5-2003

Enron at the Margin

William H. Widen

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*By William H. Widen**

"[They] seem[] to have abandoned representational drawing for abstract impressionism or surrealism. Jackson Pollock may have been a great artist, but you don't want him painting your living room. Salvador Dali may have been a genius, but you don't want him painting your house."[1]

PART 1: INTRODUCTION

The public wants to see business bad guys go to jail[2] and Congress has responded to public outrage at corporate wrongdoing by passing new legislation.[3] There was early government prosecutorial action on the WorldCom, Adelphia, and Arthur Anderson fronts[4] while the public impatiently clamored for prosecutors to pursue officers and directors of Enron Corp.,[5] the company that got us started with first exposure to this new round of corporate malfeasance.[6] The public got its wish for Enron scalps; first blood came with the guilty plea of Michael

*Associate Professor of Law, University of Miami School of Law, Coral Gables, Florida. A.B. Stanford University, 1980; J.D. Harvard Law School, 1983. E-mail: wwiden@law.miami.edu. Professor Widen practiced commercial and corporate law at Cravath, Swaine & Moore from 1984 to 2001 in New York City, where he was a partner. This Article benefited from comments received at faculty workshops held at Harvard Law School in May 2002 and at University of Miami School of Law in September 2002. Also, helpful comments were provided at various stages of this project by Professors David Carlson, Paul Shupack, and Arthur Jacobson at Cardozo Law School.

1. Dan Ackman, *Accounting for Texans*, FORBES.COM, Jan. 16, 2002 (describing Enron's accounting disclosure approach), *at* http://www.forbes.com/2002/01/16/0116topnews.html.

2. Jonathan Weil, *The Other Shoe Has Yet to Drop In Enron Case*, WALL ST. J., Aug. 5, 2002, at B1 (explaining how the public media has placed pressure on prosecutors to "do" something about Enron, particularly in light of the announced prosecutions on other fronts).

3. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745; *see also* Richard A. Oppel Jr., *Lawmakers Turn to Other Efforts to Deal With Scandals*, N.Y. TIMES, July 26, 2002, at C6; *see generally* Neil Weinberg, *Criminalizing Capitalism*, FORBES.COM, May 12, 2003 (describing political reaction to popular pressure to address corporate scandals), *at* http://www.forbes.com/forbes/2003/0512/074.html.

4. Carrie Johnson, *Collar-Blind Law or Smear? Opinion Split on Complaints: Prosecutors Call Tactics Appropriate*, WASH. POST, Dec. 27, 2002, at E1. Arthur Anderson was convicted of obstruction of justice for its destruction of documents relating to its representation of Enron.

5. Enron Corp. is an Oregon corporation. It is referred to in this Article simply as "Enron." As the context requires, the term "Enron" sometimes is used to refer to the consolidated group of companies, including actions taken by a subsidiary.

6. Indeed, the CNN program "Moneyline" created a scoreboard to track Enron prosecutions (listed at zero as of Aug. 5, 2002) compared with prosecutions of other recent corporate wrong-

Kopper to money laundering and conspiracy to commit wire fraud.[7] Further dominos have started to fall at Enron with the arrest and indictment of Andrew Fastow and, most recently, with indictments against eleven executives relating to Enron's broadband business unit.[8]

At one level, we should be happy to observe the opening salvo as the Enron crowd begins to meet justice, regardless of the charges used to get results. This is in the tradition of convicting Al Capone for tax fraud.[9] We ask prosecutors simply to get the job done no matter what the path. Such an approach, however, might leave us deeply unsatisfied with the big picture, for it does not attack directly what ails corporate and legal culture in a broader sense.

The cultural problem revealed by Enron ultimately is not subject to correction by teaching lawyers more accounting,[10] fine tuning rules governing the use of "gatekeepers" in corporate matters,[11] or requiring and expecting more from independent directors,[12] though all these measures would help in a small way. The problem is

doings (listed at eighteen as of Aug. 5, 2002). *See generally* Enron Fraud InfoCenter, *available at* http://www.enronfraudinfocenter.com/information.php.

7. *See, e.g.*, Jonathan Weil et al., *Guilty Plea by Enron's Kopper Increases Scrutiny of Ex-CFO: Admission of Two Felonies By Former Finance Aide Seen as Watershed in Case*, WALL ST. J., Aug. 22, 2002, at A1.

8. *See* Indictment, United States v. Fastow (S.D. Tex. 2002) (No. H-02-0665) [hereinafter Fastow Indictment], *available at* http://news.findlaw.com/hdocs/docs/enron/usfastow103102ind.pdf; Warrant for Arrest, United States v. Fastow (S.D. Tex. 2002) (No. H-02-889-M), *available at* http://news.findlaw.com/wsj/docs/enron/usfastow100102cmp.pdf; *see also* Alexei Barrionuevo et al., *Enron's Fastow Charged With Fraud*, WALL ST. J., Oct. 3, 2002, at A3. *But see* Jonathan Weil & Alexei Barrionuevo, *Justice Department Finds Building Criminal Case Against Lay Tough*, WALL ST. J., Aug. 26, 2002, at A3 (reporting that prosecutors are having a much tougher time figuring out how to charge Kenneth Lay, the former Enron chairman, with criminal wrongdoing). More recently, indictments have resulted from Enron's dealings with Blockbuster Entertainment. *See 2 from Enron Are Indicted in Video Case*, N.Y. TIMES, Mar. 27, 2003, § C, at 2; Kurt Eichenwald, *U.S. Indicts 11 Former Enron Executives*, N.Y. TIMES, May 2, 2003 (describing eight new first time indictments for traditional forms of fraud).

9. Alleged tax law violations figure prominently in the current pursuit of corporate wrongdoers, including the Rigas family in the case of Adelphia, and Dennis Koslowski, the former CEO of Tyco. *See* Jerry Markon & Robert Frank, *Five Adelphia Officials Arrested on Fraud Charges: Three in the Rigas Family, Two Other Executives Held, Accused of Massive Looting*, WALL ST. J., July 25, 2002, at A3; Indictment, People v. Kozlowski (N.Y. Crim. Ct. 2002) (No. 3418102) ("constituting[, *inter alia*,] the felon[y] of Failure to Collect Sales Tax in violation of § 1817 (c)(2)(a) of the New York State Tax Law").

10. *See generally* Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows*, 57 BUS. LAW. 1421 (2002). More knowledge of accounting would help lawyers advise clients against engaging in unethical transactions by indirection. It is easier to point to a technical rule than to engage a client in a discussion of ethics. The more technical rules in one's arsenal, the more able a lawyer will be to approach ethics through the backdoor.

11. *See generally* John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403 (2002). Professor Coffee is right to identify a massive failing of traditional third-party gatekeepers, such as accountants, investment analysts, and rating agencies, to alert the investment community to the Enron fraud. Such a failure can be expected when technical compliance with rules becomes a substitute for general ethical behavior. This debate will be played out in discussions over whether accounting should shift its emphasis from technical compliance to a general policy of fair disclosure. *Id.* at 1417.

12. *See generally* Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371 (2002). In reading Judge Strine's article, I am struck by how truly impossible it is to expect true independence from so-called "independent" directors chosen in the traditional way. I expect no help from independent directors unless they are chosen from the ranks of institutional investors, such as persons who manage large pension funds. Placing representatives of such investors on boards, however, presents numerous other structural problems, including management of access to insider information.

that corporate and legal culture has lost all sense of right and wrong.[13] Norms of business behavior have evolved so that compliance with the positive law is the sole standard of ethical conduct—a role for which the positive law is ill-suited.

We all recognize that stealing money is wrong. To the extent certain Enron executives siphoned off funds from the corporation, they should be punished.[14] Similarly, we all recognize that gross misstatements, such as those apparently contained in WorldCom's financial reports and Enron's reports concerning its broadband business, amount to fraud of the basest kind. Yet, the proximate cause of Enron's downfall was neither what amounts to petty theft from a company with a one-time $70 billion market capitalization,[15] nor a bald shifting of numbers from one column in a ledger book to another, as alleged in WorldCom, nor making up a business out of whole cloth, as in the case of Enron's broadband services. Rather, the proximate cause of Enron's downfall was the financial engineering schemes exemplified by the so-called "Raptor" transactions[16] and the business and legal ethos that spawned them.[17]

13. *See* Thomas G. Donlan, *Ethical Indifference: Some Architects of the Telecom Bust Reveal Their Moral Bankruptcy*, BARRON'S ONLINE, Sept. 30, 2002 (discussing how architects of the telecom bust reveal their moral bankruptcy). C. J. Satterwhite (compiled by Mark A. Stein), *An Insider Judges Wall St.: Proftis 'Too Fast and Too Vast,'* N.Y. TIMES, Apr. 6, 2003, § 3, at 2 ("'It's a case of total moral bankruptcy.'") (quoting president of investment firm).

14. *See* Associated Press, *Ex-Bankers Indicted in Case Tied to Enron*, WALL ST. J., Sept. 13, 2002, at B5 (reporting that three former British bankers stole $7.3 million from British bank in the same transaction that Fastow and Kopper siphoned off $12.3 million); *see also* Mark Maremont & Jerry Markon, *Former Tyco Executives Are Charged*, WALL ST. J., Sept. 13, 2002, at A3 (reporting that two Tyco executives stole $170 million). For a comprehensive discussion of the rules of professional responsibility implicated by the Enron fiasco, see Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 BUS. LAW. 143 (2002). A discussion of these specific rules are beyond the scope of this Article.

15. *See* George F. Will, *2001: Ring the Bells Backward*, NEWSWEEK, Dec. 24, 2001, at 64 (noting the highpoint of Enron's market capitalization).

16. *See* WILLIAM C. POWERS, JR. ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 97 (2002) [hereinafter POWERS REPORT] ("The transactions . . . that had the greatest impact on Enron's financial statements involved four SPEs known as the 'Raptors.'"), *available at* http://news.findlaw.com/hdocs/docs/enron/specinv020102rpt1.pdf. The Powers Report was commissioned to conduct an investigation of a variety of related-party transactions and, in particular, the transactions that led to Enron's third-quarter 2001 earnings charge and restatement. *See generally* PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS, THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE, S. REP. NO. 107-10 (2002) [hereinafter SENATE REPORT ON ENRON DIRECTORS] (discussing the results of the Senate investigation into the Enron failure), *available at* http://news.findlaw.com/hdocs/docs/enron/senpsi70802rpt.pdf; *In re* Enron Corp., FIRST INTERIM REPORT OF NEAL BATSON, COURT-APPOINTED EXAMINER, No. 01-16034 (Bankr. S.D.N.Y. Sept. 21, 2002) [hereinafter BATSON] (describing various Enron structured financial transactions), *available at* 2002 WL 31113331. Part 2 of this Article contains a description of the Raptor transaction structure used by Enron to inflate its reported earnings. *See infra* notes 63–96 and accompanying text. The name of the first Raptor special purpose company is "Talon." The Powers Report uses the name "Talon" to identify this company and the term "Raptor I" to identify the first Raptor transaction.

17. This ethos is grounded, in part, in the mistaken view that white-collar crime is not really "crime" as traditionally understood. The concept of white-collar crime was formulated by Professor E. H. Sutherland and presented to the American Sociological Society in 1939. *See generally* Peter P. Lejins, *Theory, History and Current Policy Issues Regarding Economic Crime, in* THE SANCTIONS IN THE FIELD OF ECONOMIC CRIMINAL LAW (1983). The concept of white collar crime highlights the fact that middle and upper class professional and business people commit many violations of the positive criminal law, but these violations do not result in criminal prosecution or incarceration. *Id.* The value of this observation is that in formulating general propositions about criminality, the entire criminal population,

In a very real sense, unlike the case of Al Capone, it is the technical details of these financial transactions that are at the heart of the matter. An outline of many of these financial transactions is contained in the "Powers Report" prepared by a special committee of the board of directors of Enron after disclosure of accounting irregularities, which preceded Enron's bankruptcy.[18]

What is particularly insidious about the Raptor transactions is that they were presented to Enron's board of directors and approved for the express purpose of providing an "accounting hedge" to manipulate the reported financial results of the corporation.[19] In the most favorable light based on a belief that the law and rules of accounting had been "technically" complied with, the Enron board approved a series of transactions advertised as having no economic substance.[20] These transactions were constructed for the one purpose of improving the financial appearance of Enron by inflating reported earnings.[21] In blunt terms, these deals were structured to deceive the readers of Enron's financial statements, albeit using a form of deception that those involved *perhaps* believed complied with law and accounting rules. The technical compliance would, on this view, insulate the deception from legal liability.[22]

not merely the prosecuted and imprisoned segment, must be considered. The financial engineering exemplified by the Raptor transactions is pure white collar crime motivated by economic gain, though not easily classified as a traditional crime against property.

18. *See generally* POWERS REPORT, *supra* note 16. William C. Powers, Jr., is the Dean of the University of Texas Law School.

19. *See generally* SENATE REPORT ON ENRON DIRECTORS, *supra* note 16. The Finance Committee of the Enron board voted to recommend the Raptor project to the full board. The full board approved Raptor I on May 2, 2000. POWERS REPORT, *supra* note 16, at 107. "The Finance Committee was also given information strongly suggesting, if not making perfectly clear, that the Raptor vehicle was not a true economic hedge. Notes on the presentation materials [given to the Finance Committee] . . . state: 'Does not transfer economic risk but transfers P&L volatility.'" *Id.* at 106. Other presentation materials given to an internal business unit in May 2000 similarly indicate that the Raptor program was "'[n]ot an economic hedge; . . . credit risk retained with Enron Corp.'" *Id.* at 107 n.50 (alteration in original). The SENATE REPORT ON ENRON DIRECTORS concludes that Enron directors and management generally understood both the deception and the transaction structure used to create the deception. SENATE REPORT ON ENRON DIRECTORS, *supra* note 16, at 24, 38. The Powers Report does not indicate the extent to which particular information available to the Finance Committee was shared with the entire board. Ben F. Glisan, Jr. (Treasurer) and Richard Causey (Chief Accounting Officer) made the presentation to the Finance Committee on May 1, 2000, with Kenneth Lay (Chairman and Chief Executive Officer), Jeffrey Skilling (President and Chief Operating Officer and, later, CEO), and Andrew S. Fastow (Chief Financial Officer) in attendance. POWERS REPORT, *supra* note 16, at 105. Indeed, Ken Lay was sufficiently informed about the Raptor transactions to know that there was not time to get a third-party hedge. Dan Ackman, *Ken Lay's Best Defense*, FORBES.COM, Feb. 13, 2002, *at* http://www.forbes.com/2002/02/13/0213topnews.html. This concern over speed is odd given the board presentation indicating that the hedges had no economic substance.

20. POWERS REPORTS, *supra* note 16, at 171 ("The Raptor transactions had little economic substance. In effect, they were transfers of economic risk from one Enron pocket to another, apparently to create income that would offset mark-to-market losses on merchant investments on Enron's income statement."). *See generally* Dan Ackman, *Enron Documents Indicate Possible Cover-Up*, FORBES.COM, Apr. 3, 2002, *at* http://www.forbes.com/2002/04/03/0403topnews.html ("'It's like somebody sat down with the rules and said, "How can we get around them? They structured these things to comply with the letter of the law but totally violated the spirit."'") (quoting accounting professor).

21. *Id.* at 4 ("Many of the most significant transactions apparently were designed to accomplish favorable financial statement results, not to achieve *bona fide* economic objectives or to transfer risk."); *accord* SENATE REPORT ON ENRON DIRECTORS, *supra* note 16, at 3.

22. A general intent to deceive both the investing public and creditors by orchestrating transactions for the purpose of manipulating published financial reports seems to have permeated the Enron

Enron illustrates what can be called the "ethic of technical compliance"—the attitude that deception in this form is simply acceptable business as usual—because technical compliance with law is the only standard by which praise or blame of conduct is determined.[23] The philosophy that it is permissible to structure one's business affairs to minimize the payment of income tax has migrated to the philosophy of preparing financial reporting,[24] where such an approach is simply and obviously inappropriate, given the purpose of financial reporting.[25] This ethic also has roots in "literalism"—"the doctrine that a facially accurate but knowingly deceptive statement does not violate prohibitions" against making false or misleading statements.[26] Literalism is found in the adversarial process and is exemplified by President Clinton's deposition testimony in the Paula Jones case.[27] Lastly, this ethic is nurtured by the "principle of professional 'nonaccountability'"—the notion that a lawyer is not responsible for either the means or the ends

corporate culture. *See* Paul Krugman, *Cronies in Arms*, N.Y. TIMES, Sept. 17, 2002, at A29 (describing an e-mail that said, "'Close a bigger deal. Hide the loss before the 1Q.'"). Though the narrative of the Powers Report is less direct, the presentation made to the Finance Committee relating to the Raptor transactions reflects this same intent to deceive. *See generally* Ackman, *supra* note 20 (explaining "overall tenor [of Enron transactions] demonstrates that the goal was not to provide full disclosure, but to do the opposite—albeit within the technical limits of the rules").

23. Tax law is one practice area where the ethic of technical compliance has strong roots. It is accepted that one may arrange one's affairs so as to minimize payment of tax. Thus, many transactions are structured with this goal as the sole or primary aim. Even in the area of tax law, however, some rules appeal to substance over form. *See generally* Charles I. Kingson, *The Confusion Over Tax Ownership*, 93 TAX NOTES 409 (2001) (discussing form and substance in tax shelter transactions). The legitimate business purpose of tax-motivated transactions is saving money. In financial reporting, however, the purpose is to report as accurately as possible on the financial health of a business entity. To be sure, in preparing such reports, many judgment calls must be made, whether estimates of valuation or otherwise. We need to be careful not to make the good faith exercise of these judgments subject to criticism or sanction. *See* Robert H. Frank, *The Case for Sanctions*, N.Y. TIMES, Aug. 24, 2002, at A13 (containing comments by a professor of economics at Cornell University). Transactions structured for the sole purpose of changing the financial statement presentation without any economic purpose, however, do not fall into this category.

24. To see how pervasive the belief that manipulation of financial reports is acceptable, one need look no farther than the well respected General Electric company and the rumors of "earnings management" by its former chief executive officer, Jack Welch. *See* Leslie Wayne & Alex Kuczynski, *Tarnished Image Places Welch in Unlikely Company*, N.Y. TIMES, Sept. 16, 2002, at C1 (noting that Welch is being mentioned in the same context as Kenneth Lay and other wrong doers). "'G.E. did not bring good things to accounting,' said Robert Friedman, an analyst for Standard & Poor's. 'They used accounting sleight-of-hand to meet their short-term earnings goals. I believe they propped up earnings more than they deserved.'" *Id.*

25. The relationship of tax treatment to faulty accounting presentation is discussed in Stephen B. Cohen, *Even Before Enron: Bank Regulators, The Income Tax, The S&L Crisis, and Deceptive Accounting at the Supreme Court*, 5 GREEN BAG 387 (2002) (discussing Frank Lyon Co. v. United States, 435 U.S. 561 (1978), and Cottage Savings Ass'n v. Comm'r, 499 U.S. 554 (1991)). The same mentality of technical compliance can be found in reporting executive compensation for public companies where loopholes have been exploited to hide from investors excessive "perks" given to management. *See* David Cay Johnston & Reed Abelson, *G.E.'s Ex-Chief to Pay for Perks, But the Question Is: How Much?*, N.Y. TIMES, Sept. 17, 2002, at C1 ("'[V]ery sharp corporate lawyers . . . have taken a small exception and turned it into a huge loophole.'") (quoting John Coffee of Columbia Law School).

26. *See* William H. Simon, *What Does It Mean to Practice Law "In the Interests of Justice" in the Twenty-first Century?: The Belated Decline of Literalism in Professional Responsibility Doctrine: Soft Deception and the Rule of Law*, 70 FORDHAM L. REV. 1881, 1881, 1892 (2002) (arguing that the demise of literalism should be welcomed).

27. *Id.* at 1887, 1896–97.

achieved in legal representation.[28] Dominant legal norms emphasize that lawyers should not identify themselves with a client's cause.[29]

We might fairly ask, "What were these 'fiduciaries' and their lawyers thinking about?" An accurate financial picture is essential to the analysis of both stockholders and creditors, including those creditors who entered into derivative transactions with Enron.[30] Any director informed about the purpose of the Raptor structure must have understood how that purpose was diametrically opposed to the basic goal of financial reporting.[31] We expect more from fiduciaries than technical compliance and literalism.

But for a single accounting infelicity,[32] initially the Raptor transactions were characterized as essentially legal and in compliance with the letter, though not the spirit, of accounting rules.[33] Presumably, Enron's lawyers, and not simply its

28. *See* Austin Sarat, *Between (the Presence of) Violence and (the Possibility of) Justice: Lawyering Against Capital Punishment*, *in* CAUSE LAWYERING: POLITICAL COMMITMENTS AND PROFESSIONAL RESPONSIBILITIES 318–19 (Austin Sarat & Stuart Scheingold eds., 1998) [hereinafter CAUSE LAWYERING]; *see also* Austin Sarat, *Enactments of Professionalism: A Study of Judges' and Lawyers' Accounts of Ethics and Civility in Litigation*, 67 FORDHAM L. REV. 809, 818–23 (1998) (discussing "[t]he adversary system excuse . . . as a corollary [to] the standard conception of the lawyer's role"); Robert Eli Rosen, *On the Social Significance of Critical Lawyering*, 3 LEGAL ETHICS 169 (Spring 2001); Robert Eli Rosen, *Problem-Setting and Serving the Organizational Client: Legal Diagnosis and Professional Independence*, 56 U. MIAMI L. REV. 179 (2001).

29. *See, e.g.*, Ronen Shamir & Sara Chinski, *Destruction of Houses and Construction of a Cause: Lawyers and Bedouins in the Israeli Courts*, *in* CAUSE LAWYERING, *supra* note 28, at 235.

30. Generally, participants in derivative transactions will not enter into a contract with an entity that is not rated investment grade (i.e., AAA, AA, A or BBB) by a rating agency, unless the entity posts collateral or other credit support. It is not financially possible for a major derivatives dealer to post collateral for all of its derivative positions. Thus, a high credit rating is essential to a derivatives dealer so that business can be conducted on a largely unsecured basis. By artificially improving its financial picture, Enron may have maintained its low investment grade rating of BBB, allowing it to remain a major player in the derivatives markets. The derivatives business had become Enron's largest and most profitable business segment. *See* Form 10-K, filed by Enron Corp., dated Apr. 2, 2001 [hereinafter Enron Corp., Form 10-K], *available at* http://www.sec.gov/Archives/edgar/data/1024401/000102440101500010/0001024401-01-500010.txt.

31. *See generally* SENATE REPORT ON ENRON DIRECTORS, *supra* note 16. The notion that compliance with technical rules might legitimize misleading disclosure in financial reporting stands in stark contrast with recent regulatory efforts to enhance disclosure available to ordinary investors. *See generally* Brian K. Barry, Comment, *The Securities and Exchange Commission's Regulation Fair Disclosure: Parity of Information or Parody of Information?*, 56 U. MIAMI L. REV. 645 (2002) (discussing motivations behind adoption of Regulation FD).

32. An accounting rule apparently was applied incorrectly when Enron reported a note receivable from Raptor I as a net asset on its balance sheet. POWERS REPORT, *supra* note 16, at 125–26.

33. The criminal indictment filed against Fastow alleges an additional problem: that a side agreement prevented third-party equity needed to deconsolidate the Raptors from Enron's financial statements from being at risk. *See* Fastow Indictment, *supra* note 8, at 25. The Powers Report makes much of the fact that the Raptor structure had the effect of treating the issuance of equity securities as income and that this treatment of equity issuance as income violates a fundamental principle of accounting. Though this was the ultimate effect of the Raptor transactions, we shall see in Part 2 of this Article that, as a technical matter, income was recognized on the increase in value of derivative transactions between Enron and the Raptors based upon movements in the market price of securities of other issuers. Both Enron stock and stock equivalents supported the solvency of certain of the Raptor entities who issued the derivatives contracts. Without considering the value of Enron stock and stock equivalents, the derivative transactions relating to these other securities would have had no value and, thus, could not properly have been reflected in income. Thus, the Raptor structure accomplished indirectly what could not have been done directly. The Powers Report states, "the accounting treatment was

accountants, approved the structure of these transactions in some formal way.[34] A significant aspect of the Enron meltdown is that officers, such as Kenneth Lay, and, more generally, the other members of the Enron board of directors, likely did not steal directly from the cash register. Instead, they relied upon assurances of technical compliance to insulate them from the consequences of improper behavior as they inflated the price of Enron stock for their own gain.[35]

The culture of financial engineering, rather than garden-variety graft, should be seen as the primary evil that needs to be addressed. A large company can survive the theft of $50 million or so by the likes of an Andrew Fastow or a Michael Kopper. Neither an individual company nor a broader corporate and legal culture can long survive things like "accounting hedges." Following the arrest of Fastow and the more recent indictments relating to Enron's broadband business, it is an open question whether the government will pursue Enron management and directors who did not directly steal funds from the corporation or make wholesale fabrications, and whether our government has both the legal tools and the political will for such pursuit.[36] The decisions made by prosecutors may have broad implications for our economic system—particularly if action is not taken.[37]

clikely wrong, notwithstanding creative efforts to circumvent accounting principles through the complex structuring of transactions that lacked fundamental economic substance." POWERS REPORT, *supra* note 16, at 5 (emphasis added). Clear mistakes in accounting treatment occurred in other Enron transactions where insufficient third-party equity was contributed to special purpose entities. This resulted in Enron failing to include those entities in its consolidated financial statements. The criminal complaint against Fastow attempts to find a similar defect in the Raptor structure by virtue of a side agreement to hold the third-party investors harmless. *See* Criminal Complaint, United States v. Fastow (S.D. Tex. 2002) (No. H-02-889-M) [hereinafter Fastow Complaint], *available* at http://news.findlaw.com/wsj/docs/enron/usfastow100102cmp.pdf.

34. "Attorneys from Vinson & Elkins also were consulted frequently, particularly on securities law issues, and also prepared the transaction documents." POWERS REPORT, *supra* note 16, at 100. Vinson & Elkins got a second chance to review the Raptor transactions after Sherry Watkins complained in a letter to Kenneth Lay about the accounting treatment for various Enron transactions. *See* Cramton, *supra* note 14, at 162–63 (citing Opinion Letter from Max Hendrick III, Vinson & Elkins, L.L.P., to James V. Derrick, Jr., Executive Vice President and General Counsel, Enron Corp. (Oct. 15, 2001), *available at* 2001 WL 1764266); *see also* POWERS REPORT, *supra* note 16, at 173–77. Even on second review, Vinson & Elkins did not criticize the Raptor transaction structure from a legal perspective. *Id.* at 176.

35. *See generally* William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002) (discussing the consequences of blindly pursuing increase in stock price).

36. *See* Judith Burns, *SEC Denies Report that Enron Directors Might Elude Punishment*, WALL ST. J., Sept. 25, 2002. Wendy Gramm, wife of Senator Phil Gramm, R-Texas, was an Enron director and reported close friend of Harvey Pitt, now former Chairman of the SEC. Pitt angrily denied reports that corporate wrongdoers at Enron would not be pursued. Attorney General Ashcroft has vowed to pursue and punish corporate offenders. *See Ashcroft Vows to Continue Crackdown on Corporate Fraud*, WALL ST. J., Sept. 27, 2002 ("there is a danger if 'corporate cultures that foster criminal behavior' go unchallenged because 'American markets lose integrity in the eyes of our citizens and the world'"). Civil complaints against Enron directors alleging fraud have been dismissed by Judge Hamon. *See* Kurt Eichenwald, *Enron's Outside Directors Win a Round in Court*, N.Y. TIMES, Mar. 14, 2003, § C, at 6. A more recent indication of the commitment to resolving this problem was demonstrated by giving increased funding for the SEC to continue its pursuit of corporate malfeasance. *See* Richard W. Stevenson, *Bush Proposes Big Increase in Securities Commission's Budget*, N.Y. TIMES, Jan. 12, 2003, § 1, at 22.

37. *See generally* Joseph E. Murphy, *Enron, Ethics and Lessons for Lawyers*, BUS. LAW TODAY, Jan./Feb. 2003, at 11. "The trend has been so extensive that it may be undermining the entire capital market. Instead of a single storm sinking a few ships and passing on out to sea, it appears the impact

These "innocent" players perhaps rationalize that they were victimized by the likes of Fastow and Kopper. They will protest that their hands were clean and that they did not know laws were being violated.[38] This Article attempts to show that Kenneth Lay, Jeffrey Skilling, and other officers and members of the Enron board of directors and their professional advisors are, nevertheless, the real culprits regardless of whether they had knowledge or not.[39] The rest is an expensive and distracting sideshow.[40]

For corporate and legal culture to begin on the road to recovery, one path is to pursue criminal sanctions against those who did not steal money but nevertheless did structure and approve the "accounting hedges" achieved through the Raptor

is closer to a corporate Watergate—an event that causes fundamental rethinking of society's assumptions." *Id.* To have a law and not enforce it or, worse yet, to actually indicate an intention not to enforce it, is an unworkable situation. This is precisely the case with Regulation FD, where the SEC said it would not go after "'grey area' violations." Neal Lipschutz, *Reg FD Actions Show SEC at Its Worst*, CORP. GOVERNANCE, Dec. 5, 2002, at 1. And yet, the very purpose of grey areas operates to control conduct of properly advised clients within desired parameters. For instance, consider Justice Brandeis' discussion regarding grey areas of law in general:

> "I have been asked many times as regard to particular practices or agreements as to whether they were legal or illegal . . . . One [group of] gentlemen said to me, '[w]e do not know where we can go.' To which I replied, 'I think your lawyers or anyone else can tell you where a fairly safe course lies. If you are walking along a precipice no human being can tell you how near you can go to that precipice without falling over, because you may stumble on a loose stone, you may slip and go over; but anybody can tell you where you can walk perfectly safe within convenient distance of that precipice.' The difficulty which men have felt . . . has been that they have wanted to go the limit rather than that they have wanted to go safely."

Richard S. Gruner & Louis M. Brown, *Organizational Justice: Recognizing and Rewarding the Good Citizen Corporation*, 21 J. CORP. L. 731, 754 n.135 (1996) (quoting *Hearings on S. Res. No. 98 Before the Senate Comm. on Interstate Commerce*, S. Res. No. 98, 62nd Cong., 1st Sess. 1161 (1911), *quoted in* HARRY FIRST, BUSINESS CRIME 27 (1990)) (alteration in original); *see also* Cramton, *supra* note 14, at 165 n.105; Jonathan D. Glater, *Top Debt Rating Agencies Take a Look at Accounting*, N.Y. TIMES, Jan. 11, 2003, at C1.

38. To succeed, this defense must overcome the general maxim that "ignorance of the law is no excuse." The conventional rationale given for the rule is not that all men know the law but that, if recognized, it is an excuse that every man will plead and that no man can refute. *See* John Selden, *Law, in Table-Talk*, *in* THE QUOTABLE LAWYER 133 (David S. Shrager & Elizabeth Frost eds., 1986). A richer justification for the rule is given in Dan M. Kahan, *Ignorance of Law Is an Excuse—But Only for the Virtuous*, 96 MICH. L. REV. 127 (1997) [hereinafter *Ignorance of Law*]. A tendency to claim ignorance and blame subordinates for unwelcome behavior has a surface similarity to the strategy expected to be used by Slobodan Milosevic to defend against allegations of war crimes in the former Yugoslavia. Prosecutors argued that Milosevic, as president of Yugoslavia, "exercised 'command responsibility' over army, police and interior ministry forces . . . before atrocities and ethnic cleansing triggered Nato bombing." Ian Black, *Milosevic Protests as Curtain Falls on First Act of His Trial*, THE GUARDIAN (LONDON), Sept. 12, 2002, at 17. We might ask whether any notion of "command responsibility" operates in the sphere of corporate governance when criminal laws are violated.

39. Clyde Haberman, *Letting the Capitalists Eat Crow*, N.Y. TIMES, July 12, 2002, at B1 ("Thanks to the shenanigans of Enron, WorldCom, Tyco and the rest, the Dow Jones industrial average has fallen further in the last three months than it did in the wake of the Sept. 11 terrorist attacks.").

40. The emphasis in the Powers Report reflects the tendency to focus on the wrong problem. A tremendous effort has been made in the Powers Report to detail both conflicts of interest and excessive compensation paid in structuring the various transactions, including the Raptors. I believe these present serious problems but miss the larger point. I can take away both the excessive fees and the conflicts of interest and still have a Raptor transaction that hides losses from the income statement, causes dilution per share, and eventually brings down Enron.

transactions (including, perhaps, the lawyers involved).[41] Some way must be found to send the message to the business and legal communities that financial engineering of the Enron flavor is not acceptable.[42] Laws and regulations are not simply transaction costs to be overcome or worked around—a healthy respect for the law, and the consequences for its violation, needs to be reestablished.[43] If, like Enron, you claim to play a technical game and push the limits of the laws and rules, perhaps you should pay full price for technical violations if they can be found.[44] Indeed, this Article argues that imposing liability for technical violations

41. A lawyer's duty, under criminal law, to refrain from aiding and abetting a client's criminal conduct is best described by three elements: (i) the client violates the criminal law; (ii) the lawyer has knowledge of facts sufficient to identify the violation; and (iii) the lawyer performs an act that substantially furthers the criminal conduct. *See* Cramton, *supra* note 14, at 151 (citing Geoffrey C. Hazard, Jr., *How Far May a Lawyer Go in Assisting a Client in Legally Wrongful Conduct?*, 35 U. MIAMI L. REV. 669, 682–83 (1981)). Actions have been brought claiming criminal liability. *See In re* Enron Corp. Sec. Derivative & Erisa Litig., 235 F. Supp. 2d 549, 708 (S.D. Tex. 2002) (denying, for example, Vinson & Elkins's Motion to Dismiss while granting Kirkland & Ellis's Motion to Dismiss, each for allegations of traditional securities fraud).

In public statements, federal government officials have indicated a willingness to vigorously pursue criminal sanctions against corporate wrongdoers where warranted. *See, e.g.*, *U.S. Aide Sees Corporate Criminal Cases*, N.Y. TIMES, July 26, 2002, at C6 (statement of Deputy Attorney General Larry D. Thompson).

42. The debate about the role criminal law should play in modifying behavior is a long running one. *See* Sharon L. Davies, *The Jurisprudence of Willfulness: An Evolving Theory of Excusable Ignorance*, 48 DUKE L. J. 341, 342–43 & n.4 (1998) [hereinafter *Jurisprudence of Willfulness*]; *see generally* Jonathan Simon, *Governing Through Crime*, *in* THE CRIME CONUNDRUM: ESSAYS ON CRIMINAL JUSTICE 171–89 (Lawrence M. Friedman & George Fisher eds., 1997). This Article does not solve this difficult problem.

Imposition of criminal penalties to deter unwelcome behavior is most justified in the area of white collar crime. White collar criminals are, one the whole, better educated and better advised. Also, they are wealthier and have more to lose, both financially and in harm to reputation, than the common street criminal. A potential white collar criminal is both more likely to be aware of possible violations of law (and thus, can choose to avoid violations) and is less likely to be subject to other competing influences, such as poverty or drug addiction, that might provide competing motivations for a violation.

The criminal law also may have a pedagogical function. *See, e.g.*, M. Edgardo Rotman, *La question de la fonction preventive du droit penal dans la creation et l'application des norms penales economiques*, *in* THE SANCTIONS IN THE FIELD OF ECONOMIC CRIMINAL LAW 41 (1983). In the area of economic crimes, the justification for sanctions is least likely to be based on a motivation to rehabilitate the offender due to the fact that "most economic offenders are usually well adjusted socially." *Id.* at 42.

43. A significant part of the corporate governance problems we see today may stem from teaching in business schools that regulations are merely transaction costs to be overcome and not important to the proper functioning of a market. This, coupled with a more general lack of respect for the law, leads to business school graduates not internalizing a proper attitude towards rules and regulations. *See* Brendan Lally, *Business Ethics 101*, N.Y. TIMES, Aug. 27, 2002, at A16 (noting that, in a letter to the editor, a recent M.B.A. graduate noted, "[c]reating value where none exists, cheating customers and employees, and putting perception before reality are all boilerplate curriculum"). In response, business school admissions offices have started to test the ethics of the applicants, *see* Lynnley Browning, *M.B.A. Programs Now Screen for Integrity, Too*, N.Y. TIMES, Sept. 15, 2002, § 3, at 4, and some companies are replacing existing executives who do not have law degrees with new executives with legal backgrounds, *see* Patrick McGeehan, *Salomon Smith Barney Chief Ousted in Citigroup Shuffle*, N.Y. TIMES, Sept. 9, 2002, at A20.

44. An awareness is emerging that technical compliance with rules is not sufficient. *See* Art Berkowitz & Richard Rampell, *Fixing Flaws in the System Should Be Next Reform Step*, Special to the WALL ST. J.-Online, Sept. 12, 2002 ("Searching for loopholes to justify what we know is wrong isn't in the long-range best interest of the stockholders or of the capital markets. When someone starts a conversation by stating that there is no law against it, we will ask if it is ethical."), *available at* http://

is the only alternative when positive law becomes a surrogate for ethical standards of conduct.[45]

The best weapon for such an Enron safari might be the margin regulations.[46] The margin regulations simply provide that a person may not borrow[47] or lend[48] more than $50 to purchase $100 of margin stock if the loan is secured *directly or indirectly* by margin stock.[49] "Margin stock" is a defined term in the margin regulations that includes publicly traded equity securities, debt convertible into publicly traded equity securities, and rights to purchase publicly traded equity securities.[50] At the time the Raptor transactions were structured, "margin stock" included shares of Enron common stock.[51] This Article shows how Enron violated these regulations.

www.enronprofessionalsguide.com/art_fixflaws.html; *see also* United States v. Simon, 425 F.2d 796 (2d Cir. 1969) (Friendly, J.); Coffee, *supra* note 11; *cf.* Cramton, *supra* note 14.

45. The rationale for pursuing technical violations extends beyond possible violations of margin regulations to any other area in which Enron failed to comply with the law.

46. 12 C.F.R. pts. 220, 221, 224 (2002). The margin regulations are promulgated by the Board of Governors of the Federal Reserve System pursuant to section 7 of the Securities Exchange Act of 1934. 15 U.S.C. § 78(g) (2000). Section 7(a) gives the purpose for the regulations as follows:

> For the purpose of preventing the excessive use of credit for the purchase or carrying of securities, the Board of Governors of the Federal Reserve System shall, prior to October 1, 1934, and from time to time thereafter, prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security or a security futures product).

To be sure, prosecutors are focusing on other activities in addition to wire and mail fraud, such as bribes paid in foreign transactions, *see* John R. Wilke, *Enron Criminal Probe Focuses on Alleged Corruption Abroad*, WALL ST. J., Aug. 5, 2002, at A1, and manipulation of the energy markets in California, *see* Kurt Eichenwald & Matt Richtel, *Enron Trader Pleads Guilty to Conspiracy*, N.Y. TIMES, Oct. 18, 2002, at C1 (pleading guilty to illegally manipulating California power market during state's energy crisis). I do not mean to suggest that other crimes were not committed or should not be pursued in the Enron fiasco. *See supra* note 6; *2 from Enron Are Indicted in Video Case, supra* note 8.

47. 12 C.F.R. pt. 224 (2002). Regulation X governs the use of credit by borrowers to purchase margin stock. *Id.*

48. 12 C.F.R. pt. 220 (Regulation T) and 12 C.F.R. pt. 221 (Regulation U) govern the extension of credit by lenders to purchasers of margin stock. Regulation T governs the extension of credit by brokers and dealers and is not directly at issue in the Enron case. 12 C.F.R. pt. 220. Regulation U governs the extension of credit by banks and other lenders (not broker and dealers). *Id.* pt. 221. Prior to 1998, Regulation U governed the extension of credit by banks and Regulation G governed the extension of credit by other lenders. In 1998, Regulation G was folded into Regulation U. Accordingly, pre-1998 interpretations and case law discussing the scope of Regulation G is directly relevant to consideration of current Regulation U. Not all possible lenders are subject to the margin regulations. Purchasers of publicly issued debt securities are excluded from the definition of "lender" pursuant to Federal Reserve Board interpretation. *See* Revlon, Inc. v. Pantry Pride, Inc., 621 F. Supp. 804, 815 (D. Del. 1985). And, an equity security, such as a preferred stock, may be considered a debt security for purposes of the margin regulations. *See* Koppers Co. v. Am. Express Co., 689 F. Supp. 1417, 1419 (W.D. Pa. 1988).

49. 12 C.F.R. § 221.3 (2002).

50. *Id.* § 221.2; *see generally* Kenneth C. Kettering, *Repledge Deconstructed*, 61 U. PITT. L. REV. 45 (1999) (discussing how margin stock impacts broker transactions).

51. Enron's common stock qualified as "margin stock" because it was an equity security registered on a national securities exchange. The New York Stock Exchange delisted Enron's common stock on January 15, 2002. Press Release, New York Stock Exchange, NYSE Suspends Trading in Enron Corp. and Related Securities and Moves to Remove from the List (Jan. 15, 2002), *available at* http://www.nyse.com/press/NT0006F602.html.

Surprised? Why not use our vaunted disclosure laws, such as Rule 10b-5 instead?[52] Answer: the margin regulations may provide a good, clean kill, although quibbling over language in Enron's public disclosures and the level of "knowledge" of the culprits may not.[53] The key statutory difference between pursuing a margin violation and pursuing a disclosure violation is found in the structure of section 32(a) of the Securities Exchange Act.

> Any person who willfully violates any provision of this title (other than section 30A), or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this title, or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this title or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 15 of this title, or by any self-regulatory organization in connection with an application for membership or participation therein or to become associated with a member thereof, which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than \$5,000,000, or imprisoned not more than 20 years, or both, except that when such person is a person other than a natural person, a fine not exceeding \$25,000,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.[54]

To prove a margin violation, a prosecutor need only show *willful* conduct by the defendant.[55] To prove a disclosure violation, a prosecutor needs to show both

52. Rule 10b-5, 17 C.F.R. § 240.10b-5 (2002), is promulgated pursuant to section 10(b) of Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2000). This rule makes it unlawful to make any material misstatement or omission in connection with the purchase or sale of a security. Rule 10b-5, 17 C.F.R. § 240.10b-5 (2002). Plaintiffs often use this rule to challenge the adequacy of disclosure documents filed with the SEC by companies registered pursuant to the Securities Exchange Act.

53. The government's complaint against Fastow relies, in part, on proof of the existence of an undisclosed side deal that should have resulted in the consolidation of Raptor I with Enron. It appears from the complaint that Kopper will testify to the existence of this arrangement. Although this approach may help convict Fastow, the strategy of relying on undisclosed side deals likely will not help convict Lay, Skilling, or other members of the board of directors. *See* Fastow Indictment, *supra* note 8; Fastow Complaint, *supra* note 33, at 25–27; *see also* Kurt Eichenwald, *Secret Deal Part of Tangle in Enron Case*, N.Y. TIMES, Oct. 1, 2002, at C1.

54. 15 U.S.C.A. § 78ff (Supp. 2003).

55. The lower "willful" standard is not free from legal hurdles. The current state of the law as it relates to section 32(a) is that a person can willfully violate an SEC rule even if he does not know of its existence. *See infra* note 138. Even though satisfaction of a "willful" requirement in other contexts may require a greater degree of awareness, the scope of the term is particularly limited in section 32(a). The concept is thus very close to the concept of "willful" required for finding a criminal violation at common law, namely, that the violation was not the result of innocent mistake of fact, negligence, inadvertence, or diminished capacity. Nevertheless, some courts have placed a minimum "bad" intent gloss on the scope of "willfulness" under section 32(a). *See, e.g.*, United States v. Peltz, 433 F.2d 48, 54 (2d Cir. 1970) (Friendly, J.); United States v. Dixon, 536 F.2d 1388, 1396 (2d Cir. 1976) (Friendly, J.) ("[A]n intention to deceive is enough to meet the modest requirements of the first clause of § 32(a) . . . ."); *see also Ignorance of the Law*, *supra* note 38, at 145–46. *But see* United States v. Schwartz, 464 F.2d 499, 509 (2d Cir. 1972) (Clarie, J.) (stating that bad intent is not required for a violation); United

willful and knowing conduct.[56] The requirement that a defendant have knowledge that a material misstatement or omission in a filed report is false is known as the "*scienter*" requirement.[57] A knowledge requirement only becomes relevant in the context of a margin violation if the prosecutor seeks a jail sentence. Even there, it can be argued that the knowledge requirement imposed by the last clause of section 32(a)[58] to permit imposition of a prison sentence for a margin violation is less stringent than the level of *scienter* that must be shown to convict for a disclosure violation.[59] As a fallback, fines can be imposed for a margin violation if ignorance of law is used successfully as a defense to avoid a prison sentence. Failure to disclose the margin violations also may form the basis for a clear disclosure violation.[60] A significant problem facing prosecutors who want to pursue Enron's officers and directors is how to prove *scienter* to demonstrate a disclosure violation, particularly for those who did not steal funds.[61] Use of a margin regulation violation as proposed in this Article does an end run around the "knowledge" problem by finding a crime for which knowledge is not an element.[62]

States v. Charnay, 537 F.2d 341, 357 (9th Cir. 1976) ("[T]he intent necessary . . . is merely that of intending to do the acts prohibited, rather than intent to violate the statute."). *See generally* Norwood P. Beveridge, *Is* Mens Rea *Required for a Criminal Violation of the Federal Securities Laws?*, 52 BUS. LAW. 35 (1996) (arguing that *mens rea* should be part of any criminal violation). In the Second Circuit cases, the distinguishing factor was the presence of Judge Friendly, who argued for presence of a minimum bad intent. For a comprehensive, in-depth discussion of the erosion of the doctrine *ignorantia legis non excusat* in a wide variety of contexts, see *Jurisprudence of Willfulness*, *supra* note 42.

56. The requirement of both willful and knowing conduct as a predicate to a traditional securities law violation is found in both the language of section 32(a), *supra* text accompanying note 54, and in the requirement of "scienter" discussed in *infra* note 57.

57. *See* Cramton, *supra* note 14, at 149–50 (summarizing *scienter* under the federal securities acts). The requirement of demonstrating *scienter* has been construed to require actual knowledge that a statement contains a material misstatement or omission or a reckless disregard for the truth or falsity of a statement that proves to be materially misleading. United States v. Weiner, 578 F.2d 757, 787 (9th Cir. 1978) (stating that proof of reckless indifference permits an inference of willful and knowing participation in a fraud); *cf.* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (finding that *scienter*, and not merely negligence, is required to be shown in private suit for civil damages under Rule 10b-5); Van Dyke v. Coburn Enters., Inc., 873 F.2d 1094, 1100 (8th Cir. 1989) (concluding that recklessness satisfies *scienter* requirement for civil liability).

58. 15 U.S.C. § 78ff (2000).

59. *See* United States v. Lilley, 291 F. Supp. 989, 992–93 (S.D. Tex. 1968).

60. There is no private right of action under the margin regulations. *See* Walck v. Am. Stock Exch., Inc., 687 F.2d 778, 788–89 (3d Cir. 1982). Nevertheless, private litigants have tended to use a margin violation (or the possibility of a margin violation) to attack disclosure documentation as deficient for failure to describe the alleged violation. In the context of tender offers, the failure to disclose a margin violation is asserted as a violation of the Williams Act. *See, e.g.*, Polaroid Corp. v. Disney, 862 F.2d 987, 989–90 (3d Cir. 1988); West Point-Pepperell, Inc. v. Farley Inc., 711 F. Supp. 1088, 1093–94 (N.D. Ga. 1988); Revlon, Inc. v. Pantry Pride, Inc., 621 F. Supp. 804, 807–08 (D. Del. 1985).

61. *See* Kurt Eichenwald, *The Findings Against Enron*, N.Y. TIMES, Sept. 23, 2002, at C1. The first task for the prosecutor is to prove "a primary violation for liability," which includes the *scienter* element. Aldridge v. A.T. Cross Corp., 284 F.3d 72, 84 (1st Cir. 2002). An additional hurdle may be to prove the element of control if liability is asserted against a "control person" of Enron. *See* Loftus C. Carson, II, *The Liability of Controlling Persons Under the Federal Securities Acts*, 72 NOTRE DAME L. REV. 263, 313–43 (1997) (noting, however, that having control is sufficient to satisfy the requirements for control person but that actual exercise of control is not needed). Some courts, however, require evidence that indicates actual exercise of control. *Aldridge*, 284 F.3d at 85.

62. *See, e.g.*, McNeal v. Paine, Webber, Jackson & Curtis, Inc., 429 F. Supp. 359, 365 n.3 (N.D. Ga. 1977) ("Thus, the scienter requirement of § 10(b) and Rule 10(b)-5 would not be relevant to a

This Article continues with a description of the structure and rationale for the Raptor transactions, thereby providing a window to observe just how far certain lawyers and accountants exalted form over substance, and in the process of going up to the edge of legality, stepped over the line. Part 3 elaborates on how Enron failed to comply with the margin regulations. Part 4 discusses criminal sanctions against the parties involved and some associated consequences of a decision to prosecute technical violations of law. Part 5 concludes the Article with some observations on the message that a decision to either prosecute or not to prosecute will send to the public.

PART 2: WHAT ENRON DID AND WHY: ENRON JR. AND RAPTOR LITE

Set forth below is a description of a simplified transaction between two hypothetical companies that shall be called "Enron Jr." and "Raptor Lite." The hypothetical transaction between these two entities illustrates the essence of the actual transactions between Enron and various special purpose entities that proximately caused the downgrade in Enron's credit rating and its subsequent bankruptcy filing.[63] It is a composite of features from various transactions described in the Powers Report. It illustrates both the motivation behind creation of a complicated financial structure and fills in details about how that structure violated the margin regulations.

Enron seems to have generated many flavors of fraud, from inflating earnings through sham asset sales, hiding losses, disguising debt, and so forth.[64] The type of transaction described below masks losses that otherwise would reduce reported earnings. It does not involve sham asset sales or disguised debt.

Enron's public disclosure[65] of transactions that masked losses directly caused Enron's bankruptcy because of the importance that large commercial lenders place on reported earnings. Earnings are the base number from which a banker calculates EBIT and EBITDA,[66] both financial ratios used to assess the strength of

§ 7 cause of action."). At a minimum, the analysis contained in this Article might be used in a purely instrumental way to trip up participants in the Enron scandal. The SEC used margin violations as part of its attack against "parking" stock. *See, e.g.*, SEC v. Jefferies, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,171, at 95,760, 95,761 (S.D.N.Y. Mar. 19, 1987); *see generally* William R. McLucas et al., *Common Sense, Flexibility, and Enforcement of the Federal Securities Laws*, 51 BUS. LAW. 1221, 1227–29 (1996) (discussing laws violated while "parking" stock). Reflection on the appropriate use of criminal sanctions to regulate behavior of business people is found at *infra* notes 129–71 and accompanying text.

63. The Raptor transactions concealed almost $1 billion in losses and resulted in a reduction of the equity accounts of Enron by over $700 million. POWERS REPORT, *supra* note 16, at 99.

64. *See generally* POWERS REPORT, *supra* note 16; SENATE REPORT ON ENRON DIRECTORS, *supra* note 16; BATSON, *supra* note 16. Recent examples of corporate misconduct are not confined to Enron or the United States. *See, e.g.*, Wayne Arnold, *Insurer's Officers Broke Laws, Australian Inquiry Concludes*, N.Y. TIMES, Jan. 14, 2003, at W1.

65. *See* Form 8-K, filed by Enron Corp., dated Nov. 8, 2001, *available at* http://www.sec.gov/cgi-bin/txt-srch-sec.

66. EBIT stands for "earnings before interest and taxes" and EBITDA stands for "earnings before interest, taxes, depreciation and amortization."

cash flow available to pay debt service on loans. When it became known that Enron's reported earnings number was not sound, commercial lenders would not refinance maturing long-term loans nor would they roll over short-term borrowings. Enron found itself in a liquidity crisis, as it did not have the cash flow or financing sources to pay its debts as they became due. Enron was insolvent in the "equity" sense, regardless of the true state of its balance sheet, once commercial lenders refused to rely on its reported earnings. Enron had to file for bankruptcy protection.

ENRON'S MERCHANT INVESTMENT DILEMMA

Enron Jr. is formed by issuance of 1000 shares of its common stock to the public for $1000. Enron Jr. registers its shares of common stock as a class on the New York Stock Exchange.[67] This registration of common stock results in shares of Enron Jr.'s common stock being classified as "margin stock" under Regulation U.[68]

Enron Jr. uses the proceeds of its common stock issuance to purchase plant, property, and equipment ("PP&E") for $500 and to purchase an equity investment in an Internet company for $500.[69] The PP&E generate some positive cash flow and give Enron Jr. some earnings, which it uses to pay expenses. The market value of the Internet company investment increases by $1000 to $1500. Even though Enron Jr. does not sell the investment, for financial accounting purposes the investment is marked to market and the increase in value is treated as income to Enron Jr. because the investment is classified as a "merchant investment."[70] The market price of shares of Enron Jr. increases to $2 per share.

67. For purposes of this example, we shall ignore the fact that the New York Stock Exchange would not accept such a small company for listing. Note, however, that listing on the exchange is by class of shares (e.g., common stock) and not by particular shares issued (e.g., the initial 1000 shares sold to the public). This means that all shares of Enron Jr. common stock constitute "margin stock" for as long as the New York Stock Exchange lists Enron Jr. common stock.

68. *See* 12 C.F.R. § 221 (2002).

69. The numbers in the example have been selected for ease of illustration. Possible legal issues under the Investment Company Act created by the asset allocation should be ignored. The reader will not be confronted with a surprise violation of the Investment Company Act later in the Article. Similarly, no attempt has been made to select numbers to illustrate compliance with the three percent outside equity requirement under accounting rules or to address tax structure. *See* Floyd Norris, *Accounting Rules Changed to Bar Tactics Used by Enron*, N.Y. TIMES, Jan. 16, 2003, at C4. The Raptor transactions do not appear technically deficient in these respects. The Fastow Complaint, however, alleges that the three percent outside equity contributed to the Raptors should be ignored based on a secret global galactic agreement, pursuant to which Enron agreed to assure a return on equity. *See* Fastow Complaint, *supra* note 33, at 5. It appears that Enron may have agreed with equity investors in other transactions similarly to support outside investors who provided three percent equity to satisfy this technical requirement. *See* Richard A. Oppel Jr. & Kurt Eichenwald, *Inquiry Said to Examine Citigroup Role in Enron Deal*, N.Y. TIMES, Dec. 9, 2002, at C1 (describing alleged oral agreement to "support" a three percent equity interest in Bacchus transaction).

70. Enron made limited use of fair value accounting when it marked to market selected assets under existing accounting rules. POWERS REPORT, *supra* note 16, at 109. In 1998 there was a decision to investigate the move toward more general use of a fair value accounting standard. For example, the Financial Accounting Standards Board (FASB) released an article advocating the use of a "fair value" method of asset valuation. *See* DIANA W. WILLIS, FINANCIAL ASSETS AND LIABILITIES—FAIR VALUE OR

Enron Jr. becomes nervous that its merchant investment may decline in value. Such a decline would be treated as a loss for financial accounting purposes, even if Enron Jr. does not sell the merchant investment, because the investment is marked to market at increasingly lower values. The problem for Enron Jr. becomes how to insulate itself from adverse financial reporting effects if this merchant investment declines in value. A reported loss on the merchant investment might cause a reduction in the trading price of Enron Jr. stock and, perhaps, result in a lower credit rating. In the actual Enron corporation, advocates for the Raptor transaction structure considered this problem to be one of managing "'P&L [statement] volatility.'"[71]

Solutions Not Available to Enron

The first simple, easy solution to P&L statement volatility is for Enron Jr. to sell its merchant investment today for $1500 and eliminate the possibility of a decline in the value of this position. The problem with such a simple strategy is that the shares in this investment are subject to a restriction on transfer that prohibits a sale of the shares for some period of time. The Internet company will have placed such a transfer restriction on the investment it sold to Enron Jr. in order to support the general value of investments made in the Internet company.

A further problem with the straightforward sale of the merchant investment is that the shares in this investment are thinly traded and, perhaps, only traded in private placements. Any attempt to sell Enron Jr.'s block of shares in the Internet company might depress the market, yielding proceeds to Enron Jr. fewer than the $1500 value implied by the current trading price (whether in public or private markets) of the Internet company's shares. Lastly, a current sale of the Internet investment would result in a gain for income tax purposes.

The second possibility is that Enron Jr. could sell the merchant investment shares forward, with a settlement date beyond the date on which the transfer restriction expires, or that it purchase a put option on the shares, also with a settlement date beyond the date of expiration of the transfer restriction.

Historical Cost? (Financial Accounting Standards Board 1998). As an apparent result of Enron, Worldcom, Adelphia, and Tyco, the FASB decided to suspend further deliberations regarding the expanded use of fair value standards. *See* Financial Accounting Standards Board, *Disclosures about Fair Value*, *available at* http://www.fasb.org/project/fairvalue.shtml (last updated Jan. 15, 2003). As it stands now the FASB intends to make its final decision sometime in 2003. *Id.* Yet, there are other important reporting issues for the board to address:

> In October, the Board began deliberating the issues related to presentation in the footnote disclosure of changes in fair values from period to period. The board decided that the proposed Statement should require some minimum level of disaggregation of the changes in the fair value of financial instruments that are not captured by payments or receipts of principal, additional purchases or partial sales, and accruals of contractual interest and dividends. The Board also decided that the proposed Statement should provide some guidance on the types of disaggregation that would be appropriate in certain circumstances.

Id.

71. *See, e.g.*, Powers Report, *supra* note 16, at 105–06, 112–13. "P&L statement" is a reference to Enron's income statement, which reports earnings.

The main problem with the second alternative set of choices is that neither a forward sale nor a put option are available on the Internet company shares from a true third-party derivatives dealer because of the thin trading volume of the merchant investment. Although such a strategy might have been available had Enron Jr. invested in shares of IBM or Coca-Cola, a third-party derivatives dealer either will not write derivatives on the merchant investment, or such a derivative would be prohibitively expensive, because the derivatives dealer would not be able to hedge its position in the marketplace to protect against a decline in value of the positions written with Enron Jr.[72]

A further possible problem with the second alternative set of choices is that the very transfer restriction imposed on the merchant investment shares may have been accompanied by restrictions on engaging in market hedging activities in respect of the merchant investment shares. Such hedging activities, even if able to be transacted in the general marketplace, might have the effect of depressing the price for the Internet company's shares. Thus, the Internet company might impose hedging restrictions, as well as transfer restrictions, on the shares sold in blocks to third parties such as Enron Jr. These further restrictions, if imposed by the Internet company to protect its stock price, thus would supplement the protection it sought by imposition of transfer restrictions in the first place. Indeed, the Powers Report makes clear that Enron placed restrictions on hedging activity related to its own shares that were transferred to the Raptor special purpose companies.[73] Similar restrictions likely were imposed on some of Enron's merchant investments.

A third alternative would be for Enron Jr. to create a synthetic hedge for its merchant investments by purchasing publicly available derivatives on shares of companies that were involved in the same or similar businesses as the Internet company but that had a larger market trading volume. Such a strategy would work if movements in price of these more widely traded investments mirrored movements in price of the merchant investment. Of course, any such strategy would not provide a perfect hedge and, if the identified synthetic connection did not hold, no protection would be provided.

Thus, Enron Jr. does not have a traditional capital market solution to protect itself against a decline in market value of its merchant investment in the Internet company.[74] Enron Jr. was happy to reflect the income as it rode the increase in value of the merchant investment upward, but it is not prepared to accept the downside. Indeed, the very accounting income on the merchant investment price increase booked by Enron Jr. may be a significant factor in maintaining an in-

72. One deficiency in Enron's financial disclosure is the repeated claims that its transactions with related parties were done on terms comparable to those that would have been negotiated with third parties. *See, e.g.*, Enron Corp., Form 10-K, *supra* note 30; *see also* POWERS REPORT, *supra* note 16, at 196. This is clearly false in the case of the derivative transactions with the Raptor special purpose companies because such transactions either would not have been available with third parties or would have been prohibitively expensive.

73. POWERS REPORT, *supra* note 16, at 99–102.

74. The Powers Report states that, "[d]ue to the size and illiquidity of many of these investments, they could not practicably be hedged through traditional transactions with third parties." *Id.* at 100.

vestment grade credit rating. In the real world, it was crucial that Enron maintain its investment grade rating for it to continue activity in its increasingly important derivatives trading business. Loss of this credit rating would effectively put Enron out of business in its most profitable business segment.[75]

FORMATION OF RAPTOR LITE AS THE SOLUTION

The solution chosen by Enron Jr. to structure around the transfer and hedging restrictions on the merchant investment, and overcome the absence of availability of third-party derivatives on its merchant investment, is to orchestrate the formation of a special purpose entity—Raptor Lite. Though true third-party derivatives dealers will not write derivatives contracts on shares of the merchant investment, Raptor Lite will write such contracts and Enron will achieve a perfect hedge.

Raptor Lite is formed by a third-party investor contributing $6 to its capital in exchange for an equity interest in Raptor Lite. Raptor Lite purchases 1000 shares of Enron Jr. from Enron Jr.[76] To pay for the purchase of shares, Raptor Lite issues Enron Jr. its note for $1500.[77] Enron Jr. rationalizes the reduced sale price for the Enron Jr. shares (i.e., $1.50 per share rather than the current $2 per share trading price) by placing a transfer restriction and a negative pledge on the shares purchased by Raptor Lite.[78] This one hundred percent debt financing of the purchase of margin stock violates the requirement that not more than fifty percent of the purchase price of margin stock be financed if the financing is secured directly or indirectly by margin stock. Indirect security is found in the transaction structure itself, as we shall see in Part 3 of this Article.

Enron Jr. purchases an equity interest in Raptor Lite for $3. The formation agreement for Raptor Lite states that the third-party investors are to receive the first $12 of distributions from Raptor Lite and Enron Jr. is to receive the next $500 of distributions. Cash flow thereafter is allocated between Enron Jr. and the third-party investor pursuant to a formula.

75. Enron's public filings with the Securities and Exchange Commission reflect both the importance of its derivatives trading business and its dependence on an investment grade credit rating. *See, e.g.*, Enron Corp., Form 10-K, *supra* note 30.

76. In the actual Raptor transactions, both actual shares and contingent future shares were transferred to the special purpose companies in their initial capitalization. The actual shares delivered were already outstanding and the contingent shares were to be delivered by a third party who would have to acquire outstanding shares in the marketplace. The shares consisting of "contingent future shares" did not have to be delivered if the market price of Enron stock dropped below a certain level. Thus, these contracts were riskier than a simple forward purchase agreement. As best I can tell from Enron's financial statements and the Powers Report, the initial transaction did not create significant dilution because Enron used rights to contingent shares which it had initially acquired to protect against dilution relating to its employee stock option programs. *See* POWERS REPORT, *supra* note 16, at 78 n.26, 100 n.46.

77. In the actual Raptor transactions, Enron improperly reported this note on its balance sheet, which resulted in a $1 billion restatement to its capital accounts reflected in its financial statements filed in Enron Report on Form 10-Q in November 2001. *Id.* at 125–26, 128.

78. Investment banking firms typically use discounts in the range of twenty percent to forty percent when valuing stock subject to transfer restrictions. In the actual Raptor transactions, discounts approximating thirty-five percent were used. *Id.* at 100–01, 110–11.

Enron Jr. pays Raptor Lite a $3 fee for derivative consulting services.[79] If the transfer restrictions on the shares of Enron Jr. held by Raptor Lite are ignored for purposes of computing its credit capacity, Raptor Lite has a positive net worth of $512. This assessment of credit capacity assumes that shares of Enron Jr. continue to trade at $2 per share and that the block of Enron shares could be sold, when needed, at that price. Raptor Lite pays the third-party investor a priority distribution of $12. Raptor Lite's credit capacity is now an even $500 following the distribution to the third-party investor. The credit capacity is the difference between the principal amount of the loan made by Enron Jr. to Raptor Lite ($1500) and the market price of 1000 Enron shares at $2 per share ($2000). The valuation for this purpose ignores the transfer restrictions that justified the sale of such shares to Raptor Lite at a discount.

At this point, the third-party investor has already doubled its money.[80] Even though the third party retains an equity interest in Raptor Lite, it is no longer overly concerned with the ongoing transactions in which Raptor Lite engages. Raptor Lite is now ready to write derivatives transactions.[81]

RAPTOR LITE WRITES DERIVATIVES

Raptor Lite writes a put option to Enron Jr. giving Enron Jr. the right to sell to Raptor Lite the troublesome merchant investment in the Internet shares for $1500. This put protects the value of Enron Jr.'s merchant investment. Should the market price of the Internet investment decline, the value of the put increases. The increase in value of the put is counted as income that offsets the loss represented by the decline in market value of the merchant investment. A perfect hedge has been created. Typically, however, one would pay a fee for such a put right. To offset the out-of-pocket cost of the put option and avoid any requirement that cash change hands, Enron Jr. gives Raptor Lite a call option on the merchant investment, also for $1500.[82] The duration of the put and call are identical and extend beyond the term of the restriction on transfer that applies to the merchant

79. In the actual Raptor transactions, some fees were paid but additional funds were provided to the Raptors by early termination of certain derivative contracts. *See, e.g.*, *id.* at 104. It appears that these terminated derivative contracts were entered into for the sole purpose of providing cash payments to the Raptors that could then be distributed to the independent third-party investors. The third-party investors in the Raptors were needed to achieve off balance sheet treatment. The Raptors needed to be outside Enron's consolidated group so that the net in the money positions owed to Enron by the Raptors on the derivative contracts would not be eliminated in consolidation.

80. In certain of the transactions, Fastow is reported to have informed the third-party investors that they had received a return of their entire investment plus agreed upon return. *Id.* at 103 n.48. From an accounting standpoint, however, the third-party investors retained an equity position in the special purpose companies because the payments were returns "on capital" invested, not returns "of capital" invested. The Raptor entities thus remained unconsolidated.

81. In the actual Raptor transactions there was an apparently unwritten rule that no derivatives transactions would be executed on merchant investments until the third-party investors had received a significant specified return. *Id.* at 107.

82. In the actual Raptor transactions this economic result was achieved using transactions known as "'total return swaps.'" *Id.* The economic effect is equivalent to our hypothetical because any derivative can be structured by a combination of options and futures. *See generally* PAUL WILMOTT ET AL., THE MATHEMATICS OF FINANCIAL DERIVATIVES (1995).

investment shares and the term of the restriction on transfer that Enron Jr. imposed on its own shares sold to Raptor Lite.

Enron Jr. is not concerned about giving away future upside potential on its merchant investment in the Internet company because Enron Jr. believes the value of the Internet company shares will decline. Indeed, Enron Jr. would sell those shares today for $1500, if it could. Enron Jr. recognizes that Raptor Lite only has credit capacity to absorb $500 of losses on derivative contracts under current market conditions. Should the value of its merchant investment decline to $0, the credit of the hedge from Raptor Lite will be impaired by $1000 because its obligation on the put is out of the money by $1500 but, after payment of its $1500 note owed to Enron Jr., Raptor Lite has only $500 of net worth (assuming a sale of its 1000 shares of Enron Jr. for $2 per share). If the market value of shares of Enron Jr. increases, however, so will the credit capacity of Raptor Lite. Of course, the converse is true as well. A decrease in the share price of Enron Jr. will result in a contraction of the credit capacity of Raptor Lite.

Price Declines and Restructuring

In our hypothetical, the market price of the merchant investment starts a retreat back towards $500 from its high of $1500. This results in increased liability of Raptor Lite to Enron Jr. under the put contract. At the same time, the market price of Enron Jr.'s common stock starts to decline for reasons unrelated to the price decline in the merchant investment.[83] The decline in value of the Enron Jr. shares owned by Raptor Lite from the high of $2000 reduces Raptor Lite's net worth. The combination of both price declines rapidly erodes the $500 credit capacity Raptor Lite once enjoyed. Raptor Lite's liability on the hedge balloons at the same time that the value of its assets to satisfy the liability declines.

Enron Jr. decides to enhance the credit capacity of Raptor Lite so that it will not be forced to recognize a loss for financial reporting purposes. It is at this point that the transaction structure is modified to insure extensive dilution of Enron Jr.'s book value per share. Enron Jr. sells an additional 1000 of its shares of common stock forward to Raptor Lite at a substantial discount to market price in exchange for an increase in the amount of the note by $1000.[84] This is another one hundred percent debt financed transaction, and it also violates the margin regulations if direct or indirect security is present.

83. In the actual Raptor transactions, a price decline in Enron shares had a far more draconian effect because the "contingent" shares under the forward were not deliverable at all if the share price declined below a specified level. *See* Powers Report, *supra* note 16, at 100 n.46, 111 & n.52, 123. To translate into the hypothetical, if the share price of Enron Jr. declined to $1.50 per share, the Raptor would receive no shares rather than have an asset worth $1500.

84. A forward sale is an agreement to deliver shares on a future date. Alan Gersten, *Hedging Your Megawatts*, J. Acct., Nov. 1999, at 47, 48 (describing a forward "[a]s an alternative to a futures contract . . . forwards are negotiated privately between parties without going through an organized exchange, and they are customized rather than standard. The advantage of going through an organized exchange is that the exchange limits the *credit risk* on a futures contract."). The shares Enron sold forward in the restructuring were authorized shares that were not currently outstanding.

To see clearly how the dilution occurs, consider the following formula: $S_o + ([D + H]/P) = S_a$, where S_o represents shares outstanding of Enron Jr. (initially 1000 shares to the public and 1000 shares to Raptor Lite), D represents the total debt obligations of Raptor Lite to Enron Jr., H represents the amount Raptor Lite owes on the hedge of the merchant investment to Enron Jr. (i.e., the extent to which the put is in the money to Enron Jr.), P represents the price per share that Raptor Lite can realize from a sale of its Enron Jr. shares, and S_a represents the adjusted shares outstanding. The adjusted shares outstanding represents the shares required to be outstanding if we assume Enron Jr. realizes value from its put option (i.e., the hedge) from Raptor Lite. Realizing value from the hedge requires that Raptor Lite obtain its funds for payment of the put obligation by selling its investment in shares of Enron Jr. These shares represent both the 1000 outstanding shares owned by Raptor Lite and the additional 1000 shares subject to the forward contract, in each case, to the extent such shares need to be sold to raise cash to pay the obligation on the put.

Of course, the shares of Enron Jr. subject to the forward contract will not be issued and outstanding until settled at delivery because it is a forward sale. The shares sold forward are authorized shares but, at this point, they are not issued and outstanding. Nevertheless, the contract for forward delivery has value today and can be used by Raptor Lite to compute its new net worth, enhanced by the forward purchase of shares at a discount.

In effect, attributing full "in the money" value to Enron Jr.'s hedge position today can only be done on the assumption that additional shares of Enron Jr. will be issued in the future. For financial accounting, revenue is recognized currently as the size of the "in the money" position as the hedge grows. Realization of this revenue in cash, however, is dependent on issuance of shares of Enron Jr. in the future. Thus, the reported earnings per share and book value per share are overstated based on a smaller number of shares actually outstanding than is implied by the current revenue recognition. This reporting error might be corrected in calculating the diluted earnings per share but the diluted earnings per share calculation would need to reflect all shares of Enron Jr. assumed sold to cover the value of D + H, regardless of the share price P. In the actual Raptor transactions it appears that Enron may have accurately reflected this potential share dilution in some of its later reports filed on Form 10-Q.[85]

The management of Enron Jr. finally decides it cannot bear the continued dilution of adjusted earnings per share that the Raptor structure exacts as the price for masking a reduction in earnings that otherwise would be reported to reflect the decline in the value of its investment in the Internet company. The Raptor Lite transaction structure is unwound, the true earnings results announced to the financial markets, and a near riot ensues. Enron Jr. files for bankruptcy shortly thereafter.

85. Form 10-Q, filed by Enron Corp., dated May 15, 2001 [hereinafter Enron Corp., Form 10-Q] (showing the diluted earnings per share calculation), *available at* http://www.sec.gov/cgi-bin/txt-srch-sec.

Viewed in this stylized form, the Raptor transactions structure is seen as a simple margin violation coupled with a nasty tendency to create significant dilution. The price of managing "P&L statement volatility" proved too high. The board never should have approved the program.[86]

There are a few additional facts about the actual Raptor transactions worth noting.

COMPARISON OF RAPTOR LITE WITH REALITY

In the actual Raptor transactions, as initially capitalized in 2000, Enron contributed a combination of 3.9 million issued and outstanding shares and contracts to receive eighteen million additional shares of Enron stock to the Raptor special purpose companies.[87] These contracts for future delivery covered shares that were already issued and outstanding. Thus, initially no new share issuances by Enron were associated with, or implied by, recognition of value in the hedges from the Raptors, even though the credit that supported the hedges consisted of shares of Enron. New share issuances only were introduced into the Raptor structure when the transactions were restructured in the first quarter of 2001 to try to save the structure from the ravages of declines in the market prices of both Enron stock and its merchant investments.[88] This difference is reflected in a subtle addition of a line item to the calculation of diluted earnings per share that was not present in the financial statements for calendar year 2000, but does appear in the financial statements included in the Form 10-Q filings made in 2001.[89] The line item introduced was for dilution caused by "equity instruments." These equity instruments were forward contracts for delivery of twelve million new Enron shares to be issued after 2001 and contracts to deliver eighteen million additional new Enron shares if conditions to future delivery of the originally transferred eighteen million Enron shares were not satisfied.

86. In the actual Raptor transactions, it is not clear whether the board was directly informed about the restructurings that caused the most significant dilution. It appears that this restructuring may have been done by only a few officers who were knowledgeable about how fragile the Raptor structure had become. *See* POWERS REPORT, *supra* note 16, at 122.

87. Talon, the first Raptor SPE, received 3.7 million restricted shares of Enron Stock and contracts evidencing rights to 3.9 million contingent shares. *Compare id.* at 111 n.52, *with* Enron Corp., Form 10-Q, *supra* note 85.

88. POWERS REPORT, *supra* note 16, at 119 (discussing Raptor restructuring).

89. The categories for potentially dilutive securities contained in the earnings per share calculation for calendar year 2000 are for shares issued pursuant to terms of preferred stock and stock options. The stock options line item appears to relate to options held by Enron employees. *See* Enron Corp., Form 10-K, *supra* note 30. The balance is not large enough to include a report of the eighteen million contingent shares transferred to the SPEs in their initial capitalization and, in any event, it appears that these contingent shares were deliverable not by Enron but by a third party. In the first quarter 10-Q for 2001, an additional category for "other equity instruments" is introduced but it is combined with the line item for stock options. The same presentation is used in the financial statements for the second quarter 10-Q. When the third quarter 10-Q is filed, however, the category of "equity instruments" is given a separate line, and thirty million shares are reflected. These are the thirty million additional share equivalents transferred to the SPEs as of the first quarter 2001 to increase the credit

The new placeholder for additional potential dilution is significant for at least two reasons. For directors who closely read their company's financial statements, it provided an opportunity to inquire about possible adverse side effects caused by the Raptor transactions. Had such an inquiry been made, it might have led to a better understanding of the Raptor restructuring and an earlier termination of the transactions. Secondly, by 2001 it was reasonably well known in the financial community that transactions backed by a company's own stock might well lead to serious financial troubles, with or without margin violations. One publicly reported series of transactions that highlighted these risks were the loans backed by stock and equity forward transactions entered into by Patriot American Hospitality Inc., the Dallas based real estate investment trust.[90] A news report describes the problem.

> But the real story was just starting to unfold. Patriot had financed the buying spree of its 450-hotel portfolio . . . with mountains of short-term debt and unusual financial instruments called "equity forward contracts," which would be repaid in the future with Patriot stock. The contracts were, in essence, a huge bet that Patriot's stock price would climb. "It was a wrong bet," Mr. Nussbaum now concedes.
>
> Indeed, Patriot's share price declined for much of 1998. The company was forced to issue more shares to cover its equity forward contracts, diluting its existing pool of stock and pushing its share price into a potentially fatal nose dive. By the end of last year [1998], Patriot shares had lost 79% of their value—more than $3 billion in market capitalization.[91]

The lesson learned from Patriot American, as well as from other transactions known in the market, should have made a careful reader of the financial statements extremely concerned about the introduction of an "equity instruments" category into the list of potentially dilutive securities.[92] Indeed, the problem of

capacity of the Raptors which had been depleted by declines in the price of Enron stock. *See* Form 10-Q, filed by Enron Corp., dated Nov. 19, 2001, *available at* http://www.sec.gov/cgi-bin/txt-srch-sec; *see also* Form 10-Q, filed by Enron Corp., dated Aug. 14, 2001, *available at* http://www.sec.gov/cgi-bin/txt-srch-sec; Enron Corp., Form 10-Q, *supra* note 85.

90. Neal Templin, *Inn Trouble: Hurricane Georges Was Just One of the Blows That Battered Patriot*, WALL ST. J., Mar. 4, 1999, at A1.

91. *Id.*

92. Press reports indicate that Enron used similar derivatives, not involving its own stock, known as "prepaid swaps," to conceal what were, in essence, debt obligations. *See, e.g.*, Daniel Altman, *Enron's Many Strands: Finances; Enron Had More Than One Way to Disguise Rapid Rise in Debt*, N.Y. TIMES, Feb. 17, 2002, § 1, at 1. In the Patriot American transactions, it appears that Patriot in essence borrowed money that was to be repaid in shares of its own stock at the market value existing at the time of maturity of the "debt." *See, e.g.*, Templin, *supra* note 90, at A1. In Enron's prepaid swap, Enron received a single large upfront payment (read, the loan) in exchange for its obligation to make periodic payments to its counter-party (read, payments of interest and amortization of principal). *See* Altman, *supra*, at 1. Unlike in *Patriot*, Enron repaid principal with cash, not shares. The swap was considered "prepaid" because Enron's counterparty had prepaid its obligations up front in exchange for the promised stream of payments from Enron. Apparently, current accounting rules treat these prepaid swaps as hedges but not debt. *See id.*

using a company's own stock to support receivables or payables owed to that same company is recounted in case law from an earlier era.[93]

Other financial disclosures about derivatives should have provided warning signals to the board and the investment community. Enron's public filings assure the investment community that it only entered into derivative transactions with entities that were "equivalent" to investment grade. It is hard to see how this claim could be made by anyone who was informed that the Raptor transactions were mere accounting hedges without economic substance.[94] A passing attempt was made to disclose the essence of the Raptor transactions in a footnote to Enron's financial statements.[95] Perhaps more ominous than this cryptic disclosure is the revelation that this transaction, with an Enron insider, lost $500 million for the insider in less than a year's time.[96] One might pause to consider how unusual an event such a loss must be. Typically, insider transactions are winners, not losers for the insider. In addition to the unusual nature of such an insider "loss," one might have reasonably asked whether the insider's business venture was financially able to make good on such a significant loss.

PART 3: DETAILS OF WHY THE RAPTOR TRANSACTIONS DID NOT COMPLY WITH THE MARGIN REGULATIONS

Enron sold both actual shares of Enron stock and contracts for the future delivery of Enron stock to various special purpose entities or "SPEs" known as the "Raptors."[97] A right to purchase margin stock is itself margin stock under the

93. *See* United States v. Simon, 425 F.2d 796, 798–99 (2d Cir. 1969). In this case, convictions of accountants were upheld for violations of disclosure laws. *Id.* at 798, 813. Fines, but not jail sentences, were at issue. The defendants were characterized as "men of blameless lives and respected members of a learned profession." *Id.* at 799.

94. Indeed, one footnote in Enron's Annual Report reads "Based on Enron's policies, its exposures and its credit reserves, Enron does not anticipate a materially adverse effect on financial position or results of operations as a result of counterparty nonperformance." Enron Corp., Form 10-K, *supra* note 30, at n.3. Another reads, "[f]orwards, futures and other contracts are entered into with counterparties who are equivalent to investment grade. Accordingly, Enron does not anticipate any material impact to its financial position or results of operations as a result of nonperformance by the third parties on financial instruments related to non-trading activities." *Id.* The hedging activities related to the merchant investments appear to have been classified as non-trading activities, although similar statements are made with respect to counterparties in the trading divisions.

95. *See id.* at n.16.

96. In footnote 16 to the 10-K for 2002 the following statement appears: "Enron recognized revenues of approximately $500 million related to the subsequent change in the market value of these derivatives, which offset market value changes of certain merchant investments . . . ." *Id.* These derivatives are identified as those entered into with a "related party." *Id.* In fact, the related party was Andrew Fastow's LJM2 company, which owned the Raptor entities. POWERS REPORT, *supra* note 16, at 70–73, 97.

97. *See* Enron Corp., Form 10-Q, *supra* note 85, pt. 1, item 1, § 8 (describing contribution of both actual restricted shares of Enron common stock and contracts to acquire additional shares to special purpose entities); *see also* POWERS REPORT, *supra* note 16, at 100.

A typical special purpose company is a corporation or other artificial legal person formed to participate in a single transaction or type of transaction. *See generally* Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133 (1994) (providing a general discussion of direct and indirect benefits available to companies that employ a strategy of asset securitization). Being newly formed, it has no liabilities or assets other than those relevant to the particular transaction. In the case regulations.[98] These SPEs were not consolidated with Enron for financial reporting purposes. Per the Powers Report, these purchases of Enron stock and stock equivalents were almost one hundred percent debt financed, with Enron acting as financier.[99] In legalese, Enron extended "purpose credit" to the Raptors (i.e., credit for the purpose of acquiring margin stock). If this credit extension was either directly or indirectly secured by margin stock, the credit extension fails to comply with the margin regulations because the fifty percent "maximum loan value" threshold has been breached by Enron's provision of almost one hundred percent debt financing.[100]

It seems the SPEs did not give Enron *direct* security in margin stock.[101] Federal Reserve Board pronouncements discussing tender offer financing using SPEs, however, reveal that the Raptor structure itself provided *indirect* security to Enron for its "purpose credit" extensions, thus creating a rule violation.[102] These Board

of the Raptor entities, the assets consisted of shares of common stock of Enron, contracts for the future delivery of shares of Enron, and a small amount of cash. POWERS REPORT, *supra* note 16, at 100. The liabilities consisted of notes payable to Enron. *Id.* In addition, the Raptors entered into derivative transactions with Enron, which might constitute an asset or a liability depending on the date of valuation of the payments due under the derivatives contract and to whom a payment was owed. *See id.* at 102.

98. *See* 12 C.F.R. § 221.2 (2002). In addition to the contract for future delivery itself qualifying as margin stock under clause (4) of the definition, the margin regulations are clear that a loan is a purpose credit even if the proceeds are used to acquire another asset temporarily so long as the ultimate use is to acquire margin stock. *Id.* § 221.101(d). The intermediate investment in the contract for future delivery clearly has as its ultimate aim the acquisition of margin stock. A "purpose credit" is any loan "for the purpose, whether immediate, incidental, or ultimate, of buying or carrying margin stock." *Id.* § 221.2.

> The existence of purpose credit is not affected by a temporary use of proceeds if the proceeds are ultimately used to invest in margin stock. Thus, where a customer invests the proceeds of a loan in government securities with the intention of shortly thereafter selling such securities and investing in margin stock, the credit is deemed to be purpose credit from the time it is extended.

CHARLES F. RECHLIN, SECURITIES CREDIT REGULATION § 9:25, at 9-36 (2d ed. 2002) (commenting on the Board Interpretation of Jan. 3, 1947, FRRS 5-821).

99. POWERS REPORT, *supra* note 16, at 100–02.

100. The loans made by Enron to the Raptors would have been voidable and, thus, potentially unenforceable by Enron, as a result of the margin regulation violations. *See* Stonehill v. Sec. Nat'l Bank, 68 F.R.D. 24, 28, 33–35 (S.D.N.Y. 1975); Grove v. First Nat'l Bank of Herminie, 489 F.2d 512, 513, 516 (3d Cir. 1974) (per curiam). This fact provides a legal reason, in addition to an accounting based rule, to suggest that Enron's booking of certain of its notes due from the Raptors as assets was improper. *See* POWERS REPORT, *supra* note 16, at 126 (describing how the accounting treatment of the notes receivable was improper).

101. Direct security in margin stock would be created pursuant to applicable state law, as contained in Article 9 of the Uniform Commercial Code by the borrower granting a security interest to the lender in shares of margin stock. *See, e.g.*, U.C.C. §§ 9-101 to -709 (2002). The mere creation of a security interest results in direct security, regardless of whether that security interest is perfected under applicable state law.

102. Regulation U is structured to contain a general statement describing the scope of the term "indirectly secured." 12 C.F.R. § 221.2. Following this general statement, subsequent sections of the regulation elaborate on that general statement by giving stylized examples of transactions. *Id.* §§ 221.113–.124. Each example states whether the stylized example represents a case of indirect security. These examples arose from actual cases in which individuals sought advice from the Federal Reserve Board as to the status of proposed transactions. This pattern of behavior by transaction participants and regulators is not unique to practice in this area. Parties often seek advice from the

interpretations arose from transactions such as Pantry Pride's tender offer for Revlon in the mid 1980s.[103] As discussed in the regulations, indirect security results when a shell company, like an acquisition vehicle in a tender offer or a Raptor SPE, borrows money to buy margin stock.

The rationale is simple. The lender cannot be relying on anything other than margin stock for repayment. Significantly, the regulations do not require other contractual restrictions, such as a negative pledge[104] or an agreement to apply sale proceeds of stock to repay the loan, to create the presumption of indirect security (although such arrangements themselves create indirect security).[105] Use of the SPE financing structure alone is enough to create the presumption.[106] To overcome the presumption of indirect security you need another fact—such as a merger agreement or a tender offer condition for ninety percent or more of the shares of a target company.[107] Such a supplemental fact supports a claim that the lender is relying on the underlying assets of the target company, and not the margin shares of the target, in making the loan. In the case of Enron and the Raptors, no such

Securities and Exchange Commission in the form of no-action letters and from the Internal Revenue Service in the form of private letter rulings.

103. *See generally* Revlon, Inc. v. Pantry Pride, Inc., 621 F. Supp. 804 (D. Del. 1985). The Federal Reserve Board promulgated its interpretive ruling on financing provided to shell companies to purchase shares on January 10, 1986, in response to the structural issues raised by the tender offer financing raised by Pantry Pride in its bid for Revlon. *See* Final Interpretive Rule of Regulation G, 51 Fed. Reg. 1771-01 (Jan. 15, 1986).

104. A "negative pledge" is a covenant made by a borrower to the effect that it will not place mortgages or security interests on its property. This insures that the asset subject to the negative pledge will remain available to satisfy claims of the beneficiary of the covenant. As such, the negative pledge serves as a surrogate for a direct security interest in the asset. The negative pledge might be combined with a covenant limiting indebtedness in order to reserve the asset for the benefit of a single creditor or a small class of creditors. For a discussion of the use of covenants as a substitute for security interests, see Carl S. Bjerre, *Secured Transactions Inside Out: Negative Pledge Covenants, Property and Perfection*, 84 CORNELL L. REV. 305 (1999).

105. > [T]he interpretation assumed that there were no covenants or other arrangements relating to the debt securities that legally or contractually limited the shell corporation's right or ability to sell, pledge, or otherwise dispose of the target's margin stock or that made such sale, pledge, or other disposition a cause for acceleration of the debt securities. Nevertheless, the FRB concluded that the debt securities should be presumed to be indirectly secured by the margin stock of the target, stating that "credit could not be extended to such a company in good faith without reliance on the margin stock as collateral."

RECHLIN, *supra* note 98, § 9:44, at 9-57.

106. *See* Polaroid Corp. v. Disney, 862 F.2d 987, 1004 (3d Cir. 1988) ("Because it has substantially no assets or cash flow to secure its borrowings other than the Polaroid stock that it is purchasing, Shamrock's nonbank subordinated financing will also be presumed to be indirectly secured by the stock acquired by Shamrock, thus exceeding the margin regulations' 50% limitation.").

107. The interpretation lists three cases in which the presumption of indirect security would not apply to a loan made to an SPC. Final Interpretive Rule of Regulation G, 51 Fed. Reg. at 1771. The first case is where the credit extension is guaranteed by the SPC's parent company or by another company that has "substantial non-margin stock assets or cash flow." *Id.* The second case is where a merger agreement is entered into between the SPC and the target at the time the commitment to purchase the debt securities is made or before funds are advanced. *Id.* The third case is where the obligations of the lenders to extend credit are conditioned on the SPC's acquisition of the minimum number of shares necessary under applicable state law to effect a merger without the approval of either the shareholders or the directors of the target. *Id.* An additional case (mentioned in the release accompanying the interpretation but not in the interpretation itself) is where the credit extended to the SPC is in the form of debt securities that are sold in a bona fide public offering. *Id.*

supplemental facts provide a way out. To make matters worse, Enron placed contractual restrictions against transfer and use of the Enron shares as collateral on the shares transferred to the Raptor SPEs.[108] Imposition of these contractual restrictions virtually assures the creation of indirect security within the meaning of the margin regulations.[109] Thus, Enron's Raptor transaction structure creates indirect security in two separate ways.

Typical defenses to an asserted margin violation, such as the lender did not rely in good faith upon the margin stock in extending credit or did not make such loans in the ordinary course of business,[110] should be unavailable. Enron made multiple credit extensions to the Raptors in the ordinary course of its business and tracked the price of Enron shares daily to determine the extent to which the market value of the shares exceeded the principal of the notes given by the Raptors to purchase Enron stock and stock equivalents.[111] As we saw in Part 2 of this Article, this excess value supported the Raptors' obligations to Enron under derivative contracts.[112]

We also saw that the Raptor transactions failed for the simple reason that the Raptor SPEs turned out to be bad credits—they simply could not honor their increasing obligations to Enron under derivative contracts. The over-leverage that resulted from the margin violations contributed to the Raptors' credit instability.

108. "Because Talon was restricted from selling, pledging or hedging the Enron shares for three years, the shares were valued at about a 35% discount to their market value." POWERS REPORT, *supra* note 16, at 100–01. The definition of "indirect[] secur[ity]" includes an arrangement under which "[t]he customer's right or ability to sell, pledge, or otherwise dispose of margin stock owned by the customer is in any way restricted while the credit remains outstanding." 12 C.F.R. § 221.2 (2002).

109. It should also be noted that the exceptions to the general principle of the shell corporation interpretation (other than the "public offering" exception) may not be relied on with respect to debt securities entitled to the benefit of restrictive covenants, acceleration provisions, or other contractual restrictions limiting the right or ability of a borrower to sell, pledge, or otherwise dispose of margin stock.

RECHLIN, *supra* note 98, § 9:44, at 9-61 (emphasis omitted).

110. "*In the ordinary course of business* means occurring or reasonably expected to occur in carrying out or furthering any business purpose, or in the case of an individual, in the course of any activity for profit or the management or preservation of property." 12 C.F.R. § 221.2 (emphasis in original). A single loan may result in a violation of the margin regulations. *See* Federal Reserve Board Staff Opinion, FRRS 5-925.2 (Dec. 3, 1976). Moreover, a lender need not be in the business of making margin loans subject to the margin regulations. *See* Caldwell v. Genesco Employees Credit Ass'n, 393 F. Supp. 741, 745 (M.D. Tenn. 1975). The scope of "ordinary course of business" is given wide application. *See* RECHLIN, *supra* note 98, § 9:14, at 9-18 to -19.

111. As the value of Enron's merchant investments declined in the fall of 2000, the amounts Talon owed Enron increased. This became a matter of significant concern at Enron. If Talon's total liabilities (including the amount owed to Enron) exceeded its total assets (which consisted almost entirely of the unrestricted value of Enron stock and stock contracts), Enron would have to record a charge to income based on Talon's credit deficiency. *Consequently, Enron's accounting department kept track of Talon's credit capacity on a daily basis.*

POWERS REPORT, *supra* note 16, at 110 (emphasis added). The credit quality was monitored by tracking the value of Enron common stock to make sure its unrestricted value was sufficient to pay back both the purpose credit borrowed from Enron and honor the derivative contracts with Enron. Daily monitoring of this sort is completely inconsistent with a claim that the margin stock was not relied upon for repayment of the purpose loan.

112. *See supra* notes 67–71 and accompanying text.

We have a case of a rule violation causing (or, at least, contributing to) a harm that the rule was designed to protect against.[113] The Powers Report confirms that the Raptor transactions would have provided true protection for Enron had they been done with independent and creditworthy third parties.[114]

Under the Securities Exchange Act of 1934, criminal liability may attach to others who helped "arrange"[115] the infringing credit even if they did not extend credit themselves.[116] Further, liability may be imposed for aiding and abetting a primary violation. The Exchange Act and the margin rules thus combine to cast a wide net that may trip up certain of Enron's enablers. A margin violation could

113. The margin regulations were adopted as a tool to administer macro-economic policy. The concern over margin credit was driven both by a worry that the price of publicly traded securities might be artificially bid up and that use of credit for margin stock purchases would divert credit away from other productive purposes. *See generally* Jerry W. Markham, *Federal Regulation of Margin in the Commodity Futures Industry—History and Theory*, 64 TEMP. L. REV. 59 (1991). The Enron brand of financial engineering turned the typical margin violation inside out (or, we might say, outside in). Whereas a typical margin violation contributes to the creation of a market bubble as investors speculate with borrowed money and drive the price of securities to unsustainable levels, in Enron's case, the violation of the margin regulations permitted the creation of a bubble from inside the company itself by overstating earnings per share. This led investor's unwittingly to bid up the price of Enron stock to high levels above that at which the stock would have traded if a fair financial picture had been presented. The market disruption is the same when the bubble bursts, regardless of its origin. Home-grown credit, such as that extended by Enron, does not jeopardize the amount of credit generally available in the marketplace. When non-traditional lenders extend credit, however, it is not subject to supervision unless the lender reports the credit extensions to the Federal Reserve. It is not public knowledge whether Enron registered as a margin lender or reported its margin loans to the Federal Reserve.

114. *See* POWERS REPORT, *supra* note 16, at 97.

115. 15 U.S.C. § 78g(d)(1) (2000). Section 78(g)(d) provides:

> It shall be unlawful for any person not subject to subsection (c) . . . to extend or maintain credit or to *arrange* for the extension or maintenance of credit for the purpose of purchasing or carrying any security, in contravention of such rules and regulations as the Board shall prescribe to prevent the excessive use of credit for the purchasing or carrying of or trading in securities in circumvention of the other provisions of this section. Such rules and regulations may impose upon all loans made for the purpose of purchasing or carrying securities limitations similar to those imposed upon members, brokers, or dealers by subsection (c) . . . and the rules and regulations thereunder.

Id. (emphasis added). A person who merely arranges margin credit is not required to register as a lender pursuant to the margin regulations. Margin Requirements, Regulation G, [1983–1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,411, at 86,147–48 (July 28, 1983). The degree of involvement required to show "arranging" appears minimal. *See, e.g.*, *In re* Sutro Bros. & Co., Exchange Act Release No. 34-7052, [1961–1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,913 (Apr. 10, 1963) (arranging under Regulation T); *see also* Federal Reserve Staff Opinion, FRRS 5-802 (1969) (interpreting Regulation U). Finding both directors liable for voting to approve margin violations and other officers and, perhaps, lawyers liable for structuring the Raptor transactions is consistent with standards for finding aider and abettor liability for other securities law violations. *See generally* Lewis D. Lowenfels & Alan R. Bromberg, *A New Standard for Aiders and Abettors Under the Private Securities Litigation Reform Act of 1995*, 52 BUS. LAW. 1 (1996). Though private litigants may not pursue securities law claims for aiding and abetting, *see* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994), no such prohibition applies to actions brought by the government. *See* Cramton, *supra* note 14, at 169.

116. To remedy a violation of the margin regulations, the Exchange Act gives the SEC authority to initiate administrative investigations into alleged margin violations, 15 U.S.C. § 78u(a); to revoke a broker-dealer's registration under the Exchange Act, 15 U.S.C. §§ 78o(b)(4)(D); to seek injunctions in federal court against margin violators, 15 U.S.C. §§ 78u(d)–(e); and to transmit evidence of willful violations of the margin regulations by principal offenders and

bring ten years imprisonment, a $1 million fine, or both, to an individual defendant.[117] A prison sentence may not be imposed if the accused "proves that he had no knowledge of such rule or regulation."[118] It is likely that many, if not all, of the individual officers, directors, and lawyers involved in structuring and approving the Raptor transactions have heard of the margin regulations. Kenneth Lay was a significant margin borrower in his personal capacity and had to satisfy fourteen margin calls to repay loans secured by his own Enron stock as the market value of Enron shares declined.[119] Prosecutors may be able to use a burden of proof allocation such as this to secure prison sentences, in addition to fines. To avoid the possibility of prison, Enron's officers, directors, and the lawyers who advised them might feel compelled to take the stand to convince a jury of their lack of knowledge. Expanded testimony from key transaction participants might contribute to a better understanding of the true facts and to development of a more traditional case based on disclosure violations.

The fact that securities are either unregistered or restricted does not remove them from regulation under the margin regulations.[120] Furthermore, the fact that Enron, in some cases, sold contracts for the future delivery of Enron shares, rather than issued and outstanding Enron shares, should not make a difference to the analysis. When credit is extended for the ultimate purpose of purchasing margin stock, the fact that the credit might initially be used to purchase another asset is irrelevant. Indeed, it was expected that the contingent forward purchase contracts transferred to various Raptor SPEs would eventually convert into actual shares of Enron stock.[121] The value of the contingent forward contracts was determined by reference to the market price of the Enron shares into which the various forward contracts would convert.[122] Any attempts by Enron, or its lawyers, to argue that

aiders and abettors to the Attorney General of the United States for institution of criminal proceedings, 15 U.S.C. § 78u(d) (1982 & Supp. IV 1986).

Polaroid Corp. v. Disney, 862 F.2d 987, 1005 (3d Cir. 1988).

117. 15 U.S.C. § 78ff(a) (2000). The Sarbanes-Oxley Act of 2002 increased the maximum amount of the fine and jail sentence under section 32(a), but these increased penalties do not apply to acts taken prior to the revision of the law. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 1106, 116 Stat. 745, 810.

118. 15 U.S.C. § 78ff(a).

119. *See* Weil & Barrionuevo, *supra* note 8, at A3 (reporting Lay borrowed between $80 and $90 million on margin). Margin borrowing is widespread among management of large corporations. *See* Ronald Grover & Tom Lowry, *A Cable Clan on Thin Ice*, BUS. WK., Apr. 15, 2002, at 44 (describing margin borrowing by Rigas family at Adelphia).

120. *See* Federal Reserve Staff Opinion, FRRS 5-919 (May 30, 1975); *see also* Crimmins v. Am. Stock Exch., Inc., 368 F. Supp. 270, 278–79 (S.D.N.Y. 1973); *see also generally* RECHLIN, *supra* note 98, § 9:16, at 9-26. On unusual facts, the anomalous case of *Mallis v. Federal Deposit Insurance Corp.*, 568 F.2d 824 (2d Cir. 1977), leads one treatise to wrongly suggest a contrary view. *See* 69 AM. JUR. 2D *Securities Regulation* § 498 & n.91 (1993).

121. *See, e.g.*, Minutes, Meeting of the Finance Committee of the Board of Directors, Enron Corp., May 1, 2000 [hereinafter Minutes] (showing a transfer of seven million shares of stock), *available at* http://news.findlaw.com/hdocs/docs/enron/fincom050100min.pdf.

122. POWERS REPORT, *supra* note 16, at 97. "A credit may be considered to be indirectly secured by margin stock if that credit is supported or collateralized by assets which derive their value from margin stock." RECHLIN, *supra* note 98, § 9:41, at 9-52.

Enron was financing the acquisition of derivatives and not margin stock should be unsuccessful because Enron's financing committee presentation indicates intent to transfer stock and other internal Enron reports consistently analyze the Raptor transaction structure on that basis.[123] In any event, violations exist with respect to the actual shares and warrants transferred,[124] regardless of the legal characterization of the forward contracts.

The fact that Enron, in effect, financed the purchase of its own securities by the various Raptor SPEs does not remove Enron from the scope of the margin regulations. There are legitimate transactions in which a corporation finances the purchase of its own securities that are exempt from the operation of the fifty percent financing limitation the margin regulations otherwise impose.[125] Enron, however, did not advance funds to the Raptor SPEs in transactions that fell within these exceptions. The fact that the Raptor SPEs were affiliates of Enron is similarly irrelevant.[126] Thus, Enron should have complied with the fifty percent financing limitation that applies generally to margin stock secured purpose financings.

It is not public knowledge whether Enron registered with the Federal Reserve Board as a provider of margin credit. Section 221.3(b)(1) of Regulation U provides that any person (other than a broker-dealer or a bank) who, in the ordinary course of business, extends or maintains any credit secured, directly or indirectly, by any margin stock, must register with the Federal Reserve Board within thirty days after the end of any calendar quarter during which the amount of such credit extended equals or exceeds \$200,000 or the amount of such credit outstanding at any time during such calendar quarter equals or exceeds \$500,000.[127] Thus, a technical reporting violation may have occurred beyond the extension of secured credit in violation of the fifty percent limitation.

We might ask, however, whether a margin violation is central to the deception or simply a random legal fact that may catch the Enron participants, but not

123. *See* Minutes, *supra* note 121. Actual shares of Enron stock were transferred, as well as shares subject to contracts, for forward delivery. Enron Corp., Form 10-Q, *supra* note 85, pt. 1, item 1, § 8.

124. In one Raptor transaction, Enron transferred warrants to acquire shares in the New Power Company to an SPE only days before the New Power Company went public and registered on the New York Stock Exchange. POWERS REPORT, *supra* note 16, at 117–18. Though this transaction may not violate the margin regulations initially because the warrants had not yet become margin stock, the transaction would have violated the regulations at the time of the Raptor restructuring, when compliance would have been re-examined.

125. Plan lenders are excepted from the operation of certain provisions of Regulation G. 69 AM. JUR. 2D *Securities Regulation* § 513 (1993). A plan lender is a "corporation . . . that extends or maintains credit to finance the acquisition of margin stock of the corporation, its subsidiaries or its affiliates under an eligible plan." 12 C.F.R. § 221.4(a)(1) (2002). An eligible plan is an "employee stock option, purchase, or ownership plan adopted by a corporation and approved by its stockholders[, which] provides for the purchase of margin stock of the corporation, its subsidiaries, or affiliates." *Id.* § 221.4(a)(2). Under such a plan, margin securities that directly or indirectly secure credit have good faith loan value and credit extended under such a plan is treated separately from credit extended under Regulation U, except that plan lenders are required to file registration statements and reports, as are other registered lenders. *Id.* § 221.4(b). Further, a registered lender may extend and maintain purpose credit to a qualified employee stock ownership plan without regard to the provisions of Regulation U other than the registration and reporting provisions. *Id.* § 221.4(c).

126. *See* RECHLIN, *supra* note 98, § 9:14, at 9-24 n.17 (citing Federal Reserve Staff Opinion, FRRS 5-332.53 (Apr. 15, 1988)).

127. Federal Reserve Board Regulation U, 12 C.F.R. § 221.3(b)(1).

others. To be sure, the Federal Reserve Board may change the level of margin requirements to be higher or lower than the current fifty percent. For example, if the board had lowered margin requirements to ten percent in 1999, the Raptor transaction structure might have survived, deception intact, but without a violation. The same type of deceptive transaction structure, in theory, can be implemented using other asset types not subject to the margin regulations. Implementation of such a structure, however, would be difficult to administer and likely even more complex than the Raptor structure. There are three reasons for the additional complexities associated with other asset types.

First, other assets appear as assets on the balance sheet of a corporation. In the case of a corporation's own stock, however, assets can be created in the hands of another out of thin air by simply issuing shares. If the stock subject to transfer is unissued and subject to forward delivery, the only place the creation of this asset will show up in financial reports is in the diluted earnings per share calculation. Second, shares are more easily valued and devalued for appraisal purposes than other asset classes, particularly if they are publicly traded. The valuation convention of applying discounts to the value of securities that are subject to transfer restrictions creates an easy method to manipulate value against a time line, as was done in the case of the Raptors. Third, a corporation's own stock is not an asset that the corporation must use to run its business. The transfer of other asset classes a corporation must use in its business adds further complications related to management of the asset, payment of rent for its use, and, perhaps, allocation of depreciation, though Enron seemed prepared to deal with some of these complications in other transactions under investigation.

Certainly many forms of fraud may be implemented without violating the margin regulations. Nevertheless, a corporation's use of its own stock presents a particularly fertile area for financial engineering of an unwelcome kind. The larger problem presented by the margin violations, however, is the ethic of the "bad man"[128] that created the Raptor structure in the first place. The policy reasons to use technical violations of law to pursue offenders, and the ethical justification for this use of law, are discussed in Part 5 of this Article.

PART 4: CHALLENGES TO USE OF THE MARGIN REGULATIONS TO IMPOSE CRIMINAL LIABILITY AND SOME CONSEQUENCES ASSOCIATED WITH CRIMINAL LIABILITY

This Article has suggested that federal prosecutors could indict Enron's officers, directors, and lawyers for criminal violation of the margin regulations. The following challenges to these suggestions can be anticipated and addressed.

128. The reference is to Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 459 (1897):

> If you want to know the law and nothing else, you must look at it as a bad man, who cares only for the material consequences which such knowledge enables him to predict, not as a good one, who finds his reasons for conduct, whether inside the law or outside of it, in the vaguer sanctions of conscience.

First, prosecutors will never be able to make the charges stick. The officers and directors will simply defend themselves by saying that they relied on the advice of counsel.[129] Second, courts will be particularly reluctant to find lawyers criminally liable because of the chilling effect on aggressive and creative representation of clients. A similar reluctance may apply to finding directors, particularly outside directors, liable for criminal violations. It will make it more difficult to convince potential good outside directors to serve on boards. Third, the margin regulations are complex. Even sophisticated counsel might make a mistake in this area. There is a sense that it is unfair to impose criminal, as opposed to civil, penalties for violations of these sorts of laws and rules.[130] Fourth, to the extent that only fines are at stake, the fines will never be borne by the defendants because of insurance and corporate indemnification. Lastly, given the likely reliance on counsel, coupled with the complexity, it is doubtful that prosecutors will ever prove an intentional violation of these regulations by any party (including counsel).[131] As a society, we do not like to punish people for technical violations when they did not know their conduct was illegal. An inadvertent violation just does not provoke the sense of moral outrage needed to impose criminal sanctions.

These challenges can be answered at several levels. As an initial response, if we examine bedrock principles of our legal system, as recounted by Oliver Wendell Holmes in *The Common Law*,[132] we find two maxims particularly relevant to the Enron situation. First, "a *malum prohibitum* is just as much a crime as a *malum in se*."[133] Second, "[i]gnorance of the law is no excuse for breaking it."[134] If we believe these maxims remain part of our legal system, then we will be a long way toward proceeding against Enron's directors, officers, and, perhaps, lawyers for "technical" criminal violations. Generally, the level of intent required for an actor to be found guilty of a crime is simply that the act be willful—that is, not the product of some accident, mistake of fact, or mental impairment. The Raptor transactions certainly satisfy this level of intent as they were carefully crafted, presented to the board of directors, discussed, voted on, approved, and implemented.

To be sure, in many areas of the law such as tax,[135] regulation of weapons sales,[136]

129. Reliance on advice of counsel may preclude finding a "knowing" violation of section 32(a) of the Exchange Act, but should not prevent conviction for a willful violation.

130. One court found a prior version of the margin regulations to be incomprehensible, thereby making it a violation of due process to hold parties accountable for any breach of the regulations. *See* United States v. Van de Carr, 343 F. Supp. 993, 1015 (C.D. Cal. 1972). Notably, because the margin regulations were simplified during the 1980s, this issue has not been raised since. *See* RECHLIN, *supra* note 98, § 11:5, at 11-9 to -10. In any event, the issue should not arise for parties advised by prominent firms well-versed in corporate finance matters.

131. Proof of reliance on advice of counsel that is not clearly erroneous may prevent a prosecutor from showing that a defendant satisfied the "knowingly" requirement of section 32(a) of the Exchange Act. *See, e.g.*, United States v. Crosby, 294 F.2d 928, 942 (2d Cir. 1961).

132. *See generally* OLIVER WENDELL HOLMES, THE COMMON LAW (1881).

133. *Id.* at 47.

134. *Id.* at 48. This is the doctrine of *ignorantia legis non excusat*.

135. *See* Cheek v. United States, 498 U.S. 192, 201–04 (1991).

136. *See* Bryan v. United States, 524 U.S. 184, 191–96 (1998). In *Bryan*, the Court held that to show a willful violation of a statute that prohibited the unlicensed sale of firearms, the prosecution

and funds transfer reporting,[137] the Supreme Court has put a gloss on the term "willful" that requires a greater showing than the traditional common law standard.[138] Nevertheless, the Court continues to pay lip service to the maxim that ignorance of the law is no defense.[139] In cases that impose a higher standard for conviction (by reading a knowledge of the law, or at least illegality, to constitute an element of the crime), one can perceive a concern by the Court that ordinary citizens not be found criminally liable without a guilty state of mind.[140]

The registration requirements for margin lenders, however, show that the margin regulations do not govern conduct of everyday citizens.[141] The large-scale lenders and borrowers to whom these regulations apply can be expected to have the benefit of expert advice. The Court has stated its view that the term "willful" must be interpreted in context.[142] The context of a margin violation does not satisfy conditions under which the Court has demonstrated an inclination to be lenient. Nor does the structure of section 32(a) easily permit a lenient interpretation.[143]

Moral outrage at the conduct of Enron's directors, officers, and lawyers in setting up a so-called "accounting hedge" comes easily. At least some of the participants understood that hedges with the Raptors did not have real economic

must show that the defendant knew his conduct was unlawful but that it was not necessary to show a knowing violation of a particular licensing requirement. *Id.* at 196.

137. *See* Ratzlaf v. United States, 510 U.S. 135, 141–49 (1994).

138. *See generally Jurisprudence of Willfulness*, *supra* note 42. Professor Davies provides an expanded list of crimes in which courts have accepted the defense of "ignorance of the law," typically by specifying that the prosecution must demonstrate knowledge of the law by the defendant as one element of the crime. At least 160 additional federal statutes are identified as being at risk for similar treatment by use of this reasoning, including section 32(a). *Id.* at 414–27. What may insulate section 32(a) from this treatment is the fact that the phrase "willful" is contrasted with "willful and knowing" in the same section. *See* 15 U.S.C. § 78ff(a) (2002). To require that knowledge of the law is an element for a violation of the first part of section 32(a) requires ignoring both the later use in the same section of the phrase "willful and knowing" and the defense allowed at the end of section 32(a) permitting a defendant to avoid a prison sentence if he demonstrates that he had no knowledge of the law or regulation that was violated. *See id.* The contrast of "willful" with "knowing" virtually requires a statutory construction, without appeal to extrinsic materials, that the term "willful" be construed in such a way that ignorance of the law provides no defense for a violation. Often, the statutory construction is the other way around, attributing a higher standard of intent for willful than for knowing violations. *See generally Jurisprudence of Willfulness*, *supra* note 42. It is a cardinal rule of interpretation that the particular statute not be read to create surplus statutory language. *See, e.g.*, Conn. Nat'l Bank v. Germain, 503 U.S. 249, 253 (1992) ("[C]ourts should disfavor interpretations of statutes that render language superfluous.").

139. The reasoning of the Court is often contradictory. In *Bates v. United States*, 522 U.S. 23 (1997), the Court was asked to interpret a statute governing misappropriation of student loan funds. A criminal violation could be shown if the conduct was proved to be willful and knowing. *Id.* at 29, 32. Even with the knowledge requirement drafted into the statute, the Court held that the prosecution did not need to show a specific intent to injure or defraud the United States or any other person. *Id.* at 33.

140. Professor Davies refers to this as the "'non-nefarious' actor" problem. *Jurisprudence of Willfulness*, *supra* note 42, at 373.

141. *See supra* note 28 and accompanying text.

142. "'Willful,' this Court has recognized, is a 'word of many meanings,' and 'its construction [is] often . . . influenced by its context.'" *Ratzlaf*, 510 U.S. at 141 (quoting Spies v. United States, 317 U.S. 492, 497 (1943)).

143. *See supra* note 138.

significance but were done simply for purposes of financial reporting.[144] Perhaps the presence of central figures like Lay and Skilling at the Finance Committee meeting, where the true nature of the Raptor program was unveiled, provides a basis to distinguish between board members on the inside and outside directors on whom the imposition of criminal liability may appear problematic for competing policy reasons.

When a company, person, or group takes deliberate advantage of technical rules to paint a pseudo-picture of financial results thinking that compliance with law and rules will save them from the consequences of the false impressions created, society should have little trouble with a decision to impose a criminal penalty if technical compliance is found lacking.[145] This state of mind constitutes sufficiently "bad" intent to satisfy the judicial gloss that has been placed by some courts on the first part of section 32(a).[146]

Sympathy for Enron's legal advisors (to the extent consulted on the Raptors) should be particularly limited in this arena. If you want to stretch the legal system to its limits, there can be no other outcome when you make a mistake. Otherwise, a race to the bottom ensues as aggressive business types seek out lawyers with good hearts, fancy shingles, and either empty heads or an appetite for giving risky advice.[147] The facts, however, may reveal an elaborate attempt to circumvent the margin regulations. There should be no sympathy when such an attempt fails where, as here, the parties are damned by Enron's own public disclosures.[148] Criminal liability will remind lawyers to be wary of complex transactions with no clear economic purpose. Further, evidence suggests that imposing liability against large firms in the context of corporate representation will not chill creative and vigorous representation.[149]

144. Skilling described himself to the authors of the Powers Report as having, "no detailed understanding of the Raptor transactions (*apart from their general purpose*)." POWERS REPORT, *supra* note 16, at 169 (emphasis added). I believe that this general purpose was deception and that this mental state constitutes sufficient "bad intent" to satisfy the minimal test for willfulness articulated by some courts for imposition of section 32(a) liability. The Senate Committee had little trouble finding that the Enron Board of Directors was aware of the intent to deceive. *See generally* SENATE REPORT ON ENRON DIRECTORS, S. REP. NO. 107-10 (2002).

145. "Strict liability makes loopholing hazardous; it says, in effect, that the law will punish any misstep should a person attempt to negotiate the deliberate complexities and uncertainties of the law." *Ignorance of Law*, *supra* note 38, at 139. Others have suggested criminal liability as the way to proceed. *See, e.g.*, Alex Berenson, *A U.S. Push on Accounting Fraud*, N.Y. TIMES, Apr. 9, 2003, § C, at 1 (quoting president of the North American Securities Administartors Association).

146. *See supra* note 138 and accompanying text.

147. One technique to work around a problem is for a lawyer to give a reasoned legal opinion indicating that the matter "is not free from doubt" but, nevertheless, reaching a conclusion in accord with the client's wishes. The idea is to give the opinion recipient a clear conscience (or at least protect the client from any allegation of knowing wrongdoing) while insulating the lawyer from liability when the aggressive legal structure falls apart under scrutiny. The net effect is to create a zone of non-accountability.

148. *See* Enron Corp., Form 10-K, *supra* note 30, at note 16.

149. *See* David B. Wilkins, *Who Should Regulate Lawyers?*, 105 HARV. L. REV. 799, 870–71 (1992); *see generally* Elizabeth Chambliss & David B. Wilkins, *Promoting Effective Ethical Infrastructure in Large Law Firms: A Call for Research and Reporting*, 30 HOFSTRA L. REV. 691 (2002); David B. Wilkins, *In Defense of Law* and *Morality: Why Lawyers Should Have a Prima Facie Duty to Obey the Law*, 38

Increasingly, business lawyers have assumed the role of mere scribe whose sole purpose is to draft properly complex cash flows. These lawyers are not rewarded for considering the larger picture in which a transaction structure is situated, including any ethical issues that may arise. And yet, the lawyers on the transaction are the ones most likely to have some minimal ethical training that might be applied to a transaction.

In essence, there is a disturbing trend to ask lawyers not to practice law. Saying "yes" to a transaction is easier for those unburdened by knowledge or a sense that they are being looked to for ethical guidance. Society, however, is not well-served if lawyers who work on complex transactions assume a myopic stance, particularly at a time when confidence in the integrity of our financial and economic system is at a low point. Rather, society should want lawyers to identify the larger picture and advise clients of violations. We should prefer advice that directs clients to give grey areas a wide berth, rather than advice to walk the edge.[150]

In addition to possible fines and jail time, a further deterrent suggests itself for law firms. In what position will other clients of a law firm, who either missed a margin violation or intentionally structured a transaction that went too far, find themselves, particularly if criminal sanctions are sought?[151] The market may exact punishment against law firms that exceed any level of fines imposed for criminal violations.

We should not automatically label transaction complexity as a good thing. There is much talk about increasing the transparency of financial statements and other reporting. We need to keep in mind, however, that additional volumes of disclosure may not amount to useful information.[152] Enron's existing disclosure did contain some warning signals. The investment community, however, did not notice these red flags buried in footnotes and subtle changes to line items that began to appear as the Raptor transactions became financially unstable and required restructuring. If the imposition of criminal liability influenced a trend toward simpler financial structures, more easily capable of legal analysis, a side benefit might be more compact and cogent disclosure about simpler transactions.

Tactical benefits for prosecutors may accompany the pursuit of criminal violations. Enron purchased approximately $35 million worth of directors' and of-

WM. & MARY L. REV. 269 (1996); David B. Wilkins, *How Should We Determine Who Should Regulate Lawyers?—Managing Conflict and Context in Professional Regulation*, 65 FORDHAM L. REV. 465 (1996); Rosen, *supra* note 28; Robert Rosen, *"Proletarianizing" Lives: Researching Careers*, 33 LAW & SOC'Y REV. 703 (1999).

150. *See supra* note 37.

151. The possibility exists, of course, that facts not disclosed in the Powers Report would exonerate the law firm or firms involved. A particularly intriguing possibility is that informal advice was sought and given by the staff of the Federal Reserve Board that the Raptor transaction structure was somehow in compliance with margin regulations.

Only a detailed review of the transaction documents would reveal whether the lawyers involved missed the margin violation or engaged in an elaborate attempt to circumvent them. The Federal Reserve Board and others, however, are capable of deconstructing transactions to look at their substance. *See, e.g.*, Federal Reserve Board Staff Opinion, FRRS 5-942.12 (Dec. 14, 1982).

152. *See generally* GEORGE JOHNSON, FIRE IN THE MIND: SCIENCE, FAITH, AND THE SEARCH FOR ORDER 107–31 (1996).

ficers' (D&O) liability insurance policies.[153] Depending on the scope of exclusions found in these policies, insurers may be able to avoid payment of defense costs for criminal violations of the law.[154] Case law reveals a variety of forms of insurance policy exclusions including: violation of the Securities Exchange Act of 1934,[155] violating provisions of the criminal law,[156] dishonesty,[157] and so on.[158]

In addition to possible exclusion from coverage of defense costs, payment of criminal fines from proceeds of insurance policies will also be excluded from

153. The primary director and officer liability insurer was Associated Electric & Gas Insurance Services Limited (AEGIS), whose provided coverage amounted to approximately $35 million. Associated Electric & Gas Insurance Services Limited, Directors and Officers Liability Insurance Policy, Enron Corp. [hereinafter AEGIS Directors and Officers Liability Insurance Policy], *available at* http://news.findlaw.com/hdocs/docs/enron/dopolicypp1-33.pdf (last visited Mar. 17, 2003). The remainder of the coverage rested in reinsurance contracts, the detailed examination of which is beyond the scope of this Article. *See In re* Enron Corp., Notice of Presentment of Order Authorizing and Approving Direct Payment and/or Advancement of Defense Costs to Individual Defendants in Securities and ERISA Lawsuits Under the Debtors' Directors and Officers Liability Insurance and ERISA Fiduciary Liability Insurance Policies and Opportunity for Hearing, §§ 6–11 (Jan. 18, 2002) (listing insurance policies and amounts), *available at* 2002 WL 198010.

154. *See* Joseph P. Monteleone & Nicholas J. Conca, *Directors and Officers Indemnification and Liability Insurance: An Overview of Legal and Practical Issues*, 51 Bus. Law. 573, 600–07 (1996) (discussing policy exclusions). A detailed examination of the actual D&O policies is beyond the scope of this Article.

155. *See, e.g.*, Bendis v. Fed. Ins. Co., 958 F.2d 960, 963 (10th Cir. 1991) (holding that a policy exclusion for claims based on violation of federal securities laws also excluded coverage for common law fraud and tort claims based on the same factual predicates).

156. *See, e.g.*, Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. Brown, 787 F. Supp. 1424, 1428 (S.D. Fla. 1991) ("[National Union] shall not be liable to make any payment for Loss in connection with any claim or claims made against the Insureds: . . . (d) brought about or contributed to by the fraudulent, dishonest or criminal acts of the Insureds.") (alteration in original). In *National Union*, the issue centered on payment of ongoing defense costs prior to conviction. National Union was concerned about its ability to recoup defense costs paid if a conviction were obtained. The court ordered the funding of ongoing defense costs. *Id.* at 1434. An exclusion such as that in *National Union* would be significant in the Enron case as the criminal act of violating the margin regulations contributed to larger claims of fraud that might be alleged. *See also* Alstrin v. St. Paul Mercury Ins. Co., 179 F. Supp. 2d 376, 395–98 (D. Del. 2002) (excluding criminal or deliberate fraud).

157. *See, e.g.*, Citizens First Nat'l Bank v. Cincinnati Ins. Co., 200 F.3d 1102, 1107 (7th Cir. 2000) (finding policy exclusion for dishonest, fraudulent, criminal, or malicious acts); *cf.* Pac. Ins. Co. v. Gen. Dev. Corp., 28 F.3d 1093, 1096 (11th Cir. 1994) (discussing order directing payment of interim defense costs until fraud, dishonesty, or criminal acts are established by judgment). The *Pacific* decision arises from the alleged General Development Corporation fraud and ensuing bankruptcy that also gave rise to *National Union*. *Id.* at 1095. Criminal convictions obtained later were overturned on appeal. *See* United States v. Brown, 79 F.3d 1550, 1562 (11th Cir. 1996).

158. *See, e.g.*, Fed. Deposit Ins. Corp. v. Zaborac, 773 F. Supp. 137, 139–42 (C.D. Ill. 1991) (holding exclusion applicable to claims brought by the FDIC and other national and state regulatory agencies). Observers expect the contract coverage exclusions appearing in D&O policies to expand to deny liability for payments in cases of fraud. *See* Chad Bray, *Insurers May Tweak Execs' Fraud Coverage Amid Scandals*, Dow Jones New Service, Aug. 22, 2002.

An actual exclusion in one Enron D&O policy provided in pertinent part:

> The INSURER shall not be liable to make any payment for ULTIMATE NET LOSS arising from any CLAIM(S) made against any DIRECTOR or OFFICER: . . . (3) brought about or contributed to by the dishonest, fraudulent, criminal or malicious act or omission of such DIRECTOR or OFFICER if a final adjudication establishes that acts of active and deliberate dishonesty were committed or attempted with actual dishonest purpose and intent and were material to the cause of action so adjudicated . . . (E) for violation(s) of any responsibility, obligation or duty imposed

insurance coverage, either as a matter of contract or, more broadly, as a matter of public policy.[159] Thus, the first line of financial defense for an officer or director, namely the D&O policy, may be unavailable to lessen the financial sting of criminal fines for margin violations.[160]

A positive side of denying insurance coverage for defense costs and penalties relates to the future cost of D&O policies and their availability. Insurance companies have been raising premiums to levels two, three, and four times the rates in effect prior to the Enron scandal.[161] The amount of coverage is going down and some insurance companies either have, or are considering, exiting the business. To the extent the ultimate costs paid by insurers are lower than currently predicted, honest premium payers and their shareholders might benefit. The presence of criminal liability should also help protect any punitive damage awards from constitutional challenge.[162]

Indemnification provided by Enron itself to officers and directors should not significantly mitigate the financial pain of defense costs and penalties. The criminal acts took place prior to Enron's bankruptcy filing. Thus, the indemnification claims of officers and directors against Enron should be classified as pre-petition claims rather than post-petition administrative expenses. As pre-petition unsecured claims, indemnification claims should be paid only a small fraction of their face amounts. In effect, the directors and officers will stand in the same line and receive, at best, the same priority as other unsecured creditors harmed by the collapse of Enron. Further, if indemnification claims arise from conduct classified as criminal, the criminality might justify equitable subordination of the claims, thus placing payments to officers and directors behind payments made to other unsecured creditors.[163]

> upon fiduciaries by the Employee Retirement Income Security Act of 1974 or amendments thereto or by similar common or statutory law of the United States of America or any state or other jurisdiction therein.

AEGIS Directors and Officers Liability Insurance Policy, *supra* note 153, at 5–6. The actual intent to deceive investors by inflating earnings with accounting sleight of hand appears both fraudulent and dishonest, even if not illegal; dishonest, fraudulent, and criminal acts are three separate grounds for the exclusions, given the requisite intent. This intent to deceive, coupled with a finding of an actual criminal violation, would strengthen any attempt to rely on this exclusion.

159. *See* AEGIS Directors and Officers Liability Insurance Policy, *supra* note 153, at 5 ("The INSURER shall not be liable to make any payment for ULTIMATE NET LOSS arising from any CLAIM(S) made against any DIRECTOR or OFFICER: (A)(1) for any fines or penalties imposed in a criminal suit, action or proceeding[.]").

160. Adding to the sting, fines paid may not be deducted for federal income tax purposes. 26 U.S.C. § 162(f) (2000).

161. *See, e.g.*, Jonathan D. Glater, *From Investor Fury, a Legal Bandwagon*, N.Y. TIMES, Sept. 15, 2002, § 3, at 1.

162. *See generally* BMW of N. Am., Inc. v. Gore, 517 U.S. 559 (1996).

163. *See* Le Café Creme, Ltd. v. Le Rouxe (*In re* Le Café Creme, Ltd.), 244 B.R. 221, 235 (Bankr. S.D.N.Y. 2000) (noting that illegality is a type of inequitable conduct that justifies use of equitable subordination). Most courts have followed and applied the criteria articulated by the court in *In re Mobile Steel Co.*, 563 F.2d 692 (5th Cir. 1977), to determine if equitable subordination of an insider's claim is warranted. Under the *Mobile Steel* test, equitable subordination of a claim is warranted if there is a showing by a preponderance of the evidence that (i) the claim holder engaged in some type of inequitable conduct, (ii) which injured the creditors of the debtor or conferred an unfair advantage

Finding a violation of the margin regulations may provide a basis for challenging Enron's indemnification coverage to the officers and directors altogether. Enron's officers and directors can be expected to claim they had no actual knowledge that the Raptor transactions violated the margin regulations. Depending on the level of advice sought from counsel, they may further allege that counsel advised them that the Raptor transactions complied with law.[164] Reliance on advice of counsel provides a safe harbor of conduct justifying indemnification under applicable corporate law.[165]

One tricky thing about the margin regulations, however, is that legal opinion convention provides that a lawyer does not express an opinion on compliance with margin regulations unless she is specifically asked to address compliance with those regulations.[166] Thus, advice of a general nature given by counsel to the effect that the Raptor transactions complied with law might not be construed as advice on compliance with the margin regulations. This is important because it would destroy the statutory shield of reliance on advice of counsel. The possible gap in opinion coverage means that directors and officers may not be able to point to any legal advice on which they relied.[167] In such a case, the directors and officers

on the claimant, and (iii) equitable subordination of the claim is not inconsistent with provisions of the Bankruptcy Code. *Id.* at 700.

164. To establish good faith reliance on counsel in securities law litigation, the defendant must show (1) complete disclosure to counsel, (2) request for advice as to the legality of the contemplated transaction, (3) receipt of advice that the transaction was legal, and (4) good faith reliance on that advice. *See, e.g.*, SEC v. Goldfield Deep Mines Co., 758 F.2d 459, 467 (9th Cir. 1985) (quoting SEC v. Savoy Indus., Inc., 665 F.2d 1310, 1314 n.28 (D.C. Cir. 1981)).

165. *See, e.g.*, OR. REV. STAT. § 60.357 (2001):

> (2) In discharging the duties of a director, a director is entitled to rely on information, opinions, reports or statements including financial statements and other financial data, if prepared or presented by: . . . (b) Legal counsel, public accountants or other persons as to matters the director reasonably believes are within the person's professional or expert competence . . . .

166. *See generally* Committee on Legal Opinions, *Third-Party Legal Opinion Report, Including the Legal Opinion Accord, of the Section of Business Law, American Bar Association*, 47 BUS. LAW. 167 (1991) (including the ABA Guidelines).

> It is a basic principle of this Accord that the Opinion will deal in a direct way with any specific legal issue to be addressed. In this connection, an Opinion does not address any of the following legal issues unless the Opinion Giver has explicitly addressed the specific legal issue in the Opinion Letter: . . . (b) Federal Reserve Board margin regulations

Id. at 215. Texas permits the use of the ABA Accord. *See* DONALD W. GLAZER ET AL., GLAZER AND FITZGIBBON ON LEGAL OPINIONS: DRAFTING, INTERPRETING AND SUPPORTING CLOSING OPINIONS IN BUSINESS TRANSACTIONS app. 21 (2d ed. 2001) (reprinting the *Report of the Legal Opinions Committee Regarding Legal Opinions in Business Transaction*). It is the author's experience that even in the absence of direct incorporation by reference of the Accord in a legal opinion, the conventional understanding is that specific reference to the margin regulations would need to be made if the opinion were intended to address compliance with margin rules and regulations.

167. *Cf. Goldfield Deep Mines Co.*, 758 F.2d at 467 (noting that good faith reliance on counsel requires complete disclosure to counsel, a request for counsel's advice, receipt of advice as to legality, and reliance in good faith on that advice.). If Enron's officers and directors either failed to request the appropriate legal opinion on compliance with margin regulations or failed to receive it, reliance on counsel would not be available as a defense even in a case requiring a showing of *scienter*. If advice were received, the issue of good faith reliance would arise for those familiar with margin requirements from personal experience.

would be reduced to claiming they misunderstood the scope of the legal advice rendered. Such admissions, if asserted, reflect poorly on claims made by directors and officers that they diligently discharged their duties of care to the corporation.[168]

The pursuit of criminal violations allows society to confront a significant structural problem. Mere fines provide insufficient deterrence for extremely wealthy officers and directors. The stigma of a felony conviction, with attendant loss of certain civil rights, might add incentive. The further possibility of jail time would add even more incentive.

Lastly, approval by directors of Enron for transactions that violated the criminal law demonstrates, in a very direct way, that both directors and management provided inadequate supervision of corporate matters while simultaneously accepting high salaries, bonuses, and director fees. Criminal violations may be the last straw that convinces a judge or jury that the salaries, bonuses, and fees paid to these individuals were not paid in exchange for reasonably equivalent value.

If it can be shown that the officers and directors did not give reasonably equivalent value[169] for their salaries, bonuses, and fees, those payments may be recovered for Enron's bankruptcy estate by using the doctrine of fraudulent conveyance or fraudulent transfer.[170] The current federal statute relating to fraudulent transfer

168. It is easy to imagine how such a scope mistake might be made. Perhaps a cursory report on legal status was made at a board meeting to the effect that the "lawyers" have cleared the Raptor transactions. The finance Committee meeting indicated that only Arthur Anderson cleared the transaction. *See* Minutes, *supra* note 121, at 3. In an ideal world, a lawyer working on the transaction would have been present and board members would have inquired as to the scope of the legal investigation. Is it too much to hope that at least one of the more financially sophisticated board members, who themselves were margin borrowers, might have wondered aloud how it was that the Raptor transactions did not represent too large a borrowing supported by margin stock? Regardless of moral obligation, the directors and officers have a duty to inquire as to the facts of transactions to ensure that they are basing their decisions on the legally protected "business judgment rule." *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); *see also* Charles Elson, *What's Wrong with Executive Compensation?*, HARV. BUS. REV., Jan. 2003, at 68, 71. In fact, Chief Justice Veasey said:

> [I]f [directors or officers] are disingenuous or dishonest about it, it seems to me that the courts in some circumstances could treat their behavior as a breach of the fiduciary duty of good faith. I would urge boards of directors to demonstrate their independence, hold executive sessions, and follow governance procedures sincerely and effectively, not only as a guard against the intrusion of the federal government but as a guard against anything that might happen to them in a court . . . .

See id. at 76.

169. Under New York State fraudulent conveyance law, the standard is "fair consideration." *See* Hirsch v. Gersten (*In re* Centennial Textiles, Inc.), 220 B.R. 165, 172 (Bankr. S.D.N.Y. 1998). A transfer to an officer, director, or shareholder presumptively does not satisfy the "fair consideration" test. *See* Le Café Creme, Ltd. v. Le Roux (*In re* Le Café Creme, Ltd.), 244 B.R. 221, 240–41 (Bankr. S.D.N.Y. 2000). "[U]nder New York law, transfers from an insolvent corporation to an officer, director or major shareholder of that corporation are per se violative of the good faith requirement of DCL § 272 and the fact that the transfer may have been made for a fair equivalent is irrelevant." *Centennial Textiles*, 220 B.R. at 172; *see also* Atlanta Shipping Corp. v. Chem. Bank, 818 F.2d 240, 249 (2d Cir. 1987) ("[R]epayment of an antecedent debt constitutes fair consideration unless the transferee is an officer, director, or major shareholder of the transferor.").

170. *See* Cuthill v. Greenmark, LLC (*In re* World Vision Entm't, Inc.), 275 B.R. 641, 663 (M.D. Fla. 2002) (recovering brokerage commissions paid in ponzi scheme); Grigsby v. Carmell (*In re* Apex Auto. Warehouse, L.P.), 238 B.R. 758, 775 (Bankr. N.D. Ill. 1999) (finding that the debtor did not

has a one year statute of limitation. If section 544 of the Bankruptcy Code is used, state laws may be invoked for which the statute of limitations is substantially longer.[171] Use of the criminal law as a distinguishing feature to justify recovery of salaries, bonuses, and fees in the Enron case may provide a perverse sort of comfort for those officers and directors at other companies who may find their businesses in financial distress but have not violated the criminal law. If they did not commit a crime, they can always distinguish their situations from those of Enron's officers and directors. A similar analysis may support recovery of legal fees paid to Enron's lawyers.

PART 5: WHY TILT AT WINDMILLS?

The criminal law is a truly blunt instrument. Its application, even in a case such as Enron, might appear to be excessive hardball tactics, except for those found stealing money or deliberately falsifying records. Society needs to decide whether the trend towards increasingly complex financial transactions and a pervasive business attitude towards treating reporting obligations as a game to be played must be reversed. Just what does society think about the ethic of technical compliance? The increasing marginalization of the role of lawyers as ethical advisors in business practice is also at stake.[172] What really upsets people is that many of our business leaders, canonized in the last decade, have been exposed as morally bankrupt. This ethical deficiency is directly related to the insolvency of the companies under their care.

One way to characterize the behavior of Enron's officers, directors, and lawyers is as follows: They thought that what they were doing was legal, not that it was right.[173] At a minimum, this behavior hurt a lot of people economically.[174] In an

receive value for bonus paid to executive); *see also* Campbell v. Macartie (*In re* Factory Tire Distribs., Inc.), 64 B.R. 335, 339 (Bankr. W.D. Pa. 1986) (explaining that "[a] bonus is normally offered for an exemplary performance of one's duties" and finding that a bonus awarded to the debtor's principal shortly before a bankruptcy filing was nothing but a "raid on the corporate treasury"). *See generally* Sec. Investor Prot. Corp. v. Stratton Oakmont, Inc., 234 B.R. 293 (Bankr. S.D.N.Y. 1999) (implying that excessive salaries and bonuses may constitute fraudulent conveyances); *cf.* SEC v. Antar, 44 Fed. Appx. 548, 553–54 (3d Cir. 2002), *aff'g*, SEC v. Antar, 120 F. Supp. 2d 431 (D.N.J. 2000) (noting that fraudulent transfer and constructive trust doctrines were used to recover assets); Seth Schiesel, *Return Sought of $10 Million WorldCom Paid to Goldman*, N.Y. TIMES, Oct. 25, 2002, at C1 (reporting that recovery was sought by bankruptcy master because no services were provided).

171. In New York, where Enron has filed for bankruptcy, the statute of limitations is six years. *See Le Café Creme*, 244 B.R. at 237. Insolvency at the time of the transfer, however, still must be demonstrated. It is unlikely that Enron could be shown to have been insolvent for the entire six year period preceding its bankruptcy filing.

172. Some may feel that we have seen this movie before in the context of the savings and loan crisis. "Where were [the lawyers and] . . . [w]hy didn't any of them speak up or disassociate themselves from the[se] transactions?" Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901, 920 (D.D.C. 1990).

173. The general injunction of the law is, indeed, the opposite—to do what's right rather than what one thinks is legal. *See Ignorance of Law*, *supra* note 38, at 141.

174. Further consequences can be anticipated—the loss of pensions and jobs on such a massive scale will lead to anxiety and sleep disorders, alcohol and drug abuse, broken marriages, premature deaths, and, perhaps, a few suicides (in addition to those already reported). *Cf.* Haberman, *supra* note 39, at B1 (indicating that the Enron case caused more harm than the events of September 11, 2001). Placed in such a larger human context, the enormity of the breach of trust by officers and directors

era when traditional sources of moral guidance, such as our religious institutions, have diminished authority, two substitutes suggest themselves: the social norms of a community and the criminal law.[175] The norms of the business community, however, have evolved the ethos that, at least in certain areas of activity, anything goes (provided that it is not illegal).[176] These business norms stand exposed as devoid of independent content—a mere derivative of the positive criminal law.[177] In such a system, the criminal law assumes a pedagogical role, in addition to traditional functions of retribution, rehabilitation, deterrence, and the negation of wrong.

The lesson taught is simple—it is risky business for a community to adopt positive criminal law as its moral norm. In effect, the criminal law announces its own inadequacy as a moral teacher, directing the community to look elsewhere for ethical guidance. A person ignores this teaching at their peril. This is the real lesson of *ignorantia legis non excusat*.[178]

Using the criminal law as a tool to send messages might be criticized as treating persons as means and not ends. As Holmes observed, treating people as means and not ends in themselves is done by the state in a variety of situations (even

of Enron that was committed by approving transactions such as the Raptors is exposed in all its ugliness. The wreckage of this game of deception is human. Beyond the human cost, the damage to the market far exceeds the lost investment value represented by Enron shares. *Id.* And, the harm to the market even has adversely affected charitable giving. *See, e.g.*, Robert J. Hughes, *As Funds Fade, Symphonies Cut Their Programs*, WALL ST. J., Oct. 9, 2002, at B1.

175. It is a serious question whether application of common moral norms of goodness are sufficient. A conservative Christian viewpoint certainly would hold that common notions of morality are not enough; membership in the church is required. Interestingly, from a radical left perspective, the same conclusion is reached in which even a traditional post-Marxist endorsement of the gap between politics (understood as including law) and ethics is rejected. To resuscitate the radical position contra the liberal-democratic hegemony, a return to Leninism as the materialist analog to Christianity has been suggested. *See* SLAVOJ ŽIŽEK, ON BELIEF (Routledge 2001); *cf.* SLAVOJ ŽIŽEK, THE FRAGILE ABSOLUTE: OR, WHY IS THE CHRISTIAN LEGACY WORTH FIGHTING FOR? (2000) (explaining why the Christian legacy is worth fighting for from a Marxist perspective). *See generally* Amalia D. Kessler, *Enforcing Virtue: Social Norms and Self Interest in an Eighteenth-Century Merchant Court*, LAW & HIST. REV. (forthcoming Spring 2004) (discussing the role of shared religious values as a background to contract enforcement), *available at* http://www.press.uillinois.edu/journals/lhr/Kes22_1.pdf; ALASDAIR MACINTYRE, AFTER VIRTUE: A STUDY IN MORAL THEORY 256–63 (2d ed. 1984) (discussing difficulties in providing a secular account of morality, including analysis of Marxism).

176. A significant volume of recent legal scholarship has been devoted to examination of the role of social norms in regulating behavior. A recent symposium focused on the use of non-legally enforceable rules and standards to govern intra-firm behavior. *See generally* Edward B. Rock & Michael L. Wachter, Symposium, *Norms & Corporate Law: Introduction*, 149 U. PA. L. REV. 1607 (2001). In light of recent revelations of corporate fraud, excess, and theft, we might pause to consider whether non-legally enforceable rules and standards are up to the task. There comes a point when, perhaps, only the criminal law will do the job.

177. Such a business norm can be criticized as morally culpable, particularly when adopted by fiduciaries and agents as a standard of conduct applied to interactions with those they are charged with protecting and serving; thus, the intent to deceive stockholders by manipulating legal and accounting rules in disclosure documents reflects "bad" intent even when done under the mistaken impression that law and accounting rules have been technically satisfied. The violation of the margin regulations in the context of the Raptor transactions thus amounts to a mistake of law that reflects bad character.

178. *See generally Ignorance of Law*, *supra* note 38.

though it may not be a morally pretty sight).[179] When circumstances, however, have developed such that the only standard to judge right from wrong is by appeal to the positive criminal law, a different view emerges.

We are no longer dealing with mere technical violations of law for which moral fault cannot be assigned. A business ethos that does not appeal to a larger sense of right and wrong, but instead defines itself solely in terms of technical compliance, cannot distinguish between a *malum prohibitum* and a *malum in se*.[180] Once technical compliance becomes the only standard, the term "technical" no longer operates as a pejorative characterization, signaling that "wrong" was not really committed. In a system of "ethical minimalism," there is no choice but to govern through strict application of criminal law.[181]

Thus, the attempt to impose criminal sanctions for violations of technical laws and regulations, such as the margin regulations, has symbolic value even if the chance for conviction is deemed slight. The symbolic value assumes particular importance in a system that increasingly sends conflicting signals about the responsibility of its citizens to know the law.[182]

If we believe the maxim *ignorantia legis non excusat* continues to have value in its pedagogical message to the general public—by teaching that the positive criminal law is no substitute for a moral compass—pursuit of margin violations has value by strongly supporting the message. Tilting at windmills in highly publicized cases, such as Enron, may at least stem erosion of the vitality of the principle that "ignorance is no defense" in the mind of the public. Conversely, a failure to prosecute contributes to the decline of the maxim and more than a little cynicism. There is no middle ground.

Our system of corporate ownership and governance exists at the sufferance not only of stockholders, but also of the general populace. In light of this reality, we

179. *See* HOLMES, *supra* note 132, at 49.

180. Some have argued that the criminal law should not be used unless the violation is generally regarded as ethically reprehensible. *See, e.g.*, Sanford H. Kadish, *Some Observations on the Use of Criminal Sanctions in Enforcing Economic Regulations*, 30 U. CHI. L. REV. 423 (1962–63). These arguments have little force in the mouths of the offenders who have adopted the ethic of technical compliance.

181. The adherents of the business ethos, at least, cannot be heard to complain about the strict application of the criminal law to them without engaging in hypocrisy. Society viewing the business ethos from the outside may nevertheless subscribe to broader moral principles that are offended by the business ethos. Application of the criminal law from the broader perspective presents no difficulties because the offenders are seen as, and are in fact, blameworthy. An analogous situation confronted the United States at the dawn of the civil rights movement. When community norms of right and wrong were not sufficiently strong to end segregation, activists turned to the courts to achieve the ethical result. *See generally* Kingson, *supra* note 23, at 409 (stating that "[p]enalties beget ethics (or perhaps lack of ethics begets penalties)").

182. *See* Meir Dan-Cohen, *Decision Rules and Conduct Rules: On Acoustic Separation in Criminal Law*, 97 HARV. L. REV. 625, 645–48 (1984). Professor Dan-Cohen has argued that the public still believes in the maxim that ignorance of the law is no defense, despite evidence in multiple judicial decisions to the contrary. *Id.* at 645–46. This process results from selective transmission of information. *Id.* at 635, 646. In a well-publicized case like Enron, the "acoustic separation" breaks down when the general public is taught that ignorance of the law is, in fact, a defense. Prosecution of officers and directors in Enron for the margin violations would contribute to the general acoustic separation, rather than being in the vanguard of its destruction.

should recognize the significance of the choice presented to prosecutors by Enron's financial engineering and the related technical violations of positive law.[183] The decline in business and legal ethics in our large corporations, if unchecked, may signal the beginning of the end of actual capitalist markets, not merely its theoretical death.[184]

The Enron case, more than other recent well-publicized cases of fraud, illustrates the general structure of a crisis in capitalism because of the direct involvement of the board of directors and lawyers in approval and structuring of criminal acts. Some apparently upstanding citizens did a poor job of managing and advising a corporation, causing massive harm on a variety of fronts, while seduced by the siren of technical compliance. They lost sight of the fact that fiduciaries must ask what is right and wrong and not merely what is legal. Even if the Raptor transactions had been legal, it is doubtful whether any member of the Enron board of directors would claim today that these deals were, at their inception, appropriate for shareholders or other constituencies. Indeed, one would expect that many are ashamed.

The structure of this present crisis does suggest a way forward. In crafting rules governing conduct and mandating disclosure, the better course is to employ general principles rather than to draft rules of a technical and complex nature.[185] Compliance with technical rules has an insidious tendency to replace more general notions of right and wrong. In contrast, general rules and principles constantly challenge those seeking to comply to look to themselves for guidance when making difficult decisions rather than finding refuge in a technical safe harbor. If it is not possible for a person to "forget" what is right and wrong, we nevertheless would do well to enact regulatory structures that do not distract persons from this useful form of introspection.

183. The fact of white-collar crime, including failure to prosecute or incarcerate, provides ammunition for a Marxist style critique of capitalist economic, political, and social structures. When the antisocial, indeed criminal, behavior of the upper class goes unpunished it supports the view that the criminal law and justice system, in function and use, are tools of the privileged classes to maintain economic advantages through exploitation. *See* Lejins, *supra* note 17. The triumph of capitalism has been so loudly and widely acclaimed, *see generally* HERNANDO DE SOTTO, THE MYSTERY OF CAPITAL: WHY CAPITALISM TRIUMPHS IN THE WEST AND FAILS EVERYWHERE ELSE (2000), that critical perspectives have appeared in retreat as of late. Widespread public disgust with business and legal ethos, however, suggest dry rot within the capitalist structure that, if unchecked, may yet prove its downfall. In other words, Marxism delayed is not the same as Marxism denied. The challenge for a capitalist market system is to demonstrate that it is not purely pathological, in a Kantian sense, but can contain an ethical dimension. *See generally* ALENKA ZUPANČIČ, ETHICS OF THE REAL: KANT, LACAN 8 (2000) (discussing the structurally determined "missed encounter" between the pleasure principle and the dimension of the ethical).

184. For an account of the logical end of the market, see Jeanne L. Schroeder, *The End of the Market: A Psychoanalysis of Law and Economics*, 112 HARV. L. REV. 483 (1998).

185. A principles-based approach to disclosure is being considered as a remedy to improve accounting standards. *See* Floyd Norris, *Market Place; New Set of Rules Is in the Works for Accounting*, N.Y. TIMES, Oct. 22, 2002, at C1.