

**ACCOUNTABILITY ISSUES: LESSONS LEARNED
FROM ENRON'S FALL**

HEARING

BEFORE THE

COMMITTEE ON THE JUDICIARY

UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

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FEBRUARY 6, 2002

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CONTENTS

STATEMENTS OF COMMITTEE MEMBERS

	Page
Cantwell, Hon. Maria, a U.S. Senator from the State of California	64
Feingold, Hon. Russell D., a U.S. Senator from the State of Wisconsin	65
Feinstein, Hon. Dianne, a U.S. Senator from the State of California	57
Grassley, Hon. Charles E., a U.S. Senator from the State of Iowa	66
Hatch, Hon. Orrin G., a U.S. Senator from the State of Utah	7
Kohl, Hon. Herb, a U.S. Senator from the State of Wisconsin	67
Kyl, Hon. Jon, a U.S. Senator from the State of Arizona	68
Leahy, Hon. Patrick J., a U.S. Senator from the State of Vermont	1
Sessions, Hon. Jeff, a U.S. Senator from the State of Alabama	72
Thurmond, Hon. Strom, a U.S. Senator from the State of South Carolina	73

WITNESSES

Gregoire, Hon. Christine, Attorney General, State of Washington, Olympia, Washington	13
Koniak, Susan P., Professor of Law, Boston University School of Law, Boston, Massachusetts	35
Lund, Nelson, Professor of Law, George Mason University School of Law, Arlington, Virginia	30
Raynor, Bruce, President, Union of Needletrades, Industrial and Textile Em- ployees, American Federation of Labor and Congress of Industrial Organi- zations, New York, New York	17
Schatz, Steven M., Esq., Senior Partner, Wilson, Sonsini, Goodrich and Rosati Professional Corporation, Palo Alto, California	24

SUBMISSIONS FOR THE RECORD

Department of Justice, Lauren Pfeifle, Washington, D.C., statement	65
Retirement Systems of Alabama, David G. Bronner, Chief Executive Officer, Montgomery, Alabama, letter	69
Schwarcz, Steven L., Professor of Law, Duke University School of Law, Dur- ham, North Carolina, letter and attachment	70

ACCOUNTABILITY ISSUES: LESSONS LEARNED FROM ENRON'S FALL

WEDNESDAY, FEBRUARY 6, 2002

U.S. SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The committee met, pursuant to notice, at 10:03 a.m., in room SD-226, Dirksen Senate Office Building, Hon. Patrick Leahy, Chairman of the Committee, presiding.

Present: Senators Leahy, Kennedy, Kohl, Feinstein, Feingold, Schumer, Durbin, Cantwell, Edwards, Hatch, Specter, and Brownback.

OPENING STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM THE STATE OF VERMONT

Chairman LEAHY. Good morning. I have been advised that Senator Hatch is on his way and he has no objection if we begin, as we will be having votes this morning and I thought we should. We have a distinguished panel here and I do not want to hold them longer than necessary.

On November 8, as we all know, Enron announced that it had overstated earnings over the past 4 years by \$586 million and they were responsible for \$3 billion in obligations that were never reported to the public of a dollar here and a dollar there. Upon these disclosures, Enron stock fell to \$8.41 a share from a figure many times that before. Then a month later, they filed for bankruptcy. It is the largest corporate bankruptcy in our nation's history.

The worst part is it left thousands of Enron investors holding virtually worthless stock and most Enron employees lost out—most. Some did not. Those who profited seem to be the senior officers and directors who cashed out while assuring others that Enron was a solid investment, as well as the professionals from accounting firms, law firms, and business consulting firms who were paid millions of dollars to advise Enron on the practices that bankrupted their company.

Now, how did this happen? It appears that Enron, with the approval and advice of its accountants, auditors, and lawyers, used thousands of off-the-book entities to overstate corporate profits, understate corporate debts, and inflate Enron's stock prices. Some Enron executives ran these entities and they reaped millions of dollars in salaries and stock options and we see conflict of interest waivers from a quiescent Enron Board of Directors.

With the help of these professionals, both inside and outside of Enron, the company wove an elaborate web of corporate deceit. I

want to just show you on this chart. These are just a few of the secret Enron entities used to hide debt, to fake profits, and to inflate stocks. Actually, being fanciful was not limited just to their bookkeeping. Some of the same corporate imagination was unleashed in naming these hidden Enron entities.

Look at some of the names—Kenobi, Mojave, Chewco, Condor, Jedi. Whoever was naming them has probably been to a few too many movies. And, of course, some are named, perhaps the most aptly of all, after the Wild West—Rawhide, Ponderosa, Cactus, Mojave, Sundance.

Now, they had different names in all of these but they all had one thing in common. They were never honestly disclosed to the investing public, and much about these partnerships is still secret, including who participated in them and who benefited from these corporate manipulations.

Enron's web of deceit caught more than just its employees. In addition to thousands of Enron employees losing their life savings in the company's 401(k) pension plan, many other investors suffered losses because of the sudden collapse. Across the nation, pension funds for union members, teachers, government employees, policemen, firemen, and others lost more than \$1.5 billion from investments in Enron stock. State attorneys general, individual investors, and Enron employees have filed private class action lawsuits against Enron executives, Arthur Andersen, and others for security fraud. The Department of Justice and the FCC are also investigating.

Enron's web ensnared our financial market. Last week and again this week, the Dow Jones index fell hundreds of points. Why? Among other reasons, doubts emerged about the trustworthiness of balance sheets for other public companies. With more than half of Americans' households invested in the stock market today, the integrity of our financial markets is critical to our nation's economy.

During his State of the Union Address, President Bush declared that "corporate America must be made more accountable to employees and shareholders and held to the highest standards of conduct." I agree with the President and I hope that this hearing and our work in the committee and the Senate will help bring about that accountability.

Enron Chairman Kenneth Lay was questioned about the use of off-the-book arrangements during a company e-mail chat on September 26 of last year. He assured Enron employees that he and Enron's Board of Directors "were convinced both by all of our internal officers as well as our external auditor and counsel that these off-the-book arrangements were legal and totally appropriate."

Mr. Lay's accountability remains to be seen. Having said for weeks that he would testify before the Senate, of course, he abruptly canceled his appearance before he did testify before the Senate. Except for his part in a carefully orchestrated media campaign, he is not talking. No one has been able to get him to answer questions that test the accuracy of his statements from last fall, just before the fall of Enron. Nor have Mr. Skilling or Mr. Fastow or several others testified. And one who might have tragically committed suicide.

What we do know is that the actions of Enron's professional advisors raise serious ethical questions for the legal and accounting professions. They also raise questions of professional accountability. The actions of Enron and its advisors raise serious questions about the current legal environment, where auditors and outside counsel enjoy special legal protections passed by the Congress in the 1990's. and we have to ask whether this legal environment serves to encourage lax corporate governance and questionable accounting and undisciplined legal practice.

Then we had a five-to-four majority decision of the U.S. Supreme Court that gave accountants and lawyers a really big break from liability and private securities fraud actions. Chief Justice Rehnquist and Justices Scalia, Thomas, Kennedy, and O'Connor overturned what had been decades of well-settled law that allowed private fraud suits against a person, such as an auditor or attorney, who aids and abets the principal in accomplishing the fraud.

Aiding and abetting liability is especially important in securities cases. It provides incentives for accountants and lawyers to police corporate fraud. It helps overcome the profit incentive that can otherwise motivate complicity in questionable conduct.

Second, as the Enron experience shows all too well, securities fraud schemes are often very complex. They need experts, they need professionals to carry out these schemes. Instead of setting up huge financial incentives for these experts to assist in structuring corporate fraud, our laws should enlist the assistance of these professionals as guardians of the honesty of our corporate financial disclosures. Those who invest expect them to be honest in what they do. They should be helping stop fraud before it causes harm to the public and also before it undercuts the public confidence in the transparency and honesty of the market.

The Supreme Court was not alone in chipping away legal protection for investors and creating an environment in which creative accounting can morph into off-the-books maneuvering. In 1995, Congress passed the Private Securities Litigation Reform Act. President Clinton vetoed it. We overrode the veto. This version of reform contributed to the loss of professional discipline and enacted restrictions making it more difficult for victims to recover.

I recall that Senator Specter and I, along with some other members of the committee, voted against the Private Securities Litigation Reform Act when it was on the floor. We warned that its special legal protections might lead to future financial scandals. Well, beginning with Enron, the chickens have come home to roost.

No matter whether a Member of Congress voted for or against the Private Securities Litigation Reform Act, no Member of Congress, Republican or Democratic, intended for it to be used to promote corporate greed. We cannot legislate against greed, but we can and should do what is possible to prevent greed from prevailing.

In fact, the accounting industry liked the special legal protections in the Private Securities Litigation Reform Act so much that Arthur Andersen Worldwide made a trophy out of this conference report that they apparently have used in this. They shrunk it and encased it in plastic. Well, the law also shrunk the rights and protections of American investors. I could not help but think in looking

at it, there is one thing that you cannot do with it. You cannot shred it.

[Laughter.]

Chairman LEAHY. Now, there were contributions to this disaster, they are large, they are small, from the corporate officers and directors whose actions led to Enron's failure, from the well-paid professionals who helped create and carry out the corporate ruse, the regulators who did not protect the public, from the courts, from Congress, and others. So we have to make sure it does not happen again.

The worst part about this travesty would be if we do not learn from it and if we walk away. We were reminded during the savings and loan failures of the 1980's, if you do not have discipline and professionalism and an effective legal structure and accountability, greed does run rampant. Unfortunately, business failures during a permissive era rarely happen in isolation.

So Congress can do more and we should. When we forced through special exemptions for securities fraud, accountants and others made Congress a contributor to the Wild West mentality that came to be reflected in Enron's hidden partnerships. That was not what was intended and Congress should rethink and reform our laws in the other direction, so we prevent corporate deceit, we protect investors, get confidence back in our capital markets.

I will comment briefly on the relevance of the Enron bankruptcy to bankruptcy reform legislation that is now in conference between the House and the Senate. I recently received a letter from 35 law school professors regarding Section 912 of both the House-passed and Senate-passed bankruptcy reform bills. It amends the Bankruptcy Code to provide a safe harbor from bankruptcy court review for certain asset-backed securities. It is sort of a type of off-the-books financial transaction. Well, the experts tell me that the provision would encourage more companies to recast liability so they no longer appear on balance sheets. They said that would be to the detriment of the investing public and other creditors of the business. So I have asked the Department of Justice for its views on this controversial provision in light of the Enron matter so that we can get it right before the bill comes out of conference.

I am also concerned that Enron executives who made millions of dollars in sweetheart corporate deals could abuse Texas's unlimited bankruptcy homestead exemption by shielding unjust enrichment from defrauded investors by just putting it in multi-million-dollar estates. Last week on national television, the wife of Enron's former chairman disclosed that her husband is considering filing for bankruptcy protection. Under Texas law, there is no limit to the amount of money they could plow into a personal residence. I think that we have to enact a nationwide cap on homestead exemptions like the one that Senator Kohl and Senator Feinstein authored in the Senate-passed bankruptcy reform bill.

This is on our doorsteps. Our job is to make sure there are adequate doses of accountability in our legal system to stop this from happening in the future.

I look forward to the panel after we have heard from our distinguished ranking Republican member, Senator Hatch.

[The prepared statement of Senator Leahy follows.]

STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM THE STATE OF VERMONT

On November 8, Enron announced that it had overstated earnings over the past four years by \$586 million and was responsible for \$3 billion in obligations that were never reported to the public. Upon these disclosures, Enron stock fell to \$8.41 a share. Less than a month later Enron filed for bankruptcy—the largest corporate bankruptcy ever. Enron's sudden collapse left thousands of Enron investors holding virtually worthless stock, and most Enron employees lost out. Those who profited appear to be the senior officers and directors who cashed out while assuring others that Enron was a solid investment, as well as the professionals from accounting firms, law firms and business consulting firms, who were paid millions to advise Enron on these practices.

How did this happen?

It appears that Enron, with the approval and advice of its accountants, auditors and lawyers, used thousands of off-the-book entities to overstate corporate profits, understate corporate debts and inflate Enron's stock price. Some Enron executives ran these entities, reaped millions of dollars in salary and stock options, and received conflict-of-interest waivers from Enron's Board of Directors.

With the help of these professionals, both inside and outside of Enron, the company wove an elaborate web of corporate deceit. This chart shows just a few of the secret Enron entities used to hide debt, to fake profits and to inflate stocks. Being fanciful was not limited to bookkeeping. Some of this same corporate imagination was unleashed in naming these hidden Enron entities. Some were named after Star Wars films characters—Jedi, Obi-One, Kenobi and Chewco (as in Chewbacca). Some were named after birds and fish—Condor, Egret, Peregrine, Blue Heron, Osprey, Dolphin and Marlin. And some were named, perhaps the most aptly of all, after the Wild West—Rawhide, Ponderosa, Cactus, Mojave and Sundance.

Despite their different names, all these Enron-related entities had one thing in common: They were never honestly disclosed to the investing public. Much about these partnerships is still secret, including who participated in them and who benefited from these corporate manipulations.

Enron's web of deceit caught more than just its employees. In addition to thousands of Enron employees losing their life savings in the company's 401(k) pension plan, many other investors suffered losses because of sudden collapse of Enron's stock price. Across the nation, pension funds for union members, teachers, government employees and other workers lost more than \$1.5 billion from investments in Enron stock. State attorneys general, individual investors and Enron employees have filed private class action lawsuits against Enron executives, Arthur Andersen and others for securities fraud to recover their losses. The Department of Justice and the SEC are also investigating.

Enron's web has also ensnared our financial markets. Last week and again this week, the Dow Jones index fell hundreds of points as doubts emerged about the trustworthiness of balance sheets for other public companies that may have dabbled in creative financing similar to Enron's. With more than half of Americans' households invested in the stock market today, the integrity of our financial markets is critical to the nation's economy.

During his State of the Union Address, President Bush declared that "corporate America must be made more accountable to employees and shareholders and held to the highest standards of conduct." I agree with the President and hope that this hearing and our work in this Committee and in the Senate can contribute to increasing accountability.

Enron Chairman Kenneth Lay was questioned about the use of off-the-book arrangements during a company e-mail chat on September 26, 2001, and he assured Enron employees that he and Enron's Board of Directors "were convinced both by all of our internal officers as well as our external auditor and counsel that they [the off-the-book arrangements] were legal and totally appropriate."

Mr. Lay's accountability remains to be seen. Having said for weeks that he would testify before the Senate, he abruptly cancelled his appearance on Monday. Except for his part in a carefully orchestrated media campaign, he is not talking. No one has been able to get him to answer questions that test the accuracy of his statements from last fall, just before the fall of Enron. Nor have Mr. Skilling or Mr. Fastow, or several others, yet testified. Tragically, one senior Enron executive has apparently taken his own life.

What we do know is that the actions of Enron's professional advisors raise serious ethical questions for the legal and accounting professions and questions of professional accountability.

The actions of Enron and its advisors also raise serious questions about the current legal environment—where auditors and outside counsel enjoy special legal protections forced through Congress in the 1990s. Whether this legal environment serves to encourage lax corporate governance, questionable accounting and undisciplined legal practices is among the questions we explore today.

A 5 to 4 majority decision of the United States Supreme Court gave accountants and lawyers a big break from liability in private securities fraud actions in 1994. Chief Justice Rehnquist and Justices Scalia, Thomas, Kennedy and O'Connor overturned decades of well-settled law that allowed private fraud suits against a person, such as an auditor or attorney, who aids and abets the principal in accomplishing the fraud.

Aiding and abetting liability is especially important in securities fraud cases. First, it provides incentives for accountants and lawyers to police corporate fraud and helps overcome the profit incentive that can otherwise motivate complicity in questionable conduct. Second, as the Enron experience shows all too well, securities fraud schemes are often very complex. The assistance of experts and professionals is necessary to carry out fraud in complicated schemes. Instead of setting up huge financial incentives for these experts to assist in structuring corporate fraud, our laws must enlist the assistance of these professionals as guardians of the honesty of our corporate financial disclosures. They should be helping stop fraud before it causes harm to the public and undercuts public confidence in the transparency and honesty of our markets.

The Supreme Court was not alone in chipping away at legal protection for investors and creating an environment in which creative accounting can morph into off-the-books maneuvering that is destroying pensions and savings and threatens to cut the heart out of investor confidence. In 1995, Congress passed the Private Securities Litigation Reform Act—over President Clinton's veto. This version of "reform" contributed to the loss of professional discipline and enacted restrictions making it more difficult for the victims of securities fraud to bring civil actions and recover their losses.

This legislation prevents a defrauded investor from using the Racketeer-Influenced and Corrupt Organizations Act (RICO) and its remedies in almost all securities fraud cases. Securities fraud is the only exemption to our civil RICO laws. I recall that Senator Specter and I, along with other members of the committee, voted against the Private Securities Litigation Reform Act when it was on the floor of the Senate and warned that its special legal protections might lead to future financial scandals. Beginning with Enron, the chickens have come home to roost.

In fact, the accounting industry liked the special legal protections in the Private Securities Litigation Reform Act so much that Andersen Worldwide made a trophy out of the conference report by shrinking it and encasing it in plastic. What the law did was shrink the rights and protections of American investors. Well, at least you can't shred it.

There were contributions to this disaster, large and small, from the corporate officers and directors whose actions led to Enron's failure, from the well-paid professionals who helped create and carry out the complicated corporate ruse when they should have been raising concerns, from the regulators who did not protect the public and our public markets, from Congress and from the courts. Now we must contribute to making the Enron situation right and making sure that this does not happen again. This travesty will be compounded if we do not now learn from it and try to prevent it from happening again. Unfortunately, as we were reminded again during the savings and loan failures of the 1980s, without discipline, professionalism, an effective legal structure, and accountability, greed can run rampant, with devastating results. And unfortunately, business failures during a permissive era rarely happen in isolation.

Congress can do more to make sure that our laws help deter corporate fraud and we should help defrauded investors to recoup their losses. In fact, by forcing through special exemptions for securities fraud, accountants and others made Congress a contributor to the Wild West mentality that came to be reflected in Enron's hidden partnerships. The time has come for Congress to re-think and reform our laws in the other direction in order to prevent corporate deceit, to protect investors and to restore full confidence in the capital markets.

I should also comment briefly on the relevance of the Enron bankruptcy to bankruptcy reform legislation that is now in conference between the House and Senate. I recently received a letter from 35 law school professors regarding Section 912 of both the House-passed and Senate-passed bankruptcy reform bills. This section amends the Bankruptcy Code to provide a safe harbor from bankruptcy court review for certain asset-backed securitizations—a type of complex, off-the-books financial transaction. These bankruptcy experts believe that the provision "would encourage

more companies to recast liabilities so that they no longer appear on balance sheets, much to the detriment of the investing public and other creditors of the business." I have asked the Department of Justice for its views on this controversial provision in light of the Enron matter and intend to work with the other conferees to get this matter right.

I am also concerned that Enron executives who made millions of dollars in sweetheart corporate deals could abuse Texas's unlimited bankruptcy homestead exemption by shielding any unjust enrichment from defrauded investors. Last week on national television, the wife of Enron's former Chairman and former CEO, disclosed that her husband is considering filing for bankruptcy protection. Under Texas law there are no limits on the dollar amount that debtors may plow in their personal residences and then shield from creditors in bankruptcy. The Enron demise underscores the need for Congress to enact a nationwide cap on homestead exemptions, such as the cap that Senator Kohl and Senator Feinstein authored in the Senate-passed bankruptcy reform bill.

Accountability and transparency help our markets work as they should, in ways that benefit investors, employees, consumers and our national economy. The Enron experience has arrived on our doorstep, and our job is to make sure that there are adequate doses of accountability in our legal system to prevent such debacles in the future, and to offer a constructive remedy if there are not.

I look forward to the comments and questions of the Senators participating today and to hearing from our panel of witnesses. I will introduce them after we hear from our distinguished Ranking Republican Member, Senator Hatch.

**STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM
THE STATE OF UTAH**

Senator HATCH. Thank you, Mr. Chairman. I want to first commend you for calling this important hearing on the lessons we can learn from the Enron collapse. I appreciate the willingness of all of our witnesses here today to testify on such short notice and I look forward to hearing all of your testimony. It is important. I would especially like to thank Washington State Attorney General Christine Gregoire for making the trip here to the other Washington to talk about the States' pension plan lawsuits. We are all concerned and feel for the many hard-working people who lost their pensions and their hard-earned savings.

Mr. Chairman, we all know about the unbelievable chain of events that led so many innocent Enron investors to lose so much so very quickly. Enron's highest trading point was \$90. Today, it is worth about 26 cents. Injured parties include pension funds that lost hundreds of millions of dollars, Enron employees, who lost virtually the entire value of their 401(k) plans, and individual investors, both large and small, who have suffered losses that may include many people's life savings.

These are not just personal tragedies. This is a failure of the transparent system meant to protect investors in our securities market, and, of course, it is a national shame. I am glad that we are here today to learn about the lawsuits being filed against Enron, the business and ethical conflicts that got us where we are today, and suggested reforms to make the system work better in the future. No investor should ever lose confidence in our securities market and no American should ever have to fear for the safety of his or her retirement savings programs.

As several witnesses will testify here today, in 1995, Congress overwhelmingly passed the bipartisan Private Securities Litigation Reform Act, overriding a Presidential veto. This law was meant to reform securities class action practices and to abate the epidemic of so-called "strike suits" that were plaguing American businesses,

particularly in the nascent high-tech industry. For instance, I have been led to believe by one 1995 estimate that a majority of Silicon Valley firms have been sued by plaintiffs' lawyers in class action lawsuits, and one in every eight companies on the New York Stock Exchange was being sued for securities fraud every 5 years. Whether that is right or wrong, we will have to try and determine that.

But that law was meant to reform securities class action practices and to abate the epidemic of so-called strike suits that were plaguing American businesses, particularly in the high-tech industry. Now, in these suits, nominal shareholders and/or professional plaintiffs and their lawyers were holding American corporations hostage with causes of action based on non-performance of publicly traded stock. Every time the stock price would go down or an earnings report was off, lawyers would line up on the courthouse steps to allege securities fraud on the part of the corporation or its advisors. Ultimately, these class actions were not only damaging to the businesses that would get tied up in meritless suits, but also to American consumers who were losing the benefits of innovations that had to be put on hold while managers and directors were otherwise engaged in directing against frivolous lawsuits or litigation.

The provision of the Private Securities Litigation Reform Act that is most squarely under the jurisdiction of the Judiciary Committee is the exemption for securities fraud under the civil provisions of the Racketeer and Corrupt Organizations Act, or RICO. In 1995, the Securities and Exchange Commission vigorously supported the inclusion of this provision in the PSLRA and the former chairman, President Clinton's appointee, Arthur Levitt, was one of its most vocal proponents. Chairman Levitt testified before Congress that, "because securities laws generally provide adequate remedies for those injured by securities fraud, it is both unnecessary and unfair to expose defendants in securities cases to the threat of treble damages and other extraordinary remedies provided by RICO."

It is important to note, especially in light of the ongoing criminal investigation of Enron, that this provision does not exempt any person from being criminally convicted under the RICO statute in connection with securities fraud.

Legislation has recently been introduced in the House and may also be introduced here in the Senate that would remove the civil RICO exemption for securities fraud. It is my hope that we will give such legislation measured and careful consideration while studying the lessons learned from Enron. The PSLRA was designed to weed out frivolous lawsuits, not to prevent legitimate claims, like the ones represented here today, from being prosecuted. I look forward to hearing testimony from the witnesses on this matter.

I also look forward to hearing from the witnesses about the ethical questions that have been raised regarding the conduct of the attorneys who set up the Enron deals and the analysts rating Enron stock. In particular, I would like to know where the lawyers were when Andersen and Enron started shredding documents. Why would any attorney allow or even encourage a client to commit possible obstruction of justice in the face of civil lawsuits and criminal investigations? Now, maybe it was not. I do not know. We will have to hear, and we have to keep an open mind on these matters to

make sure that we do not just jump all over people because of appearance irregularities. I am not just talking about the law firms involved, however, but also the in-house counsels who are held to the same ethical standards as every other member of the bar.

The final aspect of the Enron debate that I would like to address here today involves the proper and appropriate, and I should add constitutional, oversight role of Congress. Of course, I am referring to the General Accounting Office's threatened lawsuit against Vice President Cheney. As I have often said elsewhere, I strongly believe that the GAO's original efforts to impose disclosure of White House policy discussions and meetings raise serious constitutional and privacy concerns. From a policy standpoint, I believe that the powers asserted by the GAO in initially seeking specific details of the meetings attended by the Vice President deserve our attention.

From a constitutional perspective, I strongly feel that the GAO's interpretation of its investigative powers raises substantial separation of powers questions. I have looked carefully at the legal arguments on both sides of this issue and have real concerns regarding the GAO's novel case and look forward to hearing whether the exercise of such powers by the GAO can be reconciled with the basic constitutional principles that underlie the doctrine of separation of powers.

I would like to just take a minute to comment on the asset-backed securitization provisions in the bankruptcy bill. Let me say, when I first heard of the concerns raised in light of the Enron debacle, I did want to examine the policy implications of the provision in the bankruptcy reform bill, and after reviewing it, I must say that the provision would, to some extent, act counter to the goal of the bankrupt corporation's rehabilitation in bankruptcy.

But it is important to recognize that in this instance, the enrichment of the corporate debtor's estate to pay off creditors may not be the greater good. For example, the proceeds of an asset-backed securitization could allow sufficient liquidity to help a company avoid bankruptcy altogether. It would provide for greater certainty in the financial markets, as well. At the very least, such securitization could well provide essential funds to help the corporate debtor to stave off an accelerated bankruptcy filing, a much preferred outcome for both employees and shareholders.

Also, I should caution that the reforms of Section 912 should be viewed in perspective. Most companies that engage in securitization transactions do not end up in bankruptcy, nor do they engage in the alleged fraudulent acts we have been reading about with regard to Enron's dealings, assuming the accounts are true, and I do not assume that. I just have noticed them.

Moreover, Section 912, which, as my colleagues may know, is limited to securitization transactions and would not encourage the kinds of abuses that occurred in Enron. Those problems reportedly were caused by Enron's manipulative use of special purpose entities capitalized by Enron stock in order to, A) sell assets at inflated profits, enabling Enron to recognize the inflated profit for financial statement purposes and, B) sell assets that would be falling in value in order to book the sale proceeds and avoid having to later write down asset value. These are accounting, not bankruptcy law, failures.

Finally, I should also note, and I would be happy to listen to any of our witnesses respond to my comments, that under our Federal securities laws, a company originating a securitization transaction is prohibited from capitalizing the special purpose vehicle, or SPV, a trust that is set up to enable the transaction with company stock, or pension funds.

Contrary to some of the accusations of observers, most, if not all of whom have been part of the vocal minority of opponents to meaningful bankruptcy reform, I do not believe that Section 912 of the reform legislation, which has passed both houses of Congress, I might add, overwhelmingly, could cause Enron-style abuses.

I would also like to comment on the concerns raised with respect to the now-famous homestead issue in the bankruptcy reform bill. Mr. Raynor will make a point in his testimony about the homestead exemptions in place in both Texas and Florida under those States' constitutions. I should also like to note and thank Senator Kohl and others who have been true and genuine leaders on addressing this issue in the bankruptcy reform legislation. Senator Kohl has not tried to use this, as some others have, to derail needed reforms and has been very open to compromise or compromises that address the underlying problem.

I agree that it is an injustice that rich debtors conceal their assets from creditors in large homesteads in these and a few other States. I do not think anyone would disagree with that, especially now. However, it is important to know the real fact that either of the House and Senate bills, which are now in conference, would address the homestead issue quite effectively and would squarely address Mr. Raynor's concerns.

As we know, the Senate bill contains a flat \$125,000 cap on the homestead exemption any debtor can claim when filing for Chapter 7 bankruptcy. The House bill contains a \$100,000 cap on the homestead exemption a debtor may claim when filing for Chapter 7 bankruptcy on property acquired in the 2-years preceding the filing. The House bill also contains an additional 7-year look-back for fraud or abuse. In any case where such fraud or abuse is found, the homestead exemption would not apply. Thus, a fraudulently rich Enron executive cannot shield such assets unless he or she has been really planning for both the debacle and to use bankruptcy for more than 7 years. That, I do not think, has ever been alleged by anyone and would be pretty remarkable.

I should also say that the House language is the bipartisan compromise reached during last year's conference report, which passed overwhelmingly last year with veto-proof margins. I think the goal of the reformers, particularly with respect to the homestead cap, is to prevent forum shopping and abuse, and both the House and Senate provisions would do just that.

Additionally, the means test reforms in the bill, these have a profound effect on the availability of the homestead exemption in every State. Under the means test, above-average-income debtors will most likely be placed in Chapter 13, where they will have to come up with a payment plan, not liquidate. In fact, if last year's compromise had been enacted into law and not vetoed by President Clinton, we would not be sitting here today worrying about whether or not Enron executives are hiding assets in their homes as we

speak. I think this calls for us to complete our work on the bankruptcy reform conference committee and get the bill to President Bush for his signature. That way, we will not have to talk again with the 20/20 hindsight when and if the next Enron occurs, if that is the case.

Again, I want to thank the chairman for calling this hearing. I look forward to hearing the witnesses and I appreciate the efforts that you have all put forth in being here today. Thank you, Mr. Chairman.

[The prepared statement of Senator Hatch follows.]

STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM THE STATE OF UTAH

I want to first commend you for calling this important hearing on the lessons we can learn from the Enron collapse. I appreciate the willingness of all the witnesses to testify on such short notice and I look forward to hearing all of your testimony. I would especially like to thank Washington State Attorney General Gregoire [Greg-waar] for making the trip here to the other Washington to talk about the States' pension plan lawsuits. We are all concerned and feel for the many hard-working people who lost their pensions and hard-earned savings.

Mr. Chairman, we all know about the unbelievable chain of events that led so many innocent Enron investors to lose so much so very quickly. Enron's highest trading point was \$90; today, it is worth about 26 cents. Injured parties include pension funds that lost hundreds of millions of dollars, Enron employees who lost virtually the entire value of their 401Ks, and individual investors, both large and small, who have suffered losses that may include many peoples' life savings. These are not just personal tragedies; this failure of the "transparent system" meant to protect investors in our securities market is a national shame. I am glad we are here today to learn about the lawsuits being filed against Enron, the business and ethical conflicts that got us where we are today and suggested reforms to make the system work better in the future. No investor should ever lose confidence in our securities market, and no American should ever have to fear for the safety of his or her retirement savings.

As several witnesses will testify here today, in 1995 Congress overwhelmingly passed the bi-partisan "Private Securities Litigation Reform Act," overriding a presidential veto. This law was meant to reform securities class action practices and to abate the epidemic of so-called "strike suits" that were plaguing American businesses, particularly in the nascent high-tech industry. In these suits, nominal shareholders and/or "professional plaintiffs" and their lawyers were holding American corporations hostage with causes of action based on the non-performance of publically traded stock. Every time a stock price would go down or an earnings report was off, lawyers would line up on the court house steps to allege securities fraud on the part of the corporation or its advisors. Ultimately, these class actions were not only damaging to the businesses that would get tied up in meritless suits, but also to American consumers who were losing the benefits of innovations that had to be put on hold while managers and directors were otherwise engaged in defending against frivolous litigation.

The provision of the Private Securities Litigation Reform Act that is most squarely under the jurisdiction of the Judiciary Committee is the exemption for securities fraud under the civil provisions of the Racketeer and Corrupt Organizations Act (RICO). In 1995, The Securities and Exchange Commission vigorously supported the inclusion of this provision in the PSLRA, and the former Chairman, President Clinton's appointee, Arthur Levitt, was one of its most vocal proponents. Chairman Levitt testified before Congress that: "because securities laws generally provide adequate remedies for those injured by securities fraud, it is both unnecessary and unfair to expose defendants in securities cases to the threat of treble damages and other extraordinary remedies provided by RICO." It is important to note, especially in light of the ongoing criminal investigation of Enron, that this provision does not exempt any person from being criminally convicted under the RICO statute in connection with securities fraud.

Legislation has recently been introduced in the House, and may also be considered here in the Senate, that would remove the civil RICO exemption for securities fraud. It is my hope that we will give such legislation measured and careful consideration while studying the lessons learned from Enron. The PSLRA was designed to weed out frivolous law suits, not to prevent legitimate claims like the ones rep-

resented here today from being prosecuted. I look forward to hearing testimony from the witnesses on this matter.

I also look forward to hearing from the witnesses about the ethical questions that have been raised regarding the conduct of the attorneys who set up the Enron deals and the analysts rating Enron stock. In particular I would like to know where the lawyers were when Anderson and Enron started shredding documents? Why would any attorney allow, or even encourage, a client to commit possible obstruction of justice in the face of civil law suits and criminal investigations? I am not just talking about the law firms involved, but also the in-house counsels who are held to the same ethical standards as every other member of the bar.

The final aspect of the Enron debate that I'd like to address here today involves the proper and appropriate - and I should add Constitutional - oversight role of Congress. Of course, I am referring to the General Accounting Office's threatened lawsuit against Vice President Cheney. As I've said elsewhere, I strongly believe that the GAO's original efforts to impose disclosure of White House policy discussions and meetings raise serious constitutional and policy concerns. From a policy standpoint, I believe that the powers asserted by the GAO in initially seeking specific details of the meetings attended by the Vice President deserve our attention.

From a constitutional perspective, I strongly feel that the GAO's interpretation of its investigative powers raises substantial separation of powers questions. I have looked carefully at the legal arguments on both sides of this issue and have real concerns regarding the GAO's novel case and look forward to hearing whether the exercise of such powers by the GAO can be reconciled with the basic constitutional principles that underlie the doctrine of separation of powers.

Again, I thank the Chairman for calling this hearing and I look forward to hearing from the witnesses.

Chairman LEAHY. I thank you very much for being here, but I would comment on two things. One, this came as a result of our last effort on legislation and we wanted to make sure we do not make that mistake again because nobody in the Congress, as I said, Republican or Democratic, intended that. I do not want to see, whether it is bankruptcy legislation or anything else, being in somebody's door stopper or paperweight saying, away we go. You cannot legislate against greed, but you can stop greed from succeeding.

Christine Gregoire is the Attorney General for Washington State. She is here today to tell us about Washington State's pending securities fraud litigation, the one that recovered more than \$100 million from lost Enron investments in the State's pension fund. General Gregoire is Past President of the National Association of Attorneys General. She is a lead negotiator for the States in the historic 1998 class action tobacco litigation.

Bruce Raynor is the President of the Union of Needletrades, Industrial, and Textile Employees. He is here to testify on behalf of the UNITE Amalgamated Bank and the AFL-CIO. UNITE and its members suffered a double-whammy from Enron's fall since the union pension fund lost money and Amalgamated Bank, which UNITE owns, lost \$10 million, I believe it is, in Enron investments. UNITE is engaged in private securities litigation against Enron executives and Arthur Andersen to recoup its losses.

Steve Schatz is a partner with Wilson, Sonsini, Goodrich and Rosati in Palo Alto, California. He will be testifying today. He is the Past President of the Association of Business Trial Lawyers of Northern California. He has been a lead lawyer in more than 60 securities class actions suits. He will discuss securities litigation in light of the Enron debacle and the benefits of the Private Securities Litigation Reform Act.

Professor Nelson Lund of George Mason University Law School is also joining us today. Professor Lund has held positions in the

Department of Justice, the Office of the Solicitor General, and the Office of Legal Counsel. Professor Lund will testify about constitutional issues and the lessons that will be learned from Enron's fall.

Professor Susan Koniak of Boston University School of Law, a leading expert in legal ethics and professional responsibility and securities law, will testify about the ethical issues raised by the roles of inside and outside advisors on Enron's finances. Professor Koniak is the co-author on the law on ethics on lawyering—how lawyers should act, the definitive treatise on the scope of an attorney's professional responsibilities to the public and legal profession. It is actually a book that more and more law firms are requiring their students to read and then maybe to keep on their desk.

General Gregoire, welcome, and we will start with you.

STATEMENT OF HON. CHRISTINE O. GREGOIRE, ATTORNEY GENERAL, STATE OF WASHINGTON, OLYMPIA, WASHINGTON

General GREGOIRE. Good morning, Mr. Chairman and members of the committee. Thank you for the opportunity to be here today and speak with you about this important and troubling issue. As Washington State Attorney General, I am working on several fronts to sort out the impacts on millions of our State residents from the secretive, questionable, and potentially illegal business practices of Enron.

In Washington, we feel like Enron has been the gathering of the perfect storm. First, they gouged our consumers and ratepayers with highly questionable power prices last year, and now, sadly, they have defrauded our investors and others across the nation.

Enron first came on our radar screen in June 2000, when the Western States began to experience a serious energy crisis. About 1 year ago, I joined the Attorneys General of California and Oregon in an investigation of whether the energy market was being manipulated. The price spikes, unplanned maintenance outages, transmission capacity restraints certainly were peculiar and warranted a closer look.

Over a year later, I wish I could tell you the answer. While the companies, including Enron, keep insisting to you that they have nothing to hide, in fact, they have refused consistently to turn over documents in document production necessary for us to determine once and for all what role they played in the energy pricing atmosphere. I can tell you that the price of some unregulated long-term energy contracts in the West dropped as much as 30 percent when Enron declared bankruptcy in December. Now, that may be just a coincidence, but until Enron begins cooperating with our investigation, we simply will not know. So I applaud the efforts of Senator Cantwell and Senator Wyden to push for a 206 Federal investigation by FERC.

Currently, I am also involved in a lawsuit against Enron on behalf of our State pension fund. At least 31 public pension funds across the Nation have lost an estimated \$1.5 billion on their Enron investments. These are losses to our funds for the retirement obligations made to millions of police officers, fire fighters, teachers, and other public servants around the nation. I have joined attorneys general from Ohio and Georgia in seeking lead plaintiff status in the class action lawsuits filed on behalf of inves-

tors against Enron, its executives, and Arthur Andersen. There are 1.3 million employees and retirees covered by our three systems.

Our suit contends that Enron and others violated the Securities and Exchange Act by improper accounting, disclosure of false and misleading information, and some outrageous examples of insider trading. We have alleged that Enron used offshore tax havens to hide its debt burden from investors and that it misstated its financial position and investors' equity in the company repeatedly.

As a State Attorney General, I warned consumers about avoiding shady get-rich-quick schemes and I urged them to check a company out carefully before handing over their money. In Enron's case, investors followed the rules. They listened to Wall Street. They relied on the audits. They relied on published financial reports. They assumed there was adequate regulatory oversight by the Federal Government. They assumed that the seventh largest company in America was playing by the rules, and in the end, they found themselves ripped off just like the naive person who lost money in a pyramid scheme. Now investors find themselves having to sue, with a real question whether they will be able to recoup their losses, little or no accountability by the accountants, and an insurance policy likely to be denied because of fraud by the directors.

Enron's ability to operate in secrecy with soft or limited regulatory oversight and with apparently no independent audit oversight are the common factors behind our lawsuit and the energy price manipulation probe.

I know Congress is discussing a number of lessons learned from the implosion of Enron and what we can do to avoid future problems. I have just a few thoughts.

First, we must see that SEC has the quality staff and the necessary resources to investigate and take enforcement action. But before we try to rely on government and government regulation for the solution, it seems that first we should focus on what is a terribly flawed function that is going on. It appears that the accountants for Enron, and I fear for many other companies, have put their allegiance to money over their ultimate allegiance owed to the creditors, the stockholders, and the investing public. It is time to look at other ways to hold accounting firms more accountable.

As we have learned in the Enron case, document retention rules obviously need more scrutiny. Clearly, we need to consider prohibiting accounting firms from collecting consulting fees from the companies they audit. I would also like to suggest recent amendments to the securities laws be reviewed to ensure responsible parties, such as auditors and others, are not improperly shielded from liability. In particular, I think a review of the statute of limitations, stay of discovery, denial of aiding and abetting liability, and proportionate liability all are in order.

Finally, Senator Leahy and members of the committee, I would suggest that the fundamental problem here has to do with simple corporate culture. It is a problem, I am afraid, as you suggest, that is far more pervasive than Enron and not something about which we can legislate.

As Attorney General, when we take consumer protection or anti-trust actions, we find that those companies who are defendants have discarded their business ethics and values and replaced them

with a goal of making money at whatever cost. The new economy may demand new ways to do business, but values from the old economy still are vital. Directors have a fiduciary responsibility to investors. Auditors have a responsibility for independent audits that the public can trust, and corporate executives should put investors before their hunger for profits and stock options.

Again, thank you, Senator Leahy and members of the committee, for the opportunity to testify before you today.

Chairman LEAHY. Thank you, General.

[The prepared statement of Ms. Gregoire follows.]

STATEMENT OF HON. CHRISTINE O. GREGOIRE, ATTORNEY GENERAL OF WASHINGTON STATE

Good morning. Thank you Senator Leahy and members of the committee for the opportunity to testify here today and your work on this important and troubling issue.

As Washington's Attorney General I am working on several fronts to sort out the impacts on millions of state residents from the secretive, questionable, and potentially illegal business practices of Enron. Clearly it is a corporation with a troubled culture that cared little for its customers, employees and investors, and now we all are left to try and pick up the pieces and see what can be done to make sure this never happens again.

In Washington we feel like Enron has been the gathering of the perfect storm. First they gouged our consumers and ratepayers with highly questionable power prices last summer, and now, sadly, they have defrauded our investors and others across the nation.

Enron first came on our radar screen in June 2000, when the Western States began to experience a serious energy crisis. About one year ago I joined the attorneys general of California and Oregon in an investigation of whether the energy market was being manipulated.

The price spikes, unplanned maintenance outages and transmission capacity restraints certainly were peculiar and warranted a closer look.

Wholesale market rates for a megawatt-hour of electricity skyrocketed from \$30 to \$300 and even as high as \$3,000. Was that the result of natural market forces, or was there manipulation?

Over a year later, I wish I could tell you the answer. But while the companies, including Enron, keep insisting to you that they have nothing to hide, in fact they have refused to turn over documents necessary for us to determine once and for all what role they played in energy pricing.

I can tell you that the price of some unregulated long-term energy contracts in the West dropped by as much as 30 percent when Enron declared bankruptcy in December. It may be just a coincidence, but until Enron begins cooperating with investigators, we won't know.

So I applaud the efforts of Senators Cantwell and Wyden to push for a federal investigation.

Currently I am also involved in a lawsuit against Enron on behalf of our state pension fund. At least 31 public pension funds across the nation have lost an estimated \$1.5 billion on Enron investments. These are losses to our funds for the retirement obligations made to millions of police officers, firefighters, teachers and other public servants around this nation.

I have joined attorneys general from Ohio and Georgia in seeking lead plaintiff status in the class action lawsuits filed on behalf of investors against Enron, its executives and Arthur Andersen. There are 1.3 million employees and retirees covered by our three systems.

Our suit contends Enron and others violated the Securities and Exchange Act by improper accounting, disclosure of false and misleading information, and some outrageous examples of insider trading.

We have alleged that Enron used off-shore tax havens to hide its debt burden from investors and that it misstated its financial position and investors' equity in the company repeatedly.

As a state Attorney General, I warn consumers about avoiding shady get-rich-quick schemes and I urge them to check a company out carefully before handing over money.

In Enron's case, investors followed the rules. They listened to Wall Street. They relied on audits and published financial reports. They assumed there was adequate

government regulatory oversight. And they assumed the seventh largest company in America was playing by the rules. In the end they found themselves ripped off just like the naïve person who lost money in a pyramid scheme.

Now investors find themselves having to sue with questionable financial restitution, little or no accountability by the accountants, and an insurance policy likely to be denied because of fraud by the directors.

Enron's ability to operate in secrecy, with soft or limited regulatory review, and with apparently no independent audit oversight are the common factors behind our lawsuit and the energy price manipulation probe.

I know Congress is discussing a number of lessons learned from the implosion of Enron and what we can do to avoid future problems. I have a few thoughts.

First, the SEC must have quality staff and necessary resources to investigate and take enforcement action.

But before we try to rely on government and government regulation for the solution, it seems we first should focus on the terribly flawed audit function.

It appears the accountants for Enron, and I fear many other companies, have put their allegiance to money over their ultimate allegiance owed to creditors, stockholders and the investing public. The auditing role is not a business partner but an independent force in the market place that lets investors make decisions based on accurate financial information.

The United States Supreme Court recognized this in a 1984 opinion in which it referred to the role of the accountant. "This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."

Something obviously went dreadfully wrong with this independent role with a duty to the public and I think we need to hold the accounting industry accountable.

Approximately 67 percent of the class action litigation against publicly-traded companies today allege accounting fraud as a basis of liability.

As Attorney General in case after case of Medicaid Fraud, we file against providers who claim they have simply followed accounting schemes approved by their accountants.

The problem is, when the providers are found guilty of fraud, the accountants walk away. I don't think it is too strong to suggest that in many cases, the accounting firms are facilitating the commission of a white collar crime, but they aren't held accountable.

For that reason I support the discussions I have heard to provide more accountability by accounting firms, and to end the peer review process which has resulted in negligible censure or discipline.

And as an elected Attorney General, who is not beholden to my state agency clients and can give them independent legal advice, I strongly support proposals to prohibit accounting firms from collecting consulting fees from clients they are auditing.

It is time to look at other ways to hold accounting firms more accountable. I don't have specific answers today, but I think there are some fertile areas to look at - particularly those areas where the industry has built up a shield from accountability.

As we have learned in the Enron case, document retention rules obviously need more scrutiny.

I would also suggest recent amendments to the Securities laws be reviewed to ensure responsible parties, such as auditors and others, are not improperly shielded from liability. In particular, I think a review of the statute of limitations and proportionate liability are in order.

Finally, Senator Leahy and members of the committee, I would suggest the real problem here has to do with corporate culture. It is a problem, I am afraid, that is far more pervasive than Enron and is not something you legislate.

As Attorney General, whenever we take Consumer Protection or Antitrust actions we find the company has discarded its business ethics and values and replaced them with a goal of making money whatever the cost.

The new economy may demand new ways to do business. But values from the old economy still are vital. Directors have a fiduciary responsibility to investors. Auditors have a responsibility for independent audits that the public can trust. And corporate executives should put investors before their hunger for profits and stock options.

Thank you for the opportunity to testify today.

Chairman LEAHY. Mr. Raynor?

**STATEMENT OF BRUCE RAYNOR, PRESIDENT, UNION OF
NEEDLETRADES, INDUSTRIAL, AND TEXTILE EMPLOYEES,
AFL-CIO, NEW YORK, NEW YORK**

Mr. RAYNOR. Thank you, Mr. Chairman. I appreciate the opportunity to testify before this distinguished committee that includes my Senator, the Senator from New York, Senator Schumer.

I am the President of UNITE, which is the 250,000-member union of garment, laundry, and textile workers. We also own the Amalgamated Bank of New York, which is a bank that is the only labor-owned bank in America that invests the pension funds, some \$6 billion of pension fund money and custodians for \$23 billion, of workers' pensions. That is the retirement of hospital workers and teachers and janitors and textile workers and garment workers. The workers whose money we invest do not earn enough to save very much. Their entire future depends upon their pensions and we are outraged by what has happened in the Enron situation that has stolen their money and we implore you and ask you to help us do something about it.

This is not the first time in my years as a labor union organizer that I have seen pension issues such as this. Unfortunately, it is not the first time. Fifteen years ago, we sued Cannon Mills in North Carolina when the owner of that company took the assets of the pension fund to make a corporate transaction and left those workers with \$40-a-month pensions after working 35 years in a textile mill in North Carolina, which today they are drawing and cannot possibly live on.

The Enron case, in our opinion, represents not simply a single horrible example of abuse but something that is systemic. Kenny Lay, who has become a national figure in our society these days—some of his close personal friends call him “Kenny Boy”—Kenny Lay said in 1997 that Enron intends to be the people's cops—I am quoting—“to blow the whistle on monopolies and to challenge legislators and regulators to get the job done, done right and done now.” Kenny Lay was not the people's cop. Kenny Lay was the people's crook.

The fact is that I wish Enron was an isolated example. We have seen over the years the rise in accounting fraud, 400 instances of corporate accounting fraud that has cost retirees—this is not investors' pension fund money, this is the pension fund money of retired workers who work hard for a living—\$31 billion in accounting fraud.

Now, we have got Harvey Pitt, the Chairman of the SEC, a former Arthur Andersen lawyer, gives us a great deal of confidence that someone is watching what is going on here. And then we have the prospect that the administration has nominated two Big Five accounting representatives to round out the majority of the SEC. We implore the Senate and the committee to not let that happen. The American people, retired workers, need an SEC that will enforce the law and will not allow these corporate criminals to steal people's money, particularly workers in pension funds.

Institutional investors are particularly vulnerable to accounting fraud because we invest our money largely in index funds. When you are a large institutional investor, it is the least expensive and safest way to invest money. We rely upon the market forces, which

rely upon accurate information certified by auditors that the market can analyze and price securities at. Our pension funds, as most big public pension funds and all the union funds, invest in index funds. Index funds are the most vulnerable to accounting fraud and lack of information and something must be done about that.

Our bank and our pension funds have been active institutional investors, trying to regulate corporate governance. We file resolutions aimed at corporations, and one of the practices that has become rampant is the ignoring of majority shareholder votes. Great Lakes Chemical has had five majority shareholder votes and ignored every single one of them. Management has a majority of the shareholders vote against a certain policy or for one and they choose to ignore it. Can you imagine what would happen in our country if a majority voted for a candidate for the U.S. Senate and that person was not put in office? It is absolutely amazing to me.

The reform legislation a few years ago that Congress passed accomplished some good things. The reform legislation took lawyers away from controlling securities litigation and gave it to the plaintiffs, to the pension funds, to the retired workers who deserve to control it. But it also provided protections for executives, provided protections for companies that need to be changed.

One of the items in that so-called reform legislation that needs to be looked at very carefully is the standard we use. The standard is intentionality. That is like making public prosecutors of our litigation. We cannot possibly be charged with the responsibility to uncover evidence to find out that someone intentionally defrauded us. Recklessness should be a standard. If you are reckless with retirees' money, then that ought to make you liable.

Retirees also should be able to collect from any pocket they can find. There is joint and several liability that was part of that law that needs to be looked at very, very carefully. When someone defrauds retired workers who work hard all their lives, they ought to be able to go to any pocket that they can to get their money back, or at least a portion of their money back.

And then there needs to be some effective regulation of the accounting industry, and then we also have to stop the Enron-style so-called independent directors. Those are directors that depend upon the company, that do business with the company, that rely upon the company to earn a living and they cannot possibly be independent directors. The AFL-CIO and the Council of Institutional Investors has filed many motions against requiring companies—asking companies to have only real independent directors on auditing committees.

Let me conclude by saying this, that we believe that this is not an isolated example but a part of the abuse of corporate power in our society. Retirees and workers need, deserve, and are ready to fight for some kind of control to protect ourselves from this and we ask the Senate to join us in that.

Chairman LEAHY. Thank you, Mr. Raynor.

[The prepared statement of Mr. Raynor follows.]

STATEMENT OF BRUCE RAYNOR, PRESIDENT, UNION OF NEEDLETRADES, INDUSTRIAL AND TEXTILE EMPLOYEES

My name is Bruce Raynor. I am President of the Union of Needletrades, Industrial and Textile Employees, (UNITE). I am also a Vice President of the American

Federation of Labor and Congress of Industrial Organizations (“AFL–CIO”), the Vice Chair of the Amalgamated Bank and a Co-Chair of the Council of Institutional Investors. My testimony today is given on behalf of the AFL–CIO, UNITE, and the Amalgamated Bank.

UNITE represents over 250,000 workers in the apparel, textile, laundry, distribution and other manufacturing industries across the United States. UNITE members participate in over 35 multi-employer retirement and other benefit plans with total assets of over \$4 billion. The AFL–CIO’s member unions represent 13 million American workers and sponsor pension plans with over \$400 billion in assets. Amalgamated Bank acts as a financial advisor and custodian to defined benefit retirement plans. Amalgamated has over \$6 billion under management in its LongView Collective Investment Trust Fund (“LongView Funds”) and over \$23 billion in custodial accounts, which collectively represent a portion of the retirement savings of hundreds of thousands of electricians, operating engineers, hotel employees, service employees and public employees as well as textile and garment workers. I appreciate the opportunity to appear this morning before this committee.

Over the past 30 years, as a labor organizer, elected labor leader, Bank official, and investor activist, I have witnessed first hand, at the bargaining table and from the picket line, the ongoing efforts of corporate leaders to bend the rules, hide the facts, and take whatever steps necessary to mislead investors and deny their workers a fair share of a company’s gains. And far too often, these actions impact not only the wages and working conditions of active workers, but also the equally significant pension funds of retirees who have given a life’s service to the very company that cuts them off. Ten years ago, I stood and fought alongside retirees from the Fieldcrest-Cannon textile mills, workers who had put 40 years into mills that filled their lungs with cotton dust and their wallets with meager paychecks. Those retirees had seen their monthly pension checks dwindle to \$40 a month, because \$39 million from their pension funds had been given to a former owner of their mill as part of the mill’s sale just four years before. And just as we’ve seen in the Enron case, that deal was done by insiders, hidden in the cost of a sale, for the single benefit of one corporate leader, as if it were a minor footnote. For those retirees in 1991, like so many retirees and former workers at Enron, losing one’s pension defined their ability to survive at a time in life when they deserved to retire with dignity.

This fight, like the one we were able to win in Kannapolis NC, is about workers who pay taxes, help build their communities, and deserve the right to trust an economic investment system that they want to support as they seek a stable retirement. And just as then, we hear the same basic refrain on factory floors, Athere ought to be a law against that kind of behavior.@ I hope my testimony today will provide this committee with basic ways that you can act to restore confidence in the public arena and the economic markets.

WORKER FUNDS’ EFFORTS AT ENRON

On November 2, 2001, the Amalgamated Bank and the AFL–CIO wrote to Ken Lay and Dean Powers and to outside director in response to the initial revelations of insider transactions and false accounting statements. I should note the Amalgamated’s Longview index funds held over \$15 million in Enron’s securities on behalf of our clients. We asked that Enron reform its board, riddled with conflicts of interest, some disclosed and some undisclosed. Receiving no answer, we wrote again on November 9, 2001, after the announcement of the Dynergy transaction, asking that persons of high integrity and reputation, with no prior connection to Enron, be asked to join the Enron board. We also asked that the company immediately disclose all the details of its financial situation in order to restore the capital market’s ability to price Enron’s securities and reduce the mounting uncertainty among investors.

We received a perfunctory acknowledgement from a corporate staffer. It is quite possible that had Enron taken early on the steps we urged, much of the panic that occurred both among its investors and its customers would have been avoided and a more orderly and less destructive adjustment to the true state of Enron’s finances might have been achieved. But as we all know, they did not, and Enron filed for bankruptcy on December 2, 2001.

At that point, the Amalgamated Bank chose to litigate to try and recover some of our worker beneficiaries’ money. On December 5, 2001, acting on behalf of the Long View Funds, Amalgamated Bank brought a class action lawsuit against Kenneth Lay, Enron’s Board Chairman, and other high ranking Enron officials for insider trading, breach of their disclosure duties to their shareholders and other wholesale violations of the nation’s securities law. We also sued Arthur Andersen.

We are seeking recovery of billions of dollars in damages and the freezing of more than \$1 billion in proceeds from insider trading.

Unfortunately, the Enron debacle is no aberration. It is only the most recent and, perhaps, worst case in a series of securities frauds and self dealing acts by corporate executives centered around a corrupted relationship between corporate executives, their boards, attorneys, and public auditors. Absent systematic legal and regulatory reform, the Enrons of the future are a certainty.

RISE OF ACCOUNTING FRAUD

Waste Management, RiteAid, Sunbeam Corporation, McKesson, Cendant, and, most recently, Enron—these large cap companies are included in many major indices and, as a result, are among the core holdings of public employee and union pension funds. These are also just a few of the companies that in the past few years have admitted to filing false financial statements with the SEC and have, as a result, restated billions of dollars in previously-reported earnings. More than 400 other publicly-traded companies in the past several years have admitted to reporting inflated earnings statements. The resulting drop in share prices has caused over \$31 billion of dollars in losses to investors, foremost of whom are workers' pension funds like UNITE's funds and the Amalgamated Bank's clients—funds that are responsible for investing and safeguarding the retirement savings of millions of working men and women in this country. A headline in USA Today (June 22, 2001) described accurately what is happening: "Fuzzy Accounting Raises Flags—Crafty Accounting Can Steer Investors Wrong." That's why as a benefit plan trustee and fiduciary, I found it astounding to read the quote in Barron's magazine attributed to SEC Chairman Harvey Pitt that "there is nothing rotten with the accounting profession." The evidence suggests otherwise.

The big five audit firms have been engaged in a race to the bottom in financial reporting which has undermined a core element of our capital markets—the integrity of public company financial reporting. Accurate financial statements are essential to informed investor decisions, confidence in our markets, and the allocation of capital to credible businesses that create long-term economic job growth and positive investor returns. The collapse of Enron dramatically demonstrates the systematic failures in these vital controls that are intended to ensure transparency and fairness in business.

Over 9,000 new public companies were created by the IPO boom of the 1980s-1990s—more than half of all existing public companies today. Many of these new public companies were smaller high-growth high-tech or bio-tech companies where the pressure to show earnings growth is intense. Others were Dot-Com enterprises which have no earnings and were under pressure to show revenue increases—or create apparent profits by using so-called "pro forma" accounting to generate financial results which Generally Accepted Accounting Principles (GAAP) would never sanction.

An article in the *Journal of Business* (Francois Degeorge, Jayendu Patel, Richard Zeckhauser, *Earnings Management to Exceed Thresholds*, *Journal of Business*, 1999, Vol 72, no 1.) concluded: "executives have both the incentive and ability to manage earnings." Manipulation was most frequently present when needed to meet bright line tests, i.e. earnings estimates, and occurred most often in the fourth quarter just when the supposedly independent auditors are arriving on the scene for the annual audit. What does this conclusion suggest about the effectiveness of annual audits by so called independent accountants? Another study concludes "we have no doubt that short term earnings are being manipulated in many, if not all, companies." (W. Bruns and K. Merchant *The Dangerous Morality of Managing Earnings*, *Management Accounting*, 72, 1996)

Worth Magazine ran a story, "Taking the Lies Out of Earnings," which concluded, "earnings are becoming an increasingly less reliable tool for investors, as changes in executive compensation and accounting practices give corporate officials both a reason to bend the rules and greater leeway in doing so." (February 1997 issue)

According to Richard Walker—the former SEC enforcement chief who resigned earlier this year—"If we had nothing else to do, the accounting investigations alone would keep us busy for the next five or 10 years." ("SEC List of Accounting-Fraud Probes Grows, Stretching Agency's Resources," *The Wall Street Journal*, July 6, 2001.) In short, Enron was a disaster waiting to happen.

AUDITOR CONFLICTS

At the center of the erosion in accounting practices are the conflicts of interest created when "independent" auditors are also providing consulting services to their audit clients. We have seen that at Enron, according to the Powers Committee re-

port, Arthur Andersen was actually structuring, as a consultant, the partnerships whose accounting treatment it was then approving as the independent auditor—in effect auditing itself. Andersen then flatly denied it had done this in appearances before the Senate Commerce Committee and the House Financial Services Committee.

As a result of new regulations fought for by the SEC under former Chairman Arthur Levitt, with the support of the Council of Institutional Investors and the AFL-CIO and against fierce opposition from the accounting industry and the Congress, this year companies were forced to disclose previously secret information about their audit firms' consulting work. We now are learning how much companies pay their supposedly independent auditors for consulting services as compared to fees for "independent" audit work. The SEC had guessed consulting fees would run 25%-40% more than audit fees.

In fact, of total corporate payments to auditors only about 27 cents of every dollar is for audit work—the rest is for consulting services. ("Auditors Exposed! Cozy Deals Alleged! How 'Independent' Are These Book Checkers?" U.S. News & World Report, July 23, 2001.)

There can be no question these huge consulting fees have undermined the independence of the big accounting firms. According to The Wall Street Journal, "Study Faults Work of Auditors Who Consult" (August 1, 2001):

Auditing firms are more likely to compromise and stretch the bounds of accepted accounting practices when they are receiving substantial consulting fees from the firms they audit, according to an academic study. . . .The study— by professors at Massachusetts Institute of Technology, Michigan State University and Stanford University— is one of the first to pore through financial filings to answer empirically one of the key questions facing the accounting industry: How objective can an accounting firm be in an audit when it is also making millions of dollars providing the same client with other services?. . . "Our study suggests that paying an accounting firm more for nonaudit services impairs auditor independence and reduces the quality of earnings," said Karen Nelson, a co-author and accounting professor at Stanford.

We also need to recognize the obstacles preventing the SEC— the supposed "cop on the beat"— from doing its job. The resources of the SEC have long been outstripped by our surging markets. When Arthur Levitt tried to take on the accounting industry, Congress opposed him. Now the SEC is headed by a lawyer who used to represent Arthur Andersen and the other big accounting firms who fought to continue to conceal the billions in consulting fees they were pocketing from their corporate clients while certifying billions in phony profits. The White House has indicated it intends to fill two further seats on the SEC with Big Five audit firm partners—essentially giving the Big Five control of the Commission.

Pressure to Manipulate Earnings Driven by Runaway Executive Pay While the protections against accounting fraud have been weakened, the incentive on the part of executives to commit accounting fraud has been greatly increased by the phenomenon of runaway executive compensation. The AFL-CIO has been calling attention to this scandal since 1997 at its website www.paywatch.org. The explosion in executive pay was fueled by FASB's refusal, again under Congressional pressure in the mid-1990's, to require companies to account for the economic reality of executive option grants in their financial statements. These huge grants then became an overwhelming incentive for executives to pump up stock prices—even when their companies' real performance was less than stellar.

According to a recent Watson Wyatt study (AStock Option Over-hang; Shareholder Boon, Shareholder Burden?@ 2001 study), an important cause of the recent devastation of tech stocks is the ill effects of enormous stock-option grants over the past several years. Stock options became an addiction of pandemic proportions in the 1990s. Companies liked them because they did not have to be counted as an expense and made earnings look better than they really were. Executives liked them because they provided easy riches as the greatest bull market of all time pushed stocks higher and higher, regardless of individual corporate performance. But this had hidden costs. It overstated real corporate earnings by billions of dollars during the past decade. And the more options there were, the less valuable the underlying stock became, creating real dilution that lowered actual earnings per share even more.

The Watson Wyatt study documents that even before the recent Nasdaq/NYSE collapse, companies giving the biggest option grants produced lower total returns to shareholders and higher stock volatility. The study, which examined option grants and stock price moves at 850 of the nation's largest companies, concluded that the heavy use of stock options had motivated executives to pursue riskier business strategies, like adding debt and making high-priced stock buy-backs. These strategies re-

flected the difference between an option holder, which has an upside but not a downside, and a stockholder, who paid real money for the stock and for whom the downside is very real.

Companies with a high percentage of outstanding options also suffer from option overhang. In 1998 and 1999, companies with the highest growth in option overhang produced much lower returns to shareholders. Now, the bill for all these options is coming due. The study concludes companies should encourage outright stock ownership instead of options. Companies that do so show higher returns to shareholders. As it becomes clearer that options exacerbated corporate stock declines, perhaps executives at companies with option excesses will be forced to rethink their strategy. But it is doubtful. Executives know that stock options mean having their cake and eating it too; but now comes the indigestion— unfortunately it's for their shareholders, not them.

And, it is even worse. We not only have executives getting compliant boards to re-price their options lower when the stock declines, but to keep doing it, literally chasing the stock price downward to continue to protect the insiders from either the vagaries of the market or their own mistakes. Amazon.com fell from over \$120, re-priced at \$23 and then again at \$13. Clarent re-priced at over \$50, then \$26, and now \$13. Excessive stock option grants and abusive re-pricing actions are clear examples of ignoring the interests of the true owners of corporations and of the need for better corporate governance procedures to make executives more accountable to the true owners of the enterprise.

INSTITUTIONAL INVESTORS VULNERABLE TO ACCOUNTING FRAUD

Now let me take a moment to explain why institutional investors are particularly vulnerable to accounting fraud. Large institutions with billions of dollars invested in the equity markets typically invest most of their assets in index funds. Index funds buy the entire market and hold each company's stock in proportion to its market capitalization. Index funds rely on the market to accurately price the securities in which they invest—and their track record of beating the average active manager is testimony to the depth of the liquidity of our markets and the effectiveness of our system of market regulation. Index funds are also by far the cheapest way to prudently invest in the equity markets. But index funds are also the perfect victim of accounting fraud—if corporate numbers are fraudulent, the markets will price stocks too high, and index funds cannot help but be the victims. That is why the Longview Funds have always seen good corporate governance, strong securities regulation and independent auditors, backed up by activist institutional investors ready to sue when victimized, as key to our money management strategy.

For the past ten years, Amalgamated Bank has joined other institutional investors in seeking to persuade corporate America to adopt a wide variety of governance improvements— smaller annually-elected boards dominated by independent directors; appointment of only independent directors to audit, nominating and compensation committees; and, now that there is disclosure of fees paid to auditors, the hiring of auditors unencumbered by conflicts of interest. However, even facing scrutiny from institutional investors, corporations have ignored shareholder resolutions that passed with overwhelming votes. We cannot protect our interests effectively in corporate annual meetings or in our courts when the laws and the regulators are allowing the companies in which we invest and the auditors who are supposed to be protecting us to steal from us with impunity.

LIABILITY LIMITS IN PSLRA ENCOURAGE ACCOUNTING FRAUD

When I talk about laws that protect the misconduct we saw at Enron, I am thinking particularly of the 1995 amendments to the federal securities laws, the Private Securities Litigation Reform Act ("PSLRA"). While parts of this legislation had positive consequences, such as the lead plaintiff provisions that took control of litigation from the lawyers and gave it to the investors, the bulk of this legislation imposed a series of often impossible hurdles for investors seeking to hold corporate executives and accountants liable for securities fraud. To put it bluntly, congress opened the door and Enron and its ilk drove right on through. The PSLRA was enacted on December 22, 1995, when the Senate overrode a veto by one vote.

Testimony by consumer and investor groups warned that the proposed drastic cut-back on investor protections against and remedies for securities fraud would reduce corporate executives' and securities professionals' accountability for misconduct. This, in turn, would result in an increase in securities fraud and investor losses and impair investor confidence, thus harming capital formation and our nation's economy. Not only was the PSLRA opposed by Arthur Levitt's SEC and vetoed by President Clinton, but virtually every major consumer, labor and investor group in Amer-

ica and the vast majority of America's newspapers editorialized against the PSLRA. They all warned that it would grant those best positioned to profit from stock price inflation a license to lie and result in a massive upsurge of fraudulent conduct and investor losses. Those predictions have now come true with a vengeance.

THE WORKER-INVESTOR REFORM AGENDA: SECURITIES LAW, BANKRUPTCY LAW,
PENSION LAW

Now Enron has exposed to widespread public attention a whole series of conflicts of interest and inadequate regulation affecting our capital markets and our retirement savings system—problems that the labor movement and institutional investors have been warning about for years. But with the exception of a few brave public spirited individuals like Arthur Levitt, few here in Washington heeded these warnings. But now is the time to act on a range of issues. I will begin with where this Committee has clearest jurisdiction. Congress needs to:

(1) Restore meaningful access to the courts for investors victimized by accounting fraud. We need to restore the right of investors to sue accountants and lawyers for aiding and abetting their clients' securities fraud. Every major securities fraud case since the passage of the Private Securities Litigation Reform Act has had significant involvement on the part of auditors and attorneys, but the victims of their actions cannot sue them for their role in it. We also need to restore access to victims of Enron like conspiracies to claims under civil RICO. Nothing looks more like a racketeering conspiracy than the events involving Enron, Andersen, their law firms and their political allies, yet the PSLRA immunizes these racketeers against RICO liability. Congress also needs to establish one clear and fair standard nationally for liability for securities fraud, and that standard should be recklessness. The intentionality requirement some federal courts have inferred is in the PSLRA effectively makes it impossible for investors to recover in most securities fraud cases. It requires private litigants to essentially find an informant—a task more suited to a criminal investigation by the government. Finally, the PSLRA repealed joint and several liability, which has a particularly harmful impact in the most serious cases like Enron where the company itself, as a result of its conduct, is bankrupt. Joint and several liability should be restored.

(2) Reform the bankruptcy laws so that rich miscreants in Texas and Florida can't sit in their million dollar homes while their victims across town get thrown out of their apartments—as is literally happening in Houston today. In this regard the bankruptcy bill this Congress passed last year is a shocking travesty—it would punish the victims of Enron who have to file for personal bankruptcy while legitimizing the very transactions Enron used to hide its liabilities. (Prof. Elizabeth Warren and 34 Bankruptcy Law Professors letter to Chairmen Leahy and Sensenbrenner, January 23rd, 2002) It should die where it is now in conference.

(3) Put into place an effective public regulatory organization over the accounting industry and end the practice of so-called "independent" auditors collecting millions of dollars of non-audit fees from companies they are auditing. The AFL-CIO has petitioned the SEC to enact further rules ensuring auditor independence, but in light of the lack of responsiveness and the conflicts of interest potentially affecting a majority of the Commission on this issue, we believe Congress must act either by mandating rulemaking or by enacting a ban on consulting by audit firms into law.

(4) Ensure corporate directors are really independent of the CEO's they are supposed to be overseeing by ending the practice of having Enron-style independent directors who were really financially and politically dependent on Enron executives. The AFL-CIO and the Council of Institutional Investors have both petitioned the SEC to enact rules that would have this effect, but there has been no response from the Commission and we frankly believe that Congressional action is needed either to mandate rulemaking or to enact the principles of independence into law.

(5) Reform the accounting treatment of stock options given to corporate insiders and put meaningful restrictions on how those options may be exercised and sold so that we won't see again executives who are running a company into the ground simultaneously taking a billion dollars out of the company by exercising options.

(6) Reform 401(k)-type retirement savings plans to prevent employers from pushing employer stock into worker retirement accounts—a practice which is great for employers because it is cash-free but terrible for workers whose retirement savings are bet entirely on one company. In this regard President Bush's proposals are completely inadequate to this problem, and in fact would put employees' retirement savings further at risk by repealing ERISA's current ban on conflicted investment advice by 401-k money managers trying to promote high fee and high risk investment options.

CONCLUSION: PEOPLE ARE HURTING—CONGRESS MUST ACT

The corruption of our securities markets which Enron symbolizes has hurt a lot of people. While it is too early to tell how long or severe the current recession will be, no one can deny that significant economic harm has occurred due to collapse of our securities markets. Financial and accounting scandals have plunged companies into crises leading to many bankruptcies. Investor losses have turned into a reverse wealth effect. Massive layoffs abound. Capital formation has been impaired as burned investors shun the IPO market. New public offerings are sparse in today's environment.

Baby boomers without defined benefit retirement plans are considering what to do next now that their 401(k)s have been hit. According to Business Week ("Retirement Gets Scary for Baby Boomers," July 30, 2001):

Lulled by recent dreams of early and easy retirement, millions of Americans are suddenly facing the harsh truth that they will have a much harder time retiring.... Those with lots of high-tech company stock in their 401(k)s may be in the worst shape.... Stripped of the illusions fed by a booming stock market, retirement is shaping up to be a nightmare of cost and complexity.

Or as an article in the New York Times puts it—"the inevitable bottom line of a 401(k) system—postponed retirement—is surfacing." ("Workers Find Retirement is Receding Toward 70," New York Times, February 3, 2002, Money and Business, p. 4.) The truth is what the labor movement has been saying for decades—401-k plans are a good supplement to a defined pension plan and Social Security, but a disastrous replacement.

And then there are individuals like the many Enron 401-k participants who came to Washington last week—secretaries, vice-presidents, electrical lineworkers—people in their 50's who gave a lifetime to their employer and were rewarded with layoff notices, bounced severance checks and empty retirement accounts. Surely these people should receive the ill-gotten gains of the insiders here.

I will conclude by pointing out that the workers I represent are appalled by what happened at Enron. I wish I could say that they are shocked. But they are not. They are not shocked because what happened at Enron has exposed something that they know very well—the reality of excess corporate power in our society. That power manifests itself daily. It is demonstrated in the stimulus bill supported by the administration that provides a windfall for the wealthiest people in our society while giving workers almost nothing. That power was also behind a multi-billion dollar bailout of the airline industry, while, again, workers received almost nothing. The story of how millionaire executives used their wealth and political clout to rig the rules and free themselves from accountability, and then used that freedom to enrich themselves while workers, consumers, and small investors pay the consequences is becoming all too commonplace in our society.

These then are the lessons of the last several years, only most dramatically demonstrated by Enron. It is now up to Congress to act, quickly and decisively to protect the American people's retirement income and prevent the Enron's of the future. The labor movement and institutional investor community stand ready to work with this Committee and this Congress to adopt true reform legislation. Thank you for considering our views.

Chairman LEAHY. Mr. Schatz?

STATEMENT OF STEVEN M. SCHATZ, WILSON, SONSINI, GOODRICH AND ROSATI PROFESSIONAL CORPORATION, PALO ALTO, CALIFORNIA

Mr. SCHATZ. Thank you, Senator Leahy. Chairman Leahy and members of the Senate Judiciary Committee, it is an honor to appear before you today and offer my thoughts on possible responses to the Enron debacle. My knowledge of the specific details of what happened at Enron comes only from media accounts, but for purposes of today's discussion, I assume they are substantially accurate.

As a former Federal prosecutor in the Southern District of New York, I am simply appalled by the rampant fraud that reportedly took place at Enron. As a member at Wilson, Sonsini, Goodrich and Rosati, which represents some of Silicon Valley's most innovative

and successful companies, and someone who has personally represented technology companies ranging from multi-billion-dollar enterprises to smaller but no less innovative companies, all of which depend on the country's capital and financial markets, I am deeply troubled by the Enron scandal's effects, those effects on the markets, investors, and employees.

There can be no doubt that the perpetrators of this fraud must be punished, punished swiftly, and punished severely. In addition to punishing the culpable, I think we all agree that the Enron fraud and the fact that it continued undetected for so long and harmed so many people demands us to take a hard look at certain reforms to prevent such a reoccurrence.

In crafting an adequate and well-reasoned response, however, we must not allow our anger at Enron's egregious and, I believe, aberrational conduct to have unintended negative consequences. Specifically, I am concerned that some of the recent proposals to revise provisions of the PSLRA may inadvertently and unfairly punish the many honest companies and employees that make our economy flourish.

As you no doubt are aware, with broad and deep bipartisan support, Congress passed the Reform Act of 1995 to curb what it accurately perceived as substantial litigation abuses by the private plaintiffs' securities class action bar. As Senator Hatch previously indicated, prior to its passage, the announcement of disappointing quarterly results all too frequently led to a host of fraud by hindsight litigations. Indeed, some of the best companies in the valley had to endure such lawsuits.

Three provisions of the Reform Act are particularly crucial to protecting companies and their employees from frivolous and abusive litigation. Those three are the safe harbor for forward-looking statements, the discovery stay, and the heightened pleading standard. None of these provisions facilitated Enron's accounting scandal and none will shield Enron from the consequences of its conduct. Let me consider each in turn.

Roughly speaking, the Reform Act's safe harbor encourages companies to publicly disclose their predictions of future performance by insulating them from liability in the event that those predictions do not come true. This protection, in conjunction with Regulation FD, has allowed investors to benefit from increased information flow and to make more informed financial decisions. In order to limit potentially burdensome fishing expeditions, discovery in private securities class actions are stayed until plaintiffs survive a motion to dismiss, that is, until they establish that their complaint is not facially inadequate.

At the same time, the Reform Act compels companies to preserve all relevant evidence while the case is pending and allows discovery when evidence is at risk. This expressed command not to destroy evidence is a strong protection for plaintiffs, and clearly, the Reform Act's pleading standard will not preclude the plaintiffs from proceeding in this case.

In that regard, it is clear that what the pleading standard does do is it sets a barrier so that when meritless cases are filed, companies do not have to bear the expense of those lawsuits unless and

until there has been a decision that the complaint is facially sufficient.

The Reform Act did not cause the Enron scandal but it did help curtail the filing of lawsuits. But even with the Reform Act, this past year, 487 companies have been sued in private class action lawsuits, nearly double the next highest number of lawsuits.

I would like to briefly comment on some of the proposed legislation. There is a proposed bill in the House that would allow plaintiffs to add legal claims to their securities class action complaints and thereby seeking treble damages. At first blush, it seems tempting to increase penalties for wrongdoers. However, cases such as Enron's already involve damages beyond any defendant's ability to pay, even absent the addition of RICO penalties. This proposal would do little to inflict additional pain on those that commit the fraud. Rather, it would allow plaintiffs' counsel to reflexively include a RICO claim and obtain unfair leverage and settlement negotiations in the typical case that they file.

As Senator Hatch previously indicated——

Chairman LEAHY. Mr. Schatz, just to let you know, we have a vote coming up. If you could sum up, we will put your whole statement in the record.

Mr. SCHATZ. Very well. I will just summarize it, Senator, that Chairman Levitt himself supported the exclusion of RICO.

Senator Leahy, let me make just two other points if I could.

Chairman LEAHY. You are a good enough trial lawyer. I am sure you can make them in 15 seconds. Go ahead.

Mr. SCHATZ. Your Honor——

[Laughter.]

Mr. SCHATZ. Senator Leahy, the current provision allows for joint and several liability for knowing misconduct and that is one of the virtues of the legislation, and again, I believe that the discovery stay here did not impede the prosecution of the case. It was the fact that individuals flaunted the provisions of the Reform Act.

Chairman LEAHY. Thank you.

[The prepared statement of Mr. Schatz follows.]

STATEMENT OF STEVEN M. SCHATZ, ESQ., WILSON, SONSINI, GOODRICH AND ROSATI
PROFESSIONAL CORPORATION, PALO ALTO, CALIFORNIA

Chairman Leahy, Senator Hatch, and Members of the Senate Judiciary Committee:

It is an honor to appear before you today and offer my thoughts on possible responses to the Enron debacle. As a former federal prosecutor, I urge you to bring swift and severe punishment to the wrong-doers who have apparently harmed so many innocent people. As an advisor to numerous honest companies that depend on the capital markets, however, I urge you to be sensitive to the indirect consequences your actions may have on those whom are frequently targets of frivolous litigation.

I. INTRODUCTION

For four and a half years, I served as Assistant United States Attorney for the Southern District of New York in the Criminal Division. That experience has given me particular insight into the types of frauds that rapacious companies and rapacious individuals can and do perpetrate, and has impressed upon me the importance of harshly punishing those who would exploit their positions for personal gain at the expense of others. I applaud your efforts today to ensure that wrong-doers face appropriately severe consequences.

Today, I am a senior member of the law firm of Wilson Sonsini Goodrich & Rosati, P.C., located in Silicon Valley and numbering over 700 lawyers. We are proud to represent some of the most innovative, successful companies in the United States.

Our clients include leaders in computers (Hewlett-Packard, Sun), semiconductors (Cypress, LSI Logic, Micron, VIA), disk drives (Seagate), electronics manufacturing (Solectron), software (Autodesk, Sybase), networking (3Com, Juniper, Broadcom), aviation (America West), and biotechnology (Genentech). We currently represent approximately 300 public companies. We also represent hundreds of start-ups that are working to become leaders of their industry sectors. Frankly, our clients depend on the availability of capital and the integrity of the financial markets, both of which the Enron scandal has jeopardized. I am heartened to know that you are considering measures to ameliorate these harms and protect against future abuses.

As a litigator, I have devoted a significant portion of the last seventeen years of my life to defending securities class action, representing clients such as Hewlett-Packard, Informix, Convergent Technologies, InfoSpace, Unisys, Cirrus Logic, Critical Path, Splash, Ventana Medical Systems, Robertson Stephens & Co., Santa Cruz Operations, MicroAge, Pyramid Technology, STAC Electronics, Ventritex, Laserscope and Continental Savings. In defending more than sixty securities class actions over the past two decades, I have personally witnessed the explosive growth of frivolous litigation, the measures Congress has taken to curb abusive litigation tactics, and the salutary effects those measures have had.

Others have detailed, and will detail, the specific conduct that allegedly gave rise to fraud at Enron, and I yield to their expertise.¹ I think we all agree that the Enron fraud—and the fact that it continued undetected for so long and harmed so many people—demands us to take a hard look at certain reforms. Simply put, we must prevent such a situation from ever recurring. In crafting an adequate and well-reasoned response, however, we must not allow our anger at Enron's egregious conduct to have unintended, negative consequences. Specifically, I am concerned that recent, and perhaps well-meaning, proposals to revise provisions of the Private Securities Litigation Reform Act² may inadvertently and unfairly punish the many honest companies and employees that make our economy flourish.

II. THE PRIVATE SECURITIES LITIGATION REFORM ACT

As you are no doubt aware, Congress passed the Reform Act in 1995 to curb what it accurately perceived as substantial litigation abuses by the private plaintiffs securities class action bar. Congress took this action in response to “significant evidence of abuse in private securities lawsuits,” including, among other things, “the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action.”³ These meritless cases diverted companies' attention from their core businesses and forced them either to spend millions in defense costs or millions on unwarranted settlements. Simply put, abusive litigation cost public companies—and hence the investing public—tremendous amounts of money each year.

Recognizing this serious problem, Congress adopted the Reform Act with broad bipartisan support. The Act contains numerous provisions, but three are particularly crucial to protecting companies and their employees from frivolous and abusive litigation. Those three are: the Safe Harbor for forward-looking statements, the discovery stay, and the heightened pleading standard. None of these provisions facilitated Enron's accounting scandal, and none will shield Enron from the consequences of its fraudulent conduct. Let me very briefly consider each in turn.

A. SAFE HARBOR

The Reform Act's Safe Harbor encourages companies to publicly disclose their predictions of future performance by insulating them from liability in the event those predictions do not come true. Specifically, the Safe Harbor provides that “[A defendant] shall not be liable with respect to any forward-looking statement, whether written or oral, if and to the extent that . . . the forward looking statement is . . . identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.”⁴ The Safe Harbor

¹ My knowledge of the specific details of what happened at Enron comes only from media accounts, but for purposes of today's discussion, I will assume that they are substantially accurate.

² H.R. Conf. Rep. No. 104-369 (1995), reprinted in 1995 U.S.C.C.A.N. 730 (“Conference Report”).

³ Conference Report at 31.

⁴ 15 U.S.C. § 78u-5(c)(1)(A).

also protects forecasts and projections of future results that are not accompanied by “meaningful cautionary statements” by requiring plaintiffs to demonstrate that they were made with actual knowledge of falsity.⁵

This protection, in conjunction with Regulation FD, has allowed investors to benefit from increased information flow and to make more informed financial decisions, by making companies less nervous about disclosing their necessarily uncertain hopes for the future. The Safe Harbor often serves as an effective tool for companies unfairly accused of fraud-by-hindsight. It does not, however, provide any protection for perpetrators of accounting frauds such as Enron’s. Indeed, the Safe Harbor expressly does not apply to audited financial statements. In short, the Enron scandal and the Safe Harbor have nothing to do with each other.

B. DISCOVERY STAY

Congress enacted another core provision of the Reform Act, the discovery stay, in response to evidence that “the abuse of the discovery process. . .impose[d] costs so burdensome that it is often economical for the victimized party to settle” private securities class actions, regardless of guilt.⁶ In order to limit potentially unnecessary and burdensome fishing-expeditions, discovery in such cases is stayed until plaintiffs survive a motion to dismiss; that is, until they establish that their complaint is not facially inadequate.⁷ At the same time, the Reform Act compels companies to preserve all relevant evidence while the case is pending,⁸ and allows discovery when evidence is at risk.⁹

The Reform Act’s express command not to destroy evidence strongly protects plaintiffs. More importantly, in cases such as Enron’s, in which the fraud seems clear and the likelihood of surviving a motion to dismiss seems almost certain, the Reform Act ultimately does nothing to prevent plaintiffs from getting the evidence they need.

C. HEIGHTENED PLEADING STANDARD

Finally, the Reform Act provides a heightened pleading standard designed to weed out cases where plaintiffs lack a substantial basis for their fraud accusations.¹⁰ Specifically, it requires that every securities class action complaint “shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.”¹¹ It further requires plaintiffs to “state with particularity facts giving rise to a strong inference” of scienter.¹² Given the extent of its fraud, Enron can hardly expect to benefit from this provision; undoubtedly there will be no issue with respect to the pleading standard in that case.

The key Reform Act provisions did not cause the Enron scandal and will not allow Enron to escape punishment. They do, however, protect companies from frivolous lawsuits, onerous discovery and exposure to extortionary settlements. The concerns which motivated Congress to enact the Reform Act in 1995 and the Securities Litigation Uniform Standards Act in 1998 are equally valid today, as demonstrated by the fact that the number of private securities class actions filed each year continues to rise. The Reform Act remains of vital importance in defending honest companies against these often meritless suits.

III. REFORM PROPOSALS

In evaluating proposals to modify the Reform Act, I urge you to be sensitive to potential spillover effects on frivolous cases. Reform is vital, but it is also imperative

⁵ Conference Report at 43-44.

⁶ Conference Report at 31.

⁷ *Id.* at 37.

⁸ *Id.*

⁹ *Id.*

¹⁰ It is worth noting that the Courts of Appeals have divided on the proper interpretation of this heightened pleading standard, compare *Novak v. Kasaks* 216 F.3d 300 (2d Cir. 2000) with *In re Silicon Graphics, Inc. Securities Litigation*, 183 F.3d 970 (1999). The Ninth Circuit interpretation appears more consistent with Congressional intent, particularly in the light of the fact that certain amendments adopting other interpretations were rejected. See 141 Cong. Rec. S9170 (daily ed. June 27, 1995). Should Congress decide to amend the Reform Act in response to recent events, it may wish to take the opportunity to clarify and reaffirm that the Ninth Circuit’s interpretation of the pleading standard is correct.

¹¹ 15 U.S.C. § 78u-4(b)(1).

¹² 15 U.S.C. § 78u-4(b)(2).

not to undermine key aspects of the Reform Act. In our zeal to respond to the Enron disaster, we must be careful to avoid creating new vehicles for frivolous litigation.

For example, one proposed bill would allow plaintiffs to add RICO claims to their securities class action complaints, and thereby seek treble damages.¹³ At first blush, it may seem appealing to increase penalties for wrong-doers. In actual fact, however, cases such as Enron's already involve damages beyond any defendant's ability to pay, even absent the addition of RICO penalties. Thus, this proposal would do little to inflict additional pain on those who commit fraud.

Rather, this provision would allow plaintiffs' counsel to reflexively include a RICO claim in every garden-variety securities class action complaint, providing additional—and typically unwarranted—leverage in settlement negotiations. By adopting this provision, Congress would simply increase the frequency with which “innocent parties are often forced to pay exorbitant ‘settlements’”¹⁴—precisely the sort of abuse this body sought to deter in 1995. Indeed, no less than then-SEC Chairman Arthur Levitt testified in favor of the RICO exclusion, recognizing that “[b]ecause the securities laws generally provide adequate remedies for those injured by securities fraud, it is . . . unfair to expose defendants in securities cases to the threat of treble damages and other extraordinary remedies provided by RICO.”¹⁵

Similar proposals involve efforts to impose aider and abettor liability and/or joint and several liability for securities violations.¹⁶ In weighing these proposals, it bears mentioning that the Reform Act (in a section titled “Reduction of Coercive Settlements”) already imposes joint and several liability—without exception—for knowingly violating the securities laws; in addition, the Act already specifies that if a defendant cannot pay its share of the damages due to insolvency, each of the other defendants must make an additional payment—up to 50% of their own liability—to make up the shortfall in plaintiff's recovery.¹⁷ The Reform Act provides for even broader contributions to make whole certain small investors. Also, in evaluating aiding and abetting liability proposals, it should be recognized that courts have taken a broad view of direct liability. Undue expansion of these doctrines could become a tool allowing plaintiffs to expose tangential defendants to enormous risk even in frivolous cases.

Effectively, expanding the scope of liability would give plaintiffs an undeserved bargaining chip with which to compel settlement of meritless cases. Congress recognized this risk in the enactment of the Reform Act, criticizing plaintiffs' “targeting of deep pocket defendants. . . without regard to their actual culpability.”¹⁸ These concerns remain equally pressing today, and should be fully considered in any reforms. In addition, keep in mind that the SEC is authorized to investigate and pursue civilly and/or administratively anyone who violates the federal securities laws, whether directly or as an aider and abettor, and, where appropriate, can refer the matter for criminal prosecution.

Another proposal would allow immediate discovery in cases where a company's accountant is named as a defendant.¹⁹ No doubt this was drafted to prevent Arthur Anderson-type document destruction abuses. Unfortunately, it would also allow plaintiffs to gut the Reform Act's discovery stay simply by naming company auditors in every lawsuit. (Moreover, as I explained before, the Reform Act itself prohibits the destruction of documents and provides severe penalties for violations.) Congress must carefully consider whether it wishes to punish every honest company with onerous and costly discovery obligations in response to Enron's extreme misconduct, particularly when early discovery will serve little purpose.

IV. CONCLUSIONS

In addition to the proposals that have already been suggested, Congress has many other options. For example, Congress may wish to consider approaches that would require auditors to make affirmative and descriptive assertions about companies in their financial statements. In a recent speech, a former SEC Commissioner raised the possibility that auditors be required to supplement their audited financial statements with “an opinion and report describing significant accounting treatments and judgments that comply with GAAP but that, if disclosed, would have a material ef-

¹³ H.R. 3644, 107th Cong. (2d Sess. 2002).

¹⁴ Conference Report at 32.

¹⁵ Conference Report at 47.

¹⁶ H.R. 3617, 107th Cong. § 3 (2d Sess. 2002).

¹⁷ 15 U.S.C. § 78u-4(f); Conference Report at 39.

¹⁸ Conference Report at 31.

¹⁹ H.R. 3617, 107th Cong. (2d Sess. 2002)

fect on the valuation” of the company.²⁰ This sort of response suggests one possible remedy that should be explored and may be part of an overall approach to deter Enron-like abuses. Naturally, the various proposals offered in response to the Enron debacle will need to be carefully studied, and their advantages and disadvantages carefully weighed, before any decisions regarding the appropriate prophylactic actions and reforms are made.

Enron has hurt our financial markets, our economy, and millions of innocent investors. Reform is vital; we must act to prevent this from ever happening again. At the same time, we must make sure that our response does not do more harm than good, and thus must be sensitive to the collateral consequences that reforms may have for frivolous class actions. We should not let the extreme circumstances of the Enron matter cause us to forget the very real and tangible reasons for enacting the Reform Act.

Chairman LEAHY. Professor Lund?

STATEMENT OF NELSON LUND, PROFESSOR OF LAW, GEORGE MASON UNIVERSITY SCHOOL OF LAW, ARLINGTON, VIRGINIA

Mr. LUND. Mr. Chairman, members of the committee, I am honored by your invitation to comment on the accountability issues that have arisen in connection with Enron’s bankruptcy and its aftermath. These issues are obviously numerous and variegated. My testimony addresses questions of Congressional oversight and investigation that have suddenly attained renewed prominence. In particular, I will comment on the role of the GAO in obtaining information held by the executive branch. I have submitted detailed written testimony for the record, which I will very briefly summarize this morning.

As you know, Congress and the executive have had a great many disputes with each other about Congressional access to information that the executive has preferred not to share. There was a significant dispute about this issue during the administration of President Washington and the tug of war has been going on ever since.

Neither the Congressional right to conduct investigations nor the executive’s right to resist disclosure of information to Congress is expressly granted by the Constitution. Given the implicit nature of both rights, it should not be surprising that Members of Congress have tended to have a somewhat different view of the constitutional allocation of power than Presidents and their lawyers have taken. Traditionally, these disputes have been settled through negotiation, compromise, and sometimes capitulation, but as far as I am aware, no court has ever issued a final judgment resolving such a dispute when the President has asserted his constitutional claims. That may be about to change.

The Comptroller General has demanded that the Vice President disclose information about private meetings that he held while he was a member of the National Energy Policy Development Group, or NEPD Group, which was entrusted by the President with the task of developing recommendations for a new energy policy. After the Vice President resisted this request, the Comptroller General stopped pursuing it last September, but in the wake of the Enron controversy, he has announced that he plans to bring a lawsuit to compel the Vice President’s compliance.

²⁰ See Joseph A. Grundfest, Enron: Can We Craft an Efficient Disclosure-Based Policy Response?, Presentation to the Silicon Valley Chapter of The Federalist Society (Jan. 29, 2002). As proposed, this obligation would not expose auditors to private civil liability for non-compliance.

I think this raises the question of whether the GAO's demand is authorized by the statute. It is possible, though not very easy, I think, to read the statute to authorize a GAO investigation of the NEPD Group's activities. But even assuming that the statute authorizes GAO to investigate the work of the NEPD Group, the statute clearly does not purport to authorize the GAO to use any and all means to conduct its investigations. Thus, the real question is whether the statute purports to require that the Vice President comply with GAO's demands for records about the nature of specific meetings, and I think that it does not.

There is a general principle of statutory construction under which ambiguous statutes should be interpreted so as to avoid serious constitutional questions, and the constitutional questions raised by the GAO demand letter are very serious indeed. Beginning with George Washington, Presidents have consistently claimed that they may withhold some information from Congress and the Supreme Court has recognized that a right of executive privilege does exist. It is implicit in the Constitution.

The most recent case law from the D.C. Circuit contains language that would appear to cover this case, although it arose in the somewhat different context of an independent counsel investigation. When one steps back from the case law, which in any event cannot provide a definitive resolution, the serious nature of the constitutional questions becomes even more apparent.

In 1796 when the House of Representatives was debating its response to President Washington's refusal to provide the House with documents relating to the Jay Treaty, a Congressman, a Congressman named James Madison, argued that the House must have a right to ask for whatever information it saw fit. He also contended, however, that the President must have a correlative right to refuse the request if he saw fit. I think Madison's point was that the President could not be compelled to disclose information, just as the Congress could not be compelled to enact legislation without what it considered adequate information, and Madison subsequently did vote against an appropriation to implement the Jay Treaty.

That has become the traditional way to resolve these disputes, with each party using its political leverage to bargain over the outcome. The resulting compromises have no doubt frequently left both sides dissatisfied, but neither side has ever had to concede a matter of principle to the other. Once the courts become involved, that may change.

I believe that Madison did identify the constitutionally appropriate presumption. Applied to the present case, this suggests that Congress might refuse to enact President Bush's energy proposals if a majority of legislators believe that they first needed more information about the Vice President's work on the NEPD group. But that is not at all what is going on here. Instead, we have a situation where neither House of Congress or even a Congressional committee has demanded any documents from the Vice President, and the GAO's purpose in conducting the investigation is, so far as I have been able to ascertain, somewhat unclear.

While I was thinking about these issues, I began to wonder what would happen if a staffer in the White House Office for Political

Operations were to ask the FBI to investigate all meetings between Senators and private parties or even with their own staffs at which matters before the Congress were discussed or mentioned, such as energy or, for that matter, the regulation of the accounting profession. If the FBI then demanded the Senators provide documents and records like those that the GAO has sought from the Vice President, I imagine that quite a firestorm would ensue. The cases are not perfectly analogous, of course, but I think the hypothetical does suggest one reason why it might not make much sense for the Comptroller General to provoke a constitutional confrontation in this case.

Elected officials in the legislative and executive branches have a long history of resolving their differences in the manner suggested by Congressman Madison without involving the courts. The lawsuit that the Comptroller General is threatening to bring will no doubt be very interesting to professors like me, but I am not sure it will serve the long-term institutional interests of Congress.

Chairman LEAHY. And I should also note, Professor, that I appreciate your defense of Vice President Cheney having a closed door hearing. We are not investigating the Vice President in this hearing.

Mr. LUND. Yes, I understand that.

Chairman LEAHY. I just want to make sure we do not lead anybody astray here.

Mr. LUND. Right. I understand that, Mr. Chairman. That concludes my presentation. I would be happy to answer any questions.

Chairman LEAHY. Thank you.

[The prepared statement of Mr. Lund follows.]

STATEMENT OF NELSON LUND, PROFESSOR OF LAW, GEORGE MASON UNIVERSITY
SCHOOL OF LAW

Mr. Chairman, Senator Hatch, Members of the Committee, I'm honored by your invitation to comment on the accountability issues that have arisen in connection with Enron's bankruptcy and its aftermath. These issues are obviously numerous and variegated. My testimony addresses questions of congressional oversight and investigation that have attained renewed prominence because of the Enron bankruptcy and the subsequent intense congressional interest in conducting its own investigations of this matter. In particular, I will comment today on the role of the GAO in disputes over access to information held by the Executive Branch.

As you know, Congress and the Executive have had a great many disputes with each other about congressional access to information that the Executive has preferred not to share. There was a significant dispute about this issue during the administration of President Washington, and the tug of war has been going on ever since. Neither the congressional right to conduct investigations, nor the Executive's right to resist disclosure of information to Congress, is expressly granted by the Constitution. Given the implicit nature of both rights, it should not be surprising that Members of Congress have tended to have a somewhat different view of the constitutional allocation of power than Presidents and their lawyers have taken. Traditionally, these disputes have been settled through negotiation, compromise, and sometimes capitulation. But as far as I'm aware, no court has ever issued a final judgment resolving such a dispute when the President has asserted his constitutional claims. That may be about to change.

The Comptroller General—acting in response to a request from Congressmen Dingell and Waxman—has demanded that the Vice President disclose information about private meetings that he held while he was a member of the National Energy Policy Development Group (“NEPD Group”), which was entrusted by the President with the task of developing recommendations for a new energy policy. The Comptroller General's demand letter was quite comprehensive, for it embraced all meetings in which the Vice President participated and it required a full account of every meeting, including “any information presented” as well as minutes or notes of the

meeting. The Vice President responded that the GAO lacks statutory authority to enforce these demands, and argued that the demands would exceed Congress' constitutional authority even if the GAO was acting pursuant to statutory authorization. At one point, the Comptroller General appeared to withdraw his most intrusive inquiries, but he continued to seek a number of details about every meeting the Vice President and his support staff had, including the identity of everyone who attended every meeting, the agenda of the meeting, and the manner in which the Vice President or the staff decided who would be invited.

The Comptroller General stopped pursuing his demands in September, but in the wake of the Enron controversy he has announced that he plans to bring a lawsuit to compel the Vice President's compliance.

Is the GAO's demand authorized by the statute?

Two sources of authorization have been suggested. First, the GAO's organic statute authorizes the Comptroller General to "evaluate the results of a program or activity the Government carries out under existing law." A natural reading of the reference to programs or activities carried out "under existing law" suggests that these evaluations are meant to cover programs and activities established by Congress, rather than activities conducted under the President's independent constitutional authority to develop recommendations for future action. "Existing law," however, could conceivably be construed to include the Constitution, which might enable this provision to cover the Vice President's "activities" in preparing policy recommendations for the President.

The statute also authorizes the GAO to investigate "all matters related to the receipt, disbursement, and use of public money." This statutory language is on its face so broad that it could conceivably cover any matter related in any way, no matter how remote or indirect, to the use of public money. Because the Vice President receives a salary from the Treasury, and because public funds were no doubt used in other ways in connection with the meetings that the GAO is purporting to investigate, the statute could be read to authorize an investigation of these meetings.

Assuming for the sake of argument that the statute authorizes GAO to evaluate or investigate the work of the NEPD Group, however, the statute clearly does not purport to authorize the GAO to use any and all means to conduct its investigations or evaluations. The Vice President has already provided some records to the GAO, and the real question is whether the statute purports to require that the Vice President comply with GAO's demands for additional records about the nature of specific meetings. I think that it does not.

The statute requires government "agencies" to supply information about their activities to the GAO, and the term "agency" is given a broad definition that includes every "department, agency, or instrumentality of the United States Government" other than the legislative branch or the Supreme Court. The bare language of the statute could conceivably be stretched to include the Vice President, either as such or in his role as a member of the NEPD Group, but it certainly need not be so interpreted. Under the interpretive principle adopted by the Supreme Court in *Franklin v. Massachusetts*, moreover, the statute should not be construed to cover the President, and probably not the Vice President either, because it does not expressly so provide.

In any event, the express-statement rule invoked in *Franklin v. Massachusetts* is related to a more general principle of statutory construction, under which ambiguous statutes should be interpreted so as to avoid serious constitutional questions. And the constitutional questions raised by the GAO demand letter are very serious indeed. Beginning with George Washington, Presidents have consistently claimed that they may withhold some information from Congress, and the Supreme Court has recognized that a right of executive privilege is indeed implicit in the Constitution. Although the exact contours of the Executive's privilege of confidentiality remain subject to some uncertainty, the GAO's demands at the very least raise serious constitutional questions.

The most recent major decision on executive privilege arose from the Independent Counsel investigation of Secretary Mike Espy. The White House refused to disclose a number of documents that had been generated in the course of the Administration's own investigation of allegations against Espy. Notwithstanding the fact that many of these documents had never been shown to the President, the D.C. Circuit held that most of them were immune from discovery by the Independent Counsel. The court explained that the privilege extends:

to communications authored or solicited and received by those members of an immediate White House advisor's staff who have broad and significant responsibility for investigating and formulating the advice to be given the President on the particular matter to which the communications relate. Only communications at that

level are close enough to the President to be revelatory of his deliberations or to pose a risk to the candor of his advisors.

Vice President Cheney plainly qualifies under this or any other description of a high-level advisor, and much of what the GAO demanded amounts to “communications authored or solicited and received by” the Vice President and his staff. Even after the GAO’s apparent narrowing of its demands, it continues to demand “records providing the following information with regard to each of these meetings: (a) the date and location, (b) any person present, including his or her name, title, and office of clients represented, (c) the purpose and agenda, . . . and (f) how [members of the NEPDG, group support staff, the Vice President himself or others] determined who would be invited to the meetings.” These records would appear to be “communications” and they were presumably authored or received by the Vice President’s staff.

Although the Espy court noted that its decision applied only in the context of judicial proceedings, it would be surprising if the courts were to give the privilege a narrower scope in the context of a GAO inquiry into the President’s policy-development process than it has in the context of a serious criminal investigation.

When one steps back from case law, which in any event cannot provide a definitive resolution, the serious nature of the constitutional questions becomes even more apparent. In 1796, when the House of Representatives was debating its response to President Washington’s refusal to provide the House with documents relating to the Jay Treaty, Congressman James Madison argued that the House must have a right to ask for whatever information it thought fit. He also contended, however, that the President must have a correlative right to refuse the request if he saw fit. Madison concluded that “[i]f the Executive conceived that, in relation to his own department, papers could not be safely communicated, he might, on that ground, refuse them, because he was the competent though a responsible judge within his own department.” Madison’s point was that the President could not be compelled to disclose information, just as Congress could not be compelled to enact legislation without what it considered adequate information. And Madison subsequently did vote against an appropriation to implement the Jay Treaty. This has become the traditional way to resolve these disputes, with each party using its political leverage to bargain over the outcome. The resulting compromises have no doubt frequently left both sides dissatisfied, but neither side has ever had to concede a matter of principle to the other. Once the courts become involved, that may change.

Without claiming that Madison’s theory would properly settle every dispute between Congress and the Executive, I believe that Madison did identify the constitutionally appropriate initial presumption. Applied to the present case, Madison’s approach suggests that Congress might refuse to enact President Bush’s energy proposals if a majority of legislators believed they first needed more information about the Vice President’s work in the NEPD Group. But that is not at all what is going on here. Instead, we have a situation where neither House of Congress, or even a congressional committee, has demanded any documents from the Vice President, and the GAO’s purpose in conducting the investigation is, so far as I have been able to ascertain, rather unclear. Construing a statute that is at best ambiguous to permit this kind of constitutionally dubious fishing expedition would seem highly questionable at best.

While I was thinking about these issues, I began to wonder what would happen if a staffer in the White House office for political operations were to ask the FBI to investigate all meetings between Senators and private parties, at which matters before the Congress were discussed or mentioned (such as energy, or for that matter the regulation of the accounting profession). If the FBI then demanded that Senators provide documents and records like those that the GAO has sought from the Vice President, I imagine that quite a firestorm would ensue. And properly so.

The two cases are not perfectly analogous, but the hypothetical does suggest one reason why it might not make much sense for the Comptroller General to provoke a constitutional confrontation in this case. Elected officials in the legislative and executive branches have a long history of resolving their differences in the manner suggested by Congressman Madison, without involving the courts. The lawsuit that the Comptroller General is threatening to bring will no doubt be very interesting to professors like me, but it seems unlikely to serve the long-term institutional interests of the Congress.

Mr. Chairman, I’d be happy to answer any questions the committee may have.

Chairman LEAHY. Professor Koniak?

STATEMENT OF SUSAN P. KONIAK, PROFESSOR OF LAW, BOSTON UNIVERSITY SCHOOL OF LAW, BOSTON, MASSACHUSETTS

Ms. KONIAK. I want to thank the chairman, the ranking member, Senator Hatch, my Senator, Senator Kennedy, and Senator Edwards, who first suggested that I come here and testify.

Financial scandals are not new. In the early 1970's, there was OPM. In the later 1970's, there was National Student Marketing. In the 1980's, there was the savings and loan debacle. and in each of those scandals, what ultimately became clear was that none of the fraudulent schemes could have succeeded without the assistance of very trained lawyers from very prestigious law firms. Now we have Enron, and I have no doubt that when the facts are known here, we will find that lawyers played a big role here, as well.

The list of people and entities that may have broken the law in this Enron disaster is long—Enron itself, its Board of Directors, senior management, its accountants, Wall Street analysts, managers of pension funds, investment banks, partnerships with strange names, the people who invested in those partnerships, and, of course, Enron's lawyers. But Enron was not the only institution to have lawyers. Everyone on the list I just read had a lawyer, too.

Tightening the reins on accountants is a good idea, but as I have just said, accountants have lawyers. Those lawyers are perfectly capable of helping accountants slip loose of whatever reins you devise, just as they apparently helped Enron slip loose of the reins of corporate and securities law. No reforms you enact will do much good unless you rein in the lawyers.

Thus far, Enron's accountants have borne the lion's share of the blame, but let me put this as plainly as I can. To pull the wool over the eyes of the investing public, regulators, and the media for any considerable period of time, a corporation needs more than malleable accountants. It needs the help of lawyers.

Vinson and Elkins, Enron's lawyers, have received some grief. They will undoubtedly receive more. But I want to start not with Enron's lawyers but Andersen's. Some group of people at Arthur Andersen shredded some substantial number of documents. This shredding not only left Andersen's reputation in ruins, it put Andersen in serious legal jeopardy under civil and criminal law. What were its lawyers doing while this was going on?

The facts thus far suggest three possibilities, and none of them are good. First, they were encouraging the destruction, or they were recklessly ignoring the strong likelihood that documents would be headed for the shredder, or finally, they were acting carelessly in relation to whether or not Enron's documents ended up being preserved. What they should have been doing was issuing unequivocal direction that all Enron documents should be preserved and devising procedures to make sure that happened.

On October 12, an in-house lawyer at Andersen wrote a hopelessly ambiguous memo referring people to a hopelessly ambiguous policy that was entitled, "Retention and Destruction of Documents." Andersen now describes that document in euphemistic terms as being not robust and poorly written, to say the least.

The policy, which was written undoubtedly by a lawyer, could have easily been read to say, shred everything you would like until

a subpoena or litigation is actually filed. Then preserve everything, which is what the law would require.

But this in-house lawyer at Arthur Andersen was not the only lawyer at the job at the time that this shredding occurred. Davis Polk was on the job representing Arthur Andersen from at least October 16, and according to Nancy Temple's testimony, the in-house lawyer, she consulted with Davis Polk on October 16 about the destruction and retention of documents at Andersen.

The shredding party began on October 23. That means that Davis Polk was on the job for 1 week in which it let stand this ambiguous memo and ambiguous policy that, as I said, and I have read both documents, could have easily been read to say "shred" as "not shred." They were on the job for 2 weeks, and apparently nothing was done to withdraw the Temple memo. They were on the job for 3 weeks and nothing was done. Nothing was done until November 8, when Arthur Andersen finally received the subpoena and the correct legal advice went out at that point, advice that should have gone out at least 3 weeks earlier, which was to preserve the documents.

We may never know because of the destruction of these documents what went on, but that is not the best part of the story. The best part of the story is that Davis Polk is now purporting to conduct an investigation into what went wrong at Arthur Andersen. Who is going to investigate Davis Polk? One of the first questions to be asked in such an investigation is what were your lawyers doing? Were they just sitting around? Did they understand the importance of preserving those documents? Did they do anything to make sure that happens?

Vinson and Elkins has gotten a lot of grief, as they should have, for conducting an investigation when their own work was involved. Davis Polk seems to be doing that now. I raise that as an example of how pervasive this problem is. These are well respected firms.

My testimony has detailed explanation. I just would like to say two other things before I close, and a list of recommendations.

One is, this is when you can tell when a lawyer is in trouble. It is a three-part test. It is quite easy. Your lawyer is committing a crime or fraud. You have enough facts in front of you that you should have figured it out, that it was either careless of you not to or you were reckless not to have figured it out. And with that mental state, you then act anyway to help or sit around and do nothing when you know that you have a duty to act when you represent a corporation.

Negligence here, from the material that we have already received, seems quite clear. That means malpractice was committed. Negligence means you have a little bunch of facts in front of you that suggests badness. Here, in front of the lawyers, there seems to be a mountain of red flags, flashing lights going off all over the place, which they ignored and continued to operate and help and not do anything by telling the Board. That is recklessness. The difference between negligence is this amount versus this amount of facts.

Congress changed the law to make it that lawyers could not easily be sued when they were reckless. That has to change.

Chairman LEAHY. Professor, we are going to have to—

Ms. KONIAK. I am happy to conclude on that, to change.
 Chairman LEAHY. Thank you, and we are going to go back to that with further questions.
 [The prepared statement of Ms. Koniak follows.]

STATEMENT OF SUSAN P. KONIAK, PROFESSOR OF LAW, BOSTON UNIVERSITY SCHOOL OF LAW

I. INTRODUCTION

Twelve years ago in a court opinion dealing with some aspects of the Lincoln Savings and Loan fraud, Judge Stanley Sporkin wrote: "Where . . . were the . . . accountants and attorneys. . . ? . . . [W]ith all the professional talent involved (both accounting and legal), why [didn't] at least one professional. . . [act] to stop the overreaching that took place in this case"?¹ Now, there is Enron. And we are here asking the same questions, Judge Sporkin and others were asking 12 years ago. To paraphrase Pete Seeger, "When will [we] ever learn?"

No one should have been surprised in the aftermath of the savings and loan crisis to learn that lawyers and accountants had averted their eyes from the fraud being perpetrated by some in the banking industry during the 1980s. Before the savings and loan debacle, there was OPM, a computer leasing company in New York that was a virtual fraud-factory that bilked such venerable institutions as Manufacturers Hanover and American Express. After filing bankruptcy, OPM's Trustee issued a report that detailed how much OPM's lawyers knew about its client's shenanigans and how much help they provided their fraud-doing client; Stuart Taylor wrote a detailed expose of the involvement of OPM's lawyers in seeing to it that their client's fraud went undiscovered. And no one should have been surprised by that either.

Before OPM, in the 1970s, lawyers and accountants aided and abetted the fraud that brought down National Student Marketing Corporation. And the law firms in most of these instances were not marginal players, they were pillars of the bar: venerable and well respected firms. Firms who settled with the government (and/or with defrauded investors) for their role in assisting Charles Keating, the head of Lincoln Savings and Loan included: Sidley and Austin, Kaye, Scholer and Jones Day. And participating as helpers in the National Student Marketing fraud were the law firms of Lord Bissell and Brook and White & Case. I hasten to add that had I had "world enough and time" those firms would appear on a much larger list, a list that would include many other prestigious firms. That is to say, the firms named above did nothing, unfortunately, that most other prestigious law firms haven't done themselves. And now we sit here in 2002 professing to be shocked, shocked that gambling is going on at Rick's saloon and that well respected law firms and accounting firms may have been involved.

Thus far, Enron's accountants have borne the lion's share of the blame for helping the wrongdoers at Enron commit what appears now to have been massive fraud. Let me put this as plainly as possible: To pull the wool over the eyes of the investing public, regulators and the media for any considerable period of time a corporation needs more than malleable accountants, it needs the help of lawyers. Perhaps Lee Harvey Oswald acted alone, but Enron and its accountants did not. When all the facts that can be known about what happened here are known, one thing will be clear everyone in the drama had a lawyer whispering in its ear (Enron, Arthur Andersen, the investment banks, the questionable partnerships that hid Enron's losses and bilked Enron's funds, the investors in those partnerships and on and on). And one more thing will be clear: no lawyer stepped in to stop this calamity.

Tightening the reins on accountants is a good idea, but, as I have just said, accountants have lawyers too.² Those lawyers are perfectly capable of helping account-

¹ Lincoln Sav. & Loan Ass'n Wall, 743 F. Supp. 901, 920 (D.D.C. 1990).

² Consider this exchange from the House Energy Committee:

Representative Markey: Okay, let me—so you were—you were also worried that Andersen would be required to comply with the financial fraud reporting requirements of Section 10(a) of the Securities and Exchange Act, the Wyden-Dingell-Markey amendment that requires accounts to immediately report evidence of financial fraud to senior management, the board; and, if they take no action within five days to report the fraud to the SEC. You make that clear. If so, why didn't you order the shredding to stop?

Ms. Temple [an in-house lawyer at Andersen]: Congressman, there was no conclusion that there was any financial fraud, or that—in fact, no conclusion that there was no misleading statement. After consultation with others in the firm, and Davis Polk, I was being careful in

Continued

ants slip loose of whatever reins you devise, just as they apparently helped Enron slip loose the reins of corporate and securities law unless Congress, the SEC and state regulators³ rein in lawyers too. Something needs to be done about the lawyers, if confidence is to be restored in the financial statements issued by companies. What the securities laws demand, is ultimately a legal question, not one for accountants. When documents must be preserved, is not simply a matter of some accounting convention; it depends on law: tax law, statutes prohibiting obstruction of justice, civil rules on spoliation of evidence, state laws on tampering with evidence and other such legal constraints.

All too often lawyers act as if they were wearing magic caps—hats that transport them to some alternative reality, a law free zone, in which they are free to do anything and everything for the person or entity paying the lawyers' fees, a magic land where lawyers need not fear that law will come crashing down on them.⁴ "It may hit the client, but it will never hit me." There are no such magic caps. But the scant attention that has thus far been paid to the role of lawyers in this mess suggests that the myth of the magic cap has spread far and wide. With the report issued by Enron this weekend, Vinson & Elkins, Enron's primary outside law firm, which has thus far received relatively little grief, will undoubtedly receive much more scrutiny. Later on, I will get to that firm and the other firms that Enron may have employed to help it with its financial shenanigans later. But to make concrete just how pervasive the magic cap myth has become, I want to start not with Enron's lawyers, but with Arthur Andersen's, in particular with the lawyers who are advising Arthur Andersen right now. They're acting like they're wearing magic caps, and everyone appears to be going along. Let me explain what I mean.

II. TO SHRED OR NOT TO SHRED, TO INVESTIGATE OR TO STEP ASIDE

Some group of people at Arthur Andersen shredded some substantial number of Enron documents. The shredding not only left Andersen's reputation in ruins, it put Andersen into serious legal jeopardy under civil and criminal law. What were Andersen's lawyers doing while Andersen's accountants and staff were doing that shredding? The facts disclosed thus far suggest three possibilities; none of them good. Andersen's lawyers were either (1) encouraging this destruction through none-too-subtle hints; (2) recklessly ignoring the strong likelihood that documents were headed for the shredder; or (3) acting carelessly in relation to whether the Enron files were preserved or not.

What should they have done to prevent the wholesale shredding that apparently began on or about October 23rd and continued for some considerable time thereafter? What they did way too late: Issue unequivocal legal advice that all Enron documents were to be preserved and suggest procedures to Andersen's management that would have helped ensure that the documents were actually preserved.

Instead on October 12th Nancy Temple, a member of Andersen's in-house legal staff, wrote the now infamously ambiguous retention/destruction memo that David Duncan, the Andersen partner in charge of Enron's account, has told congressional investigators he read as authorizing him to begin the shredding. I have read that memo and the policy that it says might be "helpful" and thus suggests should be followed. As I read those documents, it seems like Attorney Temple's memo was an effort to encourage others to destroy Enron documents, while preserving for its author the ability to deny that she meant any such thing. (Indeed, Andersen's retention/destruction policy seems designed to achieve that same result and was probably written by a lawyer too).

Perhaps, Attorney Temple did not mean the memo that way She has testified that she did not. She says that she meant the partner in charge, Mr. Duncan, to read the policy and interpret what it meant for himself. Why? Was she unsure of what the policy demanded? If so, was it sensible to believe an accountant would have an easier time deciphering it, this document that resembles a legal regulation much more than an accounting rule? And what of the law's demands? Did she have no information to give Mr. Duncan and the other accountants on that either?

asking Davis Polk to look at all angles and all issues, and advise us. And the conclusion was there were no further steps to take.

³By state regulators, I mean primarily state courts and bar disciplinary authorities. They have a role to play too. They should reexamine the rules that govern lawyers licensed by the states. Bare disciplinary authorities should also be better funded. Having said that, I assure you that such authorities will never have the resources necessary to take on the large and quite powerful law firms that are so often the relevant players in major and even minor securities' frauds. The federal government thus has an important role to play here.

⁴See generally Koniak, *The Law Between the Bar and the State*, 70 N.Car.L.Rev. 1389 (1992).

But this is not a tale of one poorly-intentioned or careless lawyer, writing a reckless or slipshod memo on one particular day. The story gets much worse. Attorney Temple wrote her incredibly unhelpful memo on October 12th. A few days earlier, Arthur Andersen hired the well respected firm of Davis, Polk & Wardwell to advise it on Enron-related matters. Now, according to the testimony of Mr. Andrews, a senior partner at Arthur Andersen, while Davis Polk was retained before the October 12th memo was written, it did not begin its work for Andersen until October 16th.⁵ No matter. Attorney Temple has testified that on Davis Polk's first day on the job, October 16th, she consulted with Davis Polk lawyers on "document retention and destruction."⁶ Thus, before the major shredding party at Andersen began, which was on or around October 23rd,⁷ Davis Polk was consulted on the steps Andersen was taking or not taking to see to it that documents were preserved.

Did Davis Polk advise Temple or anyone else at Arthur Andersen to clarify Temple's October 12th memo when she talked to Davis Polk lawyers on October 16th?

Davis Polk was on the job about a week before the shredding extravaganza began. Why didn't it take steps to see to it that Andersen's notes, drafts and e-mails on Enron were preserved? We don't know what, if anything, Davis Polk did advise because Arthur Andersen seems to be relying on attorney-client privilege when it comes to what Davis Polk said,⁸ but we do know that the Temple memo was not withdrawn and the Andersen retention/destruction policy was not clarified in the first week of Davis Polk's involvement in this case or the second week or the third.

Before October 22nd, Arthur Andersen's lawyers should have done something to make it clear to Andersen partners and staff that the Enron files were to be preserved. The preservation of those Enron documents was necessary to protect Andersen's legal interests as well as its future viability as a respected accounting firm. First, how is Andersen to demonstrate its innocence, assuming it is innocent, when its files are not intact. Second, assuming someone at Andersen did something wrong on the Enron account, how is Andersen to convince people that it has not gotten to the bottom of the problem and made all necessary changes when its files are incomplete. Third, if your client destroys documents when it is reasonably foreseeable that it will be sued and the documents will be relevant to that suit, a judge can instruct the jury to assume that the destroyed evidence would have shown your client's guilt.⁹ And that is the least of the legal troubles that the destruction of these documents might bring.

On October 22nd, Enron disclosed that the SEC had opened an inquiry into the company's financial dealings, particularly the strange partnership transactions and Enron's fuzzy disclosures on those deals. As with most legal matters, there is some uncertainty on precisely how formal an investigation by a government agency must

⁵ Testifying before the House Energy Committee, Mr. Andrews of Arthur Andersen said: "Mr. Chairman, the firm was retained on October 9th, and commenced work with us on October 16th." [All quotes and references in this testimony to the House Energy Committee Testimony were taken from the New York Times' website transcript of the hearing.]

⁶ In testimony before the House Energy Committee, Attorney Temple said: I believe in my conversation on October 16th I discussed the documentation and retention issues that had arisen as of the date with Davis Polk.

⁷ Generally see the testimony before the House Energy Committee.

⁸ I said "seems to" because Ms. Temple did testify, albeit somewhat vaguely, on the advice Davis Polk provided on another of her acts that has received some negative attention: her request to have her name removed from some document and her suggestion that a reference to Andersen concluding something was "misleading" also be deleted. Her testimony before the House Energy Committee included these exchanges:

Representative Whitefield: Okay. Now—and then Nancy Temple wrote a memo to Mr. Duncan on the 16th, which is one day after his memo to file, in which he's concerned about this misleading recurring charges statement. And she said, "Dave, here are a few suggested comments. I recommend deleting reference to consultation with the legal group and deleting my name on the memo. I also suggest deleting language that might suggest we have concluded the release is misleading." Why did you write that memo, Ms. Temple?

Ms. Temple: I wrote that after reviewing the draft and consulting with our outside legal counsel. First—Representative

Whitefield: Outside? Which outside?

Ms. Temple: Davis Polk.

At numerous other times during the hearing she alluded to advice given by Davis Polk, sometimes with a little more content (which might affect a claim of privilege) and other times not. See also footnote 2 above.

⁹ See e.g., *Byrnie v. Town of Cromwell Bd. of Educ.*, 243 F.3d 93 (2d Cir. 2001) ("We have defined spoliation as 'the destruction or significant alteration of evidence, or the failure to preserve property for another's use as evidence in pending or reasonably foreseeable litigation.' *West v. Goodyear Tire & Rubber Co.*, 167 F.3d 776, 779 (2d Cir. 1999). The spoliation of evidence germane to proof of an issue at trial can support an inference that the evidence would have been unfavorable to the party responsible for its destruction,' *v. United States*, 150 F.3d 112, 126 (2^d Cir. 1998). (Emphasis added).

be before destroying documents might qualify as obstruction of justice.¹⁰ But there is precedent that holds that some, if not all, preliminary inquiries by the SEC qualify.¹¹ Presumably, Arthur Andersen had no interest in being accused of obstructing justice, even if it could ultimately establish its innocence because the government could not quite prove that it had the requisite corrupt intent or because some court held that the SEC's inquiry of Enron was not formal enough to constitute "a proceeding" under the obstruction statute. Given that Andersen's very survival might be threatened, if it managed to convey that as Enron started coming apart, Andersen was busy flirting with violations of the criminal code, Andersen's lawyers should have done everything possible to clarify the Temple memo and Andersen's poorly written policy—at the latest—immediately after they became aware that an informal SEC inquiry of Enron was underway. They didn't.

On October 25, Enron, getting good legal advice—at least at this point—sent e-mails to its employees worldwide and to its auditors at Andersen, directing everyone to preserve all Enron documents. Andersen's lawyers take no action to rescind the Temple memo or to clarify the policy to which the memo refers. A few more days go by, and on October 31, Enron announces that the SEC investigation has been upgraded to "formal." Now any doubt about the potential applicability of § 1505 should have been removed. Still Andersen's lawyers did nothing. Even assuming that they somehow imagined that Temple's memo and Andersen's nonrobust, poorly written retention policy¹² were adequate to convey the "don't destroy documents" advice that they should have been giving, why weren't Andersen's lawyers checking to see what procedures Andersen was following to ensure that Temple's supposed directive was being followed by Andersen's Enron team?

Finally, Andersen receives its own subpoena from the SEC. That happened, I believe, on November 8th. The next day Attorney Temple calls Duncan, the head of Andersen's Enron team, and leaves him a message to preserve all documents. Apparently, that message managed to convey what Temple's October 12th e-mail and Andersen's woefully inadequate retention/destruction policy could not. Duncan's assistant now sends out an e-mail to those shredding Enron documents and tells them to stop. That e-mail went out the same day Temple left her voice message for Duncan with its clear legal advice. The following day, November 10th, Attorney Temple sends an e-mail memo to the personnel at Andersen, which said in part, according to press reports:

One of the first things we must do in preparing to respond to this subpoena and the lawsuits is to take all necessary steps to preserve all the documents and other materials that we may have relating to the claims that are being filed. . . .

To do this we must first insure [sic] that all documents and materials already in existence are preserved and that nothing is done to destroy or discard any documents or materials now in your possession.¹³

What took her so long? And why didn't Davis Polk, Andersen's outside counsel, do any better than Attorney Temple and the rest of Andersen's in-house legal team managed to do?

Most troubling, how is it possible that Davis Polk has agreed to conduct an investigation for Arthur Andersen to discover how so much shredding could have gone on at Arthur Andersen between October 23rd and November 9th? That shredding occurred on Davis Polk's watch. Who is going to find out why Arthur Andersen's out-

¹⁰ See generally, Construction and Application of 18 USCA § 1505 Making It a Federal Offense to Obstruct Proceedings Before Federal Departments or Agencies or Congressional Committees, 8 A.L.R. Fed. 893

¹¹ See *United States v. Batten* 226 F Supp 492 (D.D.C. 1964) cert. den. 380 US 912, 13 L Ed 2D 799, 85 S Ct 898, reh den 381 US 930, 14 L Ed 2d 688, 85 Ct 1557 (preliminary investigation by the Securities and Exchange Commission). There is, however, some dispute about whether the fact that a subpoena had issued to the witness in that case, whom the defendant was accused of trying to influence, was critical to the holding. See particularly, *US v. Edgemon*, 1997 U.S. Dist. Lexis 23820 (ED Tenn). On the other hand, in *Rice v. US*, F.2d 709 (8th Cir. 1966,) the court albeit in dicta, said:

In our view, it would be absurd to hold that Congress meant to proscribe interference with the administrative process only after a Labor Board Proceeding had reached a certain formal stage and let go unpunished individuals who obstruct earlier preliminary proceeding. . . . Congress did not limit the term "proceeding" as used in §§ 1505 to only those acts committed after a formal stage was reached, and we cannot so limit the term.

And in *United States v. Kelly*, 36 F.3d 1118, 1127 (D.C. Cir. 1994) the court summarized *Batten*' holding this way: "the SEC's authority to issue subpoenas and administer oaths in conjunction with its investigations made an SEC investigation a § 1505 proceeding" (Emphasis added).

¹² This is how Andersen executives testified that they now view the policy. See House Energy Committee hearing.

¹³ Susan Schmidt and Kathleen Day, Testimony is Sought on File Shredding, Wash. Post, Jan. 20, 2002, at A5 (quoting Temple's November 10th e-mail).

side counsel, Davis Polk, did not properly protect its client and Enron's documents? Davis Polk? One of the first questions Andersen needs to ask in its internal investigation is: where were the lawyers? The lawyers who were out to lunch at the critical time should not be the ones Andersen or the rest of us should be depending on to explain what went wrong. It's that simple.

Vinson & Elkins should have refused to investigate allegations of misconduct at Enron that happened on their watch, even if the firm had played no active part in any of the alleged wrongdoing.¹⁴ But they accepted an engagement that, if done right, would have required them to assess objectively their own competence, honesty and adherence to the law. That law firms routinely accept just such assignments is outrageous, but they do. It shows just how deeply they believe in those magic caps—deeply enough to imagine that they can assess a legal landscape that they were part of, as if they were not there at all. Vinson & Elkins had no magic cap and Davis Polk doesn't have one either.

III. ASSUME THERE WAS SECURITIES FRAUD, NOW ASSUME THERE WERE LAWYERS. YOU SEE I REPEAT MYSELF

The mere fact that there are always lawyers around when securities fraud is taking place does not mean that lawyers cause securities fraud nor does it demonstrate that they are always in a position to discover it or stop it from taking place. They aren't. In plain English, fraud, as I tell my students year in and year out, is lying to someone to get them to give you their stuff.¹⁵ Fraud-doers are by definition liars (sneaks, cheats) and many are slick enough at lying to fool a room full of experienced lawyers. On the other hand, not all fraud-doers are quite that slick, and I dare say when it comes to securities fraud being slick enough to keep it from one's lawyers for a significant period of time takes some considerable degree of skill. Don't get me wrong, even a sophisticated and careful lawyer may not be able to detect a complex and well crafted scheme to defraud others in connection with the sale or purchase of securities. But then again many a sophisticated lawyer is not careful, at least, not about detecting securities fraud, and all too many sophisticated lawyers are all too willing to turn a blind eye.

Enron released the Powers report this weekend. I have not yet had a chance to review it thoroughly, but it seems to support, not dispel, the idea that Enron, acting through its agents, was committing securities fraud and engaging in other violations of the securities laws and other laws as well, civil and criminal wrongs. Let's assume that's so for purposes of analyzing whether Enron's in-house and outside counsel did wrong.

To make this as simple as possible a lawyer has done wrong and is likely to be in significant legal trouble when three things are true. One, the client is breaking the law. Two, the lawyer has enough facts in front of her to have been able to figure out, with the exercise of reasonable care, that number one is true. And three, with number one and number two in place, the lawyer either acts to help the client to break the law or does nothing to stop the client from breaking the law in those instances (which are not as few as some would like to think) when the lawyer has a duty to intervene.¹⁶

Using the three part test I have just laid out, we can gauge the universe of lawyers who might be in trouble by asking which clients are we likely, in the end, to discover were breaking the law? I started by assuming Enron will be in that category; possibly Arthur Andersen, possibly the partnerships that appear to have been part of what now appears to be a fraudulent scheme, some investors in those partnerships, maybe some investment banks. And while that list may include some innocent parties, it is at least as likely to have left out some individuals and entities who we will later discover were involved in violations of law.

The lawyers for any of the individuals or entities that turn out to be on the "broke the law" list constitute the universe of lawyers who need to start worrying. Vinson

¹⁴ See the report released by Enron, referred to as the Powers report, which details the investigation Vinson & Elkins conducted and criticizes the firm's investigatory work. Apparently, Sharon Watkins, the author of the memo suggesting Enron was committing massive fraud—the memo whose allegations Vinson & Elkins was charged with investigating—said in that memo that Vinson & Elkins should not be given the investigatory task because they would be ruling on their own work. How is it Watkins could figure that out and not the lawyers at Vinson & Elkins?

¹⁵ The lie can be a lie committed by omission if what is omitted is critical enough information to render that which is said seriously misleading (or as the law calls it "material" misleading).

¹⁶ See generally the excellent article by my friend and co-author, Geoffrey C. Hazard, Jr., *How Far May a Lawyer Go in Assisting a Client in Unlawful Conduct*, 35 U. of Miami L. Rev. 669 (1981).

& Elkins was Enron's outside counsel, but other law firms may have represented Enron during what may have been its crime spree and might have been in a position to have figured out that Enron was breaking the law and to have helped it to do so. Enron's in-house counsel were certainly in a position to satisfy all three parts of the test I set forth above, as were Andersen's in-house counsel, and any outside law firms who may have advised Andersen on Enron related-questions during the years Andersen was auditing and advising Enron. (Having given Davis Polk some considerable amount of grief above, I want to make clear that here I am not referring to that law firm because to my knowledge they were not providing Andersen with advice during the period of time when Andersen might have been violating the securities laws through its work for Enron).

But as my list of potential law breakers was designed to emphasize, the lawyers who may be in trouble for assisting their clients' unlawful conduct (assuming those clients turn out to have broken the law) does not end with lawyers representing Enron and Andersen.¹⁷

Now, we move to question two: Did any of the lawyers for clients who were breaking the law have enough facts in front of them to have figured out with the exercise of reasonable care that law breaking was going on? Well, the Powers report strongly suggests that if Enron was breaking the law, its in-house counsel and Vinson & Elkins had enough facts in front of them to have figured it out, had they been exercising reasonable care. I hasten to add that does not make either in-house counsel or outside counsel, guilty of any crime, but it does leave them in legal jeopardy in malpractice actions brought on Enron's behalf by the Trustee in bankruptcy or whomever ultimately emerges as the new management or entity in control of Enron.

To take just one example detailed in the Powers report, knowing that the Board had waived Enron's conflict of interest rules (and possibly having advised that it was a good idea to do so), it does not appear that any lawyer (within or outside) Enron bothered to worry much about the "procedures" that were supposed to prevent bad things from happening to Enron due to the conflicting roles its CFO was not licensed to play. The Powers report says whatever procedures were supposed to be in place, not only failed miserably but were not designed well enough to do anything but fail. It was Enron's lawyers who should have designed better procedures, or at least, monitored whatever procedures were designed to see to it that they had some reasonable chance of working. I do not know whether this was within the scope of Vinson & Elkins retainer, but in-house counsel was apparently not paying all this much mind. Some lawyer or group of lawyers appears to have been hopelessly careless on this matter. Indeed, it seems to me that a reasonably careful lawyer would have strongly advised the board not to waive the conflict rules in the first place, especially not as to the company's CFO.

The fact that agents within Enron, including senior management, may have been actively engaged in fraud does not, in most states, relieve the lawyer from a claim of negligence for having failed to take steps to have saved her client, the corporation, from harm (legal and financial) that these wrongdoing agents may have been causing.¹⁸ Again, if a careful lawyer would not have discerned that agents within the client corporation were acting unlawfully, which includes breaching their duties to the corporation by self-dealing or taking actions that would leave the corporation open to a multitude of civil lawsuits and possibly criminal charges, the lawyer

¹⁷ Although I was not asked to testify on accountants, I have discussed some and alluded to other possible wrongdoing by Arthur Andersen as a necessary predicate to an analysis of the problems that may face Andersen's lawyers. I thus think it only fair to point out (and this seems as good a place as any) that Andersen may not be the only accounting firm with legal woes related to the Andersen mess. The Powers report says Pricewaterhouse Coopers did some work on the Enron-partnership transactions. If that accounting firm also proves to have stepped over some legal line, its lawyers (in-house or outside) may be in the universe of lawyers-in-potential trouble that I have described. I just don't know enough at this point to say.

¹⁸ See *O'Melveny & Myers v. FDIC*, 512 U.S. 79 (1994). In that case the Supreme Court reversed the Ninth Circuit's opinion, finding a law firm could be liable for malpractice for having breached its duty of care to a bank by failing to have taken steps to alert its board to the ongoing fraud of the agent in charge of the bank, who was also on the board. But that reversal was on the ground that the Ninth Circuit had applied federal common law to reject the law firm's defense that the bank (its client) and the bank board already knew of the wrongdoing, so there was nothing more the law firm should have done. In reaching that conclusion, the Supreme Court mentioned that the FDIC's brief pointed out that "in the vast bulk of decisions from 43 jurisdictions, ranging from Rhode Island to Wyoming" the fraud of an agent that harmed the corporation (as is the case with Enron) would not be attributed to the corporation so as to bar a successful suit of negligence against the lawyers for failing to take steps to alert the corporation of the fraud and stop it. Indeed, on remind the Ninth Circuit explained that California law would reach that result as well and affirmed its earlier opinion. *FDIC v. O'Melveny & Myers*, 61 F.3d 17 (19th Cir. 1995).

should not be found liable. The liability of the lawyer will turn on how many red flags were in front of him, indicating ongoing fraud. The Powers report suggests there were signs aplenty. A company's lawyers can avoid liability for negligence, but not if they are careless about detecting wrongdoing by the CEO or CFO or other senior management, and only if they take steps to bring any signs of serious wrongdoing to the attention of the board and advise management and the board that the wrongdoing must stop. The Powers report suggests that did not happen, although we have yet to hear from the lawyers involved.

Malpractice, is of course a matter of state law. But extreme negligence amounting to reckless disregard of the fact that corporate actors are engaged in securities fraud has long been a matter of federal law, although that may no longer be the case. Before the mid-1990s, federal securities law, as interpreted by the courts, provided that lawyers could be sued by shareholders in a derivative action and by the SEC for failing to take steps to stop securities fraud that those lawyers had to be deaf, dumb and blind not to have detected (i.e., fraud the lawyers recklessly ignored or to which the lawyers deliberately closed their eyes). This was "aiding and abetting" securities fraud. It should be the law today, but for a number of reasons it isn't. That should change.

Before getting to why it should change. Let me explain why it is necessary for federal law to punish lawyer recklessness when state law allows a malpractice action for negligence and thus by definition presumably deters recklessness as well, both by leaving lawyers liable for less serious carelessness (negligence) and by providing punitive damages when that negligence gets out of control and rises to the level of recklessness.

First, there is the fact plain for all to see: the existence of state negligence actions has not proven to be an effective deterrent, possibly because lawyers bet on the fraud-doers staying in control of the corporation through fraud and thus there being no "clean, new" management with an interest in suing them. Possibly because lawyers believe that the wrongdoing of high corporate officials will somehow be attributed to the corporation in such a way as to bar a negligence suit or that even if such a suit may legally proceed, a jury will be loathe to hit the lawyers hard when management was so dirty itself. Perhaps, some state tort law reform, e.g., laws capping damages, have rendered it worthwhile for lawyers to risk a negligence suit when the fees to be reaped are high enough to pay whatever damages may be imposed (discounted by the risk that the negligence may go undiscovered or unprosecuted).

Perhaps it is as simple as lawyers believing (and being trained to act) as if the agents for their clients were their clients, making it much more difficult to internalize the notion that there is a client out there that doesn't know what's going on. Perhaps (and I believe there is something to this) the elimination of private causes of action against lawyers for aiding and abetting liability, the changes to RICO, restrictions on joint and several liability in many actions against lawyers, and other changes in federal law have encouraged lawyers to overlook that something as relatively trivial as negligently failing to take action to stop a fraud could still offend the law at all.

"That still couldn't be what state law says? Could it? Our magic caps undoubtedly will protect us."

The Supreme Court's decision in *Central Bank*¹⁹ and the changes Congress made in the Private Securities Litigation Reform Act²⁰ that helped lawyers to imagine themselves free (or nearly free from the constraints of law) were monumentally bad ideas.

It really is no wonder that lawyers believe they are wearing magic caps. It is true that as a response to Congress' elimination of the private cause of action against lawyers for aiding and abetting securities fraud, many courts have not been shy about holding lawyers liable as primary violators of the securities law in cases that previously would have been framed as aiding and abetting cases.²¹ But the degree to which lawyers may be liable as primary violators for what used to be thought of as "aiding" a client's fraud is quite uncertain, and that uncertainty alone is enough to encourage lawyers to avoid "knowing" that fraud is being committed by

¹⁹*Central Bank v. First Interstate Bank*, 511 U.S. 164 (1994)

²⁰Private Securities Litigation Reform Act of 1995, Pub. L. Non. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.) [hereinafter referred to as the 1995 Act].

²¹For example, a materially misleading opinion may give rise to primary liability, which would allow investors who relied on it to sue the lawyers for damages. See e.g., *Kline v. First Western Govt. Securities Inc.*, 24 F.3d 480 (3rd Cir. 1994)

their clients and to continue acting in a reckless manner that helps the fraud continue and makes it harder to discover. Lawyers are not dumb.

Consider the case of *Kline v. Boyd*,²² the lawyer there tried to sidestep liability as a primary violator of the securities laws by writing the materially misleading disclosure statements without putting the law firm's name, the respected firm of Drinker, Biddle, or his own name on any of the blatantly misleading disclosure statements that the lawyer drafted and which the lawyer knew the client would give to investors. The Third Circuit had a hell of a time explaining how that conduct—which was clearly enough to qualify as substantial assistance had private parties been able to recover for aiding and abetting—amounted to a primary violation of the securities laws. It managed and I believe its effort was admirable because any other result would invite lawyers to further securities fraud behind the curtain of the lawyer-client relationship, free from the law's reach so long as they kept their participation secret from the investors. Surely, not a good result.

While I thus applaud the result in *Kline*, I recognize that the reasoning that called this bad behavior a “primary” violation instead of aiding and abetting stretched the law as far as it could go. (I do not think it broke it, but many others disagree.) And that stretch rendered the judgment quite vulnerable and ended up destroying its value as precedent. The entire Third Circuit apparently noticed the stretch and granted a rehearing of the case en banc. That rehearing never occurred because a settlement was reached while rehearing was pending, and the decision in *Kline* that I described above was vacated as part of that settlement.

In the end then we really don't know whether a lawyer who did what the lawyer in *Kline* did may be successfully sued by investors harmed by the lawyers actions. We should know. A lawyer who does what the lawyer in *Kline* did is no different than one who puts his name on work product that he knew or should have known was materially misleading, except insofar as the anonymous draftsman may be somewhat more despicable. What sense does it make to let that guy escape damages in a civil suit?

It is true that the SEC retains jurisdiction to bring a civil cause of action against lawyers who aid and abet their clients' securities fraud, but the statutory provision that now sets out that authority provides that the SEC must allege that the lawyer “knowingly” helped.²³ Sounds fair enough on its face, but it's not. If one kills someone with reckless indifference to human life, most states call that murder and treat the defendant with little or no difference from one who kills someone with intent (premeditated murders are treated more harshly but I am not speaking here about them). If reckless indifference equals intent for ordinary folks charged with all sorts of crimes, not just murder, why should lawyers not be held to that standard too? Indeed, there is more not less reason to insist that reckless is as bad as actual knowledge when the defendant is a lawyer.

Lawyers are notorious for never “knowing” their clients are guilty. That inability is built into the ethos of the bar, which still takes its shape from the paradigm of the lawyer as advocate. And by and large, as to lawyers charged with defending client's in court, that ethos is okay. We do not want lawyers to substitute their judgment of the client's guilt for that of the jury or that of the judge. Although I hasten to add that this “no judging” attitude sometimes leads to abuse in courtrooms too, as when litigators believe they have a license in civil and criminal cases to assist perjury on the ground that they are incapable of “knowing” what the truth of the matter is. That caveat made, in general it is appropriate that the trial lawyer leave “judging” the client to the finder of fact. That's what trials are for.

But none of that applies to the lawyer who is not litigating a matter after the alleged wrong has occurred, but rather one who enters the scene before or during the client's wrongdoing—the lawyer in the role of a facilitator of the client's transactions. Indeed, very few lawyers practice in court compared to the number whose daily work is to facilitate transactions. The transaction or office lawyer, as distinguished from her trial colleagues, must understand what the client is doing and whether that is within or without the law. Otherwise, there is simply no reason for the lawyer being there.

But transaction lawyers share the ethic of trial lawyers that makes it difficult to believe, difficult to “know” that their clients are breaking the law. Complicating that problem is the fact that every good transaction lawyer understands, what every good lawyer knows, the lines of the law are almost always fuzzy at the edges. It is simply not easy to “know for sure” when those lines have been crossed, particularly when clients want to walk on the wild side and expect their lawyers to support that be-

²² Fed. Sec. L. Rep ¶90, 136. Vacated on Grant of Rehearing En Banc (3rd Cir. 1998).

²³ 15 U.S.C. 78u(f) (Supp. I 1996).

havior. The lawyer who seems too quick to judge his client is likely to be replaced rapidly with one much more willing to “believe” that his client is right.

Letting lawyers know that there is a price to be paid for failing to “know” what the facts in front of the lawyer plainly suggest—that the client is committing fraud—is absolutely necessary. Without that we create a world in which fraud doers can count on high-priced and savvy lawyers to help them with their schemes, as long as the fraud doer never directly admits to the lawyer precisely what he is up to. This is not a world we should encourage. It is a world our law should try to erase.

In 1964, Judge Friendly said this about the importance of holding lawyers and accountants liable when they recklessly disregarded evidence of their client’s securities fraud:

Congress did not mean that every mistake of law or misstatement of fact should subject an attorney or an accountant to criminal liability simply because more skilled practitioners would not have made them. But Congress equally could not have intended that men holding themselves out as members of these ancient professions should be able to escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not possess.²⁴

Congress should change the securities laws to make clear once again that such recklessness on the part of lawyers and accountants is enough to subject a lawyer to a private suit for money damages from those the lawyer’s recklessness has helped to harm. Such recklessness is rightly thought of as “criminal,” given the learning, privileged position, substantial financial rewards and expertise that come with being a securities lawyer. And if it’s rightly thought of as criminal when such privileged folks behave recklessly, it should be a civil wrong as well.

Were the lawyers who represented Enron negligent? Were they reckless? Did they actually know, what we now suspect, that Enron through its agents was committing securities fraud? I can tell you this much I am highly doubtful that they “knew,” if “knowing” means subjectively believing that Enron was breaking the law. I am sure they convinced themselves that however close to the legal line Enron was, it had not crossed it. I am sure they refused to see and took no steps to actively ferret out, facts that would have burst that bubble—facts that would have made it difficult to maintain their “belief” that nothing was rotten in the state of Denmark. Hard as I am on lawyers, I can hardly blame them. The law as “reformed” by Congress invited them to act that way. If they “knew” I am sure that it was only in the sense that it may have crossed their mind, but any agile legal mind can formulate a doubt about whether something is “illegal” to chase those occasional bogey-men away.

But the facts (as we know them so far) do seem to suggest that at least some of Enron’s lawyers and likely some of the lawyers for other actors in this drama went way beyond negligence. According to the Powers report there were not just red flags all over the place but cannons booming and music playing, all with the same message: Enron’s financial condition is way different than what it (with its lawyers’ help and its accountants’ blessings) was leading everyone to believe. A jury need not accept a lawyer’s denial of knowledge. It is perfectly free to infer that with so many major clues, some of these lawyers did “know,” no matter what they were telling themselves or what they tell the jury under oath. That is, a jury can decide not to believe the lawyer, assuming a court allows the case to get to the jury, something Congress’s reforms discourage judges from doing in cases when “actual knowledge” is in doubt.²⁵

But whatever happens or doesn’t happen to the lawyers in Enron, there is every reason to believe that there will be securities fraud in our future and every reason to believe that its success will depend in part on lawyer’s being asleep at the wheel or acting with reckless abandon. Keep in mind that in the past, as will be the case here—assuming lawyers are found to have substantially assisted fraud at Enron—the lawyers who have done wrong were (and will be) members of our finest law firms, not some nobodies from nowhere. The bar can complain all it wants about federal encroachment on self-regulation, but one thing should be abundantly clear by now: Without the discipline that fairly certain and substantial liability brings, the bar will not reform itself. Lawyers need law at least as much, if not more, than

²⁴ 328 F.2d 854 (2d Cir. 1964).

²⁵ I am referring here to the strong pleading requirements in securities actions that Congress has enacted. Whatever merit those requirements have, they operate perversely when combined with the elimination private cause of action against lawyers for aiding and abetting liability and the new “knowingly” standard for aiding and abetting actions that the SEC retains the power to bring.

everyone else.²⁶ You do neither the bar nor anyone else a favor by leaving them behind the curtain trusting in their magic caps.

RECOMMENDATIONS FOR REFORM

1. Restore private causes of action against lawyers for aiding and abetting securities law (and against accountants too).

2. Replace the “knowingly” standard that now defines the scope of the SEC’s ability to bring civil actions against lawyers and provide that recklessness will suffice in actions brought by the SEC and by private parties as well.

3. Pass legislation that removes the legal cloud that has long surrounded Rule 102(e), the securities regulation promulgated by the SEC to discipline securities lawyers and accountants.²⁷ Make it clear in that legislation that the SEC need not first secure a ruling from a federal district court affirming that the lawyer has violated the securities laws before proceeding against that lawyer via Rule 102(e).²⁸ Finally, affirm a version of the standard that the SEC has been pushing for years: in-house and outside counsel who become aware of facts strongly suggesting that an agent of a corporation is involved in securities fraud must take steps, designed to be effective, to ensure that the board understands what the lawyer has discovered and must take steps to encourage the board to take action to disclose what it has discovered to the SEC and investing public.²⁹ A lawyer who fails to take such action should be subject to discipline by the SEC whether or not he has been found liable or would ever be found liable by a court for aiding and abetting a violation of the securities law.

4. Ensure that RICO can reach organizations, as Enron may yet turn out to be, whose profits are largely the product of fraud. To the extent that the restrictions now in RICO on securities fraud as a predicate act make that statute ineffective against organizations that are (or that evolve into) little more than giant fraud ma-

²⁶In the seminal case on lawyer liability for aiding and abetting securities fraud, which the bar fought vigorously when it was brought by the SEC, the National Student Marketing Case, 457 F.Supp. 682 (D.D.C. 1978), lawyers at Lord Bissell & Brook were found to have aided and abetted securities fraud by sitting by and allowing a merger to go forward (without even speaking up to try and stop it) that the lawyers should have known (were reckless not to have known) was being consummated when the financial information in the proxy statements was materially misleading. The court, however, obviously quite sensitive to the storm of criticism that the SEC’s action had engendered from the securities bar (something the court mentions) decided that although the lawyers had aided and abetted the fraud, no sanction was necessary because they were lawyers and we could trust them to go forth and never sin again. A few years later the same (quite otherwise respectable) law firm was charged with assisting another client to violate the securities laws, a claim the law firm settled for \$24 million. In an interview with the press after that charge, the managing partner of the law firm admitted that the judge’s decision on what constituted securities fraud—the decision the judge was so sure lawyers would take seriously even without a sanction—was never circulated to the partners of the firm and that no policies of the firm were changed as a result of the “no penalty” holding by the National Student Marketing judge. See Hazard, Koniak & Cramton, *The Law and Ethics of Lawyer* 83d ed. (1999) at 117 (footnote c).

²⁷While the rule has been upheld as a valid exercise of the SEC’s rulemaking authority as to accountants, see e.g., *Touch Ross & Co. v. SEC*, 609 F.2d 570 (2d Cir. 1979). I am not aware of similarly definitive rulings when it comes to the rule’s application to lawyers. Moreover, the fact that it is a rule and not a clear statutory mandate seems to cause court’s to withhold deference from the SEC’s interpretation of the rule and application. Cf. *Checkosky v. SEC*, 23 F.3d 452 (D.C. Cir. 1994); and especially, *Checkosky v. SEC*, 139 F.3d 221 (D.C. Cir. 1998) (criticizing the SEC’s straddling of the fence on whether negligence sufficed in a 102(e) proceeding s or whether recklessness was the standard for discipline. That matter too should be decided. Moreover, I believe that some discipline, although perhaps not disbarment or suspension, should be provided on a finding of negligence. By definition negligence is the first step on the road to recklessness and it should be discouraged, at least when it comes to accountants, by the threat of SEC censure or reprimand.

²⁸See Ann Maxey, *SEC Enforcement Actions Against Securities Lawyers*, 22 Del. J. Corp. L. 537 (1997) (discussing the SEC’s declaration that it would not use 102(e) against lawyers without first seeking a court ruling that the lawyers had violated the securities laws.) The declaration was one of many retreats the SEC has had to make over the years from its efforts to see to it that securities lawyers were not recklessly assisting fraud. For a description of some of that history of retreat and how aggressively the bar reacts to any attempt by the SEC to rein in reckless securities lawyers. See Hazard, Koniak & Cramton, *The Law and Ethics of Lawyering*, 3d Ed. (1999) at pp. 117–188 & 739–758. See also Koniak, *The Law Between the Bar and the State*, 70 N.Car.L.Rev. 1389 (1992); and Koniak, *When Courts Refuse to Frame the Law and Others Frame it to their Will*, 66 S.Cal.L.Rev. 1075 (1993).

²⁹This was what the court in National Student Marketing described as a lawyer’s duty. 457 F.Supp. 682 (D.D.C. 1978). And see *In re Carter*, Fed. Sec. L. Rep. ¶82,847 (Feb. 28, 1981); and *In re Gutfreund* Fed. Sec. L. Rep. ¶83,597 (Dec. 3, 1992).

chines, the restrictions are unjustified and arbitrarily exclude a set of criminal enterprises that cause much more harm than some now covered by the statute.³⁰

5. Restore joint and several liability, when a defendant has acted recklessly, at least when the defendant is a lawyer, for the reasons given above on the problems and inadequacy of an “actual knowledge” standard of liability for lawyers. (I believe accountants too should be jointly and several liable, even when their mental state is “reckless” and not “actual knowledge.” As to lawyers and accountants, as I explained earlier, their recklessness makes them liable to their corporate client for malpractice and punitive damages (in almost all states). Given that the corporation already has a claim against the lawyers for damages, it makes little sense to make defrauded investors wait until the corporation recovers from its lawyers (in a negligence action) to have access to money that will belong to the corporation sooner or later, assuming it pursues its lawyers (and accountants) for malpractice. By eliminating joint and several liability, you simply require that there be two lawsuits (the investor action against the corporation and the negligence action by the corporation against its lawyers and accountants) for the corporation to get its hands on the assets that it may have to distribute to those harmed by the fraud.

6. Provide the SEC with sufficient funds to enforce Rule 102(e) (or preferably it’s new statutory counterpart, see recommendation 4 above) and enough funds to bring enforcement actions against lawyers (and accountants) who aid and abet securities fraud.

7. Make clear that language in the Administrative Procedure Act that provides that lawyers admitted to the bar of any state may practice before any federal agency does not preclude the SEC from setting standards for securities lawyers and imposing those standards through discipline, including disbarment, in a Rule 102(e) proceeding, an administrative enforcement action or any new statutory vehicle you may provide.³¹

8. Require, or at least encourage, the SEC and the Justice Department to announce that neither will accept for consideration of any sort any so-called “internal investigation” or “compliance report” or any similar document that purports to report on alleged wrongdoing of a corporation that was prepared by any law firm who was in the employ of the corporation at the time that the wrongdoing occurred, at least not if that law firm’s representation of the corporation during the alleged wrongdoing included any matter that is covered by the investigatory report. All such reports should include a statement by the law firm attesting to its compliance with this statutory requirement or government policy.

9. Finally, I am more than deeply conversant, having written numerous articles on the subject, with the abuses committed by plaintiffs’ lawyers in class action suits, including the abuses that occur in securities suits. I am indeed so familiar with this problem that I know that much of the most serious abuse involves a form of joint venture between unlikely allies: plaintiffs’ lawyers and defendant corporations (and defense lawyers, of course). The aim of the venture: to make money for the venturers at the expense of the absent class.

I would be happy in the future to work with any member of this Committee, majority or minority staff, on meaningful reforms to cure class action abuse. But making it safe for lawyers and accountants to aid fraud-doers with reckless abandon is not the way to address abuses in class actions. The primary victims of most class action abuse, in securities cases and all other kinds of cases, are members of the absent class. Don’t “cure” that problem by leaving them subject to injury by a different group of actors. That would make the cure worse than the disease.

CONCLUSION

If Enron was the Emerald City, no matter what individual or groups of individuals end up to have been standing behind the curtain playing the Wizard of Oz (be it Enron’s CEO, its CFO, some or all of its board of directors or whomever), I guarantee you one thing: A lawyer was standing beside them making sure the curtain stayed drawn and all the bells and whistles were hooked up and operating to fool Dorothy, the brainless scarecrow and the cowardly lion.

You want to clean this mess up? Cherchez les avocats. Take off their magic caps by passing legislation that leaves them with no doubt that the law applies to them too, not just when they “know” what’s going on but when they act recklessly with

³⁰The brief time I was provided to prepare this testimony did not allow me to refresh myself on the precise restrictions in RICO that might lead to the result I describe. I will be happy to supplement this statement at a later time with more details on this matter.

³¹See 5 U.S.C. 500(b). Note that it does not now appear to prevent this, see 500 (d)(2), but it would be wise to remove any doubt and save courts from deciding the matter.

little regard for the harm they thereby help inflict on the rest of us and on their clients too.

Chairman LEAHY. General Gregoire, again, I thank you for being here. I know Senator Cantwell and others had urged that you be here. You were one of the leaders in protecting the public health with the States' tobacco litigation, so you understand as well as anybody in the room the role that State attorneys general play in holding corporations accountable.

Under the civil RICO statute, the Attorney General of the United States is the only government actor who can bring a suit. Do you believe that it would be a good idea to give State attorneys general similar authority under our civil RICO?

General GREGOIRE. Senator Leahy, I think I can speak not only on behalf of myself, but my colleagues, as well, in that I think it is clear that we believe the best law enforcement is done as locally as possible. So we would encourage you to consider such a move and we could work in partnership with the Federal Government, which we do in most actions, but it is troubling for us that we are without authority in this regard.

Chairman LEAHY. Another thing, as you know, again, using the tobacco case as an example, you are aided by corporate whistleblowers. Several of us around here have been prosecuting attorneys or plaintiffs' attorneys and we know that many times a corporate whistleblower is the first opening. When the window opens on wrongdoing, it is often a whistleblower, for whatever the reason, conscience or anything else, comes forward. Do we need to provide some protection to corporate whistleblowers in the securities fraud area?

General GREGOIRE. I would urge you to consider this very seriously for the reason that with the amendments that were made in 1995 to call for a plaintiff to bring a complaint forward with particularity and without the ability to do discovery, more often than not, we are reliant now on whistleblowers bringing forward that kind of detailed information so we can plead the cases with particularity.

If they are not given adequate protection, then I think we are going to find ourselves even more incapable of holding accountable companies like Enron and others and making it such that investors and those of us who represent the public funds cannot bring an action because we do not have the information and there has been a stay on discovery and we are incapable of getting access to it. So I think probably more importantly than ever, we have got to protect those whistleblowers.

Chairman LEAHY. In fact, there were whistleblowers at Enron. They took some risk in coming forward, did they not?

General GREGOIRE. Considerable risk. I am, frankly, disappointed that, despite the fact they were shut down there, they did not take additional risk and go forward to the SEC or to the Justice Department, but I know there was considerable fear on their part, so I can also understand it. So protecting them, I think, is extremely important.

Chairman LEAHY. Thank you. Professor Koniak, looking back through your notes and your testimony, if I am stating it correctly, you said the 1994 *Central Bank* decision, the five-four Supreme

Court ruling that those who aid and abet securities fraud, such as accountants and lawyers, the Supreme Court held they can no longer be held liable by private parties under Federal law. Now, you disagree with that. In fact, you described it as monumentally bad, so I would take that as New England understatement that you thought the Supreme Court screwed up on that one.

We know from Enron's own report released this week that these same types of firms received literally millions of dollars in assistance in actually setting up the very corporate arrangements which are sort of problematical, but what do you think that these financial incentives encourage lawyers and accountants to do when they learn about corporate fraud?

Ms. KONIAK. There is absolutely—the decision and the legislation that affirmed the Supreme Court decision encourage lawyers who already do not need any more encouragement in this direction not to know what is going on. Now, for lawyers, lawyers are trained not to judge their clients, and that is appropriate, particularly for trial lawyers. They are not supposed to supplant the role of the jury. Judgment is for the jury.

But most lawyers are not trial lawyers. Most lawyers are facilitators of transactions, and their job is to know what is going on. But the Supreme Court decision and the legislation place a premium on not knowing, not understanding the signs that suggested that fraud or other criminal activity was going on by insulating a lawyer from liability unless the lawyer knew, had actual knowledge, and allowed and encouraged, therefore, reckless conduct. Encouraging reckless conduct among a profession that is trained to give their clients the benefit of the doubt, and for good reasons trained that way, is an invitation for disaster.

Chairman LEAHY. But you mention on trial lawyers, for example, a trial lawyer, say it is a defense lawyer in a criminal case, he cannot aid and abet his client in perjury. He could not if they realized, while there is a lawyer-client privilege, if he realized the client is planning ongoing criminal conduct, he cannot aid and abet that. He has certain duties to the court. But are you saying that in this area of security fraud, they have sort of specially carved out immunity?

Ms. KONIAK. Well—

Chairman LEAHY. Under today's law, using the Supreme Court decisions and all that—or maybe a better way of putting it, do we need to have the real threat of an aiding and abetting liability to keep people in line?

Ms. KONIAK. You need the real threat of aiding and abetting liability and the standard of recklessness to keep lawyers in line, because lawyers are helpers. The natural way in law to express helping is aiding and abetting. And lawyers, again, are trained, sometimes for good reasons, not to be the first to judge their clients. Lawyers are supposed to stand by, whether their clients were corporations, their clients were individuals, stand by their client. Knowing and believing in your heart that a client did wrong is a hard step for a lawyer to take. Understanding that your client very well may have conceded wrong because all of the signs are pointing in that direction is something that lawyers can see.

Chairman LEAHY. Thank you. Senator Hatch?

Senator HATCH. Mr. Schatz, Rule 10(b)(5) is still alive and well, is it not?

Mr. SCHATZ. Yes, Senator Hatch.

Senator HATCH. It is a pretty broad rule, is it not?

Mr. SCHATZ. I am sorry?

Senator HATCH. It is a pretty broad rule of liability.

Mr. SCHATZ. Yes, it is.

Senator HATCH. Any corporate official or person manipulating that stock or making misstatements or errors or omissions can be found liable for what is called securities fraud, right?

Mr. SCHATZ. Absolutely.

Senator HATCH. It is not like people are left high and dry here.

Mr. SCHATZ. No, 487 companies were sued this past year.

Senator HATCH. I am clearly troubled by these events, there is no question about it, that led to the Enron collapse and the possibility that securities fraud was perpetrated not only by Enron executives, but also by analysts and auditors. Of course, I think we ought to wait and see what the facts are, too. You never know. Companies do fail. But this one looks particularly bad, at least according to the media reports.

Now, based on your extensive experience in securities litigation, both before and after the enactment of the PSLRA, would any of the reforms made by Congress prevent any culpable party in the Enron debacle from being held accountable for his or her actions?

Mr. SCHATZ. No, Senator Hatch. I think, as I indicated to you, the provisions of the Reform Act had nothing to do in my mind with the Enron debacle. I think it is apparent that all potential parties are going to be brought in as defendants in the various litigation and I think at the end of the day, the system will work.

Senator HATCH. The laws are broad enough to catch manipulative or errors or emissions or false conduct?

Mr. SCHATZ. That is certainly my belief.

Senator HATCH. Could you go over again the impact of civil RICO allegations in security fraud cases? Is it not true that the plaintiffs' lawyers often use the threat of treble damages to leverage high-tech companies and individuals into settling cases they might otherwise defend? If you could also elaborate on some of the outcomes you have heard here today, as well.

Mr. SCHATZ. First, let me be explicit. In securities class action cases, there is virtually never an instance where the theoretical plaintiff-style damages are not enormous. You never have an instance where you need to treble the amount of recovery, because even as it stands now, companies and individuals are faced with staggering potential liability. What RICO would do, in my opinion, would give an unwarranted tool, and by the way, Chairman Levitt agreed that it would give an unwarranted tool to plaintiffs' class action lawyers to, if you will, extort unreasonable settlements.

Senator HATCH. Was I wrong in pointing out that a high percentage of big board companies are constantly sued and that the vast majority of the Silicon Valley firms have been sued by plaintiffs' lawyers in class action lawsuits?

Mr. SCHATZ. Senator Hatch, I do not know the exact percentages, but I can tell you that an enormous number of high technology companies have been sued, including companies which I think we

would all agree are sources of great pride for certainly the valley but also the country.

Senator HATCH. As the chairman pointed out, we are not here today to specifically examine, and I am going to ask you this, Mr. Lund, the GAO lawsuit. However, the whole reason for the GAO suit is to obtain information about Enron, so I believe the two issues are interrelated and that is why I asked you to testify here today.

So Professor Lund, as you know, Federalist Number 51, perhaps the most frequently quoted single commentary on the principle of separation of powers, James Madison wrote there that, quote, "The great security against a gradual concentration" of governmental powers in one of the three branches "consists in giving to those who administer each Department the necessary constitutional means and personal motives to resist encroachment of the others."

In your testimony, you briefly discuss one of these "constitutional means." Could you please explain or elaborate on the appropriate constitutional oversight role of Congress and the legitimacy of the GAO's action in this area?

Mr. LUND. Yes. Thank you, Senator. I think that the passage that you cited from Federalist 51, it is always good to think about that passage in connection with another passage from a different number of the Federalist where Madison pointed out that in a republican form of government, the most dangerous branch was always the legislature, was always the branch that was the most capable of unduly dominating the other departments of government.

With Federalist 51, when Madison talks about giving every part of the government the necessary means to preserve its constitutional position, I think it is especially important in the case of the executive to recognize that that means must be adequate to the task, and over the course of our history, it has proven adequate to the task, I think in part because confrontations between the executive and the legislature have taken the form of the—the serious confrontations have taken the form of confrontations between elected officials, between the President exerting executive privilege, for example, and the Congress, the Members of Congress.

What is a little worrisome about this GAO suit is, first, that it is not being—that the Comptroller General is a relatively independent and certainly unelected part of the legislative branch. It does not have the same political constraints on him that elected officials do.

And second, that it threatens to involve the courts. These matters have been litigated to some extent, but the courts have been very reluctant, and properly so, to saddle with a kind of finality that judicial judgments have the exact nature of the proper relationship between the President and the Congress. The GAO suit, I think, threatens to bring the courts in in a way that may not be healthy.

Chairman LEAHY. Again, I am sure that Vice President Cheney is appreciating the defense of his closed-door meetings here, but again, I want to emphasize, that is not the purpose of this. Others will talk about that. Others have talked about his closed-door meetings. I believe the Republican chairman of one of the House com-

mittees has raised problems with it and others, but we are not investigating that.

Senator Kennedy?

Senator KENNEDY. Thank you very much, and I want to thank all the panelists for very interesting and helpful testimony.

To Mr. Raynor, just with regards to the current bankruptcy law and the one that is in conference now, I just give you these facts on the Enron situation. It is my understanding that just before Enron filed for bankruptcy, several steps were taken. First, mid-level and low-level workers were laid off. These workers were given nothing. These workers were given nothing.

Then, second, derivative traders were given \$50 million in retention bonuses, and then executives, 500 executives were wired \$55 million in retention bonuses the day before the bankruptcy. Five hundred received \$55 million, and I understand some of those employees are still collecting paychecks.

The day after Enron filed bankruptcy, 4,500 workers were laid off, and although their severance packages would have totaled \$150 million, they were given \$4,500, a total of \$20 million under the bankruptcy wage priority. After taxes, they received \$3,000. Enron told them that under the bankruptcy law, the company could not give the workers a larger package.

Under current bankruptcy law and under the one that we are considering in the conference, the workers were not protected, were they?

Mr. RAYNOR. No, Senator. Not only were they not protected, but we believe workers and their pensions should be first in line under bankruptcy law to receive funds, and also, as we have been saying, this law in Texas and in Florida that allows executives to protect mansions while individual workers and retirees get thrown out of their apartments and their homes has got to be changed.

Senator KENNEDY. Since you mentioned that, I understand in Texas, in 1999, their property code was amended to increase an urban homestead from one to ten acres, so the law permits a Texas resident to claim a residential and business homestead if they are on contiguous lots, a person lives and works on them. Accordingly, a person who lives and works in a condominium or penthouse or even an office building may purchase the entire office building to protect their wealth under Texas law.

But the point I am trying to get at with regards to the existing bankruptcy law and the one that is in the conference, if we say we are interested in being fair to workers, we have learned a powerful lesson. We should not have to keep relearning it about what happens to workers under these circumstances, and you have made an eloquent case. If we fail to protect workers, even under our new bankruptcy law, I think it is a shame. I do not know whether you want to express an opinion about it.

Mr. RAYNOR. Let me say this, that unfortunately, my union and America's unions and workers have experienced far too many cases where companies go bankrupt and the executives get taken care of under existing laws and under many that are being proposed and the workers wind up getting cheated. Enron is a widely publicized example, but it goes on, Senator, every day, and something needs

to be done to protect workers in bankruptcies instead of corporate executives.

Senator KENNEDY. Tomorrow, our Human Resources Committee will be dealing with the pension aspects of the workers and what has happened to them and I want to just, if I could, ask both you and General Gregoire a question. You are both suing Enron because of the losses in the retirement benefit funds, so I would like to ask your thoughts regarding the 401(k)-style savings plans. Your suits contend improper accounting measures, disclosure of false and misleading information, inside trading.

General Gregoire, you assert that Enron used offshore tax havens to hide its debt burden from investors, that it misstated its financial position and investors' equity in the company. Repeatedly, you point out that it was virtually impossible for investors to make educated financial decisions because Enron was able to operate in secret with limited regulatory review and no independent audit.

Mr. Raynor, you point out that many of these problems are not confined to Enron. Enron is simply one of the worst cases of corporate corruption.

So I share your concern about the business practices that led to the losses suffered by the benefit funds, and I am also concerned about 401(k)-style funds that hold workers hostage, prevent them from selling the matching company stock until they are near retirement age. In many cases, workers holding company stock have not been permitted to sell the stock as the prices tumble, and even if they have access to information, they cannot help themselves because they are trapped by the terms of their benefit plan.

For example, like Enron, Polaroid, a major company in my State of Massachusetts, forced workers to invest their retirement savings in company stock and the employees were barred from selling until they quit or retired from the company.

So, Mr. Raynor and General Gregoire, do you believe that Congress needs to consider reform legislation to address this problem, and if so, perhaps you could share your recommendations. Mr. Raynor, we often hear that the existent laws governing the 401(k) plans give workers choice and can you tell the committee if you believe that choice is meaningful and any of your own experience on this issue, any insights that you might have.

Mr. RAYNOR. Senator, first of all, we think that it ought to be illegal for corporations to push the company stock in plans, because employees are susceptible to company pressure. They do not have the information that corporate executives have, and when companies push employees to buy stock, it becomes you are disloyal if you do not buy the company stock and that needs to be regulated and workers need to be protected from that.

Workers, many of the ones that we represent, do not have the knowledge to make those kinds of investment decisions and they need protection from their employer, and also protection under the administration's proposal to allow money managers to use their high-pressure sales tactics on our members about investment decisions. That is going to be a disaster, allowing Fidelity, for instance, to try to sell—

Senator KENNEDY. That is in the President's proposal?

Mr. RAYNOR. Yes, to allow them to sell to workers 401(k) investment decisions is something that workers need protection from, as well. The H.R. director of Enron was cashing in her money at the same time she was enforcing rules that did not allow the Enron workers to sell their stock. So, clearly, the—and many of our members have 401(k) plans, but we believe they should be an addition to defined benefit plans and not in place of defined benefit plans and we think that Congress ought to legislate in that direction.

General GREGOIRE. Senator Kennedy, I agree with Mr. Raynor. I might simply add that, you know, with respect to State pension funds like the one at hand in our State, we are well diversified, well diversified. We had every right to rely on everything that we did by way of our investment. So I do not think you can fault my investment board for what they did.

But at the end of the day, because of our diversification, our employees are still going to get benefits. The problem with the employees of companies like Enron and 401(k) is they are held captive. That is all they have. They are not diversified, and at the end of the day, they end up with nothing.

So I am here on behalf of the fire fighters and the State employees of the State of Washington and the other States to say what has happened here is a travesty and it should never have been allowed to occur, but I must say, on behalf of the workers of these companies, at the end of the day, they are the ones who have been most defrauded by this kind of conduct.

Senator KENNEDY. Thank you, Mr. Chairman.

Chairman LEAHY. Thank you. Thank you, Senator Kennedy and General Gregoire.

Senator SPECTER?

Senator SPECTER. I thank this distinguished panel for providing a lot of very important information on a great many very serious issues. I would like to pose three questions to be answered by the panel after the hearing because of the limitations of the 5-minute rule.

First, I would like your opinion as to whether auditors should be precluded from doing both—or firms like Arthur Andersen should be precluded from doing both auditing and consulting work for the same firm, like Enron, since we have seen so much of professional opinions being for sale.

Second, I would be interested in your judgment as to whether the Private Securities Litigation Act of 1995 should be repealed or modified in light of the testimony here about the very sharp limitations on pleading.

And third, I would like your opinions as to whether Congress should legislate specifically by imposing criminal penalties on accountants and lawyers who advise their clients, like Enron, on how to break the law. The attorney-client privilege protects a lawyer on giving advice as to prior conduct, but is not applicable to working with a client, which is really a co-conspirator and I would like your advice as to whether we ought to legislate specifically in this field because the imposition of criminal penalties requires great specificity and certainly would be in dealing with professionals like accountants and lawyers.

In the limited time I have, I would like to address to you, Professor Lund, questions on this issue of executive privilege.

What I want to ask you specifically, the reference to Congressman James Madison is very illuminating on the President's right to decline to provide information and the Congressional right not to enact legislation if Congress is dissatisfied with the information which it has.

I note the reference in your testimony to the *Espy* case, which articulates the broad doctrine of executive privilege on advice to the President, and would note further the opinion of the District of Columbia Circuit upholding the action of First Lady Hillary Clinton in declining to provide information to the inquiring parties, saying that they would avoid the issue as to whether she was or was not a Federal employee on the ground that Article II was implicated. The circuit there said, quote, "A statute interfering with the President's ability to seek advice directly from private citizens as a group, intermixed or not with government officials, therefore raises Article II concerns," and the court declined to order that information to be given.

When I wrote to the Comptroller General raising the issues of executive privilege and inquiring as to his authority in the sense the Vice President is not an agency, certainly would have the standing of the President as interpreted by *Franklin v. Massachusetts*, Mr. Walker, the Comptroller General, responded in part to me, "Importantly, the President has not invoked executive privilege in this case. Should he do so before we file suit, we will assess that development."

My question to you, Professor Lund, since a good bit of your statement deals with this issue, if the President did invoke executive privilege, and I might add to it, I have asked the Vice President about it and said that it has not been invoked because they feel the statute is not applicable, but if the President were to invoke executive privilege, would there be any doubt at all that that principle, to protect the deliberation and advice to the President, would resolve the matter with finality?

Mr. LUND. Well, there would be very little doubt in my mind, but I have to say that these matters have not received judicial resolution and once something goes to court, I think there is no telling. The courts may agree with me, but they may not.

Senator SPECTER. Well, is there any doubt under *Espy* or Nixon without a showing of some impropriety—

Mr. LUND. The *Espy* court expressly noted that it was deciding this case in the context of the Judicial Department and noted that a conflict between the executive and the legislature would raise somewhat different issues, and that it did not explore those issues but it limited the decision to cases involving the Judicial Department.

Senator SPECTER. But you think that would pretty much preclude it, subject to the vagaries of what the next court is going to decide on the next issue?

Mr. LUND. I would certainly expect, but more forcefully, hope that if the courts are forced to decide the issue, as I understand the issues as they have arisen with the GAO, that they would favor the Vice President, but I cannot predict that with certainty.

Senator SPECTER. You do not have to be a professor or a lawyer to understand that possibility. Even Senators understand that.

Mr. LUND. Yes, sir, I understand.

Senator SPECTER. Thank you very much.

Chairman LEAHY. Thank you, Senator Specter.

Senator Kohl?

Senator KOHL. Thank you, Mr. Chairman. We appreciate your calling this hearing today on lessons learned from Enron's failure. It would be wise to anticipate the next chapter in this story. Where corporations go bankrupt, people often follow.

The next Enron scandal might be right around the corner. Texas and four other States allow people who declare bankruptcy to keep an unlimited amount of equity in their home. So the executives who may be at fault will be able to use the bankruptcy code to escape personal responsibility. They will continue to live in multi-million-dollar mansions, even as their former employees struggle to find a new paycheck or to cover their rent.

Last week, we heard from the wife of Ken Lay, who said that they might need to declare personal bankruptcy and sell their homes in Aspen. However, Texas's homestead law will allow them to keep an unlimited amount of equity in their 13,000-square-foot Houston penthouse, which is valued at over \$7 million. Enron's former CFO, Andrew Fastow, has property and a house worth almost \$3 million. Enron's former CEO, Jeffrey Skilling, has a house worth \$2.5 million. Under Texas law, if they declare personal bankruptcy, they keep their multi-million-dollar houses while, as you know, their creditors get nothing.

While the Nation is focused on their misdeeds, real people, more than 4,000 of them fired from Enron and with 30 minutes' notice, are looking for jobs and trying to pay the bills. Millions more have seen their pension funds and personal investments disappear before their very eyes. There is no justice in a system that puts thousands of people on the street without a job, wondering about rent, but that helps perpetrators live in multi-million-dollar houses.

The bankruptcy bill that we passed in the Senate and that is now in conference would fix this injustice. It would cap the homestead exemption at \$125,000 in equity. It is a reasonable and common sense solution, and to those who have disagreed with this proposition before, I believe the Enron scandal should be enough to convince them.

Mr. Chairman, let us put this in perspective. No Enron executive has declared personal bankruptcy yet. You can be sure their attorneys are counseling them on how to do it. We have seen this before. People like Burt Reynolds, Bowie Kuhn, Paul Bilzerian, and others too numerous to list all escaped their creditors and kept living like kings. So the question is, do we intend to let Enron executives add their names to this list?

For those of you who are familiar with this homestead exemption which exists in five States right now, among which Texas is one, do you believe that it is imperative that we fix this bankruptcy law and the exception that it has for personal domiciles?

General GREGOIRE. My answer to you, Senator, would be yes. The inequities are obvious and if we are going to protect the kind of people who lost their livelihood, lost their pension, and have

nothing left while let corporate executives who have defrauded them, potentially to the tune of a criminal act, get by is just not fair in this country and I would implore you to do something about it.

Mr. RAYNOR. Senator, I have, unfortunately, seen workers in bankruptcies lose their homes and there is no law that protects them when people take their homes away and throw their furniture and their families out on the street. The value of the Enron executives' homes are equal to the entire severance given to the 4,500 workers who got severance pay. They could have doubled the severance had they not had that exemption allowing these guys to keep those mansions.

Senator KOHL. Thank you.

Mr. SCHATZ. I would agree that the homestead exemption needs to be substantially revised.

Mr. LUND. I am afraid I have to plead lack of expertise, Senator, on these complicated bankruptcy issues. I just do not know enough to comment. I am sorry.

Chairman LEAHY. Do not feel bad. Not too many people do.

Ms. KONIAK. I would like to say that, particularly because I know you are interested in class action abuse, that class actions now still provide a way in settlements for people to avoid the bankruptcy laws completely, and any priorities right into the bankruptcy laws can be avoided still—the Supreme Court has not closed the door on this—by using a class action settlement in lieu of bankruptcy under (1)(b)(i) of Rule 23 and I think the bankruptcy laws now can be avoided entirely. The creditors, any list of priorities you put in there can be avoided and you really have to look into that. Until you do that, anything you do in the bankruptcy bill is not going to be enough.

Senator KOHL. Thank you. As I said in my statement, with the exception of five States now, what we are trying to do is to put in the bankruptcy bill an equity of \$125,000 which you can maintain in a home, but beyond that, you cannot put anything into a home and have it exempted. Five States, of which Texas is one, have unlimited ability of individuals to sink money into a home and have it excepted from bankruptcy proceedings.

Believe it or not, we are having a hard time getting it passed. We passed this in the Senate. The House has not passed such an exemption, and the bankruptcy bill is now in conference where this exemption for these five States is attempted to be maintained and we are suggesting that we need to have a uniform 50-State amount of money for domicile exception and we are suggesting that be at \$125,000.

I appreciate your comments, and Mr. Chairman, I turn it back to you.

Chairman LEAHY. Thank you very much.

Next is Senator Feinstein. I understand the vote has been delayed somewhat. Senator Feinstein?

**STATEMENT OF HON. DIANNE FEINSTEIN, A U.S. SENATOR
FROM THE STATE OF CALIFORNIA**

Senator FEINSTEIN. Thanks very much, Mr. Chairman.

I just wanted to make a couple of remarks to the panel. In my judgment, this case is a real watershed. It points out so many things. It points out in the energy sector what has been a kind of unregulated, swashbuckling mentality. It points out that online futures trading is essentially nontransparent and unregulated. It points out the failure for employees, as Senator Kennedy mentioned. It is a double whammy. Here, the employees lose their job and their retirement. It points out, I think, the demise of financial reporting in our country, which, as Professor Coffey pointed out in House testimony, has deteriorated dramatically over the last 10 years. It points out the failure of all gatekeeper mechanisms, the failure of independent auditors, of financial analysts, the failure of virtually bond-rating agencies to be able to predict and deal with this. So all protective measures have essentially failed.

I think it throws into renewed scrutiny our private securities reform litigation, Mr. Schatz. I voted for it. I voted to overturn the President's veto, and yet I do not know whether the safe harbor on forward reporting, those provisions which provide for no regulation really make any sense in this new environment.

So as I see this, this is going to mean a lot of work. I mean, clearly, if it is an outside auditor, they should not be permitted to do what Arthur Andersen did, be both an outside auditor and also be a consultant. As Professor Coffey also points out, the consultant aspects of these auditors of big companies have now overwhelmed the fees for independent auditing. So it has become a whole new area that I think breeds a kind of familiarity with the company which is unhealthy in terms of its outside independent auditing role. So I see this particular bankruptcy as really needing major scrutiny from a number of different points of view.

Let me just, in the time I have left, ask a couple of questions. The 1994 Supreme Court case, *Central Bank of Denver v. First Interstate Bank of Denver*, clarified that aiders and abettors were not subject to liability in private securities fraud cases, making it harder to recover against those entities in fraud cases. But it is my understanding that the Congress specifically addressed this issue by allowing the government to file suit against aiders and abettors. While private suits on this basis are not allowed, the government can proceed. Is that true?

Mr. SCHATZ. That is correct. If that question was directed at me, that is correct.

Senator FEINSTEIN. Does anyone want to add anything on that particular question?

Ms. KONIAK. Well, they are allowed to proceed, but "knowingly" is the standard that the SEC is supposed to proceed under when they bring an aiding and abetting action and that was a change from prior law and it makes it harder even for the SEC. Plus, the SEC does not have the resources to go after all these aiders and abettors. It always had the right beforehand. Private causes of action were there in addition.

Senator FEINSTEIN. And the SEC, I believe, has asked for additional staff and been denied by the Congress, so we are going to have to be alert to that, as well.

Let me ask you this. In the Enron case, do you believe that Arthur Andersen was simply aiding and abetting, if the allegations are true, or were they direct participants in fraud and libel?

Ms. KONIAK. The courts have been struggling since Congress changed the Act in 1995 to define the line of when someone becomes a primary violator who we normally think of in regular parlance as a helper. Accountants are generally helpers. They also have liability potentially as primary violators, as do lawyers.

But it is not true, as Senator Hatch said before, that it is as easy to get someone as a primary violator as it is as an aider and abetter and my testimony gives an example, at least one example, where it is very clear the wrongdoing is enormous, but whether it can be characterized—it happened to be a lawyer in that case, but if it had been an accountant, whether a court really could find that that was primary violator versus aiding and abetting is unclear. No decision on that matter exists.

So there are still many situations that could be called aiding and abetting that offer substantial assistance, which is the standard for aiding and abetting—you have to have substantial assistance—that could not be called primary violations, and so there is a whole interconduct that is no longer available for anyone to go after except the SEC, and again, the SEC has a different mental standard than they had before to show.

Mr. SCHATZ. Senator Feinstein, if I could briefly comment—

Senator FEINSTEIN. My time has expired. Would you allow Mr. Schatz to respond?

Chairman LEAHY. Of course.

Mr. SCHATZ. First, assuming that the press reports are correct, I have little doubt that, given that there were audited financial statements here, that Arthur Andersen's conduct would be deemed to be a primary violation.

Second, with respect to your opening comments, I wish to point out that the Reform Act's safe harbor provision explicitly does not relate to the company's financial statements. So that is not a concern and it is not an issue that arises from the safe harbor.

And third, and I think this is something that certainly I see in my practice with respect to aiding and abetting, the problem that you have here is that, obviously, it is very tempting to do something in this case, but, for example, it is harder and harder to get conscientious people to serve on boards of directors, and when you have aiding and abetting liability and you employ joint and several liability when there is not knowing misconduct, it is going to become ever increasingly difficult to get conscientious people to serve on boards.

Chairman LEAHY. Thank you.

Senator FEINSTEIN. Mr. Raynor, I think, wanted to respond.

Mr. RAYNOR. Mr. Chairman, may I comment?

Chairman LEAHY. Go ahead, Mr. Raynor.

Mr. RAYNOR. On the last, on Mr. Schatz's comment, I think boards of directors in America are pretty much country clubs of a lot of wealthy and powerful people and I do not think that there is any labor shortage there.

But in terms of your specific question, the 1995 legislation protects companies and executives and law firms from private litiga-

tion. We have got to remember who that private litigation is. That is retirees. That is hospital workers and hotel workers and garment workers and electricians who now control litigation, no longer the lawyers. We are the plaintiffs, and so they are protected from us and I think that that needs to be repealed.

Senator FEINSTEIN. Thank you. Thank you, Mr. Chairman.

Chairman LEAHY. Senator Feingold?

Senator FEINGOLD. Mr. Chairman, thank you for scheduling the hearing. I do think that the Judiciary Committee has an important role to play in determining what changes in the law are necessary in the light of the horrible collapse of such a large and influential company. Like other members of the committee, I do think that the bankruptcy code is very implicated in the Enron failure.

As we all know, and as the chairman said, the bankruptcy reform bills have been sent to a conference committee. The Enron situation calls for some hard thinking by that committee and I, for one, am very grateful that that bill is not already law in the form that it was passed so that we can perhaps correct some of these.

For example, as the chairman said, and it certainly has been demonstrated through the tremendous leadership of my colleague, Senator Kohl, one provision of the bill that is squarely implicated by the debacle is the homestead exemption. Should some of Enron's executives be forced into bankruptcy by civil judgments that they defrauded investors or employees, we will perhaps see them, as Senator Kohl explained, sheltering as much of their ill-gotten gains as they can in multi-million-dollar homes, which will then be protected under the State of Texas homestead exemption.

I certainly want to point out that I think that the characterization by the ranking member of what the House bill would do in this regard is incorrect, that, in fact, those provisions in the House bill do not prevent the ability of these individuals to abuse this procedure. A bankruptcy reform bill that does not contain limits on the abuse of the homestead exemption is a fraud on the American people.

Now, another provision of the bill in which Enron has shown a spotlight is Section 912, the asset securitization, which again the ranking member referred to in his remarks, and I have to respectfully disagree with him again. This section is a deeply misguided effort to shield from the scrutiny of the bankruptcy courts transactions that move certain assets off the books of a company so that they cannot be reached by other creditors. Now, if this provision is included in the final bill, whether Enron literally was engaged in this practice or not, it will encourage questionable transactions such as those that appear to have led to Enron's demise. So I believe that Section 912 simply must be deleted from the bankruptcy bill.

Mr. Chairman, let me also describe a change to the bankruptcy code that I plan to introduce to try to address the calamities suffered by the employees and the retirees of Enron who saw their retirement savings evaporate as the stock value of the company plummeted. Under current law, claims that the company breached its fiduciary duty under ERISA in its management of retirement plans are only an unsecured debt in the Enron bankruptcy. What that means in practice is that the employees probably will not get

anything from the company, even if the company broke the law, and that is not right.

So I will introduce legislation to give the employees' claims for breach of fiduciary duties equal status in the bankruptcy and equal claims to the assets of the company with the secured lenders. If this rule is enacted, Enron's employees will have a seat at the creditors' table in the bankruptcy and perhaps they will get some satisfaction.

Just as important, in the future, the market will monitor companies to determine whether they are meeting their fiduciary obligations in administering their retirement plans. I think it would be logical for prospective lenders to require, then, as a condition of lending some certification or assurance that the company's retirement plans actually pass legal muster. In effect, the credit market will then help provide effective enforcement of the borrowing company's fiduciary obligations to its employees and retirees.

I look forward to discussing this proposal with my colleagues and I hope that we might consider it in the committee promptly.

Now, I was interested in the testimony from Mr. Schatz that can be summarized, I think, by saying that the Private Securities Litigation Reform Act played no role whatsoever in creating the climate in which the Enron scandal occurred and will not inhibit those injured by Enron or its accomplices from being fairly compensated. I am not sure, but I thought I perceived Professor Koniak squirming a bit when she heard that and I would like to give her an opportunity to respond.

Ms. KONIAK. The biggest problem with the Private Securities Reform Act is not that it makes it difficult, which it does, for some defrauded investors to recover. The biggest problem is that it takes away the deterrents, particularly from professionals who understand how to avoid direct knowledge and can put themselves in a situation of plausible deniability, which makes it very difficult to show direct knowledge, and, therefore, have a license to act recklessly. When you have professionals with a license to act recklessly, you will get this situation.

If I might just comment on Mr. Schatz's remark in answering Senator Feinstein about how the Andersen lawyers were definitely primary violators here, I could not agree more, but they will not have enough money to pay everybody and there are many other actors who have skirted the line between primary violator and aiding and abetting who did substantial help in allowing this to happen and were also not just—you should not just be legislating with this crisis in mind but with the next one in mind.

And so I disagree in that sense with the importance of changing back to the rule we had for 30 or 40 years, so this argument about unintended consequences, we know that lawyers lived, law firms prospered.

Senator FEINGOLD. Thank you, Professor. Thank you, Mr. Chairman.

Chairman LEAHY. Thank you.

Senator CANTWELL?

Senator CANTWELL. Thank you, Mr. Chairman, and in the interest of time, if I could enter a longer statement into the record, I would appreciate that.

Chairman LEAHY. Of course.

Senator CANTWELL. Clearly, the State of Washington has been greatly impacted by this Enron crisis and we have heard today from our Attorney General, who has talked about ratepayers who have suffered from perhaps price manipulation and ongoing investigation, as well as individual shareholders in our pension fund and how that pension fund has been impacted.

I would like to followup on a question in regard to the pension suit. Laws that were passed in the 1990's have limited the statute of limitations in this type of suit to 3 years, and yet almost half of the losses suffered by our pension fund are due to investments in Enron that are outside the statute of limitations. This obviously restricts our pension holders and what we will be able to recoup.

General GREGOIRE. Yes. In fact, for Washington State, our claim in the case is for approximately \$50 million when, in fact, our losses are in excess of \$100 million. But because of the statute of limitations, we are not able to make that claim.

Second, when they made their restatement, they went back as far as 1997, but because of the statute of limitations, that is not included, despite the fact they admit that they were wrong in what they said to the public. They misinformed the public in 1997 and the years subsequent to it. So I think the statute of limitations is a real concern to all of us.

Senator CANTWELL. So how do you think we should best address that?

General GREGOIRE. I think the statute of limitations actually ought to occur from when it is known or should have been known. I think that is a much more accurate reflection of what the statute of limitations ought to be, as opposed to starting when they actually began their defrauding.

The other statute of limitations problem that we have as a result of the PSLRA is with respect to those who aid and abet, in my opinion. That is the 1-year statute of limitations. If you have a stay of discovery that lasts beyond a year, then the plaintiffs are unable to get any information that could lead to a filing against a lawyer or against an accountant, despite the fact they were incapable because of the stay of discovery of getting access to that information. That, too, should be told once that lawsuit is brought. That is a very troubling aspect of the PSLRA.

Senator CANTWELL. Following up on that discovery of documents, does the 1995 Act deal with accountants' preservation of documents?

General GREGOIRE. Well, what happens as a practical matter is when accountants do their signature on the financial document for the company, they then destroy within 1 year all underlying documents that they used in the preparation of that statement. That, in this case, with respect to Enron, means that all documents held in the possession of Arthur Andersen have more likely than not been destroyed, and I mean destroyed in the normal course, not just in shredding, from 1997, 1998, and 1999. Again, they need to retain those documents, particularly when you have a stay of discovery and the statute of limitations that you do under the PSLRA. Plaintiffs' counsel are put at a tremendous disadvantage, like us in our bringing our lawsuit.

Senator CANTWELL. Mr. Chairman, as somebody who has been an executive officer of a company, I think that these are very important issues to address, as well as how they relate to those reforms that we have implemented. I know Mr. Schatz in his testimony spoke highly of these provisions, and yet we cannot just simply say that they had nothing to do with Enron or that Enron was not affected by it. Clearly, our Attorney General is having a challenge getting the documents and information that we need.

Madam Attorney General, I would like to point out, as well, that in your FERC investigation, which is in addition to the pension fund suit that we have the same challenges of getting our hands on documents and information. In fact, I think one of our utilities has been slapped with a restraining order to prevent it from disclosing the terms of their Enron contract. This is a critically important issue for us.

I had to leave the hearing, Mr. Chairman, to attend the Energy Committee, where the FERC general counsel was testifying, and where he reiterated FERC's commitment to investigate and said that they were in the process of determining what documents needed to be collected before the Commission could make a final decision that the investigation could move forward. Attorney General Gregoire, do you want to comment on what kind of documents in that case we need?

General GREGOIRE. Well, just last June, I testified here in the Senate, and at that point, Enron indicated that they would fully cooperate. We ended up in document discovery taking that issue to the State Supreme Court in California, which said that the State attorneys general were entitled to document discovery. Despite that, on January 16, we brought a motion in California court against Enron specifically to be held in contempt for failure to comply with that order. And finally, on January 31, they gave us our first document discovery, a year after we made our first request.

Again, that kind of failure to disclose, failure to cooperate with a law enforcement investigation, I think probably could have unveiled some of this some time ago, not just with regard to the energy crisis but the collapse of Enron that we see that has led to the shareholders' suit, as well.

Senator CANTWELL. Thank you, Mr. Chairman. I see my time has expired.

Chairman LEAHY. Thank you, Senator.

We will put statements in the record for all members. We will leave the record open until the end of the day for that.

I am going to recess for a few minutes. We obviously have a roll call vote on. Senator Edwards will be recognized next. If he comes back from his vote, he can take the gavel.

This has been a fascinating panel and I will state more of my thanks to all of you, but thank you very much.

[Recess from 12:03 p.m. to 12:37 p.m.]

On the basis that many are called, et cetera, et cetera, I understand from staff that the Senators who had to go over to vote are now double-teamed into other schedules and will not be coming back. As a result, we will wrap up this hearing.

Could I suggest this to each of the witnesses. If you go back over your testimony and you find that you want to elaborate on a point,

feel free to do so. This is not a game of “gotcha” in this committee. At least, that is not the way I run committees. We want to educate the Judiciary Committee and the staff. So if you see things that you wish you had said, note that as an addendum for the record and it will be included in the record. If you find that you stated a fact or a citation wrong and want to change that—I doubt if anybody on this panel would, but, in fact, sometimes we get some that would—you are allowed to do that.

I will also hold the record open for 24 hours for Senators to add any further statements, including if Senators from other committees wish to.

Some of you have been here before and you know how chaotic it can get. We in the Senate are trying to build a record here, and I am in the Judiciary Committee, for some of the issues that come before us, whether it is securities legislation, to the extent that we are involved, criminal matters, for which we are always involved, or the bankruptcy conference which is now underway. The things you have said will be involved in that.

I think all Americans—again, this is not a partisan issue—all Americans are distressed by what has happened with Enron. As I said earlier, you cannot legislate away greed. Unfortunately, greed is always there. You can, however, take legislative steps to punish those whose greed tramples on others and make others suffer. It is one thing when Michael Douglas gets a well-deserved Oscar for his role as Gordon Gekko, where he spoke of “greed is good.” That was a movie. There are no Oscars being given out to the people at Enron or at Arthur Andersen nor should they get one.

I thank you very much and we stand in recess.

[Whereupon, at 12:40 p.m., the committee was adjourned.]

[Submissions for the record follow.]

[Additional material is being retained in the Committee files.]

SUBMISSIONS FOR THE RECORD

Statement of Hon. Maria Cantwell, a U.S. Senator from the State of Washington

Thank you, Chairman Leahy for holding this hearing and for inviting my home state’s Attorney General, Christine Gregoire, to testify before the committee today on behalf of the people of Washington state.

Mr. Chairman, working people in Washington state—including our teachers, police, and firefighters—lost over \$100 million dollars as their pension fund’s investment in Enron collapsed.

Attorney General Christine Gregoire has taken a leadership role in filing a class-action lawsuit on behalf of investors defrauded by Enron.

In addition to her work on behalf of investors, she has played a key role in defending ratepayers and consumers against unfair market manipulation by Enron.

We are fortunate to have her with us today to give us the perspective of state Attorneys General.

At its core, Enron was a make-believe company more worthy of a paperback novel than a business school textbook.

But even as the details of how Enron defrauded its shareholders emerge, we are now learning of a new scheme to bilk ratepayers and line Enron’s pockets.

Some of the very same people who have lost money in my state’s pension fund are now hit with a double whammy.

Why? Because despite its collapse, Enron continues to earn hundreds of millions of dollars from over-inflated energy contracts which have resulted in massive rate hikes for consumers—including the very same people who lost money in my state’s pension fund.

I was visited by a representative of a utility in rural Washington state recently. This utility has been forced to raise its rates by about 40 percent in the last year. Customers visit its office daily—in tears—because they simply can't pay their power bills.

What is shocking is that even after its bankruptcy, Enron has charged this utility and others like it energy prices more than triple today's market.

Mr. Chairman, where there's smoke there is usually fire, and when I hear that Enron has charged utilities triple current market rates, I naturally become extremely suspicious.

And in yet another blatant attempt to conceal its activities, Enron has actually slapped a restraining order on one Northwest utility, to prevent it from disclosing just how absurd the terms of its contract are.

Last week the Energy Committee—on which I serve with Sen. Feinstein and others here today—heard testimony that Enron is only able to charge such high-prices for long-term contracts because it was able to manipulate prices in forward energy markets.

The Federal government has an obligation to right this wrong for energy consumers in the West.

That is why I called upon FERC Chairman Pat Wood to open an investigation into whether power prices in the West have been unjust and unreasonable as a result of alleged manipulation by Enron.

Thank You.

Statement of Lauren Pfeifle, Justice Department

The Justice Department today released the following statement on the Enron investigation:

"The Justice Department sees no reason to appoint a special counsel to investigate the Enron matter. Our investigators have a duty and responsibility to enforce the criminal laws in this matter. Regulations call for the appointment of a special counsel when prosecution by the Department would both present a conflict of interest and serve the public interest.

"Neither of these criteria exist for the Department of Justice in this case. No conflict of interest exists. No person involved in pursuing this investigation has any conflict, or any ties that would require a recusal. Failing to carry out our duties and responsibilities in investigating this matter would not serve the public interest."

On background, the regulation on "Grounds for Appointing a Special Counsel" states: "The Attorney General, or in cases in which the Attorney General is recused, the Acting Attorney General, with appoint a Special Counsel when he or she determines that criminal investigation of a person or matter is warranted and (a) that investigation or prosecution of that person or matter by a United States Attorney's Office or Justice litigating Division of the Department of would present a conflict of interest for the Department or other extraordinary circumstances, and (b) that under the circumstances, it would be in the public interest to appoint an outside Special Counsel to assume responsibility for the matter."

Statement of Hon. Russell D. Feingold, a U.S. Senator from the State of Wisconsin

Mr. Chairman, I want to thank you for scheduling this hearing. It may seem like every committee in the Congress wants to get into the Enron act, but I do think that the Judiciary Committee has an important role to play in determining what changes in the law are necessary in light of this horrible collapse of such a large and influential company.

I want to talk first about an area of the law that has not been addressed by the testimony today, but that I think is squarely implicated by the Enron failure—the bankruptcy code. As we all know, bankruptcy reform bills have been sent to a conference committee. The Enron situation calls for some hard thinking by that committee.

One provision of the bill that is squarely implicated by the Enron debacle is Senator Kohl's amendment dealing with the homestead exemption. Should some of Enron's executives be forced into bankruptcy by civil judgments that they defrauded investors or employees, we will undoubtedly see them sheltering as much of their ill-

gotten gains as then can in multi-million dollar homes, which will then be protected under the State of Texas's homestead exemption. As I have said before, a bankruptcy reform bill that does not contain limits on abuse of the homestead exemption is a fraud on the American people.

Another provision of the bill on which Enron has shone a spotlight is Section 912, asset securitization. This section is a deeply misguided effort to shield from the scrutiny of the bankruptcy courts transactions that move certain assets off the books of a company so that they cannot be reached by other creditors. If this provision is included in the final bill, it will encourage questionable transactions such as those that appear to have led to Enron's demise. Section 912 simply must be deleted from the bankruptcy bill.

Mr. Chairman, let me also describe an change to the bankruptcy code that I plan to introduce to try to address the calamity suffered by the employees and retirees of Enron who saw their retirement savings evaporate as the stock value of the company plummeted. Under current law, claims that the company breached its fiduciary duty under ERISA in its management of the retirement plans are only an unsecured debt in the Enron bankruptcy. What that means in practice is that the employees probably won't get anything from the company, even if the company broke the law. That's not right.

I plan to introduce legislation to give the employees' claims for breach of fiduciary duties equal status in the bankruptcy. and equal claim to the assets of the company with the secured lenders.

If this rule is enacted. Enron's employees will have a seat at the creditor's table in the bankruptcy and perhaps get some satisfaction. Just as important in the future, the market will monitor companies to determine whether they are meeting their fiduciary obligations in administering their retirement plans. I think it would be logical for prospective lenders to require, as a condition of lending, some certification or assurance that the company retirement plans pass legal muster. In effect, the credit market will help provide effective enforcement of the borrowing company's fiduciary obligations to its employees and retirees.

I look forward to discussing this proposal with my colleagues and I hope, Mr. Chairman, that we might consider this in the committee promptly, either as part of the bankruptcy conference or as separate legislation.

Statement of Hon. Charles E. Grassley, a U.S. Senator from the State of Iowa

Thank you Senator Leahy for calling this hearing. I agree there are lessons that we can learn from Enron's collapse, particularly with respect to accountability issues. I share in my colleagues' outrage over these events, and truly feel for the workers and innocent investors who lost their jobs and life savings

Government and Congressional investigators, as well as the media and legal prosecutors, are still hard at work trying to get at all the facts surrounding this case. But from what I read in the papers and from my staff's own investigative work, the facts don't look good. As efforts to uncover all the facts surrounding the Enron debacle proceed, there are legislative actions that we in Congress can take to ensure that similar corporate missteps, including fiduciary mismanagement, aren't allowed to fester elsewhere

There may be other cases of misconduct that we'll need to learn more about. For example, what about the Global Crossing bankruptcy? Obviously something smells when you have the Democratic National Committee Chairman - who just happens to be a buddy of the Chairman of Global Crossing - ten a \$100,000 stock investment into what's been reported to be an \$18 million mega-profit, while employees and shareholders are left holding the bag when the company goes bankrupt. Who knows, there may be more than one Enron out there ready to happen. Let me be loud and clear, corporations must get their shop and books in order even before we in Congress make changes to the laws. You know what the problems are, so fix them. Common sense needs to rule. If not, the integrity of our financial markets is in big trouble

As the senior Republican member on the Finance Committee, I've focused on doing something about a number of tax and pension related problems that have been exposed by the Enron collapse. In fact, I've been working on legislation to tighten pension protections for working and retired Americans. The failure of Enron has been such a devastating blow to the shareholders, workers and retirees who invested in Enron stock

Furthermore, it's a real issue when the top dogs can cash out their stock options, but employees are prohibited from doing so. According to news reports, top Enron officials were allowed to sell their shares before the stock value bottomed out, while rank-and-file employees were left out to dry. This behavior smacks of mismanagement and moral disregard for the loyal workforce and retired employees. This cannot happen again.

I'm also drafting a legislative proposal that would help the IRS prevent tax cheats from shielding tax liabilities with the use of corporate tax shelters and other vehicles often used as tax-free havens. Enron may have used as many as 900 tax-haven subsidiaries to avoid taxes and mask financial debts. That's disturbing, and underscores the need for full disclosure of tax shelters so the IRS can better police their use. My investigative staff is getting to the bottom of this.

Moreover, the Enron crash raises serious ethical questions about the roles of auditors and consultants, as well as inside and outside legal counsel who make representations about a company's finances. In order for markets to work, there must be transparency and accuracy in a company's books so that investors and shareholders can get the whole picture and make informed decisions. Complete and accurate information is the foundation for a fair system, a system that Americans can have confidence in. People invest in stocks because they think they've gotten honest, open and full disclosure of a company's financial condition. We need to reevaluate the rules eliminating conflict of interests in the work of auditors, consultants, analysts and lawyers, so that any report they produce is honest, accurate and transparent, and so the work is independent and hasn't been tainted by inside interests. In addition, we should make sure that the government regulators are not asleep at the switch. They need to be ready to crack down on those who cook the books and abuse the system. Ultimately, we need to preserve the integrity of the market system by safeguarding the integrity of information given to the public.

Statement of Hon. Herb Kohl, a U.S. Senator of the State of Wisconsin

Thank you for calling this hearing on the lessons learned from Enron's failure. It would be wise to anticipate the next chapter in this story. Where corporations go bankrupt, people follow. And the next Enron scandal might be right around the corner. Texas and four other states allow people who declare bankruptcy to keep an unlimited amount of equity in their home. So the executives who may be at fault will be able to use the bankruptcy code to escape personal responsibility. They will continue to live in multimillion-dollar mansions—even as their former employees struggle to find a new pay check or to cover the rent.

Last week, we heard from the wife of Ken Lay who said that they might need to declare personal bankruptcy and sell their homes in Aspen. But Texas' homestead law will allow them to keep an unlimited amount of equity in their 13,000-square-foot Houston penthouse—valued at \$7.1 million. Enron's former CFO, Andrew Fastow, has property and a house worth almost \$3 million. Enron's former CEO, Jeffrey Skilling, has a house worth \$2.5 million. Under Texas law, if they declare personal bankruptcy, they keep their multimillion-dollar houses. Their creditors get nothing.

While the nation is focused on their misdeeds, real people—more than 4,000 of them fired from Enron with 30 minutes notice—are looking for jobs and trying to pay the bills. Millions more have seen their pension funds and personal investments disappear before their very eyes. There is no justice in a system that puts thousands of people on the street without a job and wondering about the rent, but that helps perpetrators live in multimillion-dollar houses. That's just wrong.

The bankruptcy bill that the Senate passed and that is now in conference would fix this injustice. It would cap the homestead exemption at \$125,000 in equity. It is a reasonable and common-sense solution. And to those who have disagreed with this proposition before, the Enron scandal should be enough to convince you.

Mr. Chairman, let's put this in perspective. No Enron executive has declared personal bankruptcy yet. But you can be sure their attorneys are counseling them on how to do it. We've seen this before: Burt Reynolds, Bowie Kuhn, Paul Bilzerian and others too numerous to list all escaped their creditors and kept living like kings. Do we intend to let Enron executives add their names to this list?

Statement of Hon. Jon Kyl, a U.S. Senator from the State of Arizona

Thank you, Mr. Chairman.

On December 2, 2001, Enron Corporation filed the largest corporate bankruptcy in the history of America. Many thousands of investors across the country have seen their stock become worthless, and thousands of employees have lost both their jobs and their lifetime 401(k) retirement savings.

In one way, Enron's collapse demonstrates that no company can consider itself "too big to fail" in our free-market system; schemes like the ones we've been reading about simply won't be sustainable forever. Yet the sudden bankruptcy of the seventh largest U.S. corporation raises questions about the federal government's role and responsibilities in a free market.

Both Houses of Congress and the Departments of Justice, Labor, Commerce, as well as the Securities and Exchange Commission, and the Commodities and Futures Trading Commission, have begun investigations to determine whether the company violated federal accounting standards, securities laws, and pension laws.

Specifically, these investigations will seek to establish whether or not, through the use of accounting gimmickry and artifice, the company defrauded its investors by systematically failing to disclose financial liabilities that degraded the real value of company stock; and whether or not it harmed its employees by violating the federal pension statute, the Employee Retirement Income Security Act (ERISA), which requires employers to act as fiduciaries by managing employee retirement funds "exclusively for the benefit of plan participants and beneficiaries."

To address the pension issues highlighted by Enron's implosion, President Bush in his State of the Union Address called upon Congress to enact new protections so that 46 million American workers will have confidence that the collective \$4 trillion they have invested for their retirement—a tremendous source of capital for the national economy—is available when they need it.

The President has proposed to: 1) afford workers greater freedom to diversify and manage their own retirement funds; 2) require that senior corporate executives are held to the same restrictions as average American workers during trading "lockdown" periods; 3) ensure that workers see quarterly information about their investments and their right to diversify, and 4) expand workers' access to independent investment advice for which the employer would not be liable. (One of the major problems in the Enron case is employees who did not diversify their investments, but instead chose to put most or all of their 401 (k) contributions into Enron stock. Social Security presents a similar undiversified system, except that there is no choice.

Since Enron's failure, many who have defined retirement security in terms of Social Security, a single plan headed for bankruptcy which forces workers to invest in one financial instrument, U.S. Treasuries, have concluded that mandatory diversification is a wise investment strategy.) The Congress will also consider whether to implement a rule that I have supported which would bar accounting firms—such as Arthur Andersen, Enron's accountant—from providing both auditing and consulting work for the same client. I believe such an arrangement creates an inherent conflict of interest. It is important to remember that a Certified Public Accountant's first obligation is to the public, not the payor.

These comments are offered in my capacity as a U.S. Senator and as a member of the legislative branch of government, a government in which the constitutional separation of legislative, executive, and judicial powers is scrupulously maintained. My purpose is not to influence the ongoing DOJ, Commerce, Labor, SEC or CFTC regulatory processes, or to anticipate the conclusions of any future judicial proceedings.

Rather, it is merely to offer my view on why Congress must take care to gather the facts and make whatever statutory changes are necessary to restore employee confidence in our retirement system and investor confidence in our capital markets. Because these investigations have just begun and may ultimately be resolved in criminal and civil courts, it is very important that Congress not prejudice the outcome.

The congressional role of patient finder of fact is especially critical here. We may well end up legislating new protections, but we should not act in such a way that employers will be discouraged from offering 401(k) plans, an important benefit they voluntarily offer.

Mr. Chairman, based on initial press accounts, I believe I am safe in saying that no employee or investor, no matter how sophisticated, could have known the full extent of Enron's obligations. Until firms are required to disclose completely informa-

tion about their obligations and liabilities, employees and stockholders will not know which firms are burdened by debts that don't appear on balance sheets—debts that reduce the true value of the stock.

We can assume that, if stockholders can't reliably know the extent of corporate obligations, they will stop buying stock. If this happens, our capital markets will forfeit the public trust that allows them to function. Our economy will stagnate, our standard of living will decline, and the personal and business tax revenues necessary for vital government functions such as defense and law enforcement will be depleted.

Those of us with an appreciation for free markets have a special burden to police capitalists who abuse their freedom; we must do all we can to restore confidence in the system that we advocate as the best in the world. Those who are convicted of wrongdoing must be punished to the full extent of the law.

All Americans have a special interest in the healthy function of the markets. I agree with George Will that a properly functioning free-market system "is a complex creation of laws and mores that guarantee, among much else, transparency, meaning a sufficient stream—a torrent, really—of reliable information about the condition and conduct of corporations. By casting a cool eye on Enron's debris and those who made it, government can strengthen an economic system that depends on it."

Mr. Chairman, I could not have said it better. I look forward to working with the Chairman, the Ranking Member of the Judiciary Committee, and all of my colleagues in the Senate to take the steps needed to restore trust in a framework—namely, democratic capitalism—that has undeniably brought the most benefits to the largest numbers of people of any system ever devised.

THE RETIREMENT SYSTEMS OF ALABAMA
MONTGOMERY, ALABAMA 36104-2150
February 1, 2002

The Hon. Jeff Sessions
United States Senate
495 Russell Senate Office Building
Washington, DC 20510

Re: Enron

Dear Senator Sessions:

As I am sure you know, the Retirement Systems of Alabama (RSA) manages and administers the retirement plans and funds for all public education employees and most state, county and city employees in the State of Alabama. RSA manages and invests approximately 26 billion dollars which is held in trust for the payment of Retirement benefits for approximately 280,000 active and retired public Employees.

As prudent investment standards require, these funds are diversely invested in stocks, bonds, real estate and cash. Approximately 44% of our retirement fund assets are invested in stocks and approximately 85% of that is indexed to the S&P 500, Midcap and Smallcap indexes and approximately 15% is actively managed. Consequently, when the Enron "crash" occurred RSA suffered a \$14 million loss on the sale of Enron stock, although RSA earlier realized trading gains amounting to \$48 million, and RSA is left with bonds for which we paid approximately \$44 million and which are currently valued at approximately \$9 million.

Fortunately, because of the size of our investment trust, our conservative investment strategy and the diversification of our investments, the Enron loss has not endangered our ability to pay benefits which our retirees have earned. Furthermore, because our Retirement plans are defined benefit plans, rather than defined contribution plans benefits are guaranteed as obligations of the RSA, as a stockholder and a bond holder, is a member of the classes in the numerous class action securities fraud lawsuits which have been filed in Houston, Texas, against Enron, its officers and Arthur Andersen. We have joined with the states of Georgia, Ohio and Washington in their effort to seek lead plaintiff status in that litigation. Unfortunately, it is generally believed that available assets of Enron and its officers and auditor will not be enough to provide meaningful relief to Enron's many creditors and defrauded stockholders.

It is my hope that: (1) those responsible for this fraud on investors Enron officers, auditors, and any others who participated and contributed to this fraud will be held accountable and will be required to disgorge any personal wealth acquired in this nefarious enterprise as a strong deterrent to others, and (2) federal and state regu-

latory actions will be taken to diminish the chances of something like this ever happening again.

It is probably too late to help those who were defrauded by Enron and its officers but we should make every attempt to see that innocent investors are not defrauded in this manner and on this scale in the future.

Sincerely,

DAVID G. BRONNER
Chief Executive Officer

DUKE UNIVERSITY SCHOOL OF LAW
DURHAM, NORTH CAROLINA 27708-0360
January 24, 2002

Senator Patrick Leahy
433 Russell Senate Office Bldg
United States Senate
Washington, D.C. 20510

Congressman F. James Sensenbrenner
2332 Rayburn House Office Building,
Washington, D.C. 20515-4909

Dear Chairman Leahy and Chairman Sensenbrenner:

I am very troubled by the January 23 letter delivered to you by a group of law professors opposed to section 912 of S.420/H.R. 333. The suggestion that section 912 would encourage the types of off-balance sheet financing that Enron abused is misleading for two reasons. First, Section 912 addresses only securitization transactions, which are not the types of off-balance sheet financing that caused the problems in Enron. Second, the problems in Enron do not appear to have been caused by the creation and use of special purpose entities, per se, but rather by the off-balance sheet accounting treatment of such entities and their specially lobbied exemptions from the investment company act. Accounting treatment is governed exclusively by generally accepted accounting principles, promulgated by the Financial Accounting Standards Board and having nothing whatsoever to do with section 912. And the specially lobbied exemptions from the investment company act appear to apply only to Enron, so there will be no further similar abuses.

Using the Enron debacle to oppose section 912 therefore relies on a false analogy. I have taken the liberty of attaching a forthcoming law review article that analyzes section 912 in some detail. The article concludes that section 912 represents a public good and, if enacted, would foster significant economic benefits.

Thank you for your consideration.

Sincerely,

STEVEN L. SCHWARCZ
Professor of Law & Professor of Business Administration

Statement of Steven L. Schwarcz, Duke University School of Law, Durham, North Carolina

I have been asked to testify on section 912 of S.420/H.R.333. My testimony is intended to supplement the letter and attached article that I sent to Senator Patrick Leahy and Congressman F. James Sensenbrenner on January 24, 2002, expressing concern over a January 23 letter delivered to them by a group of law professors opposed to section 912.

Section 912, as you know, would create a "safe harbor" under bankruptcy law for true sales of eligible assets in securitization transactions. My background includes both scholarly expertise and extensive practical experience in the fields of securitization and bankruptcy. Prior to joining the Duke faculty, I was a partner at two leading law firms, where I was principally engaged in representing creditors and debtors in bankruptcy cases and in structuring securitization transactions. I also taught courses in bankruptcy and securitization at Yale Law School and Co-

lumbia Law School. In 1996 I became Professor of Law at Duke University, where my areas of scholarship include bankruptcy and securitization. Among numerous works in these fields, I have authored the widely used *Structured Finance, A Guide to the Principles of Asset Securitization* (3d edition Jan. 2002).

I believe that section 912 represents a public good and, if enacted, would foster significant economic benefits. Securitization is believed to be the most rapidly growing segment of the U.S. credit markets. The Securities and Exchange Commission has characterized it as one of our country's dominant means of capital formation. The most critical issue in a securitization is whether the transfer of eligible assets from a company to a special purpose vehicle (SPV) constitutes a sale under bankruptcy law, usually referred to as a "true sale." True sale characterization is usually necessary for the securitization transaction to successfully attract outside investors.

The law governing true sale characterization, however, is muddled and ambiguous. As a result, many otherwise viable securitization transactions cannot be done. Furthermore, even viable securitization transactions generate excessive transaction costs, mostly involving lengthy legal opinions on the issue of true sale characterization. Section 912 recognizes that these transaction costs are wasteful. It would minimize these costs by permitting true sale issues to be promptly resolved by examining the transactional documentation. Moreover, section 912 should provide a basis to do away with the present need in many securitization transactions for a two-tier structure. This would allow the benefits of securitization to be extended to middle-market companies.

There are no overriding policy reasons that would favor the current state of legal ambiguity on true sale characterization. Opponents of section 912 essentially argue that its safe harbor would provide participants in securitization with an ordinate degree of protection and immunity from the normal operation of the bankruptcy system at the expense of other creditors and debtors that seek to reorganize under the shelter of the bankruptcy laws. Those arguments, however, raise the larger question of whether securitization is efficient and fair. I believe, and have argued at length, that it is. Securitization merely replaces financial assets with cash. Unsecured creditors have the same amount of unencumbered assets to levy against after the securitization as they did before the securitization.

Some may argue that securitization nonetheless could hurt creditors where the cash received is wasted by the company originating the securitization. But one cannot assume wasteful behavior simply because a company sells assets for cash. In fact, given the scrutiny imposed by rating agencies—section 912 requires that at least one nationally recognized, Securities and Exchange Commission-approved rating agency, such as Standard & Poor's or Moody's, has rated at least one class of the SPV's securities to be investment grade—securitization may present fewer opportunities for wasteful behavior than other financing methods.

Nonetheless, securitization, just like any other sale of assets by a company, may become suspect if implemented when the company is on the brink of bankruptcy. The potential for such suspect actions, however, is not unique to securitization transactions. The same issues would arise, for example, if on the eve of bankruptcy a company sold, or borrowed money by encumbering, a factory or equipment and similarly sought to dissipate the sale or loan proceeds. Such questionable uses of proceeds are more appropriately addressed by the existing network of preference and fraudulent conveyance laws.

Moreover, securitization increases overall value by providing a new source of financing, the capital markets, whose rates are systematically lower than the rates at which many companies commonly borrow. So long as the added transaction costs are less than the interest saved by using securitization instead of secured financing, there is a net gain.

This begs the question, however, why the capital markets should be prepared to fund securitization transactions at a lower rate than secured financing. It's because a securitization based on a "true sale" effectively can separate the source of payment of the SPV's securities from the risks associated with the company originating the transaction, largely eliminating the need for investors to monitor the original company's financial condition. Although the risks associated with servicing and collecting the eligible assets still necessitate some monitoring, these risks are borne by specialists who are in the business of precisely assessing and absorbing such risks.

I acknowledge that—all other things being equal—the safe harbor for securitization proposed in section 912 to some extent would act counter to the bankruptcy goal of debtor rehabilitation. That's because the safe harbor would prevent a court from re-characterizing a securitization "sale" as a secured loan even though, in a bankruptcy reorganization case, eligible assets consisting of a business's receivables are often a prime source of collateral for debtor-in-possession financing. But

other things are not equal. For example, the proceeds of the securitization may have provided liquidity to help a debtor stave off an earlier bankruptcy filing or could allow sufficient liquidity to help the company avoid bankruptcy altogether. The safe harbor also would help to preserve reasonable commercial expectations that insure efficiency and predictability in the marketplace. Furthermore, this all must be viewed in perspective: most companies that engage in securitization transactions do not end up in bankruptcy; in contrast, the possibility that these transactions could be undone in bankruptcy casts a shadow over all securitization deals. On balance, I therefore favor the safe harbor of section 912.

This result is sensible and, indeed, parallels the regulatory safe harbor similarly instituted by the Securities and Exchange Commission, after extensive study, in its Rule 3a-7 in order to promote securitization transactions.

Finally, section 912, which is limited to securitization transactions, would not encourage the kinds of abuses that occurred in Enron. Those problems were caused by Enron's manipulative use of special purpose entities, capitalized by Enron stock, in order to (a) sell assets, at inflated profits, enabling Enron to recognize the inflated profit for financial statement purposes, and (b) sell assets that would be falling in value, in order to book the sale proceeds and avoid having to later write-down asset value. These are accounting, not bankruptcy law, failures. Moreover, a company originating a securitization transaction would be prevented by federal securities law from capitalizing the SPV with company stock. Section 912 therefore would not cause Enron-style abuses.

Statement of Hon. Jeff Sessions, a U.S. Senator from the State of Alabama

Every director and officer of a corporation owes his corporation and its shareholders a very high legal duty—a duty of loyalty.¹ This duty of loyalty is owed to all of the stockholders of the corporation and is of paramount importance if there is to be a true open and transparent capital market.

The duty of loyalty requires that officers or directors not engage in self-dealing transactions. Enron's own report released this past week, indicated that directors and officers of Enron may have engaged in such self-dealing transactions, thereby breaching their duty of loyalty. These officers breached their duty by setting up partnerships where Enron invested 97% of the capital needed (some of it in debt) for the partnership while the other partners—who were Enron officers—only invested 3%. This type of arrangement is allowable under Generally Accepted Accounting Principles.

It appears these partnerships worked to the direct advantage of the minority partners—the Enron officers. While Enron was able to hide the debt incurred to start the partnerships off its corporate balance sheet, yet still being liable for the debt, the other partners were making millions. Enron's own report states “[m]any 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.” Engaging in these types of transactions by corporate officers is a breach of the duty of loyalty that the officers owed to Enron and its stockholders. If these allegations are true, the officers and directors must be held responsible.

Furthermore, it appears that Enron insiders made millions by unloading their stock in the months leading up the collapse of this Fortune 100 company. The insiders apparently used their knowledge of inside material information to make their money while others held on to their Enron stock and lost millions. A corporate insider has a duty under Federal securities law to not trade on material non-public information. The insider has a duty to “abstain or disclose.” This means the insider must either disclose the information or abstain from trading.

If Enron insiders have engaged in these transactions, they should and will be held accountable and liable to the public for their illegal actions. It is a shame that many Americans trusted this company to be honest in its accounting practices only to discover that Enron's books were a financial “house of cards.”

Even the State of Alabama has felt the effects Enron's fall. The Retirement System of Alabama, which held investments in Enron, has lost approximately \$50 million in stocks and bonds on Enron. This retirement fund is for teachers and other state employees of Alabama. Additionally, there are several other state retirement

¹See *Marciano v. Nakash*, 535 A.2d 400,403 (Del.1987) (citing *Guth v. Loft, Inc.*, 5 A.2d 503 (Del.1939)). See also WILLIAM A. KLEIN AND JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES, 162–65 (6th ed.1996).

funds that have lost millions as a result of Enron's bankruptcy—not to mention the countless others who held investments in Enron, including Enron's own employees. If these losses were due to fraud, those responsible must be held accountable.

The key to American economic progress has been a confidence on the part of investors that the financial data they receive is honest. This confidence should and can be restored. I believe there are problems with our accounting system that must be corrected.

I also believe that the retirement funds of individuals employees are of immense importance and great care must be taken to avoid huge financial disasters that could place in poverty an entire family. I will support reforms to make these plans more secure.

It is important that the investigators and investors get to the bottom of what transpired at Enron over the past several years. There should be a full investigation that will be fair and equitable to the innocent investors. If innocent investors have been defrauded by this company or its executives then they should and will recover under our system of justice. Congress must carefully examine Enron's fall and decide if the rules need to be changed.

Statement of Hon. Strom Thurmond, a U.S. Senator from the State of South Carolina

Mr. Chairman:

Thank you for holding this timely hearing on the collapse of Enron Corporation. I hope that today's witnesses will give us a clearer understanding of what happened at Enron and how we can protect American investors from future business calamities. The bankruptcy of this giant corporation has serious implications for our economy, and we should examine closely the business and regulatory culture that led to its downfall.

I am particularly troubled by the devastating losses that many Enron employees suffered because their retirement savings were heavily invested in the company's stock. These unfortunate events have shown us the importance of pension reform, and I applaud President Bush's plan to protect the hard-earned retirement savings of our Nation's workforce. We should follow the President's lead and develop policies that would provide employees with more freedom in determining how to invest money in their 401(k) plans. Congress should also pass legislation that makes it unlawful for corporations to prohibit their employees from selling company stock while at the same time allowing senior executives to do so. As we have seen from recent press reports, it appears that Enron's upper-level management sold their stocks when it became apparent that the company was in trouble. However, the company's lower-level employees did not have the same opportunities or even enough information to know that their retirement savings were in jeopardy.

Our economic system thrives on the full disclosure of information to investors. Clearly, Enron succeeded for some time in hiding the true state of the company from investors, including its own employees. According to press reports, Enron was able to hide millions of dollars of debt in supposedly independent businesses that were in reality controlled by Enron executives. Not only were millions of dollars in debts hidden by these "outside" businesses, but the profits attributed to them were inflated. According to the Wall Street Journal, Enron acknowledged in November that it had erroneously reported \$600 million in earnings since 1997. Soon after this revelation, when investors became aware that the company indeed troubled, the company went bankrupt.

There appear to be many factors that contributed to this investor deception. We should examine them thoroughly. While Congress should not react in a knee-jerk fashion, we must review several aspects of our current financial system

that may have been factors in the Enron collapse. First of all, I am concerned about the conflicts of interest that arise for analysts employed by Wall Street firms. While they offer advice to clients on whether to buy or sell a particular company's stock, their firms may also provide lending services to the same company. While the lending side of the business is supposed to be walled off from the brokerage side, there have been allegations leveled that analysts are often discouraged from offering honest assessments of a corporation's performance.

Second, Congress should also examine the practice that consulting firms, such as Arthur Anderson, have of providing consulting and auditing services to the same client. The potential for abuse is readily apparent. This is particularly so because the consulting side of the business is more lucrative than the auditing side. Several con-

sulting firms and businesses have already made public their intentions to separate auditing and consulting services, and I find this to be an encouraging development.

Moreover, I hope that our witnesses today will discuss accounting reform in general. While some of Enron's practices appear to have violated accounting standards, others may have been set up in conformance with current standards. I believe that Congress should prohibit accounting gimmicks from hiding the true state of a corporation's financial standing. Investors should not be deceived by trickery. Rather, they should have an abundance of accurate information available to them.

While regulation of the markets should be limited, we must ensure that basic protections exist to protect shareholders and retirement savings. We should allow the market to operate unhindered, but in order to do so we must not sanction unethical and deceptive behavior. The market should not encourage immoral behavior, and it is our responsibility to take steps to help root it out. Ethical standards should be no different on Wall Street than on the Main Streets of towns and cities across this Nation.

In addition to the concerns that I have discussed, legislative proposals have been advanced that would amend our laws on securities fraud. I will gladly consider making reasonable changes to current laws, but I do not want Congress to react unwisely in the face of political pressure. It is important to keep in mind that those who may have committed wrongdoing in this case can be prosecuted under current law. Additionally, shareholders who have been injured may bring civil suits to recover their losses. Our current system does not allow those who break the law to go unpunished or to reap the benefits of their fraudulent activities. However, that being said, we should examine all proposals that may discourage future Enron-type debacles.

Some Wall Street observers have called for the repeal of certain provisions of the Private Securities Litigation Reform Act of 1995. We should be very careful regard. The PSLRA was the result of a bipartisan effort and was intended to place reasonable limitations on liability exposure in securities litigation. For example, under the PSLRA, an individual cannot bring a civil action against someone who has aided and abetted a securities fraud. Aiders and abettors would typically include professionals who were not direct violators of the law but who facilitated the commission of the fraud, such as attorneys and accountants. Although an injured person may not sue the aider or abettor, the Securities and Exchange Commission may bring a civil action against the wrongdoer. This system prevents the filing of multiple, harassing lawsuits meant to go after the deep pockets of professionals but allows for the government to sue those who have truly aided and abetted. I do not think that we should repeal this section of the Act and open the floodgates to unlimited lawsuits. However, there are some minor changes that could offer a great benefit. We should make the SEC a more meaningful enforcer. Currently, the SEC can bring civil actions against aiders and abettors if the person knowingly helped in the fraudulent activity. However, the "knowingly" standard provides incentives for lawyers and accountants to look the other way while inappropriate behavior is occurring. We should consider adding a "recklessness" standard, thereby eliminating any safe harbors for those who intentionally ignore fraudulent behavior.

Another suggested change to the PSLRA that concerns me is the elimination of the securities exemption under the racketeering laws. As part of the PSLRA, Congress prevented civil RICO claims from being brought in securities fraud cases. This reform was enacted because Congress understood that the broad language of the RICO statute permitted actions to be brought in circumstances that did not involve organized crime. Because of this broad language, RICO claims were commonly made in securities fraud cases and commercial litigation. These claims provided major incentives for defendants to settle because of the possibilities of treble damages under the RICO statute. We should be careful about re-opening the doors to abuse of RICO claims. If minor changes in the law would be adequate, we should not undo important reforms just for the sake of appearances.

Mr. Chairman, thank you for holding this important hearing. I hope that this committee will conduct a reasonable inquiry into the activities that led to Enron's all. We should develop sensible policies that encourage corporate responsibility and ethical behavior. At the same time, Congress should not rush to make unnecessary and harmful changes in the law. We should pursue a course that will discourage corporate dishonesty and punish those who violate the trust of investors. Yet we must not overreact and hamper the market's ability to deliver strong economic growth. I look forward to hearing the testimony of our witnesses today.

