Arthur Andersen & Co. -- The Rest of the Story

Abstract

A previous study by the same author, **Rush to Judgment: The Lynching of Arthur Andersen & Co.** (***Critical Perspectives on Accounting***, Vol. 15/3, pp. 345 – 375) explores the publicly available evidence regarding Enron and Andersen, as well as the actions of politicians and financial institutions. The facts show that Enron officers committed frauds ***within*** off-balance sheet partnerships (SPEs) with the willing assistance of various prominent financial institutions. None of the SPEs were audit clients of Andersen. Further, at the urging of politicians, the SEC granted Enron a special exemption to investor protection laws, allowing Enron to utilize numerous SPEs and thus setting the stage for fraud.

This study updates the findings of **Rush to Judgment: The Lynching of Arthur Andersen & Co.** to reflect the final report of Neal Batson, Enron's Court-Appointed Bankruptcy Examiner, as well as the report of Harrison Goldin, Enron North America's Court-Appointed Bankruptcy Examiner. In his investigation, Mr. Goldin examined the audit workpapers of KPMG, which audited most of the SPEs where the frauds occurred (the Chewco/JEDI SPE was apparently not audited) as well as fairness opinions prepared by PricewaterhouseCoopers.

This study also summarizes findings regarding Andersen's indictment and trial for "witness tampering" as well as Andersen's appeals to the Fifth Circuit Court of Appeals and the U.S Supreme Court, where the conviction was swiftly and unanimously overturned.

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The article, **Rush to Judgment**, has been translated into Japanese and is the basis for an article that was published as the cover article for **Balans**, Sweden's journal on accountancy. Her article, **Presumed Guilty: Arthur Andersen & Co.** is published online at http://accounting.smartpros.comx43952.xml. As a result of her articles, Mary has been a speaker at the annual meetings of the European Academy of Management and the European Accounting Association as well as at various universities in the United States, Canada and Europe.

In the wake of the Enron collapse, many concluded – before sufficient facts were available to form a reasoned judgment – that Arthur Andersen & Co. was responsible for the debacle. As the facts have been uncovered, it is clear that the destruction of Andersen, the censure of the public accounting profession and the host of new regulations regarding CPAs are all based on a theory unsupported by facts.

In February 2001 Arthur Andersen & Co. issued a clean opinion on the financial statements of Enron for the year 2000. On October 16, 2001, Enron issued a press release reporting a US $1.2 billion restatement, reducing shareholders' equity and assets on its balance sheet with no effect on the income statement.[1] In November 2001 Andersen became aware that Enron had omitted billions of dollars of debt from its balance sheet.

Andersen immediately (1) notified the Securities and Exchange Commission (SEC) and the Justice Department, (2) withdrew its audit opinions, and (3) required Enron to restate its financial statements for the years 1997-2001[2]. The restatements caused Enron to suffer a cash crunch and one month later on December 2, 2001, Enron declared bankruptcy.

Why were liabilities omitted from Enron's balance sheet?

There was a massive fraud.

How was the fraud committed?

Enron and its subsidiaries were audited by Andersen. Separate from its subsidiaries, Enron set up three primary off-balance sheet partnerships, also known as Special Purpose Entities or SPEs. Each or these partnerships or SPEs had outside

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[1] *See* http://www.enron.com/corp/pressroom/releases/2001/ene/docs/68-3QEarningsLtr.pdf (last visited October 14, 2004).

[2] *See* Press Release, Enron Corporation, Enron Provides Additional Information about Related Party and Off-balance Sheet Transactions; Company to Restate Earnings for 1997-2001 (November 8, 2001), available at http://www.enron.com/corp/pressroom/releases/2001/ene/docs/78-SECReleaseLtr.pdf.(last visited October 14, 2004).

investors – mostly institutional investors such as state retirement funds, financial institutions and corporations -- but also individuals. Because the SPEs were supposed to be independent of Enron, they did not have the same auditor. Instead, two first-tier SPEs, LJM1 and LJM2, were audited by accounting rival, KPMG. The remaining first-tier SPE, Chewco, was apparently not audited.

Andersen was also not hired to audit the hundreds of second-tier SPEs that were subsidiary to Chewco, LJM1 and LJM2. For example, Andersen was not the auditor of JEDI, RADR, Southampton, Raptors I, II, III, or IV, Swap Sub, Braveheart, Slapshot, Fishtail, Nighthawk, Whitewing, Roosevelt or Bacchus, to name just a few.

Each of these second-tier SPEs received loans from a bank or a consortium of banks which the SPEs recorded as either investments by the banks or as sales of assets or inventory to the banks or entities controlled by the banks.

The central issue was: should the primary and second-tier SPEs have been consolidated on Enron's balance sheet? That is to say, should the assets and liabilities of the hundreds of SPEs have been included in Enron's financial statements? Under rules mandated by the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB), non-consolidation was required if the sponsoring corporation (Enron) did not control the SPE and if the SPE had at least 3% outside equity.

How was Enron able to set up these SPEs?

Under normal circumstances, Enron's use of SPEs would subject Enron to the restrictive rules of the Investment Company Act of 1940 which imposes certain disclosure requirements, limits companies' investment activities and affiliate transactions and provides for a particular corporate structure. An exemption from the provisions of this law can only be granted by the SEC.

Why did the SEC grant Enron an exemption to the Investment Company Act of 1940?

The SEC granted Enron the exemption after being urged to do so by the U.S. House of Representatives' Committee on Energy and Commerce.[3]

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[3] Enron initially sought a broad, statutory exemption from the provisions of the Investment Company Act of 1940 as part of what became the National Securities Markets Improvement Act of 1996 on the grounds that Enron's investment in foreign infrastructure projects required the use of SPEs for legitimate tax, liability and governance reasons. Enron's efforts were unsuccessful. However, in its report on the bill, the House Committee on Energy and Commerce stated,

> "The Committee supports appropriate administrative action by the [SEC] from having unintended and adverse consequences to U.S. companies in the business of developing or acquiring and operating foreign infrastructure projects," that "the activities of U.S. companies involved in foreign infrastructure projects are not the sort of activities the Investment Company Act was designed to regulate" and that when exemptive relief was a requirement for investments in these projects, "the Committee expects the [SEC] to take administrative action expeditiously." (H.R. Rep. No. 104-622 at 19 June 17, 1996 as quoted in Governmental Affairs Permanent

Enron and its Chairman, Ken Lay, had powerful political connections because of generous campaign contributions to both Democrats and Republicans. The Center for Responsive Politics reports that Enron had given campaign contributions to 71 sitting senators and 43 percent of House members.[4]

In 1999, Ken Lay offered a seat on Enron's board to Robert Rubin[5], who was then Treasury Secretary under President Clinton. Lay lobbied Rubin and his successor at Treasury on issues affecting Enron.[6] Since 1999, Rubin has been Chairman of the Executive Committee and member of the Office of the Chairman of Citigroup[7], one of the banks complicit in Enron's fraud.

On November 26, 2001, six days before it declared bankruptcy, Enron contributed US $100,000 to the Democratic Senatorial Campaign.[8]

Despite strong ties to Democrats and President Clinton, Enron and Kenneth Lay were more closely associated with Republicans, especially President Bush. Enron was the President's largest donor.[9] Enron and employees gave President Bush over US $500,000 in 2001 alone.[10] Meanwhile, Andersen gave President Bush US $146,000 from 1999 to 2001.[11]

Enron gave political contributions to both Republicans and Democrats at the state level as well. It was reported that nine out of fourteen members of a state legislative committee investigating Florida's pension fund losses due to Enron's bankruptcy had received campaign contributions from Enron or one of its subsidiaries.[12]

Mr. Lay had also assisted Vice President Cheney in formulating national oil policy. The newly elected Republican National Committee Chair Mark Racicot, Secretary of the Army Thomas White, the head of the Federal Energy Regulatory Commission (FERC) Pat Woods all had strong ties to Enron.[13] Karl Rove, Chief of Staff for President Bush, had helped former Christian Coalition Director Ralph Reed secure a consulting job with Enron.[14] White House economic advisor Larry Lindsey served on the Enron Board and received US $50,000 in 2000.[15]

Subcommittee on Investigations, *Financial Oversight of Enron: The SEC and Private-Sector Watchdogs*, U.S. Senate, October 8, 2002.

[4] *See* http://www.chron.com/content/chronicle/special/01/enron/background/index.html.

[5] Associated Press, February 20, 2002. Mr. Rubin did not accept the invitation to become an Enron director.

[6] *Id*

[7] *See* http.//www.citigroup.com/citigroup/corporategovernance/bio/rubin/htm.

[8] Ivanovich D., Houston Chronicle, December 28, 2001.

[9] Associated Press, June 27, 2002.

[10] Fournier R., Associated Press, June 27, 2002.

[11] *Id*

[12] Associated Press, February 26, 2002.

[13] Ivanovich, D., Houston Chronicle, November 10, 2001.

[14] Ratcliffe R., Houston Chronicle, January 19, 2003.

[15] Associated Press, January 17, 2002.

How were Enron's SPEs able to disguise loans as either sales or equity investments?

Major international financial institutions aided and abetted the fraud by falsifying documents and accepting oral promises of repayment instead of requiring written loan documents.

How did they get away with it?

The fact that Andersen was not the auditor of Chewco, LJM1 or LJM2 (hereinafter referred to as LJM) means that Andersen did not have access to documents ***within*** these entities, including the partnership agreements identifying the partners. Thus, Andersen was forced to rely on assertions, letters of representation and confirmations of loan balances -- all of which were fraudulent -- from individuals within Enron, the Chewco and LJM partnerships and the banks and brokerages with which the partnerships did business.

If Andersen had been the auditor of Chewco and LJM, individuals in these entities might still have successfully colluded to defraud both Andersen and the Enron shareholders. However, Andersen at least would have been in the position to correctly identify the Chewco and LJM partners who were Enron personnel. It was this hidden ownership by Enron employees in Chewco and LJM that caused the SPEs to be related parties to Enron.

In addition to the undisclosed related party transactions, loans were disguised. In each of these cases, a bank or consortium of banks signed contracts with Enron's second-tier SPEs documenting either an equity investment or a sale of assets or inventory.

In the Chewco/JEDI fraud, a contract was signed detailing an investment in equity. In both its verbiage and its provisions regarding capital and control, the transaction as described in the contract required that Chewco/JEDI ***not*** be consolidated with Enron.[16] However, on the very same day, the very same individuals signed a side agreement that reversed the appropriate accounting for Chewco/JEDI.[17] The side agreement was hidden from Andersen until November 2, 2001.[18]

The hundreds of disguised loans secured by the second-tier SPEs of LJM used a different technique. Time after time, personnel in the LJM partnerships were able to convince major international financial institutions to "provide funds and supporting paperwork, set up sham offshore trading partners"[19] and resort to ***oral*** side agreements[20]

[16] Bauer T, Partner, Andersen LLP In: Testimony before the Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, February 7, 2002 (hereinafter "Bauer, February 7, 2002").
[17] *Id*
[18] *Id*
[19] Roach R., Chief Investigator, The Governmental Affairs Permanent Subcommittee on Investigations, U.S. Senate, July 23, 2002, (hereinafter "Roach, 2002").

in phony "prepay" transactions so that Enron could characterize the funds as cash flows from operations or equity transfusions rather than loans.[21]

By not demanding a loan agreement, the financial institutions jeopardized their ability to collect from Enron, thus breaching their fiduciary responsibilities to their own shareholders. Further, oral agreements leave no audit trail and thus cannot be uncovered in an audit.

In addition to signing fraudulent contracts, Enron personnel signed fraudulent representation letters[22] to Andersen, omitting the existence of side agreements, thus disguising what were in fact loans. The banks were asked by Andersen to sign standard Andersen bank confirmations which required banks to confirm all balances – whether loans or accounts – and disclose all guarantees, liabilities or contingent liabilities. The various banks failed to disclose the existence of the hidden side agreements.

When Andersen questioned the independence of offshore trading partners, Andersen required that those offshore trading partners sign representation letters stating they were independent of both Enron and the banks. Andersen was provided those letters despite the fact that the trading partners were not independent from the banks.[23]

How did Enron get caught?

Enron VP, Sherron Watkins, who reported to CFO Andrew Fastow, talked to James Hecker, an Andersen partner not on the Enron engagement. Hecker documented the conversation in a memo[24] sent to the appropriate Andersen partners. Ms. Watkins also notified Enron Chairman Kenneth Lay who hired the law firm of Vinson & Elkins to investigate.[25]

The question in the Andersen auditors' minds would have been: does Ms. Watkins know for a fact that there is fraud?[26] If so, why would an honest person continue working for a dishonest company? Further, Ms. Watkins's assertions directly

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[20] Governmental Affairs Permanent Subcommittee on Investigations, *The Role of Financial Institutions in Enron's Collapse*, U.S. Senate, July 23, 2002, (hereinafter " Governmental Affairs – Financial Institutions"), Appendix B, Knowledge and Participation of Financial Institutions in Enron's Prepays, p. B-5.

[21] Roach, 2002.

[22] Superseding Indictment at 49-53, *United States v. Causey*, No. H-04-25 (S.D. Tex. July 7, 2004); *see also* Second Amended Complaint at 45-47, 50-51, *SEC v. Lay*, No. H-04-0284 (S.D. Tex. July 8, 2004).

[23] Roach, 2002.

[24] Hecker, J., Partner, Andersen LLP, Memorandum, August 21, 2001.

[25] Watkins S. In Re: Testimony to Subcommittee on Oversight and Investigations, House Energy and Commerce Committee, February 14, 2002.

[26] This is still unclear. Ms. Watkins was an Enron VP working for CFO Andrew Fastow, whose fraud has been widely documented by various banks and who has pled guilty to fraud. Other individuals working with Ms. Watkins, including Ben Glisan and Michael Kopper, have also pled guilty to fraud. Was Ms. Watkins unaware of their activities? In her testimony before the House Committee on Energy and Commerce, Ms. Watkins blames Andersen. Did an Enron VP working for the CFO not know even by February, 2002 that Andersen was never hired to audit the SPEs where the frauds took place?

contradicted all contracts, representation letters and confirmations that were received from the banks and filed in Andersen's audit workpapers. In other words, if Ms. Watkins were correct, a host of major international financial institutions would have to be complicit in fraud. Until the Enron case, this was unimaginable.

The first evidence of fraud, the hidden Chewco side agreement, was shown to Andersen on November 2, 2001. Andersen immediately withdrew its audit opinions and required Enron to restate its earnings.

Who were these financial institutions?

- JP Morgan Chase (Chase) and LJM engaged in at least 12 sham "prepay" transactions with Enron, disguising debts with a combined value of more than $3.7 billion.[27]

- Citigroup and LJM engaged in at least 14 sham transactions with Enron, disguising debts with a combined value of at least $4.8 billion.[28]

Evidence shows that not only did Chase and Citigroup structure these phony deals with LJM but the banks started selling Enron-style "prepays" to other companies. Chase informed the Governmental Affairs Permanent Subcommittee on Investigations that Chase had entered into phony "prepays" with seven companies apart from Enron.[29] Citigroup admitted that it sold the idea to at least three companies in addition to Enron.[30]

- Enron SPEs also engaged in sham "prepays" with other banks, including Barclays, Credit Suisse First Boston, FleetBoston, Royal Bank of Canada, Royal Bank of Scotland, Toronto Dominion, with an estimated combined value in excess of $1 billion.[31]

- Merrill Lynch also participated in sham transactions where the documentation supported what appeared to be sales but were in reality loans.[32] Merrill Lynch was also private placement agent for LJM2, helping raise over $390 million from outside investors.[33] Nearly 100 Merrill Lynch executives invested in LJM2.[34]

In his Third Interim Report on Enron, Neal Batson, Enron Bankruptcy Examiner, reported on his examination of Andersen's audit workpapers in addition to documentation within both Enron and six of the financial institutions that participated in

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[27] Roach, 2002.
[28] *Id*
[29] *Id*
[30] *Id*
[31] *Id*
[32] *Id*
[33] Ivanovich D., Fowler T., Houston Chronicle, February 27, 2002.
[34] *Id*

SPEs with Enron – JP Morgan Chase, Citigroup, Barclays Bank, B/T Deutsche, Canadian Imperial Bank of Commerce and Merrill Lynch. His report was also based on interviews and sworn testimony from individuals at Andersen, Enron and various banks. The Bankruptcy Examiner concluded,

> "Evidence suggests that certain [Enron] officers entered into side agreements with Financial Institutions that they knew would have precluded the desired accounting and concealed the existence of those agreements from Andersen.
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> The evidence also suggests that certain officers concealed from Andersen particular aspects of transactions that the officers knew would have an adverse effect on the desired accounting treatment. In other instances, evidence suggests that certain Enron officers had actual knowledge that Andersen's advice regarding the accounting for SPE transactions was based on a mischaracterization of material facts or that the transactions lacked any business purpose.
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> The evidence also reflects numerous instances in which Enron officers carefully controlled the flow of information to Andersen in order to achieve a specific accounting result. In an e-mail to [Michael] Kopper regarding Chewco, Shirley Hudler of ENA [Enron North America] states, 'I don't know how we are going to "manage" the Arthur Andersen questions re[garding] Chewco's ability to repay – will work with Clint Walden ([Accounting] Support) to craft a story.'"[35]

Regarding Citigroup, Chase, Barclays Bank, B/T Deutsche, Canadian Imperial Bank of Commerce and Merrill Lynch, the Bankruptcy Examiner concluded,

> "There is evidence…that certain Financial Institutions, assisting Enron officers:
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> (i) participated in or were aware of side agreements or undisclosed understandings that they knew would invalidate Enron's desired accounting treatment if known by Andersen;
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> (ii) participated in or were aware of misrepresentation of facts to Andersen that they knew would have invalidated Enron's desired accounting treatment if known by Andersen;
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> (iii) participated in or were aware of specific aspects of the SPE that they knew would invalidate Enron's accounting treatment if known by Andersen;
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> (iv) knew, based upon their own independent analysis, that Enron's accounting treatment was improper; or
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> (v) knew that Enron's disclosure of the SPE transaction in which they participated was materially misleading to third-party creditors, investors and other users of Enron's financial statements,

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[35] Batson N., Interim Report, Court-Appointed Examiner In Re: Enron Corp., July 28, 2003, (hereinafter "Batson – July 28, 2003"), pp. 32 - 33.

> regardless of technical compliance with GAAP [generally accepted accounting principles]."[36]

Consequently, the Enron Bankruptcy Examiner Neal Batson concluded that each of these financial institutions "aided and abetted"[37] Enron officers in their fraud. Similarly, in his Final Report, Mr. Batson concluded that the Royal Bank of Scotland[38], Credit Suisse First Boston[39] and Toronto Dominion Bank[40] all aided and abetted Enron officers in breaching their fiduciary duties. Enron North America Bankruptcy Examiner Harrison Goldin concluded that there is sufficient evidence that the Bank of America[41] and Royal Bank of Canada (RBC)[42]also aided and abetted Enron officers in their fraud.

Mr. Goldin concluded that RBC not only went along with Enron's fraud but also suggested and implemented strategies "which better concealed the [frauds] from scrutiny by Enron's auditors [Andersen].[43] For example:

- "RBC proposed that Enron conceal debt with a circle of commodity swap agreements fully guaranteed by Enron or Enron North America;
- RBC proposed that Enron conceal a cross-default among the swaps as a 'common termination event;'
- RBC proposed that Enron conceal the nature of the swaps by placing loan-related covenants in the Enron Corporation guarantee rather than in the swaps;
- RBC proposed that Enron use gas commodity swaps which better concealed the swaps from…Enron's auditors [Andersen]; and
- RBC proposed that the circle of banks include another bank, JPMorgan Chase, which better concealed the effect of the swaps from Enron's auditor [Andersen]."[44]

An e-mail from RBC's vice president of risk management, John Aitken, noted that "being Enron's auditor would be a thankless task.[45]" Mr. Aitken is correct, especially since so many banks, including his own, were eagerly helping Enron defraud Andersen.

Why did financial institutions of this stature participate in a fraud?

In doing so, they earned fees far in excess of any reasonable rate of interest. Toronto Dominion's Risk Adjusted Return on capital for Enron transactions was 39%[46]

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36 *Id* at 38–39.
37 *Id* at. 4.
38 Batson, N. Final Report, Court-Appointed Examiner In Re: Enron Corp., November 4, 2003 (hereinafter "Batson – Final Report"), p.67.
39 *Id* at 75.
40 *Id* at 78.
41 Goldin H., Court-Appointed Examiner In Re: Enron North America Corp. Bankruptcy Proceeding, November 14, 2003, (hereinafter "Goldin, 2003"), p. 59.
42 *Id* at 132.
43 *Id* at 142.
44 *Id.*
45 *Id* at 101.

from the phony "prepay" transactions whereas it earned 12%[47] on other transactions with Enron. Royal Bank of Scotland calculated that it had received from the LJM1 transactions "a total return on our $7.5 million investment of approx (*sic*) $22.7 million or in excess of 1200% IRR [Internal Rate of Return]."[48] In determining how much Enron might be willing to pay for a possible prepay transaction, in "a taped telephone conversation among several JPMorgan Chase employees", one employee observed: "I think what we're trying to gauge is…how aggressive they are to pay for this stuff now…[to] discreetly get, you know, several hundred million dollars and have no market knowledge of what's going on…"[49]

Many have marveled at the rapidity of Enron's meltdown. The root cause of the bankruptcy was Enron's poor investments utilizing too much debt but the speed of the meltdown was due to a cash crunch. Why exactly did Enron suffer a cash crunch?

The banks knew that oral promises of repayment from Enron constituted disguised loans and that Enron was hiding this information from Andersen. Each of the financial institutions involved knew that Enron officers were perpetrating a fraud because they themselves were actively helping Enron disguise loans. They believed other banks were also. Personnel at various banks debated Enron's creditworthiness because they were uncertain as to the extent of Enron's fraudulent loan activity with other banks.[50] Thus, when Andersen withdrew its audit opinion, the banks faced a quandary. Should they extend credit as though the Chewco fraud -- the first Enron fraud uncovered -- were the only fraud? Or should they deny credit, knowing that the Chewco fraud was only the tip of the iceberg? Most banks denied credit, resulting in Enron's cash crunch. When Enron declared bankruptcy, it was at the time the largest bankruptcy ever.

How do we know the banks committed the frauds?

Enron Bankruptcy Neal Batson examined the Andersen audit workpapers regarding Enron, the documentation at Enron and the documentation at Citigroup, JPMorgan Chase, Barclays Bank, B/T Deutsche, Canadian Imperial Bank of Commerce, Merrill Lynch, Royal Bank of Scotland, Credit Suisse First Boston and Toronto Dominion. Enron North America Bankruptcy Examiner Harrison Goldin examined the documentation at Royal Bank of Canada and Bank of America, as well as the audit

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[46] *Id* at 80.
[47] *Id* at 81.
[48] E-mail from Kevin Howard, RBS, to Iain Robertson, et al, RBS, August 31, 2001, at RBS 6021378 [RBS 6021378 – RBS 6021379] as quoted in Batson - Final Report, p.71.
[49] Batson - July 28, 2003, Appendix E, p. 50.
[50] An e-mail from Alex Sinclair, RBS [Royal Bank of Scotland], to Brian McInnes et al., RBS, March 10, 2000 [RBS 3118862] states,

> "The scale of financial…manipulation [by Enron] is exceedingly worrying…I can see from a relationship/business perspective that there is a temptation to write another income generating transaction on the basis of…it being very short term, but the concern must obviously be that if lots of counterparties are doing this then any bad news (or shortage for whatever reason of counterparty capacity) will cut refinance ability dramatically &/or Enron's ability to manipulate, thus leading to a horrendous on-balance sheet position which would further exacerbate the position. The question is when do we stop…" as quoted in Batson – Final Report, pp. 73 – 74.

workpapers of KPMG, auditor of most of Enron's SPEs, and PricewaterhouseCoopers (PwC) who provided valuation opinions for two of the SPEs. The Bankruptcy Examiners also interviewed individuals at Enron, Andersen and the various banks.

According to Mr. Batson, all documentation found at Enron was consistent with what was given to Andersen (other than e-mail[51] not subject to audit). Hence, there was no way that Andersen could have uncovered the frauds. However, at the various banks, the Bankruptcy Examiners found widespread documentation of the frauds.

For each of these fraudulent transactions, a financial institution was willing to sign a contract with an Enron SPE, stating that funds were transferred to the SPE as either an equity investment or a purchase. These contracts were signed despite Enron's oral promises to repay the banks. Yet the banks recorded these same transactions on their own books as loans. In other words, the documentation of the transactions was totally inconsistent with the way the transactions were booked by the banks.

Thus, if any of these hundreds of transactions had been examined by the banks' internal auditors, bank examiners or outside auditors, the banks' participation in Enron's frauds would have been readily apparent. Banks have large internal audit departments that routinely check the documentation of transactions to ensure that they are correctly recorded. Query: was the internal audit function compromised by bank officers in the financial institutions complicit in Enron fraud? Or did the banks' internal auditors properly perform their responsibilities and report their bank's fraudulent activities to top management, the audit committee of the Board of Directors and the outside auditors? In short, what did the directors, outside auditors and bank examiners know? If these questions have been examined, the answers have not been made public.

The fact that the banks had oral side agreements promising to repay the Enron SPEs was widely documented in the banks' loan approval forms, loan committee agendas and minutes of loan committee meetings.[52] Indeed, the various financial institutions have claimed that Enron owes them repayment for these supposed "sales" or "equity investments." The Enron and Enron Bankruptcy Examiners have concluded regarding the banks,

> "There is sufficient evidence of inequitable conduct that the banks' claims should be subordinated to claims of other creditors."[53]

Why would banks document frauds?

In deciding whether to extend credit, the banks tried to assess whether Enron was credit-worthy. A memo to Barclays Group Credit, regarding a request to increase the loan sanction and commodities trading limits, October 24, 2001 states,

[51] Batson – July 28, 2003, p. 35.
[52] Batson - July 28, 2003, Batson - Final Report and Goldin, 2003.
[53] *Id*

> "We are also aware that [Enron] enters into off-balance sheet transactions whereby it sells and subsequently has the option to repurchase the assets. (Barclays has currently purchased assets to a value of USD 1.5 billion.) These transactions have the effect of significantly understating the debt level and assets on the balance sheet."[54]

After agreeing to extend funds, various banks noted that "the paperwork cannot reflect their [Enron's] agreement to repay" because it would "unfavorably alter Enron's desired accounting" [from Andersen].[55]

The bankers were concerned about repayment of the loans. "Barclays was even concerned about the effect of the survival of 'verbal assurances from the CFO [Fastow] as support for the Trust's equity if the CFO's tenure was at all at risk.'"[56]

Canadian Imperial Bank of Commerce (CIBC) "referred to the equity as 'trust me' equity".[57] "Numerous CIBC credit applications state either that 'executive management at Enron has represented that this money…will absolutely be repaid' or that 'Enron is Not permitted to ASSURE a repurchase of our equity (though this is our undocumented "understanding" with the CFO [Fastow]).'"[58]

How did politicians respond?

On January 24, 2002, Congressman James Greenwood (R-PA) of the House of Representatives' Energy and Commerce Committee opened the televised Enron "fact-finding" hearings of the Subcommittee on Oversight and Investigations. Without asking a single question or hearing any facts, Rep. Greenwood told Andersen partner on the Enron engagement, David Duncan,

"Enron robbed the bank, Arthur Andersen provided the getaway car and they say you were at the wheel."[59]

Regarding the Enron partnerships, Chairman Billy Tauzin (R-LA) said, "I think they [Andersen] went along and allowed things to be done that no other accounting firm would have allowed to be done."[60]

Representative John Dingell (D-MI), senior Democratic member of the House Energy and Commerce Committee, said,

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[54] Batson – July 28, 2003, Appendix F, pp. 14-15.
[55] *Id* at 49.
[56] *Id* at 26.
[57] Batson – July 28, 2003, Appendix H, p. 6.
[58] *Id* at 53.
[59] House Energy and Commerce Permanent Subcommittee on Oversight and Investigations, U.S. House of Representatives, January 24, 2002 (hereinafter "House Energy and Commerce, January 24, 2002").
[60] Nightly Business Report, February 26, 2002.

> "What happened to the inability or the reluctance of Andersen to deal with the accounts of the partnerships [Enron's SPEs] which were kept off the books and why? The fact that Andersen functioned both as an accountant and also as a consultant raises great questions."[61]

Former SEC Chairman Arthur Levitt appeared on television and stated that Andersen lacked independence because of performing "consulting work" in addition to the audit. The clear implication was that Andersen had purposely overlooked the fraud.

When these statements were made, what did these gentlemen know?

1. They knew (or should have known) that Enron officers committed frauds within off-balance sheet partnerships (hereinafter referred to as SPEs), none of which were Andersen audit clients.

2. They knew (or should have known) that the frauds within Enron SPEs were aided and abetted by various prominent international financial institutions.

3. They surely knew that the government itself had laid the groundwork for the Enron frauds by granting Enron an exemption from long-standing investor protection laws that would have limited Enron's use of SPEs. Without this exemption, Enron could not have committed the frauds in the manner they did.

How do we know that Representatives Greenwood, Tauzin and Dingell and former SEC Chairman Arthur Levitt knew that the SEC had exempted Enron from vital investor protection laws? Because it was these four individuals who were responsible. It was under the chairmanship of Clinton appointee Arthur Levitt that the SEC granted Enron an exemption to the Investment Company Act of 1940 at the request of the House Energy and Commerce Committee under the leadership of Representatives Billy Tauzin, Jim Greenwood and John Dingell.

How do we know these gentlemen knew by late January that Andersen was not the auditor of the SPEs? How do we know these gentlemen knew by the same time that at least one major international bank was complicit in the fraud and that bank was not an Andersen audit client? We know this because by late January, the government had been investigating Enron and their SPEs for months. Let's look at a timeline.

- **October 31, 2001 –** Enron announced that an SEC inquiry into Enron had been upgraded into a formal investigation ***focusing on the SPEs, namely Chewco and LJM*** (emphasis added).[62]

- **December 11, 2001** - Justice Department investigation was under way.[63]

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[61] Online Newshour: Investigating Enron, January 23, 2002.
[62] Fowler, T., Houston Chronicle, October 31, 2001.
[63] Flood, M., Houston Chronicle, December 11, 2001.

- **December 12, 2001** – Andersen Managing Partner Joseph Berardino testified before the House Committee on Financial Services, giving details of the hidden side agreement uncovered on November 2, 2001 regarding the Chewco/JEDI fraud.

- **December 14, 2001** – Committee on Energy and Commerce asked for "audit records, correspondence between Enron and Arthur Andersen, and documents ***related to Enron's off-balance sheet joint ventures [SPEs]*** (emphasis added)***."[64]***

- **January 20, 2002 –** at least nine congressional investigations had been focused on Enron.

By January 24, 2002, according to Representative Tauzin, a "joint, bipartisan team of investigators [from the House Committee on Energy and Commerce] is working on a daily basis in consultation with Department of Justice officials."[65]

What did these numerous government investigations entail?

Did the investigators examine the financial statements of Enron's SPEs but were somehow unable to read the name on the audit reports? Did the investigators examine the audit workpapers but not realize that those workpapers were prepared by rival accounting firm, KPMG, rather than Andersen? Did the investigators talk to the auditors but not know who they were talking to? One can hardly imagine such incompetence in even one investigator, much less all of them.

Another possibility is that, contrary to their public statements, government investigators for the SEC, Justice Department and the nine congressional committees did not bother to investigate any facts regarding the Enron SPEs before condemning Andersen.

The only remaining possibility is that the SEC, Justice Department and the congressional committees all knew that Andersen was not the auditor of any of Enron's SPEs where the frauds were committed but the government chose to blame Andersen anyway.

Why was Arthur Andersen & Co. blamed by politicians?

Several factors combined to fuel a firestorm:

- Part of the meltdown of Enron stock occurred during a pre-arranged 1-month period when Enron employees' 401(k) accounts were frozen while Enron switched administrators. During that period, employees were precluded from the possibility of selling their Enron stock and transferring the cash to any of

[64] Ivanovich, D., Houston Chronicle, December 14, 2001.
[65] House Energy and Commerce - January 24, 2002.

the 18 mutual funds available in the Enron 401(k) plan.[66] Some of the employees had chosen to invest nearly all their retirement funds in Enron stock. Their lack of diversification brought disastrous results.

- Lawsuits were filed accusing Enron executives and Board members of insider trading because they earned nearly $600 million over the 4 years preceding the bankruptcy.[67]

- Days before the bankruptcy, Enron paid $55.7 million in bonuses to approximately 500 employees.[68]

- J. Clifford Baxter, former Vice Chairman of Enron who resigned in May 2001, committed suicide.

- Democrats called for subpoenas of White House contacts with Enron. Democratic lawmakers and environmental groups intensified their demands for the records of Vice President Cheney's oil policy meetings.[69]

- Long-sought legislation to eliminate unregulated campaign contributions moved toward the House floor, "propelled by the perception that Enron Corp. purchased influence in massive political contributions."[70]

- CBS-New York Times poll: 67% say Bush is hiding something or lying about Enron, up from 53% the week before.[71]

- Bush shuns call by Democrats for Special Counsel. Senate Commerce Committee Chairman Ernest Hollings (D-SC) said "the Justice Department can't be objective because too many Bush officials have ties to Enron."[72]

- General Accounting Office sues White House for records on Energy Task Force meetings.[73]

- Democrats cite Enron mess to argue against privatizing Social Security.[74]

- Democrats scrutinize Bush's business record at Harken Energy.[75]

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[66] Buggs S., Houston Chronicle, December 18, 2001.
[67] Antosh N., Fowler T., Houston Chronicle, December 8, 2001.
[68] Fowler T., Houston Chronicle, December 6, 2001.
[69] Reinert P., Masterson K., Houston Chronicle – Washington Bureau, January 31, 2002.
[70] Khanna R., Houston Chronicle – Washington Bureau, January 25, 2002.
[71] Associated Press, January 27, 2002.
[72] Riechmann D., Associated Press, February 5, 2002.
[73] Reinert P., Houston Chronicle – Washington Bureau, March 5, 2002.
[74] Mason J., Houston Chronicle – Washington Bureau, March 5, 2002.
[75] Associated Press, June 27, 2002.

While the White House tried to publicly distance itself from the political turmoil, later reports indicate "officials launched a feverish series of previously undisclosed e-mail and conference call consultations, including the Council of Economic Advisors, Federal Energy Regulatory Commission and the Commodity Futures Commission. The White House Report suggests that Bush officials then became deeply concerned about political and financial fallout of the Enron debacle."[76] Pundits began calling Enron "Bush's Whitewater".[77]

On January 25, 2002, Budget Director Mitch Daniels of the Office of Management and Budget directed the General Services Administration to review federal contracts with Enron and Arthur Andersen to determine whether they are "worthy of government business."[78]

Politicians blamed Andersen because they needed political cover to distract attention from the fact that Enron had made massive political contributions and had been exempted from investor protection laws. Meanwhile Andersen was silenced by gag order.

Why has the true identity of the auditors of Enron's SPEs been hidden?

The government launched numerous investigations and surely knew that Andersen was not the auditor of the SPEs. In addition to having access to both Enron's financial statements and the Andersen's audit workpapers, government investigators must have spoken to Andersen auditors who would have correctly identified the auditors of the SPEs.

Even if not one government investigator was sufficiently competent to determine the identity of the auditors of the SPEs, the facts were available in the public domain. On January 17, 2002 Andersen made a statement regarding the Client Retention Memo dated February 6, 2001, a memo being widely quoted out of context in the media.[79] Listed in the section of the memo labeled "Take away To Do's" is the statement regarding LJM that has been strangely ignored. To quote,

> "Why did Andy (Fastow) not select AA [Andersen] as auditors [of the SPEs], including when PwC [PricewaterhouseCoopers] was replaced by

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[76] Allen M., Morgan D., The Washington Post, May 24, 2002.
[77] Ivanovich D., Houston Chronicle, January 11, 2002.
[78] Mason J., Houston Chronicle – Washington Bureau, January 24, 2002.
[79] Memorandum written by Michael D. Jones addressed to David B. Duncan and Thomas Bauer, all of Arthur Andersen, February 6, 2001. The mention of potential fees was in the context of a concern about the appearance of independence. To quote:

> "We discussed whether there would be a perceived independence issue solely considering our level of fees. We discussed that the concerns should not be on the magnitude of the fees but on the nature of fees. We ***arbitrarily*** (emphasis added) discussed that it would not be unforeseeable that fees could reach a $100 million per year amount considering the multi-disciplinary services being provided. Such amount did not trouble the participants [of the Andersen conference call] as long as the nature of services was not an issue."

> KPMG. Discussions concluded that we would likely not want to be LJM's financial advisors given potential conflicts of interest with Enron."[80]

On February 7, 2002, Thomas Bauer, Andersen partner, testified before the House Committee on Energy and Commerce. His testimony described how the fraud within Chewco was committed by means of a hidden side agreement that reversed the appropriate accounting for the transaction. Had the side agreement not been hidden from Andersen, Chewco would have been properly consolidated with Enron. Further, Bauer's testimony indicates that Andersen was not Chewco's auditor. To quote,

> "I also requested that I be provided documents relating to Chewco's formation and structure. Mr. Glisan told me that Enron did not have these documents and could not obtain them because Chewco was a third party with its own legal counsel and ownership independent of Enron."[81]

If Andersen were the auditor of Chewco, Bauer would not be asking Enron employee, Ben Glisan, for Chewco documents. Instead, Bauer would have been requesting access to Chewco documents from Chewco personnel.

On February 15, 2002, *Business Week* published an article that included the paragraph,

> "Some documents associated with LJM2 identified PricewaterhouseCoopers as the partnership's auditor. A December, 1999 memo prepared by Merrill Lynch to help sell a $200 million private placement of LJM2 partnership interests listed the firm (PwC) as LJM2's auditor. In fact, KPMG was the auditor. The PwC spokesman says his firm didn't even bid for the audit contract."[82]

In summary, the SEC, the Department of Justice and numerous congressional committees all had full access to Andersen audit workpapers regarding Enron. Is it possible that not one individual in all of these government investigations is sufficiently competent to correctly determine the identity of the auditors? The only other plausible explanation is that these investigators knew that Andersen was not the auditor of the fraudulent SPEs but hid the truth so that Andersen would be wrongly blamed.

Long before the indictment, the media also had the facts to conclude that Andersen was not the auditor of either Chewco or LJM. Yet the February 15, 2002 *Business Week* article is apparently the only media reference to date that sought to correctly identify the auditor of any of the SPEs.

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[80] Jones, M. D., Memorandum addressed to David B. Duncan, Thomas H. Bauer, all of Arthur Andersen, February 6, 2001.
[81] Bauer - February 7, 2002.
[82] McNamee M., Timmons, H. *PwC:sharing the hot seat with Andersen?* Business Week, February 15, 2002.

Amazingly, the Powers Report[83], the government reports on *The Role of the Board of Directors in Enron's Collapse*[84]*, The Role of Financial Institutions in Enron's Collapse*[85]*, Financial Oversight of Enron: The SEC and Private-Sector Watchdogs*[86]*,* the Report of the Enron Directors' Response[87], the first three Interim Reports[88] and the Final Report [89]of the Enron Bankruptcy Examiner all discuss Enron's SPEs at length but not one mentions the correct identity of the auditor of the SPEs. How can one account for the oversight of such a basic yet crucial fact?

The only official report that correctly identifies the auditor of the SPEs is the report of Harrison Goldin, Enron North America Bankruptcy Examiner[90], who examined the audit reports of KPMG as well as the fairness opinions of PricewaterhouseCoopers.

Did the Enron Board know that Andersen was not the auditor of either Chewco or LJM?

Enron Chief Financial Officer Andrew Fastow presented the ideas for the Chewco transaction in an Executive Committee meeting by conference call[91] and for the LJM2 transaction in a Finance Committee meeting. Andersen was not represented in either instance. Fastow's presentations included assurances that Andersen would be overseeing the transactions. Andersen personnel were not present to caution the Directors on the severe constraints on anybody other than the auditors of the SPEs in examining specific SPE transactions concerning banks, brokerages and other third parties. Apparently, the Directors relied on Fastow for their understanding of Andersen's responsibilities and never raised the issue with Andersen.

Andersen advised Enron on the proper criteria for what constitutes a valid non-consolidated SPE. However, determining the criteria for proper accounting treatment should not be confused with auditing the specific transactions of an audit client.

Were the Enron Directors aware that Andersen as Enron's auditor could only audit the transactions from the perspective of Enron? The frauds took place within Chewco and LJM with the assistance of numerous financial institutions. Neither Chewco nor LJM nor any of the other parties to the fraud were Andersen clients. Thus Andersen

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[83] Powers Jr. W., *Report on the Special Investigation Committee to the Board of Directors of Enron*, February 1, 2002, (hereinafter "Powers Report").
[84] Governmental Affairs Permanent Subcommittee on Investigations, *The Role of the Board of Directors in Enron's Collapse*, U.S. Senate, July 8, 2002.
[85] Governmental Affairs - Financial Institutions.
[86] Governmental Affairs Permanent Subcommittee on Investigations*, Financial Oversight of Enron: The SEC and Private-Sector Watchdogs*, U.S. Senate, October 8, 2002.
[87] Eggleston W., Nionakis N., Dimitri J. *The Outside Directors' Response to the Permanent Subcommittee on Investigations of the Senate Governmental Affairs Committee Report: The Role of the Board of* Directors *in Enron's Collapse*, August 1, 2002.
[88] Batson N., *Interim Reports, Court-Appointed Examiner In Re: Enron Corp*., September 21, 2002, January 21, 2003 and July 28, 2003.
[89] Batson - Final Report.
[90] Goldin, 2003.
[91] Powers Report, p. 153.

had no access to the SPEs' accounting records or documentation and Andersen was forced to rely on confirmations and oral and written representations (all of which were inaccurate) from the SPEs and third parties.

Should the Directors have known that Andersen was not the auditor of the SPEs? Yes, they should have. Public accounting firms document their understanding of their contractual responsibilities in an engagement letter. Andersen's engagement letter sent to the Enron Directors would have listed by name the entities Andersen was being hired to audit. The fact that none of the SPEs were included on the engagement letters for the years 1997, 1998, 1999 or 2,000 should have raised immediate questions for the Board's Audit Committee.

It is possible that given Fastow's assertions, the Audit Committee and the Board assumed that Andersen was going to audit the SPEs and did not read or carefully consider the Andersen engagement letters. This incorrect assumption might explain the Directors' lack of concern about Enron's SPEs.

On the other hand, the Andersen audit opinion and comments about internal control, etc. applied only to Andersen's client, Enron, and not to Enron's SPEs. Andersen partners cannot be blamed for believing that the Enron Directors would be reading the Andersen engagement letters and paying attention as to who (if anybody) was auditing the critical SPEs.

KPMG addressed and submitted its audit proposal regarding LJM to Andrew Fastow and Ben Glisan, vice president of Enron Global Markets, although KPMG's engagement letter was addressed to the LJM Partnerships.[92] Harrison Goldin, ENA Bankruptcy Examiner, is critical of KPMG's audit of the LJM partnerships in many respects. Specifically, Mr. Goldin states,

> "A fact finder could conclude that KPMG had actual knowledge of [Andrew] Fastow's unauthorized personal benefit and/or self-dealing involving the LJM partnerships or, at a minimum, was willfully blind to the fraudulent nature of transactions between Enron and its affiliates, on the one hand, and the LJM Partnerships (which KPMG audited) and their affiliates, on the other hand."[93]

Mr Goldin further concludes,

> "The totality of the circumstances of KPMG's retention and audit work establish that Enron was effectively KPMG's audit client, or that the relationship between the two was equivalent to privity. Accordingly, KPMG owed a duty to Enron to perform the audits of the LJM Partnerships properly and not to stand silent in the face of Fastow's self-dealing and of the impropriety of the transactions…among Enron, LJM1, LJM2 and Swap Sub."[94]

[92] Goldin, 2003, pp. 212 – 213.
[93] *Id* at 205.
[94] *Id* at 205 – 206.

Yet KPMG failed to notify the audit committee of Enron's Board as to any of the facts KPMG learned concerning the LJM transactions and Fastow's personal unauthorized profits.[95] It is possible that Enron's Board may not have known that KPMG was the auditor of the LJM partnerships.

The Powers Report was fatally flawed.

On October 31, 2001, Enron's Board of Directors elected William Powers, Dean of the University of Texas School of Law, to the Board and appointed Dean Powers as Chairman of the newly formed Special Committee of the Board to conduct an "independent investigation and review of transactions between Enron and certain related parties." The Special Committee also was charged with taking any disciplinary action that it deemed appropriate, communicating with the Securities and Exchange Commission (which had commenced a formal investigation into these matters), and recommending to the Board any other appropriate actions. The other members of the Special Committee were independent directors Frank Savage, CEO of Savage Holdings, LLC, Paulo Ferraz Pereira, Executive Vice President of investment bank Group Bozano, and Herbert S. Winokur, Jr., Chairman and CEO of Capricorn Holdings, Inc."[96]

The Special Committee retained the law firm of Wilmer, Cutler & Pickering as its counsel.[97] The firm's representation was led by William R. McLucas, former head of the Division of Enforcement of the SEC.[98] Wilmer, Cutler retained Deloitte & Touche to provide related accounting advice.[99]

The Special Committee labored under different circumstances than either the Board or government investigating committees. Unlike the Board, the Special Committee was investigating a specific and substantial problem regarding Enron's SPEs. Therefore, one would expect the Special Committee to bring more focus and expertise to the problem. However, unlike government investigators, the Special Committee did not have the power to subpoena documents.

The Report of the Special Committee (the Powers Report) was delivered February 1, 2002. The report blames Andersen. Despite detailed discussion of fraud within Enron's SPEs, nothing in the report mentions that Andersen was not the auditor of any of these SPEs. This is despite the fact that the report cites Andersen's engagement letter listing Andersen audit responsibilities for Enron but not Chewco or LJM, the focus of the investigation. In three months of study, is it possible that no one on the Special Committee or their advisors at Wilmer, Cutler and Deloitte & Touche was able to correctly identify the auditors of the SPEs from either the audit opinions or the engagement letters for the years under investigation?

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[95] *Id* at 270.
[96] Enron Corp. Form 8-K, November 8, 2001, (C)(4).
[97] *Id*
[98] *Id*
[99] *Id*

The Powers Report states that "although Andersen reviewed the [Chewco] transaction at the time it occurred, we do not know what information the firm (Andersen) received or what advice it provided."[100] The only relevant facts regarding the quality of an audit are (1) the information sought by the auditor, and (2) the information received by the auditor. By their own admission, Dean Powers and the Special Committee did not have the relevant facts necessary to reach a valid conclusion regarding Andersen because those facts can only be determined by a knowledgeable and comprehensive examination of the audit workpapers.

In summary, the Powers Report has two fatal flaws: (1) it omits the material fact that Andersen was never hired to audit Enron's SPEs, and (2) its conclusions regarding Andersen's audit are without foundation since none of the relevant facts are examined.

Why would anybody sign a report containing such glaring deficiencies? The Enron Directors were under intense scrutiny and may have been tempted to find a scapegoat. Why would the advisors at Wilmer, Cutler or Deloitte & Touche associate themselves with this report? Was there some hidden agenda?

Perhaps Deloitte & Touche's participation can be explained by an article by Jackie Spinner of the Washington Post. According to Ms. Spinner, in February 2002 Congressman Billy Tauzin (R-LA), Chairman of the House Committee on Energy and Commerce, met with representatives of the Final Four accounting firms (Deloitte & Touche, KPMG, PricewaterhouseCoopers and Ernst & Young). Over a lunch of crabcakes in a crowded restaurant overlooking what is known as the "Suicide Bridge", they agreed to "push Andersen off the bridge."[101] Did the representatives of the "Suicide Bridge" meeting also discuss how they would divide Andersen's most valuable assets – its people and its clients?

A government official conspiring with businesses to destroy a competitor could be considered racketeering subject to the RICO statutes. At the very least, such tactics are prohibited by the ethics requirements of state CPA regulators and professional associations. The American Institute of Certified Public Accountants (AICPA) Code of Conduct states that "a member shall not commit an act discreditable to the profession."[102] Further, "a member in public practice shall not seek to obtain clients by advertising or other forms of solicitation in a manner that is false, misleading or deceptive. Solicitation by coercion, over-reaching or harassing conduct is prohibited."[103] State laws regarding the conduct of CPAs and CPA firms have similar prohibitions regarding conduct.

Whatever the motives of Dean Powers and his associates may have been, the Powers Report aptly illustrates H. L Mencken's observation that "for every complex problem, there is a solution that is simple, neat and wrong."

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[100] Powers Report, p. 53.
[101] Spinner J., The Washington Post, May 12, 2002.
[102] AICPA Code of Conduct, ET Section 501.01 Rule 501 – Act discreditable.
[103] AICPA Code of Conduct, ET Section 502.01 Rule 502 – Advertising and other forms of solicitation.

Should Arthur Andersen have been able to catch the fraud?

Unfortunately, it was impossible. Auditors do not have the power of subpoena; they cannot set up wiretaps or threaten long jail sentences; they cannot threaten bodily harm. Auditors can only evaluate internal controls and search for inconsistencies by reviewing documents, talking to client personnel and asking for confirmations and representation letters from third parties.

Enron officers colluded with individuals within numerous financial institutions and their hidden side agreements -- especially oral side agreements -- left no audit trail. Arthur Andersen followed all generally accepted auditing procedures but all the representations and confirmations from Enron and the banks were fraudulent. It is a fact that it is far easier to uncover a small fraud as opposed to a massive fraud with collusion.

Was Andersen's independence compromised?

No. This was a fraud committed within SPEs that were never Andersen clients.

To a CPA, the accusation of lack of independence is no less serious than to assert, before there is even an autopsy, that a doctor whose patient died during surgery is guilty of murder. Just as there are many possible reasons for the death of a patient, there are many possible reasons why a fraud can be successfully hidden from auditors.

The year 2000 Enron financials list the US $27 million "consulting" fees paid. They include:

- US $0 for financial systems design and implementation fees;
- US $4 million paid to Accenture (formerly Andersen Consulting) which was totally independent from Andersen during 2000; and
- US $23 million primarily related to business process and risk management, tax consulting, due diligence related to acquisitions and other activities, work performed in connection with registration statements and various statutory and other audits.[104]

In short, the "consulting" was all tax or audit-related. Under SEC regulations, many services that can only be provided by auditors must be disclosed as "consulting" fees. It is ironic that the SEC definition of "consulting" is itself inherently misleading. In fact, it appears that fees generated because Andersen sought – and received -- advance SEC approval[105] before allowing Enron to set up SPEs were required by the SEC to be classified as "consulting" fees. Thus, Andersen's efforts to perform a careful audit increased their "consulting " fees, which in turn were used to condemn Andersen.

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[104] Enron 10-K, 2000.

[105] United States v. Andersen, 374 F.3rd 281 (5th Circ.2004), testimony of John Stewart. According to Mr. Stewart's testimony, in many cases the SEC agreed with Enron's more aggressive accounting rather than Andersen's more strict positions.

Even if Andersen had performed any consulting as it is generally defined (i.e. system design and implementation[106] as opposed to audit and tax-related services), Andersen's independence was not the problem. The collusion to defraud committed by the Enron SPEs (none of which were Andersen clients) and assisted by banks, brokers and other outside parties, could not have been uncovered by any audit technique in existence. An audit is based on the presumption that banks and other outside parties are honest and credible.

According to Enron Bankruptcy Examiner Neal Batson, was Andersen's audit adequate?

According to Mr. Batson,

> "Evidence suggests that, in numerous instances, material transaction information was withheld from Andersen. For example, Andersen accountants have indicated they were unaware that Enron officers had entered into side agreements guaranteeing repayment of equity that was supposedly 'at risk' in SPE transactions. Andersen accountants also indicate that, had they known this information, they would not have approved Enron's accounting for those transactions. While these facts demonstrate that Enron officers were deceiving Andersen, a fact finder could conclude that, under the circumstances, Andersen overlooked obvious risks that such activities were occurring and should have implemented an audit plan designed to detect them."[107]

However Mr. Batson did not suggest any specific audit step that would have uncovered fraud where all parties to the fraud were willing to execute phony contracts, sign dishonest confirmations and representation letters and lie to auditors. Nor did Mr.

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[106] The ban on CPA firms providing systems work to audit clients flies in the face of logic. The fear is that an audit will be compromised or appear to be compromised. This presupposes that an auditor will knowingly overlook fraud, thereby destroying her reputation, career and family's financial future, so that a partner doing systems work will get promoted. Why would any auditor do that? Lack of independence regarding systems work for an audit client might be a concern if the same individual performs the audit and does the system work, which would occur only in the very smallest firms. Even then, it would be irrational for a CPA to knowingly overlook fraud in order to gain systems work.

The reality is that financial statements are comprised of numbers generated by an accounting system. In other words, the financial statements and the audit are only as good as the accounting system. Accounting systems, like any computer, are subject to hacking and must be constantly updating to improve security and to adapt to evolving business needs. The auditor is in the best position to identify problems in a client's accounting system. In banning auditing firms from systems work on clients, we will have audit failures due to the increased probability of miscommunication between auditors, the client and the systems consultant. In addition to systems fees, businesses will incur higher audit fees because auditors will have to check the systems work before giving an opinion, not to mention decreased employee productivity in answering questions of both systems people and auditors.

The ban on providing systems work is a disaster for public accounting not because of reduced fees – to the contrary, there are more – but because it leaves auditors even more vulnerable to audit failure. It is the triumph of demagoguery over logic.

[107] Batson – Final Report, pp. 41 – 42.

Batson state that Andersen failed to perform the audit in accordance with generally accepted auditing standards.

Mr. Batson concluded that Andersen failed to discharge its duty to "determine that the audit committee is informed about the methods used to account for significant unusual accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus."[108] But according to Mr. Batson, Andersen accountants ***did*** warn the Enron Audit Committee. In an Audit Committee meeting on February 12, 2001, Andersen showed a slide stating that the application of GAAP to Enron's structured transactions often requires "significant" judgment.[109] Minutes of the Audit Committee meeting suggest that in his oral presentation, Andersen partner David Duncan may have described the risks as "extreme."[110] An argument could be made that the SEC's decision to exempt Enron from the provisions of the Investment Act of 1940 and the SEC's advance approval of specific SPE transactions constitute authoritative guidance. Whether the risk was described as "significant" or "extreme", the warning was given.

Given that Andersen warned the Enron Board about Enron's aggressive accounting, why did Andersen not resign from the Enron engagement?

Consider the context of early 2001 when Andersen's final audit of Enron for the year 2000 was being completed and Duncan was making his comments to the Enron Board. The SEC had given Enron an exemption that allowed them to use SPEs. Further, the SEC had given advance approval to Enron for various fact patterns in setting up those SPEs and trial testimony indicates that in many cases, the SEC agreed with Enron's more aggressive accounting rather than Andersen's more conservative accounting.

As we have seen, Enron could not have committed its fraud without the willing participation of numerous prominent financial institutions. Before the Enron fraud (and subsequently Parmalat, Dynegy, WorldCom, etc.) auditors accepted without question third-party representations of major financial institutions; such representations are fundamental to all audits. Therefore Andersen auditors can hardly be blamed for not suspecting rampant fraud in major financial institutions audited by reputable accounting firms.

If there had been no fraud, Enron's disclosure was in accordance with the rules set by the SEC and the Financial Accounting Standards Board. Over the years, Andersen had advocated mandatory consolidation of all SPEs but had been unsuccessful. Unfortunately, in a system of rules-based accounting, one must follow the rules even if they are nonsensical. Should Andersen have resigned, criticizing the SEC and the FASB, etc. for poor rules? Another accounting firm would have taken over the Enron job with exactly the same outcome for investors. The only difference would have been that another audit firm would have been scapegoated and destroyed instead of Andersen.

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[108] *Id* at 43.
[109] *Id* at 44.
[110] *Id*

One advocate of rules-based accounting, Professor Ed Ketz, posits that Andersen should have required consolidation regardless of the rules.[111] Andersen would then have been forced to convince Enron to accept a qualified opinion because mandatory consolidation was (and is) not in accordance with generally accepted accounting principles. Does this sound reasonable?

In my opinion, the only rational approach is to quit blaming auditors for following mandatory nonsensical rules. Instead, why not change the rules so that they protect investors? Furthermore, having seen the fallacies of rules-based accounting, why not go back to principles-based accounting whereby an auditor can insist upon full and fair disclosure to investors?

Why has the government not indicted the various banks?

Were politicians concerned about the stability of our banking system? Or were they concerned about the continuing flow of campaign contributions? On March 14, 2002, *Rollcall* reported,

> "House Energy and Commerce Committee Chairman Tauzin's Enron probe is posing a fundraising problem for his party. Securities industry firms and banks targeted by Tauzin's investigators over their role in the creation of outside partnerships run by top Enron executives are balking at giving to an upcoming fundraising event in New York City being put together by the National Republican Congressional Committee…NRCC officials have quietly passed along these protests to House GOP leaders, including top aides to Speaker Dennis Hastert (R-IL), although Hastert has made no effort to move thus far to rein in Tauzin."[112]

The impasse was apparently overcome. The banks have resumed their campaign contributions[113] and none of the institutions or their top executives have been indicted.

Some Merrill Lynch and Enron executives were indicted but none at other banks. Why not?

Four former Merrill Lynch executives and two former Enron officials were convicted of fraud for helping to set up a transaction (known as Ebarge) where Enron in December 1999 "sold" Merrill an interest in some barges off the coast of Nigeria. According to Enron Bankruptcy Examiner Neal Batson, there was an undisclosed oral side agreement that transformed the transaction into debt. According to Mr. Batson, Jeffrey McMahon, Enron's Treasurer and Executive Vice President, had asked Merrill

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[111] Ketz, J.E., *The Accounting Cycle, Rush to Judgment: Whither Arthur Andersen*, SmartPros.com, June 2004.
[112] *See* http://www.Rollcall.com/pages/news/00/2002/03/news0314c.html.
[113] *See* http://www.fecinfo.com/cgiwin/HomePages.exe/DoFn=&LookUpDate=8/5/2004.

Lynch to purchase an interest in the barges before year-end 1999 as "a bridge to permanent equity."[114] McMahon indicated that

i) the transaction would allow Enron to book $12 million in earnings;
ii) Merrill Lynch's "hold" would be for 6 months or less; and
iii) The investment would yield a 22.5% rate of return to Merrill Lynch.[115]

Merrill Lynch prepared a draft letter agreement dated December 23, 1999 regarding the Nigerian Barge transaction. This draft made specific reference to the 15% rate of return[116] to be paid to Merrill Lynch on the US $7 million investment and stated that Merrill Lynch's equity interest would subsequently be sold to third-party equity investors or purchased by Enron or an Enron affiliate.[117] These terms were subsequently omitted from the final letter agreement between Merrill Lynch and Enron dated December 29, 1999 and they did not appear in any of the operative documents.[118]

Merrill Lynch documented the oral side agreement in several instances. For example, the Merrill Lynch Credit Flash Report for the week ending December 23, 1999 described the Nigerian Barge transaction as a "relationship loan" and stated, "IBK [Investment Banking] was supportive based on Enron relationship (approx. $40mm in annual revenues) and assurances from Enron management that we will be taken out of our $7mm investment within the next 3 – 6 months."[119]

In contrast to the documentation of fraud at Merrill Lynch, former Enron employee Amanda Colpean testified that ex Enron accountant Sheila Kahanek yelled at her for drafting a document that outlined the barge agreement. According to Ms. Colpean, "She told me I had jeopardized the deal by putting certain information in the document and that if it fell into the hands of [auditor] Arthur Andersen, the deal was over."[120]

What is remarkable about Merrill Lynch as compared to the other banks that participated in Enron's frauds?

In contrast to banks such as Citigroup or JPMorgan Chase, Merrill Lynch had a limited relationship with Enron.[121] Merrill Lynch's credit exposure to Enron, as compared to other financial institutions, was minimal.[122] Merrill Lynch was involved in approximately thirty-five transactions with Enron and Enron-related entities from 1997 until Enron's bankruptcy, including underwritings, private placements of debt and equity,

[114] Batson - Final Report, Appendix I, p. 24.
[115] *Id* at 24 – 25.
[116] When coupled with the US $250,000 up front fee to be paid by Enron to Merrill Lynch, the total rate of return to Merrill Lynch on its investment for the expected six-month life of the transaction was 22.14%. *Id* at 28.
[117] *Id* at 28 – 29.
[118] *Id*
[119] *Id* at 33.
[120] Hays K., *Ex-Enron Officials' Criminal Trial Opens,* Associated Press, September 22, 2004.
[121] Batson – Final Report, Appendix I, p. 12.
[122] *Id* at 12.

structured finance transactions, derivative transactions and participation as a syndicate member in several credit facilities.[123] Merrill Lynch officers were also substantial investors in LJM2[124] and Merrill Lynch equity analysts covered Enron until Enron's bankruptcy filing.[125]

Perhaps government prosecutors found a more damning paper trail at Merrill Lynch. However, Enron Bankruptcy Examiner Neal Batson and Enron North America Bankruptcy Examiner Harrison Goldin found widespread documentation of hidden side agreement at other banks.

The activities of Merrill Lynch can be distinguished from those of Citigroup and JPMorgan Chase in two respects:

(1) Citigroup and JPMorgan Chase have admitted to the Governmental Affairs Permanent Subcommittee on Investigations that they entered into Enron-style fraudulent transactions with other companies; and

(2) Merrill Lynch is subject to regulation of accounting practices by the SEC whereas the SEC does not generally regulate banks. Instead, the Federal Reserve regulates banks but does not generally regulate accounting practices overseen by the SEC.

During congressional hearings on the extensive role that certain banks – including Citigroup, JPMorgan Chase and Merrill Lynch – played in deceptive transactions involving Enron SPEs, Senator Carl Levin (D-Mich.) and then ranking minority member Senator Susan Collins (R-Maine) identified "a current gap in federal oversight" of the banks that helped them aid and abet Enron's fraud, adding that this "is a major problem and needs immediate correction." That correction has yet to be made.[126]

As the chief regulator of the U.S. financial system, the onus on fixing the regulatory gap is on the Federal Reserve Board. Yet the Fed's primary interest isn't stopping financial fraud, but making sure the U.S. banking system remains safe and sound[127] and the Fed's most important charges – large multi-business bank holding companies – happen to earn large fees by arranging deals involving SPEs.[128]

Until this conflict is resolved, there is no regulatory mechanism to prevent banks from aiding and abetting corporate fraud. Even if there were such regulatory oversight, the mandatory non-consolidation of even law-abiding SPEs directly contravenes full and fair disclosure. One must conclude that in the eyes of the U.S. government, the

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[123] *Id*
[124] *Id* at 17.
[125] *Id* at 19.
[126] Fink, R. *Playing Favorites: Why Alan Greenspan's Fed lets banks off easy on corporate fraud*, CFO Magazine, May 2004.
[127] *Id*
[128] *id*

profitability of major financial institutions far outweighs any concern for full and fair disclosure to investors.

Why has the government not gone after KPMG, the auditors of Enron's SPEs?

Perhaps the government has not held KPMG accountable because to do so would raise the question as to why Andersen was destroyed when Andersen was not the auditor of the entities where the Enron frauds were committed. Perhaps the government also did not want to risk the destruction of another firm, with the resulting adverse impact on the economy and decreased competition among large public accounting firms.

Enron North America Bankruptcy Examiner Harrison Goldin found evidence to support a claim against KPMG for "aiding and abetting breaches of fiduciary duty"[129] by Enron officers Andrew Fastow, Ben Glisan and others. Specifically, "KPMG had actual knowledge of Fastow's unauthorized personal benefit and/or self-dealing involving the LJM Partnerships."[130]

Mr. Goldin also found evidence to support a claim that KPMG committed negligence and malpractice because there is legal precedent to state that KPMG owed a duty of privity to Enron and that KPMG also failed to audit the LJM Partnerships in accordance with Generally Accepted Auditing Standards (GAAS). For example, in completing their risk analysis, KPMG decided that the following posed no substantial risk in the audit of LJM: subjective valuation judgments of assets, the possibility of related party transactions, highly complex transactions that pose 'substance over form' questions and overly complex organizational structure.[131] Therefore, the KPMG audit never addressed these potential problems.

Whereas Enron Bankruptcy Examiner Neal Batson blames Andersen for being unable to discover the existence of hidden side agreements within SPEs that were not Andersen audit clients, ENA Bankruptcy Examiner Harrison Goldin does not fault KPMG for being unable to discover oral side agreements despite the fact that KPMG audited Enron's SPEs. Mr. Goldin is correct in not faulting KPMG because nobody can uncover oral side agreements unless there is at least one knowledgeable, honest individual within the client or the financial institutions with which the client does business. In this case, there were none.

What is the responsibility of PricewaterhouseCoopers (PwC)?

Enron North America Bankruptcy Examiner Harrison Goldin found evidence to support a claim that PwC was guilty of "professional malpractice and grossly negligent conduct" in rendering fairness opinions regarding the Rhythms/Sub Swap and the Raptors I transactions.[132] Mr. Goldin cites the following deficiencies:

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[129] Goldin, 2002, p.264.
[130] *Id*
[131] *Id* at 233-234.
[132] *Id* at 306.

(i) There was a clear conflict of interest because PwC was concurrently rendering tax and consulting services on the same transactions;[133]
(ii) Improper methodology;[134]
(iii) Although the fairness opinion was addressed to the Enron Board, it was never delivered to them;[135]
(iv) Goldin found that Andersen memos had required that Enron obtain the fairness opinions in order for the transactions to proceed;[136] and
(v) Goldin concluded that if Andersen had known the opinions were not reliable, Andersen would not have approved the transactions.[137]

Is Arthur Andersen responsible for the collapse of Enron?

No. Financial statements are historical documents reflecting the results of business decisions. Financial statements don't cause bankruptcies; poor business decisions cause bankruptcies. While accuracy is essential in financial reporting and fraud is reprehensible, it makes as much sense to blame an auditor for a bankruptcy as it does to blame a historian who writes about a war whose outcome we don't like. It is important for a historian to be factually correct but the historian did not make the decisions that lost the war.

Enron management made poor investments using borrowed money, the classic formula for bankruptcy. Further, Enron and colluding financial institutions hid debt in a massive fraud, thereby delaying the timely reporting of the inevitable bankruptcy.

Since 1988 Andersen has repeatedly urged the SEC and the Financial Accounting Standards Board (FASB) to require consolidation of off-balance sheet partnerships in order to prevent earnings manipulations.[138] What if the SEC and the FASB had supported Andersen's recommendation of mandatory consolidation? What if politicians had not bent the rules for Enron? What if Andersen had been able to detect the fraud? What if Enron had not committed a fraud? In all these cases, Enron would still be bankrupt due to

[133] *Id* at 324.
[134] *Id* at 305.
[135] *Id*
[136] *Id* at 357.
[137] *Id*
[138] In a Letter to the Editor of the *Wall Street Journal*, May 3, 2002, Patrick Dorton, Andersen spokesman, states that Andersen

> "has advocated a greater focus on a risk and reward standard that would lead to more consolidation, more on-balance sheet treatment of securitizations and thus more transparent disclosure of various types of special purpose entities. [Thus Andersen] proposed a model for consolidation of [SPEs]. We began discussing our concerns about the accounting model for SPEs with the SEC staff in 1988 and wrote letters to the FASB…on consolidation…in 1992, repeating our views in 1994, 1996 and 1999. In our December, 1994 letter we stated, 'The real issue here is whether the SPE has sufficient substance to allow the sponsor not to consolidate the SPE. If the SPE lacks substance, its creation should not cause the accounting to be different than if the SPE did not exist.' In our January 16, 1996 letter, we told the FASB, 'We are also concerned that the change the Board proposes will create significant new opportunities for "financial statement engineering" and accounting results that are contrary to the economics.'"

Enron's poor business decisions and both shareholders and creditors would have lost money.

Would Enron shareholders and employees have been protected from losses if Andersen had discovered the fraud sooner?

If the fraud had been uncovered earlier, the stock price might not have been so over-hyped (by the same banks that, according to the Enron Bankruptcy Examiner, "aided and abetted" Enron's fraud.)[139] However, shareholders are destined to be harmed in a bankruptcy even if there is no fraud. Their only recourse is to sell their stock to an unsuspecting buyer who then suffers the loss. Thus, the question is not whether shareholders are going to be harmed in a bankruptcy. The only question is the identity of the shareholders left holding the worthless investment.

Did Arthur Andersen obstruct justice?

On March 7, 2002, Andersen was charged with obstructing justice under the witness tampering provisions which make it a crime to "***knowingly corruptly*** persuading one or more Andersen employees to withhold, alter, destroy or conceal documents with the intent to impair their availability in an ***official proceeding***."[140] (Emphasis added).

The relevant dates are:

- **October 12, 2001** – Nancy Temple, Andersen in-house lawyer, sent an e-mail stating, "It might be useful to consider reminding the engagement team of our documentation and retention policy."[141]

- **October 16, 2001** – Enron restated its balance sheet with no effect on the income statement.

- **October 23, 2001** – Duncan scheduled a meeting where he "directed the engagement team to comply with Andersen's records retention policy."[142]

- **October 31, 2001** - Enron announced that an SEC inquiry regarding Enron had been upgraded to a formal investigation focusing on off-balance sheet partnerships, otherwise known as SPEs.

- **November 2, 2001** - Andersen first became aware of fraud within Enron's SPEs.

- **November 8, 2001** – Andersen received subpoena from the SEC.

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139 Batson – July 28, 2003, pp. 38-39.
140 18 U.S.C. 1512(b)(2) (2004).
141 United States District Court Transcript, United States v. Arthur Andersen, 2002 Extra LEXUS 459 (S.D. Tex. May 20, 2002)(No. H-02-121).
142 Andersen's Petition for Writ of Certiorari at 6 (N. 04-368).

David Duncan, Andersen engagement partner on the Enron audit, pled guilty to obstruction of justice and entered into a cooperation agreement.[143] At trial, Duncan testified that he destroyed ***duplicate*** memos, old magazines and requests for charitable contributions.[144]

Although no official proceeding had actually been initiated when Andersen employees were "corruptly persuading" others to shred documents, the government argued that Andersen had every reason to anticipate the commencement of an SEC proceeding and that the document destruction was therefore aimed at corruptly keeping evidence out of such a proceeding.

However, Andersen witnesses testified that until the Chewco fraud had been discovered on November 2, 2001 when Andersen required Enron to restate earnings, no formal SEC proceeding was anticipated. This is because a balance-sheet restatement does not trigger a formal SEC investigation.[145] An SEC official confirmed at trial that Andersen's expectation was correct; the agency was not planning to request documents from Andersen unless Enron restated its income.[146] Therefore, the "corrupt persuasion" took place before the fraud (which would require an income restatement) was uncovered and that fraud was committed within entities not audited by Andersen.

What is a document retention policy and what are audit workpapers?

Under Andersen's audit procedures – which had been in effect for decades – the engagement team was required to assemble one central workpaper file containing all information related to the engagement[147] in order to unambiguously document and support the resolution of accounting issues and the audit opinion. The file was to be cross-indexed so that if any item on any schedule was examined, one could immediately determine where that number originated and how it fit into the financial statements as a whole. The prior year amount was shown and any significant variation was explained in a note referenced to the item. If testing had been performed on a particular item or on operating effectiveness of internal controls, supporting schedules detailing the method of selection of items tested, the identity of the transactions tested and the results of those tests were cross-referenced to the item. If there were questions regarding the proper

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[143] *See* Cooperation Agreement, United States v. Duncan Crim. Action No. H-02-09 (S.D. Texas, April 9, 2002), *available at* http://news.corporate.findlaw.com/hdocs/docs/enron/usduncan040602agr.pdf. (last visited October 14, 2004). *See also* Information, United States v. Duncan, Crim. Action No. H-02-09 (S.D. Texas, April 9, 2002, *available at* http://www.news.corporate.findlaw.com/hdocs/docs/enron/usduncan040902crinf.pdf (last visited October 14, 2004).

[144] United States District Court Transcript, United States v. Arthur Andersen, 2002 Extra LEXIS 459 (S.D. Tex. May 16, 2002) (No. H-02-121).

[145] Andersen's Petition for Writ of Certiorari at 5 (No. 04-368)(citing the Trial Transcript at Tr. 1445-49, 1904-05, 5896, 6087).

[146] *Id* (citing the Trial Transcript at 783-84).

[147] *See* Arthur Andersen, Practice Administration: Client Engagement Information – Organization, Retention and Destruction, Statement No. 760 (Feb. 2000), available at http://www.ethicsandlawyering.com/issues/files/andersenretenpolicy.pdf (last retrieved on October 14, 2004)(hereinafter "Andersen retention policy").

accounting of an item, memos discussing the accounting issues were cross-referenced to the item. If there were documents such as legal contracts relating to an item, these were cross-referenced to the item. All schedules were signed and dated by those who performed and reviewed the work.

The objective was to produce documentation sufficient for any experienced auditor – whether or not a member of the engagement team – to understand the evidence obtained and the nature, timing, extent and results of the auditing procedures performed.[148] In short, Andersen audit documentation standards in use for decades met or exceeded the requirements of Statement on Auditing Standards (SAS) no. 96, *Audit Documentation*[149] issued as a result of the Enron fraud.

Under the principle of maintaining one central audit engagement file, drafts and preliminary versions of memos and reports, superceded workpapers, backup diskettes and other types of redundant documents were to be destroyed to protect client privacy when they were no longer useful to the engagement and no later than by the end of the engagement.[150] In the course of a large engagement, it was frequently necessary for each member of the audit team to have a copy of various memos regarding the proper accounting for certain transactions under examination. Duplicate memos as well as personal or gratuitous information were to be excluded from the central audit engagement file.[151] The normal by-product of an audit is a mountain of scrap or extraneous items and all of these items – To Do lists, review points, drafts and preliminary versions of memos and reports, backup diskettes, duplicate copies of memos, personal and gratuitous information – were supposed to have been destroyed no later that March 2001. However, the Enron engagement team failed to do so. During its obstruction of justice trial, Andersen entered into evidence two emails, one dated March 2001 and the second dated August 2001, urging the Enron engagement team to come into compliance with Andersen document retention policy. These directives were evidently ignored.

On October 23, 2001 Duncan again directed the engagement team to "comply with Andersen's records retention policy."[152] Witnesses testified that, consistent with Duncan's guidance, they attempted to "complet[e] [the] audit documentation" by

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[148] In order to assemble this comprehensive documentation, all audit engagement members utilized To Do lists in addition to review points that were written at each level of review – senior, manager and partner. Any valid point raised was cleared by documentation into the audit workpapers. For example, if an explanation was required, it was put in the audit workpaper file and the point would be cleared by the notation, "See note at Schedule XX-2." Thus, once the point had been cleared into the audit workpapers and the review process was complete with no open points remaining, such To Do lists and review point sheets became extraneous. In other words, under long-time Andersen documentation policy, it was not sufficient to correctly explain an item. Andersen documentation policy required that the correct explanation be placed on the logical schedule and cross-referenced to the item under discussion. The knowledge that point sheets would be destroyed ensured that documentation would be placed where it would be of use and not buried in a stack of point sheets.

[149] On May 15, 2002 SAS No. 96 superceded SAS No. 41, which was in effect at the time of Enron's audits of Enron.

[150] Andersen retention policy, *supra* note 123, at Sec. 3.5.3.

[151] *Id*, Sec. 2.3.

[152] Andersen's Petition for Writ of Certiorari at 6 (No. 04-368).

"making sure everything that went into the accounting issues and the conclusion was documented and available in the workpapers."[153] Although David Duncan pled guilty to witness tampering and he testified that while he thought there was some potential that the SEC might want some Andersen documents, he also told the jury that he regarded "a large part of the exercise" as making sure that the firm had an "accurate and complete picture in the workpaper documents…in case the SEC wants to look at this one day."[154] The October 23, 2001 directive to come into compliance with document retention policy was the final act of what the government termed "corrupt persuasion."

Why did David Duncan plead guilty?

The shredding took place before the receipt of a subpoena or any discussion of the possibility of a subpoena. Therefore, the shredding itself was legal as well as the document retention policy that allowed it. The government did not charge anybody for engaging in these lawful acts. The government charged Andersen with "witness tampering" on the theory that a polite request to employees to engage in lawful acts pursuant to a lawful document retention policy was somehow a criminal act.

So what was Mr. Duncan thinking? Let's look at the facts as of March 2001 from his perspective.

- Duncan knew that the criminal charges regarding witness tampering were predicated on the government's position that Andersen did something wrong regarding the Enron audit.

- Duncan knew (and he knew that the government knew) that neither he nor Andersen had been the auditor of the Enron SPEs where the frauds were committed.

- Duncan knew (and he knew that the government knew) that the frauds were aided and abetted by various major international financial institutions.

- Duncan knew (and he knew that the government knew) that the SEC, at the request of the House Committee on Energy and Commerce, had exempted Enron from a vital investor protection law, thus enabling the fraud.

- Duncan knew that before receiving any subpoena, he and other members of the audit engagement team had thrown out the normal trash generated by an audit.

- Duncan knew that his requests to adhere to Andersen's document retention policy preceded the discovery of fraud in entities where Andersen was not the auditor. It

[153] *Id* at 8 (Citing the trial transcript at Tr. 4918). The concern was "one of inclusion rather than exclusion." As one manager explained, once an audit file has been properly compiled, "it's all in the audit workpapers" so "you don't need anything else." *Id*
[154] *Id*

was the discovery of fraud that necessitated an income restatement that, in turn, triggered the SEC investigation.

Despite these facts, it was obvious that the government was intent on destroying the jobs and retirement livelihoods of over 85,000 Andersen employees and over 5,200 retirees[155] who had nothing whatever to do with Enron. That being the case, who can blame David Duncan for believing he would not get a fair trial?

Federal sentencing guidelines for fraud are based on the dollar amount of the fraud. If the government had indicted Duncan for fraud despite the fact that neither he nor Andersen were the auditors of the fraudulent SPEs, Duncan would have effectively faced a life sentence in prison. Even if he won his case after fighting the full force of the government, his legal fees would be staggering. When there is no hope for a fair trial, even an innocent person can be coerced into a guilty plea in exchange for a reduced sentence.

What about the sheer volume of documents destroyed?

Government prosecutors stated that almost two tons of paper were shredded. They showed statistics of documents shredded throughout 2001, highlighting the spike in volume that took place in October 2001. They also showed evidence of the destruction of tens of thousands of emails and other electronic documents, representing at least a three-fold increase over usual activity.[156]

However, Andersen was blocked at the trial level from providing evidence of the documents retained by the engagement team that were either not deleted, or were deleted and recaptured prior to the discovery of the Chewco fraud or were otherwise recaptured and subsequently produced to the SEC.[157] Andersen proffered evidence at trial that the volume of shredded documents represented less than 3 percent of the extraneous papers retained by the engagement team.[158] Thus, approximately 70 tons of extraneous records in addition to the complete audit workpapers were retained. The district court held this evidence inadmissible and the Fifth Circuit affirmed.[159]

The trial court refused to allow evidence of the nature, uniqueness and content of the material shredded. Andersen was able to provide testimony that contrary to prosecution testimony at both the grand jury and trial proceedings, 90 percent of the discarded documents were unrelated to Enron.[160] Witnesses testified that a library in Andersen's Houston office was being cleaned out, accounting for most of the

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[155] In the U.S. alone, over 5,200 retirees and survivors lost retirement benefits. Statistics are not available as to how many retirees and survivors worldwide lost their retirement benefits.
[156] Brief for the United States, U.S. v. Arthur Andersen, LLP, No. 02-21200 at 19(5th Cir., May 27, 2003).
[157] 374 F. 3d at 287.
[158] *See* Andersen's Petition for Writ of Certiorari at 8 (No. 04-368)(citing the Trial Transcript at Tr. 5468-71; R. 1115-16).
[159] *Id*
[160] *Cf* United States District Court Transcript, United States v. Arthur Andersen, 2002 Extra LEXIS 463 (S.D. Tex. May 23, 2002)(No. H-02-121).

shredding.[161] According to testimony of Sharon Thibault, Andersen Records Supervisor, the amount of material the Enron engagement team designated for destruction around October 23, 2001 was unusually high. However, she testified that she had not received papers to be destroyed from the Enron engagement in 10 – 11 months and the amount received in October was a 10 or 11 month backlog, approximately a half box per member of the engagement team.[162]

Finally, the trial court refused to allow the jury to hear evidence that all documents proffered by the prosecution had actually been intentionally preserved by Andersen and voluntarily turned over to the government pursuant to Andersen's waiver of attorney-client privilege.[163] Instead, the trial court ruled that it didn't matter how many copies were preserved, if even one copy were thrown out, Andersen had committed obstruction of justice.

Was the Justice Department indictment of Arthur Andersen appropriate?

Andersen was indicted in March 2002, in the height of proxy season, apparently so shareholders would pressure clients to drop Andersen as auditor. Clients reported to Andersen that before the indictment, they were actively threatened by government regulatory agencies. For example, hospitals audited by Andersen were told that they would lose Medicare funding unless they changed auditors. Despite government threats, at the time of the indictment Andersen still retained 98 percent of its clients.[164]

Prior to the indictment, government prosecutors engaged in illegal leaks.[165] Prosecutors also threatened Andersen witnesses.[166] Consequently, Rusty Hardin, Andersen's trial attorney, wrote to Michael Chertoff, Chief of the Justice Department's Criminal Division, formally requesting an investigation into possible witness tampering by the prosecution.[167]

Special Agent Paula Schanzle of the Justice Department's Federal Bureau of Investigation gave misleading testimony to both the grand jury and the trial jury when she said that "the vast majority" of shredded papers related to Enron. At trial, she admitted that she had not even reviewed half the documents presented. She was then forced to admit that over 90 percent of the documents were not Enron-related.[168]

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[161] *Id*
[162] *Id*
[163] Andersen was prepared to show that at least one and as many as nine copies had been preserved of documents identified by the government as deleted. The court excluded the evidence. (Appellate Brief for Arthur Andersen LLP, United States v. Arthur Andersen LLP, No. 02-21200 at 19 (5th Cir., May 27, 2003).
[164] Bartley R., The Wall Street Journal, June 24, 2002.
[165] Fowler T., Houston Chronicle, April 26, 2002.
[166] Fowler T., Houston Chronicle, May 9, 2002.
[167] Viles P., Moneyline CNN, May 10, 2002.
[168] *Supra* note 135.

David Duncan testified that government summaries of his interviews with FBI investigators contained errors that were "fairly voluminous".[169] The FBI had failed to change their written reports, known as FD-302s, to conform to Duncan's requests for corrections despite the fact that the government is required to do so.[170]

Finally, near the end of the trial, prosecutors admitted in court that they not only had failed to review the most crucial evidence, the Andersen audit workpapers, but they didn't know what constituted audit workpapers.[171]

Interestingly, a Senate Report on the Sarbanes-Oxley law, portions of which were passed because Congress recognized that Andersen's conduct was clearly not criminal under existing law, noted that "in the current Andersen case, prosecutors have been forced to use the 'witness tampering' statute…and to proceed under the ***legal fiction*** that the defendants are being prosecuted for telling other people to shred documents, not simply for destroying evidence themselves."[172] As counsel for Andersen has pointed out, "lenity (requiring that all ambiguities in criminal statutes be resolved in favor of the defendant) and fair warning principles forbid criminal prosecutions based on 'legal fictions.' Whether particular conduct is criminal should never be debatable, or a surprise. The theory of this prosecution criminalized conduct commonly understood to be lawful, including the document retention policies in place at almost every American corporation or professional firm of any size."[173]

Michael Chertoff, former Chief of the Criminal Division of the Justice Department was the official responsible for indicting Andersen based upon what the Senate termed a "legal fiction." As his reward, he was nominated by President Bush to the U.S. Court of Appeals for the 3rd Circuit and confirmed by the Senate with only one dissenting vote.[174] Subsequently he was appointed Secretary of the Department of Homeland Security and confirmed by a vote in the Senate of 98-0.[175]

The Trial and Review by the 5th Circuit Court of Appeals

The shredding itself was entirely legal. Therefore, Andersen was charged with "witness tampering" under 18 U.S.C. Sections 1512(b)(2)(A) and (B) which make it a crime to "knowingly…corruptly persuad[e] another person with intent to…cause" that person to "withhold" documents from, or "alter" documents for use in an "official proceeding."

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169 Fowler T., Houston Chronicle, May 17, 2002.
170 Dobb L., Moneyline, May 28, 2002.
171 On May 27, 2002, "prosecutors requested copies of actual workpapers or final documentation that accompanies finished audits, to determine what was deemed necessary to keep. Defense lawyers responded that prosecutors have had access for months to 500 boxes of workpapers under guard at Arthur Andersen's Houston office." Associated Press, May 27, 2002.
172 S. Rep. No. 107-146, at 7 (2002)(emphasis added).
173 Arthur Andersen LLP v. United States of America on Writ of Certiorari at 19 (no. 4-368).
174 *See* http://www.jewishvirtuallibrary.org/jsource/biography/chertoff.html.
175 *See* http://www.votesmart.org/issue_keyvote_detail.php?vote_id=3642.

Two points were uncontested at trial:

(1) "It was undisputed that the discarding and deletion of documents took place entirely in the open, with no attempt to hide or disguise what people were doing; and
(2) It was undeniable that ***no one*** at Andersen ever said that documents should be destroyed to keep them from the SEC. To the contrary, ***all*** the witnesses at trial who were involved in the document destruction and who spoke to the point verified that they were ***never*** told Andersen was attempting to keep materials from the SEC; that they were ***never*** told to seek out and destroy embarrassing documents, or any particular documents; that they were ***never*** told to seek out and destroy documents that discussed embarrassing facts; that they did ***not*** in fact seek out and destroy such documents; and that they did ***not*** attempt to hide particular facts from the SEC. Indeed, the government grudgingly acknowledged as much in its closing arguments."[176]

In a trial supposedly turning on the issue of criminal intent, Andersen witnesses were not allowed to testify as to their intent.[177] The judge instructed the jury that the term "knowingly corruptly persuades" means persuasion partially motivated by an "improper purpose" to "subvert, undermine, or impede the fact-finding ability of an official proceeding" even if "Andersen honestly and sincerely believed its conduct was lawful."[178] Andersen repeatedly objected to the court's determination that "corrupt" persuasion could be equated with an "improper purpose," and argued that the term requires proof of improper means of persuasion or inducement to unlawful acts, or at least conscious wrongdoing.[179]

Evidence presented at trial would require, or at the very least permit, the conclusion that no Andersen employees used improper methods of persuading coworkers, solicited conduct that was in itself unlawful, had knowledge that a crime had been committed, engaged in conscious wrongdoing or even believed that an SEC subpoena was probable at the time of the relevant conduct.[180]

The witness tampering statutes under Section 1512(b) criminalizes acts of obstruction only when they are undertaken to keep materials from an "official proceeding." Although the statute provides that the proceeding "need not be pending or about to be instituted at the time of the offense"[181], it does not otherwise specify how concrete the defendant's expectation of a proceeding must be at the time of the obstructive behavior.

[176] Appellate Brief for Arthur Andersen, United States v. Arthur Andersen LLP, No. 02-21200 at 7 (5th Cir., May 27, 2003).
[177] *Supra* note 169 at 2.
[178] *Id at 3.*
[179] *Id*
[180] *Id*
[181] 18 U.S.C. Section 1512(e)(1)

The district court instructed the jury that the term "official proceeding" included the performance of "***any*** investigative activity, formal or informal, of ***any*** agency, that might be commenced at ***any*** future time for ***any*** reason, whether or not the actor had any reason to believe that specific agency activity was contemplated."[182] Andersen objected because neither the statutory definition of what constitutes an "official proceeding" nor the SEC's own regulations can be read to include informal investigations conducted by the staff, which have no power to subpoena documents or compel testimony.[183] Indeed, the district court refused to instruct the jury that, to convict, it had to find that Andersen intended to affect a proceeding or investigation ***relating to Enron***.[184]

The reminders to comply with document policy, or "corrupt persuasion" as the government termed it, came in response to questions about the workpaper documentation process and at a time when the Enron engagement team knew that audit files would be reviewed by top management inside the firm.[185] Andersen also pointed to evidence that it took substantial steps to ensure that both historical and current audit work was accurately reflected in the audit workpapers.[186] For example, in-house attorney Nancy Temple instructed auditors inquiring about proper documentation [regarding a correction in the accounting treatment of the Raptor SPEs] ***not*** to disturb any previously completed workpaper – even if it contained errors – instead directing them to prepare a new memorandum documenting the change in position and to place the new memo alongside the older one.[187]

The trial judge ruled that even if multiple copies were saved, if one copy was destroyed, justice has been obstructed.[188] Indeed, the court excluded, as an irrelevant defense, evidence that Andersen's Enron engagement team preserved multiple copies of the very documents whose deletion the prosecution emphasized.[189]

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[182] *Supra* note 173 at 72.
[183] *Id*
[184] *Id* at 71.
[185] *Id* at 6.
[186] *Id* (citing Tr. 1425-1426, 1324-1435, 1621, 4883-4884).
[187] *Id* (citing Tr. 1425-1426, 1434-1435, 4883-4884).
[188] Associated Press, May 31, 2002.
[189] During trial the government had directed particular attention to an e-mail sent by Enron employee Rodney Faldyn that had been deleted by David Duncan and that the government claimed included material embarrassing to Andersen. At closing argument, the prosecutor described and read from this e-mail, and then said: "And this is a deleted e-mail, ladies and gentlemen. It's got that asterisk next to it [signifying that it had been deleted and subsequently ***recovered***] ***and you won't find another copy of this anywhere in evidence***. Do you think the SEC would have wanted to see this document?" (Emphasis added). In fact, however a copy of the e-mail ***had*** been preserved, Andersen ***had*** provided a copy to the SEC, and a retained copy ***was included*** in the group of exhibits that Andersen had sought to submit. The only reason the jury could not "find another copy of this [document] anywhere in evidence," as the prosecutor carefully put it, was that the government had objected to the introduction of Andersen's exhibit and the court, citing relevance grounds, sustained the objection. The court failed to intervene when, in the government's rebuttal summation, made the virtually identical misleading statement (Appellate Brief for Arthur Andersen, United States v. Arthur Andersen LLP, No. 02-21200 at 22 and 84 (5th Cir., May 27, 2003)(citing Tr. 2792-2803, 6386-6387, 6457-6458, 6467, 6688-6689, 6691, 6650).

The government testified at length regarding FBI notes that purported to reflect statements made by David Duncan, the government's most important witness. Mr. Duncan testified that the summaries of statements made in four interview sessions with prosecutors and FBI agents – known as "FD-302 forms" – contained "fairly voluminous" misstatements that he had brought to the government's attention. Although required by law, the government failed to correct the misstatements in the FD-302 forms. The court refused to let Andersen inquire into the nature and extent of the inaccuracies[190], thus undermining Andersen's cross-examination of the key witness. Because of the refusal of the FBI and the court to either correct the record or to allow discussion of the nature and extent of the alleged misstatements, there is no way to judge their relevance. Therefore, any FD-302 summaries of witness interviews in the Andersen case must be regarded with skepticism and any conclusions drawn from them are also suspect.[191]

Jurors were told they could convict even if they disagreed on exactly who at Andersen had criminal intent.[192] According to the jury foreman, the issue of proportionality, the fact that a guilty verdict would be against a firm of 26,000 [in the U.S., 85,000 worldwide instead of against individuals who may have committed some wrong], was expressly ruled out by [the Judge's] jury instructions.[193] The Judge sided with the prosecution in 96 percent of her rulings.[194] To break jury deadlock, Judge Harmon ruled that the jury did not need to find Andersen guilty beyond a reasonable doubt in order to convict.[195]

According to juror comments after the trial, jurors did not even discuss whether Duncan was guilty.[196] Instead, they based their decision on an e-mail from Nancy Temple, a second-year in-house lawyer. In editing a draft of an internal memo regarding unaudited quarterly earnings[197] she suggested to David Duncan that her name be removed because it would "increase the chances that I might be called as a witness, which I prefer to avoid."[198] This revision is considered standard legal practice to maintain attorney-

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[190] *Id* at 84 (citing Tr. 2146-2147, 2154-2155, 2105-2111, 2145-2161, 2732-2737).
[191] The notes and sources of *Conspiracy of Fools* by Kurt Eichenwald indicate that for his discussion regarding Andersen, Mr. Eichenwald relied heavily on the inaccurate FBI interview notes. Therefore, Mr. Eichenwald's comments regarding Andersen are also unreliable.
[192] Flood M., Fowler T., Houston Chronicle, June 15, 2002.
[193] Criner O., Moneyline, CNN, June 17, 2002.
[194] Dobbs L. June 17, 2002.
[195] Austin American Statesman, June 13, 2002.
[196] Glater J., The New York Times, June 16, 2002.
[197] Duncan's memorandum, labeled a "first draft," memorialized Andersen's doubts about whether Enron could characterize certain charges as "non-recurring" in a press release. Temple recommended deletion of "language that might suggest we've concluded the release is misleading." But that suggestion was validated by Duncan's own testimony that the consultation team ***had not*** "concluded" that the release was "misleading" – a term with legal significance under the securities law. Nor did her edits hide Andersen's concerns: she retained sentences advising that "[Andersen] had strong concerns that the presentation of the charges as non-recurring could be misconstrued or misunderstood by investors," and only proposed removal of a reference to past SEC actions based on press releases. Temple's e-mail promised further consultation "within the legal group" and she consulted with outside counsel on the subject. (Arthur Andersen LLP v. United States of America on Writ of Certiorari)(Citing the Trial Transcript at Tr. 1798, 1363-4).
[198] Criner O., Moneyline, CNN, June 17, 2002

client privilege.[199] The statute regarding obstruction of justice specifically allows the advice of counsel in the ordinary course of business.[200] Thus, Andersen was convicted for an action specifically permitted under law.

Andersen subsequently moved for a judgment of acquittal or a new trial, arguing that the evidence did not support the verdict.[201] The motion also sought relief by pointing to post-verdict comments made by six jurors, indicating that the jury had in fact rejected the government's allegations and theory of the case.[202] The jury was able to reach its unanimous verdict, these jurors explained, only by finding that Andersen in-house attorney Nancy Temple committed obstruction on a single occasion by advising David Duncan about proposed edits to a draft memorandum to the file – conduct that, Andersen argued, was not charged as an act of obstruction in the indictment and is plainly not criminal at all.[203] The district court denied the motion and gave Andersen the maximum sentence.[204]

U.S. District Court Judge Harmon, who presided over the Andersen trial, subsequently ruled that Nancy Temple should be dismissed from the civil lawsuit filed by Enron shareholders.[205] This absolves Ms. Temple of civil responsibility but she is still subject to a 5-year statute of limitations on a possible criminal charge of obstruction of justice.[206] The jurors' conviction of Andersen turned on the supposed criminality of Ms. Temple's e-mail. Yet the same judge who could have thrown out that verdict as a miscarriage of justice subsequently ruled that the e-mail does not rise to a matter worthy of civil litigation.

Andersen appealed the decision of the district court and the verdict was confirmed. In their opinion, the Fifth Circuit's recital of facts omits material facts.[207] The recital discusses Enron's SPEs but fails to mention that Andersen was never hired to audit those SPEs. The recital also fails to mention that numerous major international banks aided and abetted Enron personnel in defrauding Andersen and the Enron shareholders. The recital omits any mention that Enron officers were criminally charged with defrauding Andersen. Further, the recital misstates the amount of fees earned by Andersen from the Enron engagement in 2000 and erroneously states that Andersen expected to earn US $100 million in 2001.[208] Could these omissions and misstatements have influenced the opinion of the Fifth Circuit's opinion?

In summary, in the *Andersen* case, the Fifth Circuit has criminalized polite requests to engage in lawful behavior by holding that Section 1512 witness tampering

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[199] Gillers S., *The Flaw in the Andersen Verdict*, The New York Times, June 18, 2002.
[200] *Id*
[201] *Supra* note 173 at 11.
[202] *Id*
[203] *Id* (citing R. 1382-1387).
[204] *Id* (citing R. 1452).
[205] Flood M., Fowler T., Houston Chronicle, January 28, 2003.
[206] *Id*
[207] United States v. Andersen, 374 F.3d 281 (5th Cir. 2004).
[208] *Supra* note at 76.

covers certain acts to cause ***others*** to destroy evidence, but not a defendant's own destruction of evidence.[209] Because the statute covering a defendant's ***own*** conduct applies only when a proceeding is pending, the upshot of the Fifth Circuit's holding is that in October 2001 David Duncan was free to throw his own documents in the trash; his secretary was free to throw those same documents in the trash; but it was suddenly a serious felony for Mr. Duncan to ***ask*** his secretary to throw a document in the trash.[210] On the basis of the 5th Circuit's decision, one must conclude that it is legal for a company to have a document retention policy as long as, ***at apparently any time,*** no supervisor tells employees to follow that legal document retention policy.

In contrast, while under subpoena, Enron employees engaged in document shredding from November 2001 until January 2002.[211] Neither Enron nor any individual at Enron has been indicted for obstruction of justice.

Andersen was convicted of "witness tampering" for requesting that Andersen employees engage in lawful behavior. The indictment and trial were predicated on the accusation that Andersen must have overlooked fraud. Yet neither Andersen nor any of its partners have been charged criminally or by the SEC with violations of the securities laws in connection with their work at Enron.[212] To the contrary, the government has charged Enron executives with seven counts of defrauding Andersen during the course of the audit, stating that Enron executives employed "secret oral side deals, backdated documents, disguised debt, material omissions, and outright false statements," and made "false statements to auditors."[213] Similarly, the government has charged executives of WorldCom, Qwest, Dynegy, etc. with defrauding Andersen.

Andersen Appeal to the U.S. Supreme Court

The U.S. Supreme Court agreed to hear Andersen's final appeal[214] which focused solely on the Trial Court's instructions to the jury. Andersen's petition was supported by three *amicus curiae* briefs: one submitted jointly by the Washington Legal Foundation and the U.S. Chamber of Commerce and the others by the National Association of Criminal Defense Lawyers and the American Institute of Certified Public Accountants. All three briefs focus on the fact that the *Andersen* verdict criminalized innocent behavior, with inevitable dire consequences for individuals, businesses and the criminal justice system.

In a 9-0 decision, the Supreme Court reversed the judgment of the Court of Appeals[215] in an opinion delivered by Chief Justice Rehnquist. In part, the opinion states,

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209 *Supra* note 164 at 12.
210 *Id* at 22.
211 Associated Press, January 21, 2002.
212 *Supra* note 173 at 5.
213 Superseding Indictment at 49-53, *United States v. Causey*, No. H-04-25 (S.D. Tex. July 7, 2004); *see also* Second Amended Complaint at 45-47, 50-51, *SEC v. Lay,* No. H-04-0284 (S.D. Tex. July 8, 2004).
214 Associated Press, January 7, 2005.
215 544 U.S. No. 04-368, May 31, 2005.

"Our attention is focused on what it means to 'knowingly…corruptly persuad[e]' another person 'with intent to …cause' that person to 'withhold' documents from, or 'alter' documents for use in, an 'official proceeding.'"[216]

"We have traditionally exercised restraint in assessing the reach of a federal criminal statute, both out of deference to the prerogatives of Congress and out of concern that 'a fair warning should be given to the world in language that the common world will understand, of what the law intends to do if a certain line is passed.'"[217]

"Such restraint is particularly appropriate here, where the act underlying the conviction – 'persua[sion]' – is by itself innocuous. Indeed, 'persuad[ing]' a person 'with intent to…cause' that person to 'withhold' testimony or documents from a Government proceeding or Government official is not inherently malign."[218]

"'Document retention policies,' which are created in part to keep certain information from getting into the hands of others, including the Government, are common in business. It is, of course, not wrongful for a manager to instruct his employees to comply with a valid document retention policy under ordinary circumstances."[219]

"Acknowledging this point, the parties have largely focused their attention on the word 'corruptly' as the key to what may or may not lawfully be done in the situation presented here. Section 1512(b) punishes not just 'corruptly persuad[ing]' another, but ***'knowingly***…corruptly persuad[ing]' another. The Government suggests that 'knowingly' does not modify 'corruptly persuades,' but that is not how the statute most naturally reads. It provides the *mens rea* [220]– 'knowingly' – and then a list of acts – 'uses intimidation or physical force, threatens, or corruptly persuades.' The Government suggests that it is 'questionable whether Congress would employ such an inelegant formulation as "knowingly…corruptly persuades."' Long experience has not taught us to share the Government's doubts on this score, and we must simply interpret the statute as written."[221]

"Only persons conscious of wrongdoing can be said to 'knowingly… corruptly persuade.' And limiting criminality to persuaders conscious of their wrongdoing sensibly allows Section 1512(b) to reach only those with the level of 'culpability…we usually require in order to impose criminal liability.'"[222]

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[216] *Id* at 6.
[217] *Id*
[218] *Id* at 7.
[219] *Id*
[220] Criminal intent
[221] *Id* at 8.
[222] *Id* at 9.

"The jury instructions at issue simply failed to covey the requisite consciousness of wrongdoing. Indeed, it is striking how little culpability the instructions required. For example, the jury was told that, 'even if [petitioner] honestly and sincerely believed that its conduct was lawful, you may find [petitioner] guilty.'"[223]

"The instructions also diluted the meaning of 'corruptly' so that it covered innocent conduct. The parties vigorously disputed how the jury would be instructed on 'corruptly.' The District Court based its instruction on…the Fifth Circuit Pattern Jury Instruction…[which] defined 'corruptly' as '"knowingly and dishonestly, with the specific intent to subvert or undermine the integrity"' of a proceeding. The Government, however, insisted on excluding 'dishonestly' and adding the term 'impede' to the phrase 'subvert or undermine.' The District Court agreed over petitioner's [Andersen's] objections, and the jury was told to convict if it found petitioner intended to 'subvert, undermine, or impede' governmental factfinding by suggesting to its employees that they enforce the [Andersen] document retention policy."[224]

"These changes were significant. No longer was any type of 'dishonest[y]' necessary to a finding of guilt, and it was enough for petitioner to have simply 'impede[d]' the Government's factfinding ability. As the Government conceded at oral argument, 'impede' has broader connotations than '"subvert"' or even '"undermine,"' and many of these connotations do not incorporate any 'corrupt[ness]' at all. By definition, anyone who innocently persuades another to withhold information from the Government 'get[s] in the way of the progress of' the Government. With regard to such innocent conduct, the 'corruptly' instructions did no limiting work whatsoever."[225]

"The instructions were also infirm for another reason. They led the jury to believe that it did not have to find ***any*** nexus between the 'persua[sion]' to destroy documents and any particular proceeding. In resisting any type of nexus element, the Government relies heavily on Section 1512(e)(1), which states that any official proceeding 'need not be pending or about to be instituted at the time of the offense.' It is, however, one thing to say that a proceeding 'need not be pending or about to be instituted at the time of the offense,' and quite another to say a proceeding need not even be foreseen. A 'knowingly…corrup[t] persuade[r]' cannot be someone who persuades others to shred documents under a document retention policy when he does not have in contemplation any particular official proceeding in which those documents might be material."[226]

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[223] *Id*
[224] *Id* at 9 – 10.
[225] *Id* at 10.
[226] *Id* at 10 – 11.

"For these reasons, the jury instructions were flawed in important respects. The judgment of the Court of Appeals is reversed, and the case is remanded for further proceedings consistent with this opinion."[227]

In summary, the Supreme Court found that the jury instructions eliminated the prosecution's requirement to prove ***any*** – much less all -- of the three elements of the crime of "witness tampering." The jury instructions disregarded (1) "knowingly" and (2) "corrupt" persuasion, as well as (3) any nexus or connection to an "official proceeding."

The Supreme Court's reversal was not based on some arcane technicality. The reversal was an acknowledgement that the jury instructions, which echo the theory of the prosecution's case against Andersen, distorted the law beyond recognition, criminalizing innocent conduct. This would allow the government to destroy at will any individual or company, just as Andersen was. For example, all taxpayers are subject to the possibility of an IRS audit. If the *Andersen* verdict had been allowed to stand, a taxpayer could be destroyed if he or she had ***ever*** asked anyone to throw out any duplicate memos or other trash.

Despite the fact that the jury instructions were in effect a directed verdict, the jury was out for seven days before declaring itself deadlocked. The jury was able to reach a verdict only after the District Court issued an "Allen charge" and declared that proof beyond a reasonable doubt was not required.

"Only in America does the highest court in the land decide a case about whether a trial is fair after the defendant is executed."

– Rusty Hardin, Attorney[228]

Is Arthur Andersen & Co. entirely blameless?

No. Failure to destroy trash such as duplicate copies of memos, meeting agendas, etc. by the end of the audit in February 2001 was both sloppy and contrary to Andersen document retention policy. However, it was neither illegal nor unethical. If Andersen auditors had destroyed duplicate memos, etc. when they were supposed to, they would not have been shredding them in October 2001.

Would that have saved Andersen?

Probably not. Politicians needed a scapegoat to distract attention from the fact that money bought -- and continues to buy -- preferential government treatment, to the detriment of investors and taxpayers.

[227] *Id* at 11 – 12.

[228] Farrell, G. *A Posthumous Victory,* USA Today, Nay 31, 2005.

If the duplicates, drafts, etc. had been destroyed on a timely basis, the Justice Department could have used the same "legal fiction" in order to indict and destroy Andersen. Under the jury instructions handed down by Judge Harmon in the *Andersen* case as affirmed by the 5^{th} Circuit, the jury would have been forced to find Andersen guilty if any Andersen employee on the Enron engagement had ***ever*** been told to follow the lawful Andersen document retention policy.

What about other audit failures?

Politicians, the Justice Department, the media and academics focused attention on the Waste Management and Sunbeam audits. What happened in these cases?

Anybody who has not examined the audit workpapers of Waste Management and Sundbeam has no way of knowing. The only information available is the SEC's version of events, and the government's track record on Enron calls into question government statements regarding audits. It may be that one or more Andersen people made some mistake that was not caught in the review process. More likely scenarios include the deliberate withholding of pertinent information from the auditors, a miscommunication between the clients and Andersen or within Andersen itself or a difference of opinion regarding what constitutes a material amount requiring an adjustment to the books. Or it may be that the government was no more competent and/or honest than they were in the Enron case. We simply don't know the facts. Both cases did take place when the SEC had a political agenda, namely to ban accounting firms from providing systems work to audit clients.

The SEC has the power to destroy any public accounting firm. Consequently, if a firm wants to survive, it will settle all but the most egregious of the government's claims regardless of the merits of the case. By the terms of the settlement, Andersen was under gag order regarding the cases.

What about the Baptist Foundation of Arizona? Again, without examining the audit workpapers, we don't know much. However, the jurors in the civil case, lacking any political agenda, give some insight.

> "One-third of the Maricopa County Superior Court jurors…couldn't believe that [Andersen] agreed to a $217 million settlement. 'A judgement would have been for a much lower amount' [because] 'the case was going in Andersen's favor, and they hadn't even put on its witnesses.' Other jurors agreed that foundation employees, directors and officers knew of the financial fraud as early as December 1996, hid it from the auditors and were primarily to blame."[229]

What about the audit failures at RiteAid, Kmart, Adelphia, Tyco, Xerox, Royal Ahern, Royal Dutch Shell, Parmalat, Yukos, Superior Bank, Aurora Foods, HealthSouth,

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[229] Jarman M., Harris, C. *Andersen was winning the Baptist Case, Jurors Said,* The Arizona Republic, May 7, 2002.

Hayes Lemmerz, Shurgard Storage, Cutter & Buck, KrispyKreme, MicroStrategy, Inc., Critical Path, Inc., Safety-Kleen Corp., Nortel Networks, Orbital Sciences Corp. InfoSpace, Metropolitan Mortage and Securities, AOL, Computer Associates, AIG, Navistar International, NextCard, Inc, Cendant and JDS Uniphase? These restatements are similar in two respects: (1) none were clients of Arthur Andersen, and (2) there has been little mention of their auditors in the media. There are various reasons for the restatements; without a review of the audit workpapers, it would be irresponsible to make a judgment on the quality of the audits.

These restatements were not insignificant. Xerox admitted that its income was overstated by $1.42 billion or 52.3% after an earlier restatement reducing income by $207 million or 11.4% for the same period.[230] Yukos has been accused of omitting tax liabilities variously described of between $5 – 24.5 billion from its financial statements.[231] Royal Dutch Shell confessed that its oil and gas reserves were approximately 25% lower than previously stated.[232] JDS Uniphase Corp. restated quarterly results from a $1.3 billion loss to a whopping $41.9 billion loss.[233]

On January 27, 2005, former Ernst & Young partner Thomas Trauger was sentenced to serve 12 months in federal prison, pay a $5000 fine and undergo 2 years of supervised release for his admission that he "knowingly altered, destroyed and falsified audit workpapers with the intent to impede, obstruct and influence an investigation of the SEC" relating to the audit of NextCard, Inc.[234] During his testimony before the SEC, Trauger did not tell the SEC that documents related to the annual audit of NextCard and the quarterly working papers for the year 2001 had been altered and that considerable portions of those documents were deleted in November 2001."[235] It is not clear whether the documents deleted in the course of the audit were incorrect, preliminary versions or not. It is also not clear whether in 2001, he could have foreseen the 2003 SEC investigation of NextCard. Ernst & Young was not charged.

In a case described as "the largest tax evasion scheme in U.S. history," seventeen former KPMG executives have been charged with conspiracy in a scheme to sell fraudulent tax shelters that shorted the Internal Revenue Service (IRS) at least $2.5 billion.[236] Other alleged conspirators charged in the case are identified as an outside attorney and an investment advisor.[237] The indictment includes 43 counts of tax evasion and 2 counts of obstruction.[238] Each of the defendants has not been charged with the same offenses.[239] Although KPMG as an entity was charged in a criminal complaint, the firm

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[230] *Financial Statement Restatements: Trends, Market Impact, Regulatory Responses and Remaining Challenges*, General Accounting Office, GAO-03-138, October 2002 (http://www.gao.gov/new.items/d03138.pdf), Appendix XX, p. 226.
[231] Cox J., *Is the End Near for Russia's Yukos?* USA Today, November 30, 2004.
[232] *Royal Dutch/Shell to Settle U.S. Lawsuit*, Associated Press, July 12, 2005.
[233] GAO-03-138, Appendix X, p.158.
[234] *See* www.doj.gov/usao/can/press/html/2005_01_27_trauger.html.
[235] *Id*
[236] *New Charges Issued in KPMG Probe* (http://www.accounting web.com/cgi-bin/item.cgi?id=101397).
[237] *Id*
[238] *Id*
[239] *Id*

was granted a 'deferred prosecution' and avoided indictment by acknowledging their misconduct, accepting operational oversight by the government and paying a $456 million fine.[240] KPMG and law firm Sidley, Austin, Brown & Wood agreed to pay $195 million to investors to settle their class action law suit.[241] The tax shelters sold by KPMG have not been determined to be illegal by any court of law.[242]

What Happens Next?

The Justice Department has not yet announced whether it will retry Andersen. It seems unlikely for two reasons. First, a conviction is remote if the government is forced to prove criminal wrongdoing under the law, with Andersen being allowed to present all relevant evidence in its defense and to fully cross-examine witnesses. The fact that the Department of Justice has indicted officers at Enron (as well as at WorldCom, Qwest, etc.) for defrauding Andersen is an admission that Andersen did nothing wrong. Second, through its campaign of character assassination, threats and legal manipulation, the government succeeded in destroying Andersen long before the trial began.

David Duncan, Andersen auditor, pled guilty to an act that, according to the Supreme Court, is entirely legal. Charges against Mr. Duncan have not been dropped.

Do Andersen People Have Any Recourse?

Enron officers and numerous financial institutions conspired to commit fraud and frame Andersen. Knowing this, our government decided to destroy Andersen

One would think that Andersen has grounds to sue the government for malicious prosecution. One would also think that Andersen has the grounds to sue the various financial institutions which, in collusion with Enron officers, framed Andersen. One could hardly list all the individuals or institutions who could be sued for defamation of character. But legal actions require both money and faith in the integrity of our legal system. Both have been destroyed by the actions of our government.

Legal counsel has advised Andersen retirees that they have no standing to sue the various financial institutions that framed Andersen, the root cause of the destruction of both Andersen and retiree benefits. In contrast, Enron – not Enron shareholders but Enron itself -- has been able to collect from the banks[243] that aided and abetted Enron in its fraud. Does this make sense?

Banks have also agreed to enormous payments to settle claims of Enron shareholders. Canadian Imperial Bank of Commerce agreed to pay $2.4 billion.[244] Earlier

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[240] *Id*
[241] *Id*
[242] *Id*
[243] Canadian Imperial Bank of Commerce (CIBC) to pay Enron $250 million to settle its part of the "Megaclaims" lawsuit filed by Enron against banks, alleging that they "aided and abetted" fraud. CIBC has also agreed to subordinate $40 million in claims against the bank. (Associated Press, August 5, 2005).
[244] *Big Wall St. Settlement reported in Enron case.* Houston Chronicle, 2005.

JPMorgan Chase and Citigroup agreed to settle for $2.2 billion and $2 billion respectively.[245] Among the remaining defendants are Barclays PLC, Credit Suisse First Boston, Merrill Lynch, Toronto Dominion, Royal Bank of Canada, Deutshe Bank AG and Royal Bank of Scotland.[246] In addition, J.P.Morgan Chase, Citigroup and Merrill Lynch paid settlements to the SEC in the amounts of $135 million, $120 million and $80 million respectively for their roles in Enron's manipulation of its financial statements.[247] In addition to the federal payments, J.P.Morgan Chase and Citigroup agreed to pay $50 million total to New York state and New York City to settle a similar investigation.[248] Citigroup's settlement with the SEC includes $19 million to settle charges that it helped Dynegy, Inc. commit fraud.[249]

Legal counsel has further advised retirees that they can sue the U.S. government ***only*** if the government grants permission. Apparently our government can destroy at will any company or individual on phony charges and never be called to account.

Frauds

Enron's frauds were engineered by Enron officers in collusion with individuals at various financial institutions by means of (1) omission of material facts and (2) dishonest representations. Similarly, Andersen's destruction was orchestrated by (1) omission of material facts and (2) dishonest representations. Both are frauds, one no better than the other.

One must ask: how many people at Enron participated in Enron's fraud? Because Enron booked transactions in a manner consistent with the wording of the fraudulent agreements signed with various banks, there was no written documentation of the fraud at Enron. This fact not only made it impossible for Andersen to expose the fraud but it makes it difficult even now to pinpoint the Enron perpetrators.[250] Bank documentation of the various frauds is the source of the indictments against Enron's CFO Andrew Fastow and others. Those at Enron who were complicit in the fraud were not only willing to sign fraudulent agreements and representation letters in order to defraud shareholders; they were also willing to look auditors in the eye and lie, knowing they were framing the auditors and destroying their careers.

The documentation of fraud at the various banks was both open and extensive. Loan committee agendas, loan committee minutes and loan approval forms – all of which name names -- referred to oral side agreements and the fact that Enron was hiding loans from Andersen. Banks don't lend billions with no loan agreement unless top management approves. That being the case, how many at each of the banks knew? Hundreds? More? Where are the indictments? Did the banks' boards or outside auditors

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[245] *Id*
[246] *Id*
[247] Wall Street Journal, *J.P.Morgan, Citigroup to pay $300 million in Enron Case*, July 28, 2003.
[248] *Id*
[249] *Id*
[250] For example, it is not yet clear whether Enron Chairman Ken Lay was complicit in Enron's fraud.

know? Did even one person at any of these banks refuse to participate in the fraud? How is it that nobody had the decency to notify Andersen?

Similarly, how many people in the SEC, Justice Department and congressional committees knew that Andersen was never the auditor of any of the SPEs where the frauds were committed? Hundreds?

The discovery of the hidden side agreement between Enron SPE Chewco and Barclays Bank prompted Andersen to withdraw its audit opinion and notify the SEC and Justice Department in November, 2001. The relevance of the hidden side agreement was described to Congress on December 12, 2001[251] and testimony described in detail the Chewco fraud on February 7, 2002.[252] Yet these facts were swept aside in favor of unsubstantiated accusations by those intent on covering up their own culpability.[253]

Where was the SEC? Surely there are individuals in the SEC who are sufficiently competent to read an audit opinion and correctly analyze a fraud. Why did none of these individuals speak up?

The decision to indict Arthur Andersen was reportedly made by Michael Chertoff. Yet he surely did not gather all information himself nor did he argue the case himself. Did anybody at the Justice Department refuse to participate in an indictment unsupported by evidence and based upon a legal interpretation characterized by Justice Scalia as "weird"?[254] Did nobody question the ethics of destroying the livelihoods of 86,000 employees and countless retirees when only a few, if any, might have done anything wrong?

Why did a district court judge and three appellate court judges condone this farce? Why does a case have to go all the way to the U.S. Supreme Court before we can find people with sufficient intelligence and integrity to read the plainly-worded law?

Why did numerous individuals in all three branches of the government condone the destruction of people they knew to be innocent? Were government officials bribed? Were they coerced?

The media and academics, including accounting and auditing professors, jumped to conclusions without asking the obvious first questions, namely:

1. Precisely how was the fraud carried out?

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[251] Berardino, J.F., Managing Partner of Andersen. In: Testimony before the U.S. House of Representatives, Committee on Financial Services, December 12, 2001.

[252] Bauer, T. Partner, Andersen LLP, In: Testimony before the Subcommittee on Oversight and Investigations , House Energy and Commerce Committee, February 7, 2002.

[253]Rep. Tauzin, Chairman of the House Energy and Commerce Committee that urged the SEC to exempt Enron from investor protection laws, also chaired the Committee's Enron hearings. "Tauzin is a perverse kind of consumer advocate – one for whom the theater is much more than the substance. Tauzin, a former amateur actor, calls his Enron hearings 'The Show', and that is clearly how he thinks of them." Plotz, D. *The Potemkin Populism of the Republicans' Chief Enron Investigator.* (http:/slate.msn.com/?id=206048)

[254] Oral Arguments, p. 28. Arthur Andersen LLP v. United States, No. 04-368.

2. Who was party to the fraud?
3. Where was the fraud perpetrated?
4. Who was the auditor of the entities where the fraud was perpetrated?
5. In the normal course of an audit, would there have been anything in the client's documentation that would have indicated fraud to the auditors?

Once those questions are answered, it becomes clear that KPMG as auditor of Enron's SPEs had no chance of knowing about oral side agreements that disguised the existence of loans.

The next obvious question is: why would Andersen want to hide anything from the government or investors? Andersen was framed. People who have been framed don't want to hide facts; they want the facts to come out. Not only was the indictment based on a mischaracterization of the law; its premise just doesn't make sense. Yet most in the media parroted the words of politicians and the Justice Department without any critical evaluation.

There are two notable exceptions. Immediately after the Justice Department's indictment of Arthur Andersen, Carl Jeffers called it "one of the most heinous travesties of justice we have seen in America in the past 25 years."[255] Mr. Jeffers challenged the Bush Administration to "justify its actions and show that due process has not been discarded and that political expediency is not a factor in this scandal."[256]

Lou Dobbs of CNN's Moneyline repeatedly questioned the ethics of indicting and destroying a firm of 85,000 for the alleged misdeeds of a few or -- as it turns out – none while not indicting Enron or the individuals who committed the fraud. In turn, Mr. Dobbs was himself attacked by The Wall Street Journal and the New York Times.[257] Mr. Dobbs noted,

> "There is no question that in [the Andersen] case the national news media chose to simply follow almost guppy-like the offerings from the Justice Department. Why? I don't know. To watch this process [the indictment] go forward and no one say a word – it was unbelievable to me! It's still – still utterly maddening!"[258]

Having condemned Andersen without asking even the most elementary questions, the news media have shown no interest in correcting the record. Some reporters argue that the identity of the auditors of the fraudulent entities is irrelevant. They don't let facts interfere with their story. Others say that our government's deliberate destruction of innocent people in order to cover up political corruption is not news. In the words of one New York Times reporter, "Right or wrong, The Beast moves on."

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[255] Jeffers, C., *Arthur Andersen, Scapegoat for Justice*, March 20, 2002.
[256] *Id*
[257] Rose, M., *Lou Dobbs' Defense of Andersen on CNN Show Raises Eyebrows*, The Wall Street Journal, April 3, 2002.
[258] *See* http://www.onthemedia.org/transcripts/transcripts_062102_dobbs.html

One factor in the sloppy reporting of the Andersen case is the media's reliance first on the flawed Powers Report and then on accounting faculty who also failed to ask the obvious questions. One University of Texas faculty member, Professor Michael Granof, illustrates the problem. In a published interview, the auditing professor "freely admit[ted] that the collapse of Enron and subsequent implosion of Arthur Andersen is the best thing that ever happened to him."[259] He has written two op-ed pieces for the New York Times and one for the Los Angeles Times, leading to his appearances on MSNBC and CNNfn.[260] He went to Paris to give an Enron talk to a think tank that is the equivalent to the French Council on Foreign Relations and a talk regarding Enron in Colorado.[261] By late 2002, he was spending at least two hours a week with reporters discussing the accounting scandals of 2002."[262]

Yet when later questioned, Professor Granof admitted that he had not known that Andersen was not the auditor of the entities where the Enron frauds were committed. When asked why he didn't know facts readily available in the public domain, he said he had relied on the reporting of the New York Times and the Powers Report because he "did not have time to perform research." Professor Granof concluded that regardless of facts, his opinion wasn't changed.

Many have been swayed by Barbara Toffler's *Final Accounting: Ambition, Greed and the Fall of Arthur Andersen.* Ms. Toffler, formerly the partner-in-charge of Ethics and Responsible Business Practices consulting services at Arthur Andersen, is considered an expert on management ethics. With no background in either accounting or auditing and no access to the facts regarding the Enron audit, Ms. Toffler made assumptions, stated those assumptions as facts and then concluded that Andersen was guilty of wrongdoing. Ms. Toffler accuses Andersen people of "over-billing". Yet she was not in a position to assess any billing practices other than her own. Ms. Toffler admits that she cheated her clients and that Andersen fired her. Could these two facts be related?

Ms. Toffler's book and speeches, undertaken to garner fame and fortune, smear tens of thousands of people she can't possibly know. The blanket condemnation of a group of individuals is both unethical and bigoted..

In contrast, one voice of reason among academics was Professor Emeritus Abe Briloff of Baruch College who saw through government propaganda when he presented his paper titled *The Lynching of Arthur Andersen* to the American Accounting Association in 2002.

The treatment of Andersen people by the government, media and academics is a chilling parallel to France's infamous *Dreyfus* case. In 1894 Captain Alfred Dreyfus was accused of treason based on the dubious evidence that handwriting on a note resembled

[259] Seale, A., *Alcalde Magazine Runs Q & A with Professor Michael Granof,* October 31, 2002. (http://www.mccombs.utexas.edu/news/pressreleases/granof_alcalde.asp)
[260] *Id*
[261] *Id*
[262] *Id*

his. Captain Dreyfus protested his innocence but his being both a Jew and an Alsatian weighed heavily with his judges. He was convicted and sentenced to life imprisonment in solitary confinement on Devil's Island. When evidence came to light that the traitor was another officer in the High Command named Major Esterhazy (who was in fact Dreyfus' accuser), the evidence was suppressed. By dint of forgery and perjury, the real traitor, Major Esterhazy, was acquitted by court martial. The writer, Emile Zola, spoke out on Dreyfus' behalf and was vilified, prosecuted and sentenced for writing the article "J'Accuse"(1898), accusing the authorities of framing Dreyfus. The court of Appeals ordered a new court martial and again found Dreyfus guilty. Although the President later pardoned Dreyfus, agitation for complete exoneration continued until 1906, when the supreme court of appeals (a civil court) cleared Dreyfus, who was reinstated as a major. The traitor, Major Esterhazy, went free.

In both the *Dreyfus* and *Andersen* cases, governments deliberately incited mob hysteria against individuals they knew to be innocent while letting guilty parties go free. In both cases, many, many individuals abandoned all principle.

The *Dreyfus* case differs from the *Andersen* case in several respects:

1. Whereas Dreyfus stood alone, in the *Andersen* case, countless thousands of Andersen people were vilified and their livelihoods destroyed.

2. Captain Dreyfus was fraudulently convicted of a real crime – treason – whereas Andersen was fraudulently convicted for asking employees to perform a routine audit procedure.

3. The *Dreyfus* case exposed government fraud. The *Andersen* case uncovered corruption at many levels of our government as well as among major components of the world's financial system.

4. Whereas Dreyfus had no connection to the treason, in the *Andersen* case, the government "crucified the messengers" who reported the fraud, as well as all their associates.

5. In the *Dreyfus* case, the French government attempted to rectify its grievous injustice whereas in the U. S., no one has been held accountable. Instead, politicians and most in the media and academia have studiously ignored the dead skunk rotting just inches in front of their faces.

Who were Andersen people and what has happened to them?

Andersen people alive today include distinguished veterans of World War II, Korea and Vietnam, some crippled in service to their country. They include former presidents and board members of the American Institute of CPAs as well as various state societies of accounting. They include leaders of the Internal Revenue Service, the Government Accountability Office, the Financial Accounting Standards Board and many prominent business leaders. By partnership agreement, Andersen partners contributed approximately 10% of their gross pay as well as countless hours to charitable organizations. In addition, Andersen personnel followed a tradition of giving back to the community by donating both money and expertise to a wide range of charities.

The loss of jobs and retirement benefits has created varied hardships. Many joined other accounting firms which, in many cases, reimbursed partners for their lost Andersen capital. However, many left public accounting in disgust, losing all capital. Young Andersen partners who had financed their capital contributions to join the partnership were particularly hard hit. For years, Andersen had arranged for partners' capital loans to be financed by Citigroup, one of the banks complicit in Enron's fraud. Therefore, many former Andersen partners are still making payments to Citigroup – a bank that framed them – for capital destroyed in part because of Citigroup's fraud.

In addition to CPAs, Arthur Andersen employed tens of thousands of technical and office support staff. These individuals were left without jobs for many months, faced with a poor economy and a hostile environment. For many, savings, homes and health care all evaporated.

Among retirees, the elderly and the widows have suffered the most. Retirees in their 80s and 90s are the most dependent on retirement benefits because they did not have access to pretax savings in 401(k) accounts and a substantial portion of their partner earnings were reinvested to finance expansion of the firm. These individuals cannot replace their losses because their earning years are over; some do not expect to have money to last their lifetimes. They are most likely to have health problems, leaving them more vulnerable to emotional devastation in the face of hatred and vilification.

These are the general effects, but only individual portraits tell the story. On hearing the news of the indictment, the managing partner of the Sao Paulo, Brazil office collapsed with a heart attack and died at the office amid his colleagues. Two former employees of the Denver office committed suicide. Decades of fighting multiple sclerosis had left one retiree a quadriplegic, as well as draining his family's financial resources. Another faced a heart transplant, wondering if he would get a heart in time and if he did so, whether he would have the insurance to pay for the transplant. Both faced death worrying about how their widows would survive.

Several retirees have severely handicapped children who will never be financially or emotionally independent. The destruction of Andersen means that despite the parents' careful planning, these most vulnerable children will be left unprotected.

Many widows whose husbands died before 2002 have commented that they are glad their husbands never lived to see what their country has done to their firm. At the other end of the age spectrum, young parents report that, because of their association with Andersen, their young schoolchildren were hazed. This problem was widespread in both Canada and the U.S.

In response to the crisis, Andersen people rallied to help those most in need. Retirees visited widows and the elderly in nursing homes to help where they could. Retirees also set up a mentor network to offer their skills and contacts as well as moral support to those looking for jobs. Shunned by society, Andersen people stood tall and, in the words of Rudyard Kipling, "kept their heads when all about were losing theirs."[263]

Blaming Andersen is useful in hiding larger problems. What are they?

Non-consolidated SPEs pose a systemic problem because SPEs are supposedly independent and may be audited by an accounting firm different than that auditing the sponsoring corporation, in this case Enron. While hiring a different auditor for the SPEs was preferable from the standpoint of Andersen's concern for maintaining both the fact and appearance of independence, the fact that Andersen was not hired to audit the SPEs left Andersen more vulnerable to Enron's fraud. The proposed change requiring 10% outside equity (rather than the 3% requirement in effect at the time of the Enron fraud) does nothing to mitigate that problem. Whether the required minimum outside equity requirement is 3% or 10%, the mandatory non-consolidation of SPEs is directly contrary to "full and fair disclosure." According to Ron Fink of CFO Magazine, even this *de minimus* change was stalled by a Federal Reserve Board concerned that bank profits might be limited.[264]

According to the U.S. Senate Governmental Affairs Permanent Subcommittee on Investigations, JP Morgan Chase and Citigroup admitted to persuading other corporations to participate in Enron-style frauds. Yet the corporations were not identified. Who were these rogue corporations?[265] Which auditors did they defraud? Presumably these corporations received exemptions from the SEC allowing them to set up SPEs, enabling them to engage in fraudulent transactions. How much and to whom did these corporations pay campaign contributions?

In the Enron case and those emulating the Enron frauds, the banks' willingness to disguise loans reversed the appropriate accounting from mandatory consolidation to mandatory non-consolidation. Yet disguised loans are not merely a problem limited to SPEs. Disguised loans are themselves fraudulent. In the Parmalat fraud, disguised loans

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[263] Kipling, R. *If.*

[264] Fink R.,*Playing Favorites: Why Alan Greenspan's Fed lets banks off easy on corporate fraud*, CFO Magazine, May 2004.

[265] JP Morgan Chase (Chase) and Citigroup agreed to pay US$300 million to settle charges they helped Enron and Dynegy fraudulently manipulate financial statements (Fowler T, Houston Chronicle, July 29, 2003). Subsequently, Jamie Olis, former mid-level tax planner at Houston's Dynegy Corporation, was convicted for helping disguise a $300 million loan to Dynegy as cash flow from a gas trade. In a motion filed with U.S. District Court Judge Sim Lake, Olis noted that his crime included conspiring to hide information from Arthur Andersen & Co. so that Andersen would not characterize the deal as debt. Yet he had never been accused of hiding information from Dynegy's bankers and lawyers; they were in fact the designers of the fraudulent transaction.

The banks involved included Citibank, Deutsche Bank AG and Credit Suisse First Boston. According to Olis' attorney, the law firms involved were Vinson & Elkins; Bracewell & Patterson; Milbank, Tweed, Hadley & McCloy; and Houston's Andrews Kurth (Koppel, N. *Wearing Blinders*, The American Lawyer, Vol. XXVI, No. 7, July 2004).

by Citigroup, Credit Suisse First Boston, B/T Deutsche and Bank of America were used to defraud auditors (Deloitte Touche and Grant Thornton) and shareholders.[266]

The most serious problem hidden by the government's scapegoating of Andersen is the fact that campaign contributions have politicized both the SEC and the Justice Department. The granting of exemptions from investor protection laws to corporations who make large political contributions has two profound effects:

(1) The fundamental accounting principle of consistency is destroyed. An investor comparing financial statements of two companies in the same industry should be able to assume that the companies use comparable accounting methodology.

(2) Granting exemptions to political favorites opens the door to political graft and corruption.

Similarly, the politicization of the SEC and the Justice Department undermines the rule of law.

Scapegoating Andersen presents additional problems. What are they*?*

The indictment of Andersen destroyed the firm that, according to academic commentators, had the ***lowest*** rate of restatements among the major accounting firms from 1997 to 2001.[267]

The indictment affected not only Andersen employees and retirees but it also created hardship for Andersen alumni, clients, suppliers and landlords.

The U.S. General Accounting Office has concluded that the criminal indictment of Andersen and its subsequent dissolution has significantly increased market concentration among large public accounting firms. "The increased degree of concentration [due to the destruction of Andersen] coupled with the recently imposed restrictions [of the Sarbanes-Oxley Act of 2002] on the provision of non-audit services by incumbent auditors to their audit clients could increase the potential for [illegal] collusive behavior or the exercise of market power."[268] The study also noted that it is "unclear whether and to what extent the Antitrust Division [of the Department of Justice] was consulted and to what extent the Department of Justice's Antitrust Division had input into the decision to criminally indict Andersen."[269]

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[266] Reilly D., Galloni A., *Spilling Over: Banks come under Scrutiny for Parmalat Scandal,* The Wall Street Journal, September 28, 2004.
[267] Eisenberg T., Macey J., *Was Arthur Andersen Different? An Empirical Examination of Major Accounting Firms' Audits of large Clients*, Research Paper No. 287, at 14 (2003) (unpublished manuscript, on file with Yale Law School), *available at* papers.ssrn.com/abstract=468761
[268] U.S. General Accounting Office Report to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services, *Public Accounting Firms: Mandated Study on Consolidation and Competition*, July, 2003, GAO-03-864, p. 26.
[269] *Id* at 19.

Because of the increased concentration among the large accounting firms, former SEC Commissioner Richard Breeden advocates splitting the Final Four accounting firms – Deloitte Touche, PwC, Ernst & Young and KPMG – into as many as eight accounting firms because "the concentration is too big to be healthy."[270]

Auditors and partners of auditors are assessing the extreme risk in public accounting today. Some CPAs are no longer willing to audit public companies or are leaving the profession altogether. Auditor resignations have jumped in the wake of the Sarbanes-Oxley Act of 2002 – the political solution to supposed auditor complicity in financial scandals – and the government's execution of Andersen.[271] The sharp rise in [Final Four auditor] resignations has drawn concern from federal regulators.[272] SEC Chief Accountant Donald Nicolaisen told Bloomberg News that Sarbanes-Oxley "should not be a convenient tool for (audit firms) to manage their business. I've expressed my views to the CEOs of the Big Firms that I think it is their responsibility not to run away from the marketplace. They do have a responsibility in the public trust."[273]

Recent Developments

- In the wake of Hurricane Katrina, thousands of hurricane victims were left for days without food, water and shelter. Some, including nursing home residents, drowned days after the hurricane touched shore. Where was help for these people?

The Department of Homeland Security, headed by Michael Chertoff -- the same Michael Chertoff who indicted Andersen -- is responsible for the bungled federal response to Katrina. Federal Emergency Management Agency (FEMA) chief Michael Brown reports to Secretary Chertoff. When critics assailed Brown for delays in aid that might have cost hundreds of lives, he was relieved of his duties by Secretary Chertoff.

However, according to the National Response Plan, the federal government's blueprint for handling disasters, it was Chertoff – not Brown – who was in charge of managing the national response to a catastrophic disaster.[274] An order issued by President Bush in 2003 also assigned that responsibility to the Homeland Security director.[275] According to a memo written by Chertoff, he did not shift that power to FEMA director Brown until late afternoon or evening on Tuesday, August 30[276] despite Katrina's early morning landfall on Monday, August 29.[277] Yet on August 27[278], the National Hurricane

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[270] CFO Staff, CFO Magazine, June 1, 2004.
[271] Desilver D., *In the Auditors' Hands*, Seattle Times, October 4, 2004.
[272] *Id*
[273] *Id*
[274] Landay, J., Young A. and McCaffrey S. *Was FEMA's Brown the Fall Guy?* Knight Ridder Newspapers, September 14, 2005.
[275] *Id.*
[276] *Id.*
[277] *Id.*
[278] *Id.*

Center had predicted that Katrina would strike the Gulf Coast with "catastrophic" force within 48 hours. For political expediency, Secretary Chertoff sacrificed someone he knew did not have the authority to act, thereby covering up his own culpability.

Also reminiscent of the Andersen story is the fact that the media called for Brown's resignation before asking the first most obvious question, namely: who had the authority and responsibility to launch the federal rescue effort? Whether Mr. Brown would have performed better or worse than Mr. Chertoff is a separate question.

- In his announcement of the indictment of Arthur Andersen, Deputy Attorney General Larry Thompson stated,

> "Arthur Andersen is charged with a crime that attacks the justice system itself by impeding investigators and regulators from getting at the truth. This indictment alleges just such a subversion of our justice system."[279]

Andersen responded that the indictment is "riddled with factual and legal errors establishing that the government's case entirely lacks substance"[280] and that it is "without precedent and an extraordinary abuse of prosecutorial discretion. Given the circumstances of this case, this is a gross abuse of government power."[281]

Nine Supreme Court justices agreed with Andersen. None agreed with Mr. Thompson.

It has been reported that former Deputy Attorney Larry Thompson was considered by President Bush for nomination to the U.S. Supreme Court.[282]

- Congress' Government Accountability Office (GAO) reports that since 2002, defrauded investors have received only about 1 percent of the billions of dollars collected for them by the SEC.[283]

- Department of Justice lawyers moved to dismiss criminal charges against Arthur Andersen in an appellate court filing, paving the way for the U.S. District Court to dismiss charges with prejudice, meaning that charges cannot later be re-filed.[284]

- Attorneys for David Duncan, Andersen partner, filed a motion to withdraw his guilty plea, on the grounds that he did not say that he knew he acted illegally

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279 Mittelstadt M., *Feds Charge Defiant Andersen over Shredding Files*, Dallas Morning News, March 15, 2002.
280 *See* Statement form Arthur Andersen & Co., March 15, 2002.
281 *Id.*
282 *Familiar Faces Among Popular Choices*, Associated Press, September 5, 2005.
283 Gordon M., *Few Investors get Restitution from SEC Fund*, Associated Press, October 4, 2005.
284 Roper, John C., *Government Won't Retry Andersen Criminal Case*, Houston Chronicle, November 23, 2005.

> when telling employees to follow Andersen's document retention policy.[285] The Justice Department has stated that it will not oppose Duncan's motion.[286]

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According to Congressman James Greenwood,

> "Enron robbed the bank, Arthur Andersen provided the getaway car and David Duncan was at the wheel."

In the interest of full and fair disclosure, a restatement is in order. To state the facts accurately,

> "Enron robbed the bank, politicians provided the getaway car and major international banks were at the wheel."

What would our Founding Fathers think of this sorry spectacle? In a discussion of the philosophy of those who founded America, author Bernard Bailyn notes,

> "Freedom in the end depends on the integrity and to some degree the virtue of rulers and ruled alike."[287]

Bailyn then quotes James Madison, whose words describing "this great republican principle" ring out across the centuries,

> "that the people will have the virtue and intelligence to select men of virtue and wisdom. Is there no virtue among us? – If there be not, we are in a wretched situation. No theoretical checks – no form of Government, can render us secure."[288]

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[285] *Id.*
[286] *Id.*
[287] Bailyn, B. *To Begin the World Anew*, First Vintage Books Edition, 2004, p. 34.
[288] *Id* citing Bailyn, *The Ideological Origins of the American Revolution* (enlarged ed., Cambridge, Mass., 1992), pp. 46 – 51, 86 – 92, 130 – 138; Madison, *Federalist* No. 51, in Bailyn, ed., *Debate,* II, 164; Madison's speech in the Virginia ratifying convention, June 20, 1788,in Jensen et al., *Documentary History,* X, 1417.