Corporation Law After Enron: The Possibility of a Capitalist Reimagination

David A. Westbrook
University at Buffalo School of Law

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Corporation Law After Enron: The Possibility of a Capitalist Reimagination

DAVID A. WESTBROOK*

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* Associate Professor of Law, University at Buffalo Law School, State University of New York. This Article draws on theoretical work done for a book, City of Gold: An Apology for Global Capitalism in a Time of Discontent (Routledge 2003). Special thanks are due to my colleagues Phil Halpern and Amy Westbrook for encouraging me to express some of my thinking about capitalism in the less daunting format of the law review article and in the context of a concrete issue, the Enron debacle. A presentation to the faculty at Emory Law School was quite helpful, as were seminars in corporation law at both UB Law School and Emory Law School. The workshop, “Complicitous Understandings: Doing Ethnography Within Modern Logics,” Department of Anthropology, Rice University, May 16–17, 2003, was very stimulating. I particularly appreciate the interest and comments of Brandon Becker, Bill Buzbee, Bill Carney, John Kenneth Galbraith, Jean-Marc Gollier, Doug Holmes, the late Charles Kindleberger, Mae Kuykendall, George Marcus, Howard Miller, Marc Miller, Jeff Pennell, Jack Schlegel, and Valerie Szczepanik. Dawn Rooth provided excellent research assistance throughout the writing of this article. Gabe Gilman and Charles Miller did some great pinch hitting. Barb Kennedy did her usual utterly competent yet friendly job with the practicalities. UB Law School provided much appreciated financial support for the research of this Article. Once again, any mistakes are mine alone.

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CONCLUSION: TOWARDS A REIMAGINATION OF CORPORATION LAW

INTRODUCTION: ENRON AS THE OCCASION FOR A PARADIGM SHIFT IN CORPORATION LAW SCHOLARSHIP

Consider the following possibility: Right up until the company's demise, the management of Enron embodied much of academic thinking about how corporations should govern themselves. In general, Enron's managers did what schools of law, business, and accounting taught them to do. More unsettling still, consider the possibility that Enron's senior management and directors generally acted in what seemed to be the best interests of Enron's shareholders. In short, consider the disturbing possibility that Enron demonstrates just how weak our thinking about the corporation and about capitalism is.

Regardless of what exactly happened at Enron (pretty much everything, it turns out), the company's collapse should serve as an occasion for reflection in the legal academy and as the basis for a thought experiment. After Enron, we can see how a great company can implode—even if no specific rules are broken, and even if the principles that animate corporation law scholarship are maintained. Enron's collapse suggests that corporation law scholarship has been wrong-headed, or at least that it has been addressing questions different from those, perhaps more important, questions posed by Enron's demise and the host of recent accounting scandals. This Article maintains that Enron provides both an occasion and substantive material for reimagining corporation law in terms

1. "Enron" was actually a vast tribe of almost 3,000 related legal entities, headed by Enron Corp., a publicly-traded Oregon corporation. Permanent Subcomm. on Investigations of the Senate Comm. on Governmental Affairs, 107th Cong., Report on the Role of the Board of Directors in Enron's Collapse 23 (Comm. Print 70) (hereinafter Enron Report).


3. See infra notes 12-30 and accompanying text.
of questions and concerns different from those that have informed academic thinking and teaching about the corporation since at least the 1930s. In short, Enron offers scholars considerable reason to shift their attention, and thus, to reinvent their field.

What would such a reimagined field look like? Enron gives corporation law scholars reason to focus attention on property rather than contract as the institution most fundamental to understanding the corporation. With similar shifts of attention, corporation law could be understood as a branch of public law rather than a branch of private law; the conflict between shareholders and management could be supplanted by the conflict between current shareholders, including management, and the rest of the world. Financial markets could be recast in explicitly political terms as governance mechanisms, at which point accounting, and economic life generally, would be seen as subject to the vagaries that attend other forms of political life. Understanding corporations as a form of political life might even lead us to question the basis of our loyalty to financial capitalism, and ask in what way we believe ourselves to be well-governed by our markets and what might be done to improve that governance.

The reimagining of corporation law expounded here is more explicitly capitalistic than is traditional among scholars tending to either the political left or right. In contrast to views from the left, which tend to be antagonistic to markets, this reimagining operates through, rather than against, the price mechanism. In contrast to views from the right, which tend to assume capitalism is good, functional, or even natural, and thereby tend to be antagonistic to politics, this Article understands corporations and the financial markets that govern them in intractably political terms, calling for considerable attention from the state. However, the reimagination suggested here is not merely or primarily a rejection of well-established positions in corporation law or a refutation of familiar arguments. Instead, the Article begins a rather old-fashioned project of locating corporate governance within a broader understanding of political economy, of markets understood as a mode of governance.

4. Although, as argued below, the orthodox academic approach to corporation law was established in the 1930s, there have been shifts in focus over the years, many of which are sketched in the text. Over the same period, however, there have been dramatic changes in the voice or stance of corporation law scholars. For a thoughtful account of the move from scholar as legislative counselor to scholar as theoretician, see generally Mae Kuykendall, Reflections on a Corporate Law Draftsman: Ernest L. Folk's Lessons for Writing and Judging Corporate Law (2003) (unpublished manuscript, on file with author).

5. A disclaimer is in order even at this early stage of the argument. Due to cultural inertia, the reimagining of corporation law envisaged in this Article is unlikely to occur. Moreover, it is impossible to say in advance, and difficult to say in hindsight, whether or not reimagining the corporation—telling ourselves different stories about the forms of business life—will have any particular effect on how business is actually conducted. Perhaps, or perhaps not. I am agnostic about how earlier transformations of corporation law theory affected the course of business life; I am unsure how reimagining the corporation in terms of a forthright capitalism would change things. However, changing our ideas about what “corporation law” means would change at least how we think about, and perhaps teach, such matters.
The events that call the field of corporation law into question are widely known. In the spring of 2001, Enron was ranked the seventh-largest company in the United States. On October 16, 2001, Enron announced that certain transactions with a limited partnership called LJM2 Co-Investment, L.P. (LJM2) would require a $544 million after-tax charge against its third quarter earnings and a reduction in shareholders’ equity of $1.2 billion. On October 22, 2001, Enron announced that the SEC had begun an inquiry into a number of transactions between Enron and various related parties. On November 8, 2001, Enron filed a Form 8-K with the SEC, announcing that its failure to account properly for transactions with partnerships known as LJM Cayman, L.P. (LJM1) and Chewco Investments, L.P. (Chewco) required the company to revise its financial statements for the years 1997 through 2001. Moreover, Enron announced that certain Enron employees had profited from the misstated transactions. Enron then admitted that it had for years “misstated” its earnings, its debts, and the amount of its shareholders’ equity. Enron also admitted that members of its management had made enormous, previously undisclosed personal profits through their dealings with the company.

Bluntly, the company confessed that its financial statements were untrue and had been for years. As the euphemism has it, “market confidence evaporated,” and Enron’s stock price plummeted. In September of 2000, Enron had hit a high of $90 per share. In October of 2001, Enron was trading at around $33 per share. Immediately after issuing its third quarter financial statement, Enron’s share price fell to $13.90. By the end of November, after issuing the restatement of earnings and shareholders’ equity, the share price was $0.26. On December 2, 2001, Enron filed for bankruptcy, the largest in U.S. history up until that time. The company is now mired in criminal and civil litigation.

6. ENRON REPORT, supra note 1, at 1; see also Lee Clifford, The Story of American Business: 2000 Was the Year Big Oil Came Back. But Don’t Worry, This is Not History Repeating Itself, FORTUNE, Apr. 16, 2001, at 100–03.
8. Id. at 30–31.
10. Form 8-K, supra note 9; see also POWERS REPORT, supra note 7, at 3.
12. Rebecca Smith, Enron Files for Chapter 11 Bankruptcy, Sues Dynegy, WALL ST. J., Dec. 3, 2001, at A3. Since then, WorldCom has filed for bankruptcy. WorldCom’s bankruptcy is even larger than Enron’s. Shawn Young et al., Leading the News: WorldCom Files for Bankruptcy, WALL ST. J., July 22, 2002, at A3 (reporting that WorldCom’s bankruptcy filing, listing assets valued at $107 billion, was by far the largest bankruptcy in U.S. corporate history. Enron Corp., which had filed the largest bankruptcy until then, listed assets valued at $63.4 billion).
Unfortunately, Enron's collapse was not an isolated incident. Within a short period of time, Adelphia Communications Corp.,\textsuperscript{14} Global Crossing Ltd.,\textsuperscript{15} ImClone Systems,\textsuperscript{16} Merck & Co.,\textsuperscript{17} Qwest Communications,\textsuperscript{18} Rite Aid Corp.,\textsuperscript{19}
Tyco International Ltd., WorldCom Inc., and Xerox were all accused of accounting improprieties. The accounting practices of other companies—consider AOL Time Warner and even mighty General Electric—became a topic of everyday conversation. The stock market, which had staged a modest recovery from its lows after the terrorist attacks of September 11, 2001, fell hard once again. Reconsideration of recent years’ accounting restatements, particularly those inspired by SEC enforcement actions—suppressed memories of Cedant.

20. See David Armstrong et al., Tyco Payments to Law Firm Queried, WALL ST. J., June 12, 2002, at A2 (reporting that “[t]he Securities and Exchange Commission has revived an earlier investigation into Tyco’s accounting related to its flurry of acquisitions during the past several years”); Paul Beckett & Christopher Oster, New SEC Order Doesn’t Apply to Companies Based Offshore, WALL ST. J., July 8, 2002, at C16 (mentioning that Tyco was under investigation by the SEC for its bookkeeping practices); Laurie P. Cohen & Mark Maremont, Expanding Tyco Inquiry Targets Company Spending on Executives, WALL ST. J., June 7, 2002, at A1 (reporting that investigators “became suspicious when they noticed a Jan. 3, 2002 wire transfer for $3.95 million from a Tyco bank account in Pittsburgh to a New York bank account held by art dealer Alexander Apsis”).

21. See Rebecca Blumenstein & Gregory Zuckerman, Domino Effect: Telecom’s Troubles Spread from Upstarts to Sector’s Leaders, WALL ST. J., Mar. 13, 2002, at A1 (reporting that WorldCom, “[one] of the nation’s largest phone companies, acknowledged that the Securities and Exchange Commission is investigating [its] accounting practices.”); Rebecca Blumenstein et al., WorldCom’s Problems Mount in Wake of Ebbers Departure, WALL ST. J., May 1, 2002, at A1 (“the seven-page list of documents and information [the SEC has requested from WorldCom show the agency is questioning whether some of the company’s once-stellar growth was partly an illusion created by aggressive accounting.”); Michael Schroeder et al., WorldCom Executives Are Hit With Subpoenas by House Panels, WALL ST. J., June 28, 2002, at A3 (reporting that “Rep. Billy Tauzin (R. La.), chairman of the House Energy and Commerce Committee . . . said the WorldCom case was ‘eerily similar to the accounting hocus-pocus that occurred at Enron.’”).


24. See Ken Brown & Julia Angwin, Is There Déjà Vu Value in AOL’s Suffering Stock Price?, WALL ST. J., July 26, 2002, at C1 (reporting that “investors pounded shares of AOL Time Warner, Inc. down to levels not seen since the fall of 1998” because the SEC was questioning the company’s accounting practices).

25. “The conglomerate’s size and complexity have become an issue on Wall Street following a rash of corporate scandals, which have exposed investors’ ignorance of some companies’ financial health in part due to byzantine accounting.” Tim McLaughlin, Plastics, Popular TV Shows to Buoy GE in Second Half, REUTERS ENG. NEWS SERVICES, July 8, 2002 (noting that “GE’s stock is under pressure, off more than 25 percent this year”).


MicroStrategy, Sunbeam, Waste Management and others—revealed the ubiquity of what had until recently looked like isolated incidents of accounting fraud. As scandals multiplied, what had appeared to be the misdeeds of a few "bad apples" came to be seen as a systemic problem, threatening the integrity of the markets themselves. Proposals for reform flooded Congress; cries for


32. See Turner, supra note 28 ("In 2001, 270 public companies restated numbers in their financial statements. Those numbers prove that there are more than the ‘few bad apples’ in the orchard that President Bush would have us believe following his Wall Street speech on Tuesday."); Too Little: Financial Reporting Needs Systematic Reforms; Bush’s Call for Responsibility isn’t Enough, NEWSDAY, July 10, 2002, at A24 ("Bush in essence threw his weight behind the notion that corporate abuses, such as those that brought down the Enron Corp. last year and resulted in a $3.6-billion restatement of WorldCom Inc.’s expenses last month, are the result of a few really bad apples in the business world.");

33. Securities law authority John Coffee said, “Now, we’re getting increasing evidence that there weren’t just occasional bad apples but there was a systematic failure in the degree to which auditors acquiesced in aggressive and dubious accounting auditing policies and procedures.” Carolyn Lochhead, Senate Votes 97-0 to Crack Down on Accounting Fraud/Silicon Valley Dodges Proposal to Treat Stock Options as Expenses, S.F. CHRON., July 16, 2002, at A1; see also Corporate Scandals and Politics: The Backlash Against Business, ECONOMIST, July 6, 2002, at 27 ("His [President Bush’s] rhetoric already marks a change. After the Enron affair, Mr. Bush talked about a few ‘bad apples.’ Now he is talking about threats to ‘our entire free enterprise system.’ His change was necessary not just because of the mess (to suffer one business scandal may be regarded as a misfortune; to suffer eight looks worse than careless), but also because the scandals have dangerously reinforced the idea that Republicans are soft on business.").
prosecution of those who "cooked the books" filled speeches; and a major law was passed.34 As of this writing, that is where the matter stands.

Although these events are quite dramatic, it would be foolhardy to insist that the collapse of Enron—or even widespread loss of faith in the practice of accounting, the financial disclosures of corporations, and hence the equity market—requires the legal academy to revise its understanding of the institution of the corporation. It is difficult to know when a community's perspective will change. Certainly an unexplained event, even an event as dramatic as Enron's bankruptcy, need not cause a paradigm shift.35 Professors are fairly safe in their towers and, therefore, have substantial liberty to ignore the world and revise their thoughts only when they see fit. So, for example, basic courses on corporation law continue to instruct students in arcane, even archaic, concepts such as appraisal rights,36 shareholder derivative suits,37 and shareholder proposals,38 even though the corporation law that most students will practice has little to do with these legal devices.

More than the cozy insulation of the professoriate is at issue here. It is not obvious that Enron means much for corporation law per se. Whatever Enron's significance for laws pertaining to many aspects of corporate life—the accounting industry and its rules, corporate taxation, derivative regulation, insider trading, political influence, professional representation, retirement benefits, securities disclosure, white collar crime, and no doubt other legally regulated social practices—the case has few, if any, obviously important lessons for the fundamen-


35. The once fashionable term "paradigm shift" was appropriated by the legal community from Thomas Kuhn. See Thomas Kuhn, The Structure of Scientific Revolutions passim (1962). Putting aside any differences in the nature of "theory" in the natural sciences and in the law, Kuhn made it quite clear that anomalous phenomena do not automatically trigger abandonment of one theory and adoption of another. The moment of transition between the old and the new theories is unpredictable. This much, at any rate, seems quite true in legal thought. See John Henry Schlegel, Of Duncan, Peter, and Thomas Kuhn, 22 CARDOZO L. REV. 1061, 1063–65 (2001). One of the minor purposes of the present Article is to resuggest the use of Kuhn, but this time in service of an explicitly subjunctive, instead of normative or even hortatory, scholarly voice. Cf. Pierre Schlag, Normative and Nowhere to Go, 43 STAN. L. REV. 167 (1990) (providing an early example of Schlag's argument against the political and intellectual seriousness of the moralizing of law professors). And, as every Southerner knows, the subjunctive is much more polite.

36. Appraisal rights were already unimportant forty years ago, when Bayless Manning wrote his classic article on the subject. Bayless Manning, Shareholders Appraisal Remedy: An Essay for Frank Coker, 72 YALE L.J. 223, 262 (1962) ("In a world as awry as this one [appraisal remedies] do not loom very important.").

37. Shareholder derivative suits do fulfill an important function, which is why they have not been outlawed, despite widespread belief that they are abused. More importantly for the present discussion, shareholder derivative suits fulfill an important pedagogical function: They produce judicial decisions that discuss fiduciary duties, explaining the facts and applying doctrinal rules. While shareholder derivative suits are indeed a considerable distance from most transactional practices, such cases are not far from first-year law courses.

38. Shareholder proposals are important to non-governmental organizations and to teaching about the corporation as if it were the situs for political action—a very problematic claim popular among progressive academics, albeit with little purchase on everyday corporate life.
tal theory of corporation law. The Enron case undoubtedly featured outrageous greed, fraud, and various kinds of professional malpractice, and that is quite enough to explain a great deal of drama; indeed, those are precisely the terms in which the current situation is usually described. The Chairman of the Federal Reserve spoke of “infectious greed,” and any number of politicians and respected commentators have stressed the need to punish those who steal from their corporations.

But what, if anything, do such statements mean for corporation law scholarship? Enron certainly serves as a reminder that directors need to exercise oversight for the benefit of shareholders, or that the economic system depends on a degree of trust, or that management should not “cook the books”—but these are hardly new lessons. Many reforms have been proposed and a few were enacted by the Sarbanes-Oxley Act of 2002. So, for example, Sarbanes-Oxley requires publicly listed companies to have certain features, notably an audit committee composed of independent directors. However, the independence of directors is a very familiar suggestion for improving corporate governance. More generally, the requirements set forth by Sarbanes-Oxley hardly represent a new direction in corporate governance, at least as conceived in the United States. Hardly a year after Enron’s bankruptcy, commentators began insisting that Enron does not require fundamental rethinking of our institutions at all.

Instead of dismissing Enron’s significance to corporation law, this Article depicts Enron as a possible turning point for our thinking about the corporation. Future historians of fin de siècle legal thought may see Enron as marking the

40. The canonical citation for this proposition is Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919).
43. Sarbanes-Oxley Act § 301.
44. Indeed, even a cursory reading of the Act makes clear how little, substantively, is changed. With a few notable exceptions—for example, oversight of the accounting industry and the requirement of accountants on audit committees—the Act simply amplifies existing law, especially the Securities and Exchange Act. Whether such amplification will have any effect is open to question. See generally MICHAEL A. PERINO, ENRON’S LEGISLATIVE AFTERMATH: SOME REFLECTIONS ON THE DETERRENCE ASPECTS OF THE SARBANES-OXLEY ACT OF 2002, 76 ST. JOHN’S L. REV. 671 (2002) (concluding that Sarbanes-Oxley is unlikely to have much impact on deterrence, except perhaps through its increased funding of the enforcement activities of the SEC).
45. There are problems, however, with the application of quite distinctively American notions about how to improve corporate governance in foreign corporations, many of which operate with different corporate structures.
46. See, e.g., Thumped: But Don’t Write off American Capitalism Just Yet, Economist, July 13, 2002, at 11. Lawrence Lindsay, economic adviser to President Bush, said that “[r]isk-taking necessarily means that sometimes the risk-taker fails. That’s part of the success of our system. It’s important that we remember not to throw the baby out with the bathwater.” Marketplace (Minnesota Public Radio broadcast, June 4, 2002).
end of one era and the beginning of another. Enron could become a milestone in the jurisprudence of the corporation, equivalent in stature to John Dewey's repudiation of the entity theory, or to Adolph Berle and Gardiner Means' discussion of the corporation as a drama enacted between shareholders and management, or to Henry Manne's application of marketplace reasoning to classic problems of corporate governance and control. As remarked above, it is difficult to foresee whether such a consensus will form about Enron, but for present purposes it suffices to understand how, as an intellectual matter, Enron could come to be so important.

This Article considers how Enron could prove to be truly significant for the intellectual subdiscipline of corporation law. To examine that question more deeply, Part I provides legal and factual details of the transactions and disclosures that brought Enron down. Part II sets forth and critiques what might be called the orthodox understanding of Enron's collapse—a corporate governance morality tale that animates contemporary punditry, political posturing, and reform—and argues that the conventional story is implausible. The current corporate governance paradigm does not adequately explain Enron or similar scandals, and therefore the paradigm is open to change. Part III sets forth a more plausible interpretation of the Enron case. This revised version of Enron's collapse explicitly understands the corporate drama—the actors and their motivations—differently from the traditional framework that informs the conventional story. Part III exemplifies a view of the corporation that could be obtained from shifting paradigms. Part IV provides an explicit, if necessarily brief, sketch of this new paradigm and shows how it differs from corporation law as currently taught. The Article concludes with a gentle critique and suggestions for the practice of corporation law scholarship.

I. A SKETCH OF ENRON'S COLLAPSE

A. DISCLOSURE, FAILURE, AND TELLING THE TALE

No less a corporation law scholar than Adolph Berle once denigrated academic writing: "The academic form consists of a requirement of about three

47. There is something a bit delicious about this stance, which simultaneously espouses, dismisses, and gently critiques existing treatments of law and whimsically suggests possible (if perhaps unlikely) alternatives, sometime prior to dinner. I am hardly the first to approach a very traditional corner of the American legal academy with this attitude. See, e.g., DUNCAN KENNEDY, A CRITIQUE OF ADJUDICATION: FIN DE SIÈCLE (1997) (treating judicial interpretation with a similarly blithe regard).


hundred pages in pure shop talk to prove to the academic mind that you know what you are talking about, and then you are allowed about thirty pages to say what you really think."51 I agree, and so invite any readers who are already at least roughly familiar with the disclosures that led to the Enron bankruptcy to skip Part I, skim Part II, and resume reading with Part III.

This Article is concerned with how the academic and policy discourse of corporation law might change in response to Enron. The policy community’s response to Enron is largely based on the factual and legal findings of a report issued by the Special Investigative Committee of Enron’s Board of Directors, so a few words about that report are in order. On October 28, 2001, in response to the crisis at Enron, the Board of Directors established a Special Committee, which came to be called the Special Investigative Committee.52 The Committee was charged with investigating the related-party transactions that were the subject of the SEC’s investigation.53 On February 1, 2002, the Committee issued its report, usually referred to as the “Powers Report,”54 to Enron’s Board. The Powers Report was also released to the public and soon became the most authoritative account of what happened at Enron.55 While perhaps an even more extensive history of Enron’s collapse will be written, drawing on the various litigations, investigations, and policy researches undertaken since the fall of 2001, for the foreseeable future the Powers Report will remain the influential version of the story—Malory to Kenneth Lay’s Arthurian adventures in applied economics.

Enron’s story is fascinating in part because the company grew so quickly and then imploded even faster. The story of Enron’s death is classically dramatic: Brilliant success leads to overweening pride, which precipitates a sudden fall and death.56 Our understanding of Enron, a dizzyingly complex company whose enterprise was to control legal rights to (or derived from) various instantiations of abstract commodities like “energy” or “broadband communications,” is thus organized not by the scope of Enron’s business, but by what caused the company to die. And this, too, is a traditional way to understand complex situations: Malory tells a story of betrayal culminating in disaster and the death of the king.57 The New York Review of Books twice reviewed the Powers

52. POWERS REPORT, supra note 7, at 31.
53. Id.
54. The Committee was chaired by William Powers, Jr., a member of the Enron Board of Directors and Dean of the University of Texas School of Law.
55. I was once an associate at Wilmer, Cutler & Pickering, the law firm that served as counsel to the Special Investigative Committee and that drafted the Powers Report. However, I left in 1998 and had nothing to do with the Powers Report.
56. While Enron hardly qualifies as a tragedy, it is interesting that the broad outline of the firm’s story tracks traditional ideas of the tragic form. See, e.g., Bethany McLean, Why Enron Went Bust, FORTUNE, Dec. 24, 2001, at 58 (“If you believe the old saying that ‘those whom the gods would destroy they first make proud,’ perhaps this saga isn’t so surprising.”).
Report, each time emphasizing the role of “betrayal” at Enron. But who was betrayed, and how?

In establishing the Special Investigative Committee, Enron’s Board of Directors wanted to know what had happened. How could the announced transactions have been authorized, and how could the ultimately fatal decisions not to disclose those transactions more fully, and more promptly, have been reached? The Powers Report makes no effort to provide a global—and necessarily speculative—overview of Enron’s mismanagement. Instead, the Powers Report analyzes how Enron’s corporate governance mechanisms failed with respect to the specific transactions disclosed by the company in the fall of 2001. The failures with which the Powers Report concerns itself therefore involved only three entities: LJM2, announced on October 16, 2001; and Chewco and LJM1, announced on November 8, 2001. Thus, the Powers Report should be understood almost as if it were a case study—an analysis and extended illustration of how Enron did business. The Powers Report is not an explanation of where the money went and, in that direct sense, why the company went bankrupt. But for present purposes—an understanding of the intellectual possibilities open to corporation law—the Powers Report provides a more than adequate account of how business was transacted at Enron.

While the focus on these particular transactions is understandable, the official account of Enron’s collapse has a deeply accidental quality. Enron did not become insolvent because it lost money in the transactions analyzed in the Powers Report. Enron became insolvent because the market lost faith in the company. Subsequent processes have brought other, perhaps worse, problems at Enron to light. So, for example, the Interim Examiner’s Report in the bankruptcy proceeding focuses on a somewhat different set of profoundly


60. Chewco and LJM1 were established before LJM2, and in general, the transactions involving Chewco and LJM1 are simpler than the LJM2 transactions. Consequently, the Powers Report and this Article discuss the Chewco and LJM1 transactions before turning to the LJM2 transactions.

61. Frank Partnoy argues that this is an oversimplification. To get ahead of my story, Partnoy argues that institutional investors were willing to buy Enron stock that they perceived to be undervalued by the market. Enron’s stock price collapse was caused by institutional investors who sold their positions, because they realized that Enron’s debt levels were far higher than had previously been revealed. Enron’s actual debt levels were highly likely to lead to the downgrading of Enron’s credit rating, which would make Enron’s trading business—contractually dependent on a high credit rating—impossible to sustain. Frank Partnoy, A Revisionist View of Enron and the Sudden Death of “May,” 48 VILL. L. REV. 1245, 1255–56 (2003). A few thoughts: First, as an empirical account of the behavior of institutional investors in this case, Partnoy’s story is quite plausible, and it would be nice to have direct evidence for it. Second, measuring the reasons for losing faith in a stock is tricky; revelations about debt and about Special Purpose Entities (SPEs) may both play roles. Third, from the corporate governance perspective of this Article, manipulating debt (and so credit ratings) is not different in kind from manipulating income (and so P/E ratios).
flawed transactions.\textsuperscript{62} We cannot know, but it is certainly imaginable that the announcement of these or still other transactions would have had a similar effect on Enron's share price.\textsuperscript{63} One can also imagine a more ordinary insolvency for Enron, one not precipitated by the evaporation of shareholder confidence; Enron's positions may well have driven the company into insolvency in the months after December.

Moreover, as already suggested, the facts that we do know teach a wide variety of lessons. There are many Enron stories, each with its own moral, for many areas of law and many sorts of actors in the financial markets, ranging from accountants to underwriters. The focus of this Article—what Enron means for our thinking about corporation law—is by no means exclusive. Rather than understanding Enron as a single narrative about a company's demise, it might make more sense to understand Enron as a context for a collection of stories, like Never-Never Land or the forest in which the Brothers Grimm heard their tales.\textsuperscript{64}

B. THE DISCLOSURES OF NOVEMBER 8, 2001: JEDI, CHEWCO AND UMI

1. JEDI and Chewco

The story of JEDI and Chewco begins in 1993, when Enron and the California Public Employees' Retirement System (CalPERS) established Joint Energy Development Investment L.P. (JEDI), an investment partnership. Enron was the general partner of JEDI and contributed $250 million worth of Enron stock. CalPERS was the limited partner, but it exerted substantial control over the partnership and also contributed $250 million in cash.\textsuperscript{65} Enron did not consolidate JEDI's balance sheet with its own,\textsuperscript{66} and therefore Enron's quarterly financial disclosures did not reflect JEDI's economic situation.\textsuperscript{67} In fact, JEDI was the first of the so-called "off-the-balance-sheet" entities whose ultimate consolidation by Enron would result in Enron's disastrous restatements of earnings and shareholders' equity.\textsuperscript{68}

Enron's failure to consolidate its JEDI position in the mid-1990s appears to have been well within the accounting rules and, more generally, within the standards for fair disclosure established by the securities laws.\textsuperscript{69} In 1997,
however, JEDI's situation changed,\textsuperscript{70} and Enron's failure to consolidate JEDI thereafter violated both the spirit and the letter of the disclosure rules.\textsuperscript{71} To understand how Enron ran afoul of the rules, with regard to both JEDI and Chewco, and with regard to at least some of the LJM transactions discussed below, an overview of the regulatory regime that determines when related-party transactions must be disclosed is required.

To begin at the most general level, both section 5 of the Securities Act of 1933 and the Securities and Exchange Act of 1934\textsuperscript{72} require that a publicly-traded entity disclose its assets and liabilities. Administrative regulations promulgated under the Securities and Exchange Act specify how that disclosure shall be made.\textsuperscript{73} In particular, publicly-traded companies must file quarterly financial statements.\textsuperscript{74} The accounting on such statements is to be done in accordance with professional standards in the accounting industry, known as Generally Accepted Accounting Principles (GAAP).\textsuperscript{75} So confronting Enron every quarter, as it prepared its financial statements, was this question: What were the GAAP rules governing the consolidation of related parties such as JEDI?

The rules were (and still are) less than completely clear. In general, however, GAAP establishes a presumption in favor of consolidation, that is, of giving more information to investors.\textsuperscript{76} That said, GAAP also establishes that a corporation (say Enron) with an investment in a second entity (such as JEDI) need not consolidate the second entity in its financial statements, so long as the second entity is sufficiently independent of the investing corporation.\textsuperscript{77} Although Enron was the general partner of JEDI, Enron's power over JEDI was limited by its agreement with CalPERS, which gave CalPERS substantial control.\textsuperscript{78} And with regard to outside investment, CalPERS—a party clearly "outside" Enron—had contributed 50% of the capital to JEDI.\textsuperscript{79} Consequently, as JEDI was originally established, Enron did not need to consolidate JEDI into its financials.\textsuperscript{80}

As mentioned above, JEDI's situation changed in 1997. Enron wanted to create a new and larger investment partnership, JEDI II, capitalized at $1

\textsuperscript{70} Id. at 43, 46–52.
\textsuperscript{71} Id. at 52.
\textsuperscript{73} See Securities Exchange Act, § 13 (giving Commission power to issue regulations).
\textsuperscript{74} Id., 17 C.F.R. § 240-13a-3 (2003).
\textsuperscript{76} See FIN. ACCOUNTING STANDARDS BD., CONSOLIDATION OF CERTAIN SPECIAL PURPOSE ENTITIES: AN INTERPRETATION OF ARB 51i (2002) (Proposed Interpretation) [hereinafter FASB Draft]; POWERS REPORT, supra note 7, at 38.
\textsuperscript{77} POWERS REPORT, supra note 7, at 5, 38–39, 49.
\textsuperscript{78} Id. at 43.
\textsuperscript{79} Id.
\textsuperscript{80} Id.
Enron believed that CalPERS would not invest in both JEDI II and JEDI. Enron therefore proposed to redeem CalPERS' interest in JEDI, freeing CalPERS to invest in JEDI II. This posed a problem. If Enron simply bought CalPERS out, then Enron would both control and own JEDI outright, and would have to consolidate JEDI on its balance sheet. Because Enron did not want to do that, it needed an independent buyer for CalPERS' interest in JEDI.

Rather than find an outside buyer in the marketplace, however, Enron decided to create a buyer: Chewco. Chewco was a Special Purpose Entity (SPE). Chewco’s raison d’être was to be Enron’s partner in JEDI. Yet despite being literally Enron’s creature, Chewco had to be sufficiently independent of Enron to qualify for non-consolidation treatment. Less politely phrased, Chewco had to be independent to keep both Chewco itself and JEDI off Enron’s books.

Done properly, non-consolidation is perfectly legal and, in some circumstances, even sensible. Viewed abstractly, the question is the degree of ownership that separates an investment from proprietorship. A small investment (consider a few shares or a bank deposit) does nothing to destroy the independence of the parties; parties to a relatively small investment remain discrete entities. If Enron bought a few thousand shares of Microsoft, for example, it clearly would be wrongheaded to require Enron to report Microsoft’s financial status as if it were Enron’s. However, if Enron were to establish a legally distinct entity, for example Chewco, which (as discussed below) had little if any economic existence apart from Enron, then Enron should consider Chewco’s business as part of its own. Enron stood to profit from Chewco’s successes and, more to the point, suffer from Chewco’s losses. And that is precisely the sort of information a reasonable investor would want to know. Therefore, the Powers Report concluded, Enron should have to consolidate Chewco’s financials. But between the easy cases at the extremes, where should the line between investment and proprietorship be drawn?

Temptation is inherent in the institutional device of the Special Purpose Entity (SPE). SPEs were invented for synthetic leases—of buildings, for example. Suppose a company wishes to buy an expensive asset, such as Enron’s Houston headquarters building, but must use debt to do so. The company wants

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81. Id.
82. Id.
83. Id. at 6.
84. Id. at 43.
85. Id. at 6–7, 44.
86. SPEs are also called Special Purpose Vehicles. For an overview, see generally Bala G. Dharan, Financial Engineering with Special Purpose Entities, in ENRON AND BEYOND: TECHNICAL ANALYSIS OF ACCOUNTING, CORPORATE GOVERNANCE, AND SECURITIES ISSUES (Julia K. Brazelton & Janice L. Ammons eds., 2002); Enron Bankruptcy: Hearing Before House Energy and Commerce Comm., 107th Cong. (Feb. 6, 2002) (testimony of Dr. Bala Dharan).
87. POWERS REPORT, supra note 7, at 52.
88. See id. at 38.
the building, but is not especially fond of the debt. The company, for these purposes called a sponsor or a transferor, creates an SPE and then transfers sufficient assets (and perhaps loan guarantees) to enable the SPE to purchase the asset. Whatever debt is required to purchase the asset is carried by the SPE, not the sponsor. In exchange for its transfer of assets and so forth, the sponsor perhaps receives a note receivable (an asset) and a long-term lease. The sponsor ends up with the use of the asset, the building, but without the accompanying debt on its books.

From synthetic leases, however, SPEs have come to be used for asset management writ large, that is, for portfolio management. Through SPEs, different companies can profitably manage different kinds of assets and their associated risks and returns. Therefore, it makes sense for companies to sell, hedge, insure—to contract around—risks and their attendant rewards. For example, banks, car companies, credit card companies, and a host of other institutions that lend money to consumers, generally choose not to manage the repayment streams generated by their loans. Instead, they sell their loans to SPEs, interests in which may be offered in the asset-backed securities market. In short, SPEs offer the form, and many of the legal and accounting results, of a sale, but such sales are “synthetic.” The counterparty is created so that the “sale” can be done.

Herein lies the temptation: The creation of an SPE can provide a company with a docile counterparty with which to execute a deal. The sponsor can achieve a fundamental benefit of a sale—the loss of responsibility—without the cost, publicity, and discipline associated with an arm’s-length transaction. In addition, although the sponsor may appear to have received cash or its equivalent (such as a note), such appearances may be deceptive if the SPE is not in a position to make good on the note. The policy question presented by the use of SPEs, then, is how to prevent them from being overly docile—how to prevent SPEs from being used to “contract” on non-economic terms.

In light of the temptation to use SPEs to shed responsibility—a temptation to which Enron succumbed time and again—the accounting profession has attempted to require that the relationship between companies and their SPEs be at least somewhat independent; that the SPE not be used as the tool of the sponsor. There is a certain schizophrenia here: SPEs are created for the “special purposes” of their sponsors, yet SPEs must be somewhat independent

89. See id. at 37.
90. The FASB notes that “SPEs engaged in activities other than leasing or securitizations generally are not addressed by the existing accounting literature. The Board has been told that existing practices related to those SPEs have been developed by analogy to requirements for SPE lessors even though their characteristics may be very different.” FASB DRAFT, supra note 76, at ii.
91. To turn the problem around: Fraud can be defined as the transfer of value on non-economic terms, while purporting to be a business enterprise. The ease with which SPEs can be used for such transfers invites fraud.
of those sponsors. As already suggested, disclosure laws for synthetic leases attempted to manage this tension by requiring an SPE's financial data to be consolidated with that of its sponsor, unless the SPE has an independent owner or owners.

Assuming, as did the Powers Report, that the regime devised for synthetic leases applies to the transactions in question, the independence of an SPE's owner or owners is considered in terms of legal control and beneficial interest.\(^9\)

First, to be considered "independent," the non-sponsor owners must exercise some control over the SPE.\(^9\) This is an explicitly subjective standard. How much control the owners must exercise is very unclear. It is also unclear what relationship the non-sponsor owners may have with the sponsor owners without compromising the independence of the SPE.

Second, the independent owners must have made "a substantive capital investment in the SPE,"\(^9\) and that investment "must have substantive risks and rewards of ownership during the entire term of the transaction."\(^9\) The SEC staff has taken the position that the "outside" money at risk must comprise at least 3% of the equity of the SPE.\(^9\) The independent stake must be really at risk (that is, no guaranteed returns) and must be at risk throughout the transaction in question.\(^9\)

Against this backdrop, Chewco was formed in November of 1997 to close the buy-out of CalPERS' partnership interest in JEDI.\(^9\) When Chewco was formed, there was no outside investment; Chewco was capitalized with loans guaranteed by Enron.\(^10\) Chewco used the proceeds of those loans to pay CalPERS.\(^10\) Michael J. Kopper, an Enron employee in the Finance Group headed by CFO

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Enron's use of off-balance-sheet SPEs from the trillions of dollars of supposedly "legitimate" securitization and other structured finance transactions that use SPEs).

93. Sarbanes-Oxley has required the SEC to do a study and propose rules regarding off-balance sheet transactions and SPEs. See Sarbanes-Oxley Act § 401(c).

94. POWERS REPORT, supra note 7, at 5, 39.

95. Id. at 39.

96. Id.

97. Id. Terminology is a bit confusing here. This is often referred to as the "outside equity" requirement. And yet the insistence that the "capital at risk" bear the risks and rewards of ownership indicates that the three percent in question is three percent of the total capitalization of the entity, whether that capitalization is characterized as equity or debt. The FASB has recently tried to clarify this situation, by insisting that the outside investor contribute a percentage of "total assets" sufficient to finance the ongoing operation of the SPE. See FASB DRAFT, supra note 76, at 5.

98. Three percent is not very much; however, the question is not one of voting control, but of risk of loss. For example, three percent of a one-hundred million-dollar entity (three million dollars) is a lot of money to lose outright, unless one is protecting a market capitalization worth billions, at which point the temptation to guarantee the outside investor's return may be unbearable. Perhaps with that dynamic in mind, the FASB has proposed that the standard be changed to ten percent—that is, an SPE with less than ten percent "outside" money at risk—would be presumed not to have sufficient financial where-withal to finance its activities. See id.

99. POWERS REPORT, supra note 7, at 44.

100. Id. at 45.

101. Id.
Andrew Fastow, served as the managing member of Chewco. Chewco’s
ownership structure was a web of partnerships and limited liability companies,
most under Michael Kopper’s control. At least the outlines of the Chewco
transaction were presented to the Executive Committee of Enron’s Board of
Directors and mentioned to the full Board.

Enron was aware that, as established, Chewco did not qualify for non-
consolidation. In November and December of 1997, Chewco was restruc-
tured, apparently in an effort to provide it with sufficient independent control
and outside equity to qualify. Under the new capital structure, the burden of
Chewco’s money was derived from bank loans guaranteed by Enron or from
loans made by JEDI to Chewco. Additional money was invested by Chew-
co’s partners. That additional investment, however, was derived from further
loans made by Barclays Bank, loans that were ultimately collateralized with
cash provided by Enron. To make a very long story short, Chewco never had
3% outside equity at risk, and therefore Chewco never qualified for non-
consolidation.

Dealings among Enron, JEDI, and Chewco were dodgy at best. The Powers
Report describes several highly questionable transactions, including the follow-
ing: Chewco and Kopper received substantial fees from both JEDI and Enron;
Chewco paid Enron fees putatively for guaranteeing Chewco’s debt to Barclay’s
Bank, and Enron improperly recognized these fees as income; JEDI paid Enron
certain management fees; and Enron improperly recognized income from the
appreciation of Enron stock held by JEDI. In early 2001, however, Enron
appears to have decided that JEDI no longer served an economic purpose for
Enron and should therefore be terminated. Consequently, Enron bought out
Chewco’s interest in JEDI on terms extremely favorable to Chewco and its
investors. Enron even paid most of the taxes on the income Chewco’s investors
made from the transaction.

By October of 2001, both the media and the SEC were quite interested in
Enron’s related-party transactions. At this time, the Enron Board requested a
briefing on Chewco. Enron, the law firm of Vinson & Elkins, and the
accounting firm Arthur Andersen—all of whom had been involved in Chewco’s

102. Id. at 44; ENRON REPORT, supra note 1, at 13.
103. POWERS REPORT, supra note 7, at 46.
104. Id. at 45.
105. Id. at 49.
106. Id.
107. Id.
108. FORM 8-K, supra note 9, at 4; see also POWERS REPORT, supra note 7, at 52 (noting that Enron’s
     provision of collateral for Chewco loan was “fatal” to the three percent requirement).
109. POWERS REPORT, supra note 7, at 54–60. Enron did not recognize a corresponding loss from the
decline in value of the same stock. Id. at 59–60.
110. Id. at 60. The Powers Report provides no details of the substance of that decision.
111. Id. at 64–65.
112. Id. at 66.
creation—once again reviewed Chewco’s situation. Only then did they decide that Chewco had no independent owners;\textsuperscript{113} therefore, Chewco’s returns over the years should have been consolidated with Enron’s.\textsuperscript{114} Moreover, because Chewco and Enron were its only investors, JEDI was not truly independent either, and its returns should have been consolidated with Enron’s as well.\textsuperscript{115} Enron restated its prior financials—going back to November of 1997—on November 8, 2001.\textsuperscript{116} The impact on Enron’s financials was substantial, resulting in hundreds of millions of dollars of reductions to earnings and hundreds of millions of dollars of additional debt.\textsuperscript{117} That said, it is important to keep in mind how large Enron was. In 2000, for example, Enron reported revenues in excess of $100 billion.\textsuperscript{118}

2. LJMI

LJM Cayman, L.P. (LJM1) was formed in June of 1999 to manage certain Enron assets.\textsuperscript{119} LJM1 was the model on which LJM2, discussed below, was based, and many of the problems that beset LJM2 were also present in LJM1. LJM1 was used for three transactions,\textsuperscript{120} only one of which, Rhythms Netconnections (Rhythms), is discussed here.

In March 1998, Enron purchased 5.4 million shares of Rhythms, a privately-held business internet service provider, paying approximately $1.85 per share for a total of nearly $10 million.\textsuperscript{121} In April 1999, Rhythms held an initial public offering that opened at $21 per share.\textsuperscript{122} On its first day of public trading, Rhythms closed at $69 per share.\textsuperscript{123} Unfortunately for Enron, under its purchase agreement with Rhythms, Enron had to hold its Rhythms stock until the end of 1999.\textsuperscript{124} Although Enron had made money on paper, GAAP required that Enron’s investment in publicly-traded securities (like Rhythms’) be “marked to market”—that is, carried on Enron’s books at their current market price, regardless of whether or not Enron had actually sold the securities.\textsuperscript{125} Therefore Enron

\textsuperscript{113. Id. at 66–67.}
\textsuperscript{114. Id.}
\textsuperscript{115. Id. at 67.}
\textsuperscript{116. Id.}
\textsuperscript{119. POWERS REPORT, supra note 7, at 68–70.}
\textsuperscript{120. Id. at 70.}
\textsuperscript{121. Id. at 77.}
\textsuperscript{122. Id.}
\textsuperscript{123. Id.}
\textsuperscript{124. Id.}
\textsuperscript{125. Id.}
was quite exposed to subsequent declines in the price of Rhythms stock, which would result in a charge against earnings, even if Enron's overall investment, considered *ab initio*, had been profitable.\(^{126}\)

At the same time, Enron owned forward contracts to buy its own stock at a fixed price from an investment bank.\(^{127}\) Because the contract price was consider-
ably below the current trading price for Enron stock, the contracts were valuable. This value was of limited use to Enron, however, because a corporation generally cannot show earnings due to the appreciation of its own stock or instruments—such as forward contracts—whose value is based on the company's stock. Enron therefore sought some way to employ the value of its forward contracts.

On June 18, 1999, CFO Fastow, CEO Lay, and President and COO Jeffrey Skilling decided to use an SPE, LJM1,\(^{128}\) both to employ the value of Enron's forward contracts and to shield Enron from the market risk of its Rhythms investment.\(^{129}\) Enron restructured its forward contracts in such a way as to give itself a pool of its own shares. Enron transferred this stock to LJM1.\(^{130}\) Both the formation of LJM1 and the transactions needed to hedge Enron's position in Rhythms were accomplished with great speed. The partnership was formed within the month; the Rhythms transactions closed on June 30.\(^{131}\) LJM1 and the Rhythms transaction were presented to the full Board for approval by Lay, Skilling, and Fastow on June 28.\(^{132}\) Fastow in particular sought and received a determination by the Board that his participation in LJM1 and related entities, including remuneration, "will not adversely affect the interests of Enron."\(^{133}\)

Thus authorized, established, and capitalized, LJM1 was in a position to enter hedging transactions with Enron.

At the core of Enron's hedge with LJM1 was a put option under which Enron could compel LJM1 to buy Rhythms shares from Enron at $56 per share, thereby theoretically locking in an enormous profit for Enron.\(^{134}\) The fly in the ointment was that LJM1 was not necessarily capable of bearing Enron's portfolio risk. LJM1's main asset was Enron stock; consequently, the ability of LJM1 to perform under the put option was limited by the strength of Enron's stock

\(^{126}\) *Id.* at 77–78.

\(^{127}\) *Id.* at 78. Enron had originally entered into these forward contracts in order to hedge its exposure to options that it had granted to employees.

\(^{128}\) *Id.* at 68, 79.

\(^{129}\) *Id.* at 78.

\(^{130}\) *Id.* at 79.

\(^{131}\) *Id.* at 80.

\(^{132}\) *Id.* at 79.

\(^{133}\) *Id.* at 69.

\(^{134}\) This is a simplification. The actual transaction involved more entities—for example, LJM Swap Sub L.P. and LJM Swap Co. *Id.* at 79–80. Presumably there was a reason behind Enron's creation of this many entities, but beyond some point it is difficult to know (or care) what the reason was. See, e.g., *id.* at 80 ("We do not know why Swap Sub was used . . ."). I have begun to suspect baroque sensibilities in the management suite.
price.\textsuperscript{135} If the price of Rhythms and Enron stock declined simultaneously, LJM1 could be obligated to buy Rhythms stock from Enron, but LJM1 would have limited funds with which to pay, precisely because the price of the Enron stock held by LJM1 had declined. In such circumstances, Enron therefore would be at best partially hedged. Despite the substantial risks inherent in that structure, Andersen approved the capitalization of LJM1 with Enron stock.\textsuperscript{136}

The LJM1 structure did not eliminate Enron’s exposure to volatility in its Rhythms investment.\textsuperscript{137} Because the put option was fixed, it only established a floor for Enron’s losses. Increases and subsequent declines in the value of Rhythms stock were still marked to market and, therefore, still caused volatility on Enron’s earnings statements. Enron and LJM1 consequently entered into further transactions designed to reduce Rhythms’ volatility further, with limited success.\textsuperscript{138} In the first quarter of 2000, due to continued volatility in its Rhythms position, the decline in price of the Rhythms stock, and because the contractual restriction on Enron’s sale of its Rhythms investment had finally expired, Enron decided to sell off its Rhythms investment.\textsuperscript{139}

With the underlying source of risk gone, Enron had no need for its hedging arrangements with LJM1. Unwinding the Rhythms hedge resulted in tens of millions of dollars in profits to LJM1. Rather than maximize its return on the Rhythms transactions, Enron retained substantial value in LJM1 and related entities.\textsuperscript{140} Evidently unbeknownst to Enron’s senior management and its Board,\textsuperscript{141} several Enron employees, including Fastow, had interests in the unwind. Individuals with duties to Enron thus made millions of dollars at Enron’s expense, without informing other members of management or the Board of Directors.

C. DISCLOSURES OF OCTOBER 16, 2001: LJM2

At the suggestion of Fastow, Enron created LJM2 in October of 1999. As with LJM1, LJM2’s purpose was to help Enron manage its assets and, especially, to hedge risks presented to Enron by its portfolio of merchant investments. The basic business idea, presented to the Board of Directors, was as follows. Enron would form and help capitalize LJM2. LJM2 would also seek outside investment, mostly from institutional investors via a private place-
ment. Enron would use LJM2 to buy and sell assets. Because LJM2 was an SPE (a ‘related party’), it would be privy to information about Enron’s business and its assets. More particularly, LJM2 would have intimate knowledge of Enron and its business because LJM2 would be under the control of Andrew Fastow, Enron’s Chief Financial Officer. Consequently, LJM2 would be able to do deals to the profit of both parties without the usual risks and transaction costs associated with deals between entities that are foreign to one another.

While the structure of LJM2 and its deals was far more complicated than described here, and even more complicated than most of Enron’s deals, the fundamental ideas and risks at issue were not new to Enron’s management or its Board. LJM2 was a logical extension of business concepts and techniques Enron had previously used in transactions involving Chewco and LJM1. Both the Finance Committee and the full Board approved the creation of LJM2 on October 11, 1999. In doing so, the Board again determined that “Fastow’s participation in LJM2 would not adversely affect the best interests of Enron.”

Enron and LJM1 and LJM2 conducted over twenty transactions. The Powers Report does not discuss them all; even a cursory description of each of the LJM2 transactions discussed by the Powers Report is beyond the scope of this Article. The most important transactions, which are worth understanding at least in the abstract, are the so-called “Raptor” transactions. There were four “Raptors,” entities set up by LJM2 and under its control. Three of the four Raptors were capitalized with Enron stock (or with assets whose value depended on the value of Enron stock) in order to engage in transactions that were designed to be—or at the very least look like—hedges against losses in Enron’s merchant investment portfolio.

Raptor I is illustrative. An SPE called Talon was created and funded on April 18, 2000. LJM2 invested $30 million cash in Talon. Enron invested $1000 cash, a $50 million promissory note, and stock and obligations to deliver stock with a fair market value figured to be $537 million. Talon’s freedom to sell its Enron stock was restricted by contract. As a result, Talon’s Enron stock was valued at a 35% discount to its then current market value. Thus capitalized,
Enron figured that Talon could absorb losses of up to $213 million on its derivative contracts with Enron.\(^{152}\)

Before Enron began negotiating hedge contracts with Talon, however, LJM2 almost immediately received $41 million dollars back, a 30% return on its $30 million dollar investment in Talon.\(^{153}\) The Powers Report strongly implies that this was an unwritten guarantee by Enron of LJM2's position.\(^{154}\) If so, then the transaction should have been consolidated.\(^{155}\) Under the agreement between LJM2 and Enron, if LJM2 did not receive this return on investment within six months, then LJM2 had the right to force Enron to redeem LJM2's interest in Talon.\(^{156}\) In the event of such a forced buy-out, however, Talon would be valued on the basis of the unrestricted market value of Talon's Enron shares. In that case, Talon's Enron shares would be worth 65% more than their restricted value (the value used to back Enron's hedges), and hence LJM2's stake in Talon would be worth considerably more. Instead, Talon paid LJM2 $41 million.\(^{157}\)

There was, of course, a problem: Talon was not capitalized with, and so did not have, $41 million in cash. Talon therefore had to generate cash in order to pay LJM2. Cash for the transaction was generated by selling a put option for $41 million to Enron on Enron's own shares.\(^{158}\) The put was written at $57.50 per share for six months in the future. In light of Enron's current share price of about $70, the put was not worth much—there is no reason to force somebody to buy shares at below market price. Moreover, it is odd for a company to bet that its own share price will fall. In effect, Enron paid Talon to pay LJM2. Shortly thereafter, the put was settled, $4 million was returned to Enron, and Talon paid LJM2 $41 million.\(^{159}\)

Thus capitalized, and with its pressing obligations to LJM2 satisfied, Talon was free to enter into hedging transactions with Enron. Almost all of Talon's transactions, and the transactions of Raptors II and IV, were "total return swaps." A total return swap is relatively simple: A contract obligates the parties to pay one another based on the performance of an underlying asset—in this case, a portfolio of securities owned by Enron. The value of the contract is thus derived (hence "derivative") from the performance of the securities named in the contract; if the securities become more valuable—that is, if the market goes up—then Enron owes Talon money. If Enron's securities become less valuable,
then Talon pays Enron. Assuming (contrary to fact, as it happened) that Talon was a creditworthy counterparty, such a contract would shield Enron from the effects of marketplace volatility on its merchant investment. If its investments increased in price, Enron stood to make money on the investments, but would be obligated to pay Talon under the terms of its total return swap. If, on the other hand, the price of Enron’s investments fell, Enron could console itself with the fact that Talon owed it money under the swap. In short, Enron used Talon as an insurer.

The Finance Committee of Enron’s Board of Directors was informed of how Talon was established and capitalized, although it is not clear in what detail. The transactions establishing Talon closed on April 18, 2000. On May 1, Enron’s management presented the Raptor I arrangements to the Finance Committee of Enron’s Board of Directors. While there is some uncertainty regarding the exact details that were presented, the Finance Committee recommended that the Raptor I transactions be approved by the Board of Directors. On May 2, the Board of Directors approved the Raptor structure. In late summer and early fall of 2000, Enron and Talon concluded a number of total return swaps, all dated as of August 3, 2000. The Raptor transactions looked better on paper than in practice. Raptors I, II, and IV were capitalized primarily with Enron stock and, worse, contingent contracts for Enron stock. Therefore, the ability of Talon and the other Raptor entities to pay Enron—to make good on their obligations under the swap agreements that were their raison d’être—was dependent on the price of Enron’s stock. If Enron’s merchant portfolio and Enron’s stock fell simultaneously, then Talon would be obliged to pay Enron under the swap agreement, but would not have resources to do so. This happened in the broad bear market of 2000.

The capital structure of Raptor III was even more delicate. Enron owned a massive stake in The New Power Company (TNPC) and was hedging the economic risk of certain stakes in the company held by another entity. Raptor III was created to hedge against the possibility of Enron’s losses in TNPC. However, Raptor III was capitalized largely with TNPC stock. Enron’s total return swap with TNPC was, therefore, almost worthless as a hedge. If TNPC did badly, Enron would lose money, thereby obligating Raptor III to pay under the swap agreement. But if TNPC did badly, Raptor III would have no resources with which to fulfill its obligations under the swap.

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Fortune was not kind to Enron. Especially after the market peaked in the

160. Id. at 105–06.
161. The Powers Report speculates that backdating to August 3, 2000 allowed Enron to lock in the maximum possible return on its hedge of its investment in a company called Avici, because the price of Avici shares peaked on that date. While disadvantageous to Talon, and therefore LJM2, LJM2 had already secured its return on investment. See id. at 108.
162. Id. at 115.
163. Id. at 118.
spring of 2000, the weaknesses inherent in Enron's "hedges" began to show. As the price of stock in Enron's merchant portfolio fell, Enron increasingly was owed money by the Raptors, obligations that Enron booked as income and reported to the SEC and the financial markets. At the same time, as the price of Enron and TNPC stock also fell, the Raptors became increasingly unable—even in theory—to pay. Enron, in short, had hedge agreements with uncreditworthy counterparties. From the fall of 2000 until late summer of 2001, Enron engaged in a series of Byzantine transactions designed to keep the Raptors solvent, including "costless collars," cross-guarantees among the Raptors, cross-collateralization of the Raptors, and a new investment by Enron (of contracts to receive Enron stock). Nothing worked. By the end of the first quarter of 2001, Enron was owed some $504 million by the Raptors that the Raptors were incapable of paying. Rather than recognizing the loss and booking it as a loss to credit reserves, however, Enron booked a mere $36.6 million charge and hoped the economic situation would improve. It did not.

In the early fall of 2001, Enron decided to unwind the Raptors. Enron first bought out LJM2's residual interest, at a "negotiated" price of "approximately $35 million." Under Arthur Andersen's direction, Enron accounted for the buy-out as follows: The Raptors had assets calculated to be worth $2.5 billion and liabilities calculated to be $3.2 billion. The cost of terminating the Raptors, then, would be approximately $700 million (the difference between the Raptors' assets and liabilities), plus the $35 million paid to LJM2, resulting in a $710 million charge against earnings on Enron's financial statement for the third quarter of 2001.

In the same statement, Enron reduced its shareholders' equity by $1.2 billion. Two significant revisions of Enron's accounting led to this restatement. First, recall that Enron capitalized the Raptors largely by contributing stock and stock contracts. In exchange for its investment in the various Raptor entities, Enron received notes receivable, which were booked as an increase to "notes receivable"—that is, as an increase to assets. The cumulative nominal value of such notes receivable resulted in increases to assets, and hence to shareholders' equity, of $1 billion. In the summer of 2001, Enron and Arthur Andersen

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164. Id. at 119.
165. Id. at 125.
166. A "collar" is a transaction combining a put and a call option, so that the gain or loss a party can make on the transaction is limited, hence "collared." The collar is costless if the option premiums offset one another, and therefore no money need change hands at the establishment of the arrangement. See id. at Glossary.
167. Id. at 119–25.
168. Id. at 121.
169. Id. at 123.
170. Id. at 127. The "negotiations" were between Fastow and Kopper.
171. Id. at 127–28, 132.
172. Id. at 98.
173. Id. at 125.
decided that this accounting treatment was wrong and that the increase to shareholders' equity should not have been booked.\(^\text{175}\)

Second, the notes receivable that Enron held at the time of the termination of the Raptors were valued at $1.9 billion.\(^\text{176}\) Upon dissolution of the Raptors, Enron received the Enron stock and stock contracts, valued at $2.1 billion. The difference, $200 million, was recorded as a reduction to shareholders' equity. Adding the $200 million to the $1 billion discussed in the preceding paragraph produces the $1.2 billion restatement of shareholders' equity that Enron made on October 16, 2001.\(^\text{177}\)

\section*{II. Enron's Collapse from the Perspective of Conventional Corporation Law}

\subsection*{A. The Conventional Story}

So what does this all mean? For the policy community, Enron told a collection of stories containing morals that call for specific actions, many of which were taken in the Sarbanes-Oxley Act. But does Enron teach us a general lesson about corporate governance? The question is obscured not just by the press of politics, but by the unsurprising tendency to discuss Enron in terms of conventional, even shopworn, understandings of what constitutes a corporation and how it operates. The political discourse surrounding Enron often tacitly assumes that we know how corporations function, so we understand how they misfunction and, therefore, we are in a position to propose improvements. Reflection on Enron, however, strongly suggests that the orthodox understandings of the corporation are inadequate. Due to the inadequacies of this interpretive frame, most of the current talk about Enron, while perhaps not wrong, is somewhat inapt and most of the current proposals, while perhaps good ideas, do not directly address the fundamental problems.\(^\text{178}\)

The understanding of what happened at Enron that informs contemporary political discussion runs along the following lines: Once upon a time (1985) there were two little energy companies, Houston Natural Gas and InterNorth, that decided to merge. In 1986 the new company christened itself Enron and named Kenneth Lay, former CEO of Houston Natural Gas, to be its Chief Executive Officer. Enron prospered and its stock did very well. The company grew quickly and, from its base in Houston, Enron came to the modest understanding of its business as the buying and selling of rights, first in energy and related industries, and then water and broadband, and the financial services implied thereby, worldwide. In the course of its rapid expansion, Enron ac-

\begin{flushleft}
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175. \textit{Powers Report, supra note 7, at 126.}
176. \textit{Id. at 126, n.60.}
177. \textit{Id.}
\end{flushleft}
quired numerous companies and fixed assets, such as power-generating facilities, that were not expected to repay Enron’s investment in the short term. Such purchases left Enron saddled with considerable debt that threatened to slow its further expansion and hinder its trading operations (which were high-margin and thus dependent on an excellent credit rating). Enron could not issue more shares without diluting existing shareholdings and reducing its earnings per share, which could be expected to result in a drop in the company’s share price. Nor did Enron want to take on substantially more debt, again for fear of weakening its credit rating. Moreover, Enron found itself exposed to substantial volatility in its investments, particularly its merchant investments in publicly traded stock, which Enron was required to mark to market on a quarterly basis—that is, Enron was required to show the gains and losses it would have made had it sold the stock, even when Enron continued to hold the stock. In short, in a number of ways Enron’s portfolio was beginning to constrain its business. Enron therefore decided to syndicate its positions by closing transactions with private investors that allowed Enron to rationalize its portfolio.

Sufficient numbers of private investors proved hard to find, however, and so Enron began creating SPEs. Some SPEs had outside investment; others did not. Various deals done with SPEs benefited Enron by allowing it to book income, to avoid booking debt, to hedge risks, or at least to appear to do such things. Individuals employed by Enron, some of them officers, ran the SPEs. In particular, many of the SPEs were the idea of CFO Fastow or were promoted by his office. Fastow himself directly or indirectly controlled many of the SPEs. Fastow and other Enron employees involved were extremely well paid for their involvement in the SPEs, through fees and especially through capital appreciation.

There were any number of problems with Enron’s disclosure of the transactions discussed above as well as the many transactions not discussed here or in the Powers Report. Many of the problems that did attract the attention of the Powers Report, however, can be summarized under four headings:

(i) Independence: If an SPE does not have an independent owner, its financial situation should be consolidated with the financial disclosures of its sponsor and primary investor. Many of the SPEs established by Enron did not have independent owners. Consequently, their financial situation (significantly, their debts) should have been disclosed by Enron on its financial statements. Conversely, income made by Enron from deals with these SPEs should not have been reported as such.

179. See Powers Report, supra note 7, at 36.
180. See id. at 77.
181. See id. at 41 (describing Enron’s inability to find third parties that were willing to invest in Chewco).
182. See id. passim.
183. See id. at 3.
(ii) Fake hedges: Especially after the stock market peaked in the spring of 2000, Enron was highly exposed to losses in its portfolio of merchant investments. Enron then “hedged” its exposure to this stock. The hedges had numerous problems. Most of them were ultimately funded with Enron stock and therefore did not provide Enron with insurance when Enron’s own stock price began to fall. Moreover, many of the counterparties to these hedge agreements were SPEs that were not, in fact, independent of Enron. Therefore, Enron was actually self-insuring, but was reporting that its risks were borne by a creditworthy outside party.184

(iii) Conflicts of interest/violations of the duty of loyalty: Enron employees, especially Andrew Fastow, benefited mightily from the related-party transactions. These transactions frequently presented opportunities for self-dealing. In many cases, Enron employees were told not to negotiate zealously in Enron’s best interest. Enron guaranteed the risks of those invested in the SPEs. In short, Enron shareholders were “defrauded” by the self-dealing of certain members of management.185

(iv) Failure of internal and external oversight: Enron was an incredibly complicated company, and it has proven difficult to determine the degree to which anyone inside the company was aware of the company’s transactions at any given moment. Jeffrey Skilling professed substantial ignorance to Congress;186 Kenneth Lay invoked his Fifth Amendment privilege against self-incrimination.187 That said, both the Powers Report and the Senate Report concluded that Enron’s senior management, including Lay and the Board of Directors, should have done more to prevent fraud.188 External oversight mechanisms also failed. Enron was badly advised by its lawyers, primarily Vinson & Elkins, and its accountants, primarily Arthur Andersen, which has since collapsed.189 Financial market professionals now seem incapable of overseeing, and limiting, corporate malfeasance like Enron’s. Not just Arthur Andersen, but the entire accounting industry, since winnowed down to the Big Four, is riven by conflicts of interest and a plethora of rules that are misleading.190 Financial

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184. “In effect, Enron was hedging risk with itself.” *Id.* at 97.

185. In the Enron case, the word “fraud” is used often, but usually in the expansive sense familiar from securities law—that is, to mean a lack of candor or disclosure. The Powers Report and other sources contain remarkably few allegations of a lie told face-to-face by one insider to another.


188. *ENRON REPORT*, supra note 1, at 3; *POWERS REPORT*, supra note 7, at 162.

189. See, e.g., *Andersen Verdict Signals New Government Crackdown*, L.A. TIMES, June 18, 2002, at C1; *Arthur Andersen Closing the Book on its Auditing*, HOUS. CHRON., Sept. 1, 2002, at 3. However, it is worth noting how durable an entity can be. See *Andersen Tells Court it Doesn’t Intend to Set Dissolution*, WALL ST. J., Aug. 14, 2003, at C13 (claiming that the firm, though shorn of its auditing and most other business, is an “ongoing entity”).

market analysts are too gullible or too optimistic—or simply are misleading themselves—in their assessment of companies they would like to sell. Broker-dealers are similarly limited. Banks lent money so that Enron could continue to prop up its house of cards. The entire system of “gatekeepers” against fraud failed.191 The SEC should have done more, but it was hamstrung by lack of resources.192 Wall Street failed to provide market discipline for far too long and faith in the financial industries has suffered as a result. Although the markets rallied briefly after Enron, continued revelations of faulty accounting and inadequate disclosure at other companies led market indices to decline to levels not seen since early 1997.

The conventional wisdom is that the challenge posed by Enron and other accounting scandals is to find a way to keep managers from using accounting trickery to make fraudulent disclosures to the stock market and to ensure that oversight mechanisms catch managers bent on fraud.193 In response to this challenge, internal and external “gatekeeping” efforts have intensified. Corporate managers have attempted to reassure investors that their financial disclosures are accurate in a variety of ways, ranging from jawboning,194 to refusing to give consulting work to their auditors,195 to expensing options.196 The SEC has required CEOs of the largest publicly-traded companies to sign affidavits affirming the quality of their financial disclosures.197 President Bush has promised that the government “will use the full weight of the law to expose and root out corruption. My administration will do everything in our power to end the days of cooking the books, shading the truth, and breaking our laws.”198 Executives like Dennis Kozlowski (Tyco)199 and John Rigas (Adelphia)200 have

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191. See, e.g., The Fall of Enron: How Could It Have Happened?: Hearing Before the Senate Comm. on Governmental Affairs, 107th Cong. (Jan. 24, 2002), at 24–27 (statement of Frank Partnoy). “The institutions sharing the blame include auditors, law firms, banks, securities analysts, independent directors, and credit rating agencies.” Id. at 31.
192. In response, the SEC is getting a larger budget. See Sarbanes-Oxley Act, tit. VI.
194. See, e.g., Emily Nelson, P&G Posts Profit Increase, GLOBE & MAIL, Feb. 1, 2002, at B9 (stating that “P&G executives tried to reassure investors concerned about P&G’s accounting practices”).
195. See Key Auditing Firms Act to Quell Storm, CHI. TRIB., Feb. 1, 2002, at 1 (noting that Disney announced it would no longer use the same firm for consulting and auditing services).
197. See Sarbanes-Oxley Act § 302; Evelyn Cruz Sroufe et al., CEO and CFO Certifications Under the Sarbanes-Oxley Act, PRACT. LAW. NO. 48-8, at 23 (Dec. 2002).
been noisily prosecuted for fraud. Arthur Andersen, which shredded documents in advance of an SEC investigation into its relationship with Enron, was convicted of criminal obstruction of justice and has wound up its core auditing business.\(^{201}\) Congress enacted the Sarbanes-Oxley Act of 2002, which, among other things, provides more funds for investigation of corporate crimes,\(^{202}\) stiffer penalties for those convicted of such crimes,\(^{203}\) more legal oversight of accountants,\(^{204}\) and greater requirements for the independence of corporate boards.\(^{205}\)

B. THE IMPLAUSIBILITY OF THE CONVENTIONAL STORY

Disclosures sufficiently misleading to be violations of the securities laws are traditionally called “fraud.” Fraud is a form of theft, and theft is a crime. And so President Bush has spoken of a Corporate Fraud Task Force, within the Department of Justice, “which will target major accounting fraud and other criminal activity in corporate finance. The task force will function as a financial crimes SWAT team overseeing the investigation of corporate abusers and bringing them to account.”\(^{206}\) Similar statements of outrage were made by influential members of Congress across the political spectrum.\(^{207}\) But while conventional enough, the idea that Enron was stolen from its shareholders by certain rogue managers, whose ilk can be deterred by tough young lawyers in wool suits, is simply too primitive. Enron was never a convenience store.

Let us begin with the perpetrators, especially Andrew Fastow. Fastow has been indicted\(^{208}\) and may indeed be a bad man. Perhaps Enron’s entire senior management team was comprised of bad people. I do not know them and I have no interest in defending them here. There certainly seems to have been a fair amount of greed, lying, and various illegalities, including securities fraud, at


\(^{202}\) Sarbanes-Oxley Act § 109.

\(^{203}\) Id. §§ 802, 807, 903 and 904.

\(^{204}\) Id. § 101.

\(^{205}\) Id. § 301.

\(^{206}\) Bush, supra note 198.

\(^{207}\) See Howard Kurtz, Election Ads Turn Up Heat on Corporate Fraud, WASH. POST, July 31, 2002, at A4 (discussing the post-Enron “wake of [political campaign] ads built around the theme of corruption”).

Enron headquarters. But that said, “criminal corporate finance” is far from an adequate explanation of the implosion of a company of Enron’s size. It is difficult to believe that the sinfulness of Enron’s management—the greed, lying, and fraud—was powerful enough to lie dormant for years and defeat a host of legal institutions, which historically have been fairly successful in preventing managerial abuse and especially self-dealing, ultimately resulting in the then-largest bankruptcy in U.S. history. The “crime” theory implicitly requires us to assume that Andrew Fastow was a corporate Mephistopheles who led Enron to perdition.

Understanding Enron as very bad fraud is even less satisfying when we consider the string of companies, from Adelphia to Xerox, that recently have had accounting scandals. As any number of commentators have noted, a few randomly distributed “bad apples” does not explain accounting problems widespread enough to threaten faith in the markets themselves. Enron is a dramatic example of a systemic problem. But what, precisely, is the problem? A hint comes from the national market oracle, Alan Greenspan, who speaks of a sort of epidemic, an “infectious greed.” Greenspan seems to be saying that during the last few years, the Zeitgeist (or at least der Geist des Marktes, with which Greenspan undoubtedly is in close communication) became somewhat blind, lustful, tempted—in a word, crazed.

This sentiment is echoed by The Economist when it associates corporate fraud with the bull market, indeed the bubble economy, of the late 1990s. Evidently, in the late 1990s many businessfolk stopped thinking of themselves as stodgy pillars of the community and began thinking of themselves as plutocrats, and in the effort to become plutocrats in fact, they lied, stole, and otherwise broke the laws regulating the securities markets. Not a very attractive assessment, perhaps, but hardly shocking to anybody who has glanced at the shelves in an airport bookstore, watched any of the television channels devoted to business entertainment, or been politically sentient during the last few decades of American life. Taking such a view, however, implicitly admits that the problem is not fraud in the simple sense of individuals who commit crimes,
but something more akin to the "madness of crowds" long understood to be a malaise of business culture. If Enron is part of a crime wave—a widespread violation of the spirit and often the letter of the securities laws mandating disclosure—it is a wave of such breadth that it requires us to look at the business culture that engendered the criminality, rather than the individuals who committed particular violations.

Insofar as Adelphia through Xerox, inclusive of Enron, indicates a problem with modern business culture, punishing the bad apples is something of a distraction. This is not to say that punishing the bad apples is the wrong thing to do. One way to inform a culture is through legal sanctions that punish those individuals who violate cultural norms. Worries about the system of American capitalism may well inspire us to jail managers who break securities laws, under the motto "the only real deterrent is orange jumpsuits." We must not forget that criminal laws have been broken; it is hard to feel too sorry or surprised when the lawbreakers are punished. That said, the fact that the scapegoats may not be completely innocent does not mean they cannot be scapegoats.

Our willingness to understand Enron as theft and punish individual managers is supported by our understanding of what the corporation is and what corporate management does. Habitual patterns of thought reassert themselves: Illegally inadequate disclosure is traditionally characterized as fraud; fraud is understood as theft; and so the question is, who stole the company? Things are stolen from


215. In his address to Congress, Greenspan supported stiff penalties and even jail time. "[E]ven a small increase in the likelihood of large, possibly criminal penalties for egregious behavior of CEOs can have profoundly important effects on all aspects of corporate governance because the fulcrum of governance is the chief executive officer." Fed Chief Rips Corporate Misconduct, WALL ST. J., July 17, 2002, at A6.


217. Hard but not impossible. In Buffalo, there has been considerable sympathy for John Rigas, founder of Adelphia, owner of the Sabres hockey team, and an old man, who was widely regarded as a pillar of the community. Rigas was very publicly arrested rather than allowed to turn himself in to authorities. See, e.g., Dan Herbeck, Rigases Do Have History on Their Side: Public Display of Adelphia Arrests Aside, Obtaining Convictions and Prison Terms for Corporate Defendants Is No Easy Task, BUFF. NEWS, July 26, 2002, at A1 ("Many western New Yorkers expressed sympathy [after seeing television images of an exhausted John Rigas, who has suffered from heart problems, hustled into a police car after his arrest]."

218. "The principals emerge as rogues, to be roughly expelled by the respectable business community. There lies much truth in the characterization. But the rogue characterization serves a double function—it deflects attention from the respectable community's own business practices." Bratton, supra note 11, at 1283.
owners—that is, the shareholders—and who is the traditional enemy of shareholders? Management. Much of the outrage over Enron was prefigured by Berle and Means in their classic 1933 account, *The Modern Corporation and Private Property*, which depicts the central problem of corporation law as the restraint of managers’ ability to take advantage of shareholders.\(^\text{219}\)

But here too there are problems, at least if the point is to tell a story of criminal culpability. Fastow and Lay and other Enron management and employees were also Enron shareholders. That has been a central tenet of corporation law theory and practice for the last two decades: Management’s temptation to defraud shareholders should be removed by making managers into shareholders. And while there was some cashing out,\(^\text{220}\) Enron’s management lost a great deal of money, and perhaps more importantly, ceased to be players due to the collapse of Enron’s share price. It is difficult to believe that Enron’s management wanted the company to fail or even wished to jeopardize the company.

It is true that Fastow and certain other Enron employees made great sums of money through their involvement in the SPEs with which Enron conducted the now infamous off-the-books transactions. Even as Fastow was CFO of Enron, with all the fiduciary duties that job entails, he had investment interests in and was being paid by Enron’s counterparties, whose economic interests were, at least in theory, opposed to Enron’s. Is this a conflict of interest? The Powers Report certainly thought so: “Fastow and other Enron employees received tens of millions of dollars they should not have received. These benefits came at Enron’s expense.”\(^\text{221}\) The Department of Justice has pursued these benefits, obtaining a confession from Kopper\(^\text{222}\) and indicting Fastow.\(^\text{223}\)

Even assuming that criminal acts occurred, how, exactly, were these millions of dollars “received”? Thirty million dollars, the amount the Powers Report claims Fastow was paid in conjunction with the transactions in question,\(^\text{224}\) is not petty cash. One can be paid such sums only with the active participation of numerous institutions, starting with Enron itself, but also including banks and (especially in the case of stock payments) numerous financial intermediaries. All such institutions are audited. Decisions to transfer millions of dollars are rarely made by isolated individuals. As the Powers Report points out, “[t]here were literally hundreds of people who were involved, in one way or another, in

\(^{219}\) See *supra* note 49 and accompanying text.

\(^{220}\) Notably, Kenneth Lay drew $77 million on a line of credit established with Enron, paying back the burden of the debt (save some $7 million) with Enron stock, and without disclosing the repayment as a sale. *Enron Report, supra* note 1, at 53–54.

\(^{221}\) *Powers Report, supra* note 7, at 16.


\(^{223}\) *Supra* note 208.

\(^{224}\) *Powers Report, supra* note 7, at 3.
the transactions we reviewed." Not only did the Enron transactions ultimately result in substantial losses to the responsible parties, but execution of the transactions also required widespread cooperation. How did Fastow et al. secure such widespread cooperation?

Moreover, if these transactions entailed illegal conflicts of interest, then such cooperation was collusion. To make matters more mysterious still, such collusion did nothing to benefit many of the people who cooperated, including independent directors, various employees, members of management, to say nothing of Arthur Andersen and Vinson & Elkins. In fact, insofar as revelation of the off-the-books transactions and the profits made by Fastow and others from those transactions led to the downfall of Enron and Arthur Andersen, such collusion was directly against the long-term interest of many of those who cooperated with Fastow. The Powers Report again and again “fails to understand” or finds it “inexplicable,” or simply admits “we do not know” why basic conflicts of interest, legal or accounting violations, and other problems go unremarked by people who stand to gain little from the transaction.

In the traditional understanding of the corporate drama, the role of the board of directors is to be a guard. The board ensures that managers act in the interest of the company and especially its shareholders, rather than in their own interests. Unsurprisingly, then, the Senate Permanent Subcommittee on Investigations found Enron’s Board of Directors largely to blame. The Board, the Subcommittee found, ignored “more than a dozen red flags” about Enron’s off-the-books financial dealings. “The Board witnessed numerous indications of questionable practices by Enron management over several years, but chose to ignore them.” Through their attorney, outside directors have objected that they sometimes were not told of questionable deals. Robert Jaedicke, once head of the Board’s Audit Committee and former Dean of Stanford’s Business School, claimed that it was Arthur Andersen’s job to confront difficult accounting issues. “Enron paid Arthur Andersen some pretty hefty fees . . . so that those accounting judgments . . . would be properly made.” The Subcommittee was not impressed by this argument: “But much of what was wrong at Enron was not concealed from its Board of Directors. High-risk accounting practices, extensive undisclosed off-the-books transactions, inappropriate conflict of inter-

225. Id. at 35 n.6.
226. See id. at 7, 42, 53 n.13, 54, 55, 63 n.20, 80, 83, 86 n.31, 94, 95, 154 n.70.
227. ENRON REPORT, supra note 1, at 59.
228. Id. at 3, 11.
230. ENRON REPORT, supra note 1, at 19. It is difficult to believe that accounting issues are not also the responsibility of the audit committee of the board. Fortunately, in accounting, as in other areas of life, cash payment is the best way to get the right answer, and Andersen had been paid good money.
est transactions and excessive compensation plans were known to and author-
ized by the Board."\textsuperscript{231} While Enron was so complicated that the directors
cannot be assumed to have known all the relevant transactions well, the
evidence appears to be overwhelming that the Board knew quite a lot about
many relevant transactions. The directors were certainly told enough to ask
probing questions. And, as a matter of corporation law, if one is charged with
oversight, then lack of knowledge is not much of a defense; one may have a
duty to investigate.\textsuperscript{232} Both the Senate Report and the Powers Report conclude
that in failing to ask questions, Enron’s directors did not fulfill their duty.

Albeit awkwardly, Enron’s directors raise a point that is worth some thought.
Enron’s very complexity appears to pose a problem: What can we expect
directors—especially independent directors, who do not work for the com-
pany—to know? Enron’s directors, and for that matter Enron’s auditors, have
claimed that they were misled by Enron’s management—they argue that no
audit, no oversight, can defeat intentional and systematic lying.\textsuperscript{233} The Subcommittee
was only slightly sympathetic to this position: “[T]he investigation found
a board that routinely relied on Enron management and Andersen representa-
tives with little or no effort to verify the information provided.”\textsuperscript{234} But while the
Subcommittee insists that Enron’s directors should have done more to inform
themselves, it also seems to agree that the problem is the quality of information
available to Enron’s directors and the care with which such information is
analyzed.\textsuperscript{235} But just what level of care in such matters do we actually expect to
get from directors? Any reading of the Powers Report—which expressly acknowl-
edges its simplification of the matters it discusses\textsuperscript{236}—suggests how compli-
cated the operations of Enron were.\textsuperscript{237} How much independent understanding
can part-time directors be expected to acquire? Are directors up to the task? A
recent poll of executives found that some fifty-nine percent “believe that their
company boards don’t have the financial smarts to determine if their books are
cooked.”\textsuperscript{238}

What constitutes the appropriate standard of care for directors of publicly-
traded corporations is an interesting issue, but it is only tangentially, if at all,
presented by the Enron case. Enron’s Board was stellar. In addition to Jaedicke,
it included luminaries from the energy industry, Ph.D. economists such as

\begin{itemize}
\item \textsuperscript{231} \textit{Id.} at 14.
\item \textsuperscript{232} \textit{Cf. Smith v. Van Gorkom}, 488 A.2d 858, 872 (Del. 1985) (“a director’s duty to inform himself
in preparation for a decision derives from the fiduciary capacity in which he serves the corporation and
its stockholders.”).
\item \textsuperscript{233} \textit{ENRON REPORT, supra} note 1, at 14.
\item \textsuperscript{234} \textit{Id.}
\item \textsuperscript{235} The Subcommittee notes, again and again, how short Enron’s board meetings were, in light of
the complexity of the matters decided. \textit{E.g.}, \textit{id.} at 9.
\item \textsuperscript{236} \textit{See POWERS REPORT, supra} note 7, at 1–2.
\item \textsuperscript{237} \textit{See id.} at 29, 35 n.6.
\item \textsuperscript{238} Janet Whitman, \textit{AP Online Poll: Boards Can’t Decipher Books}, \textit{AP ONLINE}, July 12, 2002,
available at 2002 WL 23895861.
\end{itemize}
Wendy Gramm, and others with substantial experience managing corporations. If these people could not adequately understand Enron’s business, then we cannot expect any boards to monitor their companies, leaving the entire institution of the board of directors as monitor open to doubt. While loss of faith in the idea of the corporate board would hardly be the end of the world, it should be acknowledged that insisting that Enron’s business was so complicated that it required directors more sophisticated than Enron’s is tantamount to arguing that, at least in very complex companies, boards cannot fulfill their traditional roles.

Moreover, the implication of this line of argument is that Enron’s Board was not sophisticated enough at accounting. It is unclear what such a proposition means. Arthur Andersen, evidently, was not sophisticated enough at accounting either. Enron sought highly competent accounting and legal advice, and Enron followed such advice. It was precisely such sophisticated advice that Enron ultimately restated, although it is not absolutely clear that the restatements are correct either. Moreover, as already noted, Enron’s audit committee was headed by a professor of accounting. Whatever went wrong at Enron was not due to a lack of sophistication or “smarts.”

Most damning of all, as both the Powers Report and especially the Senate Report point out, the Enron Board did know a great deal about the transactions that were eventually disclosed. For the Subcommittee to speak of “verification” is to miss its own, more important, point: Enron’s Board approved of much of the business that eventually brought the company down. At least in many cases, the directors verified what they were told, they merely would have added detail to their existing knowledge. Enron’s directors made mistakes, but the mistakes were not, at least in the first instance, due to the unavailability of information or to their own intellectual incapacity. In short, the lesson here is not about the Board members’ capabilities.

Fastow and others were not “caught” because their transactions were, in general, approved or at least permitted. As recounted above, some of the transactions were specifically authorized by the Board of Directors or by other upper level management. Fastow’s conflict of interest with regard to the formation of the LJM partnerships was approved by the Board, which decided it was in Enron’s interest to have someone as knowledgeable as Fastow running the transactions, even though Fastow would profit thereby. Other transactions were authorized because of Fastow’s position in the corporate hierarchy, a position not challenged until the company was collapsing. Fastow was not “caught” because, in an important sense, the off-the-books transactions were

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240. See supra text accompanying note 230.

241. One might go further and argue that the Board seems to have thought that, in light of the work, risks and expertise required, and in light of the service rendered to Enron, Fastow deserved to profit handsomely from his involvement with Enron’s SPEs.
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legitimate, at least within Enron. The question is not, "how did these actions escape detection," but "how did a culture arise in which these actions were acceptable?"

"Caught" is a misleading word to use when thinking about what went on at Enron. Other misleading words are "cooking the books," "fraud," and "theft." All such words imply that a few actors, the infamous "bad apples," mysteriously managed to fool hundreds of sophisticated and more or less upright people into colluding with them. However evil Enron's management may have been, the conventional morality tale—bad people at the top stole the company while good people were not watching—just does not suffice as an explanation for Enron's collapse. More importantly for those of us who think about corporation law, understanding Enron as theft just does not teach us much.

III. THE STORY RETOLD

The Enron story can be told in a far simpler, more plausible, and ultimately more instructive fashion than that of the conventional story, in which a horde of Mephistophelian financial geniuses at Enron and various other companies simultaneously defrauded shareholders and bewitched the usual guardians of corporate probity. This more plausible interpretation of what happened at Enron—indeed, at most of the companies recently afflicted with accounting scandals—follows straightforwardly from three relatively unproblematic propositions and one perhaps rather startling thesis.

Proposition One: Shareholders, managers, and inside directors are all directly interested in high share prices, because they own either shares or call options. Moreover, managers and directors have fiduciary obligations to shareholders to concern themselves with share prices. Insofar as they sympathize with their clients (one way to keep one's job), accountants and lawyers are indirectly interested in the maintenance of a corporation's share prices.

Proposition Two: Managers and directors believe that a firm's financial statements affect its share prices. For example, in its annual report, Enron's management claimed to be "laser-focused on earnings per share (EPS), and we expect to continue strong earnings performance." Consequently, management believes that its decisions on how to account for various aspects of a company's business are very important to the company's share price and economic fortune.

Proposition Three: A firm's financial statements are a description of the company, rather than a mathematically-derived answer to a set problem. There

243. Even managers very focused on shareholder welfare may find earnings per share too simple a metric. See, e.g., Henry T.C. Hu, Buffett, Corporate Objectives, and the Nature of Sheep, 19 Cardozo L. Rev. 379, 383–84 (1997) ("While many managers still cling to EPS, it is becoming increasingly clear that the reliance on EPS as the sole or dominant indicator of corporate performance embodies little more than folk wisdom as to how shareholder wealth is created.").
are various ways to describe many aspects of business that are legally, professionally, and intellectually acceptable. Choosing among such descriptions requires judgment; these judgments are the stuff of professional institutionalization. This proposition is commonly put forward under the motto that accounting is an art rather than a science. It would be more correct to say that accounting is a form of professionally constrained advocacy, like forensics.244

The Thesis: Enron’s collapse did not result from a conflict of interest between Enron’s management and its shareholders. Far more important than any such conflicts of interest were the alignment of interests between shareholders and management, including those of Andrew Fastow.

With these ideas in mind, the story of Enron is disturbingly simple. Enron’s management endeavored to make a great deal of money for shareholders, including themselves. To do so, Enron sought to manage its portfolio of investments intelligently. This meant selling debt and hedging risk. Enron used SPEs, both with and without outside investors. Enron sought and received professional advice that reassured Enron’s management that its strategies legally could be realized. While the accounting for such transactions was in many instances at least “aggressive,” the benefits for Enron’s balance sheet could not be gainsaid.245 Enron’s off-balance-sheet transactions benefited shareholders; Enron’s management team and team of advisors were sophisticated; the firm had been stunningly successful since its founding under the same management. Enron’s Board unsurprisingly supported management’s efforts.

One might argue that this story does not explain why so many people acquiesced in lies. But to say that Enron’s accounting was “cooking the books” implies that management and their accountants knew what the true numbers were. No doubt this was the case in some circumstances (people do lie), but matters are rarely so black and white. There is little reason to believe that rich professionals frequently jeopardize their positions by telling outright lies. Real accounting problems tend to be difficult, and so the temptations, which often hardly can be articulated, are very difficult to resist. Professionals tell themselves and the market stories—plausible stories in which things might work out. For example, Enron’s management intended to find an outside investor willing to put up money equal to 3% of Chewco’s equity to ensure that there was no question that Chewco, and hence JEDI, qualified for non-consolidation.246 But they failed to do so and then hoped that a labyrinthine structure involving Barclays Bank and a relatively low-level Enron employee, Kopper, would be

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244. This is not to say that accounting is infinitely malleable, or that how one makes financial disclosures does not matter. It is possible to use accounting to tell what we all would agree is an outright lie, but those are the primitive and uninteresting cases. The harder questions in both accounting and law arise when interest modulates communication in ways that are neither untrue nor acceptable.


246. See POWERS REPORT, supra note 7, at 49 (referring to ultimately unsuccessful efforts to obtain outside equity, including preparing a private placement memorandum and making contact with potential investors).
sufficiently independent to qualify. For another example, it is not clear that Fastow did not qualify as an owner sufficiently independent of Enron to render both LJM partnerships eligible for non-consolidation.\textsuperscript{247} For a third example, if Enron’s shares did not decrease in value, neither its LJM1 (Rhythms Netconnections) nor its LJM2 (Raptor) hedges would have been put under pressure, and these hedges would have smoothed Enron’s earnings. Is it prudent for businessfolk to tell such hopeful stories? No. Understandable? Yes. In the interests of (diversified) shareholders? Quite possibly, at least if the transactions are considered individually.

Whether or not individual managers at Enron in fact acted in good faith is likely to be important to the litigants, but it is not a matter of concern to corporation law theory or to this Article. What is significant for corporation law theory is that Enron demonstrates how even very aggressive earnings management could be in the interests of shareholders and, therefore, of managers as well. Many people at and connected with Enron appear honestly to have believed that the transactions in question were both legal and were making money for shareholders.\textsuperscript{248} Bluntly put, earnings management is, or at least appears to be, in the best interest of the shareholders, which is why earnings management is so common. Now that Enron has collapsed, it is easy to disparage the understandings that led to various decisions by senior management and by the Board of Directors. However, this disparagement may be misplaced. In light of the stratospheric valuations of Enron stock, the risks presented by Enron’s accounting techniques may have been completely acceptable at the time, or at least may have been thought, in good faith, to have been acceptable.\textsuperscript{249}

The problem with Enron’s baroque operations, beautiful in their way, is not whether they individually comply with obscure FASB positions but rather their cumulative opacity. It is still not clear what Enron’s earnings—or the proper numbers for shareholder equity—were in the third quarter of 2001. Enron restated its numbers, under rising regulatory and political pressure, and presumably restated its numbers in good faith. But the Powers Report questions whether Enron restated its numbers “correctly,”—that is, there were other defensible, perhaps methodologically superior, ways to account for the establishment and unwinding of the Raptors.\textsuperscript{250} At some point, the analyst—whether an

\textsuperscript{247} See id. at 76.
\textsuperscript{248} See supra notes 224–41 and accompanying text.
\textsuperscript{249} William Bratton put it very well:

Enron in collapse was wrought into the fabric of our corporate governance system every bit as much as Jack Welch’s General Electric (GE) was in success. Like GE under Jack Welch, Enron under Ken Lay and Jeff Skilling pursued maximum shareholder value . . . . Similarly aggressive accounting and soft numbers are commonplace in business today. They have become wrought into the practice of shareholder value maximization.

Bratton, supra note 11, at 1283.

\textsuperscript{250} Powers Report, supra note 7, at 128. Wilmer, Cutler & Pickering retained Deloitte & Touche, LLP for accounting advice. Id. at 32.
advisor, a market analyst, an investor, or a scholar writing after the fact—simply loses track of the transactions and how to account for them. Who knows what the right answer is?251

This is not a question that can be asked safely of a publicly-traded company. Whether a restatement exposes a prior lie, a negligent error, or something in the middle, investors suddenly realize their own ignorance. By admitting that its numbers were badly wrong, Enron destroyed widespread, if perhaps naïve, faith252 that investors had in their own ability to make sense of the company’s financial disclosures. Enron’s announcements conclusively demonstrated to investors that they did not know what the company was about and that therefore they had no solid understanding on which to base their investment decisions. Many investors concluded that they had no business investing in something about which they were so ignorant and sold their shares of Enron. A falling market generates its own momentum; the sell-off became a rout and the company was forced to declare bankruptcy.

IV. THE ARGUMENT

A. FAILURE OF THE OLD PARADIGM

What does all of this mean for the academic subdiscipline of corporation law? At least since Berle and Means published The Modern Corporation in 1933, the most influential book on corporation law and “the Bible” of the Roosevelt administration,253 the corporation has been understood by the legal academy in terms of the separation of ownership and management functions, in the persons of shareholders on the one hand and managers and directors on the other.254 This separation has given rise to what has been understood to be the central problem of corporate governance—the perennial possibility that managers would have interests that conflicted with owners. The task of corporation law, then, has been to devise ways to keep managers from abusing their position


253. SCHWARZ, supra note 51, at 60–61. The splash made by The Modern Corporation was huge. Charles Beard compared it with the Federalist Papers, Jerome Frank with The Wealth of Nations. See id.

254. This is the usual reduction of Berle’s thought; Berle himself had many other concerns. In particular, during the 1920s and 1930s, Berle was worried about the concentration of capital and the de facto construction of an oligarchy. At the same time, Berle thought that modern industrialization required bigness, collectivization through some mechanism. Berle therefore disagreed with progressives who believed that the health of the markets could be achieved through antitrust law, the break-up of large concerns. Nor did Berle believe that the state should directly control the means of production. The answer for Berle, and to a great extent for Roosevelt (Berle was Roosevelt’s “braintruster” and an advisor generally without office), was substantial government involvement in a system of private enterprise, “state capitalism.” For Berle, therefore, the Modern Corporation’s reliance on the judiciary was just the tip of the iceberg of state participation in business life.
and taking advantage of the absentee owners of the corporation, the sharehold-
ers. This descriptive framework—corporation law understood as the drama
arising from the separation between owners and managers—remains in wide
use today, albeit with modifications, particularly in terminology.\textsuperscript{255}

The solution proposed by Berle and Means was to strengthen the existing
system of fiduciary duties owed by managers and directors to shareholders and
to provide more causes of action through which shareholders could obtain
judicial review of managerial decisions. In practice, Berle and Means proposed
that the courts would regulate corporate life in order to protect shareholders
from managerial conflicts of interest.\textsuperscript{256} Berle and Mean's prescriptions—more
duties to shareholders, more causes of action, more litigation, more judicial
decisions—have not been as heartily adopted as their description of the conflict
between shareholders and management.\textsuperscript{257} The judicial system is hardly an
ideal way to conduct business life, and the threat of litigation provides insuffi-
cient deterrence, or at least guidance, for ambitious managers, as the Enron case
demonstrates. Enron has been widely understood in terms of management's
self-enrichment at the company's expense. If the problem at Enron was rapa-
cious management, then the many legal institutions that Enron and other
corporations use to protect shareholders from the greed of managers—fiduciary
duties, board oversight, audit committees, outside accounting and legal advice,
corporate codes of conduct, duties to disclose financial dealings to the federal
government, and so forth—all somehow failed.

Moreover, aside from the bother and waste of litigation, courts tend to work
after the fact. Courts cannot put Enron back together again, any more than all
the king's horses and all the king's men could rebuild Humpty Dumpty.\textsuperscript{258}
About all one can hope is that market participants will learn from the mistakes
of others. But in light of the market's ability to present seemingly new (at least
with regard to the particulars) risks and temptations, the hope that market
participants will learn how to avoid legal risks seems unrealistic. Markets can
be expected to generate temptations as fast as, if not faster than, courts can be
expected to generate adverse consequences for succumbing. Therefore the

\begin{footnotes}
\footnotetext{255. See William W. Bratton, \textit{Berle and Means Reconsidered at the Century's Turn}, 26 J. CORP. L. 737, 761 (2001) (noting that the separation between owners and managers was reborn as the agency problem).}
\footnotetext{256. See \textit{id.} at 765.}
\footnotetext{257. For an overview see \textit{id.} at 765–68.}
\end{footnotes}
solution proposed by Berle and Means is at best partial.\textsuperscript{259}

If Berle and Means inaugurated an era of corporate doctrine focused on the separation of ownership and management and management's ability to abuse shareholder interests, then Henry Manne may be said to have inaugurated the next orthodoxy.\textsuperscript{260} At least since Manne's work in the 1960s, corporate governance has been understood as a commodity, regulated, like other commodities, by market mechanisms.\textsuperscript{261} In particular, Manne and his many epigones taught that managers were not free to do as they pleased with shareholders' money but were constrained by market forces. There was a market for corporate control—that is, a takeover market—and wayward managers could and would be ousted by profit-seeking shareholders.\textsuperscript{262} Therefore, in general, there was no need for the extensive regulation and judicial oversight sought by Berle and Means and other New Deal liberals.

If the market for managers had sticks, it also had carrots. Over the course of the 1980s, especially in high-tech industries, a company's managers increasingly were paid in stock and stock options.\textsuperscript{263} This idea seemed to make good sense; when the company made money, shareholders would make money, and it would be fitting that managers would be paid for their service to shareholders.\textsuperscript{264} Conversely, if the company did poorly, share prices would not appreciate and management would receive less compensation. Thus, managers would have incentives to make money for shareholders. The problem posed by Berle and Means could be solved—not by fiduciary duties and the threat of litigation, but by granting equity interests or, more politely, by the proper construction of incentive systems.

In 1990, Jensen and Murphy influentially expressed this idea by bringing

\begin{itemize}
  \item \textsuperscript{259} Cf. Bratton, \textit{ supra} note 255, at 766 (noting that because financial science, in theory available to the judge, yields no determinate answer, judicial decisionmaking seems less legitimate than contract).
  \item \textsuperscript{260} See \textit{Economic Policy and the Regulation of Corporate Securities} (Henry G. Manne ed., 1969) (proceedings of a 1968 symposium sponsored by the National Law Center of George Washington University and the American Enterprise Institute for Public Policy Research). Many of the participants explicitly claimed their work was an advance over traditional corporation law. See also \textit{Corporations and Private Property: A Conference Sponsored by the Hoover Institution, 26 J.L. & ECON. 235 (1983)} (detailing a conference on 50th anniversary of \textit{The Modern Corporation}, at which many participants argued that Berle and Mean's views had been superceded by the new scholarship).
  \item \textsuperscript{261} See \textit{William J. Carney, The Legacy of 'The Market for Corporate Control' and the Origins of the Theory of the Firm}, 50 \textit{Case W. Res. L. Rev.} 215, 233–36 (1999) (recognizing Manne as the most important corporation law theorist at least since the 1960s and noting that he was the first legal academic to develop the notions that shares consisted of a bundle of rights and "that there were positive returns to acquiring voting control of firms, and that these returns come from improved management").
  \item \textsuperscript{262} See \textit{Manne, Mergers and the Market for Corporate Control, supra} note 50, at 112.
  \item \textsuperscript{263} For a general explanation, see Robert Dean Ellis, \textit{Equity Derivatives, Executive Compensation, and Agency Costs}, 35 \textit{Hous. L. Rev.} 399 (1998).
  \item \textsuperscript{264} There was, of course, another reason compensation of managers through options became so popular so quickly. Options paid out to management are noted on the company's financial statements, but no cost is charged against earnings. Warren Buffett has famously railed against this practice. See, e.g., \textit{Warren Buffet, Editorial, Stock Options and Common Sense, WASH. POST, Apr. 9, 2002, at A19.} There are numerous proposals to end this practice.
\end{itemize}
“compensation concerns into the dominant conceptual model for contemporary law theorizing, the agency cost model.” In their view, paying managers with securities in the company was efficient—that is, it was a good idea as a matter of public policy—because it reduced the monitoring or self-dealing costs that shareholders otherwise would incur. The merits of performance-based compensation soon were written into the tax code, which permits corporations to deduct compensation in excess of $1 million paid to an individual employee only if such compensation is performance-based. More importantly still, performance-based compensation became the norm across corporate America, especially in the high-technology industries of which the nation is so proud.

Such management incentive systems are not perfect. Shareholders’ interests may diverge from the interests of managers paid in options for many reasons. For example, because an option to buy a share above the price at which the share is trading (an option that is “underwater”) is almost worthless, an option holder may rationally choose a riskier strategy than a shareholder. Moreover, managers often do not actually bear the risks suggested by the term “performance-based” compensation. Companies are notorious for buying back, issuing additional, or repricing options, or otherwise relieving managers of the risks that would be associated with true ownership. Also, the divergence of


266. Jensen and Murphy built on Jensen and Meckling’s very influential earlier work on principal-agent (shareholder-management) problems in the corporation. See generally Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976). The agency-cost model offered plausible explanations for at least two major phenomena in recent American business history—the rise of the conglomerate and the emergence of the leveraged management buy-out, both of which seemed to require the prior existence of inefficient markets. If their pay, and especially their perks, were tied to the size of the conglomerate, then managers might be inspired to create fundamentally inefficient conglomerates, which would be the targets for efficiency producing bust-up takeovers. Second, if managers were compensated through a wage rather than through capital appreciation, then they might choose to loaf. If money were sufficiently cheap, however, those same managers might be inspired to conduct a leveraged management buy-out (LMBO) of existing shareholders. In an LMBO, managers borrow money, buy shares, and work hard to pay off their debt and pay themselves well. Thus, management compensation looked to explain otherwise problematic past inefficiencies, as well as promote future efficiencies. See Yablon, supra note 265, at 275–81.

267. See I.R.C. § 162(m) (2000). A discussion of the accounting and tax treatment of options, and currently proposed reforms thereof, is beyond the scope of this Article.

268. See William W. Bratton, Jr., The New Economic Theory of the Firm: Critical Perspectives from History, 41 Stan. L. Rev. 1471, 1493 (1989) (citing Berle and noting that “managerialism faced the problem of the corporation’s inability to replicate exactly the individual economic actor’s profit-maximizing behavior pattern”).

269. Today we hear proposals that corporate managers should be compensated not with stock options, but with equity itself. See Felix G. Royhatin, An Agenda for Corporate Reform, Wall St. J., June 24, 2002, at A16.

270. See Yablon, supra note 265, at 273–74.
interests is greater between managers paid in options and non- or under-diversified shareholders, such as an employee who has retirement funds in the company.\textsuperscript{271} And management tends to pay itself too much—that is, the old agency problem is not simply solved by the ability to pay options.\textsuperscript{272} For these and other reasons, the interests of shareholders and management continue to diverge somewhat, even if management is paid with stock and stock options.\textsuperscript{273}

Important as such qualifications may be, however, such misalignments are matters of degree. As a rough and ready matter, options become more valuable as shares become more valuable—option holders have interests roughly aligned with shareholders.\textsuperscript{274} Rather than emphasize how options fail to align the incentives of managers perfectly with those of shareholders, we should pay attention to the consequences of the substantial convergence of the interests of shareholders and managers, interests which were traditionally viewed as antagonistic. Characterizing Enron in terms of the convergence, rather than the divergence, of shareholder and managerial interests could be important for the discipline of corporation law; understanding Enron to be a failure that arose out of this alignment of interests—that was even fostered by the alignment of such interests—could be the issue over which the paradigm shifts.

However, Enron can also logically be understood as the simple failure of institutional strategies (equity incentives and fiduciary duties) to protect owners from managers. Institutions, whether legally enforceable obligations or management incentive plans, are human constructs and therefore fallible. In the Enron case, it could be argued, the greed and fraud were simply stronger than the institutions constructed to combat them. Perhaps we need to strengthen the legal constraints upon managers; perhaps we need to rethink how we compensate

\textsuperscript{271} We also hear proposals for legislation requiring diversification of investments in 401(k) programs. For recent proposed legislation, see Pension Security Act, H.R. 3762, 107th Cong. (2002); Economic Security and Worker Assistance Act, H.R. 3529, 107th Cong. (2001); Retirement Security Advice Act, H.R. 2269, 107th Cong. (2001). Cf. Enron and Beyond: Legislative Solutions: Hearing Before the Subcomm. on Employer-Employee Relations of the House Comm. on Educ. and the Workforce, 107th Cong. (Feb. 27, 2002), at 8–9 (statement of Angela Reynolds, NCR Corp.) (supporting diversification but urging legislative caution).

\textsuperscript{272} See, e.g., Lucian Arye Bebchuk et al., \textit{Managerial Power and Rent Extraction in the Design of Executive Compensation}, 69 U. CHI. L. REV. 751, 793 (2002) (arguing that the most relevant empirical data suggest that the design of options programs is consistent with the presence of managerial power and rent extraction); Lawrence A. Cunningham, \textit{Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance}, 84 CORNELL L. REV. 1133, 1177–78 (1999) (describing the alignment of shareholder and managerial interests through executive stock options as a "chimera"); Charles M. Yablon, \textit{Overcompensating: The Corporate Lawyer and Executive Pay}, 92 COLUM. L. REV. 1867, 1869 (1992) ("[E]xecutive compensation may now have reached such levels of outrageousness that some form of legal reaction is likely to occur.").

\textsuperscript{273} Note, however, that the divergence of shareholder and manager interests permits, even requires, the retelling of the traditional story. Because they have different interests, shareholders and managers are in conflict, as we have been taught since \textit{The Modern Corporation}.

\textsuperscript{274} Note that the interests of shareholders are not perfectly aligned either, due to differences among shareholders' portfolios, risk tolerances, and their various situations.
auditors. In short, perhaps Sarbanes-Oxley is enough. Such reforms may even do some good, but these are questions of application rather than principle. That is, we may persist in understanding Enron—as Enron has been understood by the Powers Report, the President of the United States, Congress, the SEC, and most other commentators—to ask again the question that corporation law has considered central since Berle and Means: How do we compel managers to take care of owner-shareholders?

As suggested above, however, there is a quite different way to understand the lessons of Enron for corporation law. Just as we should not expect a medicine for heart disease to be effective against cancer, the institutions of our corporation law should not be understood to have failed in the Enron case, but instead should be seen as treatments for a disease fundamentally different from the disease plaguing Enron. Our prescription of remedies for Enron that were designed to eliminate or contain conflicts of interest and managerial greed rest on a diagnosis of the old problem of the separation between owners and managers. But Enron had a different problem. The key conflict at Enron, and perhaps at most publicly-traded corporations, is between owners and the rest of the world.

B. THE CORPORATION AS PROPERTY

Enron challenges the canonical idea of what a corporation is. For several generations, scholars have insisted that the corporation is, in some metaphysical sense, a nexus of contracts. The idea has a long history. If, as Berle and Means taught, corporations are networks of reciprocal relationships, then corporations tend to be understood in contractual terms, as a set of agreements among corporate actors. Henry Manne’s works, in conjunction with microeconomic

275. Michael Jensen, for example, still believes that executive compensation should be linked to share price, but in ways more complicated than has generally been the practice. Face Value: How to Pay Bosses, ECONOMIST, Nov. 16, 2002, at 60.

276. This is not to deny that one might understand calamities like Enron in other ways. Clearly this was a pathological corporate culture and so one might undertake an explanation from the perspective of behavioral economics. See generally Donald C. Langevoort, Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation, 97 NW. U. L. REV. 135 (2002).

277. At around the same time, Ronald Coase published The Nature of the Firm, which argued that firms could be understood as arrangements that arose when the exigencies of life—transaction costs—precluded the ongoing negotiation of specific contracts. R.H. Coase, The Nature of the Firm, 4 ECONOMICA 386 (1937), reprinted in The Nature of the Firm 18 (Oliver E. Williamson & Sidney G. Winter eds., 1991). Although Coase was not influential for many years after its publication, see id. at 61, many legal scholars (who call themselves “contractarians”) erroneously came to lean on The Nature of the Firm as authority for the “economic” understanding of the firm as a nexus of contracts. But Coase’s project begins with the question of why we observe an absence of markets—contracts in the usual sense—within markets, namely in the hierarchical structures of firms. Id. at 19. Conversely, if firms are the optimal mode of organizing production, why do markets exist at all? “Why is not all production carried on by one big firm?” Id. at 23. Coase’s answer, of course, is transaction costs. In the world, the formation and operation of firms (and hence the return to the entrepreneur) requires that someone bear transaction costs; other transaction costs are associated with contracting in an open market. Id. at 62 (Coase explaining, in a lecture delivered in 1987, his intentions some fifty years
approaches to the corporation, made this understanding of the corporation explicit.

Here again, we find that Enron embodied, rather than violated, contemporary thinking about what the corporation is. Fastow certainly treated the corporation as a nexus of contracts. In early 2001, less than a year before the implosion, Jeffrey Skilling, then President of Enron, thought that market forces and widespread deregulation would lead to the disintegration of old-style corporations into their economic functions, which would then be “virtually integrated” by trading firms—that is, by Enron. From this perspective, as exemplified by the LJM transactions, a given risk need not be owned by the corporation; it could be sold or contracted away. Nor was the absence of a willing buyer much of an impediment. An SPE—that is, a legal entity created for a particular (“special”) business purpose—could be established to play the role of the counterparty. Such entities were, of course, merely additional nexuses of contracts, and their shape and content varied as a function of the contracts that comprised them. For Fastow, and indeed for Enron’s management and its advisers—principally, but not exclusively, Arthur Andersen and Vinson & Elkins—there was nothing particularly fixed about the clan of entities known as “Enron.” Enron was a beautiful realization of the idea—widely presumed among legal academics interested in economics—that a corporation has no substantial existence but is merely a nexus of contracts.

However, the practices of accounting, and hence investing, assume that a corporation has some value, some net of its assets and liabilities, that can be called shareholders’ equity and priced. For the financial markets to function properly, accountants must be able to determine that the corporation in question is of some size and not another, that “this” is what belongs to the corporation, and “that” is what the corporation owes. Rephrased, for all the focus on income statements, the act of investing presumes that it is possible to draw up a balance sheet.

Prices require property, which in turn entails legal boundaries, or demarcations separating what is owned from the rest of the world. Demarcation of

earlier). So for Coase, in the first instance, the firm is anything but a nexus of contracts. Instead the firm is a site where the costs of continuous contracting (forming a market) outweigh the costs of forming the entity. Ironies abound in the legal academy’s appreciation of the great economist. See generally Daniel A. Farber, Parody Lost/Pragmatism Regained: The Ironic History of the Coase Theorem, 83 Va. L. Rev. 397 (1997).

278. See supra Part I; see also Bratton, supra note 11, at 1285 (“[V]iewing itself as a real time nexus of contracts, Enron looked out at the field of traditional large, vertically integrated, asset-based companies and saw a great arbitrage opportunity.”).

279. See Bratton, supra note 11, at 1288–94.

280. See, e.g., Powers Report, supra note 7, at 41–46 (discussing creation of Chewco), 68–70 (discussing creation of LJM1), 70–75 (discussing creation of LJM2).

281. There have been other conceptions of the corporation, and the idea that the corporation is a nexus of contracts is not completely uncontested, even today. Enron, however, provides new reasons to be skeptical of the claim that the corporation should be understood solely as an aggregation of individual interests.
different sorts of property is achieved in different ways—by the physical
dimension of personal property, by the metes and bounds of a patent, by the
registered title and plat backed by a survey for real property, and so forth. The
boundaries of an operating business are not so easily determined, but for
economic purposes the boundaries should be set by the company’s financials.
Enron’s financials, in contrast, established no determinate boundaries. Where
Enron’s “business” started and stopped was impossible to say. The membrane
surrounding Enron was porous, a constantly renegotiated web of contracts with
parties related in various, often ambiguous ways, and assets and liabilities could
be made to flow across that membrane at management’s will. Indeed, even the
image of a cellular membrane may claim too much, for Enron had no definable
boundary, no clear division between itself and its related parties.

Confronted with an “entity” such as Enron, in which ordinary assumptions
about the corporation have dissolved in a morass of contractual obligation, how
is one to price a share? Enron’s financial statements, and its destruction of
investors’ trust, frustrated the act of pricing. Simply put, without pricing finan-
cial capitalism cannot exist. Therefore, assuming that corporation law is an
elaboration of institutional forms that live within and are largely governed
by markets, especially financial markets, Enron could inspire corporation law
scholars to ask about capitalism’s requirements. One of those requirements is
property, because without property there is no price, and without price, no
money economy. If Enron marks a paradigm shift in corporation law, it is likely
to be because corporation law scholars turn their attention and the grammar of
their thought from ways we typify as “contract” to ways typified as “prop-
erty.”

Corporation law scholars of an American Legal Realist persuasion may
object that a contractual right is a form of property and, more generally, that it
seems wrong to make much hinge on an admittedly formal and abstract
distinction between “contract” and “property.” While I am somewhat sympa-
thetic to this objection and have no wish to fetishize a structuralist convenience,
the emphasis on contract in corporate law has not been meaningless. The claim
that the corporation is a nexus of contracts has been deemed sufficiently
meaningful by its proponents to have been made repeatedly. The proposition
indicates a stance toward the corporation characterized by a general emphasis
on the individual’s ability to contract and therefore on the enabling rather than

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282. Henry Sumner Maine famously said “the movement of the progressive societies has hitherto
been a movement from Status to Contract.” HENRY J. S. MAINE, ANCIENT LAW 165 (Henry Holt & Co.,
4th American from 10th London ed. 1906) (emphasis omitted). The Enron case suggests that Maine’s
aphorism is not true for corporation law.

283. A Westlaw JLR search for “nexus of contracts” turned up 529 articles that employed the phrase.
Precisely what the phrase means, however, remains debated. See, e.g., Stephen M. Bainbridge, The
Board of Directors as Nexus of Contracts, 88 IOWA L. REV. 1 (2002); G. Mitu Gulati et al., Connected
mandatory nature of much of state law. More importantly for present purposes, the “nexus of contracts,” however defined in detail and whatever its merits as metaphysics, encourages a fluid conception of the corporation. Fluidity is one way to understand why the pricing mechanism failed with regard to Enron. After Enron, then, capitalistic concerns for how firms as a whole are priced may seem more pressing than ensuring flexibility within firms, and consequently we may spend more time thinking about what shareholders supposedly own.

C. CORPORATION LAW AS PUBLIC LAW

Shifting their attention from contract to property paradoxically would require legal scholars to reimagine the problem of corporate governance as essentially a question of public law. Accounting matters, and the shift from contract to property may be necessary, because our capitalist system is governed by price mechanisms, and it is property interests that are priced. In this light, Enron’s accounting problems are significant because they led to mispricing and then volatility once the investment community lost faith in its information on the company. While Enron’s collapse did not damage the energy markets in an immediately obvious fashion, it is difficult to argue that such markets—as they came to be dominated by Enron—were efficiently constructed. Nor can Enron’s damage to a fragile stock market, to say nothing of the retirement savings of its employees, be overlooked. But the problem raised by Enron is more fundamental than the considerable harms directly caused by the company’s collapse. Indeed, the problem raised by Enron is more important than the “confidence” so beloved by the SEC—that is, the willingness of individual investors to make their capital available to the financial markets. Insofar as we are capitalists who believe some set of social arrangements is ordered best by the efficient pricing of companies, Enron bespeaks a larger political problem—a failure of capitalism to order society well. Enron thus encourages us to think


285. The metaphysical aspect of much of this discussion is truly strange and unsurprisingly awkward—lawyers cannot be expected to be philosophers. Corporation law scholarship awaits a Dewey.

286. “Contract” and “property” are used here rather notionally, to indicate a shift in emphasis rather than a strict separation of legal institutions. Certainly, a party’s benefits under a contract may be understood as property.

287. One would have to argue that the Enron bubble, the irrational valuation of the firm, did not affect the rational behavior of the firm. Such an argument is implausible for at least two complementary reasons. First, the incentives of the firm’s managers were determined irrationally, by the bubble. Second, insofar as Enron’s stock price was ever well-founded, it was upon the proposition that Enron had discovered new ways to trade energy and other things, and Enron therefore enjoyed market power. Enron certainly was suspected of anticompetitive behavior. See, e.g., Kathleen Nye Flynn, L.A. Files Suit Over Pricing of Natural Gas; City Seeks $218 Million From Company It Says Conspired With Enron to Inflate Energy Prices, L.A. TIMES, July 12, 2003, at B3.
about the corporation in essentially public terms: Does the organization of the corporation work to the good of society?288

Defenders of our equity markets may argue that the market ultimately corrected itself against Enron’s misdeeds.289 In response, it is worth noting that the years for which Enron restated its earnings and shareholder equity (1997–2001) represent a length of time longer than the term of a U.S. President. Even more telling, Enron was not alone; the idea that the market is now “corrected” seems speculative and hopeful but hardly well-founded.290 After the revelations of 2002, many Americans understandably have formed a strong belief that many, perhaps most, corporate financial statements are not to be believed.291

Once this trust is eroded, it is difficult to restore—perhaps impossible for those who obviously are self-interested. Managers have difficulty credibly maintaining that, whatever shenanigans may have bedeviled their recent reporting, now they are telling the truth. Certainly, managers may try to bolster the credibility of their disclosures by relying on professionals such as accountants, lawyers, and other fiduciaries, especially outside directors, all of whom have duties to tell the truth. Accountants, lawyers, and outside directors, however, conspicuously have failed in Enron and like cases. As a practical matter, in light of the complexity of modern accounting and modern business, investors must rely on trust in the system; as of this writing, that trust is in very short supply.

This is obviously a problem of securities law, or more accurately, of making the securities laws effective. But it also would seem to be a problem of corporation law: How do we create a corporate culture that furthers a capitalistic society’s interest in being well-governed?292 Considering the corporation in

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288. The paradigm for which I am arguing recalls a somewhat overlooked aspect of Berle’s thought, the focus on the public and social consequences of institutions and transactions simultaneously understood to be private. Berle once claimed he wanted to be the Karl Marx of the shareholding class. SCHWARZ, supra note 51, at 62.


290. The editorial board of The Economist unsurprisingly embraced the idea that just such a market correction had taken place:

[T]he most effective remedy for these ethical and mental breakdowns has already been dispensed, frustrating as this is for politicians with careers to make. . . . The technology-stock bubble has well and truly burst. The mood has changed from mania to remorse. Until further notice, regulation or no regulation, investors will be on their guard, and financial orthodoxy and corporate probity will once again be celebrated and valued.


291. Neil H. Aronson, Preventing Future Enrons: Implementing the Sarbanes-Oxley Act of 2002, 8 STAN. J. L. BUS. & FIN. 127, 142 (“Congress and the SEC recognized that investors have lost much of their trust in financial statements, whether audited or unaudited.”).

terms of property rather than contract might provide a place to start. Note that
the proposition that corporations essentially are webs of contracts—that owners
and managers are counterparties in the key contract that constitutes the corpora-
tion’s existence—entails the traditional distinction between owners and managers. If, however, concern for the operation of capitalism causes us to focus on
the nature of the corporation as property, then it is obvious that shareholders and
managers are both inside the fence as owners. Consideration of the corporation
as property thus entails a new central conflict, between owners and “the world”
against whom property interests are commonly defined. Thus, by causing
corporation law scholars to pay attention to the requirements of capitalism—
sound prices, and therefore property—Enron could cause the crux of corpora-
tion law to shift from the conflict between shareholders and managers to the
conflict between owners (shareholders, managers, and directors) and the public.

D. THE CORPORATION BETWEEN WALL STREET AND MAIN STREET

The distinction between owners and nonowners, and its central importance
for corporation law, is obscured for many corporation law scholars by the
widespread tendency to blur the distinction between the financial and the real
markets. Despite the attention paid to the financial markets over the last few
decades by corporation law scholars (and economists concerned with the corpo-
ration), and despite the dominance of finance as a way to understand the
 corporative structure, corporation law scholars generally conflate the financial
markets and the real markets. Such conflation is implicit in the hope that giving
managers equity (rewards determined by Wall Street) will make them better
managers of operating companies (improving their performance on, and benefits
to, Main Street). But there are distinctions between the financial and the real
markets, and it is the interplay between finance and operations that informs the
incentives for corporate management. Shares are financial instruments; sharehold-
ers and, to a great extent, managers are paid through such instruments. The
value of the incentives for shareholders (including managers) are, therefore,
determined on the financial markets and only indirectly by the real markets.
Understanding what this interplay between the financial and the real markets
means for management’s incentives is critical to understanding the problem for
corporation law theory posed by cases like Enron.

To be very schematic, the property interests of shareholders and managers—
shares and rights to shares—are legally defined interests in the governance and
assets of a company. It stands to reason that interests in a company with bright
prospects are worth more than equivalent interests in a company with a less
promising future. Share prices therefore are generally understood to be collective judgments on a company’s future business. To compensate a manager
through equity, or options to buy equity, ties the manager’s compensation
directly to his or her performance in managing the company.

This familiar logic generally takes insufficient account of an important
fact—namely, the existence of the financial markets. At least in publicly-traded
companies, equity, or options to buy equity, are not directly related to the company's operational performance at all. The prices for shares are set by trading on the equity markets, by supply and demand rather than by some independent correlation between share price and the actual performance of the company in the real economy. The incentives for shareholders and managers are thus directly matters of the financial economy and only indirectly matters of the real economy. Ignoring any distributions of dividends from retained earnings, shareholders and managers make money not because their company does well but because the company's shares achieve high prices. Managers have an additional interest in high share prices: If share prices are high relative to the earnings potential or asset base of the corporation, then the corporation is less vulnerable to takeover and the ouster of management. Assuming that managers respond rationally to incentives, the primary task of a company's management is to influence the perception of the company's stock on the stock market, to increase demand for the stock and hence its price. Managing the company's actual operations is important, but only insofar as success in the real economy contributes to esteem in the financial economy.

Managing the share price, as opposed to the company itself, is not a breach of fiduciary duty to shareholders. Shareholders only make money insofar as their shares are valued highly. And so it is important that General Electric, for example, is good at making business loans and light bulbs and jet engines and many other things, but it is more important that the financial markets appreciate just how good General Electric is at maintaining positive earnings, quarter after quarter.

Jeremy Siegel points out that the unrealistic expectations of future earnings, and hence the dramatic rise in share prices, would have been limited if investors had insisted on dividends. Siegel also points out that the absence of dividends is a relatively recent phenomenon, greatly encouraged by the tax code (which allows corporations to deduct interest paid on debt but not on dividends and also taxes dividends paid to individuals). Jeremy Siegel, Stocks are Still an Oasis, WALL St. J., July 25, 2002, at A10. Siegel's argument is nicely made but of limited application to this Article. First, investors who buy a security solely on account of its income stream are investing in debt. Owning equity (rather than debt) entails a bet on capital appreciation—value held in the company rather than paid out as a dividend. An old-fashioned stock that pays regular and substantial dividends thus splits the difference. Second, implicit in the back-to-dividends argument is a desire for equities that are solid and resistant to violent repricing. In the current economy, however, the most valuable assets of many companies are often quite soft—for example, brands, rights, or contracts. If the brands are sullied or the contracts dishonored, their value—and hence the company's viability—may disappear quite quickly, and shareholders take last from what monetizable assets may remain to the bankrupt estate. In such circumstances, it would be rational for shareholders to quickly reprice even a company that has historically paid regular dividends.

This is simply a restatement of the argument in Manne, Mergers and the Market for Corporate Control, supra note 50, and its progeny.

As Nobel laureate in economics George Akerlof recently put it, "When you give chief executives too much compensation in stock options, they concentrate too much on the stock price and there is a perverse incentive to raise the stock price..." Louis Uchitelle, Will a Deck of Options Always be Stacked?, N.Y. TIMES, Apr. 7, 2002, at 3:4.

As suggested above, shareholders may also be paid a portion of the company's operating profits, as a dividend, but this generally is a small portion of the value of a share.
Similarly, it may be to the benefit of shareholders, and therefore rational, for Enron to have lost real money on a transaction with a related party, if such a transaction allowed Enron to avoid consolidating certain debts that would reduce earnings or shareholders' equity in its quarterly reports. Most specifically, a related-party transaction that paid Enron CFO Fastow millions of dollars (a loss in the real market) but kept reported earnings up (earning much more money in the financial market) could easily be in the interest of shareholders, and therefore the company itself. This appears to have been what Enron's Board of Directors approved.  

A point of clarification is in order. Implicit in the idea of performance-based compensation is the idea that a corporation's share price, determined on the financial markets, accurately expresses the corporation's performance—a collective judgment about facts in the real world. For purposes of corporate governance, the important difference between the financial economy and the real economy has been ignored, or at least treated as if it were insignificant. This oversight may be due to a set of beliefs usually discussed under the rubric of the efficient market hypothesis, the idea that the price reflects the collective information about the object priced. Most such discussions center on whether price movements can be predicted—that is, whether, under what circumstances, and to what extent an investor can beat the market. The range of tenable positions on such questions is broad; the literature is voluminous. Many, perhaps most, corporation law scholars and economists are comfortable with the proposition that the financial markets are usually fairly efficient—that is, that sooner or later share prices will make sense vis-à-vis the operating business in question. For someone with this fundamental faith in markets, equity interests priced on Wall Street simply and accurately reflect how management is actually doing on Main Street. From this perspective, the idea that equity interests could be used to correlate management's compensation to the company's operational performance is very plausible.  

This Article makes no strong claim with regard to the efficiency of financial

297. GE has been criticized for its accounting practices—and doubts remain. See, e.g., GE Defends Integrity of its Data Reports, as Earnings are Due, WALL ST. J., July 12, 2002, at A2.

298. Cassidy has it almost right: "The most insidious aspect of executive stock options is that—especially in tough times—they give senior managers a strong incentive to mislead investors about the true condition of their companies." Cassidy, supra note 292, at 72. It is the market as a whole that needs to be misled—that is, potential investors (whether or not they hold stock), rather than current investors—so that current investors benefit, just like executives, as owners of desirable properties; equity or options to buy equity.

299. For an introduction to, and excerpts from, the literature, see RONALD J. GILSON & BERNARD S. BLACK, (SOME OF) THE ESSENTIALS OF FINANCE AND INVESTMENT (1993).

300. This point should not be overstated. Robust versions of the efficient capital markets hypothesis ("ECMH") have always been controversial, and support for them has waned in recent years. Indeed, Enron's stratospheric rise and fall—the Enron bubble—itself calls ECMH into question. See Jeffrey N. Gordon, What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections, 69 U. CHI. L. REV. 1233, 1235–40 (2002); see also Langevoort, supra note 276, at 136. That said, the idea of informational efficiency remains central to modern finance.
markets, provides no principled relationship between a company's fortunes in the real economy and its share price, and has nothing to say about price theory. This Article assumes only that markets are not very strong form efficient—that is, that inside information is not priced, that public disclosure affects stock prices, and that the relationship between the financial markets and the real markets is volatile—rather modest assumptions at present. Managers like Ken Lay have inside information and, unless one believes in the strong form of the efficient markets hypothesis, can make money by trading on it. That appears to be the recent experience.

However, it is a bit misleading to state this Article's assumptions in terms of the well-rehearsed arguments about efficient markets and to point out that, at least with regard to insider trading, crime does pay. Efficient market arguments typically are structured around the act of investment—the actions of players in the financial economy who have a plethora of easily executed choices. This Article, however, is concerned with the incentives for managers, players in the real economy, whose options are far more contextually constrained. The question at issue here is not the familiar one of beating the market and, by extension, how closely the market's perception (price) approximates reality. Rather, the question is how the play between the financial economy and the real economy informs the management and oversight of operating companies.301 Put differently, the law on insider trading has traditionally been concerned with profits made on secrets, true information the market does not yet know. But why try to learn (or protect) secrets if you can control what the market knows?302

If we turn our attention from investors to managers, we immediately notice two basic differences between the financial and the real markets: people and leverage. First, to generalize a point made above, the financial economy and the real economy are easy to distinguish sociologically. Financial analysts are not the people operating the business; Main Street is not Wall Street. If both shareholders and managers are paid by Wall Street, then the primary task of an operating company's management is to curry the approval of people in the financial community. Managers of publicly-traded companies are thus distracted from the nominal business—the real economy business—of the company. Enron's primary business was managing its earnings and controlling what the

301. It is true that managerial choices are sometimes understood as “investments.” Whether a manager should spend money on information technology or on R&D, for example, may be understood as an investment question. Such investments, however, are quantitatively and qualitatively different from the opportunities provided by investment across the financial markets.

302. For the philosophically minded, the traditional, orthodox understanding suffers from a dualism familiar from (perhaps descended from) caricatures of Cartesian science: Objects exist and are contemplated, perhaps even evaluated, by disinterested minds. Investors “know” about the markets and their knowledge is expressed through the language of price. To pun on Rorty, we too often discuss capitalism as if the financial markets were, in fact, a mirror of society, rather than a constitutive mechanism. See Richard Rorty, Philosophy and the Mirror of Nature (1979).
markets knew about its operations.³⁰³

It is true that financial markets often discipline company managers, as corporation law scholars have remarked at least since Manne. Disciplined management, however, need not necessarily mean management that actually attends to its operations in the real economy. What disciplined management means is that management responds to the concerns of the financial markets. Such catering may or may not involve running the business well. After all, players in the financial markets do not care about the actual products of a given company; they wish to make money. Sticking to one’s knitting is not the only way to make money. Indeed, few financial market participants knit—that is, focus on the performance of an activity in which they have a competitive advantage; instead, they trade.

Second, to generalize another point already made with regard to Enron, shares generally trade at a multiple of a company’s earnings, often a very high multiple. Thus, a dollar on an earnings statement may mean many dollars of shareholder value. An extra dollar of reported earnings can mean that shareholders, and therefore managers, make many more dollars. The converse is also true. For example, Enron’s announcement of October 16 erased millions of dollars of reported earnings and $1.2 billion dollars of shareholders’ equity, but—even restated—Enron was a huge company with a great deal of income.³⁰⁴ Nonetheless, Enron’s share prices plummeted, destroying tens of billions of dollars of market capitalization. In short, relatively small movements in the real economy can mean enormous movements in the financial economy. The financial markets are levers.

If shares are property and management is to act to benefit shareholders by increasing the value of their property, then a dollar of company money spent to manage the perception of the company on Wall Street can be a great investment. Through the magic of the financial markets, money spent to manage earnings—producing glowing reports of success in the real economy—can be returned many fold to shareholders through increases in the price of their shares. Publicly-traded companies are thus in a position analogous to that of retail companies; profitability is dependent on the management of perception. In retail, the management of perception is called advertising; in finance, it is called earnings management. But whereas advertising generally is intended to influence the public perception of a company’s products, thereby boosting sales,

³⁰³ In a humorous “memo” addressed to a corporate board, Daniel Akst lays out much of my argument with more wit (and brevity) than scholarship seems to allow:

So what [chief executives] want more than anything is stock—lots of it . . . . This is called ‘aligning management’s interests with those of shareholders,’ and it’s crucial to helping chief executives understand the complicated principle that you’re not just in business to make money—that the real goal is to raise the stock price. Otherwise, who knows what kind of silly agenda they might follow?


³⁰⁴ For example, in its 8-K of November 8, 2001, Enron reported a net income of $847 million for the year 2000, rather than the $979 million previously reported. Form 8-K, supra note 9.
management of a publicly-traded company is incentivized to influence the perception of a company's securities, thereby boosting demand for such securities and the compensation received by managers. Here again there is a certain distraction, a certain emphasis on the financial at the expense of the real.

The Powers Report repeatedly remarks that certain related-party transactions make little or no "economic" sense but do make sense insofar as such transactions allow Enron's accounting to look better. On such transactions, Enron lost money. Moreover, Enron paid exorbitant sums to SPEs, in part due to the intervention of Enron employees on the SPEs' behalf. Enron often paid its own employees for doing business against Enron. Such payments are widely referred to as conflicts of interest, and they may be. But the question is not as simple as the Powers Report implies. The conflict of interest charge assumes that Enron's business was trade in energy (and water and broadband), full stop. But here it is important to be more precise: Enron's managers and other shareholders became wealthier when Enron's share price increased, making their shares and options more valuable. Enron's purpose was to make its shares more valuable; its sundry businesses were merely means to that end. Consequently, for Enron's management to lose money in the real economy in order to make (or to protect) many times more money in the financial economy could be an entirely rational economic decision, and proper in the sense of being in the interest of shareholders—at least as rational and proper as money spent on advertising.

But this is not just the perspective of an Enron shareholder; it is the perspective of any shareholder in a publicly-traded company. For managers and other shareholders of publicly-traded companies, accounting is the real business, because through reporting on the real economy (accounting), the company's prospects are multiplied, and shares are assigned a price by the financial markets. Insofar as a company is considered as a set of property entitlements (shares), rather than operations (the business), and insofar as shares trade at a price/earnings (P/E) ratio greater than one, then the need to manage perceptions in the financial marketplace will always trump "real" business considerations. Rephrased, managers and other shareholders will always have incen-

305. "Many of the most significant transactions apparently were designed to accomplish favorable financial statement results, not to achieve bona fide economic objectives or to transfer risk." Powers Report, supra note 7, at 4.

306. See supra Part I. The Powers Report notes that "the LJM Partnerships made a profit on every transaction, even when the asset it had purchased appears to have declined in market value..." Powers Report, supra note 7, at 134.

307. See, e.g., id. at 156; Enron Report, supra note 1, at 24–39.

308. The windup of LJM1 certainly appears to have involved self-dealing. See supra notes 140–41 and accompanying text.

309. See McLean, supra note 56 ("[L]ike Enron's management, investors cared only about the stock price too. And as long as Enron posted the earnings it promised (and talked up big ideas like broadband), the stock price was supposed to keep on rising—as, indeed, it did for a while.").

310. Enron traded at a P/E of 70/1. Id.
tives to get the best price for their shares, even if they have to damage the operating business in order to do so. And here again we sense a certain distraction—from the perspective of its shareholders, Enron was about finance, not energy or broadband. More generally, from the perspective of their shareholders, publicly-traded corporations are about finance, not business. Enron is merely a case of excess, an overdose of a widely-used drug.  

E. THE CAPITALIST PUBLIC AND THE CANCER OF FINANCE

Is this troubling? Enron’s management made mistakes, some of them quite possibly criminal, but their mistakes are ultimately more understandable as efforts to fulfill, rather than violate, the core precept of orthodox corporation law, which is to maximize shareholder value. Enron’s management did not abscond with the company. On the contrary, until the crash, Enron’s successes were truly spectacular. Enron is theoretically troubling, but ultimately it is problematic for reasons that have little to do with the conventional understanding of the internal drama of the corporation and everything to do with our understanding of the purposes that corporations and financial markets should serve. Enron is problematic not because shareholders were abused but because managers, on behalf of shareholders like themselves, deceived the financial markets designed to govern them. Enron’s management used the distinction between the real and financial markets to divert billions of dollars to its company that would have been better employed elsewhere. Enron dramatically demonstrates how financial markets create incentives (options) and mechanisms (financial statements) that undermine the market’s capacity to govern well. Financial capitalism, like a cancerous body, supplies the instruments of its own corruption.

That finance is capitalism’s cancer may be counterintuitive for both fans and critics of shareholder capitalism, and so a point of clarification may be useful. Among those who believe in shareholder primacy, shareholders are generally understood to be proxies for the public. Unsurprisingly, this view appears common among (or at least it is commonly voiced by) participants in the financial markets, whose consumers generally are shareholders, and by market regulators, who are traditionally concerned for the individual investor. Since shareholding has become more widespread in the last few decades, and especially as retirement savings have moved from defined benefit to defined contribution plans, thereby transforming the middle class into equity market participants, the equation between the shareholder and the public has become more understandable. That said, the shareholder qua shareholder, an investor, has an interest quite different from that of the public.

311. Varying time horizons may provide a possible distinction between earnings management in a company like Enron and a company like General Electric. Certainly one could imagine that some of Enron’s management knew that Enron’s positions could not hold. Assuming they accepted the inevitability of the firm’s collapse, their best strategy would be to pump the stock’s price as high as possible and to cash out as the price crested. Again, however, the actual subjective intention of Enron’s personnel is not the topic of this Article.
For many years, publicly-minded corporation law scholars have been critical of shareholder capitalism and have been concerned with stakeholders other than shareholders, notably employees and "the community," especially the local community in which a corporation conducts its business. While often important, "stakeholder" is not what I mean by public. Stakeholders are not the public precisely because they are stakeholders. A corporation's employees, or its neighbors, have direct relationships with and interests in the corporation and what it does. Such interests may be in conflict with those of shareholders, and one may be concerned that such conflicts are well resolved. One may even think that a public resolution—for example, legislation, regulation, or adjudication—of some of these conflicts is appropriate. That said, conflicts between a corporation's shareholders and other stakeholders result from interests directly held by stakeholders because of their relationships to the corporation, their own "stakes." Stakeholder interests are thus particular and are, in that sense, private.

In a second, and more common, understanding of the term, "the public" as consumers has interests in tension with the interests of shareholders. Consumers are interested not in the company itself but in what the company provides to the real economy. Most of us depend on companies like Enron to ensure that energy is delivered to homes, businesses, and factories, so that we can heat, cook, run lights and computers, manufacture, and so forth. It is obvious—but strangely missing from the corporation law thinking of academics for the last few decades—that a consumer's interest in goods and services is quite a different thing from a shareholder's interest in the share price. Consumers want goods and services cheaply; shareholders want the investment community to desire their shares and bid the price up. These desires are quite different from one another and the relationship between them is hardly congruent.

Indeed, shareholders have an interest that is generally in opposition to that of consumers. Success in the financial economy means that capital is returning a great deal on investment; this usually implies that profit margins on retail sales are high, which generally means that retail prices are also high. Consumers, however, are interested in getting real goods and services cheaply—that is, they

312. The literature is voluminous. The classic piece is E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustee?*, 45 Harv. L. Rev. 1147 (1932). More recent contributions include Kent Greenfield, *Ultra Vires Lives! A Stakeholder Analysis of Corporate Illegality (With Notes on How Corporate Law Could Reinforce International Law Norms)*, 87 Va. L. Rev. 1279 (2001); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 Tex. L. Rev. 579 (1992); Lawrence E. Mitchell, *Cooperation and Constraint in the Modern Corporation: An Inquiry into the Causes of Corporate Immorality*, 73 Tex. L. Rev. 477 (1995). For a somewhat different take and overview, see Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)*, 53 Bus. Law. 429 (1998). As these titles may suggest, however, the stakeholder discussion, and the hostile takeover defense and corporate constituency statutes that are the legislative expression of these concerns, again recall the traditional structure of corporation law. In the stakeholder discourse, the issue remains the role of the directors and whose interests they should protect. The point of this Article is that corporations, and capitalism, pose interesting questions even if directors do their jobs very well.
are interested in low profit margins and thus a low return on capital. Classical economics relies on competition to keep prices, and hence profit margins and the return on investment, low. In competitive markets, the public benefits to the cost of the investors. Conversely, in anticompetitive markets, profit margins are high (companies can extract monopoly rents), and so the return on investment is high. Monopolies, if they can be defended, are good investments, vide Microsoft.313

By the “public” interest in capitalism, however, I mean something even more explicitly political than the aggregate of consumers. I mean something akin to the idea, familiar from thinking about republican democracy, of the citizen. Quite independently of our private interests in obtaining a particular consumer good, we might wish that society were well-governed. We also might believe that a host of social questions are best resolved through a system of financial capitalism not entirely unlike the current American system.314 More specifically, we might hope that financial markets would foster the realization of good ideas, help good companies prosper, and discipline bad companies. We might, at least in some circumstances, understand as a political ideal what market cheerleaders—for example, the editorial board of The Wall Street Journal—claim we already enjoy: the well-functioning market. The principled interest in such markets is what I mean by the public interest in capitalism.

The public, understood in this manner, has interests quite at odds with those of shareholders, a conflict dramatically demonstrated by Enron. While the public has an interest in well-functioning markets, shareholders are interested in the demand for their property rights to the company. The public is interested in a kind of truth: that social choices be well made. Shareholders, in contrast, are interested in a desire; hence the analogy between earnings management and advertising. In this tension between the public’s interest and the interest of participants lies the fundamental political problem for capitalist societies: the plausibility of pricing. Do we, the public, believe that a given company is relatively well priced—that is, the company is being rewarded because it is in fact a good company performing well in a competitive environment? Or do we believe that a company’s price reflects a set of embedded lies or other distortions in the market? If we believe the latter, then that particular market has become implausible for us, and in that sense, inauthentic and corrupt (and insofar as change is unlikely, that company is probably a good investment).


314. One need not (should not) go as far as Lay, who claimed to be “passionate about markets.” The Amazing Disintegrating Firm—Enron, ECONOMIST, Dec. 8, 2001, at 61.
F. POSTMODERN CAPITALISM: ACCOUNTING AS RHETORIC

This question can be rephrased as a conflict over the credibility of financial disclosures or, more broadly, accounting. From the perspective of the corporation’s management, financial disclosures are inescapably a form of self-presentation and therefore intrinsically self-interested. From this perspective, accounting is a form of rhetoric, like courtroom lawyering. This is not necessarily bad; it is simply the situation from which such communications are made. From the perspective of a capitalist public, however, information about the company must be true, or else the company cannot be priced effectively and capitalism loses its appeal as a system of social ordering. Capitalists cannot sustain the belief that financial reporting is mere advertising—that there is no distinction between Wall Street and Madison Avenue. A central problem for postmodern capitalism is how to maintain a language that simultaneously is understood to be self-interested and in that sense unprincipled, but that must be used for public ends and therefore must be principled.

While understandable, recent outrage over “cooking the books” obscures the nature of the problem. Such talk implies that a company’s financials should simply be true. If the financial statements are not true, then the company has lied (“cooked the books”), or has made a mistake (is stupid). But while the evasive character of language, including accounting, does not make lying or stupidity impossible, a focus on lying and stupidity may cause the evasive character of language to be overlooked. Language is more than “true” or “false,” and when it is spoken by those who have clear incentives, we should expect a slant. Understanding accounting as a form of advocacy does not mean anything goes, but instead means that even good accountants are not expected (or allowed) to determine “the reality” of a company’s situation. The political question, then, is how to arrive at a collective truth (price a company, for instance), in spite of the foibles of our communication—such as the optimistic and self-serving perspective from which a company’s financials are written.

At a philosophical level, the problem is not new but is instead intrinsic to political uses of language, to any situation in which language requires trust in

315. Bernhard Grossfeld has a similarly linguistic understanding of law and accounting, but focuses on the competition between lawyers and accountants. See Bernhard Grossfeld, Lawyers and Accountants: A Semiotic Competition, 36 WAKE FOREST L. REV. 167 (2001). Grossfeld suggests that at its deepest levels, the competition between the professions reflects differences between numerical and linguistic ways of appropriating reality. Thus, in contrast with the present article, Grossfeld sees law as fundamentally different from accounting. While some of the examples and details of Grossfeld’s argument come off as a bit naive in light of post-Enron understandings of what accountants do, Grossfeld’s basic argument remains very provocative. On balance, however, I think Grossfeld, like many humanists, believes accounting is about numbers, which he takes somewhat too seriously, and therefore he overemphasizes the differences between lawyers and accountants.

316. Over the last few years, courts have sanctioned a considerable amount of optimism in prospectuses. Whether this trend will continue in light of Enron is, at least in the short to medium term, doubtful.
the face of interest. The problem is especially familiar to lawyers—legal ethics courses seem to be comprised of little else—who wrestle with the tensions between zealous advocacy of a client’s (private) interest and the court’s (public) interest in discovering the truth. What is a little odd is that accountants, perhaps relying on the somewhat mystical authority of numbers, or perhaps on the epistemological backwardness of economists, or perhaps simply unwilling to call attention to the conflicts of interest that run through their profession, have been so slow to recognize how problematic their enterprise is. The accounting reforms that Enron and subsequent scandals have spawned, however, should make it obvious both that accounting is advocacy—that is, it is less principled—and that accounting is central to pricing—that is, it is more politically vital—to a greater degree than has heretofore been recognized.

For the sake of clarity, this Article has argued that earnings management is a universal practice among publicly-traded companies. That simplification misleadingly suggests that companies could stop managing earnings and speak the unvarnished truth. It would be more correct to say that while accounting is a form of advocacy, there is good and bad advocacy. Some litigants handle themselves well and some do not. Just as we may make distinctions among things said in the courtroom, we may make distinctions among financial accounts. We can distinguish between Enron’s accounting and the accounting of any number of other companies, ranging from companies whose financials have been criticized but which are widely reckoned fundamentally sound, to companies whose presentations of themselves are as honest as they can be—which remains different from being true. The question is not true or false, but how far is too far? How aggressive is too aggressive?

Such distinctions are essentially matters of culture. A cynical old saying goes that employees are expected to pilfer from the till up to the wrist, but not up to the elbow. Social life requires such lines—limits on the extent to which a community will countenance the fulfillment of self-interest. Professional organizations, whether of lawyers or accountants, serve to articulate such lines, to make it clear to practitioners where the lines are and to punish those who cross them. The Enron case provides numerous instances in which the rules were unclear; therefore, practitioners did not know where the lines were, and, far from punishing infractions, the profession provided substantial incentives to bend the rules. Accounting has failed to fulfill its political function as a profession and is in that sense unhealthy. Reform is overdue.

318. Larry Cunningham has argued for a renewal of lawyers’ interest in accounting. See Lawrence A. Cunningham, Sharing Accounting’s Burden: Business Lawyers in Enron’s Dark Shadows, 57 BUS. LAW. 1421 (2002). Accountants may ultimately learn more from the encounter than lawyers.
319. I owe the saying, and its application here, to Jack Schlegel.
320. For an historical account of and a fairly radical attack on the current structure of the industry, see Sean M. O’Connor, The Inevitability of Enron and the Impossibility of ‘Auditor Independence’
However, a reformed practice of accounting will not solve the problem of fair pricing once and for all, any more than the legal profession has somehow solved its analogous problem of justice for litigants. Such problems are not to be solved. The tension between truth and interest may be managed by appropriate institutions, but there is no reason to believe that a more sensible understanding of corporation law, fully conscious of accounting as a political language, can ever lay to rest the suspicion that interest has corrupted, or at least obscured, the truth. A paradigm shift in corporation law may happen, but one would have to be somewhat naive, a true believer by nature, to be overly excited about the possibility. The spectacular errors of the last few years should have raised in all of us, not just Ken Lay, the anxiety that we are knights gone somewhere astray, and there is no reason to believe we have found our way yet, or ever will.

G. SUMMARY OF THE ARGUMENT

This Article has argued that Enron might occasion a paradigm shift for American corporation law scholarship. If it does, we might expect the new paradigm to differ from the old in the following ways. Within the new paradigm:

- The conception of the corporation as a nexus of contracts is limited by the requirements of accounting and finance;
- Among the fundamental legal institutions that comprise the corporation, property is worthy of more attention than it has latterly received, at the expense of contract;
- Corporation law reimagines itself as public law, concerned with the public role of the corporation as a whole, rather than with private conflicts of interests among actors within the corporation;
- Incentives for management and shareholders are analyzed in terms of the distinction between, rather than the conflation of, the financial and real economies;
- The old metaphysical debate over how efficient—that is, how accurate—are prices paid by investors is transformed into a more practical discussion of the incentives that financial instruments create for managers, and hence, for the real operations of businesses;
- The distinction between the financial community and the business community requires attention. The financial community is no longer tacitly assumed to be the business community;
- Attention is paid to the possibilities for managers to use the financial economy to leverage the results of their operations;
- The public is understood in ways derived from capitalist theory itself;

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Under the Current Audit System (2002) (unpublished manuscript, on file with the University of Pittsburgh School of Law).
Shareholder interests are understood to be distinct from, and often antagonistic to, the public interest;
Accounting is understood as rhetoric, like legal argument;
Ultimately at stake in corporation law is the degree of credibility—and hence authority—achieved by a market in a given time and place.

Or maybe not.

CONCLUSION: TOWARDS A REIMAGINATION OF CORPORATION LAW

Odd as it may sound, in important senses capitalism—considered to be a system of social ordering—has been rather peripheral to corporation law scholarship in the Twentieth Century. One might go even further and argue that in the Twentieth Century, for all the importance of corporations to American society, corporation law was essentially private in character and became more so as the century progressed. The public aspects of corporation law were acknowledged but generally understood in opposition to market forces. Moreover, the public aspects of corporation law increasingly have been marginalized or have been exiled to regulatory courses like labor or environmental law.

The early Nineteenth Century, in contrast, understood the corporation as a means for the state to accomplish certain economic goals, including fostering markets. The canonical statement of this view is Chief Justice Marshall’s in the Dartmouth College case, in which Marshall explicitly understands the corporation’s legal status to be a function of its incorporation—that is, as an expression of the state. In the course of the Nineteenth Century, however, as corporations became the ordinary way of doing business, the explicitly governmental function of the corporation—embodied in the legislature’s grant of the corporate charter—became less significant. In the terms of modern legal scholarship, “concession” theories of the nature of the corporation became less compelling, not so much because they were wrong, but because they explained so little of corporate life.

At least since the late 1920s, when John Dewey demolished the so called “real entity” theory of the corporation, and Berle was writing the articles that in 1933 became The Modern Corporation and Private Property, the focus of corporation law has been on the drama among corporate actors. Corporation law has come to be understood as an inquiry into relations within the corpora-

321. Trs. of Dartmouth Coll. v. Woodward, 17 U.S. 518, 562 (1819). Marshall is clear, however, that the corporation is not an agent of the government. Id. at 616–17.
322. See Dewey, supra note 48. The real entity theory may be described as the impulse to see the corporation, and other civic bodies, as social organisms in their own right, entities which are distinct from the interests of the people who participate in the corporation. Dewey argued, very pragmatically, that for the purposes of law and policy, the question was not what the corporation was, but what the practical effect of legislating one rule, as opposed to another, would be.
323. See Berle & Means, supra note 49; see also Schwarz, supra note 51, at 55–59 (discussing intellectual development of The Modern Corporation).
tion, more micro than macro, more private than public. Since Henry Manne and the triumph of law and economics approaches to corporations, this preference for the internal over the external has only increased. Indeed, contemporary corporations scholars have minimized the public character of the corporation by understanding state statutes of incorporation—the remnants of the old grant by the legislature—merely as laws of general applicability that provide default provisions. The parties are generally free to alter such provisions by contract, and a lively debate has ensued over what, if any, corporation law ought to be mandatory. As early as 1962, Bayless Manning could argue that corporate law, as an area of substantive public law, had ceased to exist.

Even when understood as the legal articulation of relations within the corporation, however, corporation law has been thought of as politically important. Certainly both Dewey and Berle, to say nothing of early reformers like Brandeis, were concerned with the concentration of vast economic and hence political power in the hands of corporate managers. The possibility that the American corporation might be the legal mechanism through which American republican democracy degenerated into oligarchy has been an abiding concern of academics over the ensuing decades. Less dramatically, generations of scholars have argued that in light of their prominence in social life, corporations have a political responsibility that extends beyond the triumvirate of shareholders, managers, and directors to other “stakeholders” and ultimately to the community itself.

However, such political concerns generally have not been addressed through market mechanisms. Politically engaged corporation law scholarship has tended to shy away from market modes of governance. Three broad examples should make this point clear. First, the corporation’s responsibility to the broader community has been thought to require a rule allowing managers and directors to make donations to charity. Yet courts and legislatures have, by and large, allowed such donations only insofar as the company can show that the donation will in some way benefit shareholders. Similarly, explicitly political concerns have been thought to require various reforms to corporate governance structures rather than setting forth substantive public policy. On this view, the point of corporation law is to provide, by relatively efficient statute, a template embodying the outcomes most parties would have reached under conditions of perfect contracting. “The corporate code in almost every state is an ‘enabling’ statute.”

324. In the jargon, corporation law has come to be seen as enabling the activities of private actors, rather than setting forth substantive public policy. On this view, the point of corporation law is to provide, by relatively efficient statute, a template embodying the outcomes most parties would have reached under conditions of perfect contracting. “The corporate code in almost every state is an ‘enabling’ statute.” Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 Colum. L. Rev. 1416, 1417 (1989); see also John C. Coffee, Jr., The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role, 89 Colum. L. Rev. 1618 (1989).

325. Manning, supra note 36, at 245 n.37.

326. For a recent expression of this anxiety, see Paul Krugman, For Richer, N.Y. Times Mag., Oct. 20, 2002, at 62.

327. See supra note 312.


that would allow shareholders more "voice"—that is, many academics and other commentators have believed that the political significance of corporate action requires shareholder democracy. Again, courts, legislatures, and the SEC have not been entirely deaf to such arguments and allow corporations to function in some ways as if they were private legislatures. At the same time, shareholder democracy—beyond voting as instructed by the incumbent board of directors—is hardly the mainstay of corporate governance. Nor can it be argued that contests for the control of corporations are resolved in an essentially democratic fashion. For a third example, continuing with the idea of corporate control, courts and anti-takeover statutes have allowed the board of directors, in considering a potential takeover of their corporation, to consider interests of stakeholders other than the shareholders. In each of these examples, efforts have been made to realize political concerns through some mechanism other than the price mechanism.

Although they have received great, even inordinate, attention from legal scholars who wish to make public policy through corporation law, these efforts have resulted in very little positive law. None of these efforts to make corporations responsive to the broader polity is central to the governance of corporations today or in the foreseeable future. None of these political concerns have much impact on the practice of corporate lawyers. To be blunt, much progressive twentieth-century legal scholarship has treated the corporation as if it were a republican government. But the corporation only rarely and superficially bears any resemblance to such a government, and so such scholarship is rarely relevant to business life, which is largely, if not exclusively, governed through the price mechanism.

Law and economics scholars have argued that corporate actors should be allowed to contract freely, that such contractual freedom tends to produce


331. See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). Such exceptions, however, tend to prove the rule. First, the legal discretion of boards to think of persons other than shareholders is limited to extraordinary circumstances. As a practical matter, and more importantly, boards of directors are disciplined by the fact that shareholders can vote for directors, and presumably they will vote for directors that best represent shareholder interests. As Henry Manne pointed out in Mergers and the Market for Corporate Control and elsewhere, the market for directors serves to limit the ability of directors to serve interests other than shareholder interests. Manne, Mergers and the Market for Corporate Control, supra note 50. To compound the matter, many institutional shareholders—for example, pension fund managers or mutual fund managers—are themselves legally bound to seek the interests of their shareholders. Indeed, even though the interests of stakeholders other than shareholders receive some mention, far more central to the takeover jurisprudence of the most significant jurisdiction for corporation law (Delaware) is the requirement that directors act in the best interests of shareholders, even holding an auction if necessary. See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

332. Traditional non-market interventions can be understood to change property entitlements or other aspects of the context in which market activity takes place and thus, in an indirect sense, as market reforms. But the point of this Article is to urge that we consider markets directly.
efficient outcomes, and that efficient outcomes are good for both individual firms and society as a whole. This, however, is not much of a political argument either; such gestures toward efficiency are generally just that—gestures. Efficiency is equated with free contract, and within competitive markets only efficient companies are expected to survive. Therefore, contemporary corporations, the products of a Darwinian winnowing, must have the structure that the parties, were they perfectly informed, would choose ex ante. The policy prescription is simple and clear: Because the conditions for perfect contracting already exist, no governmental intervention is necessary. Microeconomics, a concern for relations within the firm, thus substitutes for political thought, a concern for how the firm participates in its society. The substitution is underwritten by the general faith, familiar since Mandeville’s Fable of the Bees, that individual pursuit of self-interest will further the common good and therefore is not only permissible but desirable politically. The gesture towards efficiency thus stands in for—and precludes—actually thinking about the nitty-gritty political question of just how a given market benefits society writ large.

Few corporation law scholars have been willing to go so far, to argue that there is no need for corporation law, that contract takes care of everything. In particular, parties to a contract, such as shareholders, may have difficulty monitoring the performance of the other parties, such as management. Law and economics scholarship has attempted to address the conflict between owners and managers—now understood as an “agency problem”—through the creation of proper incentives. Such scholarship presumes that our sympathies lie with shareholders, perhaps under the belief that what is good for shareholders (lowering their monitoring costs) is good for society as a whole, the public. But, as Adam Smith famously recognized about competing firms, there is no reason to believe that two self-interested parties will not contract to collude against the public; shareholders and managers whose interests are aligned have every incentive to pump their stock. At the very least, there is no reason to assume, with much contemporary corporation law, that if the micro questions are addressed properly—if shareholders and managers can contract freely—then the macro situation will take care of itself. Such scholarship is not seriously

333. See Bratton, supra note 268, at 1478–80 (discussing scholarship drawing on seminal work of Alchian and Demsetz).
335. Smith’s view was rather bleak:

People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices. It is impossible indeed to prevent such meetings, by any law which either could be executed, or would be consistent with liberty and justice. But though the law cannot hinder people of the same trade from sometimes assembling together, it ought to do nothing to facilitate such assemblies; much less to render them necessary.

concerned with politics. To overstate for the sake of clarity, corporation law scholarship over the last few generations has lacked an adequate political economy. The political—in the sense of socially concerned—approaches to corporation law (associated with the “left”) have not been capitalistic, and the economic approaches to corporation law (associated with the “right”) have not been self-consciously political. Enron could teach scholars on both the left and the right to pay attention to the requirements and political consequences of the price mechanism. Rephrased, Enron should inspire scholars to understand the corporation in terms of a capitalist political economy.

For those on the left, concerned with the importance of corporations to society as a whole, Enron exemplifies the by-now obvious fact that publicly-traded corporations are governed through the price mechanisms of the financial markets. Any serious political theory of the corporation, then, has to take account of, and probably operate through, the price mechanism. Things like shareholder democracy and eleemosynary impulses by management are not what makes the corporate world go round. Money does.

At the same time, Enron also demonstrates that the focus on individual contracts that has dominated corporation law on the right for the last several decades is politically naïve. The alignment of incentives—solving shareholders’ agency problems—need not result in sensible markets at all. Under modern corporate governance schemes, management and shareholders have congruent interests in high stock prices. A high stock price, however, is not synonymous with a good company or with a socially optimal allocation of resources or, to put the matter in baldly political terms, with good governance. Solving the microeconomic problems—sorting out the relations between shareholders and management—does not mean that the macroeconomic situation will take care of itself. Corporation law scholars on the right should again confront the question traditionally associated with securities regulation: How do we build markets worthy of trust?

The traditional securities law notion of confidence in the markets, however, is only the tip of the political iceberg. With its focus on the separation of ownership and control—that is, agency problems—corporation law has overlooked even more fundamental distinctions. Shareholder value is not defined by the actual success of a given company in the real economy, much less by service to the public. Shareholder value is defined by the perception, in the financial markets, of that company’s likelihood of future success—in part, its ability to take from the marketplace. Not only are reality (value) and perception (price) not the same thing, and not only are financial markets not the same thing as the real markets, but our public ends for the corporation (service), are usually

336. It must be remembered, especially in the ivory tower, that there are other worthy, perhaps even more worthy, concerns than politics. But legal scholars, at least in the United States, tend to understand themselves in political terms.
antithetical to the shareholder’s purpose for the corporation (profit). Traditional corporation law scholarship has made an entirely understandable compound error, indeed an error of capitalistic faith—that is, corporation law scholars have blurred distinctions between reality and perception, between the real and financial economies, and between service to the broad public (erroneously reduced to “efficiency”) and the profit of those within the corporation. If the task is designing corporate governance structures so that companies serve us better than Enron and others have, we should try to avoid such confusions.

I rather doubt, however, that institutional design is the task at hand. It is not clear that academic corporation law has had much influence on the institution of the corporation in the United States or worldwide. Quite apart from the ability to influence policy, however, there are sound reasons for thinking as clearly as we can about corporation law. If we were to pick up Manning’s challenge and attempt to be about something, academic corporation law scholars could do worse than confronting central political questions of capitalism on their own terms, neither eschewing markets on moral grounds nor claiming the authority of science for political positions. One way to start a capitalist inquiry into corporation law would be by asking whether and in what sense we thought prices in a given market were, or could be, truthful. From such a perspective we could begin to ask ourselves the extent to which a society founded on price is worthy of obedience, loyalty, or affection.

Or we can just hang the horse thieves and carry on as before.

337. For more on my doubts that politics is likely to redeem scholarship, see David A. Westbrook, Pierre Schlag and the Temple of Boredom, 57 U. MIAMI L. REV. 649 (2003).