Enron

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Class 6: Governance/Andersen

A. Governance

1. Selections from the Powers Report
2. Jeffrey N. Gordon, What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections

B. Andersen

1. Arthur Andersen, Practice Administration: Notification of Threatened or Actual Litigation, Governmental or Professional Investigations, Receipt of a Subpoena, or Other Requests for Documents or Testimony (Formal or Informal), Statement No. 780, October 1999
2. Arthur Andersen, Practice Administration: Client Engagement Information—Organization, Retention and Destruction, Statement No. 760, February, 2000
3. Arthur Andersen, Letter of response to Justice Department, March 13, 2002
4. Indictment, United States v. Arthur Andersen, LLP, March 7, 2002, released March 14, 2002
5. Arthur Andersen, Updated analysis on the Justice Indictment of Andersen, March 15, 2002
6. Docket in US v. Duncan
7. Cooperation Agreement in US v. Duncan
8. Information in US v. Duncan

REPORT OF INVESTIGATION

BY THE

SPECIAL INVESTIGATIVE COMMITTEE
OF THE
BOARD OF DIRECTORS OF ENRON CORP.

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VII. OVERSIGHT BY THE BOARD OF DIRECTORS AND MANAGEMENT[64/]

Oversight of the related-party transactions by Enron's Board of Directors and Management failed for many reasons. As a threshold matter, in our opinion the very concept of related-party transactions of this magnitude with the CFO was flawed. The Board put many controls in place, but the controls were not adequate, and they were not adequately implemented. Some senior members of Management did not exercise sufficient oversight, and did not respond adequately when issues arose that required a vigorous response. The Board assigned the Audit and Compliance Committee an expanded duty to review the transactions, but the Committee carried out the reviews only in a cursory way. The Board of Directors was denied important information that might have led it to take action, but the Board also did not fully appreciate the significance of some of the specific information that came before it. Enron's outside auditors supposedly examined Enron's internal controls, but did not identify or bring to the Audit Committee's attention the inadequacies in their implementation.

A. Oversight by the Board of Directors

Enron's Board of Directors played a role in approving and overseeing the related-party transactions. This section examines the involvement of the Board and its Committees, where they were involved, in (1) the Chewco transaction, (2) permitting

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64/ The portions of this Section describing and evaluating actions of the Board and its Committees are solely the views of Powers and Troubh.

Fastow to proceed with LJM1 and LJM2 despite his conflict of interest, (3) creating the Raptor vehicles, and (4) overseeing the ongoing relationship between Enron and LJM.[65/]

1. The Chewco Transaction

We found no evidence that the Board of Directors (other than Skilling) was aware that an Enron employee, Kopper, was an investor in or manager of Chewco.[66/] Because substantial Enron loan guarantees were required to permit Chewco to acquire CalPERS' interest in JEDI, the Chewco transaction was brought before the Executive Committee of the Board (by conference call) on November 5, 1997. Fastow made the presentation. According to the minutes of the meeting, Fastow reviewed "the corporate structure of the acquiring company." The minutes and the interviews we conducted do not reveal any disclosure to the Executive Committee of Kopper's role, and they do not indicate that the Executive Committee (or Lay) was asked for or made the finding necessary under Enron's Code of Conduct to permit Kopper to have a financial interest in Chewco. Both Fastow and Kopper participated in the telephonic meeting. Each had an obligation to bring Kopper's role to the Committee's attention. Fastow and Kopper have declined to be interviewed on this subject.

65/ We have not seen any evidence that any member of the Board of Directors had a financial interest in any of the partnerships that are discussed here.

66/ Skilling said he was aware that Kopper had a managerial role in Chewco, but not that Kopper had a financial interest. He said he believes he disclosed this to the Board at some point, but we found no other evidence that he did. We also saw no evidence that the Board, other than possibly Skilling, was aware of Enron's repurchasing Chewco's interest in JEDI or of the associated tax indemnity payment.

2. Creation of LJM1 and LJM2

The Board understood that LJM1 and LJM2, both recommended by Management, presented substantially different issues. The Board discussed the advantages and disadvantages of permitting Fastow to manage each of these partnerships. The Board also recognized the need to ensure that Fastow did not profit unfairly at Enron's expense, and adopted substantial controls. Nevertheless, these controls did not accomplish their intended purpose.

LJM1. LJM1 came before the Board on June 28, 1999. The Board believed it was addressing a specific, already-negotiated transaction, rather than a series of future transactions. This was the Rhythms "hedge." It was presented as a transaction that would benefit Enron by reducing income statement volatility resulting from a large investment that could not be sold. The Board understood that (1) the terms were already fixed, (2) Enron would receive an opinion by PricewaterhouseCoopers as to the fairness of the consideration received by Enron, and (3) Fastow would not benefit from changes in the value of Enron stock that Enron contributed to the transaction. The Board saw little need to address controls over already-completed negotiations. Indeed, the Board's resolution specified that Lay and Skilling—neither of whom had a conflict of interest—would represent Enron "in the event of a change in the terms of [the Rhythms] transaction from those presented to the Board for its consideration."[67/]

67/ In fact, there were subsequent changes in the Rhythms transaction, including the additional put and call options in July 1999 and the change in the LJM1 payment from $50 million to $64 million. We found no evidence that either Lay or Skilling was

When it approved LJM1, the Board does not appear to have considered the need to set up a procedure to obtain detailed information about Fastow's compensation from or financial interest in the transactions. This information should have been necessary to ensure that Fastow would not benefit from changes in the value of Enron stock, as Fastow had promised. Even though the Board was informed that "LJM may negotiate with the Company regarding the purchase of additional assets in the Merchant Portfolio," it did not consider the need for safeguards that would protect Enron in transactions between Enron and LJM1. In fact, LJM1 did purchase an interest in Cuiaba from Enron in September 1999.

LJM2. In the case of LJM2, the proposal presented to the Board contemplated creation of an entity with which Enron would conduct a number of transactions. The principal stated advantage of Fastow's involvement in LJM2 was that it could then purchase assets that Enron wanted to sell more quickly and with lower transaction costs. This was a legitimate potential advantage of LJM2, and it was proper for the Board to consider it.[68/]

Nevertheless, there were very substantial risks arising from Fastow's acknowledged conflict of interest. First, given Fastow's position as Enron's CFO, LJM2 would create a poor public appearance, even if the transactions had been immaculate and

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advised of or approved these changes, despite the Board's resolution requiring their approval of any changes.

[68/] The Board was apparently not informed of the involvement of other Enron employees in LJM2, including Kopper's financial stake and the extent of the role played by other Enron employees under the Services Agreement between Enron and LJM2.

there had been sound controls. The minutes do not reflect discussion of this issue, but our interviews indicate that it was raised. During the rising stock market, analysts and investors generally ignored Fastow's dual roles and his conflict of interest, but when doubts were cast on Enron's transactions with LJM1 and LJM2 in connection with Enron's earnings announcement on October 16, 2001, this appearance became a serious problem.

Second, Fastow's position at Enron and his financial incentives and duties arising out of LJM1 and LJM2 could cause transactions to occur on terms unfair to Enron or overly generous to LJM1 and LJM2.[69/] The Board discussed this issue at length and concluded that the risk could be adequately mitigated. The Directors viewed the prospective LJM2 relationship as providing an additional potential buyer for assets in Enron business units. If LJM2 offered a better price than other buyers on asset purchases or other transactions, Enron would sell to LJM2. This could occur because Fastow's familiarity with the assets might improve his assessment of the risk, or might lower his transaction costs for due diligence. In our interviews, several Directors cited these benefits of permitting Fastow to manage LJM2. If a better price was available elsewhere, Enron could sell to the higher bidder. Based on Fastow's presentation, the Directors envisioned a model in which Enron business units controlled the assets to be sold to

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[69/] The presentation to the Board on LJM1 discussed the structure by which Fastow would be compensated, and therefore provided the Board with a basis for forming an expectation about the level of his compensation. The presentation to the Board on LJM2 did not. It provided only that "LJM2 has typical private equity fund fees and promote [sic]," targeted at "$200 + million institutional private equity." When LJM2 was initially approved, it does not appear that there was discussion at the Board level about a much larger fund and the levels of compensation Fastow would receive, although it was discussed later.

LJM2 (or alternative potential buyers) and would be negotiating on behalf of Enron. Because each business unit's financial results were at stake, the Board assumed they had an incentive to insist that the transactions were on the most favorable terms available in the market. This was a plausible assumption, but in practice this incentive proved ineffective in ensuring arm's-length dealings.

Moreover, several Directors stated that they believed Andersen would review the transactions to provide a safeguard. The minutes of the Finance Committee meeting on October 11, 1999 (apparently not attended by representatives of Andersen) identify "the review by Arthur Andersen LLP" as a factor in the Committee's consideration of LJM2. Andersen did in fact (1) provide substantial services with respect to structuring and accounting for many of the transactions, (2) review Enron's financial statement disclosures with respect to the related-party transactions (including representations that "the terms of the transactions were reasonable and no less favorable than the terms of similar arrangements with unrelated third parties"), and (3) confirm Andersen's involvement in representations to the Audit and Compliance Committee at its annual reviews of the LJM transactions. The Board was entitled to rely on Andersen's involvement in these respects. In addition, one would reasonably expect auditors to raise questions to their client—the Audit and Compliance Committee—if confronted with transactions whose economic substance was in doubt, or if controls required by the Board of Directors were not followed, as was the case here.[70/]

[70/] We are unable to determine why Andersen did not detect the various control failures described below. At its meeting with the Audit and Compliance Committee on May 1, 2000, an Andersen representative identified related-party transactions as an area

Further, the Board adopted, or was informed that Management had adopted, a number of controls to protect Enron's interests. When the LJM2 proposal was brought to the Finance Committee and the Board in October 1999, two specific controls were recommended and adopted:

- Enron's Chief Accounting Officer, Rick Causey, and Chief Risk Officer, Rick Buy, would review and approve all transactions between Enron and LJM2.
- The Audit and Compliance Committee of the Board would annually review all transactions from the last year "and make any recommendations they deemed appropriate."

In addition, the Board noted that Enron had no "obligation" to engage in transactions with LJM. The Board also was told that disclosures of individual related-party asset sales was "probably" required in periodic SEC filings and proxy solicitation materials, which would mean involving Enron's internal lawyers, outside counsel at Vinson & Elkins, and Andersen to review the disclosures.

Additional controls were added, or described as having been added, at later meetings. A year later, on October 6 and 7, 2000, respectively, the Finance Committee and the full Board considered a proposal with respect to a new entity, LJM3.[71/] Fastow informed the Directors, in a meeting at which Skilling, Causey and Buy were present,

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to be given "high priorit[y] due to the inherent risks that were present." Moreover, in the engagement letter between Andersen and Enron dated May 2, 2000, the engagement partner wrote that Andersen's work would "consist of an examination of management's assertion that the system of internal control of Enron as of December 31, 2000, was adequate to provide reasonable assurance as to the reliability of financial statements. . . ." Because Andersen declined to permit its representatives to be interviewed, we do not know what, if any, steps Andersen took in light of these observations.

71/ LJM3 was never created.

that additional controls over transactions between Enron and LJM1 and LJM2 had been put in place. These included:

- Fastow expressly agreed that he still owed his fiduciary responsibility to Enron.
- The Board or the Office of the Chairman could ask Fastow to resign from LJM at any time.
- Skilling, in addition to Buy and Causey, approved all transactions between Enron and the LJM partnerships.
- The Legal Department was responsible for maintaining audit trails and files on all transactions.
- A review of Fastow's economic interest in Enron and LJM was presented to Skilling.

One Director also proposed that the Finance Committee review the LJM transactions on a quarterly basis. Another Director proposed that the Compensation and Management Development Committee review the compensation received by Fastow from the LJM partnerships and Enron. Both proposals were adopted by the Finance Committee.

Finally, the Finance Committee (in addition to the Audit and Compliance Committee) was informed on February 12, 2001, of still more procedures and controls:

- The use within Enron of an "LJM Deal Approval Sheet"—in addition to the normal DASH—for every transaction with LJM, describing the transaction and its economics, and requiring approval by senior level commercial, technical, and commercial support professionals. (This procedure had, in fact, been adopted by early 2000.)
- The use of an "LJM Approval Process Checklist" that included matters such as alternative sales options and counter-parties; a determination that the transaction was conducted at arm's length, and any evidence to the contrary; disclosure obligations; and review not only by Causey and Buy but also by Skilling.
- LJM senior professionals do not ever negotiate on behalf of Enron.
- People negotiating on behalf of Enron "report to senior Enron professionals apart from Andrew Fastow."

- Global Finance Commercial, Legal and Accounting Departments monitor compliance with procedures and controls, and regularly update Causey and Buy.

- Internal and outside counsel are regularly consulted regarding disclosure obligations and review any such disclosures.

These controls were a genuine effort by the Board to satisfy itself that Enron's interests would be protected.

At bottom, however, the need for such an extensive set of controls said something fundamental about the wisdom of permitting the CFO to take on this conflict of interest. The two members of the Special Committee participating in this review of the Board's actions believe that a conflict of this significance that could be managed only through so many controls and procedures should not have been approved in the first place.

3. Creation of the Raptor Vehicles

The Board authorized Raptor I in May of 2000. The Board was entitled to rely on assurances it received that Enron's internal accountants and Andersen had fully evaluated and approved the accounting treatment of the transaction, but there was nevertheless an opportunity for the members of the Board to identify flaws and pursue open questions.[72/]

72/ The Board cannot be faulted for lack of oversight over the most troubling Raptor transactions: Raptor III and the Raptor restructuring. With the possible exception of Skilling, who says he recalls being vaguely aware of these particular events, the members of the Board do not appear to have been informed about these transactions. Neither the minutes nor the witnesses we interviewed indicate that Raptor III was ever brought to the Board or its Committees. This may have been because no Enron stock was issued. Raptor III also does not appear to have been disclosed at the February 2001 meetings of the Audit and Compliance Committee or the Finance Committee. The list presented at the February 2001 meetings refers generally to "Raptors I, II, III, IV," but the Finance Committee had reason to believe the transactions referred to as Raptors III and IV were

Raptor I was presented to the Finance Committee on May 1, 2000. It was presented to the Board the following day. The Committee and Board were not given all of the details, but they were given a substantial amount of information. They understood this transaction to be another version of the Rhythms transaction, which they had approved the previous year and believed to have performed successfully. They were informed that the hedging capacity of Raptor I came from the value of Enron's own stock, with which Enron would "seed" the vehicle. They were informed that Enron would purchase a share-settled put on approximately seven million shares of its own stock. Handwritten notes apparently taken by the corporate secretary suggest that the Committee was informed that the structure "[d]oes not transfer economic risk but transfers P&L volatility." At least some members of the Committee understood that this was an accounting-related transaction, not an economic hedge. On a list the Committee (and, it appears, the Board) was shown about the risks posed by the Raptor vehicle, the first risk was of "[a]ccounting scrutiny." The list said that this risk was mitigated by the fact that the "[t]ransaction [was] reviewed by CAO [Causey] and Arthur Anderson [sic]."

We believe that each of these elements should have been the subject of detailed questioning that might have led the Finance Committee or the Board to discover the fundamental flaws in the design and purpose of the transaction. The discussion, if accurately described by the handwritten notes, suggested an absence of economic substance: a hedge that does not transfer economic risk is not a real hedge. While it is often the case that *sales* to SPEs transfer only limited economic risk, a *hedge* that does

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substantially identical to Raptor I. Raptor III, as described earlier in this Report, was not presented to or authorized by the Board.

not transfer economic risk is not a meaningful concept. Enron's purchasing a "put" on its own stock from Talon (Raptor I)—a bet against the value of that stock—had no apparent business purpose. The statement that the first risk to be considered was that of "[a]ccounting scrutiny" was a red flag that should have led to the Board's referring the proposal to the Audit and Compliance Committee for careful assessment of any controversial accounting issues, and should have led that Committee to conduct a probing discussion with Andersen.

The involvement of Enron's internal accountants, and the reported (and actual) involvement of Andersen, gave the Finance Committee and the Board reason to presume that the transaction was proper. Raptor was an extremely complex transaction, presented to the Committee by advocates who conveyed confidence and assurance that the proposal was in Enron's best interests, and that it was in compliance with legal and accounting rules. Nevertheless, this was a proposal that deserved closer and more critical examination.

4. Board Oversight of the Ongoing Relationship with LJM

Two control procedures adopted by the Board (and indeed sound corporate governance) called for specific oversight by Committees of the Board. These were periodic reviews of the transactions and of Fastow's compensation from LJM.[73/]

[73/] Enron's Board of Directors met five times each year in regular meetings, and from time to time in special meetings. The regular meetings typically involved committee meetings as well. The Finance Committee and the Audit and Compliance Committee each generally met for one to two hours the afternoon before the Board meeting.

Committee Review. In addition to the meetings at which LJM1 and LJM2 were approved, the Audit and Compliance Committee and the Finance Committee reviewed certain aspects of the LJM transactions. The Audit and Compliance Committee did so by means of annual reviews in February 2000 and February 2001. The Finance Committee did so by means of a report from Fastow on May 1, 2000 and an annual review in February 2001.

The Committee reviews did not effectively supplement Management's oversight (such as it was). Though part of this may be attributed to the Committees, part may not. The Committees were severely hampered by the fact that significant information about the LJM relationship was withheld from them, in at least five respects:

First, in each of the two years in which the February annual review occurred, Causey presented to the Committees a list of transactions with LJM1 and LJM2 in the preceding year. The lists were incomplete (though Causey says he did not know this, and in any event a more complete presentation may not have affected the Committee's review): the 1999 list identified eight transactions, when in fact there were ten, and the 2000 list of transactions omitted the "buyback" transactions described earlier. Knowledge of these "buyback" transactions would have raised substantial questions about the nature and purpose of the earlier sales.

Second, Fastow represented to the Finance Committee on May 1, 2000, that LJM2 had a projected internal rate of return on its investments of 17.95%, which was consistent with the returns the Committee members said they anticipated for a "bridge" investor such as LJM2. In contrast, at the annual meeting of LJM2 limited partners on

October 26, 2000, Fastow presented written materials showing that their projected internal rate of return on these investments was 51%. While some of this dramatic increase may have been attributable to transactions after May 1—in particular the Raptor transactions—there is no indication that Fastow ever corrected the misimpression he gave the Finance Committee about the anticipated profitability of LJM2.

Third, it appears that, at the meeting for the February 2001 review, the Committees were not provided with important information. The presentation included a discussion of the Raptor vehicles that had been created the preceding year. Apparently, however, the Committees were not told that two of the vehicles then owed Enron approximately $175 million more than they had the capacity to pay. This information was contained in a report that was provided daily to Causey and Buy, but it appears that neither of them brought it to either Committee's attention.

Fourth, it does not appear that the Board was informed either that, by March of 2001, this deficit had grown to about $500 million, or that this would have led to a charge against Enron's earnings in that quarter if not addressed prior to March 31. Nor does it appear that the Board was informed about restructuring the Raptor vehicles on March 26, 2001, or the transfer of approximately $800 million of Enron stock contracts that was part of that transaction. The restructuring was directed at avoiding a charge to earnings. While these transactions may or may not have required Board action as a technical matter, it is difficult to understand why matters of such significance and sensitivity at Enron would not have been brought to the attention of the Board. Causey and Buy, among others, were aware of the deficit and restructuring. Skilling recalls being only

vaguely aware of these events, but other witnesses have told us that Skilling, then in his first quarter as CEO, was aware of and intensely interested in the restructuring.

Fifth, recent public disclosures show that Andersen held an internal meeting on February 5, 2001, to address serious concerns about Enron's accounting for and oversight of the LJM relationship. The people attending that meeting reportedly decided to suggest that Enron establish a special committee of the Board of Directors to review the fairness of LJM transactions or to provide for other procedures or controls, such as competitive bidding. Enron's Audit and Compliance Committee held a meeting one week later, on February 12, 2001, which was attended by David B. Duncan and Thomas H. Bauer, two of the Andersen partners who (according to the public disclosures) had also been in attendance at the Andersen meeting on February 5. We are told (although the minutes do not reflect) that the Committee also conducted an executive session with the Andersen representatives, in the absence of Enron's management, to inquire if Andersen had any concerns it wished to express. There is no evidence that Andersen raised concerns about LJM.

There is no evidence of any discussion by either Andersen representative about the problems or concerns they apparently had discussed internally just one week earlier. None of the Committee members we interviewed recalls that such concerns were raised, and the minutes make no mention of any discussion of the subject. Rather, according to the minutes and to written presentation materials, Duncan reported that "no material weaknesses had been identified" in Andersen's audit and that Andersen's "[o]pinion

regarding internal control ... [w]ill be unqualified."[74/] While we have not had access to either Duncan or Bauer, the minutes do not indicate that the Andersen representatives made any comments to the Committee about controls while Causey was reviewing them, or recommended forming a special committee to review the fairness of the LJM transactions, or recommended any other procedures or review.

The Board cannot be faulted for failing to act on information that was withheld, but it can be faulted for the limited scrutiny it gave to the transactions between Enron and the LJM partnerships. The Board had agreed to permit Enron to take on the risks of doing business with its CFO, but had done so on the condition that the Audit and Compliance Committee (and later also the Finance Committee) review Enron's transactions with the LJM partnerships. These reviews were a significant part of the control structure, and should have been more than just another brief item on the agenda.

In fact, the reviews were brief, reportedly lasting ten to fifteen minutes. More to the point, the specific economic terms, and the benefits to LJM1 or LJM2 (or to Fastow), were not discussed. There does not appear to have been much, if any, probing with respect to the underlying basis for Causey's representation that the transactions were at arm's-length and that "the process was working effectively." The reviews did provide the Committees with what they believed was an assurance that Causey had in fact looked at the transactions—an entirely appropriate objective for a Board Committee-level review

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74/ The written materials included "Selected Observations" on financial reporting. "Related party transactions" were one of five areas singled out in this section. Andersen's comments were that "Relationship issues add scrutiny risk to: [j]udgmental structuring and valuation issues [and] [u]nderstanding of transaction completeness" and "Required disclosures reviewed for adequacy."

of ordinary transactions with outside parties.[75] But these were not normal transactions. There was little point in relying on Audit and Compliance Committee review as a control over these transactions if that review did not have more depth or substance.[76]

Review of Fastow's Compensation. Committee-mandated procedures required reviewing Fastow's compensation from LJM1 and LJM2. This should have been an important control. As much as any other procedure, it might have provided a warning if the transactions were on terms too generous to LJM1 or LJM2. It might have indicated whether the representation that Fastow would not profit from increases in the price of Enron stock was accurate. It might have revealed whether Fastow's gains were inconsistent with the understanding reported by a number of Board members that he would be receiving only modest compensation from LJM, commensurate with the approximately three hours per week he told the Finance Committee in May 2000 he was spending on LJM matters.

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[75] Or. St. § 60.357(2) (1999) ("a director is entitled to rely on information, opinions, reports or statements including financial statements and other financial data, if prepared or presented by: . . . [o]ne or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented [and] legal counsel, public accountants or other persons as to matters the director reasonably believes are within the person's professional or expert competence . . . .").

[76] The need for careful scrutiny became even greater in May 2000, when Fastow asserted to the Finance Committee that transactions between Enron and the two LJM entities had provided earnings to Enron during 1999 of $229.5 million. Enron's total net income for the two quarters of 1999 in which the LJM partnerships had been existence was $549 million. The following year, Enron's 2000 Form 10-K disclosed that it had generated some $500 million of revenues in 2000 (virtually all of it going directly to the bottom line) from the Raptor transactions alone, thereby offsetting losses on Enron merchant investments that would otherwise have reduced earnings. These were very substantial contributors to Enron's earnings for each of those periods.

We have seen only very limited information concerning Fastow's compensation from the LJM partnerships. As discussed above in Section IV, we have seen documents indicating that Fastow's family foundation received $4.5 million in May 2000 from the Southampton investment. We also have reviewed some 1999 and 2000 Schedules K-1 for the partnerships that Fastow provided. At a minimum, the K-1s indicate that Fastow's partnership capital increased by $15 million in 1999 and $16 million in 2000, for a total of over $31 million, and that he received distributions of $18.7 million in 2000.

The Board's review apparently never occurred until October 2001, after newspaper reports focused attention on Fastow's involvement in LJM1 and LJM2. (The information Fastow provided orally to members of the Board in October 2001 is generally consistent with the figures discussed above.) The only references we have found to procedures for checking whether Fastow's compensation was modest, as the Board had expected, are in the minutes of the October 6, 2000 meeting of the Finance Committee. There, Fastow told the Committee (in Skilling's presence) that Skilling received "a review of [Fastow's] economic interest in [Enron] and the LJM funds," and the Committee then unanimously agreed that the Compensation Committee should review Fastow's compensation from LJM1 and LJM2. Although a number of members of the Compensation Committee were present at this Finance Committee meeting, it does not appear that the Compensation Committee thereafter performed a review. Moreover, Skilling said he did not review the *actual* amount of Fastow's LJM1 or LJM2 compensation. He said that, instead, he received a handwritten document (from Fastow)

showing only that Fastow's economic stake in Enron was substantially larger than his economic stake in LJM1 and LJM2.[77]

Some witnesses expressed the view that direct inquiry into Fastow's compensation would have been inappropriate or intrusive, or might have compromised the independence of LJM. We do not understand this reticence, and we disagree. First, the Board apparently *did* require inquiry into Fastow's compensation, but it either was not done or was done ineffectively. Second, we do not believe that requiring Fastow to provide a copy of his tax return from the partnerships, or similar information, would have been inappropriate. The independence of LJM was not predicated on Fastow's independence from Enron; rather, it was predicated on the existence of a structure within LJM that created limited partner control because Fastow *was* technically viewed as being controlled by Enron. Thus Enron's scrutinizing Fastow's compensation was not inconsistent with the independence of LJM.

B. Oversight by Management

Management had the primary responsibility for implementing the Board's resolutions and controls. Management failed to do this in several respects. No one

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[77] Skilling reasoned that Fastow's comparatively larger economic stake in Enron relative to his interest in the LJM partnerships would create an incentive for Fastow to place Enron's interests ahead of those of LJM1 and LJM2. This was the objective of the exercise, as Skilling saw it. While we understand this explanation, we do not believe that the reasoning is valid. Even if Fastow's economic interest in Enron were far greater than his interest in LJM1 and LJM2, his potential benefits from even one transaction that favored LJM1 or LJM2—in which he had a direct and substantial stake—might far outweigh any detriment to him as a holder of stock or options in Enron, on which the transaction could be expected to have minimal financial impact.

accepted primary responsibility for oversight, the controls were not executed properly, and there were apparent structural defects in the controls that no one undertook to remedy or to bring to the Board's attention. In short, no one was minding the store.

The most fundamental management control flaw was the lack of separation between LJM and Enron personnel, and the failure to recognize that the inherent conflict was persistent and unmanageable. Fastow, as CFO, knew what assets Enron's business units wanted to sell, how badly and how soon they wanted to sell them, and whether they had alternative buyers. He was in a position to exert great pressure and influence, directly or indirectly, on Enron personnel who were negotiating with LJM. We have been told of instances in which he used that pressure to try to obtain better terms for LJM, and where people reporting to him instructed business units that LJM would be the buyer of the asset they wished to sell. Pursuant to the Services Agreement between Enron and LJM, Enron employees worked for LJM while still sitting in their Enron offices, side by side with people who were acting on behalf of Enron. Simply put, there was little of the separation and independence required to enable Enron employees to negotiate effectively against LJM2.

In many cases, the safeguard requiring that a transaction could be negotiated on behalf of Enron only by employees who did not report to Fastow was ignored. We have identified at least 13 transactions between Enron and LJM2 in which the individuals negotiating on behalf of Enron reported directly or indirectly to Fastow.

This situation led one Fastow subordinate, then-Treasurer Jeff McMahon, to complain to Skilling in March 2000. While McMahon's and Skilling's recollections of

their conversation differ, McMahon's contemporaneous handwritten discussion points, which he says he followed in the meeting, include these notations:

- "LJM situation where AF [Andy Fastow] wears 2 hats and upside comp is so great creates a conflict I am right in the middle of."
- "I find myself negotiating with Andy [to whom he then reported] on Enron matters and am pressured to do a deal that I do not believe is in the best interests of the shareholders."
- "Bonuses do get affected -- MK [Michael Kopper], JM [Jeff McMahon]"[78/]

McMahon's notes also indicate he raised the concern that Fastow was pressuring investment banks that did business with Enron to invest in LJM2.

Skilling has said he recalls the conversation focusing only on McMahon's compensation. Even if that is true, it still may have suggested that Fastow's conflict was placing pressure on an Enron employee. The conversation presented an issue that required remedial action: a solution by Management, a report to the Board that its controls were not working properly, or both. Skilling took no action of which we are aware, and shortly thereafter McMahon accepted a transfer within Enron that removed him from contact with LJM. Neither Skilling nor McMahon raised the issue with Lay or the Board.

Conflicts continued. Indeed, the Raptor transactions, which provided the most lucrative returns to LJM2 of any of its transactions with Enron, followed soon after McMahon's meeting with Skilling. The Raptor I transaction was designed by Ben

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78/ McMahon says this was a reference to his perception that Kopper, who had worked closely with Fastow, had received a very large bonus, while McMahon felt he had been penalized for his resistance with respect to LJM.

Glisan—McMahon's successor as Treasurer—who reported to Fastow, and by others in Fastow's Global Finance Group. Another Enron employee responsible for later Raptors was Trushar Patel. He was in the Global Finance Group and married to Anne Yaeger Patel, an Enron employee who assisted Fastow at LJM2. Both Yaeger Patel and Glisan also shared in the Southampton Place partnership windfall, during the same period the Raptor transactions were in progress.

The Board's first and most-relied-on control was review of transactions by the Chief Accounting Officer, Causey, and the Chief Risk Officer, Buy. Neither ignored his responsibility completely, but neither appears to have given the transactions anywhere near the level of scrutiny the Board understood they were giving. Neither imposed a procedure for identifying all LJM1 or LJM2 transactions and for assuring that they went through the required procedures. It appears that some of the transactions, including the "buybacks" of assets previously sold to LJM1 or LJM2, did not even come to Causey or Buy for review. Although Buy has said he was aware that changes were made to the Raptors during the first quarter of 2001, he also said he was not involved in reviewing those changes. He should have reviewed this transaction, like all other transactions with LJM2.

Even with respect to the transactions that he did review, Causey said he viewed his role as being primarily determining that the appropriate business unit personnel had signed off. Buy said he viewed his role as being primarily to evaluate Enron's risk.[79/] It

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79/ Buy and a subordinate who assisted him on certain of the transactions have said that in cases where Enron was selling to LJM2 an interest in an asset that Enron had acquired, they checked to see that the sale price was consistent with the acquisition price.

does not appear that Causey or Buy had the necessary time, or spent the necessary time, to provide an effective check, even though the Board was led to believe they had done so.

Skilling appears to have been almost entirely uninvolved in overseeing the LJM transactions, even though in October 2000 the Finance Committee was told by Fastow—apparently in Skilling's presence—that Skilling had undertaken substantial duties.[80/] Fastow told the Committee that there could be no transactions with the LJM entities without Skilling's approval, and that Skilling was reviewing Fastow's compensation. Skilling described himself to us as having little or no role with respect to the individual LJM transactions, and said he had no detailed understanding of the Raptor transactions (apart from their general purpose). His signature is absent from many LJM Deal Approval Sheets, even though the Finance Committee was told that his approval was required. Skilling said he would sign off on transactions if Causey and Buy had signed off, suggesting he made no independent assessment of the transactions' fairness. This was not sufficient in light of the representations to the Board.

It does not appear that Lay had, or was intended to have, any managerial role in connection with LJM once the entities became operational. His involvement was principally on the same basis as other Directors. By the accounts of both Lay and

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This appears to be the one point in the review process at which there was an appropriate examination of the substance of the transactions; in fact, the price of the assets sold by Enron to LJM2 does not appear to have been where the problems arose.

80/ The minutes of the October 6, 2000 meeting of the Finance Committee report Fastow saying that "Buy, Causey and Skilling review all transactions between the Company and the LJM funds." The minutes state that Skilling, along with Buy and Causey, "attended the meeting." Skilling told us that he may not have been present for Fastow's remarks.

Skilling, the division of labor between them was that Skilling, as President and COO (later CEO) had full responsibility for domestic operational activities such as these. Skilling said he would keep Lay apprised of major issues, but does not recall discussing LJM matters with him. Likewise, the Enron employees we interviewed did not recall discussing LJM matters with Lay after the entities were created other than at Board and Board Committee meetings, except in two instances after he resumed the position of CEO in August and September of 2001 (the Watkins letter, discussed in Section VII.C, and the termination of the Raptors, discussed in Section V.E.). Still, during the period while Lay was CEO, he bore ultimate management responsibility.

Still other controls were not properly implemented. The LJM Deal Approval Sheet process was not well-designed, and it was not consistently followed. We have been unable to locate Approval Sheets for some transactions. Other Approval Sheets do not have all the required signatures. The Approval Sheet form contained pre-printed check marks in boxes signifying compliance with a number of controls and disclosure concerns, with the intention that a signature would be added to certify the accuracy of the pre-printed check-marks. Some transactions closed before the Approval Sheets were completed. The Approval Sheets did not require any documentation of efforts to find third party, unrelated buyers for Enron assets other than LJM1 or LJM2, and it does not appear that such efforts were systematically pursued. Some of the questions on the Approval Sheets were framed with boilerplate conclusions ("Was this transaction done strictly on an arm's-length basis?"), and others were worded in a fashion that set unreasonably low standards or were worded in the negative ("Was Enron advised by any third party that this transaction was not fair, from a financial perspective, to Enron?"). In

practice, it appears the LJM Deal Approval Sheets were a formality that provided little control.

Apart from these failures of execution, perhaps the most basic reason the controls failed was structural. Most of the controls were based on a model in which Enron's business units were in full command of transactions and had the time *and* motivation to find the highest price for assets they were selling. In some cases, transactions were consistent with this model, but in many of the transactions the assumptions underlying this model did not apply. The Raptor transactions had little economic substance. In effect, they were transfers of economic risk from one Enron pocket to another, apparently to create income that would offset mark-to-market losses on merchant investments on Enron's income statement. The Chief Accounting Officer was not the most effective guardian against transactions of this sort, because the Accounting Department was at or near the root of the transactions. Other transactions were temporary transfers of assets Enron wanted off its balance sheet. It is unclear in some of the cases whether economic risk ever passed from Enron to LJM1 or LJM2. The fundamental flaw in these transactions was not that the price was too low. Instead, as a matter of economic substance, it is not clear that anything was really being bought or sold. Controls that were directed at assuring a fair price to Enron were ineffective to address this problem.

In sum, the controls that were in place were not effectively implemented by Management, and the conflict was so fundamental and pervasive that it overwhelmed the controls as the relationship progressed. The failure of any of Enron's Senior Management to oversee the process, and the failure of Skilling to address the problem of Fastow's influence over the Enron side of transactions on the one occasion when, by

McMahon's account, it did come to his attention, permitted the problem to continue unabated until late 2001.

C. The Watkins Letter

In light of considerable public attention to what has been described as a "whistleblower" letter to Lay by an Enron employee, Sherron Watkins, we set out the facts as we know them here. However, we were not asked to, and we have not, conducted an inquiry into the resulting investigation.

Shortly after Enron announced Skilling's unexpected resignation on August 14, 2001, Watkins sent a one-page anonymous letter to Lay.[81/] The letter stated that "Enron has been very aggressive in its accounting—most notably the Raptor transactions." The letter raised serious questions concerning the accounting treatment and economic substance of the Raptor transactions (and transactions between Enron and Condor Trust, a subsidiary of Whitewing Associates), identifying several of the matters discussed in this Report. It concluded that "I am incredibly nervous that we will implode in a wave of accounting scandals." Lay told us that he viewed the letter as thoughtfully written and alarming.

81/ Watkins, through her counsel, declined to be interviewed by us. From other sources, we understand that she is an accountant who spent eight years at Andersen, both in Houston and New York. She joined Enron in October 1993, working for Fastow in the corporate finance area. Over the next eight years, she worked in several different positions, including jobs in Enron's materials and metals operations, Enron International, and broadband. She left Enron as part of a downsizing in the spring of 2001, but returned in June 2001 to work for Fastow on a project of listing and gathering information about assets that Enron may want to consider selling.

Lay gave a copy of the letter to James V. Derrick, Jr., Enron's General Counsel. Lay and Derrick agreed that Enron should retain an outside law firm to conduct an investigation. Derrick told us he believed that Vinson & Elkins ("V&E") was the logical choice because, among other things, it was familiar with Enron and LJM matters. Both Lay and Derrick believed that V&E would be able to conduct an investigation more quickly than another firm, and would be able to follow the road map Watkins had provided. Derrick says that he and Lay both recognized there was a downside to retaining V&E because it had been involved in the Raptor and other LJM transactions. (Watkins subsequently made this point to Lay during the meeting described below and in a supplemental letter she gave to him.) But they concluded that the investigation should be a preliminary one, designed to determine whether there were new facts indicating that a full investigation—involving independent lawyers and accountants—should be performed.

Derrick contacted V&E to determine whether it could, under the legal ethics rules, handle the investigation. He says that V&E considered the issue, and told him that it could take on the matter. Two V&E partners, including the Enron relationship partner and a litigation partner who had not done any prior work for Enron, were assigned to handle the investigation. Derrick and V&E agreed that V&E's review would not include questioning the accounting treatment and advice from Andersen, or a detailed review of individual LJM transactions. Instead, V&E would conduct a "preliminary investigation," which was defined as determining whether the facts raised by Watkins warranted further independent legal or accounting review.

Watkins subsequently identified herself as the author of the letter. On August 22, one week after she sent her letter, she met with Lay in his office for approximately one hour. She brought with her an expanded version of the letter and some supporting documents. Lay recalls that her major focus was Raptor, and she explained her concerns about the transaction to him. Lay believed that she was serious about her views and did not have any ulterior motives. He told her that Enron would investigate the issues she raised.[82/]

V&E began its investigation on August 23 or 24. Over the next two weeks, V&E reviewed documents and conducted interviews. V&E obtained the documents primarily from the General Counsel of Enron Global Finance. We were told that V&E, not Enron, selected the documents that were reviewed. V&E interviewed eight Enron officers, six of whom were at the Executive Vice President level or higher, and two Andersen partners. V&E also had informal discussions with lawyers in the firm who had worked on some of the LJM transactions, as well as in-house counsel at Enron. No former Enron officers or employees were interviewed. We were told that V&E selected the interviewees.

After completing this initial review, on September 10, V&E interviewed Watkins. In addition, V&E provided copies of Watkins' letters (both the original one-page letter and the supplemental letter that she gave to Lay at the meeting) to Andersen, and had a follow-up meeting with the Andersen partners to discuss their reactions. V&E also conducted follow-up interviews with Fastow and Causey.

82/ Andersen documents recently released by a Congressional committee indicate that, on August 20, Watkins contacted a friend in Andersen's Houston office and orally communicated her concerns.

On September 21, the V&E partners met with Lay and Derrick and made an oral presentation of their findings. That presentation closely tracked the substance of what V&E later reported in its October 15, 2001 letter to Derrick. At Lay's and Derrick's request, the V&E lawyers also briefed Robert Jaedicke, the Chairman of the Audit and Compliance Committee, on their findings. The lawyers made a similar presentation to the full Audit and Compliance Committee in early October 2001.

V&E reported in writing on its investigation in a letter to Derrick dated October 15, 2001. The letter described the scope of the undertaking and identified the documents reviewed and the witnesses interviewed. It then identified four primary areas of concern raised by Watkins: (1) the "apparent" conflict of interest due to Fastow's role in LJM; (2) the accounting treatment for the Raptor transactions; (3) the adequacy of the public disclosures of the transactions; and (4) the potential impact on Enron's financial statements. On these issues, V&E observed that Enron's procedures for monitoring LJM transactions "were generally adhered to," and the transactions "were uniformly approved by legal, technical and commercial professionals as well as the Chief Accounting and Risk Officers." V&E also noted the workplace "awkwardness" of having Enron employees working for LJM sitting next to Enron employees.

On the conflict issues, V&E described McMahon's concerns and his discussions with Fastow and Skilling (described above), but noted that McMahon was unable to identify a specific transaction where Enron suffered economic harm. V&E concluded that "none of the individuals interviewed could identify any transaction between Enron and LJM that was not reasonable from Enron's standpoint or that was contrary to Enron's best interests." On the accounting issues, V&E said that both Enron and Andersen

acknowledge "that the accounting treatment on the Condor/Whitewing and Raptor transactions is creative and aggressive, but no one has reason to believe that it is inappropriate from a technical standpoint." V&E concluded that the facts revealed in its preliminary investigation did not warrant a "further widespread investigation by independent counsel or auditors," although they did note that the "bad cosmetics" of the Raptor related-party transactions, coupled with the poor performance of the assets placed in the Raptor vehicles, created "a serious risk of adverse publicity and litigation."

V&E provided a copy of its report to Andersen. V&E also met with Watkins to describe the investigation and go over the report. The lawyers asked Watkins whether she had any additional factual information to pass along, and were told that she did not.

With the benefit of hindsight, and the information set out in this Report, Watkins was right about several of the important concerns she raised. On certain points, she was right about the problem, but had the underlying facts wrong. In other areas, particularly her views about the public perception of the transactions, her predictions were strikingly accurate. Overall, her letter provided a road map to a number of the troubling issues presented by the Raptors.

The result of the V&E review was largely predetermined by the scope and nature of the investigation and the process employed. We identified the most serious problems in the Raptor transactions only after a detailed examination of the relevant transactions and, most importantly, discussions with our accounting advisors—both steps that Enron determined (and V&E accepted) would not be part of V&E's investigation. With the exception of Watkins, V&E spoke only with very senior people at Enron and Andersen.

Those people, with few exceptions, had substantial professional and personal stakes in the matters under review. The scope and process of the investigation appear to have been structured with less skepticism than was needed to see through these particularly complex transactions.[83/]

83/ We note that by the time of Watkins' letter—August 2001—all of the Raptor transactions were complete with the exception of their termination, which occurred in September 2001.

[Draft 3/18/02]

What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections

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Abstract

The Enron case challenges some of the core beliefs and practices that have underpinned various positions in the debates about corporate law and governance, including mergers and acquisitions, since the 1980s. In particular, Enron raises at least the following problems for the received model of corporate governance:

First, it provides another set of reasons to question the strength of the efficient market hypothesis, here, the company's dizzyingly high stock price despite transparently irrational reliance on its auditors' compromised certification.

Second, it undermines faith in the corporate governance mechanism – the monitoring board – that has been offered as a substitute for unfettered shareholder access to the market for corporate control. In particular, the board's capacity to protect the integrity of financial disclosure has not kept pace with the increasing reliance on stock price performance in measuring and rewarding managerial performance.

Third, it suggests the existence of tradeoffs in the use of stock options in executive compensation because of the potential pathologies of the risk-preferring management team.

Fourth, it shows the poor fit between stock-based employee compensation and employee retirement planning. More generally, it raises questions about the shift in retirement planning towards defined contribution plans, which make employees risk bearers and financial planners, and away from defined benefit plans, which impose some of the risk and fiduciary planning obligations on firms.

Although the disclosure, monitoring and other failures may lead to useful reforms, Enron also reminds us that there is a problem that can't be solved but can only be contained in the tension between imperfectly fashioned incentives and self-restraint.

Keywords: Enron, corporate governance, efficient market, accountants, directors, stock options, pensions

JEL classifications G14, G34, K22, L14, M52

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* Alfred W. Bressler Professor of Law, Columbia Law School. I appreciate discussions and comments from Jack Coffee, Ron Gilson, Victor Fleischer, Ed Iacobucci, Jon Macey, David Schizer, some Columbia alums who wish to remain anonymous, and participants at the University of Chicago Law Review symposium. This paper bears a date of February 15, 2002.

On October 16, 2001, Enron Corp., a Houston-based energy trading and distribution company famous for its advocacy of energy deregulation, announced a $1.01 billion "non-recurring charge" related to "losses associated with certain investments ... and early termination during the third quarter of certain structured finance arrangements with a previously disclosed entity."[1] Chairman and CEO Ken Lay reassured investors about the strength of the company's core businesses, said he was "very confidant in [Enron's] strong earnings outlook" and "reaffirmed" that the company was "on track to continue strong earnings growth." Nevertheless, the write-offs produced a third quarter loss of more than $600 million and surprised Wall Street. Moreover, the Wall Street Journal reported that $35 million of the losses derived from business dealings with partnerships managed by the company's CFO, Andrew S. Fastow.[2]

The bad news, the reported conflict of interest, an ensuing SEC investigation, and the fall in Enron's stock price from the mid-$30s to the low-$20s, triggered a crisis of confidence in the company. Enron's energy trading business, its crown jewel, depended crucially on solid finances, since parties dealing with Enron were loathe to assume significant counterparty credit risk: a serious chance that Enron could not perform on a contract to buy or sell energy meant that parties would no longer trade with the firm. In desperation, Enron turned to a merger with its crosstown rival, Dynergy, to save the day. Then on Nov. 8, Enron released a bombshell. The quarterly earnings statement restated (i.e., reduced) previously reported earnings back to 1997 by $586 million, a 20 percent reduction in profits over the period, "mostly due to improperly accounting for its dealings with partnerships run by some company officers."[3] The quarterly statement revealed more about Enron's troubled financial relationship with officer-managed partnerships.

The third quarter report was devastating. The ramifying implications led

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[1] "Enron Reports Recurring Third Quarter Earnings of $0.43 Per Diluted Share; Reports Non-Recurring Charges of $1.01 Billion After-Tax; Reaffirms Recurring Earnings Estimates of $1.80 for 2001 and $2.15 for 2002; And Expands Financial Reporting," Enron Corp. Press Release, Oct. 16, 2001, available at www.enron.com. For a general "history," see Kurt Eichenwald with Diana B. Henriques, "Web of Details Did Enron In As Warnings Went Unheeded," N.Y. Times, Feb. 10, 2002, p.A1.

[2] John R. Emshwiller & Rebecca Smith, "Enron Posts Surprise 3rd-Quarter Loss After Investment, Asset Write-Downs, Wall St. J, Oct. 17, 2001." (available at wsj.com)

[3] John R. Emshwiller et al, "Enron reduces Profits for 4 Years by 20%, Citing Dealings With Officers' Partnerships," Wall.St. J., Nov. 9, 2001 (available at WSJ.com).

Dynergy to call off the merger. On December 2, barely six weeks after the crisis first broke, Enron filed for bankruptcy. The turnabout was remarkable. By some turnover measures, Enron had been the seventh largest company in the United States. Barely a year before, its stock had crested at $90 a share, yielding a market capitalization of approximately $80 billion. The company was an invariably mentioned in "most admired" lists of US companies; its CEO was lionized in Houston and a nicknamed confidant of the President of the United States.

Enron's collapse triggered investigations by a "special committee" of the Enron board, the SEC and the Justice Department, nearly a dozen congressional committees, and various shareholder plaintiffs' attorneys. The Enron board's special committee investigation suggested that a substantial fraction of the company's reported profits over a four year period had been the result of accounting manipulations.[4] Early targets included Enron's senior officers, the accountants Arthur Anderson, the Enron board and its various special oversight committees, and the law firm Vinson & Elkins, which helped put together the controversial transactions. Not only had Enron apparently filed false and misleading disclosure documents, but insiders allegedly sold stock and exercised options while publicly restating their faith in the company. By contrast, rank-and-file employees were unable to sell their Enron stock locked into so-called "401(k)" retirement plans. This particular element – privileged insiders walking away with hundreds of millions in stock-related profits while ordinary employees were losing a substantial chunk of life savings – added to the political saliency of the events.

The Enron case plays on many different dimensions, but its prominence is not merely part of popular culture's obsession with scandale de jour. Rather, Enron challenges some of the core beliefs and practices that have underpinned the academic analysis of corporate law and governance, including mergers and acquisitions, since the 1980s. These amount to an interlocking set of institutions that constitute "shareholder capitalism," American style, 2002, that we have been aggressively promoting throughout the world. In particular we have come to rely on particular set of assumptions about: the connection between stock market prices and underlying economic realities; the reliability of independent auditors, financial standards, and copious disclosure in protecting the integrity of financial reporting; the efficacy of corporate governance in monitoring managerial performance; the utility of stock options in aligning managerial and shareholder interests, and the value of employee ownership as both an incentive device as well as a retirement planning tool.

In particular, I want to asset that Enron raises at least the following problems for the received model of corporate governance:

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[4] See Report of Investigation by the Special Investigation Committee of the Board of Directors of Enron Corp, Feb. 1, 2002.

First, it provides another set of reasons to question the strength of the efficient market hypothesis, because its stock price reached dizzying heights despite transparently irrational reliance on its auditors' compromised certification.

Second, it undermines faith in the corporate governance mechanism – the monitoring board – that has been offered as a substitute for unfettered shareholder access to the market for corporate control. In particular, the board's capacity to protect the integrity of financial disclosure has not kept pace with the increasing reliance on stock price performance in measuring and rewarding managerial performance.

Third, it suggests the existence of tradeoffs in the use of stock options in executive compensation because of the potential pathologies of the risk-preferring management team.

Fourth, it shows the poor fit between stock-based employee compensation and employee retirement planning. More generally, it raises questions about the shift in retirement planning towards defined contribution plans, which make employees risk bearers and financial planners, and away from defined benefit plans, which impose some of the risk and fiduciary planning obligations on firms.[5]

I. The Efficient Market Hypothesis

Although the efficient market hypothesis is a useful null hypothesis about the workings of a well-developed capital market, sophisticated application in policy settings requires awareness of its limits as well as its power. The 1987 stock market crash, which in retrospect still seems like a random quantum fluctuation, and the recent dot.com exuberance, which looks like a classic bubble, both give ample evidence of those limitations. Even if it is the case that the prevailing stock price is best available estimate of expected future cash flows, "best" may not be very good in some cases. But Enron seems to demonstrate those limits in a new way. If the dot.com boom, for example, was a sectoral goldrush, Enron's price escalation (hitting a multiple of 60 on trailing earnings) showed how markets can ignore the handwriting on the wall for a single firm. It seemed barely possible that the internet was about to become the prime medium for transactions in the United States and that the firms which staked their claims first would achieve increasing (and enormous) returns to scale. The failure of markets adequately to assess the earnings prospects at Enron is a more granular failure and thus more troubling. How can the market price so widely diverge from intrinsic value despite the firm-specific scrutiny that market institutions, including a battalion of securities analysts, bring to bear on such

[5] For a wide-ranging account of the Enron collapse, see William W. Bratton, Enron and the Dark Side of Shareholder Value (forthcoming Tulane Law Review, May 2002).

a widely-held stock? Even if Enron lacked candor, indeed, active misled, about its true financial condition, wasn't enough was known to sophisticated market participants about Enron's murky finances so that efficient markets should never have placed such a high value on Enron's stock?

The arguments has a few steps. First, it was known and widely discussed in the analytic community that Enron's financial structure was highly complex and that the bodies were buried in off-balance sheet entities that were cryptically described in Enron's disclosure documents. No one on the outside really understood Enron's financial condition but they also knew they didn't know. As one analyst put it, Enron was a "faith" stock. Yet such willful obscurity ordinarily leads to skepticism rather than belief. Enron could have disclosed more but did not. It reveled in information asymmetry. What were we to infer from this – that it had a secret, non-patentable elixir for money-making (that investment banks wouldn't have already shopped to every other large firm)? Or rather that full disclosure would have been embarrassing? George Akerlof just won a Nobel prize for providing the answer to that question.[6] In other words, in an efficient market, Enron should have been a "lemons" stock instead of a "faith" stock.

Not so simple, you might say: Enron's accountants, Arthur Andersen, certified that the financial statements "fairly presented" the overall financial picture of the company, and the reputational capital of a Big Five accounting firm credibly bonds Anderson's certification. Andersen's failure was a surprise, you might say. But, in fact, it seems to have been a forseeable failure. That Andersen had a lot to lose from a bad audit is insufficient. No one who observed the firm-threatening bridge loans made in leveraged transactions in the 1980s by investment bankers eager for a success fee can believe that there is necessarily a link between what is rational for the firm and what actions may be taken by the firm's self-interested agents. Much depends on the way the firm manages the internal moral hazard problems. On the basis of what we knew before the Enron collapse, the credibility of Andersen's certification had been severely compromised, first because it had permitted its independence as a firm to be fatally undermined, and second, the internal governance of Andersen was insufficient to control potentially aberrant behavior by its partners.

Much has been already said about the problems raised by letting accounting firms cross-sell various consulting services to their audit clients. As one of my colleagues pithily put it, "The batter ought to worry about the umpire who is selling

[6] George Akerlof, The Market for 'Lemons': Quality Uncertainty and the Market Mechanism, 84 Q. J. Econ. 488 (1970).

life-insurance to the pitcher."[7] But the issue bears close examination for what it says about the credibility of Andersen's certification. The most important guarantor of an accountant's independence is that its firing is highly salient. This is a material event; it must be disclosed on an Schedule 8-K and even if the accountant breathes not a word about the precipitating facts (and the accountant may shout from the rooftop), it will trigger scrutiny and inquiry. Firing the accounting firm is thus a "high visibility sanction" that may well cause more harm to the sanctioning company (and its officers and directors) than to the accountant, and therefore it cannot be credibly threatened to bring into line an accountant who disagrees with management about an important accounting matter. Indeed, too vigorous an effort to force a particular accounting treatment may well trigger an accountant's resignation, also a material event.

This picture dramatically changes when the accounting firm begins to cross-sell consulting services. It is not that the accountant now has more at stake in the relationship and thus would lose more if fired by the company. Nor is it simply that the accountant may now have a particular reason to please, or at least not alienate, the client who may buy additional services, and may even hope that cooperation on difficult accounting questions will be appreciated as part of a total client relationship. Rather, it is that the client now has available a repertoire of "low visibility sanctions" to discipline the accountant's behavior. If the accountant is resistant, a contract may be withheld or not renewed (or if the accountant is cooperative, the reverse). But unlike the firing, these disciplinary measures will not be disclosed. (Even if the total amount of the accountant's consulting services is disclosed, the investor will not have a full picture of the accountant-issuer relationship, because the disclosure will not reveal the set of potential contracts.) Thus the issuer now has credible threats against an accountant who disagrees with management on an important issue. Moreover, the issuer now knows the accountant's type: no accounting firm which prizes its independence above all else would put itself in a position where that independence is so readily undermined. To push the argument further: This may be why there are two polar equilibria in the bundling of auditing and consulting services. Accountants cannot afford to compete on their relative independence. The willingness to expose oneself to low visibility sanctions – the sacrifice of inherent independence – offers such a competitive advantage in attracting audit clients that there will be a race to the bottom.

There is a related cultural factor associated with consulting that also tends to undermine the credibility of the accountant's certification. The press has often referred to the bundling of auditing and glamorous information technology consulting. But the more common, and more insidious, bundle may be auditing plus

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[7] See generally, John C. Coffee, Jr., The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting, Columbia Law School Center for Law and Economics Studies, W.P. 191, May 2001, available on SSRN.

tax planning, because of the carryover mindset from "tax planning" into "accounting planning." Tax planners provide value by structuring a company's transactions so as to minimize tax, applying a formalist's approach to the constraints of the tax law against a background interpretive norm of "reasonable basis." If a close, ingenious reading of the Code and the regulations permits a reshaping of economic reality to minimize taxes, then excelsior. Whatever the ultimate social desirability of such gamesmanship, at least it serves the narrow shareholder interest of maximizing after tax income, that is, increasing the cash in the corporate till. But this tax planning approach all too readily carries over to "accounting planning," in which the accountant aggressively construes accounting rules to maximize reported income irrespective of less illuminating disclosure to the ultimate client, the shareholders. Accounting rules, like the tax rules, become the subject of professional manipulation, despite a potentially distorted portrayal of the underlying economic reality. The ingenious evasion wins a merit badge and perhaps additional compensation.[8] Thus "independent" accountants become part of the management "team." Moreover, the balance sheet is disaggregated, as each successive transaction is evaluated on a stand-alone basis against the accounting rules, myopically applied. So in addition to the low visibility sanctions, consulting can create a culture that undermines the capacity of the accountant to make the arm's length judgment about public financials that must "fairly present" the underlying economic realities taken as a whole.

Yet all of this is known to sophisticated investors. The sharply diminished value of Andersen's certification for a company like Enron with complicated accounting, abundant consulting opportunities, and obvious accounting planning, should have been impounded in Enron's price from the get go. Apparently it was not.

There is second compromising element of the value of Andersen certification, the weakness of its internal governance mechanisms in controlling the behavior of the firm's partners, the internal agency problem.[9] The previous paragraphs addressed the independence of Andersen as a firm, but of course services were delivered by specific agents of the firm, its Houston partners. It now seems that the compensation of the Houston partners was significantly tied to their client billings

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[8] The Enron Special Committee report confirms Andersen's role in helping to structure Enron's off-balance sheet entities despite the obvious disclosure deficit that was created.

My tax colleagues think the chain of causation runs in the reverse direction: that the accountants' apparent satisfaction with literal compliance with the technical accounting rules carries over to their approach to the tax code and regulations, despite the "substance over form" interpretive stance of the IRS. But the accountant's duty to certify that audited financial "fairly present" the financial position of the company amounts to a comparable "substance over form" test as well.

[9] This section benefitted particularly from conversations with Jon Macey.

both for auditing services and consulting services. Enron might have been a relatively small client for Andersen, the firm, but it was the largest client for its Houston office, and, for the Enron relationship partners, perhaps their only significant client. The forces that would undermine the independence of the firm are much magnified in the case of the relationship partners. In a multi-office, multi-national firm like Andersen, it may be economically rational to treat each office as a profit center and to tie a significant portion of partner compensation to own-billings or office-billings. But the consequent threat to the partner's independence and the resulting risk to Andersen's reputation are forseeable and seem virtually to compel an appropriate internal monitoring mechanism. The disparity between the value of the Houston partners' share of Andersen's reputation and the value to them of a continued (or more lucrative) Enron client relationship sets up an obvious moral hazard problem. This problem is compounded by the interaction with the first compromising factor. That is, the low visibility sanctions associated with the bundling of audit and consulting services have particular compromising force at the relationship partner level because of the impact of lucrative consulting contracts on relationship partner compensation.

There are at least two obvious ways to monitor. First, an internal "inspector general" might provide disinterested internal review of important accounting judgments made by the Houston partners, an internal auditor's audit. Second, partners might rotate among offices (for the same reason that bank officers frequently rotate). Neither of these mechanisms, nor any other, seems to have been used by Andersen. Indeed, it seems that the Houston office could reject accounting judgments from Chicago headquarters with impunity.

But this absence of internal controls was no secret. It was widely known, one presumes, to accounting sophisticates, and thus the consequent undermining of the credibility of Andersen's certification should have been impounded in Enron's price. Yet throughout the period that Enron was assembling its deceptive array of off-balance sheet partnerships and special purpose entities, its stock soared.[10]

How are we to interpret the gradual fall in Enron's stock price during 2001, in absolute and market-adjusted terms, despite steadily increasing reported earnings during the period? The stock price hovered around $80 per share in January and February, drifting down to $60 in March and April, falling to $50 in the summer and to $40 by early fall. Yet the company was reporting favorable operating results including substantial increases in quarterly earnings per share, an 18 percent increase for the first quarter, a 32 percent increase for the second quarter. Perhaps there was

[10] For accounts of the cultural and monitoring failures at Andersen, see Ken Brown & Jonathan Weil, "How Andersen's Embrace of Consulting Altered the Culture of the Auditing Firm," Wall St. J., March 12, 2002, p. C1; Ianthe Jeanne Dugan, "Did You Hear the One About the Accountant? It's Not Very Funny," Wall St. J., March 14, 2002, p.A1.

information leakage from the partnership participants, who possessed nonpublic deal documents that could have revealed the potential fragility of Enron's accounting alchemy, or perhaps the pressure of skeptical short sellers was having an effect. This provides only limited vindication of the efficient market hypothesis because of the slow correction of the initial overpricing. Indeed, the pattern is consistent with an undersupply of arbitrage in the presence of "noise traders," one of the by-now classic explanations of the limitations on market efficiency.[11]

In short, Enron disturbs the efficient market hypothesis. The only compelling reason not to assume the worst about Enron's deliberately obscure financial statements was because of Andersen's certification, yet the market "knew" that the certification had little value.[12]

II. Board-Centered Corporate Governance

The efficient market hypothesis has been one of the underpinnings of the argument for shareholder choice in the decision whether to accept a hostile takeover bid at a premium to the market price. (It is by no means a necessary step to that conclusion, however, since the possibility of a gap between prevailing market price and intrinsic value hardly resolves the question of whether management has markedly better information and superior evaluative skills so as to outweigh the agency problems.) Those who argued most strenuously against unfettered shareholder access to hostile bids, for management's right to "just say no," have offered the visible hand of robust corporate governance instead of the market in corporate control as a solution to the agency problems of large public corporations. That is, the appropriate remedy for the problem of the potentially self-interested or incompetent managerial team is said to be the monitoring board. The major features are independent directors, specialized committees (especially an audit committee) consisting exclusively of independent directors to perform crucial monitoring functions, and clear charter of board authority. Some have additionally argued for stock-based compensation for directors, better to align their interests with

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[11] For a summary see Andrei Shleifer, An Introduction to Behavioral Finance 28-52 (2000).

[12] The suggestion that Enron's $90 stock price could be justified as the weighted average of investor expectations (e.g., a 50 percent chance that Enron was worth $180 a share, a 50 percent chance that it was worth nothing) is not consistent with the usual lemons equilibrium. Purchasers who are unable to determine whether the good is high or low quality assume they are purposefully being kept in the dark; they offer the low quality price, not an "average" quality price. (More technically, the value of Enron was not a "normally distributed random variable." At the very least the "low quality" outcome should have been much more heavily weighted than the "high quality" outcome.) Note also that the $90 stock price reflected a price-earnings multiple of 60. It is hard to imagine $90 per Enron share as the expected value of a probability distribution that gave significant weight to a low quality outcome.

shareholders.

Enron is an embarrassment for this position. Its board was a splendid board on paper, 14 members, only two insiders. Most of the outsiders had relevant business experience, a diverse set including accounting backgrounds, prior senior management and board positions, and senior regulatory posts. Most of the directors owned stock, some in significant amounts, almost all had received stock options or phantom stock as part of the director compensation package.. The audit committee had a state-of-the-art charter, attached to the 2001 Proxy Statement for all to admire, which made it the "overseer of the Company's reporting process and internal controls" and gave it "direct access to financial, legal, and other staff and consultants of the Company" and the power to retain other accountants, lawyer, or consultants as it thought advisable. But if the report of the Enron Special Investigation Committee is accurate, the board was ineffectual in the most fundamental way, the Audit Committee particularly somnolent if not supine. It turns out that the independence of virtually every board member, including audit committee members, was compromised by side payments of one kind or another.[13] Independence was also compromised by the bonds of long service and familiarity.

Obviously one bad board does not an argument undo, but it does reveal a certain weakness with the board as a governance mechanism. Much is made of the heuristic biases of investors that undercut the reliability of stock market prices, but Enron reveals that the heuristic failings of small groups may be even more pronounced. The gap between what the Enron board knew and could have/should have known is far greater than the valuation gap between intrinsic and market values that typically emerge from competitive markets (one-third, Fisher Black famously suggested). Things at Enron appeared to be going so well and management told such a convincing story that tell-tale signs of trouble – the proposal to suspend the corporate ethics code to permit conflicted transactions by a senior executive, an extraordinary request, really – didn't stir the antennae. Skepticism, suspicion, healthy scrutiny were inconsistent with the board's culture. Yet this sort of cognitive dissonance, which is probably wide-spread at corporations that appear successful, is also probably very common even at corporations in some trouble. Boards always seem to think that hostile bids undervalue the firm.

The Enron board failure may also reveal a certain tension in the current modes of director compensation and selection. Recruitment of directors who are qualified to be board members of a large public company may require substantial compensation, especially for directors on time-consuming or high profile committees such as the audit committee. Yet high levels of compensation may compromise director independence, since a director's sharp questioning of senior management

[13] See Joanne S. Lublin, "Inside, Outside Enron, Audit Committee is Scrutinized," Wall St. J., Feb. 1, 2002, C1.

may led to subtle pressures against his/her renomination. Stock-based director compensation is also a double-edged sword: it may both enhance the board's vigor as a shareholder agent but also increase its ambivalence about uncovering embarrassing facts that will reduce the share price. Finally, directors' independence can be compromised by both "soft conflicts," such as significant charitable contributions to an institution where a director may have a strong affiliation, or more direct conflicts, such as consulting arrangements. Both of these sorts of conflicts open the door to low visibility sanction, this time against director independence. The failure to renominate a director is high visibility, and, much as the accountant firing, may stir inquiry, whereas the making or not of a charitable contribution, or entering into or not of a consulting arrangement, are much lower visibility and thus in practice.may undercut independence even more.

One possible way to mitigate some of these tensions is to change the nominating and compensation practices for what might be called "trustee" directors in large public corporations. Even where the nominating committee consists of nominally independent directors, the CEO often plays a significant backstage role. Perhaps the members of the audit committee, for example, should, in ordinary course, be "self-nominated," that is, the committee should have the power to designate the managerial nominees for directors who will be expected to serve on the audit committee (except that a proxy contestant should have the power to make an initial designation of its own audit committee nominees). This would provide a useful safeguard of independence.[14] Compensation for audit committee members should be different, a flat fee (or time-charged) rather than incentive-based. Audit committee members are in real sense the corporation's compliance officers. To protect both the fact and appearance of their willingness to ferret out bad facts, they should not receive compensation closely tied to the corporation's profits or stock price. Finally, charitable contributions or other side payments related to a director's service should simply be eliminated, if not for all directors, then certainly for audit committee members and perhaps other "trustee" directors.

A group of "trustee directors" subject to different nomination and compensation rules differs, to be sure, from the usual U.S. pattern of generalist, non-representative, non-constituency directors. For example, employee-designated directors are a decided rarity in U.S. public corporations, found most prominently in an employee-owned firm like United Air Lines. The board's most important decisions typically involve matters of overall business strategy or executive leadership in which "trustee"-type considerations may not loom large and arguably a single-minded focus on shareholder value assures the best outcomes. But a trustee director class would not disrupt the functioning of the board. They would in all

[14] For another mechanism to protect director independence, see Ronald J. Gilson & Reinier Kraakman, Investment Companies as Guardian Shareholders: the Place of the MSIC In the Corporate Governance Debate, 45 Stanf. L. Rev. 985 (1993).

probability have the same general attitudes toward shareholder value as other directors, since ultimately they are elected by and accountable to the shareholders generally, not a particular constituency. Rather, they would be strengthened to function on behalf of shareholders in circumstances where independence from management may be crucial.

The "trustee director" approach may seem more attractive when compared to other approaches in light of Enron-type board failure. One alternative is to raise legal liability for directors for breaches of duty of care, or more particularly, breach of the duty of managerial oversight. This could be done in several different ways: expanding the circumstances in which liability might be attached,[15] narrowing the scope of director liability exculpation statutes to increase exposure to significant monetary loss, or, to similar effect, curtailing the availability of corporate indemnification or directors and officers liability insurance. Another alternative is to create mechanisms that more potently "forfeit" the reputational "bond" that directors allegedly post as guarantee of good performance. For example, in cases of significant board oversight failure, the SEC could bring a proceeding to bar the directors from serving on other public boards or institutional investors could work privately to establish such a practice. (A lesser sanction would be a disclosure requirement associated with director nomination of a party who had served on the board of a company sanctioned by the SEC for a serious disclosure violation.) Each of these alternatives depends upon accurate ex post determination of board failure and then the application of appropriate sanctions, monetary or reputational. It's a familiar move in the debate to observe that such measures may have the perverse effect of discouraging board service by the well-qualified, especially for corporations facing significant business challenges. By contrast, the "trustee director" approach is structural: it aims to affect the overall performance of the board by buttressing the particularly important role that certain directors must perform without changing the applicable legal duties. It represents the next stage in the evolution of board governance of the large public corporation, in which firms and mangers must anticipate the pressures (and temptations) of competitive capital markets.

An "audit committee" for public corporations is itself a relatively recent innovation, a product of the 1970s corporate governance movement.[16] In light of the increasing reliance on stock prices as the measure of both managerial performance and compensation, the audit committee has become an increasingly important institutional complement for the control of the associated moral hazard problems. If relatively small changes in earnings, or the growth rate of earnings, have significant impact on the stock price, and if management receives a significant

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[15] Cf. In re Caremark Int'l Inc. Derivative Litigation, 698 A,2d 959 (Del. Ch. Ct. 1996)

[16] See American Law Institute, Principles of Corporate Governance: Analysis and Recommendations, Reporter's Notes to § 3.05.

portion of its compensation through stock options, the temptations are obvious. Indeed, the increasingly widespread practice of "earnings management" was the basis for the SEC's very recent efforts to strengthen the role and accountability of audit committees [17] The Enron case reemphasizes the importance of audit committee independence and vigilance and suggests possible structural weaknesses in its present conception. Audit committees would be strengthened if their members were "trustee directors."

III. Stock-based Executive Compensation and Employee Compensation

Stock-based compensation has emerged as a major tool in the employment contracts, express and implied, for both senior managers and employees. The overly high-powered incentives of executive stock option mega-grants may have contributed to Enron's downfall.

Stock options have become an increasingly important element in executive compensation. In part this has developed from appreciation of the need to align managers' and shareholder' incentives to solve genuine problems of legitimately different perspectives. This has "finance" elements and "real" elements. On finance: Managers and shareholders start with different attitudes toward firm-specific risk. Managers generally make large firm-specific human capital investments in their firms and thus are risk-averse; shareholders in public firms are generally reasonably well-diversified (or at least have the opportunity) and thus are risk-neutral. Managers therefore might well chose projects with lower expected returns but less variance than shareholders would otherwise prefer. Executive stock options can solve this mismatch by compensating executives for the additional risk of the shareholder-preferred projects.

Stock options can also give managers particular incentives to undertake difficult measures that may even reduce the riskiness of the firm but that may be personally stressful. For example, competition inevitably means that large firms should exit from some losing businesses, close plants, redeploy assets and make other moves that will disrupt the lives of employees and other stakeholders – but that will increase the value of the firm. Stock options have also become a dominate mode of performance-based pay in which managers are rewarded for delivering good results to shareholders. They are favored in part because of a peculiar mismatch

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[17] See generally, Note, "Earnings Management, the SEC, and Corporate Governance: Director Liability Arising from the Audit Committee Report," 102 Colum. L. Rev. 168 (Gregory Rowland). Former SEC Chairman Arthur Levitt focused on audit committees as a governance reponse to earnings management in 1998. This led to a report of a "Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees" in 1999 and subsequent standard setting by the stock exchanges and rule-making by the SEC, effective in 2000.

between accounting and tax consequences: the grant of stock options is not booked as an "expense" that reduces accounting earnings yet when exercised produce a tax deduction for the firm equal to the difference between the market value of the stock and the exercise price of the option. Stock options can also serve a coordinating function among the senior management team, promoting team efforts to increase the value of the "firm" and mitigating the tendency to aggrandize one's own particular "division" of the firm. These are example of the "real" motives for stock options.

Stock options have also emerged as particularly important in contemporary mergers and acquisition practice because of the power that courts and legislatures have given to target boards to refuse a hostile bid. As I have previously argued, stock options have become the currency with which stockholders have bought back the endowment that courts and legislatures have so generously conferred on managements.[18] This works through the senior executive employment contract. At the outset of the contract the senior executive is given a pile of stock options that will vest over perhaps a ten year period, a golden handcuff you might say. But there is a crucial "acceleration clause" that provides for immediate vesting of the options in the event of a change in control. A 1980s executive who fought fiercely to preserve position, perquisites, and power is now quite willing to sell.

In each case executive stock options are used to solve a problem of incentive compatibility. But frankly no one really knows what is the optimal level of option grant: what level of stock option compensation will make an executive risk neutral like the shareholders, or willing to bite the bullet on layoffs or willing to accept a premium bid. Indeed, it's likely that each problem may have a different solution as to number, term, and exercise price. The optimal level may vary depending upon the utility curve of the particular executive, which may be affected, for example, by outside wealth. So at best the actual grant must trade off among a number of objectives. Nor is it realistic to think that the market in executive services functions very well in setting the level of option grants, particularly because the present accounting treatment of options makes them nominally costless to the corporation. But as option grants become increasingly larger, two pathologies may arise that look to have been at work in Enron: first, the fraudster, and second, the risk-preferring executive. (The more commonly identified problem, shareholder dilution, is merely distributive, not a potential threat to the existence of the firm.)

Stock options have value, of course, only if, at exercise, they are "in the money," meaning the stock price is above the exercise price. If option grants are very large and exercisable in the relatively near term, then a positive swing in the stock price can make the senior executives immediately very rich. Even if the stock price falls back, the well-timed executive option exercise is a life-changing

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[18] See Jeffrey N. Gordon, Poison Pills and the European Case, 54 U. Miami L. Rev. 839, 841 (2000).

experience. More formally, the Black-Scholes option pricing model instructs us that the value of the executive's stock option will be increasing both in the value of the underlying security and the variance (since stock options are issued "at the money"). So managers with a rich load of options have incentives to get the stock price high by any means necessary, fraud included. In particular, they have incentives to increase the riskiness of the firm, including projects that offer lower expected returns but higher variance. This will reduce the value of the firm for risk-neutral shareholders but has the potential to increase the value of managers' firm-related investments in cases where the gain in option holdings exceeds the loss to human capital. Managers become risk-preferring. Both pathologies – fraud and costly risk-taking – appear to have occurred in Enron. Enron became a hedge fund, taking leveraged bets in exotic markets that if successful would produce a huge, disproportionate bonanza for its executives. In particular, for a management team that had profited from previous option exercises, the downside seemed a problem only for the shareholders.

IV. Employee Stock Ownership and Retirement Planning

The Enron case exposes the weirdness of brigading employee stock ownership, used principally for incentive purposes, with employee retirement planning. First, employer stock is a strange tool for delivering incentives to employees. For all but senior management, the action of any individual employee will have negligible impact on the stock price. Even a major contribution to enhancing the profitability of a division is likely to go unnoticed in the consolidated results of a large public company. More precisely tailored pay-for-performance measures – bonuses, commissions, promotions, and other rewards for delivering specific results – are bound to be far more effective in providing incentives. Too stringent a focus on ownership of employer stock for its incentive effects may lead to employee disillusionment when strong individual efforts are not rewarded by a stock price increase. Rather, ownership employer stock may serve other organizational goals. The stock price, which reflects the public market's evaluation of the company, is a salient benchmark of the company's success. Management can use this focal point to rally the troops, to explain the need for difficult economic decisions, to build a sense of a common enterprise and common culture. The stock is a common currency within the company. Unlike a grand title or corporate power, it is infinitely divisible. Every employee can have some; it is "commons" stock.[19] Employer stock can also serve as a form of profit-sharing that does not require a cash outlay by the company and which receives favorable accounting treatment.

The tie-in to retirement planning makes employer stock particularly odd as an incentive device. Employer stock is typically placed to a contributory pension

[19] For a related view see Saul Levmore, Puzzling Stock Options and Compensation Norms, 149 Univ. Pa. L. Rev. 1901 (2001).

plan, for example, a 401(k) plan, or an Employee Stock Ownership Plan, which places strict limits on the employee's ability to sell the stock, and even after sale, locks up the proceeds until the employee's retirement. Thus the employee is required to take a very long view towards the benefits of employer stock appreciation.[20] Consumption is postponed a long time. In theory there should be substitution among various savings vehicles, so employer stock appreciation in a retirement account should reduce other savings, increasing the amount available for consumption, but the "mental arithmetic" seems not to work that way in practice. Note that this pattern is also very different from the incentives granted to senior managers: stock options and other stock-based compensation that begin to vest and become exercisable as quickly as one year after their grant. In other words, wealthier senior managers whose declining marginal utility should make them more likely candidates for incentives that pay off in the long run receive short-fused stock-based incentive compensation. If that is the right pay off horizon for incenting senior management, then the retirement planning link to stock-based incentives for line employees postpones the payoff long past the point of incentive compatibility.

The limited value of employer stock as an incentive device in these circumstances is, of course, the much less serious half of the retirement plan problem. Enron employees were heavily invested in employer stock in their 401(k) plans. An estimated $1.3 billion of the plan's $2.1 billion in pension assets consisted of now-worthless Enron stock.[21] To a significant extent this was the result of the peculiar accounting and tax incentives that reduced Enron's cost of pension contributions if it used its own stock combined with the pension plan rules that limited employee sales of Enron-contributed stock until age 50. Presumably those tax incentives could be redirected to reward greater diversification. But employee choices to remain undiversified also accounted for a significant portion of these losses. It is stunning the extent to which Enron's employees – probably much higher on the financial sophistication curve than most – chose to take on so much uncompensated firm specific risk.

Enron shows why we might regret the diminishment of the defined benefit pension plan and the shifting of retirement planning risk onto employees.[22] Defined

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[20] See generally Jeffrey N. Gordon, Employee Stock Ownership in Economic Transitions: The Case of United Airlines, in Klaus J. Hopt at al, Comparative Corporate Governance: The State of the Art and Emerging Research 433-34 (1998).

[21] Theo Francis & Ellen Schultz, Enron Faces Suits by 401(k) Plan Participants, Wall St. J., Nov. 23, 2001, C1. Of course these figures overstate the employees' "true" loss, since the value of Enron stock was pumped up by the accounting manipulations.

[22] See Jeffrey N. Gordon, Employees, Pensions, and the New Economic Order, 97 Colum. L. Rev. 1519, 1541-45 (1997); —, Individual Responsibility for the Investment of Retirement Savings: A Cautionary View, 64 Brooklyn L. Rev. 1037 (1998). For a polemical statement of the

benefit plans, which promise a fixed payout based on an employee's longevity with the firm and his/her final salary, are collateralized by funding requirements set by the Employee Retirement Security Act of 1974 (ERISA) and managed by fiduciaries who operate under a prudent investor standard that emphasizes the value of diversification. Defined contribution plans generally and 401(k) plans specifically are the fastest growing part of the private retirement planning universe.[23] Employees contribute a before-tax portion of their salaries, employers often match, especially with employer stock, but all the risk associated with the individual's management of his/her retirement savings is individually borne. Ironically the problem until recently is that individuals typically underweighted equities, preferring instead less risky bonds and other fixed income investments. Such conservatism meant that they would not attain retirement income targets. The Enron experience of a poorly diversified 401(k) plan – too much in employer equity – is of course just the opposite. It seems likely that the failures of individual retirement portfolio management will cluster around these two poles.

Since pension plans are voluntary with the employer, reform needs to avoid imposition of significant new costs. But the devolution to individuals of both the responsibility for retirement plan planning and the investment risk of their choices seems unwise.

Conclusion

The Enron matter will prove to be a very important event in the history of American shareholder capitalism. Many of the important institutions were subjected to a stress test and a particular firm and the outcome was poor. The real concern is that the gross overreaching at Enron is symptomatic of troubling if not egregious behavior elsewhere. Already reform seems on the way, in the restructuring of accounting firms and the establishment of a new self-regulator; in clearer standards under GAAP about the treatment of particular financing vehicles; in new elements of mandatory disclosure; in efforts to redefine "independent director." But Enron also reminds us that there is a problem that can't be solved but can only be contained in the tension between imperfectly fashioned incentives and self-restraint.

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concern, see William Wolman and Anne Colamosca, The Great 401(k) Hoax," (forthcoming 2002 from Perseus Publishing).

[23] See Council of Economic Advisors, Economic Report of the President 71 2002

Practice Administration: Notification of Threatened or Actual Litigation, Governmental or Professional Investigations, Receipt of a Subpoena, or Other Requests for Documents or Testimony (Formal or Informal), Statement No. 780

October 1999

1.0 Background and Purpose

1.1
The purpose of this Policy Statement is to address the procedures to be followed with respect to prompt notification of all litigation, investigation, and subpoena situations to the Arthur Andersen Legal Group ("AA Legal Group"). Section 2.0 outlines the process for notification of threatened or actual commencement of litigation, governmental and/or professional investigations. Section 3.0 outlines the process to be implemented upon receipt of subpoenas or other requests for documents or testimony.

1.2
Strict compliance with the following procedures is critical. Effective coordination and management of AA's defense and handling of subpoenas can only be achieved if the notification procedure is followed without exception. Without such prompt notification, AA may not be able to resolve or minimize problems before litigation is commenced and/or preserve all of its rights and options.

2.0 Procedures To Be Followed Regarding Notification of Threatened Or Actual Litigation, Governmental or Professional Investigations

2.1
This section sets forth the notification procedures to be followed in those situations where professional practice litigation against AA or any of its personnel has been commenced, has been threatened or is judged likely to occur, or where governmental or professional investigations that may involve AA or any of its personnel have been commenced or are judged likely. This section also sets forth certain notification procedures to be followed if a payment is to be made (either in cash or in services, including fee adjustments) to resolve a problem situation with a client.

2.2
These procedures are also applicable if individual AA personnel are named in any threatened or pending litigation or investigation involving AA's professional practice. This Statement deals not only with professional practice matters (i.e., relating to AA's Service Categories: ABA, TLBA, BC and GCF), but also, with litigation involving administrative matters, including without limitation, fee collections.

2.3
Prompt notification to the AA Legal Group office that serves your Area 2 shall be made in the circumstances and in the manner described below in Sections 2.4 - 2.10.

2.4
Institution of Legal Action against AA or Its Personnel - Notification shall be made promptly to both the Chicago office of the AA Legal Group and the relevant Area office of the AA Legal Group along with a copy of the relevant court papers (e.g., summons and complaint, writ, statement of claim) whenever litigation is commenced against AA or AA personnel. This policy applies not only when AA is named as a defendant (either directly by a plaintiff, or by another defendant, i.e., as a third party defendant) but also when counterclaims are made against AA in actions brought by AA, as in an action for collection of fees.

2.5
Threatened Legal Action - Notification to the relevant Area office of the AA Legal Group as well as to the relevant practice director or their functional equivalent should also be made promptly whenever legal action against AA or AA personnel is threatened or appears imminent or likely. [Please refer to Exhibit 1 for examples of circumstances to be reported pursuant to this paragraph.]

2.6
Potential Institution of Legal Action by AA - Consultation with the relevant Area office of the AA Legal Group must be made prior to the commencement of any legal action by AA, including without limitation, an action for collection of fees.

2.7
Potential Settlement of Dispute in Absence of Litigation - Consultation with the relevant Area office of the AA Legal Group must be made prior to proposing an arrangement to make either a cash payment or to provide free or reduced rate services (including fee adjustments) in order to resolve a practice problem. The tax aspects of a proposed arrangement involving a cash payment should be carefully reviewed with the appropriate HOTD and Tax Practice Director or their functional equivalent. In such a situation, the relevant Area office of the AA Legal Group must be involved since a properly prepared release in these types of situations is of great value to AA. As a general matter, AA will insist upon receiving a written release of any claims related to the practice problem prior to making a payment, agreeing to provide services or agreeing to forgive unpaid fees.

2.8
Governmental Investigations - Notification to the relevant Area office of the AA Legal Group should be made promptly when AA personnel become aware of investigations involving a client or former client and AA or any AA personnel, (e.g., investigations by a federal or state grand jury, the FBI, the Justice Department, the SEC or the IRS in the United States; the RCMP or the Department of National Revenue in Canada; the Department of Trade and Industry or the Inland Revenue in the United Kingdom, court-appointed receivers or liquidators and similar agencies in these or other countries). Where a subpoena is

served upon AA to compel the attendance of AA personnel at a hearing or deposition or for the production of documents in connection with such an investigation, the procedures set forth in Section 3.0 of this Policy Statement regarding receipt of a subpoena or other requests for documents or testimony must be followed.

2.9
Professional Investigations - Notification to the relevant Area office of the AA Legal Group should be made promptly when any professional society or regulatory body (such as the AICPA, a state CPA society, the ICAEW or similar professional society or any State Board of Accountancy or similar regulatory agency) investigation is commenced or threatened or a complaint is filed against AA or AA personnel.

2.10
Legal Action Relating to Charitable or Not-For-Profit Activities - Notification to the relevant Area office of the AA Legal Group should be made promptly when any AA personnel are named or threatened to be named as defendants in any action arising out of such person's service to a non-client charitable or not-for-profit organization.

3.0 Procedures To Be Followed Regarding Received Of A Subpoena Or Other Request For Documents Or Testimony (Formal Or Informal)

3.1
This section sets forth the process that each country and office should have in place for handling service of (i.e., delivery) and response to a subpoena or other requests for documents or testimony, including requests or demands, whether informal or formal, from government agencies, stock exchanges or any other third parties (herein referred to collectively as "subpoena(s)") that are addressed to AA as well as those addressed to specific individuals.3 This process applies to any and all such subpoenas - civil and criminal.4 5 6

3.2
Each office should establish a subpoena log in order to track and document pertinent information relating to each and every subpoena that is delivered, e.g., date and time the subpoena was served and accepted, the case name listed on the subpoena, the name of the individual who accepted service, the type of service (e.g., hand delivery, marshal's service, mail or courier), to whom and when the subpoena was circulated, the date when the subpoena was faxed to the relevant Area office of the AA Legal Group and information regarding confirmation that the subpoena was received and assigned to someone in the AA Legal Group. Exhibit 2 attached hereto is an example of such a log.

3.3
As part of this process, a person should be designated in each office as the individual who is authorized to accept service of subpoenas on behalf of AA for that office (the "authorized individual"). There should also be a "back up" individual designated who is also familiar with this process in the event that the authorized individual is absent from the office. It is important that the existence of the process and the identity of the authorized individual are properly communicated to everyone in the office, especially receptionists and other employees who may have a higher chance of contact with marshals or other process servers.

3.4
When a marshal or other process server attempts to serve a subpoena addressed to AA at one of our offices, the authorized individual should be notified immediately. The authorized individual (or the back-up designee) should be the ONLY person in that office authorized to accept service on behalf of AA. **The authorized individual should not, under any circumstance, accept service of a subpoena that names a specific individual. In such a case, the named individual should be contacted immediately to accept service personally. If the named individual is not present, the process server should be advised of this fact. If the process server leaves such a subpoena despite being advised that the named individual is not present, written notation should be made of the circumstance.**

3.5
Upon acceptance of a subpoena (whether accepted by the authorized individual or a person specifically named in a subpoena), notation should be made on the actual subpoena reflecting the date and time the subpoena was served as well as the identity of the person making the notation.

3.6
A copy of the subpoena should then be faxed promptly to the relevant Area office of the AA Legal Group, and circulated to the Market Circle Leader, Office Managing Partner, relevant engagement partner, Practice Director or their functional equivalent, and the head of the practice in that office. The Practice Director or their functional equivalent should consider the need to advise the Service Category Managing Practice Director or their functional equivalent. In certain countries, the Country/Regional Managing Partner may want to receive a copy.

3.7
After faxing the subpoena to the relevant Area office of the AA Legal Group, the authorized individual should follow-up by telephone or Lotus Notes with the relevant Area office of the AA Legal Group to confirm that the subpoena was received and that it has been assigned to someone for handling in the relevant Area office of the AA Legal Group. The authorized individual must receive positive confirmation of receipt and assignment from the relevant Area office of the AA Legal Group either via Lotus Notes, an Octel or a live conversation. All of this information should be recorded in the subpoena log so that the relevant information can be tracked both by the office and the AA Legal Group, if necessary.

4.0
No communication with anyone external to AA regarding receipt of the subpoena, including the related client and/or a client's internal or external counsel, should be made without prior consultation with the relevant Area office of the AA Legal Group. Similarly, no action should be taken with respect to responding to the subpoena, including without limitation production of documents, agreeing to appear for testimony, etc., without prior consultation with the AA Legal Group.

5.0
The guidelines and procedures outlined herein constitute the controlling AA BU guidance relating to the subject matter of this AA BU Policy Statement. Any other guidelines or procedures established at the Area, Region or Country level, or with respect to a specific Service Category, are supplemental and should be issued as Country Supplements to this Policy Statement, subject to the approval process outlined in Policy Statement No. 110-2.

6.0
Any questions with respect to these procedures should be directed to the relevant Area office of the AA Legal Group.

7.0
REFERENCES:

AA BU PS No. 630 - Collection of Accounts Receivable
AA BU PS No. 690 - Serving as an Expert Witness
AA BU Audit Objectives and Procedures – Section 2
AA BU PS No. 720 - Risk Management
AWP No. 107 - Legal Counsel
AA U.S. ABA Bulletin No. 99-11 - Management of Sensitive Client and Professional Issues

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Notes

1. Although this Statement deals with matters relating to the Arthur Andersen Business Unit ("AA"), it is possible that certain notifications, subpoenas, etc. relating to AA may refer to Andersen Worldwide ("AW") or Andersen Consulting ("AC"). These should also be handled as set forth in this Statement, i.e., forwarded to the AA Legal Group. Upon receipt of these matters, the AA Legal Group will forward them on to the appropriate individuals at AW or AC.

2. For the Americas, contact the AA Legal Group in Chicago at (312) 931-4391 (Facsimile: (312) 462-8021). For Asia/Pacific, contact the AA Legal Group in Hong Kong at 852-2853-9196 (Facsimile: 852-2543-9472). For EMEIA, contact the AA Legal Group in Paris at 33-1-55-61-0994 (Facsimile: 33-1-55-61-0999).

3. There are other AA policies that provide guidance regarding non-litigation-related requests for access to AA files. These policies and procedures are set forth in Chapter 1, Section 2 of Audit Objectives and Procedures ("AOP"). In responding to these types of requests for access to files, there is no need to consult with the relevant Area office of the AA Legal Group prior to providing access as long as the guidance set forth in Chapter 1, Section 2 of AOP are followed AND there is no threat of potential litigation or other potential problem associated with the release of files in these situations. If however, for any reason, you believe there to be any risk associated with the release of files in these situations, you should consult with the relevant Area office of the AA Legal Group prior to producing any documents.

4. This Policy Statement applies to all subpoenas served on AA or AA personnel including those related to Litigation Support and expert engagements as well as employee administrative matters.

5. Prompt notification to the relevant Area office of the AA Legal Group is also critical in those unusual circumstances where demands for documents and/or testimony are made in the form of search warrants or seizures, as well as those exceptional situations where arrest warrants for AA personnel are issued. Such requests and/or demands often require an office to comply immediately or at best, in a relatively short time period. Every effort should be made to cooperate with government officials in these situations. At the same time, immediate notification to the relevant Area office of the AA Legal Group is critical in order for counsel to assess the situation and develop a strategy to properly respond to the demand.

6. The procedures set forth in this Policy Statement apply to requests for AA historical information as well as policies and procedures when such requests are related to any situation covered by this Statement, (e.g., materials contained in Research Manager, the AARD, Subject File Riders, training course lists or descriptions).

EXAMPLES OF SITUATIONS TO BE REPORTED

Any situation that may result in a claim being made against the Firm related to services provided to clients of the Firm previously or currently should be reported pursuant to Paragraph 2.5 of this Policy Statement. Examples of such situations include, but are not limited to, the following:

- notification from clients, third parties or their counsel threatening legal action against the Firm;
- serious oral threats from clients or third parties to make a claim against the Firm;
- oral indications from management or owners that the Firm was somehow responsible for the failure of operations or the failure to detect fraud;
- the subsequent discovery of material events that cause us to withdraw or amend a previously issued report or opinion;
- the restatement of prior financial results by an attest client;
- significant criticism, either oral or written, of the quality of our work for a client by:
- regulatory authorities (i.e. securities commissions);
- government officials or significant elected representatives;
- other accountants
- seizure of client files by securities regulators or other government bodies;
- notices, warnings, disciplinary actions against the Firm partners or personnel regarding the quality of professional work;
- indications by management of insolvent/bankrupt enterprises, or guarantors of their debts, that they make take action against the Firm;
- the receivership/bankruptcy of a client subsequent to the issue of an auditors' report which did not include a going concern modification;
- Notice of Assessment or Re-Assessment in response to returns prepared/reviewed by the Firm where it appears that the Firm may have made an error;
- situations in which any taxation authority is proposing to, or has, assessed income or any other tax, or is denying a deduction or credit, contrary to prior advice given by us where that prior advice may now appear to be deficient in any way; and
- situations in which any taxation authority is suggesting that any representations made by us on behalf of a client are inaccurate, incomplete or misleading.

Example of Subpoena Log
Referred To In Section 3.2

Date	*Who Signed*	*How Received*	*Name Of Case*	*Copies Delivered To*	*Date Faxed to Legal*	*Confirmation Received*

Practice Administration: Client Engagement Information -- Organization, Retention and Destruction, Statement No. 760

February 2000

1.0 Background and Purpose

1.1
The confidentiality and proper management of client engagement information is critical to the Arthur Andersen Business Unit (AA BU). This Policy Statement describes our policies with regard to protecting the confidentiality of client information through its creation, active use to support or defend our work, and destruction.

1.2
The policies described in this memo relate to hard copy and electronic documents and files and client information used or produced by AABU personnel in providing arranged services to clients. While the specific guidelines employed by service lines may vary based on the technologies employed, all current and future service lines should adhere to the guiding principles and policies described herein. It is the responsibility of each service line and Service Category to create and maintain policies and procedures consistent with this Policy Statement.

1.3
Certain Service Categories and service lines may wish to adopt different retention guidelines based on local regulations, customs and practices, confidentiality agreements or other privileged protections and arrangements. If different guidelines are appropriate, it is the responsibility of the heads of these groups to obtain approval from the Managing Partner - Global Risk Management and communicate these different guidelines as appropriate.

1.4
More specific guidance can be obtained from other documents published or utilized by the AA BU relating to the use and confidentiality of client information such as the Personnel Reference Binder, Ethical Standards/Independence, Audit Objectives and Procedures and Service Category/Line Policies and Procedures.

2.0 Executive Summary

This Statement establishes critically important policies that enable us to protect confidential client information, retain it as needed to support or defend our work, and eliminate or destroy it when it is no longer needed. The following summarizes the significant policies expressed herein; however, it is necessary to read the entire Policy Statement for a complete understanding.

1. Material pertaining to each engagement will be contained in one central file (hard copy and/or electronic). (Section 3.1)

2. This central file will not include any personal or gratuitous information. (Section 3.1)
3. Engagement information is the property of the AA BU and will not be copied or electronically transferred to personal files of any AA personnel. (Section 3.10)
4. Only final documents will be retained; drafts and preliminary versions of information will be destroyed currently. (Section 3.5)
5. The legal and professional requirements in each country will determine the type of material, and the retention period required for engagement files. These requirements may vary by service line. In the U.S., such files will be generally retained for six years (see Exhibit A). (Section 4.4)
6. Engagement material not to be retained permanently (see Exhibit A) will be destroyed after the required retention period, subject to the approval of the engagement partner or division head. (Section 4.5)
7. Voice messages recorded in Octel or other voicemail systems must be deleted monthly or sooner. (Section 4.1.2(d))
8. Deletion of information from electronic files will be accomplished in such a way that precludes the possibility of subsequent retrieval by AA personnel or third parties. (Section 4.6)
9. In cases of threatened litigation, no related information will be destroyed. (Section 4.5.4)
10. Each country, office and service line should review their documentation, retention and destruction policies, assess where they are, develop a plan for getting into compliance with the principles of this Policy Statement, and monitor compliance on an ongoing basis.

3.0 Guiding Principles

3.1
One Central Engagement File

3.1.1
Only one central file (electronic, hard-copy or combination) will be maintained for the storage of engagement and related documents. This central file will contain all information related to the engagement.

3.1.2Multiple copies of engagement documents should not exist. Each person needing access to engagement documents should follow a process to obtain documents from the central file. The central file should contain only that information which is relevant to supporting our work. It should not contain gratuitous comments or personal information.

3.1.3At the end of the engagement, all electronic documents in all locations should be reviewed and any of continuing significance should be included in the central file area. All other documents stored in any other location should be deleted. The central file area should then be moved to a permanent storage area such as a CD and then deleted. This permanent media should be stored with the hardcopy workpapers.

3.2
Compliance with Country and Governmental Regulatory Requirements

All our document retention and destruction practices should adhere to the applicable country, legal, professional and regulatory requirements. Should any of the policies in this statement violate such requirements, we should adhere to the applicable country legal requirements, and advise the Managing Partner - Global Risk Management of the departure from this policy.

3.3
Standard Classification and Indexing System

While no specific system is mandated, a well-designed system should use the same organization structure for both hard copy and electronic documents to facilitate retrieval and easy application of the retention/destruction policy.

3.4
Retain Only Essential Information

3.4.1
Information gathered or considered in connection with performing client engagements should be evaluated by the engagement partner and manager, and only essential information to support our conclusions should be retained.

3.4.2
Management of each service line should develop and publish documentation standards indicating the types of information that should be retained.

3.4.3
It is the engagement partner's responsibility to assure compliance with these standards.

3.5
Timely Document Destruction

3.5.1
Engagement documents (in whatever form -- paper, electronic, voice) must be destroyed in accordance with the destruction guidelines set forth in Exhibit A.

3.5.2
The "central file" objective is crucial to accomplishing this objective, and to having confidence that it has been accomplished.

3.5.3
Information having relevance to our opinion or findings should be part of the central client engagement files. Drafts and preliminary versions of memos and reports, superseded workpapers, backup diskettes, and other types of

information not in the central client engagement files should be destroyed when they are no longer useful to the engagement and no later than when the engagement is completed. Draft versions of documents should be discarded or deleted at the time the final document is completed. Individuals who create these drafts are responsible for destroying them. Exceptions to this may exist in situations where the pre-final versions are the working papers (the source documents for supporting our work) in which case they should be retained.

3.5.4
Engagement personnel may want to advise clients of our destruction policy in order to eliminate their reliance on our files for prior year information.

3.6
Appropriate Discarding of Confidential Information

3.6.1
Each office should have appropriate procedures for handling wastepaper that ensure that wastepapers are securely handled after they leave the office and that confidential papers are burned, shredded or otherwise safely and completely destroyed.

3.6.2
For electronic files, appropriate techniques (such as "absolute delete") should be used to make sure the data cannot be reconstructed from the storage mechanism on which it resided.

3.7
Generic Form

Copies (or portions) of engagement-related documents that AA saves for research, template, risk management, training, best practices or other similar purposes must be saved in a generic manner -- e.g., client names changed to fictional names ("ABC Corp"). This is to avoid inadvertently disclosing client information.

3.8
Compliance

3.8.1
Global Risk Management will be responsible for assuring compliance of each Service Category with this Statement. This may be accomplished through the practice review program, internal audit or other appropriate means.

3.8.2
Each country, office and service line should review their documentation, retention and distribution policies, assess where they are, develop a plan for getting into compliance with the principles of this Policy Statement, and monitor compliance going forward.

3.9
Local Procedures

The Director - Administration for each office is responsible for the implementation of a comprehensive file management program that includes systematically controlling files during their lifetime. This means proactively managing records a) at creation, b) during the active use and c) during destruction or movement to off-site retention facilities. This Statement generally refers to the "office" as the implementor of those policies; in some geographical areas, a country or a group of offices may be the responsible entity.

3.10
Personal Use of Client Information

It is a violation of AA BU policy for personnel to use or access client engagement materials, with no substantial business purpose. Engagement information is the property of Arthur Andersen, and will not be moved, copied or electronically transferred to personal files.

4.0 Procedures

This section contains the following information and guidelines:

4.1 Indexing Workpapers, Reports and Electronic Information
4.2 Storage of Working Papers, Reports and Electronic Information
4.3 Highly Sensitive Information
4.4 Retention Guidelines
4.5 Destruction Guidelines
4.6 Suggestions for Deleting Electronic Data
4.7 Delay of Destruction

4.1
Indexing Workpapers, Reports and Electronic Information

4.1.1
Hard copy working papers and reports should be indexed by the Files Department of each office as they are received. The Files Department (Files) will assign an index code to each file.

(a) An index code is composed of two parts - the Firm client code (see Firmwide Client List), and a file number. The file number should consist, at a minimum, of the two digits of the year (e.g., 98 for 1998), plus a number serially assigned to each file received for that year. It may be useful to assign additional code letters or numbers as a prefix or suffix to the file number to further distinguish the contents of the file (i.e., report, working papers, etc.), and/or the

practice to which the file pertains. For instance, the first tax file received for 1998 tax work for XYZ Company, Inc., might be indexed XYZ123-TR981. This could indicate a 1998 tax return ("TR") file.

Once an office adopts a numbering system, it should be applied to all new files to establish uniform indexing.

(b) Where there is more than one file on an individual engagement, the partner, manager or senior may want the files indexed in a particular sequence which will be convenient for future reference. To do this, all workpapers for that engagement should be sent to the File Department at the same time, accompanied by a listing of the files in the order in which file numbers are to be assigned to them. If the individual sending papers to the Files Department wishes to index them in advance, he or she may request that the Files Department reserve numbers for that purpose.

(c) Working papers and reports of associated entities are filed under their unique client code.

4.1.2 Electronic data should be indexed and stored as described below, or stored on appropriate storage media and included with the hard copy workpapers. The file covers on the hard copy files should indicate the location of any related electronic information.

(a) Information Retained on the Network

Information retained on the network should be filed by client.
All client files stored on a networked file server should be stored in a manner as follows:
J:\division\client\year\filetype\documents

If the network is accessible by multiple parties, the data should be stored in a manner as follows:
J:\division\ptr\mgr\client\year\filetype\documents

This standard format will facilitate locating documents and will ease identifying documents ready to be destroyed within the defined timeframe. It will also reduce the risk of duplicate copies or multiple versions that are accidentally retained.

Documents can be password protected, if appropriate, to help safeguard the information. In exceptional cases, data can be stored off-line on disks or CDs to prevent access from unauthorized individuals.

(b) Information Retained on PC Hard Drives

All client files stored on PC hard drives should be indexed as follows: c:\data\client\year\filetype\documents

This information should be eliminated when it is no longer useful. At that time, the appropriate engagement documents should be stored on the network or on appropriate storage media filed with the hard copy workpapers.
(c) Information Retained on Engagement Site LANs

See Chapter 1, Section 2 of Audit Objectives and Procedures (AOP) for ABA policies regarding information on ELAN.

(d) Information Retained on Voicemail

Any supporting documentation on voicemail should be converted to electronic or hardcopy memo and filed with the engagement documents. Accordingly, voicemails should not be retained for longer than 30 days.

(e) Complete Files Retained Together

All engagement items should be placed in the hard copy file at the time the file is submitted to the Files Department for storage. The hard copy file should be complete, including any electronic files. Only final versions of data should be stored in the file. Printed copies can substitute for electronic copies and e-mail.

4.2

Storage of Working Papers, Reports and Electronic Information

4.2.1

The following policies apply to the storage of working papers:

(a) Current files should be stored in the office before transfer to storage; older files may be placed in storage outside the office in space provided by the office building or in a public or rented warehouse. Local offices can determine the number of years to retain on site.

(b) Reasonable protection against fire and other hazards should be provided in storage areas by the use of metal doors, fire-retardant walls, or other devices.

(c) Appropriate listing and indexing of such files should be maintained to facilitate access to them when required.

(d) Once approved for filing by the engagement partner or manager, sign-out procedures should be established to control the access and location of such files.

(e) Appropriate procedures should be established to prevent unauthorized access to working papers in client locations, our office or in public storage. Such papers contain confidential information, and the integrity of that information must be maintained. Accordingly, client information should not be left overnight on desks, floors, etc.

(f) In-office storage areas should be securely locked after hours. Public or rented warehouse space should not be available to persons other than AA personnel or authorized warehouse employees as necessary to file or retrieve files.

4.2.2

Methods of storing network backup, archive and other related tape, are covered fully in the AA Admin Binder, and should be referred to when developing destruction procedures for each location.

4.2.3
The following procedures ordinarily should be followed for the storage of electronic CDs or diskettes:

(a) CDs or diskettes will be used only for a specific client. Storing of multiple client data files on the same CDs or diskettes should be avoided.

(b) CDs or diskettes should be stored in our hard copy working paper files. For 8½ x 14 inch and other sized working paper files, a cardboard/vinyl diskette storage board should be used. For 8½ X11 inch and other sized binders, vinyl - holder inserts should be used. These supply items can be obtained through Central Purchasing.

(c) Each CD or diskette and any separate working paper files of printouts, etc., should be labeled with:
Client Name and Client Code
Fiscal Year-End or Period of Project
Project Name
Date of Last Update

(d) When backup copies of the CDs or diskettes and related documentation are deemed necessary, they should be stored offsite. If this is not practical, the backup copies should be kept in a separate protective cabinet outside of the General and/or Division file departments. These backup copies should also be controlled and indexed.

4.2.4
The engagement partner is responsible for assuring that all unnecessary information is destroyed before storage of client files (hard-copy and electronic).

4.3
Highly Sensitive Information

Because all client information within our organization is considered confidential, attempts to classify such information by degree of confidentiality or to provide differing protective procedures generally are to be avoided. However, where unusually sensitive information is involved or when a client specifically requests that we exercise extra precaution with respect to the confidentiality of certain information, or where the files are subject to attorney-client or accountant-client privilege, the procedures detailed below apply:

(1) In most cases, the material in question should be placed in the regular files under seal and should be labeled indicating the restrictions on opening it.

(2) In rare and extreme cases (such as investigations of officers of companies, or in cases involving public personalities), the information relating to such investigations may be highly restricted so that only approved access to such information is permitted. In these situations, the AA BU "Secretary Files" can be used to restrict access to such

data. Counterparts to the AA BU Secretary Files are maintained in each office under the direction of the Office Managing Partner (OMP) so these files do not leave the individual office.

(3) When the AA BU Secretary Files are used for this purpose, the restricted information should be indexed "AA BU Secretary File C-8" for client files.

(4) When information or a file is deposited in the AA BU Secretary Files under such circumstances, the file should carry a label indicating:

(a) the name of the entity;

(b) a general description of the information;

(c) the names of partners and managers having knowledge of the material; and

(d) to whom and under whose direction such information can be disclosed.

(5) When highly sensitive information (as described above) is deposited in the AA BU Secretary Files of an office, a file front (in the case of working papers) or a report cover (in the case of a report) must be filed and indexed in our regular files without any contents except reference to the AA BU Secretary File. In most cases, the only document appearing in the regular files will be a copy of the letter to the AA BU Secretary Files. In this way, our regular files will include a record of all papers and reports while at the same time providing methods by which access to their contents may be completely restricted.

(6) In the case of files subject to the attorney-client or accountant-client privilege, Service Category specific procedures may apply.

The confidentiality of information entrusted to us should be conscientiously protected in all phases of our professional activities.

4.4
Retention Guidelines

4.4.1 When working papers are no longer needed to support or defend our work, they should be destroyed. As a general rule, all working papers should be retained for six years and then destroyed. This period is predicated upon legal statutes of limitations in the United States.

4.4.2 File retention requirements in the Service Categories and service logs are summarized on Exhibit A. The retention periods apply to both electronic and hardcopy information. Exhibit E contains policy suggestions for

Electronic Data Retention. Each country management should determine if these exhibits should be revised for their practices. If different practices are appropriate, the Global Risk Management Group should be advised.

4.4.3 All client-related files, such as those containing correspondence, or other records and documents, should be retained until not useful. Material contained in client folders or other files maintained by individual partners and managers should be purged, and out-of-date papers and information should be destroyed in accordance with the procedures established in this Statement. However, no client-related materials in any files should be retained more than six years unless the related working papers prepared in connection with a professional engagement for a particular client are also required to be retained.

4.4.4 Assurance and Business Advisory (ABA)

Generally, the purpose of preparing and retaining ABA working papers is to provide documentation and evidence in support of a professional report. They should not be retained beyond the period of their usefulness for this function as set forth in Exhibit A. Historical information about a client's accounts and financial statements should be available from client records, and our working papers are not a proper permanent source of such data.

4.4.5 Tax, Legal and Business Advisory (TLBA)

Our Tax and Business Advisory (TBA) work involves much more than preparation and review of income tax returns. Accordingly, we impose on all our TBA services the same standards of practice that we prescribe for our income tax return engagements, except where those standards clearly have no application.

Tax working papers provide a medium to accumulate reference material necessary to provide documentation in support of tax work products such as tax returns, tax opinions, refund claims, protests, etc. They also provide support for decisions made regarding matters affecting a client's tax posture. Such working papers should not be retained beyond the period of their usefulness for these functions as set forth in Exhibit A. Historical information regarding such matters should be available from client records, and tax working papers are not a proper permanent source of such data. Positions taken and elections made on tax matters are evident from copies of the relevant tax work products themselves.

See Section 5 of -Tax and Business Advisory Services Policies and
Standards - Worldwide for additional policies related to tax files and working papers and file contents.

Working papers, documents and files related to the Legal Practice will be retained according to the regulation, customs and practices of the legal profession in each country. Accordingly, the Country Tax and Legal Partner should prepare a country supplement outlining the policies to be followed. In this connection, it should be noted that many law firms retain client information until termination of their relationships and, in other cases, may destroy information shortly after completion of an assignment. See Legal Practice Worldwide Bulletin - 97.04 for general standards of documentation.

4.4.6 Business Consulting and Global Corporate Finance (BC and GCF)

The major purpose of retaining BC and GCF working paper files is to provide documentation to support a recommendation made or conclusion reached on a particular engagement. Such papers should not be retained beyond the period of their usefulness for this function, as set forth in Exhibit A. Other material (e.g., copies of source documents, reports, and organization charts) should be left with the client or destroyed at the conclusion of the engagement unless they are a necessary part of that support.

4.4.7
Other Service Lines

Special considerations may apply to certain service lines and retention periods in certain lines may be requested by the client (particularly law firms) or the courts, in which cases the Global Risk Management Group should be advised.

4.5
Destruction Guidelines

4.5.1
The destruction of all working papers and electronic data must be accomplished in such a way as to prevent the data from falling into unauthorized hands and to prevent any possibility of reconstruction from partially destroyed files.

4.5.2
The procedures outlined below are to be followed with respect to the destruction of hardcopy working paper files. Cremation, shredding, mulching or pulping procedures are preferable. Where available, commercial facilities that are bonded and that provide proof of destruction should be used for destruction of records:

(a) Once each year, the Director - Administration in each office will initiate a comprehensive file listing, organized by service line, to be used with respect to ABA, TLBA, BC and GCF working papers which are anticipated to be destroyed under the normal retention policies set forth above.

(b) The Office Managing Partner or area Service Category Head is to issue a working paper file destruction memorandum (see Exhibit B) each year reemphasizing the BU retention polices and requesting each partner in the office to identify within 30 days any files among those anticipated to be destroyed which should be retained. These exceptions must be approved by an area Service Category Head and be supported by sound reasons. The memorandum will advise each partner as to where the comprehensive listing discussed in the preceding paragraph is available and reemphasize the relevant criteria discussed earlier in this Statement. As deemed necessary by the Managing Partner - Office (or Service Category Head), this circulation may include the partners transferred to other offices in recent years or engagement partners from referring offices.

(c) The Managing Partner - Office (or Service Category Head) is to determine the most practical means to make the comprehensive file listing available for partner review and to assure materials (if any) required to be retained under the policy guidelines set forth above are identified.

(d) Each partner is responsible for identifying materials to be retained (if any), and for responding to the working paper file destruction memorandum in writing (see Exhibit B), listing the files (if any) which should be retained, and the reason retention is appropriate.

(e) The Director - Administration will make arrangements for the destruction of all materials not specifically identified for retention based on a review and compilation of all the partner responses and will coordinate any required follow-up procedures necessary to be certain all partners have responded.
(f) A responsible individual should check the files to be destroyed against the approved list, control the destruction process and prepare a summary of disposition of files (see Exhibit C) which is to be retained permanently in the office.

4.5.3
The primary purposes for retaining electronic information on diskettes or networks are to support conclusions, to provide a backup to the copy left with the client or for use in creating subsequent year working papers, carry forward balances, etc. This information should not be retained beyond the period of its usefulness for these functions, as set forth above.

Electronic information should be retained for the same reasons and periods, and destroyed at the same time and in the same manner as hard copy working papers. Electronic data can exist in a number of different locations such as on local area networks, Lotus Notes, servers, ELANs, Zip drives, PCs, archive tapes, backup tapes and diskettes. Destruction procedures need to be considered for all such media within your local office, and the Director - Administration should make sure all necessary destruction takes place. While the procedures necessary will need to change periodically, paragraph 3.6 suggests steps to make sure this happens.

The Director of Technology serving each office is responsible for developing procedures for destroying appropriate electronic data. Exhibit E shows the majority of current possible locations, along with suggestions for destruction techniques.

4.5.4
In the event the AA BU is advised of litigation or subpoenas regarding a particular engagement, the related information should not be destroyed. See Policy Statement No. 780 - Notification of Litigation.

4.6
Suggestions for Deleting Electronic Data

4.6.1

Establish a routine for "wiping clean" or destroying all tapes, disks and other media on which records reside that are not meant to be retained for future access -- such that the data is not retrievable.

4.6.2
Servers, desktop computers and laptops should be regularly purged of all unnecessary data.

4.6.3
Stored Lotus Notes messages, documents, databases and bulletin boards must be erased in accordance with prescribed limits on retention of such records.

4.6.4
Retention of back-up and archived file server records must be limited to the required standards -- as described in the AA Admin Binder. When tapes are "recycled" for future use, they must be effectively "erased" (using a bulk eraser or other effective method) so that the data is made unretrievable.

4.6.5
Retention rules regarding Personal Computer hard-drive documents, floppy disk back-ups, personal/desk files and home files must be complied with -- these "off-line" storage opportunities must be subject to similar discipline as the network systems.

4.6.6
Subject files, Smart and WIN Smart files, Proposal Toolkits, the TIKTS database and other such specialty/research/training/reference sources in the AA BU must be monitored and "purged" of material that relates to client engagements and has exceeded its normal retention period; if such materials have continuing usefulness, they should be made generic if they are to be retained.

4.6.7
Annual statements (Exhibit D) should be obtained from each person confirming that a) he/she has destroyed all extraneous files and documents regarding engagements worked on (or they have been generically retained in a particular specialty, research or reference database) and b) any client information that they have retained on their PC's, on disks or in other locations has been destroyed.

4.6.8
All other data storage areas on the network should be purged on a regular basis to aid in enforcing proper client files storage.

4.6.9
An AATS approved disk wiping utility should be used when computers are turned in for reassignment or disposal.

4.6.10

Any diskettes stored with working papers should either be destroyed or reformatted ("absolute delete") at the same time the papers are destroyed. Diskettes or other external storage media used off-site should be managed by the engagement manager or senior. Any client data that needs to be retained should be moved to proper storage areas on the office file server and the diskettes destroyed or reformatted. This should be done at the end of the job.

4.7
Delay of Destruction

4.7.1
The purpose of obtaining responses from the responsible ABA, TLBA, BC and GCF partners for all working paper files destruction is to assure proper consideration at the appropriate level of any reason why such files should not be destroyed and to synchronize the extended period of their retention if this is necessary. Reasons for extended retention might include regulatory agency investigations (e.g., by the SEC), pending tax cases, or other legal action in connection with which the files would be necessary or useful. In such cases, material in our files cannot be altered or deleted (See Policy Statement No. 780 regarding notification of litigation). Other reasons might include litigation involving AA or the client, the number of open tax years, the possible need for historical information regarding loss or credit carryovers, LIFO inventory calculations, or arrangements that may have been made with specific clients to retain working papers under special circumstances. In some cases, destruction may be delayed to conform with the period of retention required of the client for its records on a particular matter, if the period exceeds our policy retention periods.

4.7.2
If, in the judgment of the engagement partner(s), any working paper files should not be destroyed, notation to this effect and a brief description of the reason(s) therefore should be made in responding to the destruction request. Such information should be included in the office's annual summary disposition report (see Exhibit C) which should be reviewed annually thereafter (or at such later date as may be designated by the responsible partner(s)) for reconsideration.

4.8
Any questions related to this Statement should be directed to the Global Risk Management Group.

5.0 References

- Audit Objectives and Procedures - Section 2
- Ethical Standards / Independence- Chapter 1
- Tax and Business Advisory Policies and Standards - Worldwide
- Legal Practice Worldwide Bulletin No. 97-04
- AABU Policy Statement No. 780 - Notification of Litigation

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Exhibit A
Exhibit B
Exhibit C
Exhibit D
Exhibit E

Exhibit A
Client Engagement Information
Retention Guidelines for U.S. Practice

The information below summarizes the required retention periods for the U.S. Therefore, these policies may require modification for differing legal and professional requirements in other countries and service lines. Factors (which vary materially by country and by service line) relevant to the retention or destruction of working papers and other material include:

Custom and practice
Regulatory and statutory requirements
Statute of limitations
Legal ownership of working papers and other materials

The result is that each country and each Service Category and service line (or even, in some cases, possibly sub-service lines) potentially have differing requirements with regard to the need, or requirement, to retain working papers and other materials. The only practical approach is for our policies and procedures to be developed country by country and service line by service line. Lacking such, the policies outlined in this exhibit should be followed.

The appropriate Managing Partner - Country, in consultation with local legal counsel, is responsible for initiating any such required modifications and submitting them to the Global Risk Management Group for approval and distribution. However, in no event shall the retention period be shortened from the periods mentioned below if the engagement relates to work performed for an office in another country. . Only the information described below should be retained.

As discussed in par. 4.5.4 of AA BU No. 760, if advised of litigation or subpoena, no related information should be destroyed (see AA BU No. 780).

Service Line	Type of Material	Retention Period
ABA - Financial Statement Assurance	Client File (a)/Engagement Knowledge Base/CAF (purged annually of superseded or non-relevant documents) Audit Workpapers/Central File Office copies of reports and financial statements (d) Filings with Government agencies which include (physically or by reference) our reports, such as 10K's and Registration Statements filed with the SEC	Permanently (e) Six years Permanently (e) Permanently (e)
ABA - Business Risk Consulting and Advisory	Central File, including Working Papers Office Copies of Reports (d)	When no longer useful or needed to support an opinion. Maximum of Six years (f) Permanently (e)
ABA - AA Process Solutions	Central File, including working papers (Enterprise Center Clients) Office Copies of Reports and Financial Statements Filings with Government Agencies which include (physically or by reference) our reports, such as 10Ks and Registration statements filed with SEC CAFs Project File Documentation, including: .SMART documentation and risk management action plans . Job Arrangement Letter or Contract with appropriate terms . Contract change orders . Project work plans . Engagement QA partner review documentation . Project memoranda related to client discussions of	Six years (f) Permanently (e) Permanently (e)

	issues/problems and resolution . Supporting schedules, simulations, models, or other documentation that underlie final recommendations made or end products delivered . Client satisfaction documentation and survey forms	Six years (b)
TLBA - Tax and Business Advisory	Central File, including all Working Papers Income Tax Returns Tax Basis Studies Earnings and Profits Studies Estate Planning Studies Estate and Gift Tax Returns Office Copies of Attest Reports, including Third-Party Tax Opinions and Reports on Prospective Financial Information Continuing Tax Files (including all documents that have continuing importance)	Six Years (f) Six years (f) Permanently (e) Permanently (e) Permanently (e) Permanently (e) Permanently (e) Permanently (e)
TLBA - Legal	Central File, including Working Papers Office Copy of Report or Other Deliverable (d)	Customs and practices of legal profession in each country. The policy should be determined by the Head of Legal Services and approved by the Area Practice Director of Legal Services. Permanently (e)
BC	Project File Documentation . Risk SMART documentation and risk management action plans . Job Arrangement Letter with appropriate terms	Six Years (b)

	and conditions, signed by the client and AA . Contract change orders . Project work plans . Engagement QA partner review documentation . Project status meetings . Project memoranda related to client discussions of issues/problems and resolution . Supporting schedules, electronic simulations or models, and other documentation that underlie final recommendations made or end products delivered . Client satisfaction documentation and survey forms Office Copy of Final Report or Other Deliverable (d)	Permanently (e)
Complex Claims & Events (Litigation Support)	Project File Documentation, including: . Documentation to support that an adequate conflict search was performed . Risk SMART documentation . Job Arrangement Letter with appropriate terms and conditions, signed by the client and AA . Contract change orders . AP-150, including sign-off by engagement QA partner . Client satisfaction documentation and survey forms . Retention of specific supporting schedules are required by (i) Class Action Settlement Assistance, (ii) Insurance Insolvency Consulting and (iii) FEHB Settlement Negotiations. Contact the respective service line leader for more information Office Copy of Final Report or Other Deliverable (d)	Six Years (b) Permanently (e)
Federal Government Contacts Consulting	In addition to the guidelines provided for BC, contracts with the U.S. Government require the retention of certain documentation pursuant to Federal guidelines. Contact the Office of Government Services (OGS) for more information	As directed by OGS
Other Service Lines	Central File, including Working Papers	Six Years (b)

	Office Copies of Reports (d)	Permanently (e)

THESE NOTES ARE IMPORTANT - PLEASE READ

(a) The client file is a continuously updated file and includes the reports to support the accept/retain decision, ExCEED, Understanding the Business, Assess Client Risk Controls and Determining and Managing Residual Risk Processes. Per Section 2 of AOP, the engagement team must retain certain reports from the client file in the current year workpapers; retention of other reports is optional.
(b) Six years from the date of the financial statements covered by an audit report or supplemental reports, or the date of issue of special reports on prospective financial information, or other deliverables.
(c) The Office/Country Managing Partner, in consultation with the Global Risk Management Group, may choose to extend the period, if appropriate. In no circumstances, however, should the retention period be lessened.
(d) If our arrangement letter with the client includes legal liability limitation language, such letter should be included with the office copy of our report.
(e) As described in Section 4 of AABU Policy Statement No. 760, these items do not need to be retained permanently for lost clients. These items should be retained for six years after loss of client rather than permanently.
(f) Six years from the year-end of the relevant return unless a longer period is required by local law. However, if a return is under examination or in dispute, the relevant information should not be destroyed until final resolution or settlement.

Exhibit B
WORKING PAPER DESTRUCTION MEMO SAMPLE

To: EACH PARTNER AND PRINCIPAL

Subject: CLIENT INFORMATION (INCLUDING ELECTRONIC MEDIA) DESTRUCTION

ACTION REQUIRED BY JANUARY 20___

AABU Policy Statement No. 760, which establishes guidelines for the retention, storage and destruction of working papers, requires that certain client documents be destroyed after six years. Therefore, hardcopy and electronic files prior to 20__ will be destroyed this year. This includes files requested to be retained at previous destruction periods. If you are aware of any files that fall before the above years which should not be destroyed, it is your responsibility to inform the Director – Administration of those files by _____, 20__. Working papers to be destroyed include electronic media relating to the destruction period.

Our coordinator of the Files Department has prepared a comprehensive listing of all files planned for destruction this summer. A copy of this listing is available (in some specified location, or possibly attached in smaller offices) for your review.

Exceptions to the destruction process are set forth in Exhibit A to AABU Policy Statement No. 760. Any exceptions to the destruction of information should be decided by the appropriate audit partner, or in the case of lost clients, by the Office/Country Service Category Head.

If you are not certain that the CAFs contain important information of continuing value, such as LIFO base computations, acquisition cost allocations, details of book/tax depreciation and other book/tax differences, etc., it is your responsibility to see that this information is placed in the CAF prior to authorizing destruction of the working papers.

In the Tax, Legal and Business Advisory Division, the materials which pertain to open IRS examinations or pending litigation (and similar matters discussed in Section 4 of AA BU Policy Statement No. 760) should not be destroyed. It is the responsibility of the appropriate partner to inform the Director - Administration of those files which must be retained.
Please review the attached Exhibit A and immediately determine what files, if any should not be destroyed. If you are not sure whether working paper materials fall within the above guidelines, please consult with your Service Category Head, Director - Administration or, in certain instances, with the Managing Partner -- Professional Practice Litigation. If you have any other questions about these procedures, please contact the coordinator in the Files Department.

Each partner should complete, sign and date the attached form to signify concurrence with the planned destruction, or to specify those files to be temporarily retained. All forms should be returned to the Director - Administration by or before _____, 20__.

Your assistance and immediate action concerning this matter is appreciated.

_____

(Office/Country Managing Partner or
Service Category Head, as appropriate)

Enclosure: Exhibit A of AA BU Policy Statement No. 760

FILES DESTRUCTION

To: DIRECTOR - ADMINISTRATION

Subject: FILES DESTRUCTION

From: _____

_____ I have read the files destruction memo dated _____ and am not aware of any files that should be retained, based on the file destruction guidelines.

_____ I have read the files destruction memo dated _____ and have listed below the file(s) that should be retained, based on the file destruction guidelines.

_____
Signature

_____
Date

Files To Retain:

Client Name	CLIENT CODE	FILE NUMBER	YEAR(s)	RETENTION REASON

Exhibit C
SUMMARY OF ANNUAL DISPOSITION OF FILES
_____, 2000

FILE NUMBER	YEAR	FILES TO BE DESTROYED	FILES TO BE RETAINED	FILES NOT LOCATED *

Prepared by: _____
FILES DEPARTMENT

Approved by: _____
Director - Administration or Service
Category Head

* Column will normally be blank. Engagement partners should be notified in situations where files are lost, and a memo should be prepared describing the steps taken to find the files.

Exhibit D
Annual Statement
Regarding Destruction of Client Information

To: All Personnel

From: Service Category Head

Subject: Destruction of Client Information Under Personal Control

AABU Policy Statement No. 760 dated _____, 2000, establishes guidelines for destruction of client information both hardcopy and electronic. Each year, we confirm with all our personnel that they have followed the procedures, summarized below, to assure compliance with those guidelines. Please read the procedures below and return this statement to _____ confirming that you have complied with the procedures (for more detail, see Section 4 of the Policy Statement).

1. All personal network areas, ELAN areas, Lotus notes mailboxes and databases, computer hard drives and other electronic storage media under my control has been purged of any data over six years old (diskettes should be destroyed or reformatted using "absolute delete").

2. All files related to client work (except that currently in progress) have been transferred to the network or other appropriate storage location, and has been deleted from media under my personal control; and

3. All extraneous, duplicate or nonessential files and information have been deleted.

4. All Octel messages older than 30 days have been deleted.

_____

Signed

_____

Printed Name

Exhibit E
Policy Suggestions for Electronic
Data Retention

Each office is responsible for developing its own procedures for destroying appropriate electronic data.

Electronic client documents and files can reside in a number of locations, including local office servers, regional servers, engagement site LANs, laptop computers and various portable storage media. Policies and procedures need to be in place and implemented carefully to ensure that all client files are accounted for and properly stored and destroyed according to Firm guidelines. Additionally, your policies should be reviewed with the appropriate Director of Technology to assure they are appropriate. Guidance from the AA AdminBinder should also be considered.

Below is a listing of possible electronic client document and file locations, the impact of their location and recommended policies for proper handling of these files. These policies will need to be somewhat different in each location, based on the specific environment of that location.

Location	Risk	Recommended Policy
Local Office 4File Servers	Back up may result in data being maintained for longer periods of time than is appropriate. Data can be stored in multiple locations on the network, which increases risks that data is retained for inappropriately	Refer to the AA Admin Binder for appropriate file back up procedures. It is important that only one control copy of files (on j:) be maintained. Files stored on the g: drive on the servers should be purged at the same time the

	long time periods.	c: drive purging takes place, since g: would contain only personal copies of the data and not necessarily be targeted for archival/retention.
Lotus Notes Servers	Individual mail databases and other Lotus Notes databases, such as AA OnLine, reside on regional notes servers. These databases should never be the primary storage location for client files and information. DocMan is a Lotus Notes database designed to facilitate the management and storage of client workpapers and other electronic documents prepared in connection with an audit. All DocMan databases are placed on a special regional Notes server separate from all other Firm or local office developed databases. According to DocMan procedures, the current year workpapers will be archived at the conclusion of each engagement. Since the DocMan Notes servers backups are handled regionally instead of at the local office of the engagement team, the regional administrator will be responsible for timely client data destruction. Proposal Toolbox is a database that contains "Best Practices" copies of actual proposals that have been submitted. These proposals contain information about potential clients.	General Lotus Notes servers should be backed up in the same manner as local office network servers. . Individuals should remove Lotus Notes mail items that contain client information as quickly as possible. Once the current year workpapers are archived, these archived tapes must be properly stored and marked for timely destruction in the same manner as local office file servers Replace the actual names of the companies with "ABC Company" and remove any other descriptions in the proposal documents that would identify the company.
Engagement Site LANs	Engagement Site LANs (ELANs) will use JAZ drives, zip drives or laptop	Managers (or seniors) should, at the end of each engagement, retrieve or

	computers (acting as servers) for client document storage and backups. Duplicate copies or draft copies of these files are frequently left on individual laptop computers and typically not deleted until computers are turned in for reassignment, disposal or lease termination. Since ELANs often "travel" from client location to client location, the same document storage devices (zip drives or JAZ drives) will be used at several different client locations.	otherwise make sure that the only electronic files for that engagement are the final copies stored on the ELAN document storage device. Managers (or seniors) should make sure that the floppy, zip or JAZ drive discs that contain the final client electronic files are collected and taken to the local office and filed with the client workpapers at the end of the engagement. Destruction of these discs should be performed following policy guidelines. All discs that contain client electronic files that are not final should either be properly destroyed or securely deleted. Backups of permanent ELANs should be marked appropriately with the backup date and properly stored. These backups should be stored in a protected area and destroyed according to AA BU guidelines.
Individual Laptop Computers	Laptop computers can contain client documents in the c:\data\client subdirectories. These files can be drafts or duplicates of final copies that exist either on the network server or ELANs and have been backed up to tape or disc. Archived and replicated copies of Lotus Notes databases reside in the	No client documents should reside on an individual's computer if that individual is connected to a file server or an ELAN on a regular basis. After a client engagement is complete, and proper backups of final client workpapers have been performed, all client documents on a laptop must be deleted using the "absolute delete" utility. The laptop user should regularly review laptop copies and archives of Lotus

	c:\data\notes\ subdirectory. The potential exists for client information to reside in these locally stored databases. When an individual switches laptops, care must be exercised when moving data from one laptop to another to assure that old client data is not kept.	Notes databases for document retention/destruction purposes. The local offices should distribute yearly notices to all laptop users to "absolute delete" all client data that are a year or more old.
Word Processing Departments	Word processing departments may keep copies (both hardcopy and electronic) in addition to other copies that are maintained.	Word processing files should be reviewed annually for files that have met the destruction time frame

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Arthur Andersen LLP letter of response to Justice Department

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March 13, 2002

The Honorable Michael Chertoff
Assistant Attorney General
U.S. Department of Justice
950 Pennsylvania Avenue, N.W.
Room 2720
Washington, D. C. 20530

Dear Mr. Chertoff:

As you know, attorneys on your staff are considering the institution of criminal felony proceedings against Arthur Andersen LLP in connection with the destruction of documents related to the audit of Enron Corporation. Those attorneys have demanded that Arthur Andersen LLP decide by 9:00 a.m. tomorrow whether the firm will agree to plead guilty to obstruction of justice charges or face immediate indictment. We strongly believe that it would constitute an unprecedented exercise of prosecutorial discretion and a gross abuse of governmental power to bring a criminal proceeding against the firm in the circumstances of this case.

Prosecution of Arthur Andersen LLP would be extraordinary on several levels. The Justice Department proposes to proceed under an enormously expedited schedule, for no apparent reason. The Department has refused to allow the firm to tell its story to the grand jury, in violation of both Department policy and basic precepts of fundamental fairness — also for no apparent reason. Department lawyers have refused a request to meet tomorrow with principals of the firm to discuss their plans to prosecute. The Department proposes an action that could destroy the firm, taking the livelihoods from thousands of innocent Andersen employees and retirees; that will substantially reduce any possibility that claimants against the firm will obtain a recovery; and that will greatly diminish the chance for necessary reform of the accounting profession. Most remarkably, the Department plans to press forward even though there are alternative ways to proceed that would achieve *every* valid government objective while wholly avoiding harm to the innocent. In these circumstances, prosecution would be misguided, for several reasons.

First, Arthur Andersen LLP has resolved to undertake all of the comprehensive reforms proposed on March 11 by former Federal Reserve Board Chairman Paul Volcker and the Independent Oversight Board, including sweeping reorganization of the firm, its structure, its management, and its policies. Of particular relevance to the allegations under investigation, the reforms will result in greater centralization and control of audit teams, a critical change that would prevent the kind of document destruction that occurred this past fall in Houston. Furthermore, we are willing to enter into a joint resolution with the Department of Justice and the Securities and Exchange Commission that would include the following elements:

- Deferred prosecution of the firm and the appointment of a special monitor to oversee compliance both with a new document retention policy and with other reforms that would be approved by the Justice Department.

- Adoption of a remedy by the SEC that is directed at the firm's Houston office, where the document destruction was initiated and concentrated.

- Further discipline, including immediate separation from the firm of *all* individuals — at whatever level — who were responsible for the document destruction or whose failures of oversight and negligence made that destruction possible. We will follow the direction of former Senator John Danforth, who has been advising Arthur Andersen LLP on its document retention policies, to assure that appropriate disciplinary steps are taken against all those who deserve them.

Second, at the direction of Arthur Andersen LLP, two respected law firms, Davis, Polk & Wardwell and Mayer, Brown, Rowe & Maw, have undertaken a thorough investigation of the events underlying the document destruction. This investigation, which involved interviews with more than 80 persons and review of thousands of documents, revealed that the expedited effort to destroy documents was confined to a relatively few partners and employees of the firm and was almost entirely limited to the Houston office. None of the destruction occurred with the knowledge, much less the consent, of senior firm management. Indeed, even as to those few people who engaged in document destruction, there appears to be a dearth of credible evidence that they acted with the willful criminal intent to obstruct a governmental investigation. In this regard, we believe it is significant that the Justice Department has not revealed *any* information that is inconsistent with our understanding of the relevant fundamental facts.

Third, once Arthur Andersen LLP learned of the document destruction in its Houston office, it immediately notified the Justice Department and the SEC and has been cooperating fully with the official investigations ever since. In fact, the firm was prepared to impose penalties on the partners referenced in the preceding paragraph several weeks ago — but delayed doing so in deference to the Justice Department's investigation.

Fourth, although several Arthur Andersen LLP partners and employees unquestionably exercised poor judgment, a criminal prosecution against the entire firm for obstruction of justice would be both factually and legally baseless. The obstruction of justice statute, 18 U.S.C. § 1512(b), makes it a crime for anyone to "corruptly persuade[]" "another person" to destroy documents "with intent to impair" the use of the documents "in an official proceeding." There is absolutely no support for the allegation that the firm acted "corruptly," that it sought to persuade "another person" to destroy documents, or that it believed that any destroyed document would be used in an "official proceeding." See *United States* v. *Shively*, 927 F.2d 804 (5th Cir. 1991). During the last week, counsel for the firm repeatedly have asked Justice Department prosecutors to identify the partners or other Andersen personnel who acted "corruptly" and had the requisite criminal intent to withhold documents from an "official proceeding"; the Department's lawyers repeatedly have declined to provide a meaningful response to this critical question. Moreover, the Department has not suggested that any of the discarded documents — many of which have been retrieved — actually contained any incriminating information that could have materially advanced a governmental inquiry.

Fifth, and most important, it is beyond question that the institution of criminal felony proceedings would place the survival of Arthur Andersen LLP in grave jeopardy. If the Department's actions did destroy the firm, such an outcome would have catastrophic effects:

- The death of this 89 year-old firm would leave without their livelihoods many of the firm's 28,000 partners and employees — more than 99% of whom had no involvement in the events at issue — as well as its thousands of retirees.

- The death of the firm would create enormous harm for the firm's 2,300 audit clients (representing 17% of all public companies) by placing their current SEC filings immediately in jeopardy. This collateral consequence, among others, is described in

detail in a March 5 letter to Deputy Attorney General Thompson, a copy of which you received.

- The death of the firm would have a severe adverse impact on the accounting profession generally. It would eliminate the nation's fifth largest accounting firm and thus lead to further concentration in an already concentrated market. And it would kill any possibility that the sweeping reforms proposed by Chairman Volcker will be implemented — and with it, any chance that the accounting profession will undergo much-needed changes. See Exhibit A.

- The death of the firm would severely diminish its ability to provide some measure of compensation to thousands of claimants in other litigation against Arthur Andersen LLP. In fact, were it not for the Justice Department's criminal investigation, the firm undoubtedly would have reached a settlement with the SEC that would have dealt with these important issues in ways that would have greatly benefitted the public.

We submit that there is no basis for the government to take the unprecedented step of bringing criminal felony charges against Arthur Andersen LLP when the evidence of criminal misconduct on the part of the firm as an institution is so flimsy; when the firm has put in place structural and management changes that will fundamentally reform the way it does business; when the firm is prepared to agree to meaningful alternative sanctions and remedies that more effectively address the conduct at issue; when the firm voluntarily disclosed the conduct at issue, has been cooperating fully with the government, and is prepared to impose severe discipline on the partners and employees who engaged in questionable activities; and when the direct, immediate, and undeniable result of a criminal prosecution could be the demise of the firm, with calamitous consequences for literally tens of thousands of innocent people. Indeed, any fair reading of the Justice Department's 1999 policy statement regarding federal prosecution of corporations demonstrates that the resolution proposed in this letter is squarely consistent with existing standards governing the Department's exercise of its enforcement discretion. See Federal Prosecution of Corporations, Section II. We therefore urge you to explore whether an avenue is available that would serve the legitimate interests of the federal government without imposing irreparable injury on innocent citizens, the accounting profession, and the national economy.

We stand prepared to meet at any time with you or other representatives of the government to discuss these important matters. At a minimum, if the Justice Department insists on proceeding with its present course, we urgently request that you and the Deputy Attorney General agree to meet with the principal officers of Arthur Andersen LLP before deciding whether to impose the death penalty on the firm. We also request that the Department adhere to the policies set forth in the U.S. Attorneys' Manual (§ 9-11.152) by allowing a representative of the firm to offer testimony to the grand jury before the Department proceeds with a prosecution that will place at great risk this respected accounting institution.

Thank you for your consideration of this request.

Sincerely,

MAYER, BROWN, ROWE & MAW

Richard J. Favretto

cc: Deputy Attorney General Thompson
The Honorable Stephen Cutler
The Honorable John Danforth
The Honorable Paul Volcker
Leslie R. Caldwell, Esq.

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS

- - - - - - - - - - - - - - - - - - -X

UNITED STATES OF AMERICA,

-against-

ARTHUR ANDERSEN, LLP,

Defendant.

- - - - - - - - - - - - - - - - - - -X

CR H-02-121

INDICTMENT

Cr. No. _____
(T. 18, U.S.C., §§ 1512(b)(2) and 3551 et seq.)

THE GRAND JURY CHARGES:

I. ANDERSEN AND ENRON

1. ARTHUR ANDERSEN, LLP ("ANDERSEN"), is a partnership that performs, among other things, accounting and consulting services for clients that operate businesses throughout the United States and the world. ANDERSEN is one of the so-called "Big Five" accounting firms in the United States. ANDERSEN has its headquarters in Chicago, Illinois, and maintains offices throughout the world, including in Houston, Texas.

2. Enron Corp. ("Enron") was an Oregon corporation with its principal place of business in Houston, Texas. For most of 2001, Enron was considered the seventh largest corporation in the United States based on its reported revenues. In the previous ten years, Enron had evolved from a regional natural gas provider to, among

other things, a trader of natural gas, electricity and other commodities, with retail operations in energy and other products.

3. For the past 16 years, up until it filed for bankruptcy in December 2001, Enron retained ANDERSEN to be its auditor. Enron was one of ANDERSEN's largest clients worldwide, and became ANDERSEN's largest client in ANDERSEN's Gulf Coast region. ANDERSEN earned tens of millions of dollars from Enron in annual auditing and other fees.

4. ANDERSEN performed both internal and external auditing work for Enron mainly in Houston, Texas. ANDERSEN established within Enron's offices in Houston a work space for the ANDERSEN team that had primary responsibility for performing audit work for Enron. In addition to Houston, ANDERSEN personnel performed work for Enron in, among other locations, Chicago, Illinois, Portland, Oregon, and London, England.

II. THE ANTICIPATION OF LITIGATION AGAINST ENRON AND ANDERSEN

5. In the summer and fall of 2001, a series of significant developments led to ANDERSEN's foreseeing imminent civil litigation against, and government investigations of, Enron and ANDERSEN.

6. On or about October 16, 2001, Enron issued a press release announcing a $618 million net loss for the third quarter of 2001. That same day, but not as part of the press release, Enron announced to analysts that it would reduce shareholder equity by

approximately $1.2 billion. The market reacted immediately and the stock price of Enron shares plummeted.

7. The Securities and Exchange Commission ("SEC"), which investigates possible violations of the federal securities laws, opened an inquiry into Enron the very next day, requesting in writing information from Enron.

8. In addition to the negative financial information disclosed by Enron to the public and to analysts on October 16, 2001, ANDERSEN was aware by this time of additional significant facts unknown to the public.

- The approximately $1.2 billion reduction in shareholder equity disclosed to analysts on October 16, 2001, was necessitated by ANDERSEN and Enron having previously improperly categorized hundreds of millions of dollars as an *increase*, rather than a decrease, to Enron shareholder equity.
- The Enron October 16, 2001, press release characterized numerous charges against income for the third quarter as "non-recurring" even though ANDERSEN believed the company did not have a basis for concluding that the charges would in fact be non-recurring. Indeed, ANDERSEN advised Enron against using that term, and documented its objections internally in the event of litigation, but did

not report its objections or otherwise take steps to cure the public statement.

- ANDERSEN was put on direct notice of the allegations of Sherron Watkins, a current Enron employee and former ANDERSEN employee, regarding possible fraud and other improprieties at Enron, and in particular, Enron's use of off-balance-sheet "special purpose entities" that enabled the company to camouflage the true financial condition of the company. Watkins had reported her concerns to a partner at ANDERSEN, who thereafter disseminated them within ANDERSEN, including to the team working on the Enron audit. In addition, the team had received warnings about possible undisclosed side-agreements at Enron.
- The ANDERSEN team handling the Enron audit directly contravened the accounting methodology approved by ANDERSEN's own specialists working in its Professional Standards Group. In opposition to the views of its own experts, the ANDERSEN auditors had advised Enron in the spring of 2001 that it could use a favorable accounting method for its "special purpose entities."
- In 2000, an internal review conducted by senior management within ANDERSEN evaluated the ANDERSEN team assigned to audit Enron and rated the team as only a "2"

on a scale of one to five, with five being the highest rating.

- On or about October 9, 2001, correctly anticipating litigation and government investigations, ANDERSEN, which had an internal department of lawyers for routine legal matters, retained an experienced New York law firm to handle future Enron-related litigation.

III. THE WHOLESALE DESTRUCTION OF DOCUMENTS BY ANDERSEN

9. By Friday, October 19, 2001, Enron alerted the ANDERSEN audit team that the SEC had begun an inquiry regarding the Enron "special purpose entities" and the involvement of Enron's Chief Financial Officer. The next morning, an emergency conference call among high-level ANDERSEN management was convened to address the SEC inquiry. During the call, it was decided that documentation that could assist Enron in responding to the SEC was to be assembled by the ANDERSEN auditors.

10. After spending Monday, October 22, 2001 at Enron, ANDERSEN partners assigned to the Enron engagement team launched on October 23, 2001, a wholesale destruction of documents at ANDERSEN's offices in Houston, Texas. ANDERSEN personnel were called to urgent and mandatory meetings. Instead of being advised to preserve documentation so as to assist Enron and the SEC, ANDERSEN employees on the Enron engagement team were instructed by ANDERSEN partners and others to destroy immediately documentation

relating to Enron, and told to work overtime if necessary to accomplish the destruction. During the next few weeks, an unparalleled initiative was undertaken to shred physical documentation and delete computer files. Tons of paper relating to the Enron audit were promptly shredded as part of the orchestrated document destruction. The shredder at the ANDERSEN office at the Enron building was used virtually constantly and, to handle the overload, dozens of large trunks filled with Enron documents were sent to ANDERSEN's main Houston office to be shredded. A systematic effort was also undertaken and carried out to purge the computer hard-drives and E-mail system of Enron-related files.

11. In addition to shredding and deleting documents in Houston, Texas, instructions were given to ANDERSEN personnel working on Enron audit matters in Portland, Oregon, Chicago, Illinois, and London, England, to make sure that Enron documents were destroyed there as well. Indeed, in London, a coordinated effort by ANDERSEN partners and others, similar to the initiative undertaken in Houston, was put into place to destroy Enron-related documents within days of notice of the SEC inquiry. Enron-related documents also were destroyed by ANDERSEN partners in Chicago.

12. On or about November 8, 2001, the SEC served ANDERSEN with the anticipated subpoena relating to its work for Enron. In response, members of the ANDERSEN team on the Enron audit were

alerted finally that there could be "no more shredding" because the firm had been "officially served" for documents.

THE CHARGE: OBSTRUCTION OF JUSTICE

13. On or about and between October 10, 2001, and November 9, 2001, within the Southern District of Texas and elsewhere, including Chicago, Illinois, Portland, Oregon, and London, England, ANDERSEN, through its partners and others, did knowingly, intentionally and corruptly persuade and attempt to persuade other persons, to wit: ANDERSEN employees, with intent to cause and induce such persons to (a) withhold records, documents and other objects from official proceedings, namely: regulatory and criminal proceedings and investigations, and (b) alter, destroy, mutilate

and conceal objects with intent to impair the objects' integrity and availability for use in such official proceedings.

(Title 18, United States Code, Sections 1512(b)(2) and 3551 et seq.)

A TRUE BILL

FOREPERSON

JOSHUA R. HOCHBERG
ACTING UNITED STATES ATTORNEY
SOUTHERN DISTRICT OF TEXAS

LESLIE R. CALDWELL
DIRECTOR, ENRON TASK FORCE

By:
Samuel W. Buell
Andrew Weissmann
Special Attorneys
Department of Justice

Updated analysis on the Justice indictment of Andersen: The government's factual and legal errors

March 15, 2002

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Read the March statement by Arth Andersen, LLP or indictment.

Also, read the tex letter to the Depa of Justice from th lawyers at Mayer Rowe & Maw pric indictment.

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The indictment of Arthur Andersen, LLP is riddled with factual and legal errors establishing that the government's case entirely lacks substance.

The government's central allegation is that Arthur Andersen, LLP as a firm engaged in a coordinated, pervasive, firm-wide effort to destroy documents. *That claim is false and is wholly unsupported by the facts*. It is significant that the allegations of the indictment are couched in broad, vague, and conclusory terms; they offer no detail at all, and fail *even to identify by name* the higher-ups at Arthur Andersen, LLP who the government believes masterminded the document destruction. That is because the government has no facts to support its allegations. Perhaps that is why the government refused to allow Arthur Andersen, LLP to address the grand jury.

The reality is that the document destruction was initiated and in very substantial part carried out by the Enron engagement team in Houston. The government mentions three other Arthur Andersen offices in an attempt to draw a picture of firm-wide misconduct. In fact, it is undisputed that the destruction of documents in two of those offices took place *at the direction of the Houston Enron team*, without the knowledge of anyone else at the firm. Documents were discarded in the third office mentioned by the government *on the advice of counsel*; this activity had nothing to do with the expedited destruction of documents in Houston that most concerns the government.

In particular, the government's specific misstatements include the following:

A. Allegations involving document destruction

The allegations relating to the destruction of documents – in particular, paragraphs 10 and 11 – are the heart of the indictment. These allegations are either wrong or grossly misleading.

1. **Allegation:** The indictment alleges in paragraph 10 that Arthur Andersen partners on the Enron engagement launched "a wholesale destruction of documents" at Arthur Andersen's Houston office on October 23, 2001 and that "Andersen employees on the Andersen engagement team were instructed by Andersen partners and others to immediately destroy documentation relating to Enron."

Facts:

- **The documents were destroyed *before* Arthur Andersen, LLP received a subpoena.** The indictment does *not* allege that materials were discarded after Andersen received a subpoena from the SEC, when the rules clearly required retention of documents. In fact, Andersen lawyers issued a comprehensive order to preserve Enron-related materials immediately upon receipt of the subpoena. The destruction occurred pre-subpoena, at a time when Andersen personnel could reasonably have thought that disposing of routine documents was proper. That they might have been confused on this point is not surprising: Harvey Pitt – now the

chairman of the SEC – himself wrote a law review article explaining that it is "*once a subpoena has been issued, or is about to be issued,* [that] any existing document destruction policies should be brought to an immediate halt." There is no reason that Andersen's personnel would have had any different understanding of their obligations/

- **It is very significant that the government *fails even to allege* that this activity was directed, suggested, or countenanced by Arthur Andersen's management in Chicago, or even by anyone in Houston outside the Enron engagement team.** In fact, there is absolutely *no* evidence that *anyone* on the Enron engagement team consulted with *any* senior Arthur Andersen officials – in Chicago, Houston, or elsewhere – about the destruction of documents, either before the activity began or while it was taking place.

- **The indictment carefully says nothing either about the circumstances in which the documents were destroyed or about what documents were destroyed.** In fact, the shredding and related activity occurred in broad daylight, without any effort to conceal the conduct. Consistent with usual practice, an administrative staff person reviewed the trunks and boxes before they were shredded to ensure that no workpaper files were destroyed. The decision regarding which particular documents and e-mails to discard generally was left to individual engagement team members, as it normally was when workpaper files were finalized; there is no evidence of which we are aware that staff were instructed to destroy particular kinds of documents.

- **The indictment carefully says nothing about what documents were destroyed.** It does not specifically allege, for example, that any of those documents in fact concerned the narrow subject of the SEC's inquiry (related party transactions involving Andrew Fastow). Nor does the indictment specifically allege that any of the discarded documents were either significant or incriminating – an omission that is telling because an enormous volume of deleted materials *have been recovered and are in the government's hands*. In fact, so far as can be determined, the paper and e-mails that were destroyed during the week of October 22 were of the type that ordinarily would be discarded at the end of an audit assignment when the workpaper files are completed.

- **The vast bulk of Arthur Andersen's Enron materials were retained.** To put in perspective the indictment's claim that "[t]ons of paper" were shredded, Arthur Andersen actually retained an enormous volume of documents and electronic files relating to Enron. Approximately 1500 boxes of desk files (containing an estimated three million sheets of paper) and hundreds of thousands of e-mails have been collected from the offices of Andersen personnel who worked on the Enron engagement. In addition, Arthur Andersen has been able to retrieve thousands of additional e-mails that had been deleted by relying on backup computer tapes that Andersen retains. So far as can be determined, none of these discarded documents contain incriminating "smoking guns." Andersen's central workpaper files relating to Enron also have been preserved and contain approximately 4800 official files and reports. Because of the tremendous volume of materials that have been preserved, the type of materials that normally would be destroyed, and the successful efforts to retrieve deleted e-mails, it is not possible to conclude that any of the document destruction that occurred in October and early November 2001 actually resulted in the loss of important accounting information.

2. **Allegation:** The indictment alleges in paragraph 10 that "[d]uring the next few weeks" after October 23 "an unparalleled initiative" to destroy documents was undertaken.

Facts: The vast bulk of document destruction took place during a single week following October 23. Deletion of documents tailed off dramatically during the following week and

came to an almost complete halt the week after that.

3. **Allegation:** the indictment alleges in paragraph 11 “instructions were given to Andersen personnel working on Enron audit matters in Portland, Oregon, Chicago, Illinois, and London, England, to make sure that Enron documents were destroyed there as well.”

Facts: This allegation is extremely misleading. The indictment carefully uses the passive voice – “instructions were given” – without stating *who* gave them or the context in which they were given. In fact, in two of the locations cited by the government, limited destruction took place *at the direction of the Enron engagement team in Houston*. In a third case, documents were discarded *in response to legal advice* and were tailored in a plain attempt to comply with Arthur Andersen’s document policy. Nothing in these events offers any support at all for the allegation that Arthur Andersen management or headquarters directed – or knew of – the document destruction activities.

- **Portland.** The indictment offers absolutely no details about document destruction in Portland – and that is because, on examination, there is absolutely nothing incriminating to allege. In fact, during the week of October 23, an Arthur Andersen employee on the Enron engagement team in Houston sent a voice-mail to an employee in Arthur Andersen’s office in Portland, Oregon, that led that *one* employee to delete Enron-related e-mails. That employee then forwarded the message to other Portland partners and managers who worked on Enron matters. When the lead partner on the Enron engagement in Portland and the Portland practice director learned of the voice-mail, however, *they instructed their team to disregard it*. There is no evidence that any additional documents were destroyed pursuant to the request from Houston. This episode does not demonstrate any firm-wide, coordinated program of document destruction; in fact, it proves the contrary.

- **London.** During the week of October 23, at the same time that the meetings addressing document clean up took place in Houston, two Enron engagement partners in Houston called a partner in Andersen’s London office who previously had been based in Houston. In response to that call, instructions were given in London to clean up Enron-related files. The indictment characterizes this as “a coordinated effort by Andersen partners and others, similar to the initiative undertaken in Houston.” But it is telling that the indictment does *not* describe any documents actually destroyed in London, does *not* give the amount of any such documents, and does *not* say how many people were involved in such efforts.

- **Chicago.** The indictment baldly alleges, without any elaboration at all, that “Enron-related documents also were destroyed by Andersen partners in Chicago.” On examination, it is clear why the government offers no details: the activity in Chicago was not concentrated during the week of October 22, was not coordinated in any respect with the document destruction in Houston, Portland, and London, and *did* involve routine efforts to comply with Andersen’s document retention policy.

The facts: In late September and early October 2001, some members of Andersen’s Professional Standards Group in Chicago participated in discussions of Enron accounting matters with Andersen attorney Nancy Temple; in these discussions, Temple reminded the PSG accountants that, under the Andersen document retention policy, superseded drafts of memos should be discarded. In response to this advice, PSG members discarded Enron-related materials beginning in the second week of October – *before* the SEC request for information on October 17. In addition, there does not appear to have been *any* attempt to coordinate document deletion efforts by PSG personnel. Some PSG accountants deleted only a portion of their Enron-related e-mails, retaining those that they considered to be useful precedents; others deleted e-mails as the particular accounting issues to which those e-mails related were resolved and documented in a final workpaper memorandum; others completed all of their deletions *prior* to October 17. Indeed, one partner deleted a collection of e-mails only after confirming that Temple would preserve a hard copy set of the materials – which she did. There is absolutely nothing suspicious in

this.

B. The conduct alleged is not criminal

In addition to its factual deficiencies, the indictment does not establish that a crime was committed by anyone. The offense alleged is obstruction of justice under 18 U.S.C. § 1512 (b), which makes it a crime for anyone to "corruptly persuade[]" another person to destroy documents "with intent to impair" the use of documents "in an official proceeding." These elements are not present here, for several reasons.

- **The indictment does not show that *anyone* acted with criminal intent.** There is no doubt that some Andersen personnel in Houston exercised extremely poor judgment in encouraging or permitting the expedited destruction of documents during a sensitive period for Enron. But those Andersen personnel may well have acted, not to frustrate any SEC inquiry, but to comply with the Andersen document policy at a time when their work was coming under scrutiny by senior accountants within the firm. That policy directed firm personnel to document and preserve their audit workpapers in one central file and to dispose of all other work product, such as e-mails, drafts, and personal notes. The policy required that these non-essential materials be destroyed as they became expendable during an engagement and no later than when the central file was finalized. The policy added that, in the event Andersen is "advised of litigation or subpoenas regarding a particular engagement, the related information should not be destroyed." But the policy did not expressly address those circumstances in which Andersen is not a party to litigation or the subject of a government investigation.

- **There was no "official proceeding" going on to obstruct.** The indictment alleges that Andersen personnel intended to impair the SEC informal inquiry relating to Fastow's related party transactions. But the SEC letter that was sent on October 17, which simply asked for information from Enron and specifically stated that "[t]he Commission has not determined that the matters hereby under inquiry involve violations of the federal securities laws," plainly was too informal and preliminary to qualify as an "official proceeding" within the meaning of the statute. See *United States v. Shively*, 927 F.2d 804 (5th Cir. 1991).

- **Under the governing law, there were no "corrupt" methods used to persuade anyone to destroy documents.** That makes the government's theory insupportable.

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U.S. District Court
TXS - Southern District of Texas (Houston)

CRIMINAL DOCKET FOR CASE #: 02-CR-209-ALL

USA v. Duncan

Filed: 04/09/02
Dkt# in other court: None

Case Assigned to: Judge Lynn N. Hughes

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defendant

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Disposition

Pending Counts:
18:1512B.F Obstruction of Justice
(1)
Offense Level (opening): 4
Terminated Counts:
NONE
Complaints:
NONE
U. S. Attorneys:
U S Marshal - H
FTS n
713-718-4848
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DOCKET PROCEEDINGS

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DATE	#	IMG	DOCKET ENTRY
4/9/02	1		INFORMATION as to David Duncan (1) count(s) 1 , filed. (pg) [Entry date 04/09/02]
4/9/02	2		NOTICE of Related Litigation by USA as to David Duncan , filed. This case is related to CR H-02-121, assigned to Judge Melinda Harmon. (pg) [Entry date 04/09/02]
4/9/02	3		Arraignment held before Judge Melinda Harmon Ct Reporter: Traylor App: Weissmann f/govt; Seymour and Flynn f/dft David Duncan count 1 (Defendant informed of rights.) , filed. Plea of Guilty: count 1 Bond set at $1,000 PR. Sentencing set for 8/26/02 at 1:30 before Judge Lynn Hughes. (ck) [Entry date 04/09/02]
4/9/02	4		WAIVER OF INDICTMENT by David Duncan , filed. (Signed by Judge Melinda Harmon),entered. (ck) [Entry date 04/09/02]
4/9/02	5		PR BOND with Order Setting Conditions of Release entered by David Duncan Amount $1,000.00, filed. (Signed by Judge Melinda Harmon) (ck) [Entry date 04/09/02]
4/9/02	6		Cooperation Agreement as to David Duncan, filed. (ck) [Entry date 04/09/02]
4/9/02	7		ORDER for Disclosure of PSI , PSI completion by 7/22/02 for David Duncan, Objection to PSI due 8/5/02, Final PSI due 8/21/02, Sentencing set for 1:30 8/26/02 before Judge Lynn N. Hughes (Signed by Judge Melinda Harmon), entered. Parties ntfd. (ck) [Entry date 04/09/02]
4/9/02	8		MOTION by attorney Gandolfo V. DiBlasi to appear pro hac vice as to David Duncan , filed. (lb) [Entry date 04/11/02]
4/9/02	9		MOTION by attorney Samuel Whitney Seymour to appear pro hac vice as to David Duncan , filed. (lb) [Entry date 04/11/02]
4/10/02	10		TRANSCRIPT filed in case as to David Duncan for Rearraignment Hearing for dates of 4/9/02 before Judge Melinda Harmon, filed. (Court Rptr: Anne Traylor)(loose in file) (ks) [Entry date 04/11/02]

4/16/02 11 Receipt for Surrender of Passport as to David Duncan Passport # 132024248 Country: USA , filed. (lb) [Entry date 04/16/02]

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