CORPORATE GOVERNANCE AFTER ENRON

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Enron's unraveling in November 2001, followed by other high profile corporate failures in the months that followed, opened the way for the most dramatic regulatory changes relating to corporate governance in seventy years.[1] This written Commentary takes its character from the setting in which these comments were originally delivered, at a gathering in Houston, Enron's hometown, one year after the fall.[2] Looking at the changes during that year, I focus on two aspects. Part I of this Commentary addresses federalism issues of these regulatory

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1. The reference point is the early 1930s when, as part of President Franklin Roosevelt's New Deal, Congress passed the first federal securities laws, including the Securities Act of 1933 and the Securities Exchange Act of 1934.

2. These remarks were delivered as commentary at the Frankel Lecture series on November 14, 2002, at the University of Houston Law Center. On November 6, 2001, Enron announced a massive restatement of its financial statements for the years 1997 to 2000. This followed an earlier announcement on October 16, 2001, of a decrease in shareholder equity of $1.2 billion because of some of the transactions discussed here. On December 2, 2001, Enron filed for bankruptcy, the largest such filing as of that time. *See Key Dates in Enron's Collapse*, S.F. CHRON., Jan. 2, 2002, at A11. My thanks to Kelly Beam and the Houston Law Review in organizing the symposium, which produced a turnout of almost four hundred people.

changes. Massive additions to federal statutes and regulations, and important governance modifications by self-regulatory organizations, such as the New York Stock Exchange's changes to its listing requirements, have completely overshadowed any response of state law, the traditional source of corporate law in the United States. Indeed, state law is remarkably unchanged. It may be that when viewed from a more remote vantage point, state law will return to the center stage of the corporate law debate.[3] More likely, these changes of 2002 will mark a significant enhancement in the role of federal law in the regulation of corporate governance and make it at least an equal partner with state law in this area.

Part II of this Commentary addresses a different aspect of corporate regulation prominent in Enron's rise and fall—the use and misuse of separate corporate entities. This part compares Enron's use of special purpose entities (SPEs) to other contexts in which the law has addressed possible misuses of separate corporate entities. My comparison here is to long-standing law on piercing the corporate veil, with some discussion of more recent practices concerning securitization. While there are some similarities in the freedom that U.S. law gives private planners to use separate corporate persons for a variety of reasons, the context in which SPEs are used suggests that disclosure is a likely preferred legal response as opposed to an after-the-fact judicial disregarding of the corporate entity, as occurs in piercing contexts.

I. REGULATORY RESPONSES TO ENRON

Enron's rise and fall have been well chronicled.[4] Its re-creation of itself, by developing new trading markets for energy (and water), appeared to propel it to a position among the largest U.S. corporations.[5] By fall 2001, it became better known for its employees who lost their jobs, along with their retirement savings, which were locked into plummeting Enron stock, for its top leaders who received large employment compensation packages, and for financial dealings that were extremely complex

3. *See* Larry E. Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77, 94 (2003).

4. *See, e.g.*, William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1276–83 (2002) (arguing that Enron's notoriety came from the huge numbers involved and the managers' fraudulent activities).

5. *See* SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE 6–7 (Comm. Print 2002) [hereinafter ENRON'S COLLAPSE] (noting that Enron was the seventh largest U.S. corporation at the time of its collapse), *available at* http://www.gpo.gov/congress/senate/senate12lp107.html (last visited Mar. 14, 2003).

and, as it turned out, concealed numerous questionable activities.[6] Enron's financial troubles have come to encapsulate the bursting of the bubble that seemed to have enveloped large parts of our economy in the 1990s.[7] Federal Reserve Board Chairman Alan Greenspan, whose observation about "irrational exuberance" helped define an earlier part of the bubble in the business cycle,[8] captured the fall very succinctly when he said, "[a]n infectious greed seemed to grip our business community. Our historical guardians of financial information were overwhelmed."[9]

The regulatory response to these financial upheavals spanned a wide spectrum of actions: criminal prosecutions,[10] civil investigations,[11] congressional hearings,[12] private lawsuits,[13] and proposals from other groups both here and abroad.[14] I want to

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6. *See Enron's Fastow Charged in 78-Count Federal Indictment*, CHI. TRIB., Nov. 1, 2002, at 2 (describing the indictment of former Enron CFO Andrew Fastow, who allegedly "created schemes to defraud Enron and its shareholders through transactions with off-the-books partnerships that made the company look more profitable than it was").

7. *See* Ribstein, *supra* note 3, at 83–90.

8. *See Greenspan Takes Heat for Stock Bubble but Remains Popular; Chairman Could Fall Out of Favor if Economy Stays in Doldrums, Expert Says*, BALT. SUN, Jan. 5, 2003, at 6E (describing Greenspan's phrase as the most famous description of the stock market bubble).

9. *Excerpts from Report by Greenspan at Senate*, N.Y. TIMES, July 17, 2002, at C8 (quoting Greenspan's semiannual report on the economy to the Senate Banking Committee on July 16, 2002).

10. *See, e.g.*, Laurie P. Cohen & Mark Maremont, *Tyco Ex-Director Pleads Guilty: Walsh Admits Felony Charges Over Undisclosed $20 Million Fee for Helping Arrange CIT Deal*, WALL ST. J., Dec. 18, 2002, at C1 (discussing how the former Tyco director pled guilty to felony charges related to his receipt of a $20 million payment from the company).

11. *See, e.g.*, *SEC Says Company Boards Under Scrutiny*, HOUS. CHRON., Sept. 26, 2002, at 4B (reporting that the SEC was pursuing a civil investigation of Enron's accounting practice).

12. *See, e.g.*, ENRON'S COLLAPSE, *supra* note 5, at 1–3 (reporting the findings of the April 2002 and May 2002 interviews and hearings concerning Enron's collapse).

13. *See, e.g.*, Otis Bilodeau, *Enron Report Casts Harsh Light on Lawyers*, LEGAL TIMES, Sept. 30, 2002 (discussing lawsuits filed against the law firms Vinson & Elkins and Kirkland & Ellis for their handling of Enron-related work), *available at* http://www.law.com/servlet/ContentServer?pagename=OpenMarket/Xcelerate/View&c=LawArticle&cid=1032128629756 (last visited Mar. 15, 2003).

14. *See, e.g.*, JAMES CHEEK, III ET AL., AM. BAR ASS'N, PRELIMINARY REPORT OF THE AMERICAN BAR ASSOCIATION TASK FORCE ON CORPORATE RESPONSIBILITY 44–46 (2002) (summarizing the American Bar Association's [ABA's] proposals relating to internal corporate governance and lawyer responsibilities and conduct) [hereinafter ABA PRELIMINARY REPORT], *available at* http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf (last visited Mar. 15, 2003). It reflects the consensus of the task force appointed by the ABA president in March 2002 to re-examine "the framework of laws and regulations and ethical principles governing the roles of lawyers, executive officers, directors, and other key participants" so that the ABA could contribute to legislative and regulatory reform aimed at improving corporate responsibility after the Enron bankruptcy. *Id.* at 1. As the report cover notes, however, "[t]he views expressed [in the report] have not been approved by the House of Delegates or the Board of Governors of the [ABA] and, accordingly, should not be considered as

focus on three that directly changed how corporate governance occurs in U.S. corporations: (1) federal statutory changes made by the Sarbanes-Oxley Act of 2002;[15] (2) federal regulations promulgated by the Securities and Exchange Commission (SEC), which began before the passage of the new legislation, but have increased dramatically in the wake of the new statutory requirements;[16] and (3) the listing requirements of the New York Stock Exchange (NYSE)[17] (and similar changes in the National Association of Securities Dealers Automatic Quotations (NASDAQ) listings standards),[18] which will profoundly affect what goes on in the corporate boardroom. In contrast to these changes, the response in state corporate law has been largely one of silence that has left any modifications in corporate governance to these other actors.

A. The Federal Statutory Response

Congress undertook investigations in the wake of Enron and proposed various legislation, but it was only with the cumulative impact of the corporate failings of WorldCom and other companies that legislators mustered sufficient votes for congressional action.[19] As finally enacted, the Sarbanes-Oxley Act

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representing the policy of the [ABA].” *Id.* at report cover n.*.

15. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (to be codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

16. *See, e.g.*, Paul F. Roye, Keynote Address at the Meeting of the Business Law Section of the American Bar Association, Committee on Federal Regulation of Securities (Nov. 22, 2002), *available at* http://www.sec.gov/news/speech/spch112202pfr.htm (last visited Jan. 6, 2003).

> Driving many of the Commission’s recent reforms are two pieces of sweeping legislation which were enacted by a virtually unanimous Congress in response to the events of September 11, and the rash of corporate frauds and failures occurring earlier this year. These statutes, the USA PATRIOT Act of 2001 and the Sarbanes-Oxley Act of 2002, each mandate far-reaching reforms in the regulation of our financial markets. The Commission has been devoting substantial time and attention to fulfilling these mandates under tight implementing deadlines imposed by each Act.

Id.

17. *See* New York Stock Exchange, *NYSE Approves Measures to Strengthen Corporate Accountability: New Standards Aim to Restore Investor Confidence*, *at* http://www.nyse.com/content/articles/NT0056F8D4.html (last visited Mar. 15, 2003) (describing the approved changes made to “hold listed companies to a much higher standard of corporate governance” that were made to restore the public’s confidence in corporate America).

18. *See NASDAQ to Toughen Company Standards*, N.Y. TIMES, July 26, 2002, at C6 (announcing that NASDAQ proposed new rules “to increase the independence of corporate boards and root out conflicts of interest”).

19. *See* Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 HOUS. L. REV. 1, 40–45 (2003) (discussing the history leading up to enactment of the Sarbanes-Oxley Act).

of 2002 ("Sarbox") impacts a variety of players in the corporate governance arena:

- *Changes in the Audit Process.* The most detailed regulatory change is the new accounting regulatory system that federalizes most accounting supervision. The Public Company Accounting Oversight Board will have broad powers to set standards for accounting firms and to investigate and bring disciplinary proceedings against such firms.[20] The legislation also regulates directly how the accounting function is performed. It limits contemporaneous consulting services performed by firms auditing public companies, and it requires registered public accounting firms to rotate their lead and review partners.[21] This regulation of the auditing function also dips into corporate governance in that it requires auditors to report directly to the audit committee of the board, not to company management, and provides for the audit committee to be directly responsible for the appointment, compensation, and oversight of the work of the auditors.[22] The Act requires directors who are audit committee members to be independent—a standard-setting for directors that is a new federal role.[23]

- *Changes in Internal Corporate Governance Structure.* Sarbox includes several explicit intrusions into state corporate law's structure of corporate governance. In addition to the requirement that the audit committee of the board be independent, as discussed above, the Act also prohibits personal loans to executives;[24] requires the company's chief executive officer (CEO) and chief financial officer (CFO) to reimburse the issuer for bonuses and related compensation or profits in stock sales if the company is required to restate its earnings;[25] and requires elaborate rules requiring company counsel to report evidence of material violations of securities law or breaches of fiduciary duty.[26] The Act also imposes a prohibition on insider trades during a blackout period

20. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 101, 116 Stat. 745, 750–53 (to be codified at 15 U.S.C. § 7211) (establishing a Public Company Accounting Oversight Board to protect the interests of investors through informative, accurate, and independent audit reports).

21. *Id.* § 201, 116 Stat. at 771–72 (to be codified at 15 U.S.C. §§ 78j-l, 7231).

22. *Id.* § 301, 116 Stat. at 775–77 (to be codified at 15 U.S.C. § 78j-l).

23. *Id.*

24. *Id.* § 402, 116 Stat. at 787–88 (to be codified at 15 U.S.C. § 78m).

25. *Id.* § 304, 116 Stat. at 778 (to be codified at 15 U.S.C. § 7243).

26. *Id.* § 307, 116 Stat. at 784 (to be codified at 15 U.S.C. § 7245).

when the beneficiaries of a company's pension fund cannot trade, striking at practices that occurred in the Enron context.[27]

- *Additional Disclosure.* The Act provides for additional disclosure, long the mainstay of federal law in this area. For example, the SEC is commanded to issue rules for disclosure relating to off-balance sheet transactions and pro-forma figures, and Section 16 disclosures are enhanced.[28] Some disclosures are simply disguised substance. One provision requires the company to disclose "whether or not, and if not, the reason therefor, such issuer has adopted a code of ethics for senior financial officers."[29] Similarly, another provision requires an issuer to disclose "whether or not, and if not, the reasons therefor, the audit committee . . . is comprised of at least 1 member who is a financial expert."[30] Both are likely to have much the same impact in changing corporate governance as if a state corporation code or a stock exchange listing requirement was changed to require such a governance structure.

B. SEC Regulations

The SEC began an extensive rulemaking process even before the enactment of Sarbox, and thereafter proposed a host of rules in response to the requirements of the Act.

- *Real Time Disclosure on Form 8-K.* Before 2002, the events that required a company to file a Form 8-K report, in between the 10-Q reports required quarterly and the 10-K reports required annually, were limited and discrete. There were just six required items: bankruptcy, change in control, acquiring or disposing of significant assets, change in accountants, resignation of

27. *Id.* § 306, 116 Stat. at 779–84 (to be codified at 15 U.S.C. § 7244, 29 U.S.C §§ 1021, 1132). For ten business days in November 2001, Enron employees were unable to sell their Enron stock invested in their 401(k) plans because Enron was changing plan administrators. David Ivanovich, *SEC Offers Revisions in Wake of Enron*, HOUS. CHRON., Oct. 31, 2002, at 1B. During this time, Enron executives were able to sell their stock and exercise their stock options. *Id.*

28. *See, e.g.*, SEC Ownership Reports and Trading by Officers, Directors and Principal Security Holders, 67 Fed. Reg. 56,462 (Sept. 3, 2002) (to be codified at 17 C.F.R. §§ 240, 249, 274) (implementing accelerated filing deadlines applicable to changes in beneficial ownership reports), SEC, *available at* http://www.sec.gov/rules/final/34-46421.htm (last visited Mar. 13, 2003).

29. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 406, 116 Stat. 745, 789–90 (to be codified at 15 U.S.C. § 7264).

30. *Id.* § 407, 116 Stat. at 790 (to be codified at 15 U.S.C. § 7265).

a director, and a change in fiscal year.[31] In the wake of Enron and other scandals, the SEC proposed a much broader list of immediate disclosure items, including many of the items at issue in Enron, so that we are closer to real time disclosure than we have ever been.[32] A provision of Sarbox gives further impetus for the SEC to continue requiring more "real time" disclosure.[33]

- *Officer Certification of Financial Statements.* In June 2002, the SEC required CEOs and CFOs to certify their company's financial statements pursuant to its investigatory power,[34] and such a provision was codified as a recurring obligation in Sarbox passed later in the summer.[35]

- *Reducing the time lag for required reports.* The SEC has, by rule, shortened the period after the end of a company's quarterly and annual reporting periods by which it must make the required information available to the public and the SEC.[36]

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31. U.S. SECURITIES AND EXCHANGE COMMISSION, FORM 8-K, *available at* http://www.sec.gov/divisions/corpfin/forms/8-k.htm (last visited Mar. 12, 2003).

32. *See* Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, 67 Fed. Reg. 42,914 (proposed June 25, 2002) (to be codified at 17 C.F.R. pts. 228–229, 240, 249) (proposing the addition of thirteen new items to Form 8-K and requiring reports to be filed two days after the triggering event), SEC, *available at* http://www.sec.gov/rules/proposed/33-8106.htm (last visited Mar. 12, 2003).

33. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 409, 116 Stat. 745, 791 (to be codified at 15 U.S.C. § 78m) ("Each issuer . . . shall disclose to the public on a rapid and current basis such additional information . . . as the Commission determines . . . .").

34. In June 2002, the SEC acted pursuant to its investigatory authority when it required CEOs and CFOs of almost one thousand companies to certify their financial statements. *See* SECURITIES AND EXCHANGE COMMISSION, ORDER REQUIRING THE FILING OF SWORN STATEMENTS PURSUANT TO SECTION 21(A)(1) OF THE SECURITIES EXCHANGE ACT OF 1934, OMB No. 3235-0569 (June 27, 2002), *available at* http://www.sec.gov/rules/other/4-460.htm (last visited Mar. 12, 2003) (requiring companies with revenues of at least $1.2 billion to certify the accuracy of their financial statements by August 14, 2002).

35. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 302, 116 Stat. 745, 777–78 (to be codified at 15 U.S.C. §§ 7241–7242); *see also* Certification of Disclosure in Companies' Quarterly and Annual Reports, 67 Fed. Reg. 57,276 (Sept. 9, 2002) (to be codified at 17 C.F.R. pts. 228–229, 232, 240, 249, 270, 274) (adopting requirements based on the authority of section 302 that go beyond requiring mere certification of the company's quarterly and annual reports; they also require CFOs to be responsible for maintaining the effectiveness of the issuer's internal controls and disclosing the internal controls to their auditors), SEC, *available at* http://www.sec.gov/rules/final/33-8124.htm (last visited Mar. 12, 2003).

36. Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, 67 Fed. Reg. 58,480 (Sept. 16, 2002) (to be codified at 17 C.F.R §§ 210, 229, 240, 249) (phasing in over the next three years a filing period of sixty days for annual reports and thirty-five days for quarterly reports, and requiring disclosure of availability on websites), SEC, *available at* http://www.sec.gov/rules/final/33-8128.htm (last visited Mar. 13, 2003).

- *Rules to implement statutory changes, including those relating to attorney ethics.* Many sections of Sarbox require SEC rules, and some of those have led the agency deeper into corporate governance.[37] For example, the proposed rules on attorney ethics have elaborate requirements for an attorney to go up the ladder in reporting evidence of violations of securities fraud or breach of fiduciary duty, but also include an alternative that if there is a board committee charged with that duty, much of the ladder can be avoided—another specific effort to change the corporation's governance structure.[38]

C. Changes in Listing Requirements for Stock Exchanges

The most fundamental changes to corporate governance during 2002 arose from the proposed changes in stock exchange listing requirements, most notably those of the NYSE, but also those reflected in the NASDAQ.

- The NYSE has proposed requirements for corporate governance that go to the core of how U.S. corporations are run. It will require a majority of independent directors, and it will also require that three important board committees—audit committees, compensation committees, and nominating/governance committees—be made up entirely of independent directors.[39]

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37. *See e.g.*, Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, 68 Fed. Reg. 5982 (Feb. 5, 2003) (to be codified at 17 C.F.R. pts. 228–229, 249) (stating that the Act requires the SEC to adopt rules to require the reporting of all off-balance sheet transactions and other unconsolidated entries), SEC, *available at* http://www.sec.gov/rules/final/33-8182.htm (last visited Mar. 12, 2003); Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, 67 Fed. Reg. 66,208 (proposed Oct. 30, 2002) (to be codified at 17 C.F.R. pts. 210, 228–229, 240, 249, 270, 274) (declaring that the Act requires the SEC to adopt rules requiring each company to disclose whether any of its audit committee members are financial experts, to disclose whether it has adopted a code of ethics for its financial officer, and to present a statement of responsibility of the management for establishing an adequate internal control structure), SEC, *available at* http://www.sec.gov/rules/proposed/33-8138.htm (last visited Mar. 13, 2003).

38. *See* Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71,670 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205), SEC, *available at* http://www.sec.gov/rules/proposed/33-8150.htm (last visited Mar. 12, 2003).

39. *See* New York Stock Exchange, *Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee as Approved by the NYSE Board of Directors August 1, 2002*, § 303A(1), (4)–(6) (Aug. 16, 2002), *available at* http://www.nyse.com/pdfs/corp_gov_pro_b.pdf (last visited Mar. 15, 2003).

- Independence will be defined under listing requirements in a way more specific and more imposing than requirements under state or federal law.[40]

- NASDAQ has followed a similar process.[41]

The NYSE has long had requirements that go beyond state law—for example, in requiring approval of certain fundamental transactions for which state law does not provide a vote.[42] These new requirements extend the gap between these private ordering requirements and state corporate law.

D. Where Was State Corporate Law?

Given the severity of the governance problems exposed after Enron and the variety of responses detailed above, where were the states? There has been no change in state corporate law requiring that board members be independent or that independent committees be a permanent part of a board's structure. There has been no change in the expectations of officers, including the CEO and CFO, and how their legal roles might need to evolve given the realities of modern corporations. There has been no call to revisit the duty of care to which state law purports to hold corporate officers and directors.

Even more notably, in the ongoing debate throughout 2002, it seemed that no one thought that state law was the place to address these problems. For example, the Senate Permanent Subcommittee on Investigations conducted an investigation and published a report, *The Role of the Board of Directors in Enron's Collapse*.[43] That report made a series of recommendations to a variety of actors—directors, the SEC, and self-regulatory agencies like the national stock exchanges—but nothing to the states who create and determine the structure of corporations.[44]

Corporate law has traditionally been a state law function. State law creates the corporate person and provides the skeleton to which all governance methods are attached. From time to time over the last century there have been calls to nationalize this governance structure, as for example during President Theodore

40. *Id*. § 303A(6), (13).

41. *See* NASDAQ, Proposed Rule Changes, *at* http://www.nasdaq.com/about/ProposedRuleChanges.stm (last visited Mar. 12, 2003).

42. *See, e.g.*, Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1146 (Del. 1990) (providing an example of a merger where state law did not require a corporation's shareholders to approve the deal, but stock exchange listing requirements did).

43. *See generally* ENRON'S COLLAPSE, *supra* note 5.

44. *See id*. at 4–5.

Roosevelt's trust-busting efforts in the early twentieth century[45] and President Franklin Roosevelt's New Deal responses to the economic crises of the Great Depression.[46] But in each case federal incorporation was rejected. Instead, Congress, beginning in 1934 and continuing through Sarbox, has federalized particular portions of corporate governance as seemed necessary at the time.

However, efforts to expand the federal role by broad interpretations of the antifraud provisions of the federal securities laws have been reined in by forceful U.S. Supreme Court opinions. In *Cort v. Ash*,[47] the Court said: "Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."[48] And then, in *Santa Fe Industries, Inc. v. Green*,[49] the Court reiterated: "Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."[50]

To what extent do the events since Enron suggest a change in this relationship? This can best be understood by looking at what is the corporate governance relationship at state law. Delaware, as the home to most of our largest corporations, is the most important lawgiver in this area. The fulcrum of corporate governance for Delaware is clear: All corporate power is to be exercised by or under the direction of the board of directors.[51] Shareholders can elect directors, but they do not act for the corporation.[52] Officers can act for the corporation, but only as its agents with whatever authority the directors might give them.[53]

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45. 17 THEODORE ROOSEVELT, *First Annual Message to Congress* (Dec. 3, 1901), *in* THE WORKS OF THEODORE ROOSEVELT 106 (Hermann Hagedorn ed., memorial ed. 1925) ("The nation should, without interfering with the power of the States in this matter itself, also assume power of supervision and regulation over all corporations doing interstate business.").

46. *See* Securities Act of 1933, 15 U.S.C. § 77a (2000); Securities Exchange Act of 1934, 15 U.S.C. § 78a (2000).

47. 422 U.S. 66 (1975).

48. *Id.* at 84 (emphasis added).

49. 430 U.S. 462 (1977).

50. *Id.* at 479.

51. DEL. CODE ANN. tit. 8, § 141(a) (2001).

52. *See generally id.* (illustrating that the power of a corporation lies with the board of directors and officers who may be elected by the shareholders).

53. *See id.* § 142 (expressing the duties and powers of officers selected by the

There are constraints on this broad power given to directors, as most students of corporate law could recite. Shareholder voting is required, not just to elect directors,[54] but also as a prerequisite to mergers and similar transactions after they have been proposed by directors.[55] Shareholder voting can sometimes act to cleanse conflicts of interest that exist for the directors.[56] Fiduciary duty—perhaps the most visible legal check on board power—is an after-the-fact judicial limit on the use of the power given in the corporate statute.

Corporations statutes impose little in the way of requirements as to director qualifications.[57] There is no statutory requirement that they be independent as set out in the NYSE listing requirements; indeed an entire board of insiders would satisfy corporate statutes. Similarly, there is almost nothing in corporate statutes about the duties of officers, and nothing to correspond with the duties imposed on officers by Sarbox, for example.[58] They can do as little or as much as the board might direct. In these respects, the corporate statute is sparse, even libertarian. The statute provides a bare skeleton of putting power in the directors, subject to their fiduciary duty imposed by judicial interpretations. Everything else is left to the markets and private ordering. Even for fiduciary duty, Delaware has given leeway for companies to exculpate directors from any liability for breach of the duty of care.[59]

Many corporations, of course, have gone beyond the bare requirements of the statute. It has been common to have a majority of independent directors, even before the stock exchange made its proposal. Officers have been given more and more responsibility, even though the statute is silent on this point. Delaware has not changed its statute because the combination of this statutory skeleton with the constraints of private ordering has resulted in accountability sufficient for the circumstances.

The regulatory actions of 2002 reflect a different view of this traditional picture.[60] First, federal law has put the governance

directors).

54. *Id*. § 141 (2001 & Supp. 2002).

55. *Id*. § 251 (2001).

56. *Id*. § 144.

57. *Id*. § 141(b) (2001 & Supp. 2002) ("Directors need not be stockholders unless so required by the certificate of incorporation or the bylaws. The certificate of incorporation or bylaws may prescribe other qualifications for directors.").

58. *See id*. § 142(a) (2000) ("Every corporation . . . shall have such officers with such titles and duties as shall be stated in the bylaws or in a resolution of the board of directors which is not inconsistent with the bylaws . . . .").

59. *See id*. § 102(b)(7).

60. For a more detailed discussion of these changes, see Robert B. Thompson &

focus on officers, in contrast to the state law focus on directors. Federal Reserve Board Chairman Alan Greenspan noted that "the state of corporate governance to a very large extent reflects the character of the CEO."[61] And federal law is unwilling to leave the board unfettered in what it expects and demands of officers. Not only must CEOs and CFOs certify their company's numbers, they must disgorge bonuses if these results are required to be restated.[62] In perhaps the most direct rebuke of state corporate law, federal law now bans loans to executive officers or directors.[63] Such a ban was long part of state corporate codes, but in recent years has been dropped.[64] Federal law has now reversed that policy choice made by the states.

The depth of the federal supervision of the work of officers is illustrated in the proposed rules requiring lawyers to report ethical problems. The lawyer is obligated to report evidence of wrongdoing to the chief legal officer or the CEO of the company.[65] If those officers do not respond appropriately, the statute requires that the attorney in effect police the behavior of those officers by reporting to independent directors on the board.[66] Lawyer ethics, of course, have long been a province of state law.[67] Sarbox now federalizes the relationship of a lawyer and a corporate client at least as it applies to securities fraud. But the lawyer's obligation also extends to evidence of breaches of fiduciary duty, which has the potential to bring with corporate law much of what the Supreme Court sought to leave to state law in *Santa Fe Industries, Inc. v. Green*.

Secondly, the changes of 2002 reflect that disclosure has become the most accessible method to regulate corporate governance. Disclosure is sometimes presented as an effort to make the shareholders' role in public corporations more effective, but it actually serves a set of purposes that goes much beyond

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Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. (forthcoming 2003), *available at* http://ssrn.com/abstract_id=362860 (last visited Mar. 12, 2003).

61. *Fed Chief Rips Corporate Misconduct*, WALL ST. J., July 17, 2002, at A6 (quoting Greenspan's testimony on CEOs).

62. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 116 Stat. 745, 778 (to be codified at 15 U.S.C. § 7243).

63. *See id.* § 402, 116 Stat. at 787–88 (to be codified at 15 U.S.C. § 78m).

64. *See* MODEL BUS. CORP. ACT § 47 (1969) (restricting corporate loans to directors). Delaware's statute expressly permits such loans. DEL. CODE ANN. tit. 8, § 143 (2001).

65. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (to be codified at 15 U.S.C. § 7245) (requiring "attorney[s] to report evidence of a material violation of securities law or breach of fiduciary duty . . . to the chief legal counsel or the [CEO] of the company (or the equivalent thereof)").

66. *See id.*

67. *See, e.g.*, ABA PRELIMINARY REPORT, *supra* note 14, at 15.

shareholder action. It provides directors more information by which they can evaluate the strength of the company and the performance of the officers; it strengthens the role of auditors in their own watchdog role; it enhances the effectiveness of shareholder voting and shareholder litigation as constraints on corporate governance; and it permits the governmental oversight agencies to perform more effectively.

II. THE USES AND MISUSES OF SEPARATE CORPORATE ENTITIES

Most of the discussion since the Enron collapse has been on the failure of our corporate governance structure: that boards of directors did not do their jobs; that auditors did not do their jobs; that regulators did not do their jobs; and that officers misused their positions. And that failure has produced the changes in corporate governance already discussed. This Part addresses what Enron tells us about the use of separate corporate entities. Corporate separateness is a core principle of corporate law. A corporation is a legal person separate from its shareholders, directors, and officers, even when it is wholly owned by another corporation. Modern business enterprises often include dozens, even hundreds, of separate corporations that permit private planners to structure their businesses so as to partition specific parts, assets, and liabilities of a business to achieve various tax, accounting, or liability-avoiding goals.[68]

In our legal system, the initial choice of organizing is usually left to the managers of the enterprise.[69] This respect for separate entities does not mean that it cannot be abused; it can be. When the planners of the enterprise put all of the important assets in one corporation and only a few assets in a separate corporation (owned by the first corporation or by the same shareholders who own the first corporation), and send the asset-deprived corporation out into the world to engage in whatever risky transactions might be needed in the operation of the overall business, there are grounds for legal intervention. This is illustrated in Figure 1.

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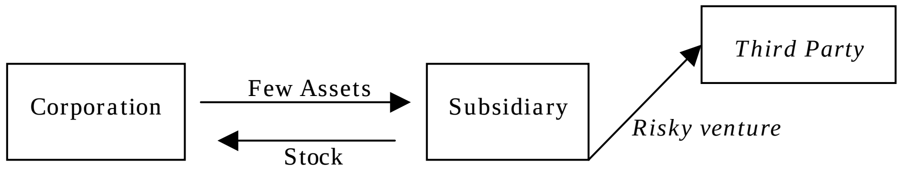
68. *See generally* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organization Law*, 110 YALE L.J. 387, 390–401 (2000) (noting various forms of asset partitioning and their effect on the assets and liabilities of creditors, managers, and owners).

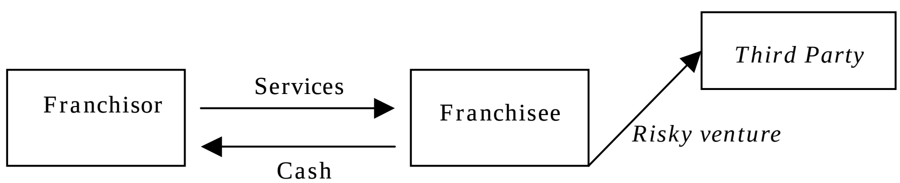
69. *See, e.g.*, Eric W. Orts, *Shirking and Sharking: A Legal Theory of the Firm*, 16 YALE L. & POL'Y REV. 265, 311 (1998) ("For most practical purposes, managers are the enterprise organizers in corporations with their authority delegated from the board.").

FIGURE 1



The long-established doctrine of "piercing the corporate veil" is used by courts to police such misuse, and there are hundreds of reported cases every year in which courts try to sort that out.[70] Piercing usually occurs in the context where one corporation or shareholder owns another, but similar issues can arise without ownership. For example, in a franchisor-franchisee situation, as illustrated in Figure 2, a third party may claim that the separation of the business into independently owned actors has nevertheless improperly separated the risk-producing side of the business from the asset-producing side in a way that is unfair to those who have been injured.[71]

FIGURE 2



Now we come to Enron. As a company, it aggressively pursued new forms of energy trading and accounting treatment. Did it similarly push the envelope in the use of separate corporate entities? And if so, is there a need for changes in how law responds to that use? The focus here has been on special purpose entities (SPEs). Enron had many of them; its year 2000 Annual Report lists three thousand affiliates and related

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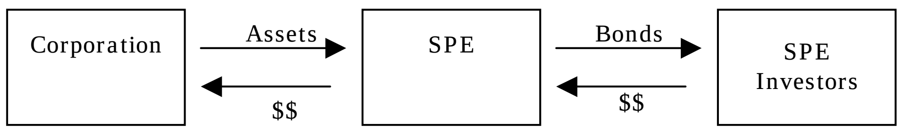
70. *See, e.g.*, Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991) (reporting on the results of 1600 piercing cases).

71. *See generally* PHILLIP I. BLUMBERG & KURT A. STRASSER, THE LAW OF CORPORATE GROUPS: ENTERPRISE LIABILITY IN COMMERCIAL RELATIONSHIPS INCLUDING FRANCHISING, LICENSING, HEALTH CARE ENTERPRISES, SUCCESSOR LIABILITY, LENDER LIABILITY, AND INHERENT AGENCY 93–95 (1998) (explaining that franchisees are typically small business owners and that their separation from the larger, asset-producing side can result in loss of the franchisee's business and personal assets and deprivation of the goodwill attributes of the franchisor).

companies, including SPEs.[72] SPEs are a legitimate way for a corporation to buy or sell risks as a form of hedging. If the counter party has a different risk profile, the SPE transaction can be a win-win transaction. For Enron, it was part of an "asset light" strategy—monetizing or syndicating assets beyond Enron itself. A simple form of securitization might look like Figure 3.

FIGURE 3



Enron's use of SPEs looked different from this simple form in several important respects,[73] although there were many garden-variety uses of SPEs by Enron in the years leading up to these events.[74] The report of the Enron board's Special Investigative Committee ("Powers Report"), chaired by Dean William Powers, examined in detail five transactions.[75] The initial report of Neal Batson ("Batson Report"), the examiner appointed in the bankruptcy proceeding, presented the details of six transactions.[76] These reports fill in important factual details about Enron's SPE transactions.

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72. ENRON CORP., 10-K (filed with the SEC on April 2, 2001) (listing Enron's various subsidiaries), *available at* http://www.enron.com/corp/investors/ (last visited Mar. 13, 2003).

73. Some Enron transactions were considerably more complicated than Figure 3. *See, e.g.*, SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FISHTAIL, BACCHUS, SUNDANCE, AND SLAPSHOT: FOUR ENRON TRANSACTIONS FUNDED AND FACILITATED BY U.S. FINANCIAL INSTITUTIONS 5–34 (Comm. Print 2003), *available at* http://www.gpo.gov/congress/senate/senate12lp107.html (last visited Mar. 14, 2003). Some U.S. financial institutions designing, participating in, and profiting from complex financial transactions explicitly intended to help U.S. public companies engage in deceptive accounting or tax strategies. *Id.* at 2–5.

74. *See* First Interim Report of Neal Batson, Court Appointed Examiner, In re: Enron Corp., et al., Debtors (Bankr. S.D.N.Y. 2002 (AJG)) (No. 01-16034) [hereinafter Batson Report I], *available at* 2002 WL 31113331; Second Interim Report of Neal Batson, Court Appointed Examiner, at 48-49, In re: Enron Corp., et al., Debtors (Bankr. S.D.N.Y. 2003) (No. 01-16034 (AJG)) ("There is nothing improper about the use of structured finance and SPEs to achieve and report business results. Enron, however, used structured finance to report results it had not achieved."), *available at* http://www.chron.com/content/news/photos/03/03/06/examinerreport.pdf (last visited Mar. 14, 2003).

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

76. Batson Report I, *supra* note 74.

The substance of the Enron strategy was a financial or paper hedge, not an economic one. As described by the Senate Report: "It was a paper hedge designed to achieve favorable financial statement results, not a substantive hedge that was intended actually to transfer Enron's risk of loss to an unrelated [third] party."[77] Enron's investments in the bubble economy of the 1990s had produced substantial gains that its managers sought to protect against subsequent fluctuations in the market.[78] Enron sought to protect itself against the volatility of various investments that it held, and it engaged in various transactions with counter parties (the SPEs) to protect itself against any decline in the value of these assets.[79] The recurring problem was that the ability of the counter party to make good on the promises it had made—in case the market turned against its position—rested on the assets available in that entity, which often turned out to be Enron stock or dependent on the value of Enron stock.[80] The Senate Report concluded that, "'[i]n effect, Enron was hedging risk with itself,'"[81] and that the SPEs had little or no economic substance to support the hedge other than Enron's own stock.[82] When the counter party's obligation to Enron under the hedge grew at the same time that the value of its major assets to make good on that process—Enron related stock—was falling in value, the stage was set for a "spiral" leading to bankruptcy.[83]

This securitization policy, as applied in Enron, had a strong flavor of earnings management. Earnings management is a common, if sometimes maligned, executive tool. The reports about Enron document the pressure that built at the end of each quarter.[84] And sometimes Enron reversed the questionable transaction after the end of the quarter.[85] The result is, as the Powers Report noted about one of the SPE transactions, "[t]he

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77. ENRON'S COLLAPSE, *supra* note 5, at 44.

78. *See id.* at 7 (noting the various financial strategies Enron used in the 1990s to improve its financial profile and hedge against future market fluctuations).

79. *See id.*

80. *See id.* (noting that although the "unconsolidated affiliates" were included in Enron's financial statements, their assets were intricately linked to Enron's holdings).

81. *Id.* at 43 (quoting POWERS REPORT, *supra* note 75, at 97).

82. *Id.* at 41 (detailing the economic problems with Enron's "Raptor" accounts).

83. POWERS REPORT, *supra* note 75, at 58–59.

84. *Id.* at 67 ("There was substantial pressure to close the transaction so that EBS could meet its second quarter numbers."). EBS refers to Enron Broadband Service, which entered into a transaction with LJM2, an SPE controlled by Enron CFO Andrew Fastow at the end of the second quarter of 2000 to dispose of a portion of EBS's unused fiber optic cable. *Id.*

85. *Id.* at 7 (noting that "Enron bought back five of the seven assets" in one LJM transaction).

returns . . . appear not to have been for a risk taken, but rather for a service provided."[86] "Enron appears to have been much more aggressive than most other companies that take advantage of securitization as a financial tool."[87] The report of the Senate Permanent Subcommittee on Investigations notes that of $60 billion of Enron assets, $27 billion were lodged with unconsolidated affiliates.[88]

SPE transactions that would be legitimate when done with independent third parties were regularly done by Enron with related parties. These kinds of transactions were "used by Enron Management to enter into transactions that it could not, or would not, do with unrelated commercial entities."[89] This abuse was most obvious in Enron's flaunting accounting requirements as to when affiliated entities cannot be consolidated on a company's financial statements. The two primary requirements are (1) that there must be an independent investor who has at least 3% of the equity at risk, and (2) that independent investors must have control of the entity.[90] When Enron was unsuccessful in finding such an independent entity for deals that it needed to close, it turned to SPEs controlled by then-CFO Andrew Fastow. Transactions structured in this way permitted Enron to obtain benefits that it would not have received from a third party. For example, one SPE transaction permitted Enron to lock in the high value of stock in Avici Systems by dating the swap "as of" August 3, 2000, when the stock was trading at its all time high of $162.50, as opposed to the $95.00 it was trading at on September 15, 2000, when the paperwork seemed to have been completed.[91] Talon, the SPE on the other side and controlled by Enron-related parties, was seemingly oblivious to the loss because it had already received its return from the venture.[92]

Some SPE transactions produced extraordinary returns for their investors who were also Enron officers and employees. Fastow and other Enron insiders who were principals in LJM and other SPEs received large returns on what were relatively small investments. This was in part because when the SPE was negotiating with Enron, those who were supposed to be

86. *Id*. at 60.

87. Bilodeau, *supra* note 13.

88. ENRON'S COLLAPSE, *supra* note 5, at 8, 36, 40.

89. POWERS REPORT, *supra* note 75, at 3.

90. *See* Bratton, *supra* note 4, at 1306 n.118 (discussing the sources of this SEC rule).

91. POWERS REPORT, *supra* note 75, at 50.

92. *See id*. (noting that LMJ2, one of Enron's partnerships, had already received its total investment from Talon). Refer to note 84 *supra* (describing the LJM transaction).

negotiating for Enron faced their boss on the other side of the proverbial bargaining table. Although the LJM transaction was presented to the board for its review, the Powers Report concluded that "the very concept of related-party transactions of this magnitude with the CFO was flawed,"[93] and that "the inherent conflict was persistent and unmanageable."[94]

Conflict was not limited to Enron insiders, but also included the company's financial lenders. While much of the initial focus was on the company insiders, as time has gone on, additional attention has been paid to banks and those who funded and invested in the SPEs. While Fastow and other insiders seemed to control the SPEs, the roster of investors was a blue chip list.[95] The terms that insiders negotiated for the SPEs, as mentioned above, provided very favorable returns. Loans made to SPEs were guaranteed by Enron,[96] and the transactions were often structured to help the banks.[97] For example, the Powers Report describes one transaction in which the return to the bank was characterized as "yield" to permit the bank to characterize the advances as loans for regulatory purposes while simultaneously allowing Enron and Chewco (the SPE) to characterize them as equity for accounting and disclosure purposes.[98] The examination in the bankruptcy proceedings suggests an argument can be made that the funds advanced by lenders to SPEs were based on Enron's creditworthiness, not the specifics of the individual transactions, such that the asset sales were disguised loans that could be brought back into the bankrupt estate.[99]

How then should we police abuses such as those just described? The menu of legal remedies would include: (1) remedies from corporate law, based on disregarding the entities; (2) remedies from bankruptcy law such as equitable subordination; or (3) remedies based on disclosure. In Enron, they probably work best in reverse order.

Piercing the veil, an after-the-fact judicial remedy under corporate law, works best when there is money in a related entity owned by the same participants that ostensibly has been set up

93. *Id*. at 68.

94. *Id*. at 76.

95. *See id*. at 35. For example, the fifty limited partners in LJM2 included the McArthur Foundation, J.P. Morgan, and Citicorp. *Id*.

96. *Id*. at 22–23.

97. *See id*. at 25 (discussing the questionable Barclay's Bank-Big River, Little River transaction).

98. *Id*.

99. *See* Batson Report I, *supra* note 74, at 18 (noting that the lenders' diligence in these transactions was questionable and warranted further review).

as an independent entity, but in fact is not. The Enron arrangements, however, are not like the context presented in Figure 1, where a supposedly distinct corporate entity is created by an otherwise solvent entity so that the legal separateness of the subsidiary can protect the initial entity from liability that the subsidiary may incur in a risky part of the business. Enron's schemes were not directed against outside creditors as much as they were against shareholders and others who were investing in Enron. This does not appear to be a case where the money is stashed in other entities. Neither Enron nor its SPEs appear to have a positive balance sheet. While the bankruptcy examiner has left open the possibility of piercing in some of the transactions that he examined, this legal approach is not likely to be the first line pursued.[100]

Where, as in the case of Enron, the total amount of money will not suffice to pay all claimants, the fight becomes one of dividing up the pie—a task for which bankruptcy law is suited. A prominent line of pursuit will be the examiner's efforts to recharacterize SPE transactions as loans, not sales of assets, which will bring those assets back into the estate while putting the banks in line with everyone else to recover the cash they originally paid for the assets.[101] Such a result will shift more of the pain to the banks.[102]

Yet that action, if successful, will only be a very partial solution to the pain that has occurred. Neither state corporate law nor federal bankruptcy law are likely to provide a remedy for the core harm done in Enron. Shareholders who were induced to pay too much for Enron securities and employees who committed their human capital to this venture will not be helped by either of those two remedies. In this context, an *ex ante* remedy is needed. To that extent, disclosure is better suited to be an effective remedy than the *ex post* remedies available elsewhere in law. In that sense, the enhanced disclosure required by Sarbox as to off-balance sheet transactions and the more vigilant application of accounting rules seem more likely to be effective to prevent misuse of separate entities as occurred in Enron.

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100. *Id*. at 14, 15 & n.95 (noting ways that various transactions could be included in the debtor's estate, such as piercing the corporate veil or reverse veil piercing).

101. *See* Eric Berger et al., *Report Details Enron's Deception: Examiner Cites Auditors, Lawyers and Banks as Part of Scheme*, HOUS. CHRON., Mar. 6, 2003, at 1B (reporting that Neil Baston's examiner's report on Enron suggests that "as much as $5 billion in cash and assets could be recovered by Enron and passed on to its unsecured creditors"), *available at* 2003 WL 3242126.

102. *See, e.g.*, Christopher Oster & Randall Smith, *Enron Deals Cost J.P. Morgan; Bank Takes $1.3 Billion Charge*, WALL ST. J., Jan. 3, 2003, at A1.