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The Enron Debacle and Gatekeeper Liability: Why Would the Gatekeepers Remain Silent?

The sudden and unexpected bankruptcy of Enron has generated understandable concerns about our system of corporate governance - - and, in particular, about the integrity of financial reporting systems. Although publicly held companies in the United States are subject to uniquely high disclosure obligations, the Enron example shows that the much vaunted transparency of the American securities markets can sometimes prove illusory and that sometimes very material information can be concealed behind opaque accounting.

When this happens, the inevitable question arises: Why didn't the gatekeepers stop them? By "gatekeepers," I mean the independent professionals who verify and analyze the disclosures of publicly held companies. These include the corporation's outside auditors, the securities analysts that follow its stock, and the bond rating agencies that review its bonds. Because these professionals have considerable reputational capital, which can be damaged by involvement in a corporate fiasco, because they face the prospect of legal liability for securities fraud, and because they have much less incentive to lie or acquiesce in fraud than do the corporate insiders, gatekeepers are the primary safeguards on whom investors rely to assure that accurate and meaningful disclosures reach the market. Yet, in the Enron case, all these protective mechanisms failed: the accountants certified financial statements that overstated Enron's financial results by over $500 million; the security analysts continued to recommend Enron's stock (in some cases with a "strong buy" recommendation) right up to virtually the moment of Enron's bankruptcy filing, and the credit rating agencies did not detect that Enron's off-balance sheet financing hid very high leverage.

Who is to blame? It would be premature at this point to even attempt to attribute responsibility. Possibly, Enron's auditors were deceived, and possibly they may have been lax and acquiescent. One simply cannot conclude from the outside on the evidence now available. What can be said, however, is that the Enron case does not stand alone. In particular, cases involving accounting irregularities have proliferated over just the last several years. Some of these cases have made it to the front of the business page and the nightly T.V. news: Cendant, Sunbeam, HBOCMcKesson, Livent, Mercury Finance, Waste Management, and Rite Aid.[1] Some of these cases have resulted in criminal prosecutions and convictions, others in SEC enforcements proceedings, and all in large settlements of private class actions. The increase in accounting irregularities is not simply an anecdotal impression. A study by Arthur Andersen has found that the number of restatements of earnings by publicly held companies has risen steadily and dramatically over the past four years from 158 in 1998 to 233 in 2000 - - or, a 47% increase over this brief period.[2]

That corporate insiders will sometimes commit fraud and suppress adverse information is not terribly surprising. After all, they benefit from it. That securities fraud escapes the attention of the professional gatekeepers may be more surprising - - and alarming. Yet, former SEC Chairman Arthur Levitt concluded in a famous 1998 speech that there had been "an erosion in the quality of earnings and therefore the quality of financial reporting."[3] Specifically, Chairman Levitt focused on a variety of what he termed "accounting gimmicks" that enabled companies to exploit the flexibility of accounting rules to obscure actual financial results and risks. Since the time of that 1998 speech, a small library of

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1 A fuller list of recent "accounting irregularity" cases can be found in Michael Young, ACCOUNTING IRREGULARITIES AND FINANCIAL FRAUD: A Corporate Governance Guide (2000).

2 See Jonathan Glater, "Flood of Lawsuits Puts Underwriters in Cross Hairs," New York Times, December 2, 2001 at Section 3, p.4.

3 See Arthur Levitt, "The Number Game," Sept. 27, 1999 ('Speech Given at NYU Center for Law and Business).

academic and empirical studies of the phenomenon of "earnings management" have been published, most of which confirm that earnings management is pervasive.[4] During his tenure, Chairman Levitt made accounting reform a major priority, and, the SEC formulated a series of new accounting rules and interpretations during the late 1990's, to restrict earnings management; it also established a "blue ribbon panel" to improve audit committee performance and persuaded both the NYSE and Nasdaq to adopt its recommendations. Finally, in a bruising battle with the accounting profession, the SEC revised its critical rule on "auditor independence." All of these measures were to varying degrees controversial, and the last - - the SEC's proposed auditor independence rule - - proved to be politically unobtainable, as the Commission was forced to accept a considerably weaker compromise that left auditors free to engage in most forms of consulting work for audit clients.[5]

Nonetheless, the Enron episode and the general increase in accounting restatements suggests that the SEC may not be winning its war against accounting irregularities. What could explain this apparent decline in the quality of financial reporting? A good case can be made that both (1) the legal threat confronting the auditor has been sharply reduced over recent years by a series of recent judicial and legislative developments, and (2) the incentives for the auditor in acquiesce in questionable accounting practices have grown, as the nature of the industry has changed. I do not suggest that this hypothesis has been proven beyond a reasonable doubt or that it fully explains the Enron debacle, but I do suggest that Congress should be aware of these developments and not view Enron as an exceptional case. Enron is different only in that it is larger. Otherwise, it is in Yogi Berra's immortal words "deja

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4 Many of these studies are available on the SSRN Electronic Network. See, e.g., Mark Nelson, John Elliott and Robin Tarpley, "Where Do Companies Attempt Earnings Management, and When Do Auditors Prevent It?" (SSRN no. id= 248129, October 22, 2000).

5 The final Commission rule is set forth in Securities Act Release 33-7919 (November 21, 2000). An earlier and tougher rule was proposed in Securities Act Release No. 33-7870 (June 30, 2000).

vue all over again." Both the diminished threat facing auditors and their increased incentive to acquiesce are briefly reviewed below.

A. The Diminished Legal Threat

Auditors have long been subject to suit under Rule 10b-5 when they certify that the financial results reported by an audit client comply with generally accepted accounting principles ("GAAP"). Indeed, auditors are named as defendants, in the majority of securities class action lawsuits filed in recent years.[6] To prevail in such a suit, however, the plaintiffs must demonstrate not only that a materially false statement was made by the auditor, but that the auditor acted with the requisite "scienter" - - that is, a mental state embracing both an intent to defraud or a reckless indifference to the truth or accuracy of the statement made. The term "scienter" is defined somewhat differently in different federal circuits, but the prevailing definition defines scienter as:

> "A highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers that is either known to the defendant or so obvious that the actor must have been aware of it." Sunstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1987).

The scienter requirements has long been a primary defense for accountants in securities fraud litigation, who can escape liability if they can convince the fact finder that they were merely negligent (even if grossly so). But the protection of this defense has been recently and greatly enhance by the following more recent developments:

1. The Enhanced Pleading Requirements of the Private Securities Litigation Reform Act of 1995 (the "PSLRA"). Under Section 21D(b)(2) of the Securities Exchange Act of 1934, which added by the PSLRA, a complaint in a securities fraud case must:

> "state with particularity facts giving rise to a strong inference that the

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6 See Glater, supra note 2.

defendant acted with the required state of mind."

In a Rule 10b-5 suit, this requires the plaintiff to plead with particularly facts giving rise to a "strong inference of fraud" on the part of the specific defendant. This pleading must be made at the outset of the litigation before the plaintiff has obtained any discovery. In practice, this provision is far more protective of auditors than of other defendants. For example, in the Enron case, plaintiffs can plead that the corporate officers at Enron withheld material information in order to permit them to sell their large stock holdings before the Enron market price collapsed. Evidence of such insider sales may (if they are large enough in percentage terms) satisfy the plaintiff's obligation to plead with particularity facts giving rise to the requisite "strong inference of fraud" on the part of Enron's insiders. But the same pleading cannot be made with respect to the auditors, who by definition do not own stock in an audit client. Although auditors may have been subject to conflicts of interest or may have been pressured into accepting improper accounting presentations, these facts will rarely be evident at the outset of the case. Hence, the auditor benefits far more from this pleading requirements than do other defendants, because the case against it must be dismissed if such facts cannot be plead prior to discovery.

2. Proportionate Liability. Section 21D(f) of the Securities Exchange Act of 1934, which was also added by the PSLRA, substituted proportionate liability for joint and several liability as the normal standard of damages in securities litigation. This change works particularly to the advantage of auditors, who, even if culpable, are usually much less so than members of management. As a practical matter, an accounting firm now knows that, so long as its actual knowledge of the fraud is not proven, its maximum exposure to damages has shrunk from joint and several liability for 100% of the losses to a likely much

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[7] There are two major exceptions to this generalization: (1) the auditor is subject to "joint and several" liability if it made a knowingly false statement, and (2) to the extent that a judgment against another co-defendant is uncollectible, the auditor may be required to pick-up a portion of that unsatisfied liability (up to 50% of its original liability). This last point has special relevance in the instant case, because Enron is insolvent and cannot be held liable.

lower percentage, probably below 25%.[7]

3. Eliminating RICO Liability for Securities Fraud. The PSLRA also ended the use of the private civil RICO statute as a means of seeking treble damages in securities fraud cases. Where once a RICO claim was a standard feature in securities class actions, because it increased the potential damages by a factor of three, the PSLRA denied plaintiffs the ability to assert a RICO claim in any case that could have been pled as a securities fraud claim in connection with the purchase or sale of a security.

4. Aiding and Abetting Liability. Even prior to the PSLRA, the Supreme Court's decision in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,511 U.S. 164 (1994), eliminated liability for aiding and abetting a securities law violation as a potential cause of action that an auditor could face in private litigation. This theory of liability had been the preferred weapon of the plaintiffs' bar in Rule 10b-5 litigation against accountants, because typically auditors aid the issuer in the preparation of its financial statements (particularly its quarterly statements). Although the SEC has regained the right to sue for some "aiding and abetting" violations pursuant to the PSLRA, private parties have not.

5. Preempting State Litigation. Although securities fraud litigation in state court became a substantial risk for accountants in the late 1990's, that risk was effectively ended in 1998 by the passage of the Uniform Standards Act, which preempted class actions and certain consolidated actions that assert causes of action, based on either state law or the common law, that allege a misrepresentation or

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[8] Section 28(f) of the Securities Exchange Act of 1934 precludes any "covered class action based upon the statutory or common law of any State or subdivision" that alleges

omission of a material fact in connection with a purchase or sale of a security.[8]

The bottom line is that, although litigation involving accounting irregularities remains common, accounting firms themselves are unlikely to be held liable for more than a nominal percentage of the losses - - except in cases where their behavior has been egregious.

B. Organizational Changes Within the Auditing Profession. Auditing firms have long marketed three general types of services to their clients: (i) auditing, (ii) tax services, and (iii) management advisory services. The last category - - management advisory services (or "MAS") - - has expanded dramatically over roughly the last decade in a manner that has transformed the accounting firm from the traditional firm of accounting professionals to a multi-disciplinary service organization. In 1981, MAS accounted for only thirteen percent of the Big Five's total revenues, but that figure has grown to fifty percent or more by 2000.[9] Over the period from 1993 to 1999, the average annual growth rate for revenues from management advisory and similar services has been twenty-six percent, while the comparable growth rates for audit and tax services has been only nine percent and thirteen percent, respectively.[10] In short, MAS has been growing at roughly three times the rate of the traditional audit service. Finally, in 1999, the U.S. revenues for management advisory and similar services for the Big Five amounted to over $15 billion.[11]

A more ominous transition involves the relative balance between audit fees and MAS fees. Not

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"a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." A similar provision is set forth in Section 16(b) of the Securities Act of 1933. Neither provision preempts an individual suit, standing alone, but the term "covered class action" includes any "single lawsuit in which ... damages are sought on behalf of more than 50 persons." Hence, sizable consolidated actions are also barred.

9 See Securities Act Release No. 33-7919 at p. 18; see also Securities Act Release No. 33-7870 (June 30, 2000) at Appendix 13, Tables 1 and 2.

10 Id. at p. 18; see also Securities Act Release No. 33-7870 at Table 1 in Appendix B.

11 Id.

until 1997 did the percentage of audit clients who paid MAS fees in excess of their audit fees to Big Five firms exceed 1.5%.[12] Yet, by 1999, this figure had grown from 1.5% to 4.6% - - an over 200% increase in only two years.[13] Moreover, average MAS fees received by the Big Five firms came to ten percent of all revenues in 1999.[14] Today, for at least some audit clients, the amount of non-audit revenues paid to their auditor already exceeds their audit fee. At least in the case of these clients, intransigence by the audit partner with regard to some "aggressive" accounting treatment proposed by the client could expose the firm to the loss of much greater non-audit revenues, which the client could presumably purchase (or threaten to purchase) elsewhere.

The danger lies in where these trends are taking us. Not only are non-audit revenues received by auditors from their audit clients beginning to exceed audit fees from the same clients, but the SEC's noted in its latest Release on auditor independence that some audit firms may be pursuing a marketing strategy under which the firm "low-balls" the audit fee (even offering to perform it at a loss) "in order to gain entry into and build a relationship with a potential client for the firm's non-audit services."[15] Once auditing becomes a de facto "loss leader" for the multi-services consulting firm, there is less reason for such a firm to resist questionable accounting practices. To be sure, some threat of liability to third parties remains, but in considering resignation, the auditing firm must now balance the threat of liability against not only the loss of its audit fees, but also the loss of far larger present and expected future non-audit revenues from the client. Other things being equal, this implies that the threat of liability (even if it were undiminished) would less often be adequate to deter.

The Enron fact pattern again illustrates this shift in the source of client revenues. According to

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12 See Securities Act Release No. 33-7870 at Table 3 in Appendix B; see also Securities Act Release No. 33-7919 at p. 19.

13 Id.

14 Id.

15 Securities Act Release No. 33-7919 at 27.

press reports, Enron paid more to Arthur Andersen in consulting fees during its last fiscal year than it paid in audit fees. In addition, it paid over $50 million in total fees to Arthur Andersen last year.[16] Put simply, this is a very different relationship that the traditional relationship between auditor and client because historically no single client would have been financially material to the auditor. Hence, the rational auditor would not risk its reputation for an audit fee that was small in percentage terms to its overall earnings. But, as the individual client becomes material to the auditor, the auditor unfortunately becomes less independent of its client.

C. Implications

In sum, a credible story can be told that auditors today are subject to less of a legal threat than a decade ago and are, correspondingly, subject to a greater temptation to defer to management with regard to questionable accounting policies. Whether this story truly explains the Enron debacle is, of course, uncertain, and no suggestion is here made that we yet know whether Enron's auditors did acquiesce improperly (as opposed to being themselves deceived by Enron).

But even if this story does fit the instant case, the policy prescriptions that should follow from it are at least equally debatable. The PSLRA was an intensely lobbied statute, and there seems little likelihood that Congress would wish to repeal or seriously modify its provisions. Even if the SEC's current auditor independence rules seems inadequate, it also seems unlikely that the SEC will wish to revisit it only a year after reaching a hard fought compromise with the industry. Finally, reliance on class action litigation to discipline auditors may not be the optimal remedy. Prior to the PSLRA, the very solvency of some auditors was coming into doubt.

What other avenues of reform are then available? Here, a noteworthy contrast can be drawn between the accounting industry and the broker-dealer industry. Broker dealers are subject to close

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[16] Last year, Enron paid Arthur Andersen $25 million in audit fees and $27 million for non-audit services. See Jerry Hirsch and Thomas Mulligan, "Auditors, Execs Target of Enron Creditors," Los Angeles Times, November 30, 2001 at Part 3-1.

supervision and professional discipline by a self-regulatory body - - the National Association of Securities Dealers ("NASD"). Nothing remotely comparable exists in the convoluted structure of accounting regulation, and professional discipline is rarely imposed.

In this light, the most conservative reform might be the creation of a truly independent, self-regulatory body, modeled after the NASD and with independent directors that did not come from the industry, to monitor and enforce self-regulatory rules for the accounting profession.[17] Although the industry may not welcome such a development, it represents far less of an intrusion into their affairs than would any attempt to expose them to greater antifraud liability.

Ultimately, the increasing frequency of accounting irregularities faces the accounting industry with an unpleasant choice: implement a serious and reliable system of self-regulation and professional discipline or expect that the courts and/or Congress over time will return to a system of punitive tort liability.

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[17] I have made a detailed proposal along these lines in an article available on the Social Science Research Network ("SSRN") website. See Coffee, "The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence, and the Governance of Accounting" (May 21, 2001) (SSRN identification number = 270944).