A decade post-Enron

The past 10 years of financial crises have resulted in a patchwork of reactive legislation, signaling what’s to come

Ten years ago, Enron Corp. collapsed in what was then the largest bankruptcy in U.S. history. Given the current financial turmoil, it is easy to forget how the collapse, and the bankruptcy dominoes that fell thereafter, shook market confidence. Congress swiftly passed the Sarbanes-Oxley Act in response. Enron was then followed by a housing and financial crisis whose economic ramifications dwarfed the previous crisis. Again, the government responded by amplifying regulatory and enforcement efforts through another statute, Dodd-Frank.

While much has been written about the details and ramifications of Sarbanes-Oxley, Dodd-Frank and the other regulatory and fraud enforcement measures of the past decade, this anniversary provides an opportunity to pause and look back at the unprecedented changes in corporate governance, bookended by responses to two very different economic crises. The government’s separate but related responses paved a rugged terrain of corporate-fraud regulation and enforcement. To understand how to move forward, and learn lessons for the decade ahead, it is important to reflect on how we got here.

FALL OF ENRON

The fall of Enron has been the subject of numerous books, an Oscar-nominated documentary and even a recent Broadway play. While Enron has come to be synonymous with corporate failure, in early 2001, Enron was the poster child of success. The company was ranked the seventh largest in the U.S. and Fortune proclaimed it “America’s Most Innovative Company” for a stunning six straight years.

But as we now know, Enron was in turmoil. As the criminal trial would show, the company relied upon a number of practices, such as off-balance sheet transactions, overvalued assets and misuse of reserve accounts, to paint a false picture of financial health.

As 2001 progressed, questions about the financial health of Enron mounted. Five days before Enron CEO Kenneth Lay assured the public that there was “no other shoe to fall,” Sherron Watkins, an Enron vice president, alerted Lay of improprieties in Enron’s financial statements, and warned him that the company may “implode in a wave of accounting scandals.” A few months later, Enron filed bankruptcy in the wake of one of the largest accounting scandals in history.

Congress promptly responded with an expansive corporate regulatory scheme. The Sarbanes-Oxley Act of 2002 was trumpeted by the president as the most far-reaching regulation of business practices since the Great Depression. It imposed enhanced internal controls, auditor independence and financial-reporting requirements designed to provide transparency and prevent the perceived sleights-of-hand that had kept Enron’s financial troubles from the public eye. The act further required senior executives to certify the accuracy of financial reports, in an attempt to deprive executives of claims of ignorance, when the financial picture of the company proved misleading or false. It created a new oversight agency: the Public Company Accounting Oversight Board. Additionally, Sarbanes-Oxley provided a whistleblower framework, setting forth procedures for companies to receive and investigate allegations, with protections for whistleblowers.

THE CURRENT CRISIS

Within a few years after the Enron collapse, the economy seemed to be back on track, with the housing market thriving. When the housing bubble ultimately burst, we experienced the largest economic downturn since the Great Depression. Many perceived failure of self-policing and lack of regulation in key financial markets to be causes of the crisis.

Again, the government responded with sweeping legislation. In June 2009, the president declared a proposal, reminiscent of the Sarbanes-Oxley announcement,
calling for a “sweeping overhaul of the U.S. financial regulatory system, a transformation on a scale not seen since the reforms that followed the Great Depression.” The result was the Dodd-Frank Wall Street Reform and Consumer Protection Act. Like Sarbanes-Oxley, Dodd-Frank was designed to respond to the then-current crisis and its perceived causes. It instituted myriad regulations directed toward regulating derivatives and swaps, lending standards and executive compensation, among other things. Similar to Sarbanes-Oxley, it created a new agency: the Consumer Financial Protection Bureau. It also redefined the rules and regulations that protect and incentivize employees to report fraud.

MORE PATCHWORK QUILT THAN TAPESTRY

While both acts relate to corporate fraud, each was enacted in response to the perceived causes of a particular crisis. This was not a single deliberative decision to set forth a harmonized regulatory scheme addressing various issues in the corporate and financial world over a number of years. Instead, the result of the overlapping legislation proved to be a patchwork quilt of related, but often incongruous corporate regulations.

The acts’ whistleblower provisions provide a window into the separate responses to very different crises and the resulting incongruity. While Watkins was not a whistleblower in the strict sense — she did not report outside the company — the unheeded red flags raised by her and others prompted Congress to include in Sarbanes-Oxley a road map for companies to provide a venue for whistleblower warnings and the course of action to take to address such complaints. Corporations responded by implementing detailed policies and procedures to facilitate internal reporting, protect whistleblowers and investigate alleged wrongdoing.

Years later, when the current financial crisis blossomed, regulatory and enforcement agencies were criticized for failing to react to warning signs and complaints. Congress responded with additional and different whistleblower provisions. According to the rules promulgated under Dodd-Frank, employees are provided a financial incentive to report wrongdoing to the SEC, and while the award may be reduced for an employee’s failure to first report a matter internally, there is no requirement to do so.

Evidencing the patchwork quilt of corporate regulation from the past decade, we are left with a situation in which a company that fully complies with the Sarbanes-Oxley internal reporting procedures nonetheless faces the prospect of learning of alleged wrongdoing for the first time with a knock on the door by the SEC or other agency, fueled by a whistleblower complaint that was never brought to the company’s attention through its internal reporting structure. In the months ahead, many compliance counsel and white-collar practitioners will be watching to see how such a scenario may impact enforcement agencies’ views as to whether a company is acting as a good corporate citizen.

This is but one example of several that have been the subject of detailed commentary, revealing the often rugged terrain created by separate remedies to crises with different perceived causes.

LESSONS FOR THE DECADE AHEAD

With a perspective on the past decade-long cycle of crisis and response, what lessons prepare for the road ahead? As the axiom goes, history never repeats itself precisely, and specific lessons from broad trends are elusive. But if anniversaries are a time to reflect and look forward, there are several broad lessons to be drawn from the past 10 years.

First, despite the inconsistencies, Sarbanes-Oxley, Dodd-Frank and the enforcement actions taken under them send one clear message: enforcement and regulatory agencies are engaged in the corporate and financial arena in ways that could not have been contemplated a decade earlier. This trend of governmental action is unlikely to abate in the near term. For example, the SEC recently announced that it filed 735 enforcement actions in the last fiscal year — the most in SEC history.

In addition to the sheer numbers of enforcement actions, there has been a change in the collaborative approach to fraud enforcement that should continue, if not increase. Government agencies are increasingly joining forces to pursue investigations and bring parallel actions due to the breadth of the current crisis and budgetary pressures. The current crisis is broader than those that have come before: It includes not just the financial and corporate arena but also the mortgage and housing market, and includes potential fraud schemes that would merely work together to attack current fraud matters through collaborative federal-state efforts.

The increased collaboration among the alphabet soup of enforcement and regulatory agencies is also due to a collateral effect of the current financial crisis: declining agency budgets. In the current downward budget cycle, agencies are working in concert more than ever before. This trend is exacerbated by a change in the mission of the FBI in the post 9/11 world, shifting resources to counterterrorism and creating a need for other agencies to play an increased role. The overarching lesson from this increased collaboration is clear: Gone are the days that inside or in-house counsel can assume that the state or federal agency with whom they are dealing is acting alone; it is increasingly likely there are additional state or federal agencies involved, resulting in overlapping criminal, civil or regulatory exposure.

The final lesson to be drawn on the anniversary of the Enron collapse is that it will not be the last. And the pattern of reactive legislation will add to an already complex regulatory and enforcement environment.

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