to boost share price whether or not the means are lawful. How corporate law might address this problem is certainly a question of great urgency.[9]

Meanwhile, another story warrants our attention. It is the utter failure of various professional "gatekeepers" to prevent Enron from deceiving investors and other corporate stakeholders.[10] Enron's auditor, the securities analysts who followed its fortunes, and the rating agencies that graded its creditworthiness all failed to discover and reveal the chicanery. Some were more directly involved than others in facilitating the subterfuge, but all failed in different ways to perform their watchdog responsibilities. In this sense, these gatekeepers share the blame for the Enron debacle.

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7. This number compares to only three restatements in 1981 and an average of only forty-nine annually from 1990 to 1997. There were 91 in 1998, 150 in 1999, and 156 in 2000. John C. Coffee Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1407 (2002); *see also* Ianthe Jeanne Dugan, *Depreciated: Did You Hear the One About the Accountant? It's Not Very Funny*, WALL ST. J., Mar. 14, 2002, at A1 (describing how, during 1990s, many auditors came under intense pressure to produce "rosy" results for shareholders, turning many into "lapdogs" of their clients).

8. *See generally* LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY (2001) (illuminating and criticizing "ethic of stock price maximization").

9. For some preliminary skepticism regarding the ability of law reform to correct deeper cultural norms in this area, see David Millon, *Why is Corporate Management Obsessed with Quarterly Earnings and What Should Be Done About It?*, 70 GEO. WASH. L. REV. (forthcoming 2003).

10. For an analysis of the role of gatekeepers in the Enron disaster, see STAFF TO THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 26–28, 69–125 (Oct. 8, 2002), *available at* http://www.senate.gov/~gov_affairs/100702watchdogsreport.pdf [hereinafter SENATE COMM. STAFF REPORT]. *See generally* Coffee, *supra* note 7.

In order to assign responsibility for what happened and to prevent future Enrons, it is not enough to identify and punish the primary violators, including Skilling, Fastow, Kopper, and others. It is also necessary to deal with the gatekeepers' failures to perform their public functions. Until this is done, we cannot expect a restoration of public confidence in our equity markets. This is where secondary liability may have an important role to play. This Comment therefore explores the potential of "causing" liability, analyzed in Van Hoey's excellent Note, as it might apply to the gatekeepers in the Enron case.

II. Gatekeepers

A. The Gatekeeper's Function

According to Professor Coffee, "the professional gatekeeper essentially assesses or vouches for the corporate client's own statements about itself or a specific transaction."[11] Gatekeepers are necessary because a corporation's assertions about itself often are inherently suspect. In various contexts, a corporation—and those in control of it—stand to gain if investors, lenders, employees, and others believe its favorable pronouncements about its own financial condition and prospects. There can be a built-in incentive to lie. Gatekeepers, therefore, are meant to serve as independent watchdogs. Their role is to subject corporate statements to disinterested scrutiny and then to certify their accuracy.[12]

As a structural matter, gatekeepers are more trustworthy than the corporations they monitor because they do not face the same conflicts of interest. Because gatekeepers are supposed to be independent, they should not stand to benefit if the public credits a company's pronouncements. Outsiders therefore should be more willing to rely on the information in question.

Furthermore, a gatekeeper puts its own reputational capital on the line each time it vouches for a corporation's self-assessment.[13] If its endorsement turns out to be unfounded, the gatekeeper forfeits some of that capital. That risk is important because the value of a gatekeeper's endorsement depends on

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11. Coffee, *supra* note 7, at 1405.

12. *See* Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916, 966 (1998) (discussing gatekeepers in terms of their role as market checks on corporate power); Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 53–61 (1986) (discussing effects of placing liability on third party enforcers of corporate transparency).

13. *See* Coffee, *supra* note 7, at 1405 (noting that gatekeepers pledge their reputational capital when they vouch for clients' statements or transactions).

its reputation for trustworthiness.[14] If it violates that trust, it cannot credibly perform its function. The gatekeeper then loses its reason for being.

B. Who Are the Gatekeepers?

Most prominently, gatekeepers include the public auditing firms that opine on the propriety of corporate financial reporting with reference to the accounting profession's own Generally Accepted Accounting Principles.[15] The auditor reviews a corporation's internally generated financial statements and tests their accuracy by examining a sample of the transactions in which the corporation engaged during the period of time under review. The auditor also analyzes the adequacy of the corporation's internal system of financial controls. Sometimes it assists in the planning of complex financial transactions in light of accounting and tax considerations. Indirectly at least, this participation can be taken as an endorsement of the legitimacy of those transactions.

"Sell-side" securities analysts work for firms that provide brokerage services to clients.[16] An analyst collects and digests information about the companies that he or she follows. The analyst relies on SEC filings and also may participate in regular conference calls with corporate management and may attend presentations in person. Based on this information and on specialized knowledge about the industry in which a particular company operates, the analyst publishes periodic reports containing assessments of the company's prospects and notices of its possible problems. The reports may include future earnings estimates. Typically available only to brokerage clients, the reports ordinarily include recommendations to buy, sell, or hold a particular stock. For these clients, the analyst provides a service that would be too costly for investors to undertake on their own. Clients therefore rely on analysts to provide research to which they otherwise would not have access.

Credit rating agencies evaluate and grade the creditworthiness of corporate borrowers. Each uses a scale including several investment grade ratings and also several non-investment (or "junk") ratings. The SEC has conferred quasi-public status upon three credit rating agencies—Moody's, Standard & Poor's, and Fitch—recognizing them as "Nationally Recognized Statistical

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14. *See id.* (theorizing that the public views gatekeepers as trustworthy because they sense that gatekeepers will not sacrifice reputation for the benefit of one client).

15. *See generally* TED J. FIFLIS, ACCOUNTING ISSUES FOR LAWYERS 106–17 (4th ed. 1991) (describing Generally Accepted Accounting Principles).

16. *See* U.S. SECURITIES AND EXCHANGE COMM'N, ANALYZING ANALYST RECOMMENDATIONS, *at* http://www.sec.gov/investor/pubs/analysts.htm (last modified June 20, 2002) (describing work of research analysts).

Ratings Organizations" (NRSROs).[17] Today, numerous federal and state regulations rely on NRSRO investment grade ratings as benchmarks serving a range of functions.[18] Issuers of publicly held debt securities also widely use the ratings to define conditions of default. Because these agencies rely on information provided by the borrowers themselves, their role is to evaluate corporations' own self-evaluations for the benefit of investors in debt securities.

In different ways, all of these institutions help members of the public to assess and rely on corporations' own presentations of their current financial condition and future prospects. Each gatekeeper's reputation for independence and expertise is the basis for the public's reliance on its evaluative judgments. Because it is not cost-effective for individuals to perform these tasks for themselves, gatekeepers significantly contribute to the efficiency of capital and other markets.

Parenthetically, it can also be noted that investment banks and elite law firms also serve a gatekeeper function. When they advise a corporation on a complex transaction, their involvement can, indirectly at least, lend an important imprimatur as to its legality and also as to its financial soundness, matters that typically are too expensive for investors to evaluate on their own. However, investment bankers and lawyers differ from auditing firms, stock analysts, and credit rating agencies because their primary constituencies are the companies they serve rather than the general public. Any certification function they might perform for the benefit of the public is secondary to their client-centered focus. Although this difference, more so as to lawyers than bankers, may be one of degree, this Comment focuses on those actors whose primary purpose is public certification.[19]

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17. 17 C.F.R. § 240.15c3-1 (2002).

18. *See* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 692 (1999) (commenting that "the web of regulation" now creating demand for NRSRO ratings "is so thick that a thorough review would occupy hundreds, perhaps thousands of pages").

19. The SEC itself also plays an important gatekeeper role. It has been criticized for its failure to prevent Enron and the other recent scandals, although it is generally agreed that the SEC has been under-staffed and under-funded for a number of years. *See* SENATE COMM. STAFF REPORT, *supra* note 10, at 8–16 (discussing the role of the SEC in combating financial fraud and noting reasons why it could not prevent the Enron scandal). Because this Comment considers gatekeepers with reference to potential causing liability, it does not consider the SEC's gatekeeper role. The financial press can also be seen as providing an important gatekeeper function. Like the others, it too was largely unsuccessful. *See* Scott Sherman, *Gimme an 'E'! Enron: Uncovering the Uncovered Story*, COLUM. JOURNALISM REV. (March/April 2002) (discussing major financial publications that celebrated Enron's success), *available at* http://www.cjr.org/year/02/2/ sherman.asp.

C. Gatekeepers' Conflicts of Interest

The model of the gatekeeper's function sketched above includes a nagging complication. In theory, those who rely on gatekeepers' pronouncements ought to pay for their services. That would give gatekeepers the incentive to perform in a manner that justifies reliance. Gatekeepers who earned a reputation for unreliability would not survive. In fact, however, no such market exists.[20]

Instead, it turns out that the person who pays the gatekeeper typically is the corporation whose credibility is already uncertain. Corporations pay their auditors and the credit rating agencies directly. Certainly this arrangement presents the possibility that these gatekeepers will be less than entirely vigilant if doing so threatens the security of these fee-generating relationships.

Although corporations do not directly compensate the analysts who follow and report on their stock, they can reward them for favorable recommendations by funneling highly lucrative investment banking business to the firms that employ them. Analysts may benefit in the form of increased compensation if they are able to help the firm land valuable investment banking work. The linkage between securities research and investment banking is a matter of much current controversy.[21]

Gatekeepers depend on harmonious client relations for their livelihood. The implications for gatekeeper independence are obvious and call into question the reliability of their endorsements. The standard model responds to this concern by assuming that the fees to be earned from a single client would never be high enough to justify the huge reputational costs that would flow from the revelation of a gatekeeper's compromised independence.[22] The Enron scandal suggests that this assumption may no longer be warranted. Before turning to a survey of how each of the gatekeepers failed to perform its function in the Enron case, we can first consider the two unexposed frauds that were the immediate causes of Enron's collapse.

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20. This fact could be taken to indicate that gatekeepers' services are not in fact as valuable as they have been assumed to be, but factors besides lack of demand can also explain the market failure. This question is better left for another day.

21. *See* Charles Gasparino et al., *Regulators to Team Up to Build Plan for Analyst Abuses, IPOs*, WALL ST. J., Oct. 4, 2002, at C4 (announcing common plan between securities regulators and Wall Street firms to combat abuses involving analysts' conflicts of interest); Jeff D. Opdyke, *Stock Advice You Can Trust?*, WALL ST. J., Oct. 31, 2002, at D1 (reporting reforms to remove incentives for analysts to "help drum up investment-banking business for their employers"); Randall Smith, *Regulators Set Accord with Securities Firms, But Some Issues Still Persist*, WALL ST. J., Dec. 23, 2002, at C1 (discussing $1.4 billion settlement between New York Attorney General, the SEC, and investment banking firms to remedy abuses related to stock research).

22. *See* Coffee, *supra* note 7, at 1405 (noting conventional logic that gatekeepers would not sacrifice reputation for the benefit of single client or fee).

III. Enron's Collapse

A. The SPEs

It is becoming increasingly evident that Enron was involved in a broad range of illegal, or at least suspect, financial maneuvers in order to enhance its financial reporting. These included manipulation of the California electric energy market[23] and questionable dealings in the market for broadband network capacity.[24] The company probably engaged in more illegal activities yet to be found.

Many of the problematic transactions involved Enron's use of so-called "special purpose entities" (SPEs). Corporations often create SPEs for a range of legitimate business objectives, including securitization of income-generating assets like accounts receivable or leases.[25] Enron, however, created hundreds of SPEs to achieve a range of more questionable objectives. These included increasing earnings and revenue through apparent sales of assets by Enron to SPEs in which there were, in fact, no genuine transfers of risk. Enron also entered into prepaid commodities trades that were actually disguised loans. It kept debt off its balance sheet by borrowing through SPEs. This was especially important for funding projects requiring heavy capital investment. Shifting these liabilities to SPEs helped Enron preserve its investment-grade credit rating.

The value of these kinds of transactions to Enron depended on treating the SPEs for accounting purposes as if they were separate, independent entities. However, if a corporation is to enjoy the benefit of separate accounting treatment for a SPE, accounting rules require that at least three percent of the SPE's total capital consist of equity provided by an independent outsider.[26] This investor must also exercise control over the SPE.[27] Failure to satisfy these conditions prevents recognition of transactions between the corporation and its

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23. *See* Joseph Kahn, *Californians Call Enron Documents the Smoking Gun*, N.Y. TIMES, May 8, 2002, at A1 (reporting federal regulators' release of Enron memoranda showing that Enron manipulated California's power market).

24. *See* Rebecca Smith & John R. Emshwiller, *Prosecutors Probe Skilling's Role in Enron's Failed Telecom Venture*, WALL ST. J., Dec. 13, 2002, at A1 (reporting the focus of federal prosecutors on the role of Skilling and other Enron executives in a failed broadband venture).

25. *See* Steven L. Schwarcz, *Enron, and the Use and Abuse of Special Purpose Entities in Corporate Structures*, 70 U. CIN. L. REV. (forthcoming 2002) (discussing securitization and distinguishing Enron's use of SPEs).

26. WILLIAM C. POWERS JR. ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 5 (2002), *available at* 2002 WL 198018 [hereinafter POWERS REPORT].

27. *Id.*

SPE and also requires that the corporation consolidate the SPE's financial results into its own financial statements.[28]

According to the Powers Report, the basic problem with Enron's dealings with its SPEs was that the transactions lacked genuine economic substance and instead "apparently were designed to accomplish favorable financial statement results, not to achieve *bona fide* economic objectives or transfer risk."[29] However, the immediate causes of Enron's collapse—and the primary focus of the Powers Report—were the revelations of two sets of faulty transactions. One involved Enron's failure to meet the three percent equity requirement for some of its SPEs. The other was the result of a number of failed hedging contracts. The public disclosure of these problems led directly to the final collapse of Enron's share price and its bankruptcy filing on December 2, 2001. Although much more might be said about the full range of Enron's financial improprieties once they all come to light, these transactions provide a useful framework for assessing the gatekeepers' failures in this case.

B. The Phantom Hedges

On October 16, 2001, Enron announced a $544 million after-tax charge against earnings and a $1.2 billion reduction in shareholders' equity. The immediate result was a sharp plunge in Enron's stock price, which had recently rallied after months of gradual decline.

Enron had entered into a series of "hedging" contracts with several SPEs.[30] These transactions were supposed to protect Enron from the downside risk associated with its investments in the stock of other companies, its so-called merchant equity portfolio.[31] The basic idea was that Enron bought put options from its SPEs, allowing it to cause the SPEs to buy these shares if they fell below a certain value.

When it set up these SPEs, Enron funded them with its own common stock.[32] Because the hedging contracts allowed Enron to avoid reflecting

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28. *Id.*

29. *Id.* at 4.

30. *See id.* at 79–82, 100–04, 115–18 (detailing actions of Enron's SPEs, including entities called LJM1, Raptor I, II, III, and IV, and several other specially created SPEs).

31. *Id.* at 13. This portfolio included holdings in Rhythms NetConnections, Inc. worth approximately $300 million as of May 1999, as well as shares in several other companies. *Id.* at 77.

32. *Id.* at 13. Enron apparently capitalized one of the SPEs, Raptor III, with stock of a company (called New Power Holdings, Inc.) in which Enron had a substantial investment. *Id.* at 114. Enron then entered into a hedging transaction with Raptor III to protect itself against loss on that investment. *Id.* Obviously, a decline in value of Enron's investment also meant a corresponding decline in the SPE's ability to perform its hedging obligation. Needless to say, the Powers Report's characterization of this transaction as an "extraordinarily fragile structure"

declines in value of its merchant investments on its income statements, Enron's management saw these transactions as a way to cash in on the dramatic rise in the market value of Enron's stock.[33] However, when the value of Enron's shares fell, the financial ability of the SPEs to perform their hedging obligations fell along with it. When the value of the merchant investment portfolio also fell, the SPEs were unable to honor their commitments to Enron. Even after Enron contributed additional shares of its stock, the SPEs still lacked sufficient capital. Once the hedges failed, Enron finally had to recognize the losses on the merchant investments as a charge against earnings on its income statement and a reduction in shareholders' equity on its balance sheet.

The basic flaw in this arrangement was that Enron funded the parties to the hedges itself and did so with its own stock. Compared to a typical hedging contract, in which there is full transfer of risk to an independent, financially self-sufficient third party, Enron itself had provided the capital that it would receive back from the SPEs under the contracts. Moreover, the SPEs' ability to shield Enron from risk was further compromised by the fact that the capital Enron provided took the form of Enron's own stock. This meant that the SPEs' ability to perform their hedging obligations depended entirely on the stability of Enron's share price. "In effect," the Powers Report concludes, "Enron was hedging risk with itself."[34]

C. *The Non-Independent SPE*

Only three weeks later, on November 8, 2001, Enron restated its financial statements for the period 1997 through 2000:

Year	**Net Income (reduction)**	**Shareholders' Equity (reduction)**	**Debt (increase)**
1997	$28 million	$258 million	$711 million
1998	$133	$391	$561
1999	$248	$710	$685
2000	$99	$754	$628

is a remarkable understatement. *Id.*

33. Ordinarily, "mark to market" accounting principles require a corporation to reflect gains and losses on merchant investments on its income statements. Hedging contracts can protect a corporation from recognizing declines in value. For Enron, its reliance on hedging transactions with the four Raptor SPEs shielded it from almost $1 billion in losses over a period of slightly more than one year. *Id.* at 132.

34. *Id.* at 97.

The problem here was the revelation that one of Enron's SPEs did not meet the three percent outside equity non-consolidation requirement. This SPE, called Chewco, was formed hastily in November 1997 in order to facilitate a transaction between Enron and the California Public Employees' Retirement System.[35] At the time of formation, Chewco was capitalized almost entirely by debt.[36] Enron's plan was to find an outside equity investor by the end of the year in order to achieve non-consolidation. It made an effort to characterize a contribution from Barclays Bank as equity, but Chewco's repayment obligation was partially collateralized.[37] That part of the Barclays investment therefore was not at risk and, accordingly, could not be counted toward the three-percent requirement.[38] Enron never found a third party to contribute the necessary outside equity.[39]

Despite failing to comply with the three-percent requirement, Enron accounted for Chewco as if it were an independent, unconsolidated SPE from 1997 until 2001.[40] Once this failure came to light, Enron and Arthur Andersen concluded in November 2001 that Enron should consolidate Chewco retroactively, resulting in the restatements printed above. These disclosures led to a further plummet in Enron's stock price and, less than a month later, its bankruptcy filing.

IV. Gatekeeper Failures

A. The Auditor

Arthur Andersen's audits of Enron's financial statements during each of the years discussed above resulted in unqualified reports. In other words, Andersen expressed its opinion that Enron's financial statements fairly presented, in all material respects, Enron's financial position in accordance with Generally Accepted Accounting Principles.[41] In the wake of the disclosures that led to Enron's downfall, it is clear that these endorsements were serious errors.

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35. *Id.* at 6–7.

36. *Id.* at 7.

37. *Id.* at 49–50.

38. *Id.* at 52.

39. A further problem with Chewco's status was the fact that, when formed, an Enron employee (Kopper) was Chewco's sole manager. *Id.* at 47–48. Later changes in Chewco's structure were supposed to limit Enron's control. The Powers Report concludes that whether these changes were sufficient to satisfy that element of the non-consolidation requirements "is not free from doubt." *Id.* at 49.

40. *Id.* at 42.

41. For discussion of audit reports generally, see LAWRENCE A. CUNNINGHAM, INTRODUCTORY ACCOUNTING AND FINANCE FOR LAWYERS 12–15 (2d ed. 1999).

Those who have studied the matter closely believe that Andersen's audit activities should not have resulted in unqualified reports. As Enron's auditor, Andersen was in a position to alert Enron's board and the investing public of the company's misleading financial statement disclosures. The Powers Report concludes that Andersen "did not fulfill its professional responsibilities in connection with its audits of Enron's financial statements, or its obligation to bring to the attention of Enron's Board (or the Audit and Compliance Committee) concerns about Enron's internal controls over related-party transactions."[42] According to Professor Bratton, Andersen "manifestly should have refused to give a favorable opinion on Enron's financials."[43] A Staff Report prepared for the Senate Committee on Governmental Affairs put the matter more bluntly: "Andersen appears to have failed miserably in its responsibility as Enron's auditor."[44]

Andersen's wrongdoing was not limited to its failure to perform its audit function. The firm was actively involved in the structuring and accounting treatment of the transactions described above. It also assisted Enron in the formulation of its public disclosures. Enron paid Andersen millions of dollars for these services. In its role as auditor, Andersen therefore undertook to review the propriety of its own work in these areas.

Why was a firm of Andersen's standing and reputation willing to assist Enron in its financial shell games and, more generally, to turn a blind eye toward accounting improprieties? It appears that conflicts of interest simply overwhelmed prudential considerations. Millions of dollars were at stake—not only audit fees but also consulting revenues.[45] And, Andersen had to consider its accounts with other clients. How would they react if they perceived Andersen as excessively nitpicky in its dealings with a widely respected company like Enron?

At the individual level, strong incentives exist for audit partners to be as cooperative as possible. Both David Duncan, the Andersen partner who was in charge of the Enron account, and his staff had actually moved into the Enron building and were serving as internal, as well as outside, auditors. Enron was

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42. POWERS REPORT, *supra* note 26, at 24.

43. Bratton, *supra* note 4, at 1287; *see also id.* at 1341 (referring to "the egregious nature of the audit breakdown").

44. SENATE COMM. STAFF REPORT, *supra* note 10, at 27.

45. According to one survey, the typical public corporation now pays its auditor three times as much in consulting fees as it does in audit fees. *See* Coffee, *supra* note 7, at 1410–11 (citing Janet Kidd Stewart & Andrew Countryman, *Local Audit Conflicts Add Up: Consulting Deals, Hiring Practices in Question*, CHI. TRIB., Feb. 24, 2002, at C1 (reporting the results of a survey measuring the independence of auditors)). Accounting firms may offer their audit services at or even below cost in order to establish a relationship that can generate much more substantial consulting fees. *Id.*

Duncan's only client. If he lost that client, he might have found himself without a job.

Andersen's willingness to risk its reputation in the service of Enron was not just a matter of financial gain. On the cost side of the ledger, the huge increase in earnings restatements during the 1990s may have reduced the reputational cost of publicly disclosed error. If restatements have become "part of doing business" for all the Big Five (now Four, since Andersen's own collapse), perhaps the relative reputational cost of a single error declines. Firms therefore may find themselves more willing to engage in behavior that they previously would have considered too risky.

B. The Analysts

Despite the steady decline in Enron's share price during 2001, analysts following the company continued to be optimistic about its prospects. Even after Enron announced on October 16th the $544 million charge against earnings and $1.2 billion reduction in shareholders' equity, all fifteen of the analysts employed by the largest investment banking firms rated Enron as a "strong buy" or "buy."[46] Ten analysts maintained their ratings after the November 8th earnings restatement, by which time Enron's share price had fallen to $8.41 from $84.00 at the beginning of the year.[47] When Enron filed for bankruptcy protection on December 2nd, only two analysts recommended sale of its shares. Seven rated it as a "hold" and one still listed it as a "buy."[48]

Richard Gross of Lehman Brothers exemplified the analysts' apparent blind faith in Enron despite mounting evidence to the contrary.[49] On October 16th he said: "The end of the world is not at hand . . . . We think investors should rustle up some courage and aggressively buy the stock."[50] Gross reiterated his "strong buy" rating in a report dated October 24th, despite acknowledging Enron's liquidity problems, and stuck to that opinion until he discontinued coverage of Enron on December 7th.[51]

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46. SENATE COMM. STAFF REPORT, *supra* note 10, at 72.

47. *See id.* at 72–73 (reporting that, even when facing reports of impending SEC investigation, lower stock price, and November 8th earnings restatement, ten analysts "did not budge from their buy or strong buy ratings on Enron's stock").

48. *Id.* at 73.

49. For discussion of other examples of overly optimistic analysts, see *id.* at 74–76.

50. Ben White, *Analysts Faulted for Forecasts*, WASH. POST, Jan. 11, 2002, at E1 (quoting Richard Gross).

51. SENATE COMM. STAFF REPORT, *supra* note 10, at 73–74. Gross's involvement in Lehman Brothers's work on the proposed merger between Enron and Dynegy apparently disabled him temporarily from speaking publicly about Enron, *id.* at 74 n.260, but that deal was called off on November 28th. *Id.* at 73.

The Enron analysts' unrealistic optimism may have been a symptom of a larger phenomenon. Recently at least, analysts working for major Wall Street firms have been strikingly unwilling to publish negative ratings. One study concluded that, during 2001, less than two percent of all sell-side analysts' recommendations were "sell."[52] According to another study, from late 1999 through most of 2000 analysts issued over 28,000 ratings, but advised investors to sell less than one percent of the time.[53]

Analysts' unwillingness to speak negatively appears to be connected to a significant structural conflict of interest.[54] The firms that employ them have a strong interest in attracting and retaining highly lucrative investment banking business. What the analysts say about a company can affect its decisions about whom to consult for assistance with a securities offering or acquisition. The banks dare not jeopardize these opportunities by employing naysayers who can bring down a company's stock price with a single negative report.

For example, in 1998 Enron apparently pressured investment bankers at Merrill Lynch to secure a better rating from the firm's analyst.[55] Enron, which generated a lot of investment banking business,[56] threatened to send it elsewhere. Soon after, the analyst responsible for following Enron left Merrill Lynch, and the firm replaced him with another analyst who promptly upgraded Enron's rating to a "buy."[57]

Pressure from the investment bankers may explain why analysts employed by firms with significant banking operations appear to be systematically more optimistic than independent research firms. In contrast to sell-side analysts, six of eight independent analysts who reported on Enron recommended sale prior to November 2001, three as early as March or April.[58] A

52. *Id.* at 81 (describing the testimony of Charles Hill, Director of Research at Thompson Financial/First Call, which explained that two-thirds of recommendations in 2001 were "buys," one-third were "holds," and less than 2% were "sells").

53. *See* Coffee, *supra* note 7, at 1408 n.24 (citing Thomson Financial/First Call study).

54. *See* SENATE COMM. STAFF REPORT, *supra* note 10, at 82–84 (recognizing the conflict between analysts' interest in producing accurate recommendations and their interest in retaining business for their employers).

55. *See id.* at 83 (reporting that "a memorandum from investment bankers at Merrill Lynch to its President indicated that Enron was pressuring Merrill Lynch to improve its rating in 1998, by threatening to withhold investment banking business").

56. Enron apparently made approximately thirty securities offerings in 2000 and 2001. *Id.* at 82 n.310.

57. *Id.* at 83. Even aside from investment banking considerations, analysts may also feel pressure directly from the companies in the form of an implicit threat not to share information if the analyst is "uncooperative." *See id.* at 88–89 (stating that a company displeased with a particular analyst's coverage may "blackball" that analyst).

58. *Id.* at 76–77.

research firm called Off Wall Street Consulting Group suggested in May that Enron was worth less than half of its $60 per share market price.[59] Relying on public information also fully available to the sell-side analysts, this firm pointed to Enron's declining profit margins, low return on capital, and heavy reliance on related-party transactions.[60]

Sell-side analysts' unwillingness to be skeptical about Enron may also be an instance of the "herd behavior" phenomenon.[61] According to one model, the reputational costs of being wrong are lower if the actor's decision is consistent with those of others than if he or she stakes out a unique position.[62] For example, if a fund manager makes an investment decision that proves to be a loser, he or she is less likely to be criticized if others made the same mistake than if the manager had acted in a contrarian manner.[63] Perhaps individual analysts had doubts about Enron but were reluctant to deviate from the pack. Better to be wrong together than to risk being wrong alone.

C. The Credit Rating Agencies

The three credit rating agencies all maintained investment grade ratings on Enron's debt until November 28, 2001, just four days before the bankruptcy filing on December 2nd.[64] Even these decisions seem to have been made reluctantly. In late October and early November, the announcement of the massive charges against earnings and shareholders' equity, disclosure of an investigation by the SEC, and Fastow's resignation led each of the agencies to reassess its ratings, but each still maintained investment grade. The Staff of the Senate Committee on Governmental Affairs concluded that "the agencies did not perform a thorough analysis of Enron's public filings; did not pay appropriate attention to allegations of financial fraud; and repeatedly took company officials at their word, without asking probing questions—despite indications that the company had misled the rating agencies in the past."[65]

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59. *Id.* at 77.

60. *See id.* at 93 (detailing Off Wall Street's concerns). For discussion of other skeptical independent analysts, see *id.* at 77–79.

61. *See* David S. Scharfstein & Jeremy C. Stein, *Herd Behavior and Investment*, 80 AM. ECON. REV. 465, 465–78 (1990) (discussing how group psychology may affect investment decisions by fund managers); Jeffrey Zweibel, *Corporate Conservatism and Relative Compensation*, 103 J. POL. ECON. 1, 1–4 (1995) (same).

62. *See* Scharfstein & Stein, *supra* note 61, at 466 (explaining managers' concern about their reputations as one reason for herd behavior).

63. *See id.* (noting that "an unprofitable decision is not as bad for reputation when others make the same mistake").

64. SENATE COMM. STAFF REPORT, *supra* note 10, at 115.

65. *Id.* at 108.

The reasons for this failure are less clear than in the cases of the auditor and the analysts, which involve severe conflicts of interest. In contrast, conflicts do not appear to have compromised the activities of the rating agencies. It is true that they are compensated for their ratings by the companies they evaluate. However, a range of federal and state regulations effectively require corporations to obtain ratings from these agencies, and the agencies do not appear to compete among themselves for this business. There is, in other words, no obvious financial incentive for grade inflation.

However, the essentially fixed demand for their services and the cozy, oligopolistic market structure in which they operate may have bred adverse consequences of a different kind. The rating agencies' abiding faith in Enron's creditworthiness may have been due to complacency rather than conflict of interest.[66] It appears that review of Enron's public filings was superficial. Even though this is the agencies' primary source of information, their evaluation did not include follow-up questioning on undecipherable items such as the opaque related-party disclosures included in Enron's Form 10-K filing for 2000.[67] The agencies instead seem to have focused their attention on readily ascertainable factors, like Enron's current cash position, rather than undertaking more searching—and more arduous—analysis of Enron's actual financial condition and its longer-term prospects.[68] Even though the agencies have privileged access to inside information,[69] at least as to Enron they seem to have been content simply to accept management statements at face value, rather than attempting to probe more deeply.[70]

The credit rating agencies' complacency may stem from their belief that they could not be held accountable for their work by those who rely on it. Courts have held that the First Amendment protects credit ratings.[71] Whether they are subject to SEC regulation under the Investment Advisers Act of

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66. This is essentially the conclusion of the Staff of the Senate Committee on Governmental Affairs. *Id.* at 116–25.

67. *Id.* at 116.

68. *Id.* at 117–18.

69. The rating agencies are not subject to Regulation FD, which restricts companies' ability to make selective disclosure of material, non-public information.

70. SENATE COMM. STAFF REPORT, *supra* note 10, at 118–19.

71. *See, e.g.*, Jefferson County Sch. Dist. v. Moody's Investor's Servs., 175 F.3d 848, 855–57 (10th Cir. 1999) (applying actual knowledge or reckless disregard standard to a claim based on a credit rating); County of Orange v. McGraw Hill Cos., 245 B.R. 151, 156 n.4 (C.D. Cal. 1999) ("Standard & Poor's ratings are speech and, absent special circumstances, are protected by the First Amendment.").

1940[72] is unclear at best,[73] and, in any event, the Commission has never undertaken an enforcement action against them based on their ratings.

V. Implications of Gatekeeper Failure

A. The Relevance of Causing Liability

1. Substantive Scope

The gatekeepers discussed above seem to be good candidates for "causing" liability. The statutes refer simply to anyone who "is, was or would be a cause" of someone else's violation "due to an act or omission that the person knew or should have known would contribute to such violation."[74] It seems quite plausible to argue that Andersen contributed to Enron's fraud on investors by issuing unqualified audit reports. Similarly, the analysts' steadfast support enabled Enron to stay afloat longer than it should have, as did the rating agencies' blind commitment to investment grade assessments right up until the eve of bankruptcy.

On its face, the statutory language is quite broad. "Contribute" can be defined to mean "assist" or "facilitate" or simply "enable." The statutes make no reference to the degree or quantum of assistance. This contrasts with the "substantial assistance" element that courts have applied in aiding and abetting actions.[75]

As Van Hoey explains, the SEC has only recently begun to attempt to make sense of this neglected language.[76] Not surprisingly, the Commission has taken a broad interpretive approach. In the *KPMG*[77] case, it held that a person may be liable for causing another's violation through negligence.[78] Rejection of a scienter requirement effectively recognizes causing to be a

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72. 15 U.S.C. § 80b-1 (2000).

73. *See* Lowe v. SEC, 472 U.S. 181, 203–11 (1985) (concluding that the term "investment adviser" does not include those who do not provide advice directly to clients).

74. 15 U.S.C. §§ 77h-1(a), 78u-3(a), 80a-9(f)(1), 80b-3(k)(1) (2000).

75. *See* Van Hoey, *supra* note 1, at 257 (examining the degree of assistance required to establish aiding and abetting).

76. *Id.* at 251.

77. KPMG Peat Marwick LLP, 74 SEC Docket 384 (Jan. 19, 2001), *aff'd sub nom.* KPMG, LLP v. SEC, 289 F.3d 109, 112 (D.C. Cir. 2002).

78. *Id.* at 421. *KPMG* involved an action brought by the SEC against an auditor for negligently causing an audit client to violate Section 13(a) of the Exchange Act. *Id.* at 385–86. Because the auditor was not independent, it contributed to the client's primary violation when it assisted the client's filing of financial statements with the SEC that had not been audited by an independent firm. *Id.* at 419.

basis for secondary liability as distinct from aiding and abetting.[79] The distinction is potentially important for causing actions brought against gatekeepers, who cannot assert their lack of knowing or reckless assistance as a defense.

In the same case, the SEC considered the degree of likelihood of future violation necessary for a cease-and-desist order and concluded that the risk "need not be very great."[80] In fact, absent evidence to the contrary, proof of a violation itself satisfies the requirement.[81] As Van Hoey points out, it is hard to imagine what kind of evidence might be deemed sufficient to rebut the presumption in the SEC's favor.[82] Again, this interpretation eases the SEC's burden in causing actions brought against gatekeepers.

As Van Hoey carefully articulates, causing liability presents difficult and as yet unresolved questions regarding causation.[83] Specifically, should but-for or cause-in-fact causation be sufficient or, instead, must the defendant's act be a more direct or immediate cause of the primary violator's wrongdoing? Van Hoey argues for a proximate cause standard, which would have the effect of narrowing the scope of causing liability.[84] It would also open up a hornets' nest of unpredictability, though real certainty regarding causation rules may be impossible to come by in any event.[85]

Cases involving nonfeasance—as opposed to active participation in another's wrongdoing—can present especially difficult causation questions. If, for example, a corporate director had performed her responsibilities (instead of doing nothing), would it really have made a difference?—was her failure a cause of insiders' fraud against the corporation?[86] Application of even a low causation standard is problematic in a case like that, especially if the director's duty under the circumstances is simply to object and then resign if the thefts do not stop.[87] A tougher proximate cause requirement would

79. Van Hoey, *supra* note 1, at 288.

80. *KPMG*, 74 SEC Docket at 430.

81. *Id.*

82. Van Hoey, *supra* note 1, at 282-83.

83. *Id.* at 301-06.

84. *Id.* at 307.

85. PROSSER AND KEETON ON THE LAW OF TORTS 263 (W. Page Keeton ed., 5th ed. 1984) ("There is perhaps nothing in the entire field of law which has called forth more disagreement, or upon which the opinions are in such a welter of confusion.").

86. *See* Francis v. United Jersey Bank, 432 A.2d 814, 817–20 (N.J. 1981) (involving completely inattentive director who did nothing to prevent insiders' fraud against corporation).

87. *See id.* at 826–27 (discussing what a director should have done if she had discovered the fraud).

depend on even more elaborate speculation about what might have happened and therefore would render a finding of liability even less likely.

Even if we assume that the failures of Enron's gatekeepers were sins of omission—of nonfeasance—rather than of active assistance,[88] the causation problem seems less perplexing. In fact, the choice between standards may not be terribly important. It is hard to imagine that a qualified audit report, or a rash of "sell" recommendations, or a significant downgrading of Enron's creditworthiness would not have led to stricter scrutiny of Enron's finances and business operations by investors and by the SEC. If the gatekeepers had done their work properly, it seems quite likely that Enron would not have flown as high as it did and would have experienced a much swifter return to earth. Even under a stricter proximate cause standard, it seems reasonable to conclude that the gatekeepers' failures contributed significantly to Enron's ability to get away with its fraudulent activities for as long as it did.

2. *Remedy*

The remedy available to the SEC in a case brought against someone for causing another to violate the securities laws is a cease-and-desist order issued by an administrative law judge. The order requires the person who caused the violation "to cease and desist from committing or causing such violation and any future violation of the same provision, rule, or regulation."[89] This is not a trivial matter, because violation of the order can be the basis for civil monetary penalties or contempt sanctions. The order can also mandate disgorgement in appropriate cases.[90]

This remedy is among the mildest weapons in the SEC's arsenal.[91] Even if it were possible to use causing liability to reach Enron's gatekeepers, one still must ask whether the sanction is harsh enough to deter future wrongdoing ex ante. Under one theory, the gatekeeper failures in Enron and other recent cases were due to under-deterrence.[92] In this regard, the Supreme Court's

88. Recall, however, that Andersen was actively involved in the structure of at least some of Enron's shady dealings. Even under a proximate cause standard, these acts should be sufficient to establish liability if Andersen's involvement was substantial.

89. 15 U.S.C. §§ 77h-1(a), 78u-3(a), 80a-9(f)(1), 80b-3(k)(1) (2000).

90. *Id.* §§ 77h-1(e), 78u-3(e), 80a-9(f)(5), 80b-3(k)(5) (2000).

91. Van Hoey shows how a cease-and-desist order is weaker than the remedies available in aiding and abetting actions, the other basis for secondary liability. Van Hoey, *supra* note 1, at 277-80.

92. *See* Coffee, *supra* note 7, at 1409–10 ("The general deterrence story focuses on the decline in the expected liability costs arising out of acquiescence by auditors in aggressive accounting policies favored by managements.").

elimination of private aiding and abetting actions was especially significant,[93] but Congress has also played a role.[94] Given the conflicts of interest built into the system, the monetary rewards of complacency, and the apparent decline in the reputational costs of exposure, it is hard to feel confident that even robust use of causing liability could significantly alter gatekeeper behavior.

B. Recent Developments

Recent developments may play a more direct role in improving gatekeeper performance than the threat of causing liability. The Sarbanes-Oxley Act of 2002[95] includes a hodgepodge of reforms, a number of them directed at the gatekeepers. The statute establishes a new independent board to oversee the accounting profession, which until now has been almost entirely self-governing.[96] It also undertakes to regulate conflicts of interest between audit work and consulting activities.[97] The statute further mandates safeguards designed to separate research and investment banking activities and to enhance analyst independence[98] and requires the SEC or the exchanges to develop new rules governing disclosure of information that may indicate conflict of interest.[99] (Meanwhile, recently adopted NYSE/NASD rules address analysts' conflicts of interest,[100] and a settlement between ten of the largest securities firms and the State of New York requires that the firms provide research for individual investors independently of the firms' investment banking activities.[101]) Sarbanes-Oxley also requires the SEC to under-

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93. *See* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 170–92 (1994) (holding that neither the antifraud statute nor the legislative scheme authorized private actions for aiding and abetting).

94. *See* Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, § 16, 112 Stat. 3227, 3227–33 (codified as amended at 15 U.S.C. § 77p (2000)) (abolishing state court class actions for securities fraud); Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, §§ 27(a)(2)(A), 27A(c), 201(g)(2), 109 Stat. 737, 738, 750, 758 (codified at 15 U.S.C. §§ 77z-1, 77z-2, 78u-4 (2000)) (including raised pleading standards, substitution of proportionate liability for joint and several liability, and restrictions on scope of RICO).

95. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 746 (to be codified at 15 U.S.C. §§ 7201–66).

96. *Id.* §§ 101–109, 116 Stat. at 750–71.

97. *Id.* §§ 201–209, 116 Stat. at 771–75.

98. *Id.* § 501, 116 Stat. at 791–93.

99. *Id.*

100. For a summary of these rules, see SENATE COMM. STAFF REPORT, *supra* note 10, at 90–91.

101. Smith, *supra* note 21, at C1. The settlement also includes over $1.4 billion in penalties and other assessments. *Id.* Additionally, it requires that the firms undertake to end

take a study of the credit rating agencies.[102] Finally, recognizing the SEC's role as a gatekeeper, the statute mandates significant budget increases.[103]

Together, all of these reforms are designed to improve the gatekeepers' performance and restore public confidence in their work. Whether they will have anything more than a symbolic effect remains to be seen.[104] Further, Sarbanes-Oxley does not itself provide for gatekeeper liability. Therefore, even if elements of the statute prove to be important, causing liability could still have a role to play in policing gatekeeper activities.

Of potentially greater importance is Judge Harmon's ruling in December 2002 in the Houston Enron case.[105] Based on their alleged "substantial participation" in the preparation of false statements about Enron's financial condition, this decision allows private actions to proceed against Arthur Andersen, Vinson & Elkins, and several major financial institutions as primary violators of Securities Exchange Act Rule 10b-5. These firms therefore face the prospect of massive money damages liability to Enron's shareholders due to their involvement in Enron's fraudulent activities. The ruling is important because private actions cannot be based on aiding and abetting alone.[106] At least as to auditors, law firms, and investment banks and other financial institutions, this decision should pose a far more serious threat than causing liability and its milder sanctions. Whether Judge Harmon's ruling will survive appellate review remains to be seen, as do the implications (if any) for the liability of securities analysts and credit rating agencies.

VI. Conclusion

The manifest gatekeeper failures that contributed to the Enron disaster provide a case study for how causing liability might apply to the recent raft of accounting scandals. It is less clear, however, whether the relatively mild

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allocation of IPO shares to corporate executives in order to generate investment banking business. *Id.*

102. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 702, 116 Stat. 746, 797–98.

103. *Id.* § 601, 116 Stat. at 793–94.

104. For a skeptical assessment, see Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1 (2002).

105. *See* Kurt Eichenwald, *Ruling Leaves Most Players Exposed to Suits on Enron: Disgruntled Investors May Have Many Targets*, N.Y. TIMES, Dec. 21, 2002, at B3 (explaining Judge Harmon's ruling in *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 235 F. Supp. 2d 549 (S.D. Tex. 2002)).

106. *See* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994) (holding that neither the antifraud statute nor the legislative scheme authorized private actions for aiding and abetting).

sanctions associated with this form of liability are potent enough to deter future gatekeepers from neglect of their public responsibilities in similar circumstances. Furthermore, post-Enron legislative and judicial developments may address the problem of gatekeeper failure more directly. New regulatory structures, legal restrictions, and the threat of liability as primary violators may stand a greater chance of enhancing gatekeeper performance and may therefore have a greater role to play in the restoration of investor confidence. Even so, Gregory Van Hoey has done an admirable service in shedding light on this neglected enforcement tool and its potential value for the pursuit of secondary violators of the securities laws. It remains to be seen what the SEC will make of it and what the effects of such initiatives might be.