Teaching Enron

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TEACHING ENRON

Milton C. Regan, Jr.*

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* Professor of Law, Georgetown University Law Center. My thanks to Vic Fleischer for comments on a draft of this article, and to Bill Bratton for his review of the description of selected transactions. I am also grateful to Jeff Bauman for comments and advice as I have taught classes based on the events surrounding Enron, as well as for countless conversations about ethics issues that arise in corporate law practice. A short discussion of some of the transactions that I analyze in this article is contained in Chapter 20 of our casebook, Legal Ethics and Corporate Practice (Milton C. Regan, Jr. & Jeffrey D. Bauman eds., 2005).

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INTRODUCTION

The word “Enron” has become a shorthand reference for corporate wrongdoing in the first years of the twenty-first century. Aside from the dizzying heights from which it fell, Enron was notable for the intricacy of the misbehavior in which it engaged. “‘Every other white-collar case in history is arithmetic,’” commented one investigator, while “‘Enron is calculus.’”1 The company created elaborate organizational structures, often with multiple layers of control, that were intended to use legal form to disguise economic substance.

Such manipulation of form obviously required the services of many lawyers. Transactional lawyers in particular have expertise in fashioning elaborate permutations of form that the law will honor, even if the result is not entirely congruent with underlying economic substance.2 It is reasonable therefore to assume that lawyers’ fingerprints were on Enron’s arrangements perhaps more than in any other recent corporate scandal.

Enron thus would seem to have especially valuable potential as an instructive case study for lawyers and law students. In particular, it promises to offer insights into the kinds of judgments that transactional lawyers must make—a group largely neglected in ethics rules and whose

2. A “triangular” merger, for instance, is an arrangement in which an acquiring company creates a new subsidiary to which it transfers its assets in return for all of the subsidiary’s stock. The boards and shareholders of the subsidiary and the acquired company then approve the merger of the two entities, thereby avoiding what otherwise would be the requirement that the merger be approved by the original acquiring company’s shareholders. Similarly, corporate subsidiaries may be substantively controlled by a parent company, but still treated formally as separate entities for certain purposes. A “synthetic lease” enables a company to sell and then lease back its assets, continue to operate exactly as before, but remove the debt associated with those assets from its books. The list is limited only by the imaginations of corporate lawyers and business professionals.
activities generally are shielded from public view. Much of the commentary on Enron’s attorneys has focused on whether these lawyers violated ethical rules or other legal provisions, and on how the law governing attorney conduct might be strengthened to prevent future transgressions.  

This commentary generally has been thoughtful and valuable as far as it goes. The application of legal rules, however, is triggered by the existence of certain facts—and the perception that these facts exist is the result of a complicated process. As Geoffrey Hazard has observed, “The difficult ethical problem . . . is not . . . what the rule says but whether the factual conditions have arisen that call the rule into operation.” This suggests that we may gain particularly rich insights into the complexity of ethical judgment by trying to understand circumstances as lawyers themselves may have seen them. Proposed transactions do not come labeled as problematic and intricate legal structures are rarely obviously fraudulent. Those characterizations are conclusions that are the product of a complex process of perception that organizes information in particular ways, based on factors such as situational cues and personal predilections. Behaving ethically requires cultivating powers of perception that are sensitive to and recognize events that carry ethical significance.

Gaining an appreciation of the circumstances in which a given set of lawyers operated can be difficult, because it requires access to details about the texture of practice that often are unavailable. In the case of Enron, however, the bankruptcy court appointed an Examiner to review many of Enron’s transactions for the purposes of determining what assets might be recovered by the company’s estate and whether Enron might have causes of action against any individuals or entities. In response, over the course of more than a year, the Examiner provided an extensive multivolume analysis of certain major transactions and the conduct of the people who helped create and implement them. Of particular interest, the Examiner’s final report contains an appendix that discusses possible causes of action that

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Enron might have against its inside and outside legal counsel, along with potential defenses to these claims.

The Examiner's reports constitute one of the most detailed accounts available of the activities of transactional lawyers as they worked on matters that later were deemed fraudulent, in some cases criminally so. The aim of this Article is not to evaluate the case for these attorneys' liability. That would require even more facts to which I do not have access. Rather, the goal is to try to imagine the world as these lawyers may have seen it at the time the events unfolded. What influences shaped their perception of what was occurring? To what situational cues were they sensitive or blind, and why? How might they have interpreted information that in retrospect seems incriminating? What precisely does it mean, in other words, to say that Enron's lawyers "blessed," "sign[ed] off," or "approved" the company's transactions? Are these conclusions consistent with how the flow of events unfolded?

Ideally, addressing these questions will shed light on broader issues. When are circumstances likely to suggest that an ethical question has arisen? What kinds of factors enhance or obscure the ability to recognize this? What rationalizations tend to be available in what circumstances that provide reassurance that nothing is amiss?

What follows is a discussion of several transactions that the Examiner analyzed for the Enron bankruptcy court. These represent only a portion of the many transactions that the Examiner analyzed, but constitute a large number of the transactions with respect to which he focused on the conduct of attorneys. In most of these cases, the Examiner found that Enron's lawyers potentially could be liable to the company under various causes of action. In some instances, the Examiner did not find potential liability. These transactions are included in my discussion, however, because they can be used to explore certain ethical issues that can arise in transactional practice.

The Examiner sometimes provides enough detail that it is possible to construct a tentative description of how things may have unfolded as they did. In these instances, the deals have particular pedagogical value by providing an opportunity to identify and discuss why lawyers did not recognize potential warning signs. In other cases, the details are sparser. These transactions are most useful as the basis for posing questions based either on the actual events or hypothetical variations on them. Finally, some deals afford an opportunity both to suggest possible explanations for behavior as well as to generate questions for discussion.

I should be especially clear on one point: I do not regard explanation necessarily as justification. Understanding why lawyers may have acted or failed to act is different from concluding that their conduct was blameless.

7. Id. at 197.
8. Id.
The aim of explanation in this context is to make lawyers and law students more sensitive to the process of exercising judgment in ambiguous situations in which wrongdoing is not apparent on its face. Appreciating how specific events may reflect tendencies in organizing information, as well as subconscious methods for avoiding confrontation with unpleasant facts, will ideally produce more sophisticated ethical discernment and deliberation. By shedding some light on the psychological and organizational influences on attorney conduct, it also may allow us to craft more sensitive responses to unethical behavior.  

Working through the transactions requires some patience. I provide diagrams in many cases in an effort to clarify specifically how deals were structured and what roles attorneys played in that process. I believe that taking the time to understand these matters will make clear that compelling human stories often lurk just beneath the surface of complex organizational structures and cutting-edge financial instruments.

Undoubtedly, instructors more imaginative than I will be able to use the Enron matters that I describe to yield even more insights than I suggest here. Whatever the pedagogical approach that it prompts, the Examiner’s account of lawyers’ behavior in these matters provides a sense of the texture and dynamics of practice that can be used to deepen our understanding of the milieu in which transactional lawyers work and must make ethical judgments.

I. ENRON

As background to the discussion of Enron’s attorneys and some of the matters on which they worked, this part focuses on what concerns were of particular significance to Enron’s business strategy and what kind of culture the company fostered to respond to them. What business pressures did Enron face, how did it attempt to address them, and what effects did this have on organizational culture? How did that culture in turn shape the business opportunities and risks that Enron executives perceived?

Enron began as a gas pipeline company in the days when natural gas prices were federally regulated. Gas producers explored for gas and pumped it out of fields, then sold it to pipelines at prices set by the federal government. The pipelines then sold gas to local utilities, also at government-regulated rates. Natural gas thus was a relatively sleepy industry, with minimal competition and no market pricing.  

By the mid-1980s, the government had deregulated the prices that natural gas producers could charge, and had encouraged pipelines to make their lines available to all gas companies. As a result, local utilities could buy gas directly from producers and then pay pipelines simply for transporting

9. One work that emphasizes the importance of this approach with respect to lawyers in general, and Enron’s lawyers in particular, is Mark A. Sargent, Lawyers in the Moral Maze, 49 Vill. L. Rev. 867 (2004).

Pipeline companies therefore had to develop separate businesses for gas transportation and gas sales.11

Deregulation resulted in much more volatile gas prices for both producers and utilities. Enron tried to hedge this volatility by providing forward contracts to deliver gas to users at specified prices on future dates. This gave natural gas users a measure of predictability by allowing them to lock in maximum prices for the gas they needed to purchase. In these transactions, Enron acted not only as a broker, but actually took possession of gas in order to meet its contractual obligations to deliver it. Enron therefore had to hedge its own risk that it might have to acquire gas to meet its commitments at prices higher than the prices it would be receiving under its contracts with utilities. It did so by entering into contracts with gas producers that set the maximum prices that Enron would have to pay.12

Enron therefore had to transform itself from a relatively stable company in a regulated industry to an entity that was able to engage in complex estimates of future prices in a volatile natural gas market. In order to do so, it began hiring people with expertise in finance, mathematical modeling, and hedging—employees whose skills and outlook often differed sharply from Enron's traditional workforce of persons who were familiar with the natural gas industry.

The cultural shift at Enron was accelerated when Jeff Skilling arrived in 1990 to become Chief Executive Officer ("CEO") of Enron Finance.13 As a consultant at McKinsey & Company, Skilling had advised Enron on how it might reposition itself to take advantage of opportunities in the new deregulated environment. As CEO of Enron Finance, he began moving the company away from reliance on physical assets such as pipelines toward an emphasis on holding financial assets—from a gas pipeline company to something more akin to an investment bank.14

Under Skilling's prodding, Enron eventually began trading not only gas, but the contracts to buy and sell gas at certain prices. These contracts essentially were derivatives—financial instruments whose prices were based on the underlying price of gas. Most were customized contracts, unregulated by exchanges. Enron sought to use derivatives to lock in maximum and minimum prices, and to seek out profits that came from exploiting the spread between the two. This "freed Enron from having to own assets involved in the production and transportation of natural gas. In theory, instead of owning a portfolio of assets—natural-gas reserves and pipelines—Enron could simply own a portfolio of contracts that would allow it to control the resources it needed."15

11. Id. at 13.
12. Id. at 31.
14. Id. at 33.
15. Id. at 37.
A crucial step in the transformation of Enron was obtaining permission from the Securities and Exchange Commission ("SEC") to use mark-to-market accounting treatment to establish the value of Enron's gas trading contracts.\footnote{16} Traditionally, the assets that these contracts represented were carried on the books at historical cost, even if market conditions resulted in increases or decreases in the prices at which they would trade. A company could not recognize the gain from appreciation in the value of such an asset until it actually sold it—until then the gain was only a theoretical possibility on paper.

A different accounting treatment, however, was used by businesses such as the trading units of investment banks, whose assets consist almost entirely of financial instruments that constantly fluctuate in value. These companies are permitted to adjust the value of their assets to reflect current market prices, even if they do not engage in the actual sale or purchase of the assets at those prices. Such an approach ostensibly provides a better picture of the actual financial condition of the company than reliance on the historical cost at which its assets have been acquired.

Ideally, the mark-to-market process is relatively accurate because valuations are based on actual prices in robust trading markets. For contracts based on price movements over a long period, however, or contracts involving assets in thinly traded markets, such price information is either of limited use or unavailable. In these cases, mark-to-market valuation requires the use of mathematical models to predict fluctuations in the price of underlying assets, and thus the anticipated long-term income from various contracts.

Skilling believed that the logic behind mark-to-market accounting applied to Enron's gas contract trading activity—that this treatment provided a better indication of the actual economic value of the company's trading unit. In June of 1991, Enron therefore requested that the SEC permit it to use this accounting approach for its natural gas contracts. In January of 1992 the SEC agreed. Enron ultimately expanded the use of mark-to-market accounting to every portion of its merchant investment business, including profits of private equity and venture capital investments.\footnote{17} By 2000, some thirty-five percent of Enron's assets received mark-to-market treatment.\footnote{18}

One particularly notable feature of mark-to-market accounting is what it permits with respect to booking revenues from long-term contracts. Under conventional accounting, a company recognizes revenues as they are received and calculates profits accordingly. Thus, for instance, if Enron had a ten-year contract to supply natural gas to a utility, it would record the revenues that it received from that contract as the utility made payments over the ten-year period. Under mark-to-market accounting, by contrast,

\footnote{16. Id. at 41.}
\footnote{17. Id. at 127.}
\footnote{18. Id.}
Enron could book the present value of the estimated revenues, and calculate the anticipated profits, for the entire ten-year period immediately when the contract was signed. Any changes in natural gas prices that affected those figures would show up as additional income or losses in later periods. Thus, if Enron expected $200 million in income over the course of a ten-year contract, it could recognize the present value of that income on its financial statements as soon as it entered into the contract.

Enron sought to use its natural gas contracts market model as the basis for expansion into trading of other items, such as oil, electricity, timber, broadband, and water. By 1999, Enron Wholesale Business, the trading arm of Enron, accounted for sixty-six percent of 1999 income before interest and taxes. At that point, top management at the company regarded trading, deal making, and risk management as Enron’s core activities.

This transformation led to an increased emphasis on hiring persons with abstract financial and analytical skills that could be applied to any type of business operation. Ideally, anything could be turned into a commodity that could be traded in a market. As people like Skilling saw it, Enron’s business was identifying these commodities, creating a market for them if need be through its own trading activity, and hedging the risks of the market for itself and others. Skilling felt that traditional capital investment in hard assets such as factories and pipelines no longer were the key to good returns. Instead, it was versatile intellectual firepower that maximized performance.

As a result, Enron became an increasingly young, well-compensated culture. By 1999, the average gas pipeline employee had been at Enron for sixteen years, while the average capital trading employee had been there for three to four years. Furthermore, Enron’s value system began to “divid[e] the world into those who ‘got it’ and those who didn’t.” Traders and dealmakers were in the first category, and traditional pipeline personnel were in the second. This dichotomy extended beyond the company as well. “Outsiders who came into regular contact with Skilling hungered to be included on the list of those who got it. This was especially true of Wall Streeters, who pride themselves on their smarts.” Enron was able when necessary to exploit this pride. As one major investor recounted,

If you asked a question that [Skilling] didn’t want to answer, he would dump a ton of data on you. But he didn’t answer. If you were brave and said you still didn’t get it, he would turn on you. “Well, it’s so obvious,”

19. Fox, supra note 10, at 88.
20. Id.
21. See id. at 79-83.
22. McLean & Elkind, supra note 13, at 110.
23. Id. at 233.
24. Id.
25. Id.
he'd say. "How can you not get it?" So the analysts and investors would pretend to get it even when they didn't.26

Whatever sense of arrogance traders and deal makers had based on their perceived intellectual superiority was reinforced by their sense of mission. They saw themselves as injecting meritocratic market principles into sleepy industries that for too long had been insulated from the bracing rigor of the market. This was consistent with the animating business spirit of the 1990s, which proclaimed that innovative high-tech companies were rewriting the book for business success. As a result, "[b]ecause the traders thought they were creating a new world, they looked upon existing rules not as guidelines to be respected but as mere conventions to be gotten around in whatever creative fashion they could devise."27

As various markets matured, the entry of other companies tended to erode Enron's competitive advantage and profit margins. The company therefore constantly needed to be on the lookout for opportunities in new markets—where it could enjoy the benefits of being the first entrant at least for awhile. This placed a premium within Enron on creativity and competition among employees to find the next big business idea.

This culture was reinforced by something called the Performance Review Committee ("PRC") process—or, more colloquially, "Rank and Yank." The PRC consisted of managers from various business units who met every six months in order to conduct personnel evaluations. Each employee was compared against all other employees in the same business unit on a bell curve in a "forced ranking."28 This ranking was the basis for one's bonus, which could come to more than a million dollars for some high achievers. More ominously, employees who were ranked in the bottom ten to twenty percent were given six months to improve their ranking by the next PRC review. If they did not, they were fired. As one observer notes, "Inevitably, because of the bell-curve aspect of PRC reviews, internal competition became a part of life at Enron."29 Managers felt that this was the best way to emphasize the importance of constantly striving for new ideas and never resting on one's laurels.

This system, however, sometimes fostered competition within business units that affected how the company functioned. Originators, for instance, negotiated long-term deals to provide commodities such as natural gas, while traders executed the buy and sell orders that made sure that Enron had the commodities available to meet its obligations. Traders were in charge of calculating "forward price curves," or estimates of the prices at which the commodity would sell in, say, years seven to ten of a ten-year contract. Originators complained that traders adjusted these projections to favor their short-term trading profits at the expense of the longer-term deal. Traders

26. Id. (quoting an unnamed investor).
27. Id. at 216.
28. Fox, supra note 10, at 84.
29. Id.
resented the fact that, as they saw it, originators received a windfall at bonus time from mark-to-market accounting simply by getting a customer to sign a contract without assuming responsibility to ensure that Enron was able to perform profitably under it. This infighting “made it more difficult for originators to sign long-term contracts. As a consequence, less business came from long-term contracts and the company had to rely even more on the shorter-term trading operation for profits.”

Enron also sought to promote innovation by fostering an entrepreneurial ethos among employees that focused on temporary teams who worked on constantly changing projects, rather than persons who fit into specific positions within an explicit organizational structure. Enron, according to Skilling, was “like a free market of people.” Job assignments could change month to month. Projects were like self-contained jobs; “[o]nce a project was over, it was up to the employee to find work elsewhere within the company.” Furthermore, in parts of the company, “managers told employees that it would hurt their chances of advancement if they stayed too long on one project.” The company started, folded, and reorganized businesses constantly. It spent more than $6 million a year on relocating offices and cubicles. As one former executive put it, “The best way to describe Enron was as a constant job search.”

The development of Enron OnLine (“EOL”), the company’s profitable online trading operation, reflected the operation of this entrepreneurial culture. Louise Kitchen, the leader of the project, never obtained approval for it from Skilling or CEO and Chairman Kenneth Lay. She assembled a team of 350 people by going directly to employees she wanted, not to their bosses. Some managers did not even know their employees were working on the project. It was not until a month before the launch of the trading program, when versions of it had already been introduced in several European countries, that project leaders even informed Skilling about it. Thus, in keeping with Enron’s culture, “even though they were about to spend millions getting EOL off the ground, chew up people’s time, and plot to radically change Enron’s business model, the coconspirators felt no need to seek approval from Skilling or [CEO and Chairman Kenneth] Lay.”

In short, Enron hired smart, ambitious people, granted them autonomy, set them loose in a competitive environment, and then ranked their performances. Skilling sought to position Enron as a dot-com with a new

30. Id. at 85.
31. Id. at 89.
32. Id. at 88.
33. Id. at 89.
34. McLean & Elkind, supra note 13, at 120.
35. Id.
36. Id. at 222.
37. Id.
38. Id.
39. Id.
business culture of constant change and a flat organizational structure.\textsuperscript{40} “Employees who didn’t add to profits or at least provide a strategic function were deemed expendable . . . .”\textsuperscript{41} This resulted in a stressful workplace that had the potential to emphasize the short-term. Originators and traders did not worry about whether the mark-to-market value of deals changed three or four years hence. By then they might be in a different business group and any erosion in the value of their deal would not affect their current PRC ranking.\textsuperscript{42}

Understanding the milieu in which Enron’s lawyers operated also requires appreciating the company’s distinctive business challenges. Enron’s role as a market maker, and the company’s own predictions to the investment community about its continued growth, required it continually to find and create new markets that enabled it to enjoy first-mover profits from trading and financing activities. Enron needed large amounts of cash in order to do this. Even though Skilling aspired to an “asset light”\textsuperscript{43} strategy in which Enron divested itself of most physical assets, creating new markets often initially required the acquisition or construction of hard assets in order to learn about a business, and then build trading and finance activities around it.\textsuperscript{44} Thus, for instance, Enron needed cash to acquire assets such as a public utility in Oregon,\textsuperscript{45} timberland in Maine, paper mills in New Jersey and Quebec,\textsuperscript{46} and fiber optic cable in various parts of the country.\textsuperscript{47} It also built massive power projects in places like India\textsuperscript{48} and pipelines in South America.\textsuperscript{49} The idea was to leverage these assets in order to “build up a complementary financial business.”\textsuperscript{50}

The problem was that Enron did not have much cash flow, despite booking large amounts of income based on mark-to-market accounting. The company might be able to record $200 million in income immediately based on the present value of the expected earnings from a contract over its multiple-year duration. That $200 million only came in the door gradually, however, over the life of the contract. As Enron’s financial statements declared, the company had considerable “recognised, but unrealized income.”\textsuperscript{51} The gap between income and actual cash flow thus was a continuing problem, which prevented Enron from using cash to finance most of its growth.

\begin{itemize}
\item \textsuperscript{40} Id. at 121.
\item \textsuperscript{41} Fox, supra note 10, at 87.
\item \textsuperscript{42} Id. at 89.
\item \textsuperscript{43} McLean & Elkind, supra note 13, at 110.
\item \textsuperscript{44} Fox, supra note 10, at 88.
\item \textsuperscript{45} Id.
\item \textsuperscript{46} McLean & Elkind, supra note 13, at 225.
\item \textsuperscript{47} Id. at 52 ($3 billion power plant in Dabhol, India).
\item \textsuperscript{48} Id. at 102 (1875-mile pipeline from Bolivia to Brazil).
\item \textsuperscript{49} Id. at 60.
\item \textsuperscript{50} McLean & Elkind, supra note 13, at 41.
\end{itemize}
One potential source of financing, of course, was the stock market. Enron likely would be successful in selling additional shares to the public because of its track record. The company, however, did not want to issue new equity to raise capital. That would lower earnings per share, which would make it harder to hit the earnings targets that the company had indicated to stock analysts.52

Finally, Enron did not want to acquire cash by incurring debt because that would adversely affect its credit rating. In order to continue growth in its trading operations, Enron needed to trade without having to post collateral. This in turn depended on its credit rating for senior unsecured long-term debt. Incurring additional debt could cause that rating to be downgraded.53 Furthermore, covenants in some of the company’s existing loan agreements required Enron to maintain a certain credit rating. Violation of this provision could result in acceleration of Enron’s loan obligations.54

The result of all this was that Enron’s desire to keep its share price high while maintaining its credit rating limited its options for narrowing the gap between its reported income and the cash flow necessary to fuel continued growth.55

One reason for attempting to ensure that Enron’s share price remained high was that the company could use its shares as currency to fund its growth. Setting and meeting increasing earnings targets was crucial to a high share price. Skilling apparently set quarterly and annual earnings per share targets based solely on what analysts told him was necessary to keep the stock price up, rather than based on analysis of operations of the various business units.56 Growth numbers thus were imposed on business units from above, with the assumption that the creative and competitive people whom Enron hired would find a way to meet them.

The difficulty with this strategy was that a company built around trading and deal making cannot possibly count on steadily increasing earnings, because trading is an inherently risky and volatile business. This is why companies whose business primarily is trading have low stock valuations.57

Furthermore, mark-to-market accounting created an earnings treadmill. Marking to market can boost growth rates because it permits booking income from long-term deals immediately. In order for its share price to stay high, a company needs to meet even more ambitious earnings targets for the next quarter. Where would these earnings come from? Enron was

52. See id. at 150.
53. Id.
54. Id. at 236.
56. McLean & Elkind, supra note 13, at 127.
57. Id. at 126.
not building up a backlog of income, because income from all existing contracts had already been fully recorded. In each quarter, in other words, traders and dealmakers "had to start again with a blank page." Enron therefore needed a constant flow of new deals that generated more income that could be booked immediately in the next quarter.

The trading and deal culture that Enron had created was unleashed to find new deals and business opportunities that would accomplish this income generation. In terms of its financial statements, Enron needed transactions that permitted it to: (1) book income and earnings on its income statement as soon as possible, (2) remove debt from its balance sheet, and (3) book cash flow from operations on its statement of cash flows. These measures would help Enron maintain the favorable financial ratios that were crucial to its stock price and credit rating.

Enron was candid that bolstering the accounting that was the basis for these ratios was more important than the underlying economics of a transaction. As Enron's own risk-management manual declared:

> Reported earnings follow the rules and principles of accounting. The results do not always create measures consistent with underlying economics. However, corporate management's performance is generally measured by accounting income, not underlying economics. Therefore, risk management strategies are directed at accounting, rather than economic, performance.

This statement reflects the fact that there is inevitable divergence between accounting treatment and economic substance. Accounting presents a stylized picture of economic activity, whose elements are assembled according to certain conventions. Its traditional conservatism—delay booking income and recognize obligations as soon as possible—may not provide the most accurate reflection of a company's operations and prospects. Furthermore, structuring a transaction one way instead of another can make it eligible for a certain accounting treatment, even though the basic economic characteristics of the transaction are no different.

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58. Fox, *supra* note 10, at 42.

59. For a list and short description of these ratios, see Second Batson Report, *supra* note 55, at 20.


61. Instead of owning an asset such as a manufacturing plant, for instance, a company can enter into a "synthetic lease" whereby it sells the plant to another party and then leases it back. The company then operates the plant as it would if it still owned it. As a result of the change in form, however, the company will be able to expense the rental payments it makes to the lessor under the synthetic lease, and its balance sheet will not be marred by the appearance of real estate ownership or by the existence of mortgage debt. However, the lessee/corporate user will retain all the tax benefits and burdens of ownership, including the ability to depreciate the real estate assets and obtain any appreciation upon a subsequent purchase of the seal property from the lessor or upon resale to a third party.
such instances, the rules themselves provide support and incentives for using form to mask substance. Thus, as two scholars have recently put it, "Accounting information is sufficiently disconnected from underlying economic reality that it presents a distorted and unreliable picture of economic consequences." 62

Enron was frank in recognizing that stock analysts, investors, and even creditors sometimes take the conventions of accounting as equivalent to the economic reality that the numbers are supposed to represent. As in any instance in which certain variables are taken as indications of performance, gaming the system by manipulating the variables is predictable behavior. 63 This behavior was especially likely near the end of business quarters in which Enron threatened to fall short of its earnings targets. Rather than revise its estimate, the company sent out requests to various business units for creative ways to squeeze out more earnings. 64

Enron created a free-wheeling culture that it believed was nimble enough to meet its business challenges, but in hindsight failed to put in place effective constraints on it. The company's Risk Assessment and Control ("RAC") office, for instance, was supposed to provide an internal review of proposed deals. A Deal Approval Sheet ("DASH") was required on each proposed transaction, which summarized the deal, indicated the range of projected returns, and estimated the risks. There was space on the sheet for the signatures of everyone who needed to approve the transaction, and a box for RAC to provide its recommendation. 65

In practice, however, the RAC appeared regularly to shy away from attempting to curb the momentum for any deal. Indeed, Chief Risk Officer Rick Buy said in a promotional video for Arthur Andersen that Enron was a ""fast-moving place. You don't want anyone . . . [who's] going to slow you down or bog you down or not be value-added . . . "" 66 Nor did RAC seem to enjoy much respect within Enron. As one deal originator said, "'If a deal had overwhelming commercial support, it got done. I treated [RAC] like dogs, and they couldn't do anything about me.'" 67 "'The corporate culture was such that you never said no to a deal. . . . It was 'how do you make a deal work?'" 68 RAC "'didn't want to be seen as someone saying no to a


63. McLean & Elkind, supra note 13, at 142 (stating that "'[w]hat [Enron was] doing—what some might even privately admit they were doing—was gaming the system'").
64. Id. at 127.
65. Id. at 115.
66. Id. at 116.
67. Id.
68. Id.
Further undermining RAC’s influence was the fact that traders and originators sat on the panels that conducted PRC evaluations of RAC personnel. At tempted by those outside the company to question a transaction also met with stiff resistance. An accountant in Andersen’s Professional Standards Group (“PSG”) in Chicago, for example, had objected to Enron booking a $50 million gain on the sale of an interest in a deal involving Blockbuster. Project Braveheart was a twenty-year contract between Enron and Blockbuster to provide video on demand (“VOD”). Revenue from the project was based on projections about “future DSL use, customer video purchases, the speed of the rollout, market share, expenses, and other factors.” As soon as the contract was signed, Enron Broadband sold most of its interest in it to an outside buyer and immediately booked profits from the sale up front.

PSG objected to this accounting treatment, but David Duncan, the accountant in charge of the Enron engagement, did not follow this advice and permitted Enron to recognize the profits. Nonetheless, the Enron Broadband Christmas party that year featured a presentation that mocked PSG’s objection. It depicted Andersen as “The Grinch Who Stole VOD,” starring Andersen as the Grinch in “the story of how the mean, heartless auditors tried to ruin the deal.”

The evolution of Enron from a gas pipeline company to a trading enterprise using mark-to-market accounting thus created certain challenges and contributed to the emergence of a particular culture within the company. The quest for continuing growth produced pressure for a constant flow of innovative transactions that were high risk but promised high reward, with expert hedging that supposedly minimized the company’s exposure. These transactions ideally secured certain outcomes that complied with the technical requirements of accounting rules, notwithstanding some divergence between accounting treatment and economic substance.

Enron’s decentralized entrepreneurial culture of multiple fluid project teams provided little systematic oversight by superiors in a conventional organizational hierarchy. Formal review processes were in place, but were buffeted by influences from both above and below in favor of moving deals forward. The project teams themselves were populated by financial whiz kids who ostensibly were creating a new era of capitalism, and who therefore had little patience for those who failed to understand the intricacies of their transactions.

69. Id.
70. Id. at 117.
71. Id. at 293.
72. Id.
73. Id. at 296.
Finally, the desire to keep the share price high through continued growth in earnings, the use of mark-to-market accounting, and the "Rank and Yank" personnel evaluation process all reinforced a short-term focus within the company. For many, deal origination became the ultimate objective, with much less attention to performance after the contract was signed—in part because Enron was always ready to sell its interest in a project if market conditions were right.

Enron’s lawyers thus operated within an environment constituted by “a steady accumulation of habits and values and actions” that shaped their understanding of behavior and events. With that environment in mind, it is time to turn to the attorneys who represented Enron and the transactions in which they were involved.

II. ENRON’S ATTORNEYS

Enron had a substantial in-house legal department, but also relied extensively on the services of law firms. This part describes the organizational structure within which Enron attorneys operated and some of the major responsibilities that they assumed.

A. Inside Counsel

James Derrick, a twenty-year veteran of the law firm of Vinson & Elkins ("V&E"), became Enron’s General Counsel in 1991. Derrick regarded Enron’s Legal Department as "world-class." Most of its lawyers had between eight and seventeen years of experience when they joined the department. Each of Enron’s several business units, such as Enron Energy Services and Enron Global Finance, had its own legal department supervised by a general counsel. Each general counsel reported to the head of the business unit in which he or she served, as well as to Derrick. Rex Rogers, the Associate General Counsel in Enron’s corporate legal department who reported directly to Derrick, was responsible for Enron’s compliance with securities laws. Weekly meetings of the general counsels of the major business units occurred in Derrick’s office. Eventually, the general counsels of Enron’s overseas units participated in

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74. Id. at 132.
76. Id. app. C, at 16 n.1.
77. Id. app. C, at 16.
78. Id.
79. Id. app. C, at 17.
80. Id.
81. Id.
82. Id.
these meetings on a monthly basis. Derrick stated that at any given time there were "probably thousands of projects" on which Enron’s in-house lawyers were working.

B. Outside Counsel

Enron retained several outside law firms, but relied most heavily on V&E. The company paid legal fees to V&E of $18.5 million in 1997, $26.6 million in 1998, $37.8 million in 1999, almost $42.8 million in 2000, and $36.4 million in 2001. Periodic advice to Enron on SEC disclosure issues was provided until 1997 by Robert Baird, and afterward by Ronald Astin. Each of these lawyers worked closely on these matters with in-house lawyer Rex Rogers. Several other V&E partners and associates worked on various transactions for Enron. At the height of its work for Enron, V&E derived a little over seven percent of its total revenues from this client.

Andrews & Kurth ("A&K") began representing Enron on certain "structured finance" transactions, described below, in 1998. A&K partner David Barbour was the primary attorney for these transactions. He was assisted by lawyers who worked on legal opinions for and on tax issues related to these deals. A&K also worked on various other Enron transactions. Enron paid legal fees to A&K of $991,000 in 1997, $2.3 million in 1998, $6.6 million in 1999, $9.7 million in 2000, and $9.2 million in 2001.

The remainder of this Article describes several of the transactions on which various Enron inside and outside attorneys worked, the Examiner’s conclusions about these transactions, and his assessment of the possible liability of attorneys for their work on these deals. The examination of each transaction then includes a discussion of the dynamics that may have shaped the situation as the lawyers understood it, poses questions that illuminate some of the judgments with ethical implications that lawyers must make in these circumstances, and presents hypothetical variations on the facts that suggest other issues that might arise in similar situations.

83. Id. app. C, at 16.
84. Id. app. C, at 21.
85. Id.
86. Id. app. C, at 20-21.
87. Id. app. C, at 24.
88. Id.
89. Id. app. C, at 25.
III. STRUCTURED FINANCE TRANSACTIONS

A. Background

The form of transaction that Enron used often to manipulate its financial statements improperly is known as a "structured finance" transaction. In basic terms, this is an arrangement in which a company sells income-generating assets to an affiliated special purpose entity ("SPE") in return for a payment from the SPE. The company selling the assets is known as the "originator" because it creates the assets, such as contracts for the receipt of a future stream of payments that are central to the transaction. The asset may be a set of accounts receivable, an investment in an enterprise, or any other interest that entitles the recipient to future income payments. The SPE purchasing the asset then issues bonds or some other form of security to investors. The issuing SPE receives the proceeds from investors and uses them to pay the seller for the asset. The income from the asset that the issuer owns is earmarked to pay periodic interest to the bondholders and eventually to repay their principal.

Companies use structured finance transactions for legitimate purposes all the time, mainly to lower the cost of borrowing money. A company may, for instance, have only a fair credit rating because of the debt that it has outstanding. This means that it must pay a higher interest rate on bonds or for a commercial loan than if its rating were higher. Creating an SPE and selling an income-producing asset to it can result in an entity with a high credit rating, which enables the SPE to borrow funds at a lower rate than the company could on its own. This is because bondholders have security for their loan in the form of the income stream from the asset. The SPE has no other creditors to satisfy with whom the bondholders must compete; its sole asset is pledged to satisfy its obligation to bondholders. When the entity passes the proceeds on to the company from whom it purchased the asset, the effect is that the originating company has been able to obtain funds through proceeds from the sale of the asset more cheaply than if it had incurred debt directly on its own behalf.

If there has been a true sale of the asset from the company to the special entity, the seller can enjoy certain benefits in its financial reports. First, if it sells the asset for a price above the price at which it obtained it, it can book


91. In some cases, as in several of the Enron transactions, the entity receiving the assets from the originator may be an affiliate of the originator. This affiliate then transfers the assets to a special purpose entity ("SPE"), which is the entity that issues the securities. In the Enron transactions, the affiliate was known as the "sponsor." See Second Batson Report, supra note 55, app. M, at 7, available at http://www.enron.com/corp/por/pdfs/examiner2/9551-13.pdf; see also Schwarz et al., supra note 90, at 11-12 (describing a common structured finance transaction in which a SPE that receives assets from the originator then transfers assets to a second SPE, which issues securities).
the difference as a gain on its income statement. Second, it can report the proceeds from the sale as cash flow from operating activities. By contrast, proceeds from a loan must be reported as cash flow from financing activities, which investors in the company regard less favorably. Finally, if the asset represents an investment in a company, a gain in the share price of that company is only a paper gain until the investment is actually sold. Selling the asset thus provides a way to "monetize" the investment in a transaction that results in the actual receipt of cash.

Enron's sale of financial assets in structured finance transactions had a major impact on its financial statements. In 2000, for instance, such transactions increased Enron's net income by $351.6 million (thirty-six percent of total net income), increased cash flow from operations by $1.2 billion (thirty-eight percent of total flow from operations), and kept $1.4 billion in debt associated with the assets off Enron's balance sheet.92

B. Enron's Financial Assets

Enron owned a number of financial assets in the form of interests in various companies, particularly in the energy and telecommunications industries. In order to monetize these assets through sale to an SPE, Enron had to comply with Financial Accounting Standard ("FAS") 140.93 This requires that for the transfer of financial assets to be treated as a sale, the transferor has to surrender control of the assets. Three conditions must be met in order to confirm such surrender. The first of these is that the assets have been "legally isolated" from the transferor.94 This means that if the transferor were to declare bankruptcy, the assets could not be treated as part of its estate and therefore available to the transferor's creditors.95 Evidence of this usually takes the form of a "true sale" legal opinion, which opines that the transfer of the assets would be considered a sale rather a loan under relevant state law.96 In Enron's case, such an opinion would provide assurance to purchasers of the SPE's securities that the income stream from

94. The other two are that the transferee (or holders of beneficial interests in it) obtains the right to pledge or exchange its interest in the assets, and that the transferor has no right to repurchase or redeem the assets before their maturity. Second Batson Report, supra note 55, app. B, at 59-60 (Accounting Standards), available at http://www.enron.com/corp/pt/pdfs/examiner2/9551-02.pdf.
95. Id. app. B, at 60.
96. Id.
the financial asset could not be used to satisfy the claims of Enron’s creditors in case that company filed for bankruptcy.

Courts look to several factors to determine if a true sale has occurred, such as whether the transferor retains benefits from and risks of holding the asset after the transfer, the actions of the parties after the transfer, the parties’ intent, the lender’s intent; the amount of the proceeds paid to the transferor compared to the value of the asset transferred, how the transaction was treated for tax and accounting purposes, and how the parties described the transaction.\(^9^7\) The essence of the inquiry is whether the economic substance of the transaction is consistent with its form; if not, courts are free to disregard its form as a sale.

In Enron’s case, if there were not a true sale the transfer would be treated essentially as a loan from the SPE bondholders to Enron, which was secured by the asset in question. In that case, despite their secured status, the bondholders would have to compete with Enron’s other creditors for repayment if the company went into bankruptcy. More importantly, from Enron’s standpoint, Enron could not record a gain from the transfer of the asset, would have to report the proceeds of the transaction as cash flow from financing activities, and would be required to reflect the debt of the SPE on its books. With few exceptions, Enron asked its outside attorneys to provide an opinion letter that Andersen could use to satisfy FAS 140.\(^9^8\)

C. The “Sales” that Weren’t

The Enron bankruptcy Examiner concluded that Enron had engaged in several supposed FAS 140 transactions in which Enron in fact did not surrender rights and risks with respect to the asset supposedly sold to the SPE. In simplified terms, a typical such Enron transaction proceeded as follows.\(^9^9\) Enron, directly or through a “Sponsor” entity, transferred a financial asset to an “Asset Limited Liability Company (‘LLC’).”\(^10^0\) This was treated as a capital contribution to the Asset LLC, for which Enron or the Sponsor received a “Class A” interest entitling it to complete voting control over the Asset LLC and a negligible economic interest in it. Enron or the Sponsor also was entitled to a special cash distribution from the LLC in an amount equal to the value of the asset as established by Enron.\(^10^1\)

The Asset LLC then issued a “Class B” interest to an SPE (which usually took the form of a trust), entitling the latter to all the economic proceeds from the asset held by the former, but no voting rights in the Asset LLC.\(^10^2\) The consideration for the Class B interest was a payment in the amount of

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98. See infra note 110 and accompanying text.
100. See infra fig.1 (step 1).
101. First Batson Report, supra note 5, at 60.
102. See infra fig.1 (step 2).
the special distribution that the Asset LLC owed Enron or the Sponsor. The SPE obtained a bank loan,\textsuperscript{103} for which it used its Class B interest as collateral, and used the proceeds, along with a small equity contribution by a third party (typically an affiliate of the lender), to pay for the Class B interest.\textsuperscript{104} The amount of the equity generally comprised at least three percent of the purchase price of the Class B interest, plus fees due the lender.\textsuperscript{105}

Upon receiving payment from the SPE, the Asset LLC then made the "special distribution" to Enron or its Sponsor as consideration for the asset that ostensibly had been sold to it.\textsuperscript{106} After giving effect to these transactions, the Asset LLC held the asset, Enron or the Sponsor held voting control over the LLC, and the SPE trust had an interest in the SPE that entitled it to proceeds from the LLC's asset.

A condition of the bank loan to the SPE to purchase the Class B interest was that Enron would enter into a "Total Return Swap."\textsuperscript{107} Under this arrangement, Enron or one of its affiliates agreed to make payments to the SPE or the lender in an amount equal to the SPE's obligation to the lender, which was usually ninety-seven percent of the purchase price of the asset that had been transferred to the Asset LLC.\textsuperscript{108} Enron or its affiliate then was entitled to first priority on the proceeds from the asset up to the amount of its Total Return Swap obligation (and, after any equity holders in the SPE received a return on their investment, any remaining proceeds).\textsuperscript{109} The effect of this was to guarantee the SPE's loan from the bank, in return for the SPE's Class B interest in the income from the asset.\textsuperscript{110}

The Examiner found that in five of the six FAS 140 transactions that he reviewed, the assets that ostensibly were the source of payment by the SPE to the security holders produced insufficient cash flow to serve this purpose, or may have been difficult to sell on acceptable terms in a genuine arms-length transaction.\textsuperscript{111} Enron's guarantee under the Total Return Swap thus "played what appears to be a substantial—if not the decisive—role" in convincing the lenders to advance funds to the SPE.\textsuperscript{112}

Several features of these deals undermined their compliance with FAS 140. Since Enron retained voting control over the asset, it had not relinquished rights in it. Furthermore, Enron also retained the rewards and risks associated with the asset. By virtue of the Class B interest it obtained

\begin{itemize}
  \item[103.] See infra fig.1 (step 3).
  \item[104.] See infra fig.1 (step 4).
  \item[105.] First Batson Report, supra note 5, at 60.
  \item[106.] See infra fig.1 (step 5).
  \item[107.] First Batson Report, supra note 5, at 64.
  \item[108.] Id.
  \item[109.] Id.
  \item[110.] See infra fig.1 (steps 6-7); see also Second Batson Report, supra note 55, app. B, at 61 (stating that, by virtue of the Total Return Swap, "Enron in substance guaranteed the debt" of the SPE).
  \item[111.] First Batson Report, supra note 5, at 16.
  \item[112.] Id.
\end{itemize}
in exchange for the Total Return Swap, it would enjoy appreciation in the value of the asset in the form of any increases in income that it generated. If, however, the asset's income stream declined to a level below the amount necessary to cover the bank loan to the SPE, Enron had to make up the difference. In effect, the money used to pay Enron for the "sale" of its asset to the Asset LLC ultimately came from a bank loan that Enron itself guaranteed.\textsuperscript{113}

The Examiner concluded that the economic substance of such a transaction as a whole, therefore, was that Enron had incurred debt for which the asset served as collateral—not that it had sold an asset to an SPE in a structured finance transaction. In effect, as the Examiner described one of these transactions, Enron "acquire[d] funds in the short term using certain assets, while retaining the opportunity to subsequently re-acquire those assets and sell the assets to a third party" at a more advantageous time.\textsuperscript{114} "The economic reality cf this transaction may thus be viewed as a bridge loan, as opposed to a sale."\textsuperscript{115}

\textsuperscript{113} See id. at 65 ("In short, substantially all of the risks and rewards of the asset remained with Enron . . . .").

\textsuperscript{114} First Batson Report, supra note 5, at 50 n.129.

\textsuperscript{115} Id.
(1) Enron transfers Asset to Asset LLC (True Sale Opinion).
(2) Asset LLC issues Class B (Income) Interest to SPE (True Issuance Opinion).
(3) Bank loan to SPE to pay for Class B Interest.
(4) SPE pays Asset LLC for Class B Interest.
(5) Asset special distribution to Enron: (a) Cash, (b) Class A (Voting) Interest.
(6) Enron total return swap effectively guarantees Bank loan to SPE.
(7) SPE transfers Class B Interest to Enron.
The Examiner came to this conclusion notwithstanding the existence of legal opinions that were issued in connection with these transactions.116 "In many of the FAS 140 Transactions," the Examiner stated, "legal isolation was not achieved..."117 The legal opinions concluding otherwise, he declared, "were limited in scope and analyzed only certain steps and specific entities, rather than the transaction in its entirety."118

To the extent that a transfer of a financial asset was not a true sale, Enron was not entitled to book a gain on its income statement from the "sale" of the asset to the Asset LLC, to report the distribution from that entity as cash flow from operating activities, or to avoid listing the bank loan as debt on its balance sheet or in the related footnotes.

D. Issue One: True Sale Versus True Issuance Opinions

V&E served as counsel to Enron on several FAS 140 transactions that closed in late 1997 and 1998.119 In the vast majority of these transactions, Enron asked V&E to deliver not a "true sale" but a "true issuance" opinion.120 In terms of the typical transaction described above, a true sale opinion speaks to whether there has been a genuine transfer of an asset from Enron (or an Enron "sponsor") to an Asset LLC.121 By contrast, a true issuance opinion deals with whether there has been a genuine transfer of a Class B interest in the asset from the Asset LLC to the SPE.122

V&E attorneys apparently were puzzled by the request for a true issuance opinion. As an internal V&E memo noted, "'a 'true issuance' by an [SPE] would accomplish little, in regard to the isolation of its financial assets from the original transferor, if there had not been a true sale or contribution of the financial assets to the [SPE].'"123 And, as the bankruptcy Examiner stated,

Vinson & Elkins believed, and Vinson & Elkins attorneys testified that they repeatedly told both Enron and Andersen, that Andersen had asked for the wrong opinion when it requested a true issuance opinion. This was potentially significant because Vinson & Elkins did not believe that it could provide a true sale opinion in some of those transactions as structured.124

117. Id.
118. Id.
120. Id. app. C, at 28.
121. See supra fig.1 (step 1).
122. See supra fig.1 (step 2). Specifically, a true issuance opinion would state that a court would not "recharacterize the issuance of the Class B Membership Interest by [the Asset LLC]... as a loan to the [Asset LLC] supported by a security interest in [its] Class B Membership Interest..." Final Batson Report, supra note 75, app. C, at 35 n.99.
124. Id. app. C, at 31-32.
The response of V&E lawyers to these misgivings was to attempt to confirm that Arthur Andersen understood the difference between a true sale and true issuance opinion, and that the accountants were comfortable that the latter would satisfy FAS 140. 125 On two transactions known as Sutton Bridge and Riverside, Terry Yates, a V&E attorney, had never been asked for a true issuance opinion, nor had any of the V&E partners whom he contacted. 126 He told an Andersen employee that he understood FAS 140 to apply to situations in which assets were bought and sold, not the grant of interests in assets. 127 He questioned whether a true issuance opinion was appropriate, but ultimately provided one in both transactions when he received reassurance from Andersen employees that this is what they wanted. "I mean they were the accountants," he said, "they understood what they wanted and based on what [they] said, I had . . . no reason to think that was not reasonable from an accounting criteria standpoint." 128

On another transaction known as Cornhusker, David Keyes, the V&E lawyer who was asked for a true issuance opinion, did not know what it was. 129 He told Arthur Andersen that he believed that accountants were asking for the wrong kind of opinion. As Ronald Astin testified, this lawyer felt that "from a lawyer’s perspective . . . what [Anderson was] asking for was [not] what his reading of the corporate rules required." 130 Keyes also pointed out to Andersen that V&E had added to its opinion the assumption that a court would not recharacterize the transaction in its entirety as a loan. 131 In other words, the opinion assumed that a true sale of the asset to the Asset LLC had occurred prior to the issuance of the Class B interest. When Andersen indicated its understanding of what V&E was providing, the firm issued a true issuance opinion.

Keyes, however, continued to have concerns about the request for a true issuance opinion. 132 One lawyer working with him on a later transaction indicated in a memo to Dilg that the event in Cornhusker that resulted in recognition of a gain to Enron was the transfer of the asset from an Enron sponsor to the Asset LLC. "This fact suggests," he said, "that, for opinion purposes, we and the accountants focused on the wrong part of the transaction." 133 The memo also noted that the characteristics of the transfer to the Asset LLC were such that "[v]irtually all law firms would refuse to give a true sale opinion" for such a transaction. 134

Eventually, Dilg scheduled a meeting with Enron general counsel Derrick to discuss, among other matters, issues relating to the V&E opinion

125. Id. app. C, at 32.
126. Id.
127. Id. app. C, at 32-33.
128. Id. app. C, at 33 n.92 (omission in original).
129. Id. app. C, at 34.
130. Id. app. C, at 34 n.98.
131. Id. app. C, at 34-35.
132. Id. app. C, at 36.
133. Id. app. C, at 37 (citation omitted).
134. Id. app. C, at 38 n.113.
Dilg focused on two questions. First, was a true issuance opinion sufficient for FAS 140 accounting treatment? Second, did the qualification in V&E’s opinion letter that a court would not recharacterize the overall transaction as a loan create any problems with respect to FAS 140? On the latter issue, Dilg’s notes for the meeting said, “We are not asked to render accounting advice but qualification we had to take in opinion could be inconsistent with [FAS 140] requirements.” Dilg noted that V&E could not remove the qualification from its opinion if asked to.

Some time after the meeting, Derrick told Dilg that he had spoken with Rick Causey, Enron’s Chief Accounting Officer, who in turn had consulted with high-level Arthur Andersen personnel. The Andersen people told him that the opinions were “satisfactory for their purposes.” Dilg reported back to V&E lawyers who had raised the issue that both Enron and Andersen understood the nature of the true issuance opinions and felt that there was no problem with them. For Dilg, this information “removed any doubt in my mind” on the question.

Keyes, however, “was still not satisfied, and he continued to raise these same issues in the next FAS 140 Transactions that he worked on for Enron. . . .” It was not until a transaction named Project Iguana closed in late 1999 that Andersen appeared to have appreciated the true issuance/true sale distinction and the assumption in V&E’s true issuance opinion letters that a court would not recharacterize the transaction as a loan. In an internal V&E e-mail, Keyes described a meeting with an Andersen person in which, the lawyer said, the Andersen representative “[f]or the first time . . . really realized that FAS 125 calls for more than what Arthur Andersen has been getting.” The lawyer went on to say,

“I think that I am blamed by some of the inside Enron attorneys . . . for drawing this distinction to AA’s attention, as it could jeopardize Enron’s FAS 125 transactions. The Enron theory is, apparently, that relations with AA must be carefully managed and that AA is a sophisticated organization that can read opinions and draw their own conclusion. I have believed that it is our professional duty to call the attention of a third party recipient to the meaning and scope of our opinion, especially in a situation where we do not believe that the recipient has a correct understanding of what it says in relation to the purpose for which the opinion is requested.”

135. Id. app. C, at 37-38.
136. Id. app. C, at 44.
137. Id. app. C, at 46.
138. Id.
139. Id.
140. Id. app. C, at 47.
141. Id.
142. Id. app. C, at 47 n.169.
143. Id.
The lawyer later, however, told the Examiner that "'I don't think that's a correct statement of legal opinion practice and I—I'm reasonably confident that what I meant by that was that I shouldn't affirmatively mislead somebody . . . .'"\(^{144}\)

The Examiner concluded that V&E possibly could be liable to Enron under Texas law for malpractice and for aiding and abetting breaches of fiduciary duties by Enron officers in connection with its work on the FAS 140 transactions. In several of these transactions, V&E attorneys "rendered true issuance opinions even though those attorneys knew that these opinions did not address the critical issues under FAS 140, as Vinson & Elkins understood those issues."\(^{145}\) In many cases, the Examiner indicated, the firm knew that Enron was retaining the risks and rewards of the asset supposedly sold, and that Enron was using Total Return Swaps to guarantee repayment of the loans that had been used to finance their "purchase."\(^{146}\)

With respect to a malpractice claim, the Examiner noted that Texas courts have held that the Texas Disciplinary Rules of Professional Conduct may sometimes be used to aid a fact finder in determining what a reasonable attorney would have done under the circumstances.\(^{147}\) For this purpose, the Examiner turned to Texas Rule 1.12, entitled "Organization as Client."\(^{148}\) This rule, said the Examiner, "is relevant in a situation where a company’s attorney knows that an officer of a company is causing the company to enter into transactions that have an improper purpose."\(^{149}\)

When an attorney encounters this situation, the rule provides that he or she "shall proceed as reasonably necessary in the best interest of the organization"\(^{150}\) and "must take reasonable remedial actions."\(^{151}\) This may consist of asking for reconsideration of the matter, recommending a second legal opinion, and referring the matter to higher authority within the organization, including to the highest authority if the matter is sufficiently serious.\(^{152}\) If a lawyer fails to take such steps when he or she knows that an officer has committed or intends to commit a legal violation likely to result in substantial injury to the organization,\(^{153}\) that lawyer does not act as a lawyer of reasonable prudence.\(^{154}\)

\(^{144}\) Id.

\(^{145}\) Id. app. C, at 179.

\(^{146}\) Id.

\(^{147}\) Id. app. C, annex 1, at 9 (Legal Standards Applicable to Attorneys).


\(^{149}\) Final Batson Report, supra note 75, app. C, annex 1, at 10.

\(^{150}\) Tex. Disciplinary R. 1.12(a).

\(^{151}\) Id. R. 1.12(b).

\(^{152}\) Id. R. 1.12(c).

\(^{153}\) Id. R. 1.12(b). The violation also must be related to a matter within the scope of the lawyer’s representation of the organization. Id.

The Examiner noted that V&E "may argue that it had no duty to question the subject matter of a legal opinion requested by an accountant." The firm also could argue that, even though there was no duty to do so, V&E attorneys informed both Andersen and Enron of its belief that Andersen was asking for the wrong opinion, and that V&E obtained assurance that the true issuance opinions were sufficient to satisfy the requirement of FAS 140 that the assets be effectively "legally isolated" from the transferor. V&E could claim that Enron had considered the concerns raised by the firm "and had made an appropriate business decision." "These arguments," stated the Examiner, "present issues of fact for determination by a fact-finder."

Questions and Discussion

Was the question whether a true issuance opinion satisfied the legal isolation requirement of FAS 140 an accounting issue or a legal issue? Paragraph 23 of FAS 125, the predecessor to FAS 140, stated,

The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about [what kind of bankruptcy might be involved], whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. . . . [T]he available evidence [must provide] reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates . . . .

V&E might maintain that Paragraph 23 leaves it to accountants to decide under "the facts and circumstances" what kind of evidence will be sufficient in a given case to satisfy the first criterion of FAS 125/140. Paragraph 23 says that one form of evidence "may" be a judgment whether a transfer of assets would be "deemed a true sale at law," but it does not require such an opinion. It was Andersen's judgment that a true issuance opinion was sufficient under FAS 140, Andersen informed Enron of this, and it was Enron's prerogative as the client to instruct V&E lawyers regarding the scope of the work that the company wanted performed.

On the other hand, the Audit Issues Task Force of the Auditing Standard Board issued an auditing interpretation in 1994 that declared, "A determination about whether the isolation criterion has been met to support

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155. Id. app. C, at 179.
156. Id. app. C, at 179-80.
157. Id. app. C, at 183.
158. Id. app. C, at 180.
159. FAS 125, supra note 93, § 23 (currently superseded by FAS 140).
a conclusion regarding surrender of control is largely a matter of law. This aspect of surrender of control, therefore, is assessed primarily from a legal perspective.\textsuperscript{160} This suggests that it is up to the lawyers to determine what type of evidence is sufficient to support a claim that transferred assets have been legally isolated.

V&E clearly had doubts about the claim that a true issuance opinion would satisfy FAS 140. An internal firm memo, albeit not prepared until November 2000, declared that

\begin{quote}
[Al]though the true issuance opinion is rendered at the step following the transfer of financial assets into the issuer, we believe that rendering a true issuance opinion . . . while technically correct, may not be responsive to the intent or purpose for which the true sale opinion is required.\textsuperscript{161}
\end{quote}

The memo further noted, "[A] 'true issuance' by an [SPE] would accomplish little, in regard to the isolation of its financial assets from the original transferor, if there had not been a true sale or contribution of the financial assets to the [SPE]."\textsuperscript{162} V&E received repeated assurances from Enron and Andersen, however, that a true issuance opinion was sufficient. Indeed, this assurance ultimately came from the General Counsel of the company and its Chief Accounting Officer.

In retrospect, it seems clear that V&E's analysis of FAS 140 was correct. Furthermore, even if Enron's and Andersen's contrary interpretation were plausible, one can argue that V&E's interpretation should have prevailed because the issue of what evidence is sufficient to establish legal isolation appears be a legal, not an accounting or business, judgment. At the same time, Enron and Andersen had some support, albeit weaker, for their interpretation. Faced with insistence on this interpretation, V&E's response for a long time was puzzlement, not suspicion. V&E lawyers repeatedly asked Enron and Andersen if they understood the difference between a true sale and true issuance opinion, and whether they were sure that the latter was all they needed. V&E's actions suggest that the lawyers believed that the client required education, not investigation.

This should not be surprising. For better or worse, most lawyers do not immediately suspect that their clients are engaged in wrongdoing when the lawyers are confronted with behavior that does not seem completely intelligible. Most people believe that they and those for whom they work have good intentions. The psychological impact of acting otherwise would be substantial. The natural inclination when faced with what seems like illogical conduct, especially by such ostensibly rational people such as business executives and accountants, is to assume a misunderstanding.


\textsuperscript{161} Final Batson Report, supra note 75, app. C, at 30 n.80.

\textsuperscript{162} Id. app. C, at 31.
Consider, for instance, a memo of June 7, 1998, by V&E attorney Tarry to Dilg about a meeting concerning an FAS 140 transaction known as MidTexas.\textsuperscript{163} In that transaction, an Enron sponsor transferred assets to an Asset LLC. As in the other FAS 140 transactions, the Asset LLC then issued an interest in the income from the assets to an SPE. The SPE paid for this interest with a loan, which Enron effectively guaranteed with a Total Return Swap. V&E delivered a true issuance opinion addressing the issuance of the interest from the Asset LLC to the SPE.\textsuperscript{164}

At the meeting, the Andersen partner commented that in transactions with a Total Return Swap, "the substantive consolidation opinion was generally difficult for law firms to give."\textsuperscript{165} Tarry did not understand this comment. He appeared to assume that the partner was referring to the true issuance opinion that V&E was rendering, which was what V&E had been told was necessary. He saw no problem with issuing such an opinion. As he noted, the SPE receiving the right to the income from the asset was clearly bankruptcy-remote. A non-consolidation opinion in that situation thus was "routinely given."\textsuperscript{166} Why, then, did the Andersen partner say that the type of opinion that V&E had issued usually was difficult to give?

It was only later, Tarry said, that another V&E lawyer suggested that the Andersen partner may have had in mind a different kind of legal opinion than the kind V&E had been providing. The Total Return Swap was relevant only to the transfer of the asset from the sponsor to the Asset LLC. If the accountants had asked for an opinion that this transfer was a true sale, he noted, "that would be much more difficult to give."\textsuperscript{167} This was because the Total Return Swap effectively meant that Enron provided a full guaranty of the loan to the SPE to buy the interest in income from the assets. "Virtually all law firms," he said, "would refuse to give a true sale opinion in a transaction that provided for full recourse back against the purported transferor of the asset."\textsuperscript{168}

This recognition did not, however, lead Tarry to surmise that Enron and Andersen knew that the transfer of the assets was not a true sale, and that they therefore may have been trying to use V&E's services to commit accounting fraud. Instead, Tarry exhibited confusion and frustration about Andersen's insistence on a true issuance opinion. His memo concluded, "I still don't understand the position the accountants are taking . . . the statements made by the Arthur Andersen partners in the . . . meeting did not make the situation any more comprehensible."\textsuperscript{169}

Similarly, as described earlier, in another FAS 140 transaction that closed in late 1999, V&E originally had agreed to give a true issuance opinion.

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\textsuperscript{163} Id. \textsuperscript{app. C, at 37 \& n.113.}
\textsuperscript{164} Id. \textsuperscript{app. C, at 36.}
\textsuperscript{165} Id. \textsuperscript{app. C, at 37 n.113.}
\textsuperscript{166} Id.
\textsuperscript{167} Id.
\textsuperscript{168} Id.
\textsuperscript{169} Id.
The details of the transaction changed, however, and V&E met with Andersen to discuss the legal opinion. As Keyes noted in an e-mail to other V&E lawyers, "[f]or the first time . . . I think [the Andersen accountant] really realized that FAS 125 calls for more than what Arthur Andersen has been getting."170

Whatever psychological resistance may have served to prevent V&E from becoming suspicious could well have been subtly reinforced by awareness of the importance that Enron attached to the FAS 140 transactions. Dilg's notes for his meeting with Derrick describe these deals as "[l]arge transactions with significant earnings impact."171 "Given the combined size of the various deals," the notes say, Enron needed to "carefully focus" on what the company should say about them in the Management Discussion & Analysis portion of its securities filings.172 The notes indicate, for instance, that the MidTexas transaction was "[s]aid to represent 25% of earnings for 2d quarter," that Cornhusker generated $40 million of gain, that EuroCash produced $55 million on the sale of assets, and that Project Churchill generated $150 million in gain.173

Given the magnitude of the income produced by these deals, V&E lawyers could have been even more receptive to accepting Andersen's explanation why a true issuance opinion was sufficient—even if they didn't fully understand the accountants' reasoning. As earlier described, Keyes apparently felt some pressure from Enron not to rock the boat by emphasizing the difference to Andersen between true sale and true issuance opinions, because this "could jeopardize Enron's FAS 125 transactions."174

Similarly, Dilg testified that if V&E was asked for a type of opinion that it believed it could not give, that might require expensive restructuring of transactions. "I didn't want to be in [the] position," Dilg said, "of Mr. Derrick hearing that Vinson and Elkins was unwilling to give an opinion that was going to cost the company a fair amount of money to restructure transactions to satisfy us without him being aware of that potential beforehand."175 This of course reflects appropriate concern that the client be fully informed. It also, however, indicates awareness that insistence on V&E's position as to what was necessary to satisfy the legal isolation requirement could prove costly to Enron. Even if only subconsciously, Dilg

170. Id. app. C, at 47 n.169. The Examiner also seemed to accept that Andersen did not fully appreciate for some time the issues surrounding the necessary legal opinion for the FAS 140 transactions. "It was not until Project Iguana," he said, "that Andersen appears to have understood the import of the true issuance/true sale distinction and the 'no recharacterization' assumption contained in Vinson & Elkins' true issuance opinion letters." Id. app. C, at 47. This was the transaction that Keyes referred to in his internal e-mail.
171. Id. app. C, at 48.
172. Id.
173. Id.
174. Id. app. C, at 47 n.169.
175. Id. app. C, at 44 n.155; see also id. app. C, at 45 (reporting that Dilg's notes from a meeting with Derrick relating to the MidTexas transaction stated, "Don't want deal to blow up at last moment and cause earnings surprise").
thus may not have been determined to press the issue forcefully with Derrick, nor displeased to hear Derrick's and Causey's assurances that a true issuance opinion was adequate.

Faced with tension between its own understanding of the legal isolation requirement and Enron's and Andersen's insistent request for a true issuance opinion, V&E appears to have tried to steer a middle course. It provided a true issuance opinion, but made explicit in the opinion that it was assuming that a court would not treat the sequence of transactions as a loan secured by the financial assets that had been transferred. This was intended to emphasize that the firm was not purporting to render a true sale opinion.

As a matter of legal analysis, however, this approach seems problematic. The legal isolation condition required assurance that the assets would not be treated as part of the transferor's estate in the event of that entity's bankruptcy. Securitization of financial assets necessarily involves a series of transactions that, considered as a whole, is supposed to produce that result (among others). V&E's opinion addressed one particular step in the sequence of transactions, but assumed what Enron was supposed to demonstrate—that the transactions together resulted in a transfer of assets that were legally isolated. Furthermore, as both V&E and Andersen comments indicated, a prerequisite for the Asset LLC's ability to issue an interest in the asset to the SPE is that the Asset LLC own the asset.

The potential problem of focusing on only one isolated part of the sequence of transactions is highlighted by the fact that V&E felt that it could not provide a true sale opinion for some of these projects. As Dilg testified with respect to the concerns that his partners had raised about rendering only a true issuance opinion, "there was something in the structure, and I can't recall the details, that would have prevented us from being able to render an opinion on the true sale nature of the transfer of the assets..."177

Was it appropriate for V&E to take such a narrow focus in its opinion in cases in which it had doubts that a true sale of assets from Enron to the Asset LLC had taken place? One question is how much information V&E had in order to make its judgment about whether there had been a true sale. Did its work on the true issuance opinion inevitably provide the firm with details about prior steps in the sequence of transactions? If V&E suspected that the original asset transfer might not always be a true sale in these transactions, could it ask to receive only information about the issuance of the Class B interest by the Asset LLC to the SPE? Could it claim that this...
is all it needed to perform its assigned task, thereby avoiding acquiring any disturbing information about the larger picture?

Or imagine a common scenario in transactional work: specialized division of labor. Suppose that V&E was asked to provide a true issuance opinion and another law firm took responsibility for rendering a true sale opinion. Could V&E then simply defer to the judgment of the other firm on the true sale issue? The Examiner noted, for instance, that some V&E partners were troubled with some of the true sale opinions given by A&K, the law firm that had begun to handle most of the FAS 140 transactions in late 1998. As V&E partner Ronald Astin testified, "I was concerned that if we believed there was something so fatally wrong with the opinion that we didn't think a reasonable lawyer could give it that it implicitly undercut the reported financial results of the company." V&E ultimately decided that it could not say that a reasonable lawyer could not provide the true sale opinions, so it did not raise the issue with Enron.

V&E's concern about A&K's true sale opinions arose with respect to disclosure issues on transactions on which V&E had not worked. The firm's conclusion that the opinions were acceptable would seem even more likely in the hypothetical case in which V&E was working on the true issuance opinion and A&K on the true sale opinion. To raise a concern in that setting would present a direct obstacle to effecting the transaction in an organizational culture that emphasized devising and closing deals quickly. Simply deferring to A&K would allow V&E to focus on its part of the deal, without having to confront troublesome questions about the transaction as a whole.

V&E's involvement in the FAS 140 transactions thus provides a useful vehicle for exploring some of the issues of ethics and judgment that arise in transactional work. In retrospect, it is not hard to claim that V&E should have stood firmly by its understanding of what was necessary to satisfy the legal isolation requirement—at least until it received a persuasive explanation from Enron and Andersen for why a true issuance opinion was sufficient. Furthermore, one can argue that at some point the failure of these parties to provide such an explanation should have evoked not puzzlement but suspicion.

Several features of the situation, however, militated against V&E responding in this way. First, there is the natural tendency to give the benefit of the doubt to persons with whom we regularly work. This tendency may have been even more pronounced in the case of Enron, a company with a reputation for cutting-edge innovation by employees who did not suffer fools gladly. It is conceivable that a lawyer operating in this milieu may have been especially reluctant to second-guess the client and its

178. See infra Part III.E for a discussion of Andrews & Kurth's work on the true sale opinions.
180. Id.
accountant, and likely instead to assume that he or she just did not fully grasp the creative approach that Enron and Anderson were taking.

Furthermore, at least some of the V&E attorneys knew that the FAS 140 transactions were generating considerable income for Enron. The prospect of telling Enron that it would have to restructure these transactions in order to obtain a true sale opinion—or even stop them altogether—must not have been a pleasant one for a law firm that prided itself on working closely with a company that was seen as a business revolutionary.

The inclination to adopt a benign interpretation of events may have been reinforced by three rationalizations that often are available in transactional work. The first is deference to other experts. V&E could claim that what Andersen needed to support the desired accounting treatment for the FAS 140 transactions was an accounting, not a legal, issue. To reiterate the statement of a V&E lawyer, “they were the accountants, they understood what they wanted . . . [and] I had . . . no reason to think that was not reasonable from an accounting criteria standpoint.”

The second rationalization is taking refuge in narrowly defined responsibility. V&E could claim that its role was confined to determining if there had been a true issuance of interest from the Asset LLC to the SPE. This is what the client wanted, and this is what V&E provided. Anything beyond this relatively narrow task was for others to consider.

Finally, corporate lawyers are supposed to defer to the business judgment of their clients, even if they may think it imprudent or misguided. Whatever risks may have existed beyond the question of whether there was a true issuance were for Enron executives to weigh and balance, not V&E. The law firm had raised its concerns with the highest-ranking legal and accounting officers at Enron. If they were comfortable with the situation, V&E could say that it had fulfilled its obligation to ensure that the client makes fully informed decisions.

These three claims often are appropriate in transactional practice. Lawyers and law students need to be aware, however, that in some cases they can serve as rationalizations that prevent clear-eyed recognition of problematic behavior. They also need to appreciate that the tendency to rely on them will be greater when a lucrative client fosters a deal-making culture that bristles at any obstacle to moving forward.

E. Issue Two: Andrews & Kurth Opinions

Beginning in November 1998, A&K represented Enron in the majority of the company’s FAS 140 transactions. From that month through October 2001, the firm delivered at least twenty-four true sale or true issuance opinion letters in connection with such transactions. In cases in which the firm provided a true issuance opinion, “[u]nlike Vinson & Elkins,
Andrews & Kurth did not raise with Enron or Andersen whether or not a true issuance opinion was responsive to the requirements of FAS 125 or FAS 140." In virtually all these transactions, an Enron sponsor transferred an asset to an Asset LLC over which it had voting control. That LLC then issued a Class B interest in the income from the asset to an SPE, which financed the purchase of that interest through a bank loan. In most transactions, Enron entered into a Total Return Swap with the SPE.

The Examiner found that A&K was aware that Enron’s goals in these transactions were to raise funds that would not be reflected as debt on its balance sheet and to recognize a gain on its income statement when the sale price of the asset exceeded the value at which Enron was carrying it on its books. He also found that the firm was aware that “the opinions it rendered in the FAS 140 Transactions were critical to Enron’s intended accounting treatment.”

A&K explicitly recognized in many of its opinions that the Total Return Swap had the characteristics of a guarantee of the loan obtained by the SPE ostensibly to purchase the asset. Furthermore, the bankruptcy Examiner noted A&K memos stating that in these transactions “Enron, as a practical matter, retains all the risks and rewards of owning the asset,” and that while the deals “were structured as sales for the purpose of accounting treatment, Enron retained full control over its interest . . . and commercially the transactions look more like financings.” Questioned by the Examiner with respect to the first statement, however, the author of the memo testified that he was “not sure it’s completely accurate,” because it did not take into account that the risks were limited to the payment of the debt, and the reward was only any appreciation in the value of the asset that exceeded what was necessary to repay the SPE’s security holders.

An additional way in which Enron allegedly sought to retain control of the asset supposedly transferred was to prepay the SPE’s loan. This resulted in unencumbering the asset whose income effectively was used to guarantee the loan. It was done by purchasing the equity interest in the SPE and then directing the SPE to pay off the loan and “unwind” the transaction. As a formal matter, the existing SPE equity holder could refuse Enron’s offer to purchase its interest. In fact, however, there was never an instance in which Enron made an offer that was not accepted. Indeed, an A&K memo to Enron in March 2000 stated, “In the deals which closed in December we were given very clear instructions that Enron had to be able to prepay and get the assets back at any time. A right to prepay in full was

183. Id. app. C, at 52 n.180.
184. Id. app. C, at 54-55.
185. Id. app. C, at 55 (footnote omitted).
186. Id. app. C, at 58.
187. Id. app. C, at 56-57.
188. Id. app. C, at 59 n.199.
189. Id. app. C, at 57 n.192.
included in the documents (as for all previous deals)." While the author of this memo clarified to the Examiner that the SPE, not Enron, had the right to prepay, he could not "identify a single instance where Enron desired the facility to be prepaid and it was refused." The prepayments occurred despite the fact that the terms of the FAS 140 transactions provided for an auction of the asset transferred to the SPE (the Class B interest) just before the date on which the SPE had to pay off its obligations to the lender and security holders. Proceeds from the auction were to provide the SPE with funds that would be paid to Enron under the Total Return Swap. A genuine auction would have transferred control of the asset to a party other than Enron or any of its affiliates.

A memo that Enron sent to A&K for revisions, however, stated that "the Auction-related mechanisms will come into play ONLY if the indebtedness is not prepaid by the Sponsor [an Enron affiliate], which is always [Enron] Global Finance’s planned means of unwind and has been, with one exception I’m aware of, the actual means of unwind." The memo noted, however, that "this prepayment plan is not memorialized in any deal documentation (and cannot be for financial accounting and legal opinion purposes)."

The Examiner found that A&K was aware as early as November 1998, in connection with the first FAS 140 transactions on which it worked, that "Enron did not intend to transfer the monetized asset to a third-party." An A&K memo recounted that the lead Enron attorney assigned to the FAS 140 transactions "did not want to mention the auction in the consent. I said this was okay as long as Enron [was] absolutely confident that there would never in practice be a sale to a third party. [The Enron attorney] said that this was correct . . . ."

A&K worked on both the FAS 140 transactions and on Enron’s steps to unwind them, sometimes simultaneously with respect to the same transaction. Some of the transactions were unwound as soon as about two weeks, four weeks, six weeks, and two months after the transaction transferring the asset had closed. Indeed, in some of the fifteen unwound transactions, the unwinds were effected before the firm issued its true sale or true issuance opinion letter for the original FAS 140 transfer of assets.

The Examiner observed that the ability of Enron to prepay the loan and equity did cause some concern to A&K. In the course of closing an FAS

191. Id. app. C, at 59-60.
194. Id. app. C, at 61. The only exception was an auction in which the purchaser of the asset was an entity controlled by Enron. Id. app. C, at 62 n.211.
195. Id. app. C, at 61.
196. Id. app. C, at 61 n.207.
197. Id.
198. See id. app. C, at 66 (summarizing unwound transactions).
199. Id.
140 transaction in late 1999, attorneys at the firm asked Enron whether prepayment and sale by Enron about two months after the transaction closed would “jeopardize the FASB 125 treatment of the transaction? Does it matter if [the Enron affiliate] intends to arrange such a sale and prepay the facility at the time of entering into the FASB 125 transaction?”

The Examiner said that he had not seen any evidence that A&K received an answer to this question. He stated, “Andrews & Kurth appeared to think that the answer required an accounting judgment, but the question calls for a legal conclusion.”

The Examiner concluded that Enron could have a cause of action against A&K for malpractice based on Texas Rule 1.12 or negligence, as well as for aiding and abetting officers’ breaches of their fiduciary duties, in connection with the firm’s work on the FAS 140 transactions. A&K, he said, knew of Enron’s accounting goals in entering into these transactions, and “also knew that the risks and rewards of owning the assets remained with Enron and that isolation of the assets was not occurring.”

Furthermore, A&K assisted Enron in unwinding several of these transactions, and in some cases began work on that project even before delivering the opinion on legal isolation of the assets that was necessary for the transaction to close. “As the number of prepayments and unwinds grew,” said the Examiner, “Andrews & Kurth also knew that the transactions were being used by certain officers of Enron to manipulate its financial statements.”

The Examiner noted that A&K may argue that it lacked knowledge of wrongful conduct because the prepayments and unwinds were permitted under the transaction documents. Loans “are routinely repaid prior to their maturity dates or otherwise modified for a variety of legitimate business purposes,” the Examiner acknowledged, “but these transactions were supposed to be sales, not loans.” A&K also may argue that the opinions were issued “as of” the closing even though they were delivered later, and thus were correct as of their effective dates. The Examiner responded, however, that “the decision to issue an opinion must be made within the context of what the attorneys know about the intent of the parties, and their conduct reveals that intent. Conduct occurring after closing but before delivery of an opinion can reflect on the intent of the parties at closing.”

Even if A&K did not have knowledge of wrongdoing, said the Examiner, a fact finder could conclude that the firm was liable for malpractice based on negligence. This conclusion would be based on a finding that a prudent attorney would have recognized that certain Enron officers did not intend for Enron to relinquish control over the assets that were transferred and

200. Id. app. C, at 60.
201. Id. app. C, at 60 n.204.
203. Id.
204. Id.
205. Id.
were using the FAS 140 transactions to manipulate the company’s financial statements.\textsuperscript{206}

Finally, the Examiner found that a fact finder could conclude that A&K was liable for aiding and abetting Enron officers’ breaches of fiduciary duties by lending substantial assistance to those breaches. This consisted of issuing opinions and preparing documents necessary for the transactions to close. A&K may claim that it “acted merely as scriveners” who memorialized the terms of the deals, but the Examiner noted that “the rendering of just one legal opinion can constitute substantial assistance under some circumstances.”\textsuperscript{207}

Questions and Discussion

As the above summary indicates, A&K began doing most of the work on Enron’s FAS 140 transactions beginning in November 1998. There is no evidence in the record on this issue, but it is natural to wonder if this development was prompted in any way by V&E’s persistent questions about the adequacy of a true issuance opinion for these transactions. Dilg’s meeting with Derrick at which the former raised V&E’s concerns was on June 8, 1998. Derrick apparently went all the way to Chief Accounting Officer Rick Causey with Dilg’s questions, and Causey informed him that Enron and Andersen were comfortable relying on the true issuance opinions. Even after this reassurance, Keyes at V&E continued to have concerns, which he raised during work on a transaction that closed in November 1998.\textsuperscript{208}

It is not clear how much in additional revenue A&K gained from assuming primary responsibility for the FAS 140 transactions. We do know, however, as indicated earlier, that its fees from Enron jumped from $991,000 in 1997 to $2.3 million in 1998, $6.6 million in 1999, and $9.7 million in 2000.\textsuperscript{209} Even though V&E’s fees from Enron still dwarfed these figures, A&K probably was pleased that it finally had begun to acquire more legal business from Houston’s most famous corporation after being left in the shadows for many years.

Might this explain why, in contrast to V&E, A&K raised no concerns with Enron or Andersen about either the sufficiency of a true issuance opinion or the propriety of a true sale opinion? It is impossible to know for sure, but reasonable to ask the question given the competition for legal services in general and for work from Enron in particular. We know, for instance, that banks competed fiercely for Enron’s business, and allegedly assisted the company in structuring questionable transactions in order to obtain it. Simply remaining silent about any reservations that A&K may

\textsuperscript{206} Id. app. C, at 188-89.
\textsuperscript{207} Id. app. C, at 188.
\textsuperscript{208} Id. app. C, at 47. Keyes apparently continued to raise the issue as late as 1999 during a project on which he worked that closed late that year. Id.
\textsuperscript{209} See supra note 89 and accompanying text.
have had about the true issuance opinion would have been relatively simple by comparison.

At least with respect to true issuance opinions, Enron and Andersen may well have told A&K that V&E had been providing true issuance opinions on FAS transactions on a regular basis—while neglecting to mention that V&E had persistently raised questions about the practice. Being told this, A&K still had an independent obligation to satisfy itself that such opinions would satisfy the legal isolation requirement. By this point, however, Enron had done several apparently successful FAS 140 transactions, and likely communicated the idea that they were relatively routine. It probably is common after several essentially identical transactions have been closed for those working on them to regard them uncritically as routine, rather than rethink their basic rationale and structure with each iteration. Using the same basic documents, supplemented by some cutting and pasting, may be all that seems necessary once the deals take on a "cookie cutter" quality.

At this point, in fact, the work often is handed off to more junior attorneys who are not expected to exercise much discretion in performing it. Indeed, such attorneys sometimes work on only a discrete portion of a larger matter, and thus are not in a position to raise questions about the broader transaction. The Examiner stated that in the "vast majority" of cases, Enron asked for a true issuance, rather than true sale, opinion. It is therefore possible that inertia contributed to A&K’s failure to express any concerns about the use of true issuance opinions in Enron’s FAS 140 transactions.

What about A&K’s provision of true sale opinions, however? It is possible that Enron told A&K that V&E had rendered such opinions on previous FAS 140 deals, or at least left A&K with that impression. If so, the "cookie cutter" mentality may have made it less likely that the firm would conduct an independent analysis of the propriety of delivering such opinions.

What is more puzzling, however, is written comments by A&K that suggest their appreciation that these transactions really were not sales but loans. The Examiner identified statements by the firm that say that the Total Return Swap resembled a loan guarantee, that Enron retained the risks and rewards associated with the assets, and that the deals were structured as sales for accounting purposes but for commercial purposes were more like loans. How could A&K acknowledge this and still give true sale opinions? If it were simply the case that A&K knowingly assisted Enron in committing fraud, then we can regard these comments as cynical acknowledgments that the company was crossing the line with the assistance of A&K. What makes this explanation less than wholly satisfying, however, is that a firm with this attitude would be unlikely to express it so explicitly in print.

What seems more likely is that A&K knew that some features of the transactions had the characteristics of loans, but also knew that this in itself did not automatically mean that they were "really" sales. Securitization is a technique that in substance is a loan, in the sense that it allows a company to borrow funds more cheaply than it otherwise would be able to.\textsuperscript{211} At the same time, the funds that the company obtains do not show up as debt on its balance sheet, but as income from the sale of assets.\textsuperscript{212}

Furthermore, securitizations typically feature some degree of recourse against the transferor of the assets, which means that this entity continues to be exposed to some of the risks associated with those assets.\textsuperscript{213} As the Examiner noted, some courts treat recourse as an indication that a purported sale was really a loan, but others hold that recourse alone is insufficient to support such a conclusion.\textsuperscript{214} Some amount of divergence between economic substance and accounting treatment thus is the rule, rather than the exception, in structured finance transactions. Courts use multi factor tests, rather than bright lines, to determine when that divergence is too great to permit companies to characterize a transaction as a sale.

Such legal ambiguity leaves lawyers with significant opportunities to rationalize their behavior. This was particularly the case with respect to Enron. As the Examiner noted, none of the reported court decisions dealing with true sales involved "transactions of the complexity found in the Selected Transactions—a multi-tiered seller/borrower structure, multiple, contemporaneous transfers down the corporate chain and the existence of various derivatives, including swaps and complex arrangements consisting of various puts and calls."\textsuperscript{215} Add to this the cognitive filters of routinization and a likely disinclination to raise questions that would jeopardize A&K's increasing work flow from Enron. A possible result is a law firm that could make the kinds of comments that the Examiner identified without believing that it was on notice that Enron was abusing accounting rules. Whether that belief was reasonable, of course, is another matter.

Even if A&K had no concerns at the outset, the Examiner concluded that it eventually knew or should have known that Enron had no intention of relinquishing control over the assets that it supposedly sold to the Asset LLC. A&K knew that Enron was unwinding the FAS 140 transactions shortly after they had closed. In fact, in some cases A&K began work on the unwind before it delivered its opinion supporting the accounting

\textsuperscript{212} See generally Schwarcz et al., supra note 90, at 1-17.
\textsuperscript{213} "[A] buyer of financial assets always must demand, to the extent consistent with a true sale, some amount of contingent recourse against the seller." Schwarcz, supra note 211, at 27 (footnote omitted).
\textsuperscript{214} First Batson Report, supra note 5, at 43-44.
\textsuperscript{215} Id. at 41.
treatment of the transaction as a sale. A&K was aware that Enron intended to retain the ability to prepay the SPE’s obligations and reacquire the assets that it had transferred. Indeed, one A&K memo inquired whether this intent jeopardized the accounting treatment of these transactions. It also was aware from an Enron memo that plans to unwind the transactions could not be memorialized for “financial accounting and legal opinion purposes.”

As an A&K lawyer noted to the Examiner, the SPE, not Enron, was the entity with the formal authority to prepay the SPE security holders and unwind the transaction. Furthermore, the SPE was not legally required to sell its interest to Enron. As a formal matter, therefore, there was no provision that ensured that Enron always would be able to purchase the SPE interest, prepay the obligations to the security holders, unwind the transaction, and reacquire the assets. As a practical matter, however, this inevitably is what happened. Here again is a divergence between form and substance. When is that divergence large enough that the lawyer must conclude that form is being abused?

In the case of the prepayments and unwinds, the issue is how probative they are concerning the intent of the parties in the FAS transactions. Specifically, do they indicate that Enron never intended to relinquish control over the assets? Intent can be inferred not only from what the parties say, but from what they do, even after a transaction has closed. At what point should A&K have concluded that, notwithstanding the formalities, these transfers of assets were not really sales? After the first transaction was unwound? The second? The fifth? What if the SPE once refused Enron’s offer to purchase the security interest? As one scholar of structured finance observes, “warning signs are more easily recognized than defined,” which means that generally they must be identified on a case-by-case basis. This means that a law firm in A&K’s position may find it easy to rationalize to itself that, all things considered, form is not being abused.

Consider other scenarios that involve even more ambiguity, and thus more opportunities for rationalization. We know, for instance, that, in addition to the unwinds, the Total Return Swaps cast doubt on the propriety of treating the FAS 140 transactions as sales. Suppose that there were no such swaps, so that there was a stronger case that the risks and rewards associated with the assets had been shifted to the Asset LLC. Would the same pattern of repayment and unwinds still create a problem, because those risks and rewards were transferred for only a brief time? Or should each repayment and unwind be treated as separate from the original transfer, and not relevant to the accounting treatment?

Or suppose that the repayments and unwinds occurred, but A&K did no work on them. That would create the opportunity for the firm to claim that

216. Final Batson Report, supra note 75, app. C, at 61 (quoting an e-mail from Enron to Andrews & Kurth).

217. Schwarcz, supra note 211, at 31.
it was unaware of these arrangements. Furthermore, even if it were aware of them, it might argue that it was responsible for only one aspect of the transaction, and did not purport to pass judgment on the work that others did on other matters.

The significance that the Examiner attached to the unwinds reflects the fact that concepts such as intent, business purpose, and economic substance theoretically are available to limit lawyers’ ability to take refuge in technical compliance with form. No transactional lawyer can assume that conformity to the letter of the law always will protect her from liability for perpetrating a breach of its spirit. At the same time, it is a matter of degree—not every violation of the spirit of the law constitutes a fundamental breach. Transactional lawyers thus need to employ not only legal, but fundamentally ethical, judgment in determining when form no longer should triumph over substance.

Finally, it is important to keep in mind that lawyers may attempt to avoid the responsibility for exercising such judgment by arguing that an issue calls for the professional judgment of another expert. As the Examiner noted, for instance, A&K asked whether the plan to unwind the FAS 140 transactions and reacquire the assets could jeopardize the accounting treatment.218 The Examiner suggested that A&K raised this as an issue for the accountants to consider, rather than a question for the lawyers. Is he right that this issue requires a legal analysis, rather than an accounting judgment? What precisely determines into which category a question falls?

On the one hand, accountants need lawyers to determine the legal rights and obligations that flow from a transaction in order to determine what accounting treatment of that configuration of rights and obligations is appropriate. On the other hand, A&K might argue that it was saying to Enron and Andersen, “This is the combination of rights, obligations, and intentions that characterize this transaction. Do the intentions jeopardize the accounting treatment?”219 Such ambiguity can make it easy to deflect responsibility.

IV. PROJECT NAHANNI

A. Background

At a September 1999 meeting between Enron and Citigroup, Enron indicated that a delay in the sale of one of its merchant investments was likely to cause it to fall short of its projection of cash flow from operations for the year.220 This source of cash flow reflects cash obtained from

219. In this case, it seems reasonable that Enron and Andersen would turn the question back to the lawyers and say, “That depends on the legal significance of these intentions.”
acquiring and selling the company’s products and services. Positive and increasing cash flows from operations “usually denote a healthy enterprise that can use this cash to expand operations, satisfy long-term obligations, or provide a return on investment to its owners.” By contrast, investors regard cash flow from investing (acquiring and selling long-term investments and assets) or financing (obtaining cash from short- and long-term debt from creditors) as a less useful reflection of the soundness of the company’s basic business operations.

The company explained that it would like to engage in a transaction with Citigroup to make up the shortfall in cash flow from operations. Citigroup’s response was Project Nahanni, which involved the sale of Treasury bills by a consolidated Enron subsidiary in which a third party created by Citigroup held a minority interest. Purchase of the Treasury bills by the subsidiary was financed by a loan from Citigroup, and proceeds from the sale of the T-bills were entered as cash flow from operating activities on Enron’s financial statements at the end of 1999. Shortly after the beginning of the year, Enron repaid the loan to Citigroup.

As the Examiner explained, the economic substance of the transaction was that Enron borrowed $500 million from Citigroup, bought T-bills with it, sold the bills, recorded the proceeds from the sale as $500 million in cash flow from operating activities, and then repaid the loan from Citigroup, all within thirty days straddling the end of the 1999 reporting year, without reflecting the loan as a debt on its financial statements.

In the announcement of its settlement with Citigroup relating to Project Nahanni and other matters, the SEC stated that the transaction was entered into “just long enough to achieve a year-end financial reporting effect,” and that characterizing proceeds from the sale of the T-bills as cash from operating activities “created the false impression that this transaction related to Enron’s regular course-of-business investments in energy and technology companies.” The Examiner similarly found that the accounting treatment of the proceeds was not in conformity with generally accepted accounting principles (“GAAP”), and that the loan obtained to purchase the T-bills by the subsidiary should have been recorded as debt on Enron’s balance sheet. In essence, the Examiner concluded, Project Nahanni served no business purpose other than to burnish Enron’s financial statements. The

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222. Id. at 263.
224. Id. at 2623.
228. Id. app. I, annex 3, at 14.
next two sections describe how the transaction was structured and the roles that lawyers played in that process.

B. The Structure of Project Nahanni

Nahanni was a form of transaction that the Examiner described as a "minority interest financing transaction."230 In these financings, Enron or an affiliate formed a majority-owned subsidiary. This subsidiary was consolidated with Enron's financial statements.231 Another entity with at least 3% equity from non-Enron sources was the minority owner in the subsidiary.232 Of the funds contributed to the subsidiary by this entity in return for its minority interest, three percent was comprised of equity and the other 97% of the proceeds of loans.233 The majority-owned subsidiary then typically loaned these funds to Enron or an Enron affiliate. This amount was reflected on Enron's balance sheet as an ostensible investment in the minority interest in the subsidiary, rather than as debt.234

For purposes of the Nahanni project, Enron created a subsidiary known as Marengo, in which a wholly owned Enron subsidiary, Yellowknife, held a majority interest as general partner.235 In return for its interest, Enron contributed $400 million in Enron notes and $100 million worth of preferred stock in one of its wholly owned subsidiaries.236 Nahanni was created as an entity to serve as the limited partner in Marengo. The source of its capital contribution to Marengo was a $485 million loan from Citigroup, secured by Nahanni's interest in Marengo, and $15 million of equity contributed to Nahanni by investors.237 With its $500 million in debt and equity Nahanni then purchased $500 million worth of Treasury securities, which it contributed to Marengo in exchange for Nahanni's limited partnership interest.238 The entire structure was put in place on December 21, 1999.239

On December 29, 1999, Enron directed Marengo to sell the Treasury bills and make the $500 million proceeds available to Enron under a demand loan from Marengo to Enron.240 As a condition of this transaction,

230. Id. app. I, annex 1, at 1. The discussion in this paragraph is drawn from Appendix I, pages 1-4. The Examiner distinguished minority interest financings from "simply third-party minority interest investments in Enron subsidiaries." Id. at 79 n.155.
234. The loan from the subsidiary to Enron was then treated as an intercompany loan that was cancelled out in the consolidation of the financial statements. Id. at 81.
236. See infra fig.2 (step 1); see also Second Batson Report, supra note 55, app. I, annex 3, at 5.
237. See infra fig.2 (step 2); see also Second Batson Report, supra note 55, app. I, annex 3, at 6-7.
238. See infra fig.2 (step 3).
240. See infra fig.2 (step 4).
Citigroup required that Enron obtain a letter of credit from a financial institution to guarantee the loan. The term of the loan could not exceed the term of the letter of credit that Enron obtained. The letter of "credit... expired on January 27, 2000, thus assuring repayment of the loan prior to that date." Enron recorded the $500 million that it had obtained from Marengo as cash flow from operating activities, which constituted 41% of the $1.2 billion in such funds for 1999.

The Examiner stated that, on January 13, 2000, Enron drew on the letter to repay the loan to Marengo with interest. On the following day Enron caused Marengo to partially redeem Nahanni’s limited partnership interest in the amount of $485 million in principal and $2.1 million in interest, which Nahanni used to repay its loan from Citigroup.

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242. See infra fig.2 (step 5).

243. See infra fig.2 (step 6).

244. See infra fig.2 (step 7).

245. The Third Batson Report says that the loan was repaid on January 13, 2000, and that $485 million was repaid to Nahanni the following day. Third Batson Report, supra note 241, app. C, at 62. The SEC Proceeding, however, says that Enron drew on the letter of credit to repay the loan to Marengo on January 24, 2000, and then directed Marengo to pay Nahanni $487.1 million, representing the principal and interest on Nahanni’s loan from Citigroup. Citigroup, Inc., 80 SEC Docket 2614, 2623 (2003). This slight difference, however, does not affect the analysis of the transaction by the Examiner and the SEC, which is based on the fact that Enron effectively received $500 million from Citigroup and arranged beforehand to repay it less than thirty days afterward. See also infra fig.2 (step 8).
FIGURE 2: PROJECT NAHANNI

(1) Enron transfers $400 million in notes and $100 million in preferred stock to Marengo, in return for majority interest and general partner status.

(2) Nahanni was created and capitalized with a $485 million loan from Citigroup and $15 million in equity from outside investors.

(3) Nahanni purchases $500 million in Treasury securities and contributes these to Marengo in return for limited partner status.

(4) On December 29, 1999, Marengo sells the Treasury securities it receives from Nahanni and transfers proceeds to Enron, in return for a demand note backed by a Letter of Credit.

(5) Enron records the proceeds it receives from Marengo as cash flow from operations for the last quarter of 1999.

(6) On January 13, 2000, Enron repays the loan from Marengo with interest.

(7) On January 14, 2000, Marengo redeems Nahanni's partnership interest in the amount of $487.1 million.

(8) Nahanni uses the $487.1 million to repay the loan from Citigroup with interest.
The payment to Nahanni did not cover the $15 million in equity that Nahanni had received from outside investors, because Enron wanted to be able to continue to use this entity for “year-end financial statement management” without having to include the debt on its own balance sheet.\textsuperscript{246}

Enron’s treatment of the $500 million as cash flow from operations was based on “the pretext that buying and selling bonds was part of Enron’s day-to-day business.”\textsuperscript{247} Enron did engage in trading in various “merchant investments”\textsuperscript{248} in companies in industries such as energy and telecommunications, which trading could be considered part of its operating activities. On the advice of Andersen,\textsuperscript{249} Enron expanded the definition of “merchant investments” in its annual 10-K report for the year ending December 31, 1999, to include government securities maturing in more than ninety days.\textsuperscript{250}

As the Examiner noted, however, Enron’s own guidelines for classifying an asset as a merchant investment describe “venture” activity in companies, projects, or infrastructure assets. “A mere short-term investment in Treasury securities,” said the Examiner, “very plainly is not the type of ‘venture’ investment contemplated by Enron as a merchant investment.”\textsuperscript{251} For this reason, the cash flow from the sale of the T-bills at a minimum should have been presented as cash flow from investing activities.

Furthermore, noted the Examiner, the transaction was “hardwired” in such a way that it in substance was not an investment but a loan.\textsuperscript{252} By “hardwired,” the Examiner meant that the transaction was structured to accomplish a particular economic result that was fundamentally inconsistent with the way it was treated for accounting purposes.\textsuperscript{253} Tying the term of the loan to the expiration date of the letter of credit effectively preordained that the loan would be repaid within thirty days of the December closing of the transaction. In practical terms, the Examiner said, the deal was structured so that “the proceeds resulting from the year-end sale of the treasury securities contributed to [Marengo] would be repaid to the Nahanni lenders within thirty days.”\textsuperscript{254} The only reason for this quick

\textsuperscript{246} Third Batson Report,\textit{ supra} note 241, app. C, at 62 n.233. The Enron Examiner found, however, that the outside equity in Nahanni was not at risk because of certain guarantees that “effectively assured repayment of both the equity and the debt portions of Nahanni’s investment.” Second Batson Report,\textit{ supra} note 55, app. I, annex 3, at 15. As a result, he said, Nahanni should have been consolidated with Enron’s financial statements, and the loan that Nahanni obtained from Citigroup recorded as debt on Enron’s balance sheet.\textit{Id.}

\textsuperscript{247} McLean & Elkind,\textit{ supra} note 13, at 157.


\textsuperscript{249} \textit{Id.}

\textsuperscript{250} \textit{Id.}

\textsuperscript{251} \textit{Id.}

\textsuperscript{252} Third Batson Report,\textit{ supra} note 241, app. C, at 61.

\textsuperscript{253} \textit{Id.}

\textsuperscript{254} \textit{Id.} app. C, at 62.
round trip of the money was for it to appear as cash flow from operations on Enron’s year-end balance statement before Enron paid it back.255

As a result, the Examiner found, there was sufficient evidence from which a fact finder could conclude that “the Nahanni transaction was implemented over year-end for the purpose of artificially inflating Enron’s cash flow from operating activities, rather than to obtain financing or for another business purpose.”256

C. Enron’s Attorneys

V&E served as outside counsel for Enron in Project Nahanni, under the supervision of Scott Sefton, General Counsel for Enron Global Finance. Although it appears that counsel for Citigroup drafted many of the transaction documents, both Sefton and V&E attorneys reviewed and analyzed the relevant material. Ronald Astin of V&E testified that Sefton, he, and V&E partner Kenneth Anderson, whose specialty was banking, finance, and loan transactions, were the attorneys representing Enron’s interest.257

Astin told the Examiner that V&E’s understanding of Nahanni was that it was akin to a revolving loan available to Enron for use over a period of time—that it would be “used, repaid and reused.”258 This is consistent with the fact that when Enron repaid the loan it directed Marengo to return only an amount reflecting Nahanni’s debt to Citigroup.

This ostensibly left sufficient equity from outside investors in Nahanni to avoid having to include any of that entity’s debt on Enron’s balance sheet.259 This in turn made Nahanni available for additional minority interest transactions with Enron. Astin testified that he was not aware that Enron intended to repay the loan shortly following the end of 1999. When he was working on the transaction, he said, he did not believe that “it was anything other than a structure that was intended to last for a significant period of time.”260

The Examiner found, however, that, “given the repeated use of specific year-end straddling dates in connection with the transaction documents, a fact finder could reasonably infer that the intent to hardwire the transaction” to accomplish prompt repayment was apparent to attorneys working on the

255. Indeed, the Examiner quoted an internal Citibank memo that described the transaction as producing “year-end window dressing” for Enron. Second Batson Report, supra note 55, app. I, annex 3, at 2.
257. Id. app. C, at 70.
258. Id. (footnote omitted).
259. Marengo was consolidated into Enron’s financial statements, but Nahanni’s interest in Marengo could be shown on Enron’s financial statements as a minority interest in a consolidated Enron subsidiary, as long as there was at least a three percent equity investment in Nahanni by an outside investor. Second Batson Report, supra note 55, app. I, annex 3, at 14-15.
Evidence of this intent includes: (1) the Marengo partnership provision permitting the Enron note to Marengo to be held only between December 17, 1999, and January 24, 2000; (2) the requirement that the letter of credit be drawn down before January 18, 2000, to pay the Enron note; (3) the expiration of the letter of credit on January 27, 2000; and (4) the fact that the Marengo Partnership Agreement permitted only one distribution to partners annually, to be made no earlier than January 13 of any year. In addition, the Examiner pointed to a memo from an associate at V&E to Sefton and Astin stating in a summary of the parties’ obligations that “‘Yukon must not continue to hold [the Enron demand note] after January 23, 2000.’”

These were among the documents reviewed by Astin or Anderson, noted the Examiner, “although neither attorney worked on all of them.” As a result, a fact finder could conclude that it was “apparent to these attorneys that the repayment of the $500 million within thirty days of the December 1999 closing, was preordained.” A fact finder also could conclude that V&E “knew of Enron’s accounting goal—to recognize funds flow at year-end—and knew that the Nahanni transaction lacked any material business purpose apart from its impact on Enron’s financial statements.”

The Examiner found that there was no evidence of any attempt by either Sefton or the V&E attorneys to raise concerns about the transaction, including the early unwind, at any time before or after it closed. He therefore concluded that Enron might have causes of action against V&E for malpractice based on Texas Rule 1.12, malpractice based on negligence, and aiding and abetting Enron officers’ breach of their fiduciary duties.

The Examiner noted that V&E might argue that Nahanni had a substantive business purpose, which was to obtain financing. If it was a financing, however, the Examiner said, “it was being entered into for a very short term and was structured to require repayment within thirty days, all to produce operating cash flow at year-end 1999.” The Examiner noted that V&E might claim that it did not know that the $500 million would be repaid so soon, “but the documents clearly require such repayment, so any such contention would present an issue of fact for the fact-finder.”

The Examiner also concluded that Enron might have causes of action against Sefton for malpractice based on Texas Rule 1.12 and breach of fiduciary duty because he knew that Nahanni “lacked any business purpose

261. Id. app. C, at 70-71.
262. Id.
263. Id. app. C, at 71 n.259.
264. Id. app. C, at 71 (footnote omitted).
265. Id. app. C, at 72.
266. Id. app. C, at 180.
267. Id. app. C, at 180, 183-84.
268. Id. app. C, at 180.
269. Id.
apart from its impact on Enron's financial statements." Sefton might argue, the Examiner noted, that he did not understand enough about the transaction to appreciate its lack of valid business purpose. This argument, however, might "provide support for a claim that he committed malpractice in light of his responsibility to oversee the legal work" on the project on Enron's behalf.

Sefton alternatively might claim that a valid business purpose animated the transaction because it was a financing. As with such a claim by V&E, the Examiner responded that the "hardwired" nature of the deal indicated that if it was a financing, it was entered into for a very short term and was structured to be repaid within thirty days that straddled the end of the fiscal year, "all to produce operating cash flow at year-end 1999." While Sefton may argue that he did not know that the $500 million would be repaid so quickly, the documents clearly indicate this, so that his claim would present an issue of fact for a fact finder.

D. Questions and Discussion

Astin described his understanding of Enron's business purpose for Project Nahanni as follows: "[A]t this point in time [Enron was] capital hungry and all I can recall thinking is that this is one more in a series of transactions where they were trying to raise money." He said that he believed that Project Nahanni created a revolving loan fund on which Enron could draw over time, and was unaware of the provision for rapid repayment of the $500 million.

The Examiner stated that certain documents prepared in connection with the transaction put Astin and Andersen on notice of the planned repayment of the $500 million within thirty days, "although neither attorney worked on all of [these documents]." Citigroup apparently created the transaction in response to Enron's request, and the bank's attorneys prepared many of the documents. Should a transactional lawyer be presumed to be familiar with all the documents prepared for a deal, regardless of who creates them? It is common for drafts to be circulated among many members of the project team for comment; does this suggest that such a presumption may be reasonable unless a lawyer can demonstrate otherwise? Even if the lawyer can rebut the presumption, she will still have to contend with the claim that a competent attorney should have been aware of the terms of key documents. To avoid a potential malpractice claim, should only deliberate concealment of the documents by another party be sufficient to exonerate the lawyer? In addition, regardless of the knowledge of any particular

270. Id. app. C, at 194-95.
271. Id. app. C, at 195.
272. Id.
273. Id.
274. Id. app. C, at 70 (footnote omitted).
275. Id. app. C, at 71.
attorney, should a law firm be liable for failing to be aware of all relevant features of a transaction?

In this case, the most direct evidence of hardwiring ostensibly available to V&E was a memo by a V&E associate that stated that the Enron demand loan could not be held after January 23, 2000.276 That memo, however, was dated February 8, 2000, after the loan had been repaid. Nonetheless, the associate preparing the memo presumably obtained his information from the relevant transaction documents, which suggests that V&E probably had access to them while the deal was being put together.

Even if V&E knew of the repayment terms at the time of the transaction, Nahanni did in fact remain available as a vehicle for further minority financing of Enron subsidiaries after the loan was repaid to Citigroup, although it was never used for this purpose. The larger structure that the deal created remained in place, even though the first transaction that used this structure would be completed in a brief period of time. V&E thus might argue that this undermines the claim that the firm knew that Nahanni was created in order to engage in only the $500 million transaction.

Even if that larger structure remained in place, however, did the $500 million transaction suggest that any future use of this structure would be for questionable purposes? What was the economic benefit to Enron of using the $500 million to purchase an asset of exactly the same value, then repaying the same amount shortly afterward? Had Enron used the money, for instance, to construct a plant or acquire a subsidiary, an observer would assume that the company expected ultimately that its investment would generate value that exceeded the amount of the $500 million purchase price. This would be true even if Enron repaid the money within thirty days. In that case, it would be easy to assume that Enron had a substantive business purpose for engaging in the transaction.

Should the absence of such a conventional business rationale for a transaction put a lawyer on notice that the company may have more sinister reasons for engaging in the deal? A lawyer may claim that whatever use a company makes of the proceeds that become available as a result of a transaction on which he works is a matter of business judgment. The lawyer is not in a position to second-guess the prudence or wisdom of that decision, even if it seems misguided or unconventional.

This seems most persuasive when a lawyer works, say, on a loan agreement, which results in proceeds that a company’s managers have discretion to use in a variety of ways. The Nahanni project, however, was not simply a loan from Citigroup to Nahanni. Rather, it was an integrated transaction intended to culminate in Enron’s use of proceeds from the sale of Treasury securities. In this instance, might a lawyer have a greater obligation to be aware of the business purpose that the transaction as a whole is supposed to serve? One dynamic that could have operated in this situation is that V&E lawyers did not fully understand Enron’s putative

276. Id. app. C, at 72.
business purpose for the transaction, but assumed that the fault lay with them for not appreciating the intricacies of yet another innovative Enron financing technique.

If a lawyer fails to identify any conventional business purpose for a transaction, should she at least be aware of how the company plans to treat it for accounting purposes? Astin said that he knew of Enron's intention to obtain proceeds from the sale of Treasury bills, and that he understood that this would result in "enhancement of cash flow."277 He did not testify, however, that he understood that the proceeds would be recorded specifically as cash flow from operations. If he had, would he then have an obligation to satisfy himself that this was appropriate? Is this a matter on which he should defer to the accountants, or must he be satisfied that their explanation is persuasive before ending his inquiry? If a transaction straddles reporting periods, is this enough of a warning sign that a lawyer should be absolutely convinced that the accounting treatment is correct?

If neither Astin nor his partner Anderson were aware of precisely how Enron planned to account for the proceeds, should they have known? That is, should they be liable for malpractice based on negligence? Does a lawyer working on a transaction have a responsibility to be informed not only about the transaction's technical compliance with legal requirements, but how the company plans to treat it for accounting purposes?

Finally, Sefton served as General Counsel of Enron Global Finance. Someone who occupies such a position might rationalize to himself that he is a generalist charged with broad oversight responsibilities, not someone equipped to dissect intricate financial transactions. While Sefton was charged with protecting Enron's interest in reviewing the documents drawn up by Citigroup's lawyers, he might argue he fulfilled that duty primarily by engaging experienced lawyers from V&E to analyze the transaction in detail.

How much can a generalist rely on specialists in a situation like this? Must the generalist at least understand the business rationale for the transaction in order to claim that his reliance is reasonable? Or should he assume that the company has a valid business purpose unless the specialists suggest otherwise? Enron Global Finance was the main engine within the company for a variety of complex financial transactions. Must the General Counsel of such a unit have enough familiarity with these kinds of arrangements to be able to analyze them in some detail? There's a good argument that the General Counsel can rely on specialists for professional judgment on close issues, but that he needs, at a minimum, to understand the economic rationales for the transactions that he is reviewing.

277. Id. app. C, at 70 (footnote omitted).
V. SUNDANCE INDUSTRIAL TRANSACTION

A. Background

As part of its efforts to expand its trading activity to new markets beyond energy sources, Enron began trading in paper, pulp, and wood products in 1997. By 2001, it held interests in paper mills in New Jersey and Quebec, timberland in Maine, and trading contracts for various forest products. The paper mills and timberland were held by two wholly owned subsidiaries, Enron North America ("ENA") and Enron Industrial Markets ("EIM"). The financial statements of these subsidiaries were consolidated with Enron's.

The trading contracts were held by Fishtail, which was an unconsolidated subsidiary whose owners were ENA; LJM2, a partnership in which Enron Chief Financial Officer ("CFO") Andrew Fastow had an interest; and a SPE called Sonoma. Sonoma in turn was owned by two parties. ENA held a Class A interest that entitled it to 0.01% of the economic proceeds from Sonoma, managing member status, and all voting rights. Caymus Trust held a Class B interest in Sonoma, entitling it to 99.99% of the economic proceeds from the SPE.

In 2001, Enron sought to place all of its forest products assets into a structure that would not be consolidated into its financial statements. Sundance Industrial partnership was created for this purpose. Sundance was structured on June 1, 2001, in the following way. EIM was the general partner, entitled to a 0.01% economic interest in Sundance. For this interest, it contributed the Quebec paper mill and the Maine timberland to the partnership. ENA was the Class A limited partner, entitled to a 79.99% economic interest in Sundance. For this interest, it contributed the New Jersey paper mill and its Class A interest in Fishtail (which held trading contracts).

Enron was the Class C limited partner in Sundance, contributing $208.5 million in cash. With this cash, Sundance purchased from Caymus Trust the Trust's Class B interest in Sonoma, which gave Sundance a 99.99% economic interest in that SPE (recall that Sonoma in turn held a 79.99% economic interest in Fishtail). Finally, Salomon Holding, a wholly owned Citigroup subsidiary, was a Class B limited partner in Sundance, which gave it a 20% economic interest in the partnership.

280. Id. app. K, at 58.
281. See infra fig.3 (step 1).
282. See infra fig.3 (step 3).
283. See infra fig.3 (step 2).
284. See infra fig.3 (steps 4-5).
In a transaction on which the Examiner focused, Salomon also purchased from ENA the Sonoma Class A interest for $20 million, and then immediately contributed this Class A interest, along with $8.5 million, to Sundance. This Class A interest entitled Sundance to 0.01% of the economic interest in Sonoma, but gave it managing member status and all voting rights in it.

285. See infra fig.3 (step 4).
286. See infra fig.3 (step 5).
(1) EIM contributes the Quebec paper mill and Maine timberland to Sundance, in return for general partner status and 0.01% economic interest in Sundance.

(2) Enron contributes $208.5 million cash to Sundance, in return for Class C limited partner status in Sundance.

(3) ENA contributes a New Jersey paper mill and Class A interest in Fishtail (which holds trading contracts), in return for Class A limited partner status in Sundance (79.99% economic interest).

(4) Salomon purchases for $20 million ENA’s Class A interest in Sonoma, (0.01% economic interest in Sonoma) which is part owner of Fishtail.

(5) Salomon contributes Class A Sonoma interest and $8.5 million cash to Sundance, in return for Class B interest (20% economic interest).
B. ENA Sale of Sonoma Class A Interest to Salomon

ENA could have directly contributed its Class A Sonoma interest to Sundance, rather than selling it to Salomon, which then contributed it to the partnership. The effect in either case would be the same: Sundance would acquire the Class A interest. Selling the interest to Salomon, however, allowed ENA to record $20 million in income from gain on the sale. This allowed Enron, through ENA, to recognize appreciation in the value of the trading business that otherwise would remain just an increase on paper. Had ENA contributed the Class A interest directly, it would have been unable to do this. Enron concluded that recognizing the proceeds as income was appropriate under FAS 140 because the transfer of the interest from ENA to Salomon was a true sale of the asset.287

As with the ostensible FAS 140 transactions discussed earlier,288 a true sale requires that the transferor relinquish control over the asset. To reiterate, one indication of such relinquishment is that a court would regard the transferred asset as legally “isolated” from the estate of the transferor in case of bankruptcy.289 Because Enron controlled Sundance as its general partner, Enron needed a legal opinion stating that the transfer would be treated as a true sale under state law so that after the transfer, the Sonoma Class A interest would not be reachable by Enron’s creditors. “Applying the principal factors considered by courts in a true sale legal analysis,” the Examiner declared, “it is clear that no sale of the Sonoma Class A interest to Salomon Holding took place.”290 The most important considerations leading to this conclusion were Salomon’s lack of control over the Class A interest, and the absence of any evidence that Salomon had any intent to own the asset.

In order for Salomon to retain the risks and rewards of owning the Class A interest, V&E suggested that a put and call agreement be included as part of the transaction.291 EIM, the general partner of Sundance, and Salomon executed such an agreement. It provided that during a six-month period Salomon had a right to call the Class A interest from Sundance (that is, to require Sundance to sell the interest back to it), and that Sundance had the right to put the interest back to Salomon (that is, to require Salomon to purchase the interest from Sundance). If Salomon called the asset, it would have to pay Sundance $20 million in cash. If Sundance put the asset back to Salomon, Salomon could either pay $20 million in cash or reduce its capital account in the partnership by the same amount.292

288. See supra Part III.C-E.
289. See FAS 140, supra note 93, at 4.
291. Id. app. K, at 78 n.331.
292. Id. app. K, at 78.
The Examiner found, however, that the terms of the put and call rights, combined with the terms of the Sundance Partnership Agreement, ensured that Salomon would never be forced to repurchase the Sonoma Class A interest. EIM could exercise the put on behalf of Sundance only on December 5, 6, or 7, 2001, after giving notice of the exercise to Salomon only on November 19, 20, or 21, 2001. This gave Salomon sufficient time to exercise its right under the partnership agreement to establish a Board of Directors to manage Sundance in place of EIM, and to create a deadlock that would cause the partnership to be dissolved.293 This meant that Salomon did not retain any genuine risk associated with the asset.

Furthermore, the Examiner stated, there was no indication that Salomon had any particular interest in the Sonoma Class A interest, which represented a 0.01% economic interest in the forest products trading contracts. Salomon conducted due diligence, for instance, on the Quebec paper mill that Sundance would hold, and "negotiated terms in the Sundance Partnership Agreement to protect that asset from being encumbered by future debt."294 By contrast, none of the internal Salomon memoranda analyzing the Sundance transaction mentioned the Sonoma Class A interest or the put and call agreement. Enron employees testified that it was Enron's idea to transfer the Class A interest to Salomon rather than contribute it directly to Sundance.295

In addition, there is evidence that the purchase price of the interest reflected internal Enron accounting methods, rather than arms-length negotiation between ENA and Salomon. "The circumstances surrounding this sale," said the Examiner, "make it difficult, if not impossible, to find any legitimate business purpose."296 There was no business reason why, instead of contributing $20 million directly to Sundance, Salomon would want to purchase an asset ostensibly worth the same amount, and then contribute that asset to the partnership.

C. Enron's Lawyers

Ronald Astin of V&E represented Enron in Project Sundance Industrial. The transaction originally had been structured so that Enron through ENA would directly contribute Sonoma's Class A interest to Sundance. A month before the anticipated closing, however, Enron advised Astin that it believed that the value of the trading assets represented by that interest had increased by $20 million since the trading activity had been moved off Enron's books into an unconsolidated subsidiary.297 Enron planned to

293. Id. Salomon could establish a Board of Directors on which it and Enron each would have fifty percent of the votes. If the Board deadlocked on any matter, Sundance would be dissolved, in which case Enron would be required to liquidate Salomon's investment, "making Enron the sole economic and voting owner of Sundance." Id. app. K, at 13.
294. Id. app. K, at 79 (footnote omitted).
295. Id. (footnote omitted).
296. Id.
realize that gain by selling to Salomon an interest that represented the increase in value. Salomon would then contribute that interest to Sundance. A draft memorandum from Astin to Enron, which Astin testified was never sent, said, “[W]e understand one result of the proposed sale transaction would be recognition of current period earnings.”

Two weeks prior to the closing, Enron told Astin that it would need a true sale opinion on the sale of the Sonoma Class A interest by ENA to Salomon in order to recognize the $20 million gain. In a draft memorandum, Astin described what was necessary for V&E to be able to render the opinion:

[W]e believe it is necessary for the transaction to reflect the assumption by [Salomon] of real risks and benefits of ownership of the Sonoma A that survive the transfer of the Sonoma A interest to Sundance. Any court reviewing the transaction would examine the substance and reality of the transaction rather than its mere form in order to assess whether the characterization chosen by the transaction parties would be respected . . .

In order for V&E to provide a true sale opinion, the memo stated, each of three conditions must be satisfied. First, “[t]he transaction must not be pre-wired (the option given to [Salomon] to contribute cash or the Sonoma A must be real).” Second, “[t]he transaction must have a commercial purpose for both parties (other than simply favorable tax or accounting . . .).” Finally, “[a]ny interest retained by [Salomon] must continue to possess aspects of risk and rewards of ownership with regard to the Sonoma A (that is, [Salomon] must have some continued ownership characteristics with regard to the asset it purchased).”

Astin focused primarily on the third condition—that Salomon retain the risks and rewards of ownership of the Sonoma A interest. Salomon’s immediate transfer of the interest to an affiliate of the seller threatened satisfaction of this condition. To address this concern, V&E suggested restructuring the transaction in order to include the put and call agreement described above. This agreement was the product of several weeks of intensive negotiation. Salomon wanted to minimize any continued risk associated with the Sonoma A interest, “which [V&E] attempted to resist.” The day before the transaction was scheduled to close, Astin stated in an internal e-mail,

298. Id.
299. Id. app. C, at 75 n.281.
300. Id. app. C, at 75.
301. Id. app. C, at 76 (footnote omitted).
302. See id. app. C, at 76 n.288 (“Astin testified that initially Vinson & Elkins attempted to get the transaction restructured so that Vinson & Elkins could give a true sale opinion.”); Second Batson Report, supra note 55, app. K, at 78 n.331 (noting that “the put and call was added at the suggestion of V&E”).
303. As a Citibank executive wrote in an internal e-mail, “Spoke with client.... They fully understand that we will blow the deal if we are at risk for the put . . . .” Second Batson Report, supra note 55, app. K, at 14.
The puts and calls are what is necessary for us to give our true sale opinion regarding true sale matters; at the moment, this is still a bone sideways in [Salomon's] throat, which is why we haven't closed. It has also put me in the annoying position of saying no serially to every request to remove the risk from Salomon, since we're already at the wall on the opinion.305

On the day of the closing itself, Salomon's attorney proposed modifying the agreement to provide that, under certain circumstances within the sole control of Salomon, the put and call could not be exercised and any prior attempts to do so would be ineffective. V&E refused to render a true sale opinion if this provision was accepted, and it was not.306

The Sundance Industrial transaction closed on June 1, 2001. The true sale opinion was dated June 30, 2001, but the opinion was not completed and executed until the end of July of that year. In that opinion, Astin included a footnote that observed that Salomon had the right to establish a Board of Directors to assume management of Sundance, and was entitled to appoint half the members of that Board. The footnote then went on to say,

If the Board of Directors, after appointment, experiences Deadlock [an event of dissolution of Sundance] at any time after notice of exercise of the Put is given, neither [Salomon's] nor [Enron's] representatives on the Board of Directors could force the Partnership to disclaim the contractual rights or obligations of Sundance with respect to such Put. Thus, [Salomon] does not have the power to block the exercise of the Put through the appointment of a Board of Directors, unless a Dissolution Event occurs before notice of exercise of the Put is required to be given under the [put and call] Agreement.307

The final clause of the footnote thus indicates that Salomon could block exercise of the put by establishing a board and creating a deadlock before notice of exercise of the put.

Attorneys at V&E testified that this was not a correct statement of the put and call agreement and the Sundance Partnership Agreement. Notwithstanding this clause, they indicated, the terms of the Partnership Agreement required that the option remain available for both parties to exercise prior to December 2000.308 Astin testified that he wrote this clause a month after the transaction closed, and that he may either have forgotten about the contrary provision of the Sundance Partnership Agreement or was referring to the termination of the partnership, rather than its dissolution though a board deadlock.309 If it was the latter, the Examiner observed, this would reflect acknowledgement that Salomon "continued to have the power

305. Id. (footnote omitted).
306. Id. app. C, at 77, 78 & n.293.
307. Id. app. C, at 78 n.298 (first alteration in original).
308. Id. app. C, at 78-79.
309. Id. app. C, at 79 n.300.
to block the exercise of the put if there were a termination of the partnership before the notice of exercise of the put were given."\textsuperscript{310}

Ultimately, the Examiner concluded that, while there was evidence that Salomon believed that its risks of owning the Sonoma Class A interest had been eliminated,\textsuperscript{311} V&E believed that it had drafted the documents so as to preserve such risk. He therefore did not find that V&E’s conduct with respect to the put and call agreement might serve as the basis for a claim against it by Enron.

The Examiner did conclude, however, that there was not a true sale of the Sonoma Class A interest to Salomon because the transaction served no business purpose\textsuperscript{312}—and that there was evidence from which a fact finder could infer that V&E knew this.\textsuperscript{313} An internal memo prepared by Astin in connection with the Sonoma A true sale opinion noted that “the transferor should be motivated by bona fide business benefits in consummating the structured finance transaction,” and that “[i]t may not be reasonable to rely on recitations set out in the documents, if the statements or conduct of the parties to the transactions are inconsistent with the recitations.”\textsuperscript{314}

In issuing its true sale opinion, V&E assumed that “each party has a valid business purpose for entering into the transaction.”\textsuperscript{315} “We wish to point out,” the opinion continued, “that we have not made any investigation or inquiry of any Party or of the books and records of any Party. Rather, we have relied on officer’s certificates and representations in the Transaction Documents as to such factual matters as we have deemed appropriate for the purposes of this opinion.”\textsuperscript{316} The Examiner concluded, however, that, the circumstances surrounding the inclusion of the “sale” at the last minute, the persistent attempts of Salomon Holding to extinguish any risk of ownership of the Sonoma Class A interest, and the difficulty that Vinson & Elkins had in negotiating the put and call provision belie that either Salomon Holding or Enron had any true business purpose in this transaction. The only purpose that Vinson & Elkins knew of from Enron’s perspective was to recognize the $20 million gain.\textsuperscript{317}

As a result, the Examiner found that there was evidence from which a fact finder could conclude that V&E was liable for malpractice under Texas Rule 1.12, and for aiding and abetting certain Enron officers’ breach of their

\textsuperscript{310} Id.
\textsuperscript{311} A description of the Sundance Industrial Transaction prepared by Citigroup on October 29, 2001, some three months after the delivery of the true sale opinion, stated with respect to Enron’s put right that “[w]e can avoid this result by calling a board and electing to dissolve the partnership prior to December 5, 2001.” Second Batson Report, supra note 55, app. K, at 78 n.337.
\textsuperscript{312} See supra notes 290-97 and accompanying text.
\textsuperscript{313} Final Batson Report, supra note 75, app. C, at 182.
\textsuperscript{314} Id. app. C, at 80 n.304.
\textsuperscript{315} Id. app. C, at 81 (quotations omitted).
\textsuperscript{316} Id. app. C, at 81 n.305.
\textsuperscript{317} Id. app. C, at 81 (footnote omitted).
fiduciary duties. The Examiner noted that V&E likely would argue that it was entitled to rely upon the assumption that the transfer of the Sonoma A interest served a legitimate business purpose. He also observed—with respect to an aiding and abetting claim—that V&E might argue that it did not substantially assist Enron in its issuance of the true sale opinion, but merely acted as a scrivener memorializing the terms of the transaction. Providing just one legal opinion, however, can constitute substantial assistance under some circumstances, the Examiner stated. The complexity of the deal and its documentation could permit a fact finder to determine that V&E was not acting simply as a scrivener.

D. Questions and Discussion

The Examiner appears to have accepted the claim that V&E genuinely believed that some risk had been transferred to Salomon as a result of the put and call provision. In V&E’s eyes, the transfer of the Sonoma A interest therefore complied with the technical requirements for a sale. The Examiner went on to say, however, that V&E nonetheless could be liable to Enron because the firm knew that the transfer served no valid business purpose. In essence, the Examiner seemed to argue, the fact that a transaction conforms to the letter of the law does not insulate a lawyer from liability if she knows that it does not conform to the law’s spirit.

Transactional lawyers confront divergences between form and substance all the time. How does a lawyer know when that divergence is so great that the law will be unwilling to defer to form on the ground that it has been abused? In the Sundance project, the Examiner based his conclusion on evidence suggesting that Salomon had no particular interest in the Sonoma A interest, that it resisted efforts to ensure that it assumed some of the risk associated with the interest, and that upon transfer it immediately contributed the interest to a partnership in which Enron had an interest. V&E might argue that once it provided for a transfer of risk to Salomon, it was entitled to assume that the sale served the business purpose that any sale serves: to furnish sale proceeds to the seller and something of value to the buyer. Enron received cash in the transaction, and Salomon received something that it could use to make its capital contribution to Sundance.

The fact that Enron told V&E of its intention to record a gain from appreciation in the value of the Sonoma interest seems to be the fact that the Examiner regards as most troublesome for the law firm. Formation of Sundance had been planned for some time, but the transaction originally was structured so that Enron would contribute the Sonoma interest directly to Sundance. Enron would be unable to recognize the appreciation on

318. Id. app. C, at 182-83.
319. Id. app. C, at 182.
320. Id. app. C, at 183.
321. See supra note 294 and accompanying text.
that interest if this occurred, however, so the company wanted to restructure the deal in a way that permitted it to do so. The Examiner regarded V&E’s knowledge of this as sufficient to charge it with notice that Enron had only an accounting, not a business, purpose, for the sale of the Sonoma interest to Salomon.

Consider, however, an analogy to tax practice. If a company has a legitimate business reason to engage in a transaction, it is appropriate for a tax lawyer to attempt to structure the transaction in a way that minimizes the company’s tax burden. Enron might argue that it had a valid business purpose for creating the Sundance partnership, which was to move its forest products assets off its books by placing them into an unconsolidated subsidiary in which Salomon held an interest. Having decided to do this, it would then have been appropriate for Enron to structure the capital contributions to that subsidiary in a way that maximized the economic benefits to Enron. As long as that arrangement transferred enough incidents of ownership to Salomon, the form of the transaction should be respected.

If this is a colorable argument, does it mean that it was defensible for Enron’s lawyers to add a feature to a transfer of assets so that it met the technical requirement for a “sale,” even if the lawyers knew that no sale was occurring in any conventional sense—as long as that transfer could be characterized as one component of a larger transaction? This is basically what V&E did by grafting the put and call provision onto the transfer agreement. This defense is the opposite of the claim that a lawyer is responsible only for a narrow, limited portion of a deal and should not be charged with evaluating the overall transaction. Instead, the argument is that the matter on which the lawyer worked is only one piece of a larger transaction that has a legitimate business purpose, and the client’s choice of form with respect to that discrete component should be honored.

What would be the implications of accepting this argument in transactional work? It probably would not be difficult to characterize many transactions requiring true sale opinions as but one piece of a larger set of interrelated transactions. Expanding the definition of what constitutes a “transaction” thus might risk weakening constraints on the manipulation of form to defeat substance.

Suppose that Enron had simply told V&E that it wanted to restructure the transaction without indicating that this would enable Enron to realize a gain on the appreciation in the value of the Sonoma interest. Would V&E then be justified in assuming that there was a valid business purpose for the transfer of assets to Salomon? This seems like an appropriate assumption in most instances, perhaps because the business purpose usually is self-evident. What if the purpose is not obvious? Should lawyers inquire about it?

As a practical matter, one would think that lawyers need this information in order to provide competent legal services. A lawyer can be more creative and effective if he is aware of what it is the client wants to accomplish. To push the analysis a step further, what if the client explains the objective and
the lawyer doesn’t completely understand the explanation? Should he give the client the benefit of the doubt or continue to press for a clearer explanation? One suspects that this situation may have arisen on occasion at Enron, where managers saw themselves as brilliantly creative and had little patience for those who “just didn’t get it.”

In the proposed scenario, could V&E simply agree to help restructure the transaction without asking why the client wanted to do so? Could the absence of an obvious business purpose later support an inference that the firm knew that the transaction had no objective other than the manipulation of Enron’s financial statements? Was the need for V&E to suggest a put and call provision in the transfer agreement a warning sign that should have alerted the attorneys that this “sale” was not intended to accomplish the usual purposes served by a sale? If not, was Salomon’s resistance to the put a red flag that more inquiry was necessary before assuming a valid business purpose?

Finally, it is worth focusing on the put and call provision for a moment. The Examiner concluded that V&E believed that the provision was effective, and therefore that some risk associated with the Sonoma interest had been transferred to Salomon. At the same time, however, the Examiner concluded in his Second Report, which analyzed the Sundance Industrial transaction in detail, that the extremely limited time during which the put and call rights could be exercised “ensured that Salomon . . . could never be forced to repurchase the Sonoma Class A interest.” The Examiner also found that the Sundance Partnership Agreement contained provisions designed to enhance Salomon’s ability to establish a Board and declare a deadlock, thereby avoiding exercise of the put. These findings served as part of the basis for the Examiner’s conclusion that “the put and call the parties placed on the asset was not designed to be implemented,” and that as a result there was no true sale of the Sonoma A interest.

In light of these findings, was V&E’s belief that the put was available for exercise a reasonable one? If the put and call agreement was subject to the Examiner’s and Salomon’s interpretation, was V&E negligent in preparing it because it did not serve the client’s objective that the transfer of the interest be treated as a true sale?

Suppose that V&E ensured that the Sundance transaction documents enabled the parties to exercise a put or call, but that the lawyers knew that Enron and Salomon had informally agreed not to exercise these rights. Could V&E still deliver a true sale opinion? Presumably not, since the intent of the parties can be inferred not only from the documents but also from the parties’ conduct.

323. See supra notes 23-26 and accompanying text.
325. Id. app. K, at 79.
326. Id. app. K, at 87.
Project Sundance Industrial thus is a useful vehicle for exploring the concept of business purpose as a constraint upon the manipulation of form. When a transactional lawyer is justified in assuming a valid purpose, and when she must investigate further, can be difficult questions to answer. In addition, Sundance raises the issue of what kind of knowledge can be attributed to lawyers working on complex transactions with multiple components.

VI. RELATED PARTY TRANSACTIONS

A. Background

Beginning in 1997 and continuing until mid-2001, Enron engaged in twenty-one transactions with Enron-created SPEs in which CFO Andrew Fastow and other Enron employees were involved. These entities were known as LJM1 and LJM2. As long as three percent of the equity at risk in the SPE was held by outside investors (and assuming a valid business purpose), these transactions could be treated for accounting purposes as occurring at arms length between two independent entities. As a result, Enron could book as income any gains that it derived from the transactions. Furthermore, it did not have to reflect on its balance sheet the assets or, especially important, the liabilities of the SPEs—that is, the SPE did not have to be consolidated into Enron’s financial reports.

The Examiner concluded that the related party transactions he reviewed “had no business purpose from Enron’s perspective, other than to achieve desired financial statement reporting.” He estimated that these and other transactions with related party SPEs permitted Enron to overstate its income by $1.5 billion and its equity by the same amount, and to understated its indebtedness by $885 million. Aside from the FAS 140 transactions, the most notable transactions between Enron and the related party SPEs involved hedging, or arrangements in which an SPE purported to indemnify Enron for the loss in value of Enron’s investments in other companies.

The discussion below of related party transactions focuses first on two matters with respect to which the Examiner found that Enron’s lawyers might be liable for malpractice and/or aiding and abetting breach of fiduciary duty: Enron’s purported hedges with the SPEs and the failure to press for adequate disclosure of Fastow’s compensation for his involvement in LJM1 and LJM2. The discussion then moves to two matters as to which the Examiner did not find potential attorney liability, but which offer a useful vehicle for analyzing issues that can arise in transactional work. The first of these is possible SPE difficulty in meeting the three percent outside

328. See McLean & Elkind, supra note 13, at 157 (“[A]s long as 3 percent of the capital in the SPE came from an independent risk . . . the SPE qualified as independent.”).
329. Id. at 6.
equity requirement, and the second is the “warehousing” of assets by Enron in SPEs.

B. Issue One: The “Hedges” that Weren’t

The hedging transactions took the same general form, with some individual variations. The impetus for them was the fact that Enron had “merchant investments” in companies that it carried on its books at current value, under the mark-to-market method of accounting. To reiterate, under this method if the share price of a company increased, Enron did not need to wait to sell shares at a gain to record an increase in income. Rather, it could reflect the change in price by increasing the value of assets on its balance sheet, and recording the appreciation as income on its income statement. By the same token, any decrease in share price had to be reflected in a reduction in the value of assets on the balance sheet and a loss on the income statement. Enron held a substantial amount of merchant investments in companies whose value was volatile. This created the prospect that Enron’s own reported financial performance could vary widely—a condition that would make the stock market nervous and dampen the value of Enron’s shares.

Parties facing this prospect can attempt to reduce their risk by entering a “hedging” transaction with another party, typically a large financial institution. For a fee, the institution essentially agrees to compensate a company such as Enron for the decline in the value of certain of its merchant investments. The amount is determined by the difference between the share price at the time of the hedge contract and the price at a certain date in the future. With a hedge, while Enron would have to record the decline in the value of its investment in its financial reports, it also would be able to record a gain in the same amount because of its right to this payment. Enron thus would be “held harmless”—it would not be affected one way or other by the decline in the value of the investment. If the share price rose, Enron would pay the hedging party the value of the increase—but it could also record the increase in value in its financial statements. Again, the result is a wash. Through such an arrangement, a company can “lock in” the value of its investments at a given time.

Enron found it difficult to find parties to hedge its risk because many of its investments were in companies for which there was not a substantial and liquid trading market. This was the case, for instance, with many high-tech energy trading and telecommunications companies. The share price of these companies often rose to dizzying heights. They also, however, posed the risk of precipitous declines. Without a party with whom to hedge, Enron could not lock in the high value of the shares. It thus would be fully exposed to the vagaries of the market.

330. Id. at 7.
331. See Fox, supra note 10, at 149.
To remedy this situation, Enron decided to create ostensibly independent SPEs with whom it could engage in hedging transactions. In order for the SPE to be treated as a separate entity that did not have to be included in Enron's financial reports, outside investors had to contribute at least three percent of the equity at risk. This contribution, and in some cases other capital, was provided by a partnership managed by Andrew Fastow known as LJM1 or LJM2. The remainder of the capital in most cases was furnished by subsidiaries of Enron.

The SPE then entered into a Total Return Swap with Enron. Under this arrangement, the SPE agreed to pay Enron the amount of any decline in the value of certain investments, while Enron agreed to pay the SPE the amount of any increase. In this way, Enron purported to lock in the value of its investments at the date of the agreement. As the bankruptcy Examiner explained,

Accordingly, if the market value of the asset were $100 on the date the hedge became effective and declined to $90 at the end of the next fiscal quarter, Enron would record a $10 decline in the value of the merchant investment on its balance sheet, but it would also record a new $10 price risk management asset on its balance sheet. The net effect on the balance sheet would be $0. The increase and decline would also offset each other on Enron's income statement.\(^3\)

The transactions with the SPEs could serve as true hedges for Enron only if the company suffered no financial impact from a decline in the value of investments that it hedged. This would occur if the SPE was able to compensate Enron for the amount of any decline. In order to cover its potential obligation, the SPE needed capital. The problem was that investors were unlikely to be interested in contributing funds to the entity because the SPE was unable to hedge its own risks of having to pay compensation to Enron. The very features of the investments that made it nearly impossible for Enron to hedge its investment with a conventional third party—their size, risk, and illiquidity—made it impossible for the SPE to enter into a true hedge with anyone else with respect to its obligations on those same investments. If the SPE did not have enough capital to cover its potential obligations to Enron, however, then Enron obtained no real protection from its hedges with the SPE.

Enron purported to solve this problem primarily by capitalizing the hedging SPE with Enron's own stock. By doing this, however, Enron was effectively hedging with itself—which is no hedge at all. As the Powers Report put it, "The economic reality of these transactions was that Enron never escaped the risk of loss, because it had provided the bulk of the capital with which the SPEs would pay Enron."\(^3\)

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The first ostensible hedging transaction with an SPE occurred when Enron established LJM to hedge Enron’s investment in a telecommunications company called RhythmsNet Connections. At a later date, Enron established a second SPE known as LJM2, and engaged in several additional purported hedges with LJM2 entities known as the “Raptors.”

C. RhythmsNet

The RhythmsNet transaction involving LJM1 was the first transaction in which Enron entered into a supposed hedge with an SPE. V&E lawyers did not work on structuring this transaction, but did work on discrete aspects of it. The story begins in March 1998, when Enron’s broadband unit purchased $10 million of shares in an Internet service provider start-up named RhythmsNet Connections. The investment eventually was calculated as a purchase at a sale price of $1.85 per share. In April 1999, Rhythms had an initial public offering (“IPO”) at a price of $21 per share, and the share price rose sharply afterward. By June 1, 1999, Enron’s $10 million investment was worth about $260 million, or $48.50 a share.

Enron treated the Rhythms investment as part of its merchant investment portfolio, which was marked to market under fair value accounting. It thus immediately booked the appreciation in the value of the Rhythms stock as income, which accounted for almost one-third of the company’s earnings in 1999. The problem was that this gain was on paper, but not in cash. Indeed, Enron could not convert it to cash for six months. As a condition of being able to buy the pre-IPO Rhythms shares, Enron was prohibited from selling or transferring the ownership risk of the shares to another party.

The company thus was exposed during this period to the risk that the share price of Rhythms would decline, which would lead to the need to book a loss. Enron desired a hedge to lock in the appreciation in the value of the Rhythms stock. It was unlikely, however, to find anyone willing to provide it at anything other than a prohibitive price. Enron held a large portion of the thinly traded stock, which meant that trying to sell the stock could itself depress the price. Furthermore, technology stocks were notoriously volatile, and a precipitous decline in value was a real possibility.

Enron CFO Andrew Fastow told Enron executives that he was willing to create a new SPE to hedge Enron’s Rhythms position. This entity was known as LJM, and later as LJM1 after Fastow created a second LJM

335. Id.
336. Id.
339. Id. app. L, annex 2, at 3.
LJM’s general partner was LJM Partners, LP, whose limited partner was Fastow and whose general partner was LJM Partners, LLC. The sole and managing member of the latter entity was Fastow. The upshot of this organizational structure was, as the Examiner put it, that “Fastow owned and controlled the general partner of LJM1.” This general partner contributed $1 million to LJM1 through Fastow in return for a 6% interest in it. LJM’s two limited partners were entities affiliated with Credit Suisse First Boston and Royal Bank of Scotland. They each contributed $7.5 million in cash to LJM1 and each owned 47% of it.

Fastow was not permitted to receive distributions of LJM in the form of Enron stock or proceeds from it. He was, however, entitled to 100% of all other distributions until he had received (1) $1 million plus the general partner’s portion of LJM1’s assets and (2) “a 25% compound annual rate of return on that amount.” Any LJM1 distributions in excess of the latter were to be made 50% to the general partner and 50% pro rata to the limited partners and general partner.

Enron was not a partner in LJM1, but funded it with about 6.7 million Enron shares worth $276 million, in return for $64 million in promissory notes. Certain restrictions were placed on LJM1’s ability to transfer or hedge these shares. These allowed LJM1 to acquire the shares at a discount of $108 million. This difference between the market value of the shares and LJM1’s ostensible obligation to Enron was intended to provide LJM1 the capacity to enter into a hedge with Enron. LJM1 then funded an entity known as Swap Sub. LJM1 formed a wholly owned entity, SwapCo, and transferred about 32,000 Enron shares to it. SwapCo then contributed these shares to Swap Sub in return for becoming Swap Sub’s general partner.

LJM1 contributed to Swap Sub $3.75 million in proceeds from the sale of about 91,000 of the Enron shares, and about 3.1 million shares of Enron, in return for a limited partnership interest in Swap Sub. The market value of these shares was $127 million, with a discounted value of $77 million, which gave Swap Sub a credit capacity of about $50 million.
then granted Enron a put option under which Enron had the right to require Swap Sub to purchase almost 5.4 million shares of Rhythms stock at a price of $56.125.\footnote{354} This prevented Enron from incurring any losses on the Rhythms investment if the share price fell below that figure.

\footnote{354} Id. app. L, annex 2, at 12-13; see also infra fig.4 (step 7).
FIGURE 4: RHYTHMSNET HEDGE

(1) LJM Partners, LP, contributes $1 million cash to LJM1, in return for general partner status.
(2) Two outside investors contribute $15 million cash to LJM1, in return for limited partner status and 94% interest.
(3) Enron contributes 6.7 million Enron shares worth $276 million, in return for $64 million in promissory notes.
(4) LJM1 contributes 3.1 million Enron shares worth $127 million and $3.75 million proceeds from sale of Enron shares to Swap Sub, in return for limited partner status.
(5) LJM1 contributes 32,000 Enron shares to wholly owned SwapCo.
(6) SwapCo contributes the 32,000 Enron shares it received from LJM1 to Swap Sub, in return for general partner status.
(7) Swap Sub enters into a hedge granting Enron a put on 5.4 million RhythmsNet shares at an exercise price of $56.125 per share.
In return for its contributions, Enron received two notes from LJM1 totaling $64 million, with no recourse for Enron against any of the LJM1 partners. In addition, Swap Sub granted Enron a put option under which Enron had the right to require Swap Sub to purchase 5.4 million shares of Rhythms stock at an exercise price of $56.125 per share.\footnote{PricewaterhouseCoopers eventually provided an opinion that the notes and the put option that Enron received (both for the shares that it contributed to LJM1) was fair consideration. Second Batson Report, \textit{supra} note 55, app. L, annex 2, at 16-17.} If Rhythms' share price fell below that figure, Enron would have to record its loss in the value of the investment under mark-to-market accounting. At the same time, however, even though Swap Sub did not have to make an actual payment until a later time, Enron was entitled immediately to record as income the payment to which it was entitled from Swap Sub, which offset that loss. This ostensibly locked in the appreciation of the Rhythms shares, holding Enron harmless for any decline in value.

The only funds that Swap Sub had available to make its eventual payment to Enron, however, were the Enron shares that it had received either directly or indirectly from LJM1. As a result, "[b]ecause this would be a return of its own property, Enron would never realize any net economic benefit."\footnote{Final Batson Report, \textit{supra} note 75, app. C, at 115.} An additional problem with the arrangement was that, to the extent that Enron's share price might be reduced by the decline in the value of its merchant investments such as Rhythms, a hedging SPE's obligation to Enron would be increasing at the same time as the value of the Enron shares that it had available to satisfy that obligation would be declining. Nonetheless, Enron included the value of the hedge in its financial statements.\footnote{Another potential problem that the Examiner noted but did not discuss at length is that the lock-up provision that was a condition of Enron's purchase of the pre-IPO Rhythms stock apparently prohibited hedging the investment in the stock. Unless the underwriters waived this provision, Enron's hedge with Swap Sub violated it. Second Batson Report, \textit{supra} note 55, app. L, annex 2, at 13-14.}

The Examiner summarized the net economic effect of the Rhythms hedge in this way:

Enron's sole motivation for entering into the Rhythms hedging transaction was to impact its income statement to achieve desired financial reporting results. Enron was indifferent as to whether it ever received cash under these hedges in the future because it was marking each option on the Rhythms stock to fair value to offset any losses attributable to declines in the value of the Rhythms stock. The hedges with Swap Sub had no economic benefit to Enron because the sole asset supporting the hedges was the Enron stock held by Swap Sub, which had been contributed by Enron. Upon settling the hedge, all Enron would receive would be the assets that it had contributed (indirectly) to Swap Sub (or their value) less the amount of any compensation paid to LJM1 and its partners.\footnote{\textit{Id.} app. L, annex 2, at 36.}
The law firm of Kirkland & Ellis established LJM1 and represented it in the Rhythms transaction. V&E represented Enron in this matter, but apparently did not participate in the planning or initial structuring of the Rhythms transaction. In-house lawyer Kristina Mordaunt appears to have directed the legal work on the deal. The principal V&E attorneys were Edward Osterberg, John Leggett, and Petrina Chandler. Osterberg and Leggett advised Enron on tax aspects of the transaction, while Chandler acted as the lead transactional lawyer within V&E.

The bankruptcy Examiner concluded that the evidence could support a finding that V&E committed malpractice because it knew that the Rhythms hedge was supported only by Enron’s own stock, and thus “was a hedge only for financial statement benefits, lacking any genuine economic substance.” He focused specifically on Osterberg, who understood from “conversations with people at Enron and the descriptions of the transaction [he] saw” that the purpose of the project was to hedge Enron’s risk on the Rhythms investment. The Examiner stated that Osterberg, however, knew that (1) Enron delivered Enron shares to Swap Sub as consideration for the hedge of Rhythms stock, (2) Enron stock constituted the assets of Swap Sub, and (3) as a result, Enron stock held by Swap Sub was the only thing of value available to meet Swap Sub’s hedging obligation to Enron.

The Examiner stated,

Osterberg therefore possessed all of the facts necessary to an understanding that Enron effectively paid significant value in a transaction in which it had no possibility of obtaining an economic return and that the Rhythms hedge was non-economic in nature and could achieve only accounting benefits. Osterberg testified, however, that during his work on [the project] he neither discussed nor considered whether the Rhythms hedge was economic in nature and did not know how Enron would account for the Rhythms hedge.

Questions and Discussion

Should malpractice be attributed to V&E by virtue of Osterberg’s knowledge of the essential features of the Rhythms hedge and his participation in the transaction? Could he claim that he was responsible only for the tax aspects of the deal, and assumed that those who worked on structuring the deal focused on the economic substance of the transaction?

The concepts of “economic substance” and “business purpose” are familiar to tax lawyers. In order for the Internal Revenue Service to honor the tax treatment chosen by the taxpayer for a transaction, that transaction

360. Id.
361. Id.
362. Id. app. C, at 180.
364. Id. app. C, at 118 (footnote omitted).
must be motivated primarily by a business purpose beyond simply reducing taxes. Tax lawyers are not permitted simply to assume in all instances that their clients have a legitimate business purpose. Once a lawyer is satisfied that a company has such a business motive for entering into a transaction, she then can attempt to devise a structure for the transaction that minimizes the company’s tax liability. Osterberg thus would have had occasion to discuss the economics of the Rhythms arrangement at least to the extent necessary to assess whether Enron was engaging in the transaction simply to lower its taxes.

Enron presumably told Osterberg that its motive for Rhythms was to hedge the volatility of the value of its merchant investments. This is a legitimate business purpose that would justify the tax treatment that the company sought. Could Osterberg simply take Enron at its word and assume that the company had a valid business purpose? Generally speaking, he would have an obligation to satisfy himself—at least as a preliminary matter—that there was no reason to disbelieve Enron’s description of its business objective. In the case of a purported hedging transaction, that obligation arguably would involve determining that the entity with which Enron was hedging had sufficient assets of its own to meet its obligations under the arrangement.

How closely would Osterberg be likely to scrutinize the Rhythms hedge? It is plausible to imagine that as a tax lawyer he was inclined to examine it most critically if the transaction created substantial tax benefits that otherwise would be unavailable. In that instance, he would be especially alert to the possibility that Enron’s stated business purpose was contrived and the arrangement produced no real economic benefits to the company. His cognitive filter thus would be influenced by his experience as a tax lawyer.

If the tax incidents of the transaction were less pronounced, however, how sensitive would he be to the possibility that there was neither a valid business purpose nor meaningful substance to the Rhythms hedge? Would that depend on whether he knew of the accounting benefits that Enron stood to gain from the deal? It would seem natural for a tax lawyer analyzing the economics of the transaction to be aware of what accounting treatment Enron planned to use. If Osterberg had this information, should it have put him on notice that Enron might be entering into the transaction not mainly for tax purposes but for accounting benefits?

If he had such notice, it is easy to imagine that Osterberg might avoid confronting its implications by characterizing the information as requiring an accounting, rather than a legal, judgment. That rationalization arguably would be flawed, because whether Enron used the appropriate accounting treatment for the transaction is an issue separate from whether obtaining that treatment was the motivation for the deal. Nonetheless, Osterberg may have relied on it while telling himself that he was responsible only for ensuring that Enron’s primary purpose in the Rhythms transaction was not to reduce its taxes.
What might Osterberg have done if he suspected that Rhythms was not a genuine economic hedge? Suppose that Osterberg asked the main in-house Enron lawyer on the deal whether it constituted a genuine hedge and was assured that it did? What if he consulted Arthur Andersen and received the same answer? If he still had some doubts in either case, should he defer to their judgment? Hedges, derivatives, and increasingly complex financial instruments were all cutting-edge tools that Enron used in its activities. Even if a lawyer did not fully understand the transactions in which they were used, he might be reluctant to admit it—especially to a client like Enron whose employees had a reputation for arrogance. Rather than keep pressing in the face of a puzzling explanation, a lawyer might rationalize that sophisticated financial professionals knew better than he.

This inclination might be especially strong if information comes in bits and pieces rather than in the form of an integrated and comprehensive whole. The Examiner said that the information that put Osterberg on notice of a problem with the deal came from conversations with Enron employees and the descriptions that he saw of the transaction. If this came in fragmented and intermittent form, how would Osterberg know that there were not other pieces of information of which he was unaware that resolved any apparent anomalies? How does someone know when he knows all there is to know? Does Osterberg’s liability depend on the fortuity of what information he happened to receive?

Does a finding of liability in these circumstances create a disincentive for lawyers to attend to anything other than their own narrow portion of a transaction? Or does it lessen the temptation to engage in willful blindness? Does anyone who works on a transaction have an obligation to understand its economic substance, even if her role does not call for an evaluation of that issue?

The Rhythms arrangement thus illustrates the fragmentation of information and responsibility that can exist in complex transactions. Such fragmentation can provide fertile ground for self-serving rationalizations. First, not everyone may receive all the information that relates to the project as a whole. Second, even when information ostensibly is accessible, professional myopia can limit how much of it a person actually sees and the significance that she attaches to it. Finally, even when someone is aware of information and appreciates its significance, she may rationalize that certain issues that it raises are the responsibility of another specialist.

Lastly, it is worth noting that the Enron Board of Directors approved the LJM/Rhythms hedge transaction. The Examiner found, however, that Enron General Counsel Derrick had not “developed an informed understanding of the transaction or performed a substantive analysis of its material terms.”

365. Id. app. C, at 119 (footnote omitted).
was sufficient? If he had concerns about the transaction but learned that the Board had approved the deal, could he reasonably resolve any concerns by deferring to the Board's decision? Or could he do so only if he knew what information the Board had received?

D. Raptors

"Building upon its experience and apparent success in hedging its position in Rhythms stock,"366 in 2000 Enron created a series of four SPEs known as the "Raptors" to engage in additional hedging transactions with Enron. In each instance, LJM2 served as the vehicle for providing three percent outside equity for the Raptor, and contributed a total of $30 million to the SPE. Attorneys from both Enron Global Finance and V&E worked on the creation of each of the Raptors. Most heavily involved were Scott Sefton from Enron and Ronald Astin and Mark Spradling from V&E. The Examiner estimated that from the third quarter of 2000 through the third quarter of 2001, Enron used these transactions to avoid reporting approximately $1.1 billion in losses from its merchant investments.367

The structure of the Raptors transactions resembled the Rhythms hedge in its essential economic features. The creation of an entity known as Talon on April 18, 2000, illustrates this structure.368 Talon was capitalized by LJM2-Talon, a majority-owned subsidiary of LJM2, and Harrier, a wholly owned subsidiary of Enron.369 LJM2-Talon contributed $30 million cash to Talon, in exchange for a membership interest.370 Harrier contributed a $50 million note and $1000 cash, but its most significant contribution involved Enron shares. Harrier transferred about 3.7 million shares of Enron stock, along with an agreement to contribute up to about 3.8 million under certain contingencies involving the price of Enron shares. All these contributions were in return for a membership interest.371 In addition, Talon made a special distribution to Harrier of a $400 million note on the date that the transaction closed.372

As in the Rhythms transaction, the Enron stock that the company contributed to Talon contained restrictions that resulted in a valuation of it at a discount from current market value. In this case, the $537 million market value was discounted by thirty-five percent to $349 million, with the resulting $188 million treated as credit capacity for Talon to enter into hedging transactions with Enron.373 Before Talon was allowed to engage in such transactions, however, it was required to make a distribution to LJM2

368. See supra fig.4 for information on the Raptor structure.
370. See infra fig.5 (step 1).
371. See infra fig.5 (step 2); see also Second Batson Report, supra note 55, app. L, annex 5, at 3.
372. See infra fig.5 (step 3).
equal to $41 million or a thirty percent annualized return. As described in more detail below, Talon obtained $41 million for this distribution through a transaction involving a put on Enron stock.

All but one of the hedging transactions took the form of Total Return Swaps. Talon agreed to pay Harrier the amount of any future losses on a certain investment, while Harrier agreed to pay Talon the amount of any future gains. No cash was to change hands between the parties, however. Instead, the payments owed by Talon or Harrier would serve as the basis for adjusting the principal of the $400 million Talon note to Harrier that was provided in a special distribution when the deal closed.

The Examiner found that in Raptor transactions such as the one with Talon, "Enron never escaped the risk of loss [on its merchant investments] since it provided all of the capital with which the Raptors could pay Enron on the [hedges]." The hedging transactions, he said, "were not real economic hedges, but were merely accounting hedges—apparently designed to generate favorable financial statement results without serving any commercial business purpose."

Enron in-house attorney Sefton and V&E attorneys Astin and Spradling participated in meetings in January and February 2000 at which they discussed and analyzed how to structure the Raptors transactions. The V&E attorneys understood that Enron’s objective in establishing the Raptors was to “smooth the volatility of their mark-to-market assets.”

While V&E raised certain questions about the implication of the Talon $41 million payment to LJM2, the Examiner found no evidence that the firm expressed any concern “regarding the Raptors’ non-economic nature.” The Enron Board apparently was told of this characteristic of the Raptor hedges in a presentation shortly after Talon was created. Notes taken by the Secretary of the Board state, “Does not transfer economic risk but transfers P[rofit] & L[oss] volatility.”

374. Id. app. L, annex 5, at 10.
375. See infra note 436; see also infra fig.5 (steps 4-5).
376. See infra fig.5 (step 6).
378. Id. app. L, annex 5, at 48. The Examiner regarded the $41 million distribution to LJM2 as effectively eliminating that entity’s risk by providing a return of and on its capital. Id. app. L, annex 5, at 12.
379. Id. app. L, annex 5, at 48.
380. Final Batson Report, supra note 75, app. C, at 140 n.616 (quoting statement of Spradling); see also id. (stating that Astin testified that Enron sought to use the Raptors to “manage the volatility that was inherent in certain of the existing merchant assets”).
381. See infra notes 461-63 and accompanying text.
383. Id. app. C, at 135 & n.593 (noting that the Enron Finance Committee was told at the May 1, 2000, presentation that the purpose of the Raptors was to “hedge the profit and loss volatility of Enron investments”); Powers Report, supra note 333, at 106; see also id. at 106 n.50 (stating that a May 2000 presentation to the Enron Board noted, “a substantial decline in the price of [Enron] stock will cause the program to terminate early and may return credit risk to Enron,’ and thus the Raptor program was ‘not an economic hedge; . . . [therefore,] credit risk retained with Enron Corp.’”).
(1) LJM2-Talon contributes $30 million cash to Talon, in return for membership interest.

(2) Harrier contributes to Talon (a) 3.7 million Enron shares worth $537 million, (b) $50 million note, (c) $1000 cash, and (d) a conditional promise for 3.8 million Enron shares, in return for membership interest.

(3) Talon makes a special distribution to Harrier of $400 million note on the closing date.

(4) Enron purchases a put on Enron stock from Talon for $41 million; the put settles after four months and Talon keeps $41 million.

(5) Talon distributes $41 million from the put to LJM2-Talon.

(6) Talon enters into hedges with Harrier, with gains and losses resulting in adjustments to the $400 million Talon note to Harrier ((3) above).
Astin and Spradling testified that this issue was never discussed in their presence while they were working on establishing the Raptors. Astin said that he did not understand that there was a distinction between an economic and an accounting hedge, nor did he regard the Raptors as noneconomic hedges. The Examiner stated that, nonetheless, other than LJM2's original investment of $30 million, Astin was "unable to identify any assets that Raptor I could use to satisfy its obligations under the hedge that did not originate with Enron." 384

On August 31, 2000, in-house Enron attorney Stuart Zisman prepared a legal risk memorandum relating to the Raptors in which he noted "[o]verall book manipulation" 385 as one possible legal risk. Zisman stated that the original understanding of the Raptors was that all types of Enron merchant investments would be included in the transactions. He said, however, that "we have discovered that a majority of the investments being introduced into the Raptor structure are bad ones. . . . [This] might lead one to believe that the financial books at Enron are being 'cooked' in order to eliminate the drag on earnings that would otherwise occur under fair value accounting." 386

Zisman's memo was distributed to ENA's General Counsel Mark Haedicke, another ENA attorney, and several ENA employees. Haedicke, said the Examiner, "dismissed the concerns expressed without further inquiry," 387 and admonished Zisman for using "colorful" and "inflammatory" language. 388 Enron Global Finance General Counsel Jordan Mintz discussed the memo with Zisman, and said that Zisman told him that his conclusions were not based on personal knowledge of the Raptor assets, and therefore may have been " overstated or even erroneous." 389

Enron in-house lawyer Joel Ephross did not work on the first two Raptors, but was the lead in-house lawyer on Raptors III and IV. He acknowledged that he understood that these hedges provided only accounting, and not economic, benefits. As he testified, "I believe the advice I gave [Enron] was that they're trading economics for accounting and that was a bad trade." 390

The Examiner found that Enron might have a claim against V&E for malpractice based on Texas Rule 1.12 and for aiding and abetting breach of fiduciary duty, as well as malpractice based on negligence. 391 He stated that V&E knew that the Raptor hedges were "only for the purpose of financial statement manipulation, and that they lacked any economic

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385. Id.
386. Id. (footnote omitted).
387. Id. app. C, at 144.
388. Id. app. C, at 143.
389. Id. app. C, at 144 n.636.
390. Id. app. C, at 144.
391. Id. app. C, at 181, 184.
Astin and Spradling knew that almost all the assets supporting the Raptors’ hedging obligations to Enron were supplied by Enron. At a minimum, the Examiner said, a reasonable attorney “should have recognized that these transactions had no business purpose other than to manipulate Enron’s financial statements, and therefore would not have participated in such transactions.”

V&E may argue, the Examiner acknowledged, that it did not determine whether the hedges were economic or accounting in nature because this was outside the scope of its representation and expertise. Furthermore, he noted, the firm may argue that the Board was explicitly told that the Raptors did not reduce economic risk, but profit and loss volatility, and that it was up to the Board to decide whether such transactions were appropriate. In addition, V&E might claim that it reasonably relied on Andersen’s approval of the accounting for the Raptor hedges.

The Examiner also found that in-house attorney Sefton could be liable for malpractice based on Texas Rule 1.12 or negligence, and for breach of his fiduciary duty to Enron. There is evidence, the Examiner said, that Sefton knew or should have known that the Raptors on which he worked had no economic purpose and were hedges only for financial statement purposes. He knew or should have known that virtually all of the assets available to LJM2 to support its hedging obligation to Enron came from Enron. Instead of taking remedial action under Texas Rule 1.12, Sefton assisted Enron with the documentation of these transactions.

The Examiner noted that Sefton may argue that he was not told, nor did he consider, whether the Raptors were economic or accounting hedges, since this was outside the scope of his legal expertise. He might also claim that the Board approved the Raptors with awareness that they “did not transfer economic risk,” and that he appropriately relied on Andersen’s approval of the accounting for the Raptors. These arguments, the Examiner said, raise issues for a fact finder.

Questions and Discussion

Astin and Spradling testified that there was no discussion in their presence about the difference between an economic and accounting hedge during their work on the Raptors transactions. Astin said that he did not

392. Id. app. C, at 181.
393. Id. app. C, at 184.
394. Id. app. C, at 181.
396. Id. app. C, at 196.
397. Id.
398. Id.
399. Id.
400. Id.
401. Id.
402. Id. app. C, at 142.
understand there to be a difference between the two and, in any event, he was never told that the Raptors provided a noneconomic hedge. Even if this precise terminology was never used in discussions with the V&E lawyers, should those lawyers nonetheless be charged with awareness that almost all of the assets that the Raptors had available to pay Enron under the hedging arrangement came from Enron?

Unlike Osterberg, who worked only on tax aspects of the Rhythms transaction, Astin and Spradling worked directly on structuring the Raptors. Indeed, given V&E’s close association with Enron and its desire to serve as problem solvers for the company, the firm’s lawyers may well have been part of a team that helped devise the Raptors explicitly as a response to Enron’s concerns about the volatility of the value of its merchant investments. Rather than serving as legal technicians who determined how to effectuate an arrangement created by others, in other words, they may have been involved in conceptualizing the Raptors from the start. If so, it would be hard to claim that they were not aware that the assets that the Raptors had available to meet their obligations consisted mostly of Enron stock. More generally, it would be hard to argue that they were not familiar with the economic substance of the arrangement, since they had helped create it.

If this is true, how could the V&E lawyers not regard the absence of economic benefit to Enron as a problem? How could they not suspect that Enron’s objective was simply to obtain accounting benefits? Consider one possibility: The merchant investments whose value the Raptor arrangement was supposed to hedge were assets whose value reflected the application of mark-to-market accounting. Given that many of them were traded in thin markets that provided little basis for calculation of fair value, their economic substance was a function of mathematical models. In this abstract realm, accounting treatment could seem to be economic reality. Obtaining permission to use mark-to-market accounting, for instance, had immediately created millions of dollars in assets that Enron could use to bolster its credit rating, engage in trading, acquire other companies, and create new markets. Constructing hedges that resulted in favorable accounting treatment might seem to promise the same alchemy. Indeed, as described earlier, Enron was explicit that its “risk management strategies are directed at accounting, rather than economic, performance.”

Remember, of course, that this was an era in which there were breathless pronouncements that traditional methods of valuation and measurements of economic vibrancy were inadequate for high-tech companies engaged in activities such as Enron’s trading and market-making. Those who believed that transactions lacked economic substance or investment decisions were not founded on economic reality risked being derided in some quarters as relying on outdated concepts. The risk of this may have been especially

403. Id. app. C, at 142-43.
404. McLean & Elkind, supra note 13, at 132.
high at Enron, given the company’s self-image as a business revolutionary. All this may have made it easier for V&E lawyers who wanted to be regarded as team players to rationalize that the Raptor transactions provided genuine economic benefits to Enron.

To reiterate an earlier point, accounting treatment often diverges from underlying economic substance to some degree. Many argue that business developments in recent years such as increasing reliance on intellectual property and technological innovation threaten to widen this divergence to a dangerous distance. Such a development can jeopardize the value of financial reporting. Perhaps even more important, it can undermine a sense of the legitimacy of accounting rules. As Donald Langevoort suggests, the 1990s were an era in which for some managers “[i]nnovation in business strategies made the lines drawn in the historic norms of financial reporting increasingly artificial and outdated. Playing conservatively by the accounting rules [was] seen as conforming to a regime in which fairness and utility were questionable as a reflection of economic reality.” As a result, “[i]n the eyes of many managers, financial reporting had lost its relevance and legitimacy.”

If Enron managers were among those who held this view—and evidence suggests that many were—they may have engaged in manipulation of accounting rules with little sense of impropriety. Indeed, they may have felt that gaming the rules was a way to compensate for the insensitivity of conventional accounting to the value of Enron’s operations. One bit of evidence in support of this conjecture is that Enron openly sought to market its “creative accounting” services to other companies. Doing so would indicate that “executives had little sense . . . that their conduct was seriously wrongful.” Another is that Enron in-house attorney Ephross freely admitted that he recognized that the Raptors were being used to obtain only accounting and not economic benefits, and that he told Enron that this was a bad trade. This statement suggests the belief that the Raptors raised questions about business, but not ethical, judgment.

This thesis may help explain what otherwise seems inexplicable: that Enron managers explicitly told the Board of Directors and its Finance Committee that the Raptors would serve as an accounting but not an economic hedge. Declaring this openly to the highest authority in the company suggests that Enron managers who worked on the Raptors regarded the divergence between form and substance in this instance as

407. Id.
408. Id. at 18.
409. Id.
411. See supra note 383 and accompanying text.
perfectly acceptable. If this is so, it suggests that even had V&E lawyers been informed that the Raptors provided accounting rather than economic benefits, they may not have regarded this as problematic. Would they be likely to be concerned if Enron employees were straightforward in telling them this and made no attempt to keep it a secret? Furthermore, if they knew that the Board would be told the same thing, could they reasonably assume that the Raptors were not being used to commit fraud?

The experience with the Raptors thus suggests at least a couple of ways in which both inside and outside counsel might have rationalized to themselves that this project raised no ethical issues. First, as with most of us, they probably proceeded on the assumption of normalcy: that people were acting in good faith when they sought a way to smooth out fluctuations in the value of Enron’s merchant investments.

Second, corporate lawyers today want to be seen as creative business problem solvers and team players, not obstructionists who tell the client what it cannot do. As a result, the lawyers may have been inclined to defer to the client in the face of strong indications that the Raptor hedges provided no genuine economic benefit to Enron. Indeed, given the seemingly magical benefits of mark-to-market accounting that the company had enjoyed, they might assume that achieving a certain accounting treatment was itself an economic benefit. The rationalizations may not seem persuasive, but keep in mind that the lawyers likely had a powerful impulse to accept them.

The assumption of normalcy and desire to be a team player may also explain why ENA General Counsel Haedicke was not more responsive when confronted with explicit speculation by an in-house lawyer that Enron’s activities with the Raptors “might lead one to believe that the financial books at Enron are being ‘cooked.’”412 The person who prepared the memo was a junior lawyer who admitted that he was not personally familiar with the assets in the Raptor structures, and that his conclusion therefore may have been “overstated or even erroneous.”413 In retrospect this may seem a frail rationale for not at least inquiring further. At the time, however, it may have been all that was necessary for someone who was predisposed not to find a problem.

E. Issue Two: Disclosure of Fastow’s LJM Compensation

Enron CFO Andrew Fastow served in a management role for the LJM entities in their transactions with Enron, earning several million dollars in addition to his compensation from Enron. In the section of Enron’s proxy statements entitled “Certain Transactions,” Item 404 of Regulation S-K required Enron to disclose information about transactions over $60,000 between the company and any of its executive officers, including “where

413. Id. app. C, at 144 n.636.
The Examiner concluded that Enron’s proxy statements filed in 2000 and 2001 did not satisfy this requirement because they did not include sufficient information about the amount of Fastow’s financial interest in Enron’s transactions with the LJM entities.

The Examiner opined that Enron might have claims against its in-house counsel because they should have made greater efforts to determine Fastow’s compensation for his role in LJM, and should have disclosed the amount both to the Enron Board of Directors and in the company’s proxy statement. The lawyers in question were Rex Rogers, who had primary responsibility for securities issues, and Scott Sefton and Jordan Mintz, who were successively General Counsel for Enron Global Finance (“EGF”), which handled the legal work for the Enron/LJM transactions.

Rogers asked Sefton, and then Mintz, to analyze and draft disclosures relating to Enron’s transactions with the LJM entities, since lawyers in EGF performed the legal work on these transactions. Because he was the most senior securities attorney at Enron, however, Rogers “actively participated in the analysis and reviewed the disclosure.” These lawyers consulted on the disclosure with V&E. The Examiner suggested that Enron also might have a claim against V&E for malpractice based on negligence, because the firm failed to inquire into material facts that were necessary to make an informed judgment about the adequacy of Enron’s disclosure.

As part of the proxy statement drafting process, Fastow was required to provide Enron with information about his interest in the LJM transactions in his response to a questionnaire sent annually to directors and officers. As the Examiner put it, “Fastow side-stepped this responsibility.” For the 2000 proxy statement, he referred the reader to an addendum to the questionnaire, which stated that Sefton was preparing a draft disclosure that the attorney would shortly make available. For the 2002 proxy statement, the addendum said that the nature of Fastow’s involvement in the LJM entities was described in Enron’s 1999 and 2000 proxy statements. Neither the questionnaire nor the sources to which it referred contained any estimate of the amount of Fastow’s financial interest in these transactions. The Examiner concluded that “Mintz took no steps to make Fastow provide a meaningful and responsive answer to the relevant question on the annual

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417. Id. app. C, at 147.
418. Id.
419. Id. app. C, at 184-86.
420. Id. app. C, at 148.
Directors and Officers Questionnaire, and the Examiner found no evidence showing that Sefton did either. 421

Efforts to obtain information for the 2001 proxy statement illustrate the concerns of the Examiner with respect to the conduct of the attorneys for Enron. In the course of working on the related party disclosures for that statement, EGF General Counsel Mintz received an e-mail from Ronald Astin of V&E on November 2, 2000, that stated, “As I hope everyone is aware, the ’senior officer[’s] name, and the nature and amount of his interest in the transaction, if quantifiable, will be disclosed in the 2001 proxy.” 422 Mintz then told Fastow that Astin had advised him that Enron would have to disclose the compensation that Fastow earned from his general partner position in LJM. 423 Fastow left a voicemail in reply to Mintz, stating his understanding that no disclosure of his compensation was necessary because the earnings that he received from participation in LJM came not from Enron, but from LJM’s limited partners. He stated, “If that thinking has changed, that’s a BIG issue and I need to know about that.” 424 Mintz forwarded a transcription of this voicemail to Rogers and copied Astin on it.

A January 2001 conversation with Fastow left Mintz with the understanding that Fastow wanted to avoid disclosing his compensation related to his position with LJM. As Mintz testified, Fastow “told me that if [Enron Chief Operating Officer] Skilling ever found out how much [Fastow] was making, Skilling would have no choice but to shut down LJM.” 425 Mintz sent an e-mail to Astin and Rogers informing them of this conversation. He asked to meet with them to discuss how to treat the Fastow disclosure issue in the proxy statement. “I think,” he said, “that the number one item on our list is to resolve the ‘where practicable’ language in connection with AF’s interest in the transactions engaged in with Enron by LJM1 and 2.” 426 The e-mail went on to say, “I spoke, again, with Andy about this earlier today and he believes (perhaps rightly so) that Skilling will shut down LJM if he knew how much Andy earned with respect to the Rhythms transaction.” 427 Mintz closed by saying, “We need to be ‘creative’ on this point,” he said, “within the contours of [SEC regulations] so as to avoid any type of stark disclosure, if at all possible.” 428

Astin testified that when he received this e-mail, he believed that it raised a significant issue for discussion. He had some skepticism, however, about its accuracy, because he had seen a Board presentation about the formation

421. Id. app. C, at 149.
422. Id. app. C, at 150.
423. Id.
424. Id. app. C, at 151.
425. Id.
426. Id.
427. Id.
428. Id.
of a possible LJM3 entity that referred to Fastow's discussions with Skilling about Fastow's compensation.429

Astin, Mintz, and Rogers met to discuss the proxy disclosure on January 18, 2001. The testimony is in dispute about what resulted from that meeting. Rogers and Astin testified that the group decided that Mintz would follow up with Fastow and get the necessary factual information. Rogers said that Astin then applied the legal standards to that information. Astin said that he never asked directly, but that the information that Mintz provided led him to infer that there had been no distributions to Fastow in 2000 related to his involvement in LJM. Mintz, on the other hand, denies that he was charged with obtaining additional information from Fastow. He claims that he understood Rogers and Astin to say that the company didn't have an obligation to pursue the issue with the CFO. In any event, no one ever asked Fastow if he had received any such payments, nor did they check LJM's records, which apparently were in the same building where Enron was located.430

As the Examiner put it, "[d]espite lacking this crucial piece of information, preparation of the related party transaction disclosure proceeded."431 Mintz testified that Astin and Rogers advised him that there was no need to make a disclosure in 2001 regarding the LJM1 Rhythms "hedge." Their argument was that the settlement of this transaction occurred under the original Rhythms agreement, which was entered into in 1999 and disclosed in 2000. Thus, there had been no new Rhythms transaction in 2000 generating income for Fastow that had to be disclosed in the 2001 proxy statement. Mintz said that he "initially disagreed" with this reasoning because he believed that it was possible to calculate and disclose Fastow's interest after the Rhythms transaction settled.432 He eventually, however, accepted the rationale for nondisclosure.433 He explained the reasoning in a later memo to Fastow in this way:

At settlement of RhythymNet [sic] it may have been practicable to determine your financial interest. However, no further disclosure was otherwise required of the RhythmsNet transaction in 2000 because settlement occurred under conditions permitted in the original agreement. Thus, there was no new transaction involving LJM1 and Enron in the year 2000 required to be disclosed in this year's proxy . . . .434

429. Id. app. C, at 152.
430. Id. app. C, at 153 & n.686 (stating "[b]y all accounts, access to LIM was as simple as walking down the hallway of Enron's corporate offices").
431. Id. app. C, at 154.
432. Id.
433. See id. app. C, at 155 (stating that Mintz, Rogers, and Astin told Derrick in March 2001 that no disclosure was required and that "all involved were comfortable with that position").
434. Id. app. C, at 156.
With respect to Fastow’s interest in LJM2, the attorneys concluded that a determination of that interest was “not practicable.” This judgment was based on the facts that the Enron/LJM2 transactions had not yet settled, and that Fastow potentially was subject to a requirement to recontribute capital to the LJM2 partnership. In Mintz’s memo to Fastow he stated, “We determined it was not practicable to quantify your interest in LJM2 in the most recent Proxy... based on the existence of multiple open and unmatured transactions making it impracticable to compute.”

On March 7, 2001, Mintz, Rogers, and Astin met with Enron General Counsel James Derrick to discuss the proxy statement disclosure of related party transactions. Based on the arguments described above, they informed him that no disclosure of Fastow’s interest in the LJM transactions with Enron was required, and he accepted their conclusion. The proxy statement was filed on March 27, 2001. The relevant portion of the proxy statement noted that Enron had entered into a number of transactions with LJM2 in 2000, and that Fastow was the managing member of LJM2’s general partner. It went on to say, “[t]he general partner of LJM2 is entitled to receive a percentage of the profits of LJM2 in excess of the general partner’s portion of the total capital contributed to LJM2, depending upon the performance of the investments made by LJM2.”

Mintz’s subsequent memo to Fastow indicated that with respect to the LJM1/Rhythms transaction, the “decision not to disclose in this instance was a close call; arguably, the more conservative approach would have been to disclose the amount of [your] interest.” If the Rhythms transaction had begun and ended in the same year, he told Fastow, “it would have been more difficult to avoid making some additional level of financial disclosure.”

Mintz circulated a draft of the memo to Rogers and Astin for comments, and Derrick eventually received a copy of it as well. Upon receiving it, Derrick contacted Astin to confirm that he was comfortable with the proxy statement, since Derrick had not understood that the determination regarding the disclosure of the LJM1/Rhythms transaction was a “close call.” Astin provided such confirmation.

Shortly afterward, without notifying Derrick or Rogers, Mintz sought advice about the related party transactions from the law firm of Fried, Frank, Harris, Shriver & Jacobson. Fried Frank regarded the amount of payments that Fastow had received from LJM as material in determining the adequacy of the disclosures that had been made and those that might be made in the future. The firm concluded that the prior disclosures were

435. Id.
436. Id. app. C, at 154-55.
437. Id. app. C, at 156.
438. Id. app. C, at 155 n.696.
439. Id. app. C, at 156.
440. Id. app. C, at 156-57.
441. Id. app. C, at 157.
incomplete. With respect to Fastow’s compensation from LJM2’s transactions with Enron, Fried Frank believed that the view that calculating the amount of Fastow’s compensation was not “practicable” because the transactions had not yet closed was “too aggressive.”442

The Examiner found that Enron might have a claim against Rogers and Mintz for malpractice based on violation of Texas Rule 1.12 and breach of fiduciary duty.443 Rogers knew that Fastow considered the amount of Fastow’s interest in the LJM transactions so large that Skilling would shut down the SPEs if he knew about it. Rather than asking Fastow how much this amount was, however, Rogers, Mintz, and Astin focused on why it was not practicable to calculate Fastow’s interest.444 The Examiner notes that Rogers may claim that his responsibility regarding disclosures “was more administrative than substantive,” and that he relied on Enron employees, as well as on V&E, with more knowledge of the SPE transactions to review the disclosures.445 With respect to Mintz, the Examiner found that there was evidence that Mintz was given responsibility to determine whether Fastow received any distributions from LJM transactions in 2000 and, if so, their amount.446

Finally, the Examiner found that Enron might have a claim against V&E for malpractice based on negligence in connection with V&E’s advice to Enron about disclosure of Fastow’s interest in LJM transactions in the 2001 proxy statement. V&E knew of Fastow’s characterization of the amount of his compensation from LJM transactions, yet it “never received or insisted upon receiving facts that were sufficiently developed to make an informed legal judgment. No one asked Fastow the simple question: How much money have you received in connection with your LJM activities?”447 The Examiner noted that the firm might contend that it relied upon Enron’s in-house attorneys to determine if it was practicable to calculate the amount of Fastow’s interest in LJM matters.448

Questions and Discussion

Mintz’s approach to disclosure, apparently shared by other lawyers working on the matter, was to be as “creative” as possible in exploring rationales under the regulations for not disclosing Fastow’s compensation from participation in LJM. As the discussion below elaborates, this premise shaped how the lawyers proceeded in gathering information and interpreting the relevant legal rules. An important question therefore is why

442. Id. app. C, at 158 (footnote omitted).
443. Id. app. C, at 192, 197.
444. Id. app. C, at 192.
446. Id. app. C, at 199.
447. Id. app. C, at 184.
448. Id.
the lawyers adopted this approach to disclosure of Fastow's LJM compensation and whether it was appropriate.

We can begin to answer this question by considering another one: Who was the Enron lawyers' client with respect to the disclosure issue? The EGF unit for which Mintz served as general counsel was the entity within Enron that was involved in most of the company's structured finance transactions. 449 As those transactions generated increasing earnings for Enron, EGF naturally rose in stature.

A crucial reason for this was Fastow and his LJM entities, which provided parties ready and willing to engage in transactions with Enron on relatively short notice. Although ultimately the facts decisively proved otherwise, Fastow steadfastly maintained that he played this role at a personal and professional sacrifice for the good of Enron. 450 The apparent success of the Enron/LJM transactions gave Fastow considerable influence within the company even beyond what his CFO position furnished. Fastow became someone whom others did not want to cross, least of all someone in EGF. His reluctance to disclose his LJM compensation to the public might even be taken as an implicit threat to discontinue the Enron/LJM transactions if disclosure were required.

In these circumstances, who was the client with respect to the disclosure issue? As a formal matter, of course, the client was Enron the entity. As a practical matter, however, the entity could speak only through "duly authorized constituents" 451 such as executives and managers. Who spoke for the company on this question? Fastow was the executive most directly involved in the LJM transactions and was the CFO of the company. The Board of Directors had approved his involvement on the belief that it would benefit Enron, and the results to date appeared to validate this judgment. Given the integral role that Fastow effectively played in the operations of Enron and its EGF unit, Mintz might well assume that Fastow spoke on behalf of the company with respect to the disclosure issue.

This assumption might be appropriate under normal circumstances. Corporate lawyers are accustomed to thinking of disclosure in terms of providing the public with the information that it needs. Executives sometimes may be disinclined to disclose this information until educated by a lawyer about why it is necessary. This scenario may not arise frequently, but it is not uncommon. The fact that Fastow was reluctant to disclose his LJM compensation thus in itself does not automatically mean that it was improper to regard him as authorized to speak for the client on this issue.

What makes this more problematic, however, is that Fastow apparently did not want the amount of his LJM compensation disclosed to Enron. His comment that Skilling would shut down LJM if he knew how much Fastow

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449. Id. app. C, at 18.
450. See McLean & Elkind, supra note 13, at 193.
earned suggested that there might be a conflict between Fastow’s personal interest and Enron’s interest. In that situation, it was inappropriate for Mintz and other lawyers to treat Fastow as Enron’s “duly authorized constituent” with respect to the disclosure issue. Indeed, Fastow’s reluctance arguably should have been taken as a warning sign that disclosure might be especially important in order to protect Enron.

Enron’s lawyers, however, were loath to interpret the situation in that way. One reason might be that Mintz was located in EGF rather than in Enron’s General Counsel’s office. His day-to-day colleagues thus tended to be business managers rather than lawyers, and he inevitably was immersed in the culture of the unit. As a result, while he was of course a lawyer, it also would be natural for Mintz to regard himself as a member of the EGF team—and there was no question that Fastow was the head of that team.

This is one foreseeable result of assigning lawyers to work in business units, rather than locating them within a central legal department. The advantage of placing a lawyer in a unit is that she is directly involved in its work flow and is privy to informal, “back channel” sources of information about its operations. Ideally, this puts the lawyer in a position to provide advice, anticipate problems, and fashion creative solutions that meet the unit’s objectives. One possible drawback, however, is that the individual’s identity as a lawyer who is subject to distinct professional demands may become less salient than her identity as a member of the business team. To the extent this occurs, it may make the lawyer insensitive to concerns that a more detached observer would recognize. If this process of informal socialization occurred with Mintz, it would be natural for him subtly to regard EGF as his client and Fastow as speaking for EGF—while convincing himself that doing so was in Enron’s best interest.452

Enron’s lawyers likely preferred not to cross swords with Fastow on an issue about which he felt so strongly. As a result, they may have convinced themselves that Fastow was exaggerating his LJM rewards in keeping with the hypercompetitive Enron culture. Perhaps they assumed that, in an era of often exorbitant compensation, whatever benefits Fastow was receiving were more than offset by the value of the LJM transactions to Enron. Maybe they rationalized that the Board would not have waived the conflict of interest prohibition for Fastow without ensuring that stringent measures were in place to prevent abuse. On paper, at least, such controls were in place. Whatever their reasoning, they approached the disclosure issue with Fastow’s wishes as their implicit marching orders—find a way to avoid disclosure if at all possible.

The most promising basis for not disclosing Fastow’s LJM compensation was that calculation of it was not “practicable.” The desire to avoid

452. “[L]awyers’ self-conception as advocates for the client, as neutral, non-judgmental facilitators of transactions, or as professionals trained to make ‘arguments’ on either side of an issue, can allow a high degree of rationalization of their complicity in conduct that is ultimately not in their corporate client’s interest . . . .” Sargent, supra note 9, at 880.
acquiring any information that would make reliance on this justification difficult seems to have shaped the way in which the lawyers proceeded. Most striking, as the Examiner observed, was the failure simply to ask Fastow directly how much compensation he had received. Not surprisingly, the lawyers differ in their recollections of who had responsibility for this. Each has a plausible story of why he depended on others for information that could have triggered a reporting obligation.

Rogers and V&E lawyer Astin testified that Mintz was responsible for obtaining from Fastow the amount of his LJM compensation. Mintz disputed this, saying that he was told by the two lawyers that there was no obligation to pursue the matter with Fastow. Astin said that he was waiting for information from Mintz, which he would then analyze to determine if disclosure were required. Not hearing from Mintz on the issue, he assumed without inquiring that there was no compensation that could be calculated.

This scenario reflects the tendency in organizations deliberately to leave matters unresolved by avoiding direct confrontation with potentially unpleasant facts. In this case, the lawyers apparently wished to conclude that determining Fastow’s LJM compensation was not “practicable.” Rogers and Astin may not have directly instructed Mintz to ask Fastow about his compensation because that would set in motion an assignment that could result in destroying this rationale for nondisclosure. Even if Rogers and Astin strongly intimated that Mintz should make an inquiry, Mintz would be inclined to interpret the slightest ambiguity otherwise.

Similarly, it would have been easy for Astin directly to ask Mintz what if anything he had learned from Fastow. Instead, Astin assumed that no news was good news. In this way, an implicit consensus may have developed that the calculation of Fastow’s compensation was not practicable, based not on detailed inquiry but on wishful thinking. By leaving responsibility ambiguous and information uncertain, the lawyers maximized their freedom to maneuver.

It is worth keeping in mind that two of the men who worked on the Fastow LJM compensation issue—Mintz and Astin—exhibited some independence on this and other matters. This belies any claim that they were simply single-minded lawyers inclined to act uncritically on their client’s behalf. Mintz, without informing the Enron legal department, sought outside advice on Fastow’s involvement with LJM and the disclosure of it. It is possible that he subsequently may have raised more pointed questions about LJM had Fastow not reduced his involvement in those entities shortly afterward.

Astin was the lawyer who first advised Mintz that Fastow’s name and compensation should be disclosed in Enron’s 2001 proxy statement. Astin also was the lawyer who resisted Salomon’s efforts to avoid being bound by the put and call agreement that Astin had said was necessary in order to issue a true sale opinion on the Sundance Industrial project. Finally, as

another section below describes in more detail, Astin also expressed concern that an LJM entity with which Enron engaged in a transaction might not have the necessary three percent outside equity to avoid being consolidated with Enron’s financial statements. \textsuperscript{454} Characterizing Mintz’s and Astin’s conduct in the Fastow compensation matter as the actions of lawyers insensitive to ethical concerns thus seems an unsatisfying explanation.

The question of disclosure in this instance also can serve as a vehicle for addressing additional issues that arise with respect to lawyers’ responsibilities. Suppose that Fastow’s superiors were aware of the amount of compensation he was receiving for this work on LJM, so there was no potential conflict between Fastow’s and Enron’s interests. Would it be more appropriate in that case for Enron’s lawyers to be as aggressive and creative as possible in avoiding disclosure? Or is this approach inconsistent with ensuring Enron’s compliance with the law? If a decision not to disclose is, as Mintz described it, a “close call,” should a lawyer resolve it in favor of advising disclosure?

The SEC is understaffed and has limited resources. It reviews only a small number of filings such as proxy statements each year. In presenting the options on disclosure, could Enron lawyers factor into their recommendation an estimate of the small likelihood that the SEC would ever review the proxy statement, as well as the likely penalty if it did? Or does the low probability of SEC detection make it even more important for lawyers to urge the client to comply with the spirit, not just the letter, of the law? If Enron management believed that the benefits from not disclosing Fastow’s LJM compensation exceeded the risks associated with nondisclosure, should the lawyers defer to this as a business judgment?

Finally, Mintz’s memo to Fastow suggested that it was “fortuitous” that the Rhythms transaction stretched over two proxy filing years, which made it possible to claim that “a disclosable transaction occurred only in the year in which financial disclosure was impracticable.” \textsuperscript{455} If Rhythms had begun and ended in the same year, Mintz said, “it would have been more difficult to avoid making some additional level of financial disclosure.” \textsuperscript{456} Would this rationale for not disclosing the compensation from the Rhythms transaction create the possibility for avoiding ever disclosing any compensation from the LJM/Enron transactions, by simply entering into an agreement in one year and not settling until the next? Suppose that Enron management asked that all transactions with LJM be structured in this way to avoid disclosure. Should a lawyer raise any objection?

\textsuperscript{454} See supra note 381 and accompanying text.
\textsuperscript{455} Final Batson Report, supra note 75, app. C, at 156.
\textsuperscript{456} Id. app. C, at 156-57.
F. Issue Three: Three Percent Outside Equity in Raptors

The remaining issue with the Raptors, along with questions arising in the Cuiaba and Chewco transactions discussed below, are those as to which the Examiner found no potential liability on the part of Enron’s lawyers. Examining these matters, however, provides an additional sense of the texture of transactional work and enhances appreciation of the kinds of issues that call for the practical and ethical judgment of lawyers engaged in this practice.

The final issue involving the Raptors concerns whether there was sufficient outside equity in an SPE known as Talon to avoid the need to consolidate Talon into Enron’s financial statements. Each Raptor’s operating agreement provided that before the Raptor could begin to enter into hedges with Enron, LJM2 was to receive 100% of all income distributed by the Raptor up to the greater of $41 million or a 30% annualized rate of return. In order to generate income to make this distribution, three of the four Raptors sold a “put” on Enron stock to Enron for $41 million.

In the case of Talon, this put gave Enron the right to require Talon to purchase about seven million shares of Enron stock in six months at a price of $57.50 per share. This is the kind of right that a purchaser buys if it expects the stock to drop below $57.50 in the next six months. At the time, however, Enron’s shares were trading at $68 per share, and it seemed highly unlikely that the price would fall below the exercise price for the put during this period.

Four months later, Enron and Talon agreed to settle this put when Enron’s share price was well above $57.50. Talon got to keep the $41 million it had charged for the put. It then distributed this amount to LJM2 in accordance with the operating agreement.

At some point during the work on Talon, Astin questioned Enron financial officer Ben Glisan about this distribution. Astin’s concern was whether it constituted a return of LJM2’s investment, such that LJM2 no longer had any equity at risk in Talon. If this were the case, Talon no longer met the 3% outside equity requirement, and its financial position would have to be consolidated into Enron’s financial statements. Prior to raising the issue with Glisan, Astin reviewed the position of the SEC on how the 3% equity remained at risk throughout the life of the SPE. Around the time that the put option was terminated, Astin confirmed with Glisan that Andersen continued to regard LJM2’s investment as being at risk.

458. See supra fig.5 (steps 4-5).
460. See supra fig.5 (step 5); see also Second Batson Report, supra note 55, app. L, annex 5, at 13.
V&E lawyer Spradling raised similar concerns, first with Dilg and then with Glisan. Spradling testified that Dilg regarded the question as an accounting issue, and that he suggested to Spradling that he “go check, make sure everybody’s comfortable with the accounting and then, you know, it doesn’t sound like a legal issue.” Both Astin and Spradling shared their question with Sefton, but did not raise the issue with Enron general counsel Derrick. Glisan reassured them that Enron Chief Accounting Officer Causey was confident that the distribution to LJM2 did not jeopardize Talon’s ability to satisfy the 3% outside equity requirement. The Examiner suggested, however, that Astin continued to have concerns. Notes of a conversation with him in connection with V&E’s later investigation of Sherron Watkins’s allegations of misconduct describe him as saying that the distribution “[p]aid LJM full investment, plus 30% rate of return. Theoretically, LJM still ha[d] capital in . . . [but] as a practical matter, LJM ha[d] its investment back.” Astin testified, however, that he had no further communications about the issue after his conversation with Glisan.

Glisan eventually pled guilty to conspiracy to commit wire and securities fraud in connection with the Raptors. With respect to Talon, he stated,

Enron and Talon entered into a “put” . . . . Although there was no true business purpose, the “put” option was purchased by Enron for $41 million. The put was designed by me and others as an ostensible reason to make a distribution of $41 million to LJM, economically providing a return of and return on capital. Since the put failed to have a true business purpose, Talon failed to meet the minimum equity test as required by applicable accounting rules.

Questions and Discussion

Was the effect of the Talon distribution to LJM2 a legal issue or an accounting issue? The ultimate question whether Talon had to be consolidated into Enron’s financial statements arguably was a judgment for the accountants. As a precondition to that conclusion, however, did the accountants need to rely on a lawyer’s determination whether the economic interest that LJM held had the legal characteristics of equity? Does the fact that Astin reviewed the SEC’s position on the issue suggest that this is the case?

Enron’s assurance to V&E attorneys may have taken the following form. Talon was established to help Enron hedge its risks. One risk is that Enron’s stock would decline in value. The “put” provided Enron protection against that risk. The $41 million that Talon received to furnish such protection was income from its operations, which it then was free to

462. Id. app. C, at 141.
463. Id. app. C, at 142.
464. Id. app. C, at 135 n.592.
distribute to its investors as it wished. This distribution thus was not a return of LJM2’s original equity, which remained at risk, but a return on that equity. Is this persuasive? Were V&E lawyers in a position to evaluate this explanation? Does it call for an accounting or a legal conclusion?

Note that Dilg instructed Spradling to engage in discussions about the accounting treatment for the LJM2 distribution so that “it doesn’t sound like a legal issue.” Did this reflect an effort to deflect responsibility, by making sure that the parties would regard the accountants, rather than the lawyers, as the professionals who had to make the ultimate decision on the issue? Or was it an attempt to clarify that the lawyers did not have the expertise to judge whether a distribution was return on or a return of equity? Characterizing a potentially troublesome issue as one that required a judgment call by the accountants rather than the lawyers would permit V&E to continue working on the transaction despite its reservations. In this way, the division of responsibilities among specialized professionals can provide the basis for a rationalization that avoids the need to confront potentially unpleasant facts.

As Astin’s comments during the Watkins investigation indicate, he continued to have doubts about the effect of the LJM2 distribution even after V&E obtained confirmation that Enron did not regard it as jeopardizing the outside equity requirement. Was assurance from Glisan that Enron’s Chief Accounting Officer saw no reason for concern sufficient to justify not following up on those doubts? Should Astin have sought further reassurance from Arthur Andersen? If Andersen provided the same response, would it be appropriate to defer to its judgment? Or did Astin’s concerns really relate to a legal issue, so that deference to accountants was inappropriate? If so, would assurance from Enron’s General Counsel’s office be enough to relieve him of further responsibility?

G. Issue Four: Cuiaba Transaction

The Examiner found that Enron was effectively warehousing many of its assets through transactions with related parties. By “warehousing,” the Examiner referred to those transactions in which

Enron temporarily transferred assets to a Related Party to impact favorably Enron’s financial statements, while Enron continued to search for a third party purchaser. In many instances, there was no third party purchaser, and Enron repurchased those assets at a premium over the price at which they were sold to the Related Party.466

To the extent that such warehousing occurred, the Examiner concluded, the transfer of the assets should be recharacterized as secured loans rather than

465. Id. app. C, at 141.
The resulting accounting treatment would be much less favorable to Enron than what it had originally reported.

The Examiner opined that one illustration of warehousing was the ostensible purchase by an LJMI subsidiary of Enron's interest in Empresa Produtora de Energia Ltda ("EPE"), which owned a power plant located in Cuiaba, Mato Grosso, Brazil.468 In mid-1999, Enron owned about 65% of EPE through its wholly owned subsidiary Enron do Brazil Holdings, Ltd ("EBHL"). The remaining 35% was owned by a Shell Oil subsidiary (22%), and a subsidiary of Transredes, S.A. (13%), an entity in which Enron held a 25% interest. Enron had the right to appoint three members of the EPE Board of Directors and the Shell subsidiary had the right to appoint the fourth.

Enron sought to reduce its interest in EPE so that it no longer would have to consolidate it in its financial statements. This would keep off Enron's books about $200 million in project debt that EPE was preparing to incur. It also would allow Enron to treat as an arms-length transaction for accounting purposes a gas supply contract between EPE and Transborder Gas Services, Ltd ("TGS"), an entity in which Enron had a 72.5% interest.

On September 30, 1999, EBHL sold to LJMB Brazil Co. ("LJMB"), a wholly owned subsidiary of LJMI, 13% of the outstanding equity in EPE and 10,000 shares of EBHL "preference shares."471 LJMB paid $10.8 million for the EPE equity and $500,000 for the preference shares. Enron also gave to LJMB its right to appoint one of the members of the EPE Board.472 As a result of the sale, EBHL (and thus Enron) reduced its ownership interest in EPE to 52%. Enron concluded that it was appropriate to deconsolidate EPE from the former's financial statements even though it owned more than 50% of EPE because, having assigned the right to appoint one Board member, it no longer had the right to appoint a majority of EPE's Board.

As part of the transaction, LJMB assumed obligations to provide a pro rata share of funds for the Cuiaba project up to $36 million.474 LJMB was not required, however, to make any loan or capital contribution under this obligation unless EBHL loaned the amount to LJMB. As a result, concluded the Examiner, "any required cash call to EPE by LJMB was in effect funded by EBHL."475 Reinforcing this protection, LJMB's

467. Id.
468. Id.
469. Id. app. L, annex 3, at 1-2.
470. Id. app. L, annex 3, at 1.
471. Id. app. L, annex 3, at 3.
472. See infra fig.6 (step 1).
473. See infra fig.6 (step 2).
475. Id.
preference shares provided that LJMB was to receive the principal amount that it loaned to EPE and interest on any loan from EBHL to LJMB.

EBHL had the exclusive right to market the EPE interests, although LJMB was permitted after May 10, 2000, to sell those interests to any third party with the consent of EBHL. If a sale occurred, LJMB was required to pay EBHL a fee equal to (1) the amount by which the sale proceeds exceeded $10.8 million (the amount that LJMB had paid for the EPE interests), less any dividends that had been paid to LJMB, plus (2) the amount necessary to result in a 13% annual return on LJMB’s investment, to rise to 25% if the sale were after May 10, 2000. Enron South America, LLC, a wholly owned Enron subsidiary, guaranteed EBHL’s obligations to LJMB.476

EBHL was unable to find a purchaser for the EPE interests. On March 28, 2001, it therefore agreed to repurchase those interests from LJMB for $13.2 million, and to redeem the EBHL preference shares for $800,000.477 The Examiner noted that “[i]t has been suggested” that this transaction was pursuant to “an undisclosed verbal agreement with LJMB to repurchase the EPE Interests.”478 He stated, however, that, despite this allegation by an Enron employee, he “is not aware of any evidence of such an agreement other than” a cryptic entry on the Enron’s Chief Accounting Officer’s calendar referring to a meeting with Andrew Fastow regarding “Global Galactic.”479

Nonetheless, the Examiner concluded that “LJMB never had any significant risk with respect to the EPE Interests and that the sole purpose for the Cuiaba Sale was to ‘warehouse’ the EPE Interests with LJMB.”480 The Examiner reached this conclusion because the EBHL preference shares were structured so that the most that LJMB could lose was the equivalent of 3% of the value of the EPE assets. In addition, the repurchase of the EPE interest provided LJMB with a 13% return on and of its investment, “even though the market value of the EPE Interests had likely decreased since the time of the Cuiaba Sale, as evidenced by EBHL’s inability to find an unrelated third party purchaser for the EPE Interests.”481 This suggested that “Enron had agreed to repurchase the EPE Interests from LJMB at a guaranteed return”482—which meant that the latter never assumed any of the risks of ownership in EPE. The warehousing allowed Enron from 1999-2001 to mark to market $85 million in income from the TGS gas contract in

477. See infra fig.6 (step 4); see also Second Batson Report, supra note 55, app. L, annex 3, at 7.
479. Id. app. L, annex 3, at 11.
480. Id. app. L, annex 3, at 10.
481. Id.
482. Id.
an ostensibly arms-length transaction with EPE, and to remove $200
million of EPE’s debt off Enron’s balance sheet.\textsuperscript{483}

Boyd Carano was the lead V&E attorney on the sale of the EPE interest
to LJMB. Just before the deal was to close, he overheard Enron employee
Cheryl Lipshutz, who represented LJMI in the Cuiaba transaction, “say
words to the effect that, at the end of the day, Enron would make LJMI
whole in the Cuiaba Transaction.”\textsuperscript{484} Carano testified that he spoke with
Enron employee Kent Castleman, who confirmed that he heard Lipshutz
make the same remark.\textsuperscript{485}

Carano then sought to contact Enron Chief Accounting Officer Rick
Causey to confirm that there was no such agreement. He did not speak
directly to Causey, but Castleman confirmed to Carano that Causey denied
that any such agreement existed. Carano evidently felt that this
confirmation was sufficiently crucial that he saved for two years two voice
mail messages from Castleman stating that there was no “make whole”
agreement.\textsuperscript{486} Lipshutz later told the Powers Committee that there was
such an understanding between Fastow and Causey.\textsuperscript{487}

\begin{thebibliography}{99}
\bibitem{483} Id. app. L, annex 3, at 14; see also infra fig.6 (steps 2-3).
\bibitem{484} Final Batson Report, \textit{supra} note 75, app. C, at 122-23.
\bibitem{485} Id. app. C, at 123 n.525.
\bibitem{486} Id. app. C, at 123 n.528.
\bibitem{487} Id. app. C, at 123.
\end{thebibliography}
On September 30, 1999, EBHL sells a 13% interest in EPE to LJMB for $10.8 million, and 10,000 EBHL preference shares for $500,000. LJMB obtains the right to appoint one EPE Board member.

Enron deconsolidates EPE from its financial statements.


On March 28, 2001, EBHL repurchases a 13% interest in EPE from LJMB for $13.2 million, and redeems EBHL preference shares for $800,000.
When Enron repurchased the EPE shares from LJMB, Carano asked Castleman whether the repurchase created the need to unwind the earlier accounting that Enron had used for the Cuiaba transaction. Castleman replied that it was a "close call," but that there was no need to do so.488

The Examiner found no basis for any claims by Enron against V&E for its work on the Cuiaba transaction. While he did not say so explicitly, he presumably believed that Carano had responded appropriately to the possibility of a make-whole agreement by seeking clarification from higher authority within Enron, up to the company's Chief Accounting Officer. The fact that Carano saved the voicemails confirming the absence of an agreement indicates the significance that he attached to this issue.

Questions and Discussion

Suppose that Carano had asked Lipshutz directly about her remark, and that she had laughed and replied, "Oh, that's a running joke around here." Could he then continue his work on the transaction under the assumption that there was no make-whole agreement? Or did he have an obligation to seek clarification from higher authority?

Does Carano's preservation of the two voicemails from Castleman suggest that Carano had some lingering unease about the transaction? That he anticipated that an occasion might arise when his work on the deal might be questioned on the ground that the transaction was not genuinely a sale? If so, should he have done anything else? Or is the possibility that the bona fides of a transaction might be subject to challenge simply a risk that every lawyer takes?

Apart from the issue of the make-whole agreement, the Examiner found that the terms of the transaction effectively shielded LJMB from any risk associated with ownership of the EPE interest. If Carano worked on the transaction, is it proper to infer that he was aware of this? Does that depend on the particular tasks that he performed on the deal? If he did not know, should he have? Does it matter whether he knew of the accounting benefits that Enron gained from the transaction?

Finally, was the question whether Enron's purchase of the EPE shares required Enron to unwind the earlier accounting an accounting or a legal issue? If it was a "close call," as Castleman told Carano, should Carano have satisfied himself that reversing the accounting was unnecessary, instead of relying on Castleman's judgment? It is unclear if Castleman was a lawyer. If he was, does that suggest that Carano regarded the issue as a legal one? If he was not, does that support a claim that the issue was an accounting one, with respect to which it was reasonable for Carano to rely on Castleman's opinion?

488. Id. app. C, at 123 n.530.
VII. CHEWCO

A. Background

One of the first SPEs that Enron created was Chewco, formed in late 1997 to acquire the California Public Employees' Retirement System ("CalPERS") interest in Joint Energy Development Investments ("JEDI"), which was an investment partnership in which Enron was a partner. Enron wanted to arrange for CalPERS to divest its interest in JEDI so that the pension fund could participate in another investment partnership with Enron. Enron did not want to purchase CalPERS' interest outright, because that would require that JEDI be consolidated with Enron's financial statements.

Enron initially sought outside investors to take the place of CalPERS. This effort was unsuccessful by late 1997, and Enron was anxious that JEDI be able to engage in transactions before the end of the year. Enron thus proposed that Enron officers and employees would invest in an entity that would assume the role of partner with Enron in JEDI by year's end. This entity was known as Chewco. As long as there was three percent equity investment in Chewco by outside investors, and Enron did not control the entity, Chewco and JEDI did not have to be consolidated with Enron's financial statements.

B. Issue One: Enron Officer Involvement in Chewco

Enron's Legal Department met with V&E lawyers in early September 1997 to discuss the formation of Chewco. The meeting included discussion of possible conflict of interest and disclosure issues stemming from Enron officers' and employees' participation in Chewco. At this time, Enron was considering permitting Enron CFO Andrew Fastow to invest in Chewco.

V&E advised Enron that Fastow's participation would require that the Board of Directors be notified, and that the Board waive the Code of Conduct provision relating to potential conflicts of interest resulting from Fastow's involvement in an entity engaged in business dealings with Enron. In addition, since Fastow was considered an "executive officer" of the company under SEC regulations, his participation in Chewco would have to be disclosed in Enron's public filings.

Following the September meeting, Enron suspended work by V&E on the Chewco matter until Enron and CalPERS could resolve their
disagreements on the terms on which CalPERS would be bought out.\footnote{Id. \emph{app. C}, at 112.} In October 1997, V&E's work on the Chewco transaction resumed. On October 31, Enron in-house lawyers sent to V&E a diagram of the proposed transaction. It listed the manager and owner of Chewco as William Kopper, a vice president in the Global Capital (later Global Finance) unit of Enron, and an immediate subordinate of Fastow. When Astin learned of Kopper's planned involvement, he discussed its ramifications with Rex Rogers and two other Enron in-house lawyers working on Chewco, and also left a voice mail message for General Counsel James Derrick about Kopper's role.\footnote{Id. \emph{app. C}, at 112-13.}

Enron's understanding at that time was that Kopper was not an "executive officer" under SEC regulations, and that his involvement in Chewco therefore did not have to be reported in Enron's public filings. Kopper's participation did, however, require that the Chairman of the Enron Board, CEO Kenneth Lay, evaluate Kopper's participation with reference to the company's Code of Conduct.\footnote{Second Batson Report, \textit{supra} note 55, \emph{app. L}, annex 1, at 5.}

Lawyers in Enron's Legal Department told V&E attorney Ronald Astin that they would handle application of the Code of Conduct and consideration of whether the Enron Board should be informed of Kopper's participation. For reasons that are unclear, Kopper's involvement in Chewco was disclosed in Enron's 1999 Form 10-K, but not in its Form 10-K for 1997, 1998, and 2000. The Examiner concluded that it should have been disclosed in those years as well.\footnote{Id. \emph{app. L}, annex 1, at 27.} In addition, the Examiner found no evidence that Kopper's potential conflict was raised as an issue with Chairman Kenneth Lay, or that Kopper's involvement in Chewco was ever disclosed to the Enron Board.\footnote{Final Batson Report, \textit{supra} note 75, \emph{app. C}, at 113.}

### Questions and Discussion

Was the use of Kopper instead of Fastow as manager and owner of Chewco a creative way to avoid having to disclose Kopper's involvement in Enron's public filings? Or was it problematic in light of the underlying purpose of the requirement that a company disclose transactions involving "executive officers"? Would it make a difference if Kopper were not a subordinate of Fastow? If V&E believed that Enron was wrong in concluding that Kopper was not an executive officer whose involvement did not have to be disclosed, what should it have done? Defer to Enron as long as there was a colorable, even if not persuasive, ground for the company's position? If V&E believed that not disclosing Kopper's involvement in Enron's public filings was plausibly permissible but unwise, what should it have done?
Did V&E have any continuing obligations with respect to Chewco once Enron’s Legal Department said that it would handle any issues relating to conflict of interest issues with respect to Kopper? What if V&E learned after the Board meeting that the Board had not been informed of Kopper’s participation in Chewco?

C. Issue Two: Three Percent Outside Equity

Capital for Chewco eventually came primarily from a $240 million loan to Chewco from Barclays,\(^500\) guaranteed by Enron,\(^501\) for which Chewco paid Enron a fee,\(^502\) a small contribution by Kopper to Chewco’s general partner,\(^503\) and an ostensible three percent equity investment from Chewco’s limited partner.\(^504\) Funding for the latter took the form of an $11.4 million contribution by Barclays Bank to the limited partner.\(^505\) This was structured formally as equity rather than debt in that the limited partner was required to pay “yield” on “certificates” to Barclays rather than interest on a loan.\(^506\) Under the accounting rules at the time dealing with special purpose entities, this allowed Barclays to characterize the advance as a loan for business purposes and Enron and Chewco to characterize it as an equity contribution for the purpose of the three percent outside equity requirement. As equity, therefore, Barclay’s contribution was supposed to be at risk, rather than entitled to guaranteed repayment as would be the case with a loan.

Barclays insisted, however, that Chewco’s limited partner set aside a reserve account of $6.6 million at closing of the transaction that was pledged to secure repayment of its $11.4 million contribution.\(^507\) JEDI sold one of its assets, and gave Chewco its share of the proceeds, which amounted to $16.6 million.\(^508\) Enron and Chewco then agreed that Chewco could use this money to fund the $6.6 million reserve account.\(^509\) The consequence of this was that $6.6 million of Barclay’s contribution was not at risk, and thus should not have been treated as equity. This had the effect of reducing the outside equity in Chewco and JEDI below the three percent required to avoid consolidating those two entities with Enron’s financial statements.

Arthur Andersen apparently was unaware of this reserve fund at the time the transaction closed. When it learned of it in the fall of 2001, it

\(^{500}\) See infra fig. 7 (step 1); see also Second Batson Report, supra note 55, app. L, annex 1, at 7.

\(^{501}\) See infra fig. 7 (step 2).

\(^{502}\) See infra fig. 7 (step 3).

\(^{503}\) See infra fig. 7 (step 4).

\(^{504}\) See infra fig. 7 (step 6); see also Second Batson Report, supra note 55, app. L, annex 1, at 10.

\(^{505}\) See infra fig. 7 (step 5).


\(^{507}\) Id. app. L, annex 1, at 12.

\(^{508}\) See infra fig. 7 (step 7).

\(^{509}\) See infra fig. 7 (step 8).
determined that Chewco and JEDI should have been consolidated in Enron’s financial statements beginning in November 1997. This resulted in a reduction in income for the third quarter of 2001 of $400 million, and a $800 million reduction in equity and $600 million increase in indebtedness as of December 31, 2000.\textsuperscript{510}

The Examiner noted that V&E’s Spradling and the Enron in-house lawyers working on Chewco knew that three percent outside equity needed to be maintained in Chewco to avoid consolidation of JEDI. He stated, however, that these lawyers “appear to have relied on the accountants’ involvement in and approval of the structure to insure that the 3% equity requirement was satisfied.”\textsuperscript{511}

An associate at V&E who worked with Spradling on the Chewco matter drafted the “side letter” establishing the reserve account that resulted in a violation of the three percent outside equity requirement. The Examiner said, however, that he had “not found evidence” that either the associate or the partner working with him “had sufficient experience with such transaction structures to appreciate the significance of the reserve accounts on the consolidation of JEDI.”\textsuperscript{512}


\textsuperscript{511} Final Batson Report, \textit{supra} note 75, app. C, at 113-14.

\textsuperscript{512} \textit{Id.} app. C, at 114.
(1) Barclays contributes $240 million to Chewco.
(2) Enron guarantees Barclays's $240 million contribution.
(3) Chewco pays Enron for the guarantee.
(4) The General Partner of Chewco controlled by Kopper and Dobson contributes $115,000 to Chewco for its partnership interest.
(5) Barclays advances $11.4 million to Chewco's limited partner, controlled first by Kopper, then Dodson, ostensibly representing a three percent outside equity at risk in Chewco.
(6) Chewco's limited partner contributes $11.4 million to Chewco in return for a partnership interest.
(7) JEDI sells an asset, and gives Chewco $16.6 million as its share of proceeds.
(8) Chewco uses $6.6 million of proceeds to establish a reserve account as security for repayment of Barclays's $11.4 million contribution.
Questions and Discussion

Was the V&E partner who supervised the associate who worked on the side letter negligent in not recognizing the significance of the letter? Was the firm negligent in not ensuring that someone with sufficient expertise to recognize its significance was in charge of the matter? Was there anyone at the firm who understood all the elements of the transaction?

As the Examiner noted, the lawyers working on Chewco relied on the accountants for assurance that the three percent outside equity requirement was satisfied. The accountants, however, apparently did not know of the side letter. It is likely that they assumed that the lawyers had brought to their attention all of the legal information necessary for them to make an accounting judgment. In these circumstances, who is to blame for the failure to meet the outside equity requirement? The Chewco structure was established quickly under considerable time pressure. Is it possible that no one fully understood all its components? Might Enron have been aware of this confusion and used it to its advantage? Or should the in-house lawyer overseeing the transaction have assumed responsibility for fully understanding all aspects of the deal?

Finally, note that accounting rules apparently permitted Barclays to treat its contribution to Chewco as a loan and Chewco and Enron to treat it as equity. In the midst of this officially sanctioned manipulability, would the side letter establishing the reserve account necessarily set off alarms that there no longer was three percent equity at risk in Chewco?

CONCLUSION

The Examiner's analyses of each of the matters that I have discussed provide a rare window into the texture and dynamics of transactional practice. While events unfolded differently in each case, there are some common features and patterns that suggest some of the characteristic issues that transactional lawyers must confront, and the judgments that they must make, in the course of their practice.

Perhaps most striking, the Enron attorneys in these matters repeatedly had to assess, even if only implicitly, the relationship between legal form and economic substance. In some respects, creative deployment of legal form is the transactional lawyer's stock in trade. Regulatory, tax, or practical business considerations may suggest that deals with identical economic results be structured differently in order to take advantage or avoid the consequences of particular legal forms. The lawyer who practices in this field thus almost inevitably encounters—indeed, helps create—divergences between form and substance. The law usually tolerates such divergences as long as transactions meet certain formal requirements.

There is, however, an outer limit to such tolerance, as we see in the Examiner's report and the case law that he discusses. Sometimes the divergence between form and substance is so great that the law will not
honor the form that parties have chosen. At some point, in other words, the law concludes that creativity has crossed the line and becomes abuse. Exactly where that line is, however, can be difficult to say. Courts take into account a variety of factors in a determination that ultimately is based on considerations of equity. A transactional lawyer thus must have one eye on technical legal requirements and another on more amorphous and open-ended equitable concerns. For this reason, acting solely as a legal technician may not serve the client’s interest.

To varying degrees, a divergence between form and substance existed in each of the matters with respect to which the Examiner concluded that Enron might have a cause of action against its attorneys. In the FAS 140 transactions, Enron’s guarantee of the loan to the SPE took the form of a Total Return Swap, a complex financial arrangement formally designed to hedge market risks rather than provide complete assurance of the return of capital. In substance, however, the Swap meant that Enron effectively advanced the money that the Asset LLC had used to purchase assets from it. In addition, the decision to prepay the SPE’s loan and unwind the transaction formally lay with the SPE investors, who were under no legal obligation to accept Enron’s offer to buy them out. In practice, however, Enron always was able to purchase their interest and ultimately unwind the transaction when it wanted to.

In Project Nahanni, $500 million passed from Citigroup to Nahanni to Marengo to Enron, and then back again, in a series of transactions that took the form of a loan, a purchase of Treasury securities, a capital contribution to a partnership, the sale of the Treasury securities, a loan of the proceeds in return for a demand note, a repayment of that loan, a redemption of a partnership interest, and a repayment to the original lender. Each step met the necessary formal requirements along the way, but the Examiner concluded that, taken together, they served no substantive business purpose.

In Sundance Industrial, an Enron entity transferred assets to Salomon in a transaction explicitly structured to meet the technical requirements for a sale. Despite the formal existence of a put and call agreement between the parties, however, the Examiner concluded that the ability to act on this agreement was so constrained that in substance it was a nullity. Furthermore, despite the formal transfer of assets, the Examiner found that Salomon had no genuine business reason for acquiring the assets. He therefore concluded that no genuine sale had taken place.

In the RhythmsNet and Raptors supposed hedges, Enron had formal agreements with SPEs to pay it amounts that would preserve the value of its merchant investments. In substance, however, the assets that the SPE’s had available to meet these obligations came from Enron, so that Enron received

513. See supra Part III.B-C.
514. See supra Part IV.
515. See supra Part V.
no genuine economic benefit from these arrangements. In considering disclosure of Andrew Fastow's compensation from LJM transactions, Enron's lawyers were able to construct a rationale for avoiding disclosure through technical compliance with regulations. The Examiner found, however, that the lawyers deliberately avoided obtaining information that might have made the technical basis for nondisclosure unavailable. More generally, the Examiner said that they had notice that Fastow's compensation was substantial, and that disclosure of it therefore was material both to investors and to Enron itself. 516

The relationship between form and substance also was salient in transactions in which the Examiner found no potential attorney liability. In the Talon Raptor putative hedge, Talon obtained $41 million by providing Enron a put on Enron stock, and then distributed this to LJM2 before it began its hedging activity. An Enron executive admitted in his plea agreement, however, that the put served no economic purpose under the circumstances. It was designed simply to provide LJM2 with a guaranteed return on its contribution to Talon—which effectively meant that there no longer was the three percent outside equity necessary for Enron to avoid consolidating Talon into its financial statements. One V&E lawyer recognized at the time that such divergence between form and substance might raise this problem, but received reassurance that it was not a concern.517

Similarly, a V&E lawyer in the Cuiaba transaction heard a comment by an Enron employee that seemed to indicate that the transfer of assets to LJMB might not be a genuine sale because Enron had promised to repurchase the assets if another buyer could not be found. He sought and received confirmation that no such agreement existed. Later, however, the employee in question testified that such an agreement was in place.518

Finally, in the Chewco transaction Enron substituted William Kopper for Andrew Fastow as manager and owner of Chewco, based on the contention that Kopper was not an "executive officer" whose involvement had to be disclosed in Enron's public filings. Kopper, however, reported directly to Fastow, and it was clear that in substance Fastow would be taking an active role in Chewco's affairs. In addition, funding for Chewco's ostensible three percent equity came from a contribution from Barclays. This contribution was structured formally as equity rather than debt. A side letter establishing a reserve account to cover some of this contribution, however, served to guarantee repayment of some of this amount—which in substance nullified its formal status as equity.519

In all these instances, a divergence between form and substance either was the basis for finding possible attorney liability, or at least raised

516. See supra Part VI.E.
517. See supra notes 457-64 and accompanying text.
518. See supra notes 484-88 and accompanying text.
519. See supra Part VII.
potentially troublesome questions. A second pattern in the events that the Examiner described is that there were various ways in which the lawyers were able either to miss, avoid confronting, or rationalize away disconcerting facts. The first element of this pattern may be the most important. This is that the law’s wide tolerance of some divergence between legal form and economic substance helps create a background assumption that such divergence is normal and not problematic. Transactional lawyers likely take this as a working premise, which means that it may require something strikingly out of the ordinary for them to conclude that things are amiss.

Lawyers’ abilities to recognize that this moment has occurred can be hindered by several influences. One is specialization. Large transactions may involve teams of lawyers who focus on specific, relatively narrow aspects of the deal. These lawyers may obtain only fragmentary knowledge of the larger picture, and thus not be in a position to learn troublesome facts. Furthermore, even if they become aware of the details of the overall transaction, they may well be inclined to insist that their responsibility is limited to the discrete task that they are being called upon to perform.

Thus, for instance, the Examiner found that, while V&E tax attorney Edward Osterberg did not help structure the RhythmsNet “hedge,” he had enough information to know that it provided no genuine economic benefit to Enron. Osterberg, however, might contend that his responsibility was confined to providing advice on the tax aspects of the transaction, and it was up to others to assess the overall economic consequences of the deal.

In addition, even if facts come to the attention of a specialist, he may not fully appreciate their significance because he is focused only on those that are relevant to performing his task. Specialization, in other words, can create a cognitive filter that influences what a lawyer perceives. As a tax lawyer, for example, Osterberg had some familiarity with the concepts of “business purpose” and “economic substance.” This may have led the Examiner to find that he was potentially liable to Enron. His inclination to scrutinize a transaction closely in terms of these concepts, however, might be activated only in transactions that resulted in substantial tax benefits for the client.

Furthermore, suppose that Osterberg had been instead an intellectual property specialist working on certain licensing issues in connection with the transaction. As someone whose work typically required less attention to business purpose than did a tax lawyer’s, would he be in as good a position to assess the significance of the facts in the Rhythms hedge as the Examiner believes Osterberg was?

A factor with effects similar to specialization is the desire to routinize certain legal work. Once the first in a planned series of similar transactions closes, successive transactions generally require less intensive and creative attention. Much of the work can become more predictable and routine,

520. See supra notes 362-64 and accompanying text.
which means that it can be handed over to junior lawyers who need exercise only minimal discretion. This practice can be efficient for both clients attempting to hold down legal costs and law firms who must respond to this desire in a competitive legal services market. The result may be that many lawyers work on transactions with only a general appreciation of their broad outlines and business purposes.

One example may be the side letter establishing a reserve fund for Barclays in the Chewco transaction. This reserve fund ultimately forced the company to consolidate JEDI retroactively into its financial statements back to 1997, and to restate its financial statements for the period 1997 through 2001. The result for this period was a reduction in net income of $508 million, a decrease in shareholders' equity by $2.1 billion, and an increase in debt of almost $2.6 billion. The impact of the side letter therefore was disastrous. With respect to potential attorney liability, however, the Examiner found that the letter was drafted by attorneys who may not have been aware of its significance for the larger transaction. It is conceivable that drafting the letter by itself was a relatively straightforward exercise, which V&E decided could be handled by a junior lawyer who made only this small contribution to the transaction.

Another way that lawyers can avoid confronting unpleasant issues is to defer to the judgments of other professionals who tend to work with them on complex business transactions. One group of professionals particularly salient in the Enron events is accountants. Accounting and legal issues can be intricately intertwined and difficult to untangle. This ambiguity creates an opportunity for a lawyer to convince herself that an issue about which she has some concern ultimately requires an accounting rather than a legal judgment. Recall, for instance, the instruction of one V&E lawyer to another with respect to whether the Talon distribution to LJM2 put Talon in noncompliance with the three percent outside equity requirement: "[G]o check, make sure everybody's comfortable with the accounting and then, you know, it doesn't sound like a legal issue." A lawyer may tell herself that as long as she provides accurate information about the law, it is up to the accountants to determine what accounting treatment is appropriate and how it can be defended—even if the lawyer may disagree with it. Thus, for example, when asked for a true issuance rather than true sale opinion in connection with the FAS 140 transactions, V&E lawyers eventually concluded that as long as the accountants understood the parameters of the opinion, it was up to them to determine whether a true issuance opinion was sufficient to justify FAS 140 accounting treatment. Similarly, A&K lawyers asked whether prepayments that occurred soon after putative FAS 140 sales might jeopardize the

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transactions, but, as the Examiner noted, appeared to regard this as an accounting, rather than a legal, issue. 523

Another similar inclination is to characterize an issue as calling for a business, rather than legal, judgment. The comments to the ethical rules say explicitly that when business managers make decisions for the organization, "the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful. Decisions concerning policy and operations, including ones entailing serious risk, are not as such in the lawyer's province." 524 To repeat an earlier point, a lawyer might claim that as long as he provides accurate information about the law, it is up to the business executive to weigh legal against other considerations. Thus, for instance, an Enron inside lawyer concluded that the Raptors provided accounting but not economic benefits to the company, and advised Enron that it was "trading economics for accounting and that was a bad trade." 525 By "bad," however, he apparently meant "unwise" rather than "illegal," and thus ultimately deferred to executives' judgment on the matter.

The tendency to characterize an issue as calling only for business judgment can operate even when a lawyer cautions that conduct may violate the law. The most that a lawyer often may be able to say is that there is a certain probability that activity might be found illegal, rather than that it is absolutely certain. Contemplated behavior thus may carry some risk of running afoul of the law, but not be definitively illegal. In these circumstances, a lawyer may rationalize that whether the risks of illegality are outweighed by other benefits calls for business, not legal, judgment. This is an approach to legal compliance that is controversial, but it does have support in some quarters. 526 A lawyer's adoption of it can be a way of trying to deflect responsibility for a client's actions even when there is a good chance that they are illegal.

Finally, a variant on deference to business judgment is to claim that the lawyer does not fully understand, and is not responsible for understanding, the business purposes that animate and the economic consequences that flow from a given transaction. The lawyer is entitled to assume that the

523. Id. app. C, at 60 n.204.
526. The federal indictment of individuals in connection with certain KPMG tax shelter opinions, for instance, alleged that a KPMG executive urged the firm not to register the shelters as required by the Internal Revenue Service because "the IRS penalties applicable to a failure to register would be dwarfed by the lucrative fees KPMG stood to collect from selling unregistered tax shelters." Sealed Indictment at 25, United States v. Stein, 05 Cr. 888 (S.D.N.Y. Aug. 24, 2005), available at http://www.quatloos.com/KPMG_individuals_IND.pdf. The indictment further alleges, "Moreover, KPMG's office of general counsel, among others, advised that by deciding not to register tax shelters, KPMG risked criminal prosecution, but . . . advised that KPMG's tax leadership could nevertheless make a business decision to not register the activity as a tax shelter." Id. at 26 (internal quotation omitted). For a description and critique of this approach, see Cynthia A. Williams, Corporate Compliance with the Law in the Era of Efficiency, 76 N.C. L. Rev. 1265 (1998).
client has a good business reason for wanting to enter into the transaction, and need not become an expert in the intricacies of the company’s business operations. Indeed, the claim may be, it is impossible in an era of rapid technological change for lawyers to be fully informed about all their clients’ business activities.

Increasing legal specialization may lend some support to this claim. The most effective corporate lawyers, however, understand their clients’ business goals and market themselves to companies as partners in devising strategies to accomplish them. This requires appreciation not only of how the company makes money, but of how various activities will be treated for accounting purposes. It is unlikely, for instance, that outside counsel who represented Enron presented themselves to the company as proficient legal technicians who confined their advice to discrete points of law. That is not the way to win a large amount of business from a major corporation.

Furthermore, to bring us full circle, a transactional lawyer must always consider the possibility, however remote, that the law will not honor legal form because it diverges too far from economic substance. In order to assess this possibility, the lawyer must know what the client hopes to achieve from a transaction and whether the economic consequences that will result are consistent with that desire. The background constraint of equity thus makes ignorance a dangerous claim.

Teaching Enron therefore can yield valuable insights if we have the patience to examine the complex transactions in which the company engaged and the lawyers who worked on them. This Article has tried to make this process easier by summarizing some of these transactions, and by recounting the Examiner’s analysis of the lawyers’ activities.

I am well aware that the discussion raises at least as many questions as it answers. Still, asking the right questions is an important feature of effective teaching. By prompting reflection and even some discomfort, it can move us closer to a more nuanced appreciation of the world that transactional lawyers inhabit and the kinds of judgments, both practical and ethical, that they must make. To reiterate an earlier point, to understand is not necessarily to forgive. In order to condemn or to forgive, however, we first must understand.