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### Enron's Tangled Web: Complex Relationships; Unanswered Questions

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#### Recommended Citation

Heminway, Joan MacLeod, Enron's Tangled Web: Complex Relationships; Unanswered Questions.  
Available at SSRN: <https://ssrn.com/abstract=491962>

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## ENRON'S TANGLED WEB: COMPLEX RELATIONSHIPS; UNANSWERED QUESTIONS

Joan MacLeod Heminway\*

*Oh what a tangled web we weave, When first we practise to deceive!*  
—Sir Walter Scott<sup>1</sup>

### I. INTRODUCTION

The “Enron affair,” as it has come to be known,<sup>2</sup> depicts in all its gloriousness and goriness, like no other set of related circumstances in recent memory, the interaction between the complex, interlocking relationships in a public company’s corporate structure and unguided federal efforts for legislative and regulatory reform—a “tangled web” to be sure.<sup>3</sup> Among other things, an exploration of the operation of these interlocking and overlapping corporate relationships during Enron Corp.’s most critical days exposes potential weaknesses in the management and control, and overall governance, of one of our country’s most favored investment vehicles, the publicly held corporation.<sup>4</sup> The various identified problems beg for responses.

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1. MARMION, Canto vi, Stanza 17.

2. See, e.g., Andrew Countryman, *401(k)s Still Heavy in Company Stock*, CHI. TRIB., Nov. 3, 2002, at C1 (“Perhaps the most enduring legacy of the Enron affair is the decimated 401(k) accounts of thousands of Enron workers.”); Carol Emert, *Line Forms to Replace Fallen Pitt*, THE SAN FRAN. CHRON., Nov. 7, 2002, at B1 (“obstruction of justice in the Enron affair”); Robert Kuttner, *Free Markets are Great—But not for Electricity*, BUS. WK., Oct. 14, 2002, at 34 (“The Enron affair forced Congress and the Securities & Exchange Commission to stiffen regulation of accounting standards and corporate governance.”); Esther Schrader, *The Nation; Crisis in Corporate America; Army Secretary Defends Role at Enron*, L.A. TIMES, July 19, 2002, at A18 (“It was the first time White has been asked to testify on Capitol Hill about the Enron affair.”); *SEC Releases Rules for Public Comment*, THE HOUSTON CHRON., Nov. 20, 2002, at 2 (“Auditor independence was among the issues at the heart of the Enron affair . . .”).

3. Although this author would like to take credit for first conceptualizing the image of a web to describe the set of relationships involved in the corporate structure, several scholars already have used this image to describe these very same relationships. See Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 700 (1982) (stating that the entire corporate structure “is a web of agency relationships”); John H. Matheson, *Corporate Governance at the Millennium: The Decline of the Poison Pill Antitakeover Defense*, 22 HAMLINE L. REV. 703, 709 (1999) (referencing “the web of agency relationships constituting the corporate structure”).

4. Professors Ayres and Choi note:

Investing in the United States has become a hobby for many. Individual ownership of equity, moreover, has increased over the past decade due in part to the introduction of internet-based trading. While providing the possibility for greater returns compared with bank savings accounts, among other investment alternatives, the public capital markets also pose greater risks for investors.

Make no mistake. The federal legislative reaction to these perceived weaknesses has been swift and decided, for better or for worse.<sup>5</sup> Law teachers and casebook authors, for example, struggle to stay apace with the seeming legion of new regulations that have emanated from the Securities and Exchange Commission (SEC)<sup>6</sup> by dictate of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley).<sup>7</sup> Of course, practitioners also are scrambling to keep up with the evolving law and regulation in this area, albeit with the more cheerful thought, whether consciously or unconsciously, that legislation and regulation on this large a scale is tantamount to a “Full Employment Act for Lawyers.”<sup>8</sup>

Even in the wake of the highly publicized corporate scandals at Enron Corp., Global Crossing Ltd., WorldCom Inc., and others, however, one cannot help but wonder whether this—or any—further federal legisla-

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Ian Ayres & Stephen Choi, *Internationalizing Outsider Trading*, 101 MICH. L. REV. 313, 314 (2002); see James A. Fanto, *Regulatory Implication of Individual Management of Pension Fund: Comparative Investor Education*, 64 BROOK. L. REV. 1083, 1093 (1998) (“investing, for better or for worse, is part of U.S. culture”); Mark Klock, *Two Possible Answers to the Enron Experience: Will It Be Regulation of Fortune Tellers or Rebirth of Secondary Liability?*, 28 IOWA J. CORP. L. 69, 75 (2002) (“a significant proportion of the U.S. population owns publicly traded stocks directly or indirectly”); Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1, 18 (1994) (noting that “the liquidity of the public markets . . . has been one of the primary advantages of modern public corporations as an investment vehicle”); Bruce A. Wolfson & Warren S. Green, *Financing Heavy Duty II: Accessing the U.S. Capital Markets*, 17 N.Y.L. SCH. J. INT’L & COMP. L. 413, 418 (1997) (“The United States capital markets remain the largest and most liquid in the world.”).

5. See Michael A. Perino, *Enron’s Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002*, 76 ST. JOHN’S L. REV. 671, 671 (2002) (describing the Congressional reaction to the recent accounting scandals as “stunning and surprisingly swift”).

6. See, e.g., 17 C.F.R. §§ 205.1-7 (2003) (attorney conduct); 17 C.F.R. § 228.303(c) (2003) (disclosure regarding off-balance sheet arrangements); 17 C.F.R. § 228.401(c) (2003) (disclosure regarding audit committee financial expert); 17 C.F.R. § 228.406 (disclosure regarding codes of ethics); 17 C.F.R. §§ 245.100-04 (2003) (pension fund blackout trading restrictions).

7. Pub. L. No. 107-204, 116 Stat. 745 at 403 (2000) (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

8. Other complex laws that require significant interpretation or otherwise generate advisory or litigation-oriented work for private practitioners also have been described in this way. See, e.g., Albert E. Elsen, *John Henry Merryman: Founding the Field of Art Law*, 39 STAN. L. REV. 1086, 1091 (1987) (referencing an Israeli statute relating to the reputational rights of artists in their artwork); William B. Gould IV, *Some Reflections on Fifty Years of the National Labor Relations Act: The Need for Labor Board and Labor Law Reform*, 38 STAN. L. REV. 937, 939 (1986) (referencing a part of the National Labor Relations Act); Cindy A. Schipani, *Environmental Law and Business in the 21st Century: Infiltration of Enterprise Theory into Environmental Jurisprudence*, 22 IOWA J. CORP. L. 599, 612 (1997) (“Some critics have gone so far as to dub CERCLA the ‘FULL EMPLOYMENT ACT FOR LAWYERS’ because of the lack of legislative clarity and the ensuing protracted litigation.”); Dick Thornburgh, *Junk Science—The Lawyer’s Ethical Responsibilities*, 25 FORDHAM URB. L.J. 449, 460 (1998) (commenting on then proposed amendments to Federal Rule of Evidence 702). The potential for generating billable hours in connection with Sarbanes-Oxley and the rules and regulations promulgated under Sarbanes-Oxley includes corporate and securities interpretation and compliance advice as well as the inevitable ensuing litigation.

tion or regulation is needed or even desirable.<sup>9</sup> Moreover, assuming federal or state legislation or regulation along the lines of Sarbanes-Oxley is necessary or desirable, one must then question whether it is appropriately targeted and, if appropriately targeted, whether its provisions ever will be sufficient to resolve the past, present, and perceived future issues emanating from the myriad of complex relationships and transactions that comprise the modern public company. This essay represents a preliminary exploration of these issues through the lens of agency and agency-related relationships in the public company context, relationships that are at the heart of the current wave of corporate scandals.

More specifically, this essay identifies a few key agency and agency-related relationships recognized by state and federal law in the public company context, each of which is implicated in Enron's very public, rapid fall from grace.<sup>10</sup> The essay then links these relationships to some of Enron's perceived problems and to associated law reform efforts, including those under Sarbanes-Oxley, for the purpose of exposing potential gaps in coverage. This exploration touches on both government relationships with corporations and relationships among constituents internal to the corporate structure.<sup>11</sup> Throughout, this essay asks difficult questions—those unresolved by existing, or even potential, law and regulation. The answers to these questions are not yet clear. Indeed, practitioners, scholars, and educators should think seriously about the role that they may play in answering these questions and in

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9. See, e.g., Darin Bartholomew, *Is Silence Golden When it Comes to Auditing?*, 36 J. MARSHALL L. REV. 57, 59 n.11 (2002) (noting the view of then SEC Chairman Harvey Pitt that Sarbanes-Oxley is unnecessary); *Corporate Reform Proposals: On the Money or Off-Base?*, Knowledge @ Wharton (2002), at <http://www.knowledge.wharton.upenn.edu/articles.cfm?catid=1&artid=588> (citing University of Pennsylvania graduate business professors who believe that more federal regulation for corporate directors is unnecessary) (on file with the University of Cincinnati Law Review).

10. See S. REP. NO. 107-70, at 1, 11 (2002) (after initially citing the extent to which Enron's collapse affected employees and investors, the committee report notes that "[o]ne of the striking features of the Enron collapse is the company's abrupt and dramatic transformation from a well-respected and award-winning company to a disgraced and bankrupt enterprise in less than three months").

11. Relationships between corporations and their financial, accounting, and legal advisors also form part of Enron's web, but they are beyond the scope of this essay. For information about these important relationships, see, e.g., Lisa M. Fairfax, *"With Friends Like These . . .": Toward A More Efficacious Response to Affinity-Based Securities and Investment Fraud*, 36 GA. L. REV. 63, 105 (2001) (noting Supreme Court recognition of the relationship of special trust between a corporation and its accountant in the insider trading context); Park McGinty, *The Twilight of Fiduciary Duties: On the Need for Shareholder Self-Help in an Age of Formalistic Proceduralism*, 46 EMORY L.J. 163, 218 (1997) (referencing the financial advisor relationship with the corporation); Richard W. Painter, *Game Theoretic and Contractarian Paradigms in the Uneasy Relationship Between Regulators and Regulatory Lawyers*, 65 FORDHAM L. REV. 149, 181-87 (1996) (describing and analyzing the relationship of a regulatory lawyer to his client); E. Norman Veasey, *The Ethical and Professional Responsibilities of the Lawyer for the Corporation in Responding to Fraudulent Conduct by Corporate Officers or Agents*, 70 TENN. L. REV. 1 (2002) (regarding the changing nature of the relationship between the corporation and its legal advisors).

“righting” any perceived “wrongs” identified in these preliminary explorations.

## II. THE WEB: IDENTIFYING PRINCIPALS, AGENTS, AND RELATED RELATIONSHIPS IN THE PUBLIC COMPANY SETTING

### A. *The State-Ordained Corporate Form*

This essay begins by identifying a few of the many state-law based agency relationships at issue in Enron’s story of corporate and securities fraud.<sup>12</sup> These agency relationships exist, for the most part, by virtue of state corporation laws, which reflect or incorporate certain principles of the common law of agency.<sup>13</sup> Three state law agency or agency-related relationships are reviewed in this essay: (i) the relationship between government lawmakers and the board of directors; (ii) the relationship between stockholders and the board of directors; and (iii) the relationship between the board of directors and executives.

Corporations, as such, do not exist without government. Corporations are creatures of law, and law is made by governments or, more specifically, by legislatures and courts. Under existing corporate law, state legislatures provide that a corporation ordained under that law shall be managed by or under the direction of a board of directors or similar governing body.<sup>14</sup> Thus, the board is the legislatively mandated center of corporate authority—the place where management

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12. It may be helpful to review some basic features of agency law at this juncture. The Second Restatement of Agency defines agency as a “fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act.” RESTATEMENT (SECOND) OF AGENCY § 1 (1958).

Key elements in a true agency relationship are the principal’s control over the agent and the agent’s obligation to act in the principal’s interest. An employer often favors an agency relationship, not because he wants to delegate “decision-making authority to another,” but because he wants to retain decision-making authority over the actions of the agent. “Agency,” properly understood, is a fiduciary relationship characterized by a promise by the agent to the principal: (1) to act on her behalf and (2) subject to her control.

Lynne L. Dallas, *Two Models of Corporate Governance: Beyond Berle and Means*, 22 U. MICH. J. L. REFORM 19, 34 (1988) (footnotes omitted).

13. See Matthew G. Dore, *Presumed Innocent? Financial Institutions, Professional Malpractice Claims, and Defenses Based on Management Misconduct*, 1995 COLUM. BUS. L. REV. 127, 196 (1995) (describing the “corporate law duty of loyalty analysis” as “consistent with agency law generally”); Daniel J. H. Greenwood, *Essential Speech: Why Corporate Speech is Not Free*, 83 IOWA L. REV. 995, 1034 (1998) (“Corporate law is centrally about agency . . .”).

14. See, e.g., CAL. CORPORATIONS CODE § 300 (Deering 2003); DEL. CODE ANN. tit. 8, § 141 (2002); MASS. ANN. LAWS ch. 156B, § 47 (Law. Co-op. 2003); N.Y. BUS. CORP. § 701 (Consol. 2003); TEX. BUS. CORP. ACT. ANN. art. 2.31 (Vernon 2002); VA. CODE ANN. § 13.1-673 (Michie 2002). For ease of reference, this essay will cite principally to Delaware corporate law, both statutory and decisional.

and control reside in the corporate structure (absent statutorily authorized charter provisions or other agreements to the contrary). Accordingly, one theory of director status, labeled the “concession theory,” holds that the directors are, in fact, agents of the state.<sup>15</sup> Admittedly, the concession theory is an imperfect fit because stockholders generally have the express authority under state corporate law to alter the board of directors’ statutory management authority and because the fiduciary relationship of the board of directors is owed to the corporation and its stockholders, not the state.<sup>16</sup> Therefore, a corporate board of directors cannot be said to be acting on behalf of the state in the same way that an agent acts on behalf of a principal.<sup>17</sup> Moreover, the state is not responsible for the actions of the board of directors as a principal would be responsible for an agent’s conduct.<sup>18</sup>

There are alternative agency-oriented explanations for director authority in the corporate setting to that posited by the concession theory. Among them is the “agency theory” of director status. This theory recognizes the directors’ allegiance to stockholders (created by directors’ fiduciary duties) by casting the directors as pseudo agents of the stockholders, rather than (as the concession theory would have it) the state government.<sup>19</sup> This is a concept within the corporate web that is both legally questionable and appealing. If the stockholders never had any of the powers given by government to the directors and never had a say in the manner in which those powers are defined or limited, how can one say that the directors act subject to the stockholders’ consent

15. See Matthew G. Dore, *The Duties and Liabilities of an Iowa Corporate Director*, 50 *DRAKE L. REV.* 207, 210 n.10 (2002) (citing Model Bus. Corp. Act Ann. § 8.01 cmt. (1985 & Supp. 1997)); Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretical Approach to Corporate Law*, 60 *U. CIN. L. REV.* 347, 349 n.7 (1991).

16. See *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985); *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984); *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939); see also Gordon, *supra* note 15, at 349 n.7; Roberta S. Karmel, *An International Perspective: Is it Time for a Federal Corporate Law?*, 57 *BROOK. L. REV.* 55, 57 (1991); Matheson, *supra* note 3, at 709; Jennifer O’Hare, *Director Communications and the Uneasy Relationship Between the Fiduciary Duty of Disclosure and the Anti-Fraud Provisions of the Federal Securities Laws*, 70 *U. CIN. L. REV.* 475, 509-10 (2002) (“Delaware law creates the corporation and then empowers the directors to manage the corporation. The state, therefore, has a significant interest in ensuring that directors act in the best interests of the corporation and its shareholders.”).

17. See *supra* note 12.

18. See, e.g., *RESTATEMENT (SECOND) OF AGENCY* §§ 140, 161, 219, 220 (1958) (regarding the liability of a principal to third persons).

19. See Dore, *supra* note 15, at 210 n.10; Jennifer Hill, *Visions and Revisions of the Shareholder*, 48 *AM. J. COMP. L.* 39, 42-43 (2000) (“[T]raditional corporate theory assumed that the role of directors was to carry out the will and implement the interests of shareholders, and that within standard principles of agency law, shareholders had a formal right to control their agents.”); Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: “Sacred Space” in Corporate Takeovers*, 80 *TEX. L. REV.* 261, 268 (2001) (“In the context of corporate law, the directors are viewed as ‘agents’ of the shareholders . . .”).

and control as an agent does?<sup>20</sup> On the other hand, the directors' fiduciary duties do exist for the benefit of the corporation and its stockholders.<sup>21</sup> For this reason, stockholders have an enforcement right principally, but not exclusively, in the form of stockholder derivative suits.<sup>22</sup>

Director authority is, of course, not absolute. It is constrained by other statutory provisions and by judicial doctrine, most prominently including the director's fiduciary duties to the corporation and its stockholders, frequently (and most completely) a matter of carefully crafted, judge-made law.<sup>23</sup> These duties<sup>24</sup> typically consist of duties of care,<sup>25</sup> including both (1) a duty of oversight as to the conduct of the day-to-day business of the corporation by corporate officers and other agents<sup>26</sup> and (2) a decision-making duty (that may be deemed to have

20. See generally Dallas, *supra* note 12, at 35 ("As corporate law scholars are well aware, managers are also not agents for shareholders. Although managers owe fiduciary duties to shareholders, they are not subject to the continuous and active control of shareholders."); Greenwood, *supra* note 13, at 1034 (describing the agency principals of corporate law as "a peculiar agency that looks neither to the views nor the actual interests of the alleged principal," noting that "[c]orporate law excludes the actual shareholders from corporate governance, bars managers from considering actual interests of the shareholders and then considers this situation entirely unproblematic"); Marcel Kahan, *The Limited Significance of Norms for Corporate Governance*, 149 U. PA. L. REV. 1869, 1878 n.35 (2001) ("Unlike principals in a standard agency relationship, shareholders of a corporation cannot themselves exercise power over the property of a corporation or give their agents binding directions on how to exercise such powers."); Eric W. Orts, *Shirking and Sharking: A Legal Theory of the Firm*, 16 YALE L. & POL'Y REV. 265, 311 (1998) ("In legal terms, the relationship between shareholders and directors/managers is not a direct agency, but rather a special form of quasi-agency governed by an overlay of state corporate law.");

21. See sources cited *supra* note 16.

22. See *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984); see also Margaret M. Blair & Lynn A. Stout, *Corporate Accountability: Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L. Q. 403, 426-27 (2001); E.C. Lashbrooke, Jr., *The Divergence of Corporate Finance and Law In Corporate Governance*, 46 S.C. L. REV. 449, 466 (1995).

23. See sources cited *supra* note 16.

24. The description of corporate fiduciary duties set forth in this sentence is extremely abbreviated and sterile, leaving out altogether the duty of disclosure (also known as the duty of candor) that underlies and complements the duties of care and loyalty and many important nuances along the way. For excellent textual descriptions, case excerpts, and other materials regarding corporate fiduciary duties, see CHARLES R. T. O'KELLEY & ROBERT B. THOMPSON, *CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS, CASES AND MATERIALS* 259-395 (3d ed. 1999). Specific references to this casebook with respect to the identified fiduciary duties are included *infra* notes 26-28.

25. See William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1299-1301 (2001) (describing the Delaware courts' historical approach to the duty of care, from the more substantive to the more procedural).

26. See O'KELLEY & THOMPSON, *supra* note 24, at 276-85 and cases cited therein. A very important point here is that a director's oversight duty of care implicates corporate officers in the corporate web because the director acts as a legally sanctioned monitor of officer behavior under this duty. The board of directors here may be seen as both a quasi-agent as to the stockholders and a principal as to the officers. See sources cited *supra* note 19 regarding the stockholder-director agency relationship and *infra* note 31 regarding the director-officer agency relationship.



both procedural and substantive components),<sup>27</sup> and duties of loyalty, which permit a director to take a corporate opportunity for her own only under limited circumstances and permit a director to engage in a conflicting-interest transaction with the corporation only if the transaction receives specified disinterested approvals or is otherwise entirely fair.<sup>28</sup>

Fiduciary duty restrictions on director decision-making power and authority are not (or at least may not be) as onerous as they sound. In fact, the effect of these duties is tempered in the enforcement context by the operation of a presumption known as the business judgment rule.<sup>29</sup> Under the business judgment rule, courts presume the directors' good faith, lack of self-interest, and fully informed status, absent an established indicator to the contrary.<sup>30</sup>

Last, but not least, it is important here briefly to touch upon the part of the corporate web that relates to the relationship between directors and officers. Under a traditional conception of the corporate legal framework, it is understood that corporate officers act as agents of the corporation or its board of directors.<sup>31</sup> Effectively, the role of the officer is to manage the day-to-day business of the firm under authority delegated to her under state law, in the corporate charter or by-laws, or by resolution of the corporation's board of directors.<sup>32</sup> Corporate officers, like directors, owe fiduciary duties of care and loyalty to the

27. See O'KELLEY & THOMPSON, *supra* note 24, at 285-310, 316-19 and cases cited therein.

28. See *id.* at 333-95 and cases cited therein.

29. See Andrew D. Shaffer, *Corporate Fiduciary—Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About*, 8 AM. BANKR. INST. L. REV. 479, 498-99 (2000) (summarizing the nature and operation of, and justifications for, the business judgment rule as it relates to officer and director decision making). For a history of the business judgment rule, see I DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* 9-11 (5th ed. 1998).

30. See *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) ("[The business judgment rule] is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."). For more general discussions of the business judgment rule, see Bayless Manning, *The Business Judgment Rule in Overview*, 45 OHIO ST. L.J. 615 (1984) and E. Norman Veasey & Julie M.S. Seitz, *The Revised Model Business Corporation Act: Comment and Observation: The Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project—A Strange Porridge*, 63 TEX. L. REV. 1483 (1985).

31. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 290 (1999); Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 611 n.40 (1997); Melvin A. Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PITT. L. REV. 945, 949 (1990) ("[T]he received legal model of the corporation contemplated that . . . the officers acted as agents of the board and executed its decisions . . .").

32. See R. William Ide, *Post-Enron Corporate Governance Opportunities: Creating a Culture of Greater Board Collaboration and Oversight*, 54 MERCER L. REV. 829, 836 (2003); Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1, 6 (1994); Veasey & Seitz, *supra* note 30, at 1490.

corporation.<sup>33</sup> Corporate officers also may be entitled to the presumptions of the business judgment rule.<sup>34</sup>

### B. Federal Securities Law Overlay

In the public company context, corporate directors and officers have an enhanced relationship with stockholders and investors—a relationship that is related to, but not part of, the state law principles described in Section A of Part II.<sup>35</sup> This enhanced relationship is characterized principally by federal disclosure obligations and legal rights associated with those obligations. There are two principal types of regulation governing disclosure obligations under the federal securities laws: mandatory disclosure and antifraud protections.<sup>36</sup> Directors and officers (and at their request, other members of corporate management) are responsible for a corporation's mandatory public disclosures under the federal securities laws.<sup>37</sup> These federal disclosure

33. See Larry Cata Backer, *Sarbanes-Oxley Act: Federalizing Norms for Officer, Lawyer, and Accountant Behavior*, 76 ST. JOHN'S L. REV. 897, 936 (2002) (referencing these duties); Robert A. McCormick, *Union Representatives as Corporate Directors: The Challenge to the Adversarial Model of Labor Relations*, 15 U. MICH. J.L. REFORM 219, 247 n.132 (1982) ("There is a division of authority regarding whether a corporate officer's fiduciary duty runs to the corporation as an entity, or to the shareholders themselves."); Arthur R. Pinto, *Corporate Governance: Monitoring the Board of Directors in American Corporations*, 46 AM. J. COMP. L. 317, 327 (1998) ("Officers have a fiduciary duty to the corporation since they are corporate agents.").

34. See Andrew M. Ferris, Note, *Jilted Suitor's Hostile Revenge Guarantees Control Premium in the Marriage of Paramount and Viacom: Paramount Communications v. QVC Network*, 637 A.2d 34 (Del. 1994), 63 U. CIN. L. REV. 941, 943-44 (1995) ("The business judgment rule is also applied to the actions of corporate officers."); Theresa A. Gabaldon, *Free Riders and the Greedy Gadget: Examining Aspects of Shareholder Litigation as an Exercise in Integrating Ethical Regulation and Laws of General Applicability*, 73 MINN. L. REV. 425, 480 n.242 ("Although most often discussed in reference to the actions of directors, the business judgment rule also applies to officers . . ."); Robert H. Rosh, Note, *New York's Response to the Director and Officer Liability Crisis: A Need to Reexamine the Importance of D & O Insurance*, 54 BROOK. L. REV. 1305, 1310 (1989) ("Executive decision making has traditionally been protected by the business judgment rule, which has afforded directors protection from liability so long as they acted 'in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes.'"); Shaffer, *supra* note 29, at 498-99; but see Jay W. Eisenhofer & John L. Reed, *Valuation Litigation*, 22 DEL. J. CORP. L. 37, 70 n.122 (1997) ("The presumptions of the business judgment rule do not apply in actions brought against corporate officers, as opposed to directors."); Franklin A. Gevurtz, *Getting Real About Corporate Social Responsibility: A Reply to Professor Greenfield*, 35 U.C. DAVIS L. REV. 645, 655 n.29 (2002) ("It is not entirely clear whether the business judgment rule applies to actions of corporate officers.").

35. See Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 163 (2002) (noting that the insider trading prohibitions under federal law "are built on fiduciary principles, particularly the duty of loyalty").

36. See Joseph A. Franco, *Why Antifraud Provisions Are Not Enough: The Significance of Opportunism, Candor and Signaling in the Economic Case for Mandatory Securities Disclosure*, 2002 COLUM. BUS. L. REV. 223, 230-31.

37. See *Corporate Law in the Twenty-First Century: The Practitioners' Prognosis*, 25 DEL. J. CORP. L. 161, 171-72 (2000) (comments of Peter A. Atkins); Lisa M. Fairfax, *The Sarbanes-Oxley Act as Confirmation of Recent Trends in Director and Officer Fiduciary Obligations*, 76 ST. JOHN'S L. REV. 953, 972-73 (2002); Faith Stevelman Kahn, *What Are the Ways of Achieving Corporate Social Responsibility?: Bombing Markets, Subverting the Rule of Law: Enron*,

obligations are additional to—but a close cousin of—any disclosure duties imposed on directors under state corporate law.<sup>38</sup>

United States insider trading restrictions typically are enforced under a broadly framed federal antifraud provision that prohibits manipulative and deceptive conduct in connection with the purchase or sale of securities.<sup>39</sup> Under applicable federal insider trading law principles, neither corporate directors nor corporate officers may trade in the corporation's securities while in possession of material, nonpublic information.<sup>40</sup> This prohibition is known as the “disclose or abstain” rule.<sup>41</sup> The basic rule appears to be clear, but application of the rule to actual facts is not always simple. Among other things, the theoretical underpinnings for the rule are unclear.<sup>42</sup> Regulatory and judicial attempts to clarify the operation of the disclose or abstain rule in the context of complex fact patterns continue to raise new unanswered questions.<sup>43</sup> This is not surprising. Insider trading is but one well known piece of a large (and growing) legal puzzle involving the possible perpetration of securities fraud under Rule 10b-5 by corporate directors and officers.<sup>44</sup> In this overall area, the relationship of public company

*Financial Fraud*, and September 11, 2001, 76 TUL. L. REV. 1579, 1609-10 (2002); Harvey L. Pitt et al., *Promises Made, Promises Kept: The Practical Implications of the Private Securities Litigation Reform Act of 1995*, 33 SANDIEGO L. REV. 845, 872-75 (1996); Stanley Sporkin, *Enforcement and Corporate Responsibility: SEC Enforcement and the Corporate Board Room*, 61 N.C. L. REV. 455, 457-58 (1983).

38. See Justice Joseph T. Walsh, *The Fiduciary Foundation of Corporate Law*, 27 IOWA J. CORP. L. 333, 337-39 (2002).

39. More specifically, insider trading principally is regulated under Rule 10b-5, 17 C.F.R. § 240.10b-5 (2003), promulgated under express authority granted in Section 10(b) of the Securities Exchange Act of 1934, as amended. 15 U.S.C. § 78j(b) (2000).

40. See *Chiarella v. United States*, 445 U.S. 222 (1980); *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969); *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

41. See *Chiarella*, 445 U.S. at 227.

42. See, e.g., Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179 (1991); Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319 (1999) [hereinafter Langevoort, *Rereading*]; Donald C. Langevoort, *Words From on High About Rule 10b-5: Chiarella's History, Central Bank's Future*, 20 DEL. J. CORP. L. 865, 870-85 (1995); Donna M. Nagy, *The “Possession vs. Use” Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never be Golden*, 67 U. CIN. L. REV. 1129, 1171 n.213 (1999); Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O'Hagan Suggestion*, 59 OHIO ST. L.J. 1223 (1998) [hereinafter Nagy, *Post-O'Hagan*].

43. Legal scholars and commentators have been at the forefront in raising these questions. See, e.g., Theresa A. Gabaldon, *Assumptions About Relationships Reflected in the Federal Securities Laws*, 17 WIS. WOMEN'S L.J. 215 (2002) (critiquing, among other things, recently adopted SEC Rule 10b5-2); Ray J. Grzebielski, *Friends, Family, Fiduciaries: Personal Relationships as a Basis for Insider Trading Violations*, 51 CATH. U. L. REV. 467 (2002) (critiquing recently adopted SEC Rule 10b5-2); Nagy, *Post-O'Hagan*, *supra* note 42, at 1037 (critiquing the Supreme Court's “restrictive and misleading ‘fraud on the source’ misappropriation theory”); Kevin E. Warner, Note, *Rethinking Trades “on the Basis of” Inside Information: Some Interpretations of SEC Rule 10b5-1*, 83 B.U. L. REV. 281 (2003) (setting forth both a defense and a critique of recently adopted SEC Rule 10b5-1).

44. Many recent securities fraud investigations and cases against Enron and other corporate issuers

directors and officers to stockholders is multifaceted and somewhat unpredictable.<sup>45</sup>

### III. ENTANGLEMENTS: ENRON AND SARBANES-OXLEY

#### A. *Personifying Enron's Tangled Web*

Tied together by these and other legal relationships, government, directors, stockholders, and officers thus form the basic framework of the web. Query, however, what this series of legal relationships between government and the internal constituents of the corporation has to do with the Enron affair and Sarbanes-Oxley. At the heart of the answer to this question is a concern that government may have afforded directors too much power. Although we only can touch on the relevant facts here, a few key examples raise a significant number of interesting and unresolved issues.

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have involved allegations that a corporate director or officer manipulated the market for the corporation's stock and deceived investors by making false or misleading statements of material facts or by omitting to state material facts. See Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 HOUS. L. REV. 1, 12 (2003) ("[S]ome executives at Enron 'worked to disguise the company's true condition in filings with the [SEC] through complex financing deals . . . .'"); Kahn, *supra* note 37, at 1594 ("Perhaps the most shocking aspect of the Enron story is that the scope of the inequity at Enron—the apparent greed, dishonesty, and callousness of the company's directors and officers—has so far (prior to any remediation that legal action may produce) been matched by the gross inequality in the distribution of its effects."); Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future*, 51 DUKE L.J. 1397, 1422-23 (2002) ("Through rather opaque disclosure of its unusual, complex, and aggressive business practices, Enron's management pumped its stock up . . . ."); E. Richie Reyes, *A Proposal to Restore Efficiency and Integrity into the Capital Markets By Mandating Corporate Disclosures of Real-Time Information and Encouraging Investor Education*, 24 HAMLINE J. PUB. L. & POL'Y 147, 154-55 (2002) (categorizing the alleged "lies" that characterize recent high-profile investigations and cases).

45. The recent criminal indictment against Martha Stewart provides an example of the complexity and novelty of the securities fraud claims that may be raised in the director and officer context. In that indictment, one of the nine charges brought against Martha Stewart was a securities fraud claim relating to the publicly traded securities of Martha Stewart Living Omnimedia, Inc. (MSLO), the public company founded by Martha Stewart. This charge alleges:

[I]n an effort to stop or at least slow the steady erosion of MSLO's stock price caused by investor concerns, STEWART made or caused to be made a series of false and misleading public statements during June 2002 regarding her sale of ImClone stock on December 27, 2001 that concealed that STEWART had been provided information regarding the sale and attempted sale of the Waksal Shares and that STEWART had sold her ImClone stock while in possession of that information. STEWART made these false statements with the intent to defraud and deceive purchasers and sellers of MSLO common stock and to maintain the value of her own MSLO stock by preventing a decline in the market price of MSLO's stock.

Indictment at 36-37, *United States v. Martha Stewart and Peter Bacanovic*, No. 03 Cr. (S.D.N.Y. filed June 4, 2003), available at <http://news.findlaw.com/wsj/docs/mstewart/usmspb60403ind.pdf>. In effect, the indictment asserts that in lying about her personal trading transaction in the stock of an unrelated corporation (ImClone), Martha Stewart allegedly acted willfully to manipulate the public market for MSLO's common stock and to deceive the investors buying and selling MSLO common stock in that market.

Enron's board of directors approved a series of transactions over an extended period of time<sup>46</sup> that transferred assets from Enron's balance sheet to various special purpose entities (SPEs) to finance Enron's operations privately—theoretically, out of the public's view—as a means of “managing” Enron's publicly reported earnings.<sup>47</sup> In other words, the board-approved transactions made Enron's public financial statements look more favorable than those financial statements, if reported together with those of the SPEs, otherwise might look. Enron's management, under the direction of the board, prepared the financial statements that reflected those transactions.<sup>48</sup> Moreover, in connection with those transactions, the board waived its own conflict of interest policies (as applicable to Enron's corporate officers), thereby allowing Enron's Chief Financial Officer, Andrew Fastow (Fastow), to participate as an investor in certain SPEs.<sup>49</sup> Interestingly, other Enron employees also owned equity interests in some of the SPEs, but did not receive conflict of interest waivers from Enron's board of directors.<sup>50</sup>

Were the board's actions in approving these SPE transactions and the related financial statements, or its approval of Fastow's participation in those transactions, appropriate exercises of the board's authority under state corporate law? At this stage in the fact-gathering, there are many questions and few answers.<sup>51</sup> An important wild card in the judicial attempt to answer these questions is the nature of the proceedings against Enron that are fully litigated to judgment at trial. Moreover, it is hard to say what policies and objectives will guide a court in answering these questions in a post-Enron world.<sup>52</sup> Will a court stretch the boundaries of an existing fiduciary duty, either procedurally or substantively, in response to the actions taken by the Enron board? Resolution of these matters must wait for another day.

In assessing the appropriateness of the Enron board's actions under state law, it is important to start by saying that the board's adoptions of resolutions approving these transactions were actions taken in the

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46. Enron's Special Investigative Committee found that Enron had used special purpose entities since the “early 1990s.” See WILLIAM C. POWERS, JR. ET AL., ENRON CORP., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 37 (Feb. 1, 2002) 2002 WL 198018 [hereinafter REPORT OF INVESTIGATION].

47. See S. REP. NO. 107-70, at 38-52 (2002); REPORT OF INVESTIGATION, *supra* note 46, at 4-5.

48. S. REP. NO. 107-70, at 38-39, 41 (2002).

49. See *id.* at 24-26.

50. REPORT OF INVESTIGATION, *supra* note 46, at 4.

51. The U.S. Senate Permanent Subcommittee on Investigations concluded that Enron's board of directors “failed to safeguard Enron shareholders . . . by allowing Enron to engage in high-risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, and excessive compensation.” S. REP. NO. 107-70, at 3.

52. See Dore, *supra* note 15, at 212-13 (asking this question under Iowa law).

management of the corporation.<sup>53</sup> Having noted that, the question then becomes whether the directors breached their fiduciary duties in taking those actions. For example, did the board's approval for the off-balance-sheet financings breach the directors' decision-making duties of care?<sup>54</sup> The answer to this question will depend upon whether the Enron directors were grossly negligent in failing to inform themselves as to all material information about the transactions under Delaware procedural due care law articulated in *Smith v. Van Gorkom*<sup>55</sup> and its progeny.<sup>56</sup>

The actions of the Enron board also may implicate substantive due care concerns.<sup>57</sup> Here, the inquiry relates to whether the board's approvals of these SPE transactions were so beyond the realm of human comprehension that they violated Delaware's substantive due care doctrine, as the same is understood from the limited decisional law in this area.<sup>58</sup> Is there a time at which, in approving approximately ten years worth of SPE transactions, the board of Directors of Enron was acting irrationally?<sup>59</sup>

Consider also the board's oversight duties.<sup>60</sup> Did the Enron directors fail to appropriately monitor members of management who prepared Enron's financial statements and related disclosures? Also, one must question whether the board failed to oversee Fastow in his investments in and work for the SPEs.<sup>61</sup> Finally, Fastow likely breached his duty of

53. As a general matter, a board of directors takes action by adopting a resolution by majority (or other required) vote at a validly convened meeting or by written consent in lieu of meeting. See DEL. CODE ANN. tit. 8, § 141(b), (f) (2002); see also *Saulsbury v. American Vulcanized Fibre Co.*, 91 A. 536, 540 (Del. 1914) (referring to "a corporate act in the sense of a resolution of the board of directors"); see also *supra* note 14 and accompanying text regarding the power of the board of directors generally.

54. See *supra* note 27.

55. 488 A.2d 858 (Del. 1985).

56. See, e.g., *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985); *Parnes v. Bally Entm't Corp.*, No. 15192, 2001 Del. Ch. LEXIS 34 (Del. Ch. Feb. 20, 2001); *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 257 (Del. Ch. 1989).

57. See *supra* note 27.

58. See *RCM Sec. Fund, Inc. v. Stanton*, 928 F.2d 1318, 1331-33 (2d Cir. 1991); *Parnes v. Bally Entm't Corp.*, 722 A.2d 1243, 1246-47 (Del. 1999) (citing *In re J.P. Stevens & Co.*, 542 A.2d 770, 780-81 (Del. Ch. 1988)); *Grobow v. Perot*, 539 A.2d 180, 189 (Del. 1988) (citing *Saxe v. Brady*, 184 A.2d 602, 610 (Del. Ch. 1962)). But see *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). The leading cases in the area of substantive due care are not Delaware cases. See *Joy v. North*, 692 F.2d 880 (2d Cir. 1982), cert. denied *sub nom.* *Citytrust v. Joy*, 460 U.S. 1051 (1983) (under Connecticut law); *Litwin v. Allen*, 25 N.Y.S.2d 667 (App. Div. 1940) (under New York law).

59. *Brehm*, 539 A.2d at 264 ("Irrationality is the outer limit of the business judgment rule. Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule.").

60. See *supra* note 26.

61. The U.S. Senate Permanent Subcommittee on Investigations found that Enron's board of directors "exercised inadequate oversight" of one transaction and of compensation controls. See S. REP. NO. 107-70, at 3.

loyalty to Enron; he was on both sides of a number of SPE transactions that (seemingly) were not fair to the corporation and did not receive effective disinterested approval by the directors or stockholders.<sup>62</sup> It seems likely that one or more courts will, at some point in the course of the proceedings against Enron, conduct a full inquiry into these matters.

This author knows of no post-Enron state law changes to date that definitively answer these and other important questions. In other words, it appears that state legislatures have not proposed new statutory initiatives, and the courts have rendered no instructive judicial decisions. Accordingly, the state law authority of the board of directors of a Delaware corporation is much as it was before we learned of Enron's corporate woes. As facts emerge and proceedings continue, however, this all may change.<sup>63</sup> Of course, some facts about *what* happened already are available.<sup>64</sup> One could conclude from these facts that Enron's directors and officers breached their fiduciary duties. Regardless, if we desire to change director or officer behavior, it is important for us to ask *why*; *why* did the Enron directors act as they did? Without understanding "the *why*," legislatures and courts cannot adopt effective *ex ante* or *ex post* legal rules to change undesired behavior. This part of the Enron analysis provides a most fascinating area for inquiry, intimately interconnected with Enron's corporate web.<sup>65</sup>

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62. See, e.g., DEL. CODE ANN. tit. 8, § 144 (2002).

63. At that time, scholarship regarding possible state law changes could be valuable. See *Id.*, *supra* note 32, at 854-70 (suggesting post-Enron changes empowered by state law).

64. See generally S. REP. NO. 107-70 (2002); REPORT OF INVESTIGATION, *supra* note 46.

65. Professor Ribstein observes:

In order to fix the markets, it is necessary to understand why the insiders who pulled accounting scams at major public corporations thought they could get away with them in efficient and regulated securities markets. A thorough understanding of the perpetrators' motives would seem to be essential in designing regulation that has a significant chance of preventing future frauds. It is too simplistic to ascribe these frauds to "greed" without accounting for the risk of detection. Notably, in contrast to notorious crooks such as Robert Vesco, none of the main characters in the recent scandals tried to flee. Moreover, the alleged perpetrators were not shady criminals but seemingly responsible business people who had earned the trust of their, even more respectable, monitors. For example, Scott Sullivan, who is accused of manipulating WorldCom's books in order to meet earnings targets, was regarded as "one of the best chief financial officers around" and "the key to WorldCom Inc.'s financial credibility." How could such a man have engaged in large-scale financial manipulation if this is proved to be the case? Similar questions arise regarding the seemingly more blatant behavior of some Enron insiders, particularly Andrew Fastow. Indeed, the insiders' conduct seems particularly puzzling, at least at first glance, given agents' usual incentives. Since agents bear severe penalties in firms if they fail, including loss of job and reputation, but normally do not get the full benefit of success, it follows that they would tend to be more cautious than their employers would want them to be, rather than the reverse.

Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 IOWA J. CORP. L. 1, 19 (2002) (footnote omitted); see also *Corporate Excesses Fuel Regulation*, GOV'T FIN. REV., Oct. 1, 2002, at 47.

Perhaps, however, a lack of director qualifications<sup>66</sup> or elements of cognitive and behavioral science, including group dynamics theories,<sup>67</sup> may help identify and explain the *why* and resolve any issues that arise from that process of identification and explanation. For example, consider the possibility that the board was co-opted by a dominant decision-maker.<sup>68</sup> Further, consider the possibility that the board operated through a consensus-driven group dynamic in which there was an apparent norm valuing agreement or devaluing dissent.<sup>69</sup>

66. These may include director independence requirements. See Jill E. Fisch, *Corporate Governance: Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 270-72 (1997) (noting efforts to revise "director qualification standards to encourage greater use of directors without relationships that could interfere with independent action"). The New York Stock Exchange, Inc. and the National Association of Securities Dealers, Inc. (through its subsidiary, the Nasdaq Stock Market, Inc.) have proposed that listed companies implement corporate governance guidelines that include director independence standards. See Corporate Governance, Exchange Act Release No. 34-47672 (April 11, 2003), available at <http://www.sec.gov/rules/sro/34-47672.htm> (proposed New York Stock Exchange Rules, as amended); Board Independence and Independent Committee, Exchange Act Release No. 34-47516 (March 17, 2003), available at <http://www.sec.gov/rules/sro/34-47516.htm> (proposed amendments to NASD Rules 4200 and 4350, as amended); see also *Id.*, *supra* note 32, at 851 n.80.

67. Professor O'Connor's article for this symposium includes a fascinating discussion and analysis of the group dynamics of Enron's board of directors from the standpoint of social psychology scholarship. See Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233 (2003); see also A Michele Dickerson, *A Behavioral Approach to Analyzing Corporate Failures*, 38 WAKEFOREST L. REV. 1 (2003) (regarding the overconfidence bias). Research in these and other areas of social science often lead legal scholars to rethink one or more of the elements of basic corporate structure from a new vantage point. Along these lines, one recent, powerful model for reconceptualizing the corporation is the Team Production Model, a framework for corporate governance based on the principle that corporations "are public as well as private entities and have some obligation to serve socially responsible goals" (TPM). Peter C. Kostant, *Team Production and the Progressive Corporate Law Agenda*, 35 U.C. DAVIS L. REV. 667 (2002) (arguing for implementation of the TPM). Kostant believes that the TPM may better control the phenomenon of powerful insiders and motivate the development of "norms of fairness." *Id.* at 683-84.

[T]he TPM posits that the board of directors of public corporations must act as an independent mediating hierarchy in order to solve the team production problem. The emphasis on independence is crucial. Blair and Stout implicitly recognize that the powerful inside senior corporate officers are stakeholders because these managers have the power to act for their own interests. Traditionally, the senior inside managers, and especially the CEOs, have completely dominated the board of directors. If this were still the case TPM would be a dubious model for the practice of corporate governance. In fact, as a result of a confluence of factors over the past fifteen years, the passive, captive, pseudo-independent board of directors is no longer the norm for large public corporations. Today's boards are more independent and active than ever before, and because TPM discusses how boards are intended to act, its application can help to solidify this trend toward even more active and independent boards. While corporate law casebooks have defined "management" as directors and senior officers, TPM helps to distinguish independent, disinterested directors from powerful self-interested officers.

*Id.* at 684-85; see also Blair & Stout, *supra* note 31 (describing the TPM).

68. One example of this phenomenon is the board of directors that is controlled by the corporation's Chief Executive Officer. For a discussion of CEO-dominated boards of directors, see O'Connor, *supra* note 67.

69. See, e.g., Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 138-39 (1997) (describing the



Alternatively, consider the possibility that board members may have “a tendency to overestimate their ability to control their environments and to avoid harm,”<sup>70</sup> resulting in an inaccurate risk assessment of the actions that they take. A better understanding of behavioral models (from whatever source derived) that can explain and help predict board decisionmaking is essential to a better understanding of what happened at Enron and how any reform efforts should be structured.<sup>71</sup>

### B. Post-Enron Reforms

Once the *why* is understood, the larger concerns then become whether (and, if so, how) to regulate corporate governance, director qualifications, or human behavior to reflect any valuable insights and whether effective regulation even is possible.<sup>72</sup> Scholarly works can appropriately focus attention both on understanding the *why* and on suggesting appropriate corrective action.<sup>73</sup> This also seems to be an area, however, where corporate counsel can step in to help the corporation understand the *why* and potentially implement effective *ex ante* corporate change within the context of existing law or through legislative initiatives.<sup>74</sup> For example, in terms of extra-legislative corporate change, corporate counsel can help corporate management construct a set of guidelines with respect to qualifications for board members or a list of qualified applicants for board seats. Moreover, if the board’s decisionmaking consists of inappropriate short cuts or other procedures,<sup>75</sup> corporate counsel can help a board of directors rectify

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application to board decisionmaking of the group cohesion model termed “groupthink”); O’Connor, *supra* note 67, at 1238, 1240 (describing “cascades” and “groupthink,” two social psychology theories that may explain these tendencies).

70. Dickerson, *supra* note 67, at 5.

71. One commentator has suggested that institutional investors commission research on, among other things, “the psychological, behavioral, and intellectual factors associated with being an effective independent director . . . .” Keith L. Johnson, *Rebuilding Corporate Boards and Refocusing Shareholders for the Post-Enron Era*, 76 ST. JOHN’S L. REV. 787, 793 (2002). Mr. Johnson also suggests that sociologists or behavioral psychologists and business, economic, and legal researchers conduct interdisciplinary corporate governance research on, among other things, director behavior and practices. *Id.* at 793-94.

72. See Ribstein, *supra* note 65, at 18-47 (analyzing why the market failures associated with the recent spate of corporate fraud are not conducive to simple regulatory solutions).

73. See *supra* notes 67-72.

74. See Roberta Romano, Law as a Product: Some Pieces of the Incorporation Puzzle, 1 J.L. ECON. & ORG. 225, 276 n.74 (1985) (highlighting the importance of the role of the corporate bar in making changes to corporate law).

75. See Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1242 (2002) (“Enron reveals that the heuristic failings of small groups may be . . . pronounced.”).

these defects and can construct tailored board procedures to ensure that decisions made do not exceed the board's authority.

Congress, however, undaunted by the apparent lack of information as to the *why*, has nonetheless responded in Sarbanes-Oxley to the underlying facts regarding Enron's board decisionmaking and oversight by using its interstate commerce powers to take action under the federal securities laws to (among other things): (1) impose on issuers of publicly traded securities additional disclosure requirements;<sup>76</sup> (2) subject public company chief executive officers and chief financial officers to certain financial statement certification requirements;<sup>77</sup> and (3) enhance audit committee responsibilities.<sup>78</sup> While these and other aspects of Sarbanes-Oxley certainly have caught the attention of directors and their counsel (at least on a temporary basis), these measures may not help to prevent future Enrons. The Enron directors may not have complied with, adequately understood, or taken seriously existing disclosure, certification, or audit committee requirements.<sup>79</sup> How, then, can we expect similarly situated directors to comply with the new, enhanced Sarbanes-Oxley requirements in these areas? Again, the necessary fact-gathering and analyses are not yet complete; but Congress and, by its direction, the SEC, seemingly have put the legislative and regulatory cart before the horse by taking action before fully exploring the reasons for the board's behavior at Enron and at other public candidates for "Corporate Enemy Number One."<sup>80</sup> This is a classic response in times of crisis.<sup>81</sup> Compliant corporations then shoulder the largest burden, distracting the board and officers from their management of the firm's business and leading to an ever-longer annual meeting proxy statement and annual report.<sup>82</sup>

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76. See 15 U.S.C. § 7266 (2003).

77. See *id.* § 7241; see also William S. Duffey, Jr., *Corporate Fraud and Accountability: A Primer On Sarbanes-Oxley Act of 2002*, 54 S.C. L. REV. 405, 409-12 (2002).

78. See 15 U.S.C. § 7213.

79. See Ribstein, *supra* note 65, at 16 ("The recent corporate frauds may have related less to problems with existing disclosure requirements than to firms' failure to comply adequately with these requirements.").

80. See *id.* (arguing that "the recent corporate frauds do not justify a new era of corporate regulation"); see also Perino, *supra* note 5, at 672 (arguing that "haste makes waste"). Perhaps Paul Krugman, op-ed columnist for The New York Times, was right last year, when he noted "demands for reform are scattershot and confused . . . . But I think they have a common theme: They're all about ending an era of laxity, in which nobody asked hard questions as long as everything looked O.K. That era is now over." Paul Krugman, *The Great Divide*, N.Y. TIMES, Jan. 29, 2002, at A21.

81. See *Idc*, *supra* note 32, at 831 (describing the passage of Sarbanes-Oxley as "a classic example of policy giving way to politics."); Ribstein, *supra* note 65, at 47 ("the hasty adoption of the Sarbanes-Oxley Act in the midst of a stock market crash was even less conducive to careful weighing of costs and benefits than the circumstances surrounding typical legislation").

82. See *Idc*, *supra* note 32, at 834 ("Parts of the Sarbanes-Oxley legislation and resulting regulatory efforts by the SEC are helpful additions to the disclosure requirements, but other parts are cumbersome

Also important in this analysis are the federal law requirements regarding director and officer roles in public disclosure and insider trading. The facts surrounding alleged disclosure violations and insider trading at Enron are evolving and are too numerous to repeat here. Highlights, however, are illustrative of the whole and are sufficient for purposes of this essay. In terms of public disclosure, accounting conventions momentarily aside, one might focus attention on the federal regulations that require textual disclosure (in periodic reports and elsewhere) of known trends and uncertainties in an issuer's historical financial statements.<sup>83</sup> These rules predate the Enron affair by almost twenty years.<sup>84</sup> Enron's directors and officers, as the human command center of the corporation, knew some or all of the details about the SPE transactions—including those regarding Enron's corporate guarantees of some SPE indebtedness—and did not publicly disclose those facts or the uncertainties created by their inevitable unraveling.<sup>85</sup> Likely, Enron's directors and officers (or some subset thereof) either did not fully understand the nature of the SPE transactions or the disclosure obligations that relate to those transactions or they affirmatively and intentionally disregarded those disclosure requirements.<sup>86</sup> In either case—lack of understanding or disregard of law—one must now wonder what purpose is served by the additional disclosures and procedures required under Sarbanes-Oxley. It is difficult to imagine how more required disclosure or process cures a lack of adequate information or understanding, on the one hand, or willful disregard of the law, on the other. As with the earlier described governance issues, an assessment of the root cause of the disclosure failures is a necessary predicate to a more comprehensive response to the issues posed by Enron.<sup>87</sup>

In addition, there is the matter of alleged insider trading by former Enron Chief Executive Officer Ken Lay (Lay) and others. Among the many securities trading transactions in which Lay engaged when he may have been in possession of material, nonpublic information were a

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intrusions into areas in which state law has greater expertise and abilities.”); Ribstein, *supra* note 65, at 39 (“Sarbanes-Oxley’s enhanced disclosure and other requirements effectively impose a tax on public ownership of stock”).

83. See 17 C.F.R. § 229.303 (2003).

84. See SEC. & EXCH. COMM’N, ADOPTION OF INTEGRATED DISCLOSURE SYSTEM, Exchange Act Release No. 34-18524, 1982 SEC LEXIS 2190 (March 3, 1982).

85. See S. REP. NO. 107-70, at 50-2 (2002); REPORT OF INVESTIGATION, *supra* note 46, at 178.

86. Observations about the nature of the failures that comprise the Enron matter have ranged from speculation that individual, human greed and conduct regulation failures are at the root of Enron’s woes to assertions that systemic failure principally is to blame. See Paul Krugman, *A System Corrupted*, N.Y. TIMES, Jan. 18, 2002, at A23 (“The Enron debacle is not just the story of a company that failed; it is the story of a system that failed. And the system didn’t fail through carelessness or laziness; it was corrupted.”).

87. See Ribstein, *supra* note 65, at 19 and accompanying text.

number (reportedly \$70 million worth) of transactions in which Lay exercised options and sold stock back to Enron to repay loans to which Lay then was subject.<sup>88</sup> In theory, Enron, as a corporate entity, had the same information at the time of those trades that Lay had, unless Lay's knowledge relates to self-dealing on his part, in which case Lay's knowledge may not be attributable to Enron under agency law principles.<sup>89</sup>

Lay's trading activities at least violate notions of fairness, on which some part of the theory justifying insider trading regulation rests.<sup>90</sup> For example, Lay and others at Enron reportedly sold Enron stock at times during which employees could not trade stock held in their employee benefit plan accounts.<sup>91</sup> This did not sit well with employees and the public at-large, leading to substantial public and media outrage over the *ex post* reporting of these transactions (which may well have been done in compliance with then applicable law and regulation).<sup>92</sup> It seems that actual legal compliance is not socially sufficient, however, where an imbalance of power is perceived to exist.<sup>93</sup> In the post-Enron environment, the perception of inappropriateness in the public eye is often more important than legal reality.

Accordingly, as a response to the perceived imbalance of power between corporate directors and officers and employee investors,

88. S. REP. NO. 107-70, at 53 (2002).

89. See Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187, at 1213-31 (2003), for reflections on agency attribution rules, including the current status of the attribution rules reflected in working drafts of the RESTATEMENT (THIRD) OF AGENCY.

90. See Fisch, *supra* note 42, at 221-23; Franco, *supra* note 36, at 243 n.38; Langevoort, *Rereading*, *supra* note 42, at 1326; Ian B. Lee, *Fairness and Insider Trading*, 2002 COLUM. BUS. L. REV. 119.

91. See Jennifer S. Recine, *Examination of the White Collar Crime Penalty Enhancements in the Sarbanes-Oxley Act*, 39 AM. CRIM. L. REV. 1535, 1539 (2002) ("Executives who knew about the company's worsening financial condition are accused of conducting \$ 1.1 billion in insider stock sales during the time that non-executive employees were blocked from trading."); Elisabeth Bumiller, *Bush, in Iowa, Urges Patience in War Effort and Reform of Pension Plans*, N.Y. TIMES, Mar. 2, 2002, at A11; Steven Greenhouse, *How Will Washington Read the Signs?; Safeguards for 401(k)'s*, N.Y. TIMES, Feb. 10, 2002, Sec. 3, at 13.

92. See Mary Flood, *The Fall of Enron; 'Enron Was a Hall of Mirrors'*, THE HOUS. CHRON., Apr. 8, 2002, at A1; Karen Masterson, *Senators Assail Enron Board*, THE HOUS. CHRON., May 8, 2002, at A6; *Street Sweep, Fridays With Floyd*, (CNN television broadcast, Apr. 12, 2002), available at LEXIS News & Business File, News Library; Tom Fowler, *The Fall of Enron; Testimony on Lay Winds Down*, THE HOUS. CHRON., Oct. 25, 2002, BUS., at 4. For each stock sale in the public markets, Lay likely would have filed a notice before the executing transaction under Rule 144 under the Securities Act of 1933, amended, 17 C.F.R. § 230.144(h) (2003) (regarding Form 144 filing) and after the transaction under Section 16(a) of the Security Act of 1934 as amended, 17 C.F.R. § 230.144(h) (2003) (regarding Form 4 and Form 5 filings).

93. See *Corporate Excesses Fuel Regulation*, *supra* note 65; Andrew Countryman, *Insiders Sell as Failure Looms*, CHI. TRIB., June 23, 2002, at C1 (noting a "backlash against legal sales of stock by company insiders"); Guy Halverson, *Why 'Insider' Stock Trades May Soon Be Much Easier To Track*, CHRISTIAN SCI. MONITOR (Boston, MA), May 28, 2002, at 19; Debora Vrana & Walter Hamilton, *Imclone Inquiry: Insider Trading an Issue That Won't Go Away*, L.A. TIMES, June 13, 2002, at Pt. 3, 1 ("Regulators also are trying to crack down on legal forms of insider trading that may be perceived as unfair to investors.").

Sarbanes-Oxley prohibits directors and executive officers from conducting transactions in the issuer's securities during pension fund "blackout periods," thereby putting corporate monitors and managers on more equal footing with their employees.<sup>94</sup> Moreover, Sarbanes-Oxley calls for enhanced public reporting of director and officer transactions under section 16(a) of the Securities and Exchange Act of 1934, as amended,<sup>95</sup> in an apparent attempt to mold the federal reporting scheme into a shape closer to the public's perception of what it should be. Federal regulation in these contexts, while perhaps not essential, at least seems appropriately tailored to the perceived problems.

Still at issue, however, is the propriety of the underlying trading transactions under federal insider trading law. There are few clear answers to questions about the legality of Lay's trading transactions in the ambiguous substantive law and regulation of insider trading in the United States.<sup>96</sup> Moreover, numerous factual issues remain unresolved. How much information did Lay have when he conducted his stock trades? How well did he understand Enron's financial statements? Did he actually know about Enron's financial misstatements or did he merely conduct his sales in disregard of the existence of any financial misstatements? What of the fact that his sales in some contexts were to Enron as opposed to uninformed public or private investors? Do we charge Enron with Lay's knowledge, whatever it may have been? The answers to many of these questions may be dependent on the answers to the others.

In this context, Sarbanes-Oxley focuses attention on the relationship between misstated financial reports and executive compensation—stock options and other incentives received by a chief executive officer or chief financial officer. Specifically, the law calls for disgorgement to an issuer of any bonus or incentive received from the issuer by the issuer's chief executive officer or chief financial officer within twelve months of a deficient public filing that requires restatement due to "misconduct."<sup>97</sup>

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94. 15 U.S.C. § 7244 (2003).

95. Pub. L. No. 107-204, 116 Stat. 745, at § 403 (amending 15 U.S.C. § 78p); *see also* White House Briefing, Stakeout Media Availability With Senator Paul Sarbanes (D-MD), Chairman of the Senate Banking, Housing and Urban Affairs Committee, Following the Signing of the Corporate Accountability Bill, FED. NEWS SERV., July 30, 2002, *available at* LEXIS News & Business Library, News File (featuring comments by U.S. Senator Paul Sarbanes regarding the signing of Sarbanes-Oxley).

96. Numerous scholars have commented on the ambiguity of U.S. insider trading regulation. *See, e.g.,* Roberta S. Karmel, *Book Review: The Relationship Between Mandatory Disclosure and Prohibitions Against Insider Trading: Why a Property Rights Theory of Inside Information is Untenable*, 59 BROOK. L. REV. 149, 151 (1993); Langevoort, *Rereading, supra* note 42, at 1336-40; Richard W. Painter, *Insider Trading and the Stock Market Thirty Years Later*, 50 CASE W. RES. 305, 310-11 (1999); Steve Thel, *Statutory Findings and Insider Trading Regulation*, 50 VAND. L. REV. 1091, 1092 (1997).

97. 15 U.S.C. § 7243 (2003).

Consider whether this is sufficient or whether further regulation of director and officer trading behavior in this environment is necessary.<sup>98</sup> If the motive of a director or officer is pure greed, it may be possible to bring the director or officer to task under existing state corporate law duty of loyalty principles. However, if federal securities laws are used to regulate more conduct, assessment of the effectiveness and efficiency of the new regulation is necessary. Again, scholars can help fill the void, and corporate counsel should consider the ways that their actions and advice may impact or resolve these issues.<sup>99</sup> Perhaps most importantly, however, scholars and corporate counsel should work together to resolve these issues.

#### IV. CONCLUSION

Clearly, there are now more questions than answers about Enron's tangled web. The message is simply this: Given the complexity of the corporate web, legislation, regulation, and decisional law cannot fill all identified gaps in corporate and securities law coverage. Law and related regulation, while perhaps necessary or advisable in certain cases, likely will be insufficient. Accordingly, scholars and lawyers must help bridge the gap through sensible and sensitive analyses of the underlying facts (as they continue to emerge) and must confidently respond with actions and proposals that meet the important legal questions posed by those facts. That is our burden in these post-Enron times, and we should not bear it lightly.

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98. Some, for example, have argued for an all-out prohibition on executive stock sales. See Pearl Meyer, Panel Discussion, *Should Directors Ever Sell?*, DIRECTORS & BOARDS, June 22, 2002, at 15.

99. In this regard, scholars and corporate counsel should consider a full range of options. For example, scholarship agendas may be revised to take into account further exploration of the *why* at Enron and other corporations involved in the corporate fraud scandals. The objective of this research and writing, which, at its best, is likely to be multi-disciplinary in nature, should have as its objective the creation of specific proposals for reform, whether legislative, regulatory, judicial, or practice-based. Scholars who teach may choose to bring these issues and their analyses into the classroom. Corporate counsel issuing a legal opinion on a transaction may change the applicable due diligence procedures to incorporate lessons learned from Enron's tangled web. Corporate counsel also may choose to use new weapons at their disposal (including those relating to third-party reporting and withdrawal from representation) as a result of legal ethics reforms resulting from recommendations of the ABA Commission on Evaluation of the Model Rules of Professional Conduct (known as Ethics 2000) and from the Sarbanes-Oxley attorney conduct initiatives. See Veasey, *supra* note 11.