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Neal F. Newman
Texas A&M University School of Law

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ENRON AND THE SPECIAL PURPOSE ENTITIES—USE OR ABUSE?—THE REAL PROBLEM—THE REAL FOCUS

Neal Newman*

I. INTRODUCTION

IN December of 2001, Enron Corporation, one of the nation's largest energy and gas providers, filed for bankruptcy under chapter 11 of the U.S. Bankruptcy Code, one of the largest corporate bankruptcy filings at that time.¹ A myriad of scholarship, books, and articles have been written on Enron's meteoric rise and fall. The failure in oversight that permeated Enron's corporate gatekeepers, such as Enron's Board of Directors and upper management, its public accountants Arthur Andersen, the Securities and Exchange Commission (SEC), and other professionals who were tasked to navigate the Enron empire, was disturbing and disconcerting on a number of levels—not the least of which being the blow to investor confidence, the foundation that the capital markets are built on.

On the heels of Enron's debacle came the Sarbanes-Oxley Act of 2002, the far reaching legislative reform that was designed to shore-up the accounting and corporate governance shortfalls that the legislature and the investing public believed allowed Enron to do what it did unabated.² Supplementing the reforms set forth in the Sarbanes-Oxley Act are a number of accounting rules, guidelines, and interpretations that are designed to curtail the type of accounting fraud Enron perpetrated through its use (or more accurately abuse) of what are referred to as special purpose entities (SPEs). Although much has been written chronicling and analyzing the various aspects of the Sarbanes-Oxley Act, little has been written analyzing the accounting guidance related to SPEs.

* Associate Professor of law, Texas Wesleyan University School of law. This essay benefited from the suggestions of professor Barbara Banoff from Florida State University and professor Jeffrey J. Haas from the New York University School of Law. Also thanks to Mr. Adam Burney and Cynthia Gustavson who both provided valuable help as research assistants. And finally, thanks to Texas Wesleyan University School of Law who supported my work through the provision of a summer research grant.

1. Richard A. Oppel, Jr. & Andrew Ross Sorkin, *Enron's Collapse: The Overview; Enron Corp. Files Largest U.S. Claim for Bankruptcy*, N.Y. TIMES, Dec. 3, 2001, at A1.
2. See Sarbanes-Oxley Act of 2002, 15 U.S.C.A. §§ 7201-02, 7211-19, 7231-34, 7241-46, 7261-66 (West 2006).

Since the Enron debacle, a dark cloud has been cast over the SPE by the investment and financial community. The line between SPE use and abuse has been blurred to the point where the two are considered one in the same, i.e., that SPEs by their very nature are these ominous, nefarious, inherently evil entities whose only purpose is to defraud, obfuscate, and manipulate financial statements. The purpose of this piece, among other things, is to challenge this assumption and conclusion.

The focus for this paper is to take a look at both the new accounting rules in the post-Enron era that have been enacted, in significant part, due to what happened with Enron and its SPE use, as well as the accounting rules related to SPEs that were in effect during both the pre and post-Enron eras. This article examines the accounting reforms and legislative approaches currently being taken regarding the accounting for and disclosures of SPEs. This piece questions whether or not those approaches are, in fact, the correct ones.

The article will examine closely the method and manner that Enron perpetrated such fraud, with the goal of demonstrating that it was not a lack of accounting rules or deficient interpretive accounting guidance that resulted in Enron's SPE improprieties. Instead, dishonest and fraudulent behavior by Enron management was the real problem. The next part of the piece will cite and critique current rules and some proposed accounting reforms being considered, analyzing their current and potential effectiveness, with the goal of highlighting reasons why the proposed reforms may not meet their desired or stated objectives. Finally, the piece will explore and suggest some alternative approaches once the issue has been reframed. In the alternative, this piece, in essence, suggests that enforcement efforts should be focused on the SPE abusers instead of the SPEs themselves.

The overall goal of this piece is to question whether we should be taking a different approach to financial fraud in the area of SPEs than the path currently being taken; the end result being that we will ultimately be making it more difficult and more costly for the myriad of legitimate SPE use that may or may not be able to continue in light of the accounting and disclosure requirements currently in place and that have been enacted to a large degree in response to what occurred with Enron.

II. WHAT IS A SPE?

A. SPEs HISTORICALLY

To understand why or, more importantly, how, Enron perpetrated the financial accounting fraud that it did, we must first understand from a general standpoint what an SPE is and, more importantly, how it works. SPEs are structures that have been around for years, only recently coming into prominence primarily due to the manner that Enron abused the SPE structure in connection with their financial reporting schemes. Since that time, accountants and CPAs alike have tasked themselves to gaining

an understanding of these previously obscure entities.³

B. WHAT ARE SPEs?—A LOOK AT THE VARIOUS FORMS

Though SPEs are considered to be complicated entities, the general premise of an SPE is simple. An SPE is an entity formed for a discreet and isolated purpose, to adhere to a specific business or economic objective; a simple premise or starting off point from which the concept builds.

The idea behind the SPE is to narrow the scope of risk to the assets and liabilities placed in the SPE, such that potential investors' or equity holders' fortunes or misfortunes will be based entirely and exclusively on what occurs with respect to the assets and liabilities placed within the SPE. Note that this is the general idea, but there are a number of variations on this single theme.

Generally, SPEs fall into three categories: (1) the joint venture, (2) the synthetic lease, and (3) the asset securitization or off-balance sheet financing. Granted, there can be a number of variations on these three major themes, but the vast majority of SPE transactions fall in one of the three. Each type will be discussed in turn.

1. *The Joint Venture*

The joint venture is perhaps the most basic and straight-forward SPE type. In a joint venture, two or more parties come together and engage in a venture that is separate and apart from their respective entities.⁴ The conduit that such ventures can occur through is the SPE. This conduit can take any number of forms: a partnership, a corporation, a trust, an LLC, etc. Understand that it's the entity's purpose, not its legal form, that the SPE moniker is derived. An example of a typical joint venture may be the construction of a gas pipeline to conduct off-shore oil drilling.⁵ In this instance, the entire scope of the venture will be transferred to a separate and discreet business entity apart from the respective companies. The SPE will own both the assets and liabilities associated with the project. Because of the isolated nature of the project, such a circumstance creates an attractive situation for investors, as the risks and rewards of the project are now isolated within the SPE, rather than an investor's success being subject to the fortunes or misfortunes of the respective corporations as a whole.⁶

3. Bob Jensen, *What's Right and What's Wrong With (SPEs), SPVs, and VIEs*, <http://www.trinity.edu/rjensen/theory/00overview/speOverview.htm> (last visited Feb. 21, 2006).

4. See Cornell Law School Legal Information Institute, *Joint Venture*, http://www.law.Cornell.edu/wex/index.php/Joint_venture (last visited July 22, 2006) (giving an overview of a joint venture).

5. Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, in *ENRON AND BEYOND: TECHNICAL ANALYSIS OF ACCOUNTING, CORPORATE GOVERNANCE, AND SECURITIES ISSUES* 103, 104 (Julia K. Brazelton & Janice L. Ammons eds., 2002).

6. *Id.*

To insure that the SPE operates in the manner the venturing parties contemplated, the chartering documents—such as the articles of incorporation, the partnership agreement, or the operating agreement, as applicable—will narrow the SPE's scope to only those permitted activities.

There are several key things to observe with the SPE used in the joint venture context. First, with the joint venture, the business purpose and rationale for entering into such ventures are clear. The design and structure of such ventures and what they are trying to do and accomplish for the most part make sense as well. Provided that proper formation occurs and proper protocols are followed, the use of the SPE in the joint venture context is a legitimate and non-controversial use of the SPE.

2. *Synthetic Leases*

a. The Typical Synthetic Lease Structure

The second category where SPEs are used as an integral part of a transaction is what is referred to as the synthetic lease. The following is a typical synthetic lease example: ABC Company wants the use of a building for its corporate offices for the next twenty years. The land and building would cost \$100 million to buy. Alternatively, ABC forms a separate legal entity, an SPE, to purchase the building. The SPE in turn borrows the necessary funds to acquire the building. The financial institution may loan the SPE up to 90 percent of the fair market value of the real estate. The loan is secured by the building. The remaining 10 percent of the cost is put up by an outside equity investor. The outside investor owns 100 percent of the shareholder equity in the SPE, which results in all of the outside equity being owned by someone other than the sponsoring corporation.⁷

b. Corporate Motivation Behind the Synthetic Lease

It is helpful to understand the underlying motivation for corporations that use the synthetic lease structure. Transactions, especially of the magnitude that are typically involved with synthetic lease transactions, will have a significant impact on both the corporation's financial statements and their tax returns. Accordingly, the goal is to structure the transaction such that it will be as advantageous as possible for both financial and tax reporting purposes.

c. Operating Versus Capital Lease—The Impact of One Versus the Other

The two ways that the transaction can be structured from the lessor's perspective is either as an operating lease or as a capital lease.⁸ The resulting characterization will have a significant impact on how the lease

7. *Id.* at 107.

8. STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 13: ACCOUNTING FOR LEASES ¶ 6(a) (1976) [hereinafter FAS 13].

transaction is accounted for. From a financial statement perspective, the end user or lessee will want to characterize the lease as an operating lease. Such characterization gives the lessee the more favorable treatment from a financial reporting perspective.⁹ When the lease transaction is characterized as an operating lease, by implication the lessee is not acquiring the asset but merely making use of it for a finite period of time and then presumably returning it back to the lessor. Accordingly, from an accounting standpoint, the lessee treats the transaction as an operating expense, recognizing the lease payments as a lease or rental expense during the lease term.¹⁰

By contrast, the capital lease is the least favored between the two alternatives as far as the lessee is concerned. With capital leases, the lessee is required to account for the transaction as if the lessee were acquiring the asset.¹¹ Accordingly, as opposed to merely expensing the periodic lease payments as would be required for operating leases, the lessee must capitalize the asset and record it as such on its balance sheet.¹² The amount the lessee records is the present value of the minimum lease payments as calculated at the lease's inception.¹³ Likewise, and more significantly, the lessee is required to record a corresponding debt obligation for the same amount.¹⁴ Additionally, because the lessee is required to treat the asset as if it is being acquired, the lessee must also record both the depreciation expense to recognize the declining value of the asset and the interest expense to reflect the financing portion of the acquired asset over the term of the lease.¹⁵

Because of the required accounting treatment, the effect on the lessee's financial statements is significant. As one would expect, publicly held companies are sensitive to how lease transactions are classified. For example, when a lessee is required to account for a lease transaction as a capital lease, recording the corresponding debt obligation has an adverse effect on ratios such as the debt-to-equity ratio.¹⁶ Likewise, the added burden of recording both depreciation and interest expense results in an overall decrease in reported net income. Investors are sensitive to these effects of a capital lease, which can have an adverse impact on a corporation's share price. Accordingly, as between the two alternatives, the lessee will want the transaction structured as an operating lease to get a more favorable accounting treatment.

9. See generally *id.* ¶¶ 6-10.

10. *Id.* ¶ 15.

11. *Id.* ¶ 10.

12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.* ¶ 11.

16. The debt-to-equity ratio measures a corporation's debt in relation to its equity. See DAVID R. HERWITZ & MATTHEW J. BARRETT, ACCOUNTING FOR LAWYERS 327 (3d ed. 2001).

d. Accounting Treatment for Synthetic Leases—Operating Versus Capital—The Characterization Criteria Under Generally Accepted Accounting Principles

As discussed earlier, because of the significant differences in accounting treatment for operating leases versus capital leases, the lessee will want to characterize the lease as an operating lease if that alternative is a viable option. Accordingly, the lessee has to make sure that the lease is structured so that operating lease treatment is proper under Generally Accepted Accounting Principles (GAAP). Statement of Financial Accounting Standards No. 13 (SFAS 13) gives guidance relating to accounting for lease transactions. Under SFAS 13, the lease may not be characterized as an operating lease if the lease meets any one of the following criteria: a.) “[t]he lease transfers ownership of the property to the lessee by the end of the lease term”;¹⁷ b.) “[t]he lease contains a bargain purchase option” (i.e., “[a] provision allowing the lessee, at his option, to purchase the leased property for a price which is sufficiently lower than the expected fair value of the property”);¹⁸ c.) “[t]he lease term . . . is equal to 75 percent or more of the estimated economic life of the leased property” (note, this criteria cannot be considered in classifying the lease, if the lease’s term begins during the last 25 percent of the asset’s estimated economic life);¹⁹ and d.) the present value of the minimum lease payments as calculated at the lease’s inception is equal to 90 percent of the fair value of the leased property (note, this criteria cannot be considered in classifying the lease if the lease’s term begins during the last 25 percent of the asset’s estimated economic life).²⁰

In looking at these four criteria, any one of which could trigger capital lease treatment, it is evident that SFAS 13 requires capital lease treatment when the economic substance of the transaction is such that the lessee is acquiring the asset. Given this set of criteria, the trick is to structure the transaction such that the transaction does not fall under any of the capital lease triggers mentioned above. Provided all of these criteria can be avoided, then operating lease treatment will be appropriate.

e. When Consolidation is Required

The final hurdle related to synthetic leases and accounting for them is the issue of whether or not the lessee has to report the lease obligation owned by the SPE on a consolidated basis. This issue is significant because if the lessee is required to report the SPE on a consolidated basis with the issuer, this would nullify any favorable accounting treatment that the lessee would otherwise enjoy because the debt obligation would be reported on the lessee’s books on a consolidated basis regardless of how the lessee characterized the lease initially. Again, the challenge in avoid-

17. FAS 13, *supra* note 8, ¶ 7(a).

18. *Id.* ¶¶ 7(b), 5(d).

19. *Id.* ¶ 7(c).

20. *Id.* ¶ 7(d).

ing consolidation is to structure the lease and the SPE so that the lease obligation is contained in such a way under GAAP that the lessee is not required to report the SPE and the debt obligation contained in the SPE on the issuer's books on a consolidated basis.

Accordingly, accounting guidelines have targeted leases that otherwise qualify as operating leases and have enumerated specific instances where those leases may still have to be accounted for on a consolidated basis on the lessee's books. In that regard, those specific instances are any one of the following: "1. [l]essee residual value guarantees and participations in both risks and rewards associated with ownership of the leased property[;] 2. [p]urchase options[;] 3. [s]pecial-purpose entity (SPE) lessor that lacks economic substance[;] 4. [p]roperty constructed to lessee's specifications[; and] 5. [l]ease payments adjusted for final construction costs."²¹

When the lease transaction contains any one of the characteristics noted above, the issue is whether operating lease treatment is still appropriate.²² Accordingly, lessees with any of the characteristics noted above would have to report the SPE on a consolidated basis when all of the following conditions exist:²³ "1. [s]ubstantially all of the activities of the SPE involve assets that are to be leased to a single lessee."²⁴ This is almost always the case as, generally, the lessee sets up the SPE for the sole purpose of taking ownership of that single asset and the corresponding debt obligation.

2. The expected substantive residual risks and substantially all the residual rewards of the leased asset(s) and the obligation imposed by the underlying debt of the SPE reside directly or indirectly with the lessee through such means as:
 - a. The lease agreement
 - b. A residual value guarantee through, for example, the assumption of first dollar of loss provisions . . .
 - c. A guarantee of the SPE's debt
 - d. An option granting the lessee a right to (1) purchase the leased asset at a fixed price or at a defined price other than fair value determined at the date of exercise or (2) receive any of the lessor's sales proceeds in excess of a stipulated amount.²⁵

And "3. [t]he owner(s) of record of the SPE has not made an initial substantive residual equity capital investment that is at risk during the entire term of the lease."²⁶

Accordingly, the lessee has to structure the lease such that it fails at least one of these three conditions. Lessees using the SPE structure for

21. EMERGING ISSUES TASK FORCE ISSUE NO. 90-15: IMPACT OF NONSUBSTANTIVE LESSORS, RESIDUAL VALUE GUARANTEES, AND OTHER PROVISIONS IN LEASING TRANSACTIONS 1 (1991) [hereinafter EITF 90-15].

22. *Id.*

23. *Id.* at 2.

24. *Id.*

25. *Id.*

26. *Id.*

their synthetic lease transactions generally structure the lease such that it fails the third criteria. The lessee accomplishes this by having a third party investor as the equity owner of the SPE. By doing this, the third party equity owners become the presumptive owners of the SPE by virtue of their equity investment.

f. How Substantial Must the Equity Investment Be to Avoid Consolidation?

The SEC weighed in on this issue and concluded that the appropriate equity investment amount "should be comparable to that expected for a substantive business involved in similar leasing transactions with similar risks and rewards."²⁷ The SEC staff concluded that 3 percent would be the minimum acceptable investment but further explained that a greater investment would "be necessary depending on the facts and circumstances, including the credit risk associated with the lessee and the market risk factors associated with the leased property."²⁸

From the reading of Emerging Issues Task Force (EITF) Issue 90-15, the inference that should have been drawn was that the 3 percent equity investment was merely meant to be a guideline or a baseline minimum to be increased when circumstances warranted. But what has happened in practice is that the 3 percent rule has become the accepted practice and the standard minimum equity investment amount required to pass SEC muster. Accordingly, most entities that structure synthetic lease transactions using SPEs have an equity investor investing at the 3 percent minimum.

Given such liberal criteria for avoiding consolidation in the pre-Enron debacle era, it would seem that issuers who wished to avoid consolidation of their affiliated SPEs could do so without much effort. Accordingly, had Enron followed these rules as prescribed, their case for innocence would have been much stronger. But as we will explore in section III, Enron's problems stemmed from departing from these rules (as liberal as they were) as they existed, which subsequently prompted changes in the criteria that a corporation must consolidate affiliated SPEs. This article in later sections will examine what these changes entail.

g. Tax Treatment for Synthetic Leases

Interestingly, and not surprisingly, the last obstacle that the lease transaction must be navigated through is assessing the proper tax treatment for the transaction. What makes the synthetic lease so appealing as a financing structure is the fact that it can be accounted for differently for financial reporting and tax purposes. The different treatment is afforded for each because the characterization criteria for tax purposes are different than the characterization criteria for financial accounting purposes.²⁹

27. *Id.* at 4.

28. *Id.*

29. See generally Rev. Rul. 55-540, 1955-2 C.B. 39.

Thus, if the transaction is structured properly, the lessee gets optimal benefits from both a financial reporting and a tax perspective.

As discussed earlier, the lessee will want to characterize the lease as an operating lease for financial reporting purposes to avoid having its income statement weighted down with interest and depreciation expense and its balance sheet burdened by recording the corresponding liability from the financing obligation. For tax purposes, however, the lessee will want to characterize the lease transaction as if the lessee is acquiring the asset with the understanding that the investing public tracks what companies report for financial reporting purposes. But companies can report different numbers to the Internal Revenue Service (IRS) due to the different reporting requirements mandated under the Internal Revenue Code.³⁰ Likewise, the income reported for tax purposes has a real economic impact on the corporation, as that number is the basis for their tax liability to the Federal Government. Accordingly, the lessee corporation will want to reduce taxable income as much as possible. One of the ways this is done is through the corporation being afforded capital lease treatment for tax purposes, thereby giving the lessee the right to record both depreciation and interest expense for tax purposes on the leased transaction, resulting in a reduction in taxable income. The key is structuring the transaction properly to be afforded such treatment.

h. The Characterization Criteria for Tax Purposes—The Benefits and Burdens Test

Unlike the bright-line tests used to characterize the lease transaction for financial reporting purposes, the characterization criteria for tax purposes use a different approach. In determining how the lease should be characterized for tax reporting purposes, the determination is based on the general principal that the transaction's economic substance coupled with the intent of the parties comprising the transaction are the determining factors as to how the lease transaction will be characterized.³¹ The IRS and the courts have taken this general principle and have applied it on a case-by-case basis to lease transactions of various types.³² The IRS, when determining who is the presumptive owner of a leased asset, looks at a number of things, the first being the intent of the parties to the transaction in question³³. The court takes that intent and couples it with the economic substance of the transaction, presumably looking for proper balance between the two.³⁴ Essentially, the court looks at the transaction's form as characterized by the parties, and then looks beyond the

30. For instance, a corporation may use different depreciation methods for financial reporting purposes such as a straight-line depreciation method for financial reporting purposes and some accelerated depreciation method allowed for tax reporting purposes. See HERWITZ & BARRETT, *supra* note 16, at 795.

31. See generally Rev. Rul. 55-540 § 4.

32. *Id.*

33. *Id.*

34. Frank Lyon Co. v. United States, 435 U.S. 561, 577 (1978).

documents to determine whether that form coincides with the economic substance.³⁵

For example, in the case where the lessee wishes to treat the lease transaction as a capital lease to enjoy the benefits of deducting depreciation and interest expense for tax purposes, the court will look to see whether the lessee, by virtue of the transaction, is vested with the true benefits and burdens of ownership.³⁶ If it is evident that the party seeking to characterize the lease transaction as a capital lease is vested with the true benefits and burdens of ownership, then the court will defer and let the characterization stand.

i. The Argument for Harmonizing the Dual Treatment for Tax and Accounting Purposes

Regarding synthetic leases and the dual treatment for tax and accounting purposes, there is sentiment in the field of academia that “this transactional sleight-of-hand should not be permitted.”³⁷ Admittedly, there is a discordant paradox when you have a company that can take the very same transaction and categorize it one way for financial accounting purposes and another for tax purposes, even though the economic substance of the transaction is the same. Some have advocated that the Financial Accounting Standards Board (FASB), the governing body that sets accounting standards, eliminate the bright-line tests used for financial reporting purposes and follow the “benefits and burdens” test that the IRS follows; the argument being that the benefits and burdens test is based on classifying the transaction on its economic substance versus an arbitrary classification that conforms to bright-line tests of form.³⁸

Likewise, the SEC has noted similar issues in its assessment of the bright-line tests set forth in determining capital versus operating treatment for leases. The crux of the SEC’s argument is that transactions that are similar in terms of economic substance can have very different accounting treatments based on slight variations in the transaction’s actual form. For example, the SEC notes, the difference between a lease that commits an issuer to payments equaling 89 percent of an asset’s fair value versus 90 percent of an asset’s fair value results in different accounting treatment, one qualifying as an operating lease and the other relegated to the less favored status of being accounted for as a capital lease.³⁹

In spite of some in the field of academia, as well as the SEC’s recognition of the current problems with the existing rules, the SEC nonetheless

35. *Id.* at 576-77.

36. *Id.* at 577.

37. Donald J. Weidner, *Synthetic Leases: Structured Finance, Financial Accounting and Tax Ownership*, 25 J. CORP. L. 445, 487 (2000).

38. *Id.* at 466.

39. SEC, REPORT AND RECOMMENDATIONS PURSUANT TO SECTION 401(c) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 63 (2005) [hereinafter SEC REPORT 401(c)].

acknowledges that it would be difficult to change those rules given that lease structuring based on the current accounting guidance is so prevalent. Such efforts to change would likely be met with strong resistance, both from preparers who have become accustomed to designing leases that achieve various reporting goals and from other parties that assist those preparers.⁴⁰

To quantify that number, as of December 31, 2003,⁴¹ it is estimated that 63 percent of the total population of issuers reported having operating leases as a part of their operations, and an estimated 22 percent reported having capital leases.⁴² In terms of the dollar amounts, an estimated \$1.2 trillion are tied up in operating leases with another estimated \$45 billion tied up in capital leases.⁴³ With the prospect of all or a significant portion of these operating leases being re-classified, resulting in debt recognition on an issuer's balance sheet, it is clear why there would be resistance to significant changes to the current accounting rules. In spite of these interesting issues related to synthetic leases, such is not this article's focus. In explaining SPEs in general, however, the piece would not be complete without some discussion of synthetic lease transactions and the current issues related to synthetic leases.

But this article focuses on SPE abuse, i.e. . a look at an issuer's failure to follow existing accounting guidance, which does not appear to be prevalent in the synthetic lease context. The issues with the synthetic lease transaction deal with whether the current accounting regime related to synthetic lease transactions is appropriate even where the letter of the law is followed explicitly. In sum, the synthetic lease discussion is here to illustrate yet another common transaction that the SPE is used in and to point out the fact that, in spite of some issues that are in flux, SPE use in forming synthetic leases is nonetheless another legitimate use of the SPE structure.

3. *Asset Securitizations—[Off-Balance Sheet Financing]*

a. *How Asset Securitizations Work*

Asset securitizations have been around for some time and constitute an important tool in the capital-raising component for corporations who need to be creative and innovative in their capital-raising efforts.⁴⁴ In a typical securitization, the corporation, referred to as the originator, will transfer a select group of assets into an SPE.⁴⁵ The assets transferred are usually account receivables.⁴⁶ But in theory, the assets can be any type of

40. *Id.*

41. *Id.* at 29.

42. *Id.* at 64.

43. *Id.*

44. For example, the first structured financings identified as such took place in the early 1970s. See STEVEN L. SCHWARCZ, *STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION* § 1:2, at 1-7 (3d ed. 2002).

45. *Id.* § 1:1, at 1-3.

46. *Id.* § 1:1, at 1-4.

asset that will have a potential future payment stream.

The SPE in turn issues some type of security in exchange for cash.⁴⁷ The security can be either in the form of debt or equity issued to third parties who are willing to invest. The securities are backed by the assets that have been transferred to the SPE.⁴⁸ The SPE in turn transfers the money received from the investors on to the originator.⁴⁹ The price the investors are willing to pay depends on the creditworthiness of the transferred assets that are backing the security.⁵⁰ If the receivables, for example, are of a high quality, i.e., the likelihood of collection is fairly certain, then investors are willing to pay more for the securities because the risk of default is low.⁵¹ The debtors who have an outstanding receivables balance owed to the originator are then informed that their balance has been transferred and are therefore instructed to send payment to the SPE instead of the originator. When the SPE receives the payments, the collected cash is transferred to the investing security holders.

If the transaction works according to plan, it can be win-win for all parties involved. The originator benefits because the securitization allows the originator to realize the receivables in the form of cash at a date sooner than they otherwise might if they waited to receive payment from the debtors at maturity. For example, an originator may receive \$9,000 today on a securitized account receivable whose face value is \$10,000. The originator is giving up the right to receive \$10,000 at a future date in exchange for receiving \$9,000 at an earlier point in time. This is a circumstance that is win-win for an originator who may have an immediate and pressing need for cash.

The transaction is likewise beneficial to the investor. The investor presumably is not concerned with immediate access to cash. So the investor is willing to pay \$9,000 for the security in exchange for the right to receive the \$10,000 receivable face value when the balance comes due and is paid. Accordingly, all parties benefit from the transaction. Additionally, there are other benefits that come with using asset securitizations as a capital raising tool, namely the accounting and financial reporting aspects related to securitizations. Those benefits will be discussed next.

b. The Financial Reporting Benefits Related to Asset Securitizations

As was discussed in the section on synthetic leases, the same issues regarding how different financing options will effect a company's financial reporting and perceived financial health are present in the asset securitization arena as well. As we saw with synthetic leases, the goal of the transaction was for the lessee to be afforded operating lease treat-

47. *Id.* § 1:1, at 1-5.

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.* § 1:3, at 1-10.

ment and the more favorable accounting that comes with such treatment. Likewise, with asset securitizations, similar issues of balance sheet sensitivity exist, although with slightly different issues related to financial reporting.

Companies benefit from asset securitizations in two ways. First, if the transaction is structured properly and most efficiently, the discount rate that investors are willing to pay is better than the cost of borrowing that an originator might otherwise incur in a typical financing transaction.⁵² Second, because of the off-balance sheet nature of the transaction, the originator is absolved from having to recognize a debt obligation, and therefore financial ratios such as the debt-to-equity ratio are improved as a result.⁵³ The debt-to-equity ratio, for example, is a ratio that may be pegged to loan covenants or is otherwise tracked by financial analysts who use such ratios to assess the overall financial health of a corporation. Accordingly, keeping this ratio low through alternative means of capital rising can be important.

Regarding the first issue, this idea is similar to what was observed with the joint venture scenario discussed earlier. When a selected group of assets is isolated and transferred to an SPE, the investor's investment decision is based solely on those assets isolated and segregated in the SPE versus being based on the creditworthiness of the originator as a whole. Accordingly, instead of the investor's fortunes being tied to the originator, they are now based exclusively on the creditworthiness of the assets isolated in the SPE.⁵⁴ As a result, the investor is willing to pay more for these assets than he otherwise might if his investment decision were based on the fortunes of the originator taken as a whole.⁵⁵

c. The Key Issue with Isolating the Assets—Bankruptcy Remoteness

One of the key aspects, however, in the securitization process is that the SPE that the assets are transferred in to must be "bankruptcy remote," meaning that the assets transferred must legally be beyond the originator's reach in the event that the originator, for instance, files for bankruptcy, and the issue of using the transferred assets to settle any claims comes into question.⁵⁶ The nuances of and the particulars of how a bankruptcy remote SPE is established is beyond the scope of this article. But in general, the SPE achieves bankruptcy remoteness through proper drafting of its chartering or incorporating documents and through its corporate governance structure.⁵⁷

Accordingly, the chartering documents will be drafted in such a way

52. *Id.* § 1:1, at 1-5.

53. *Id.* § 1:1, at 1-6.

54. *Id.* § 1:1, at 1-5.

55. *Id.*

56. *Id.* § 3:1, at 3-1.

57. *Id.* § 3:2.1, at 3-3.

that the entity's ability to declare bankruptcy is limited.⁵⁸ Understand that typically the originator in many instances may be the sole shareholder or majority shareholder in the SPE. Accordingly, to satisfy third party investors or creditors and to induce their investment, the SPE will have independent directors presiding on the SPE's board;⁵⁹ independent in this context being defined as a person who is not a director, officer, or 5 percent or more shareholder of the originator.⁶⁰ Through the chartering documents, the independent directors will be the ones vested with the exclusive authority to declare bankruptcy; the implication being that, because of their independent status, their bankruptcy decision will not be influenced by the originator's circumstances but by what is in the best interest of the SPE.⁶¹

The second issue is using securitizations to minimize the impact on the liability side of a corporation's balance sheet. In a typical financing situation, the corporation borrows the needed capital from a third party lender. From a financial reporting standpoint, what happens is the corporation takes the cash and records it as an asset. But because the funds are borrowed, the corporation must also record the corresponding liability on its balance sheet.⁶² The additional debt obligation has an adverse affect on the debt-to-equity ratio as a result. But when the corporation raises capital through the securitization process, the SPE is the entity that bears any debt obligation through, for example, the issuance of debt securities, where the investor/creditor is buying the right to the full face value of the receivables when those receivables are paid. Because the transaction is off-balance sheet, the originator is not required to record any debt obligations in exchange for the corresponding cash received in the transaction. As a result, the originator's financial portrait is painted in a more favorable light.

d. The Controversial Side of Asset Securitizations—Sale Treatment When No Sale Occurs

Regarding asset securitizations, although they are or can be legitimate techniques that companies can employ to raise capital, there are aspects of the transaction that inherently can lend themselves to abuse. For example, the issue arises at the juncture where the asset is transferred from the originator to the SPE. The issue is what the proper accounting treatment for the originator is in relation to the asset transfers. The available options are either: (1) treating the transferred assets as sales and recognizing the difference between the assets' carrying value and the actual

58. *Id.*

59. *Id.*

60. *Id.*

61. The issue of bankruptcy remoteness and when the SPE's directors can or may be required to declare bankruptcy can become more involved and more complicated in certain contexts. For a more detailed discussion on this issue, see *id.* § 3:2.1, at 3-3-3-13.

62. This accounting treatment is a general concept under the GAAP.

cash received as a gain on sale or (2) reflecting the transaction as a secured financing. What can be tempting for some originators in their quest for presenting the financial health of their company in the best light possible is recording the asset transfers as sales when the true economic substance of the transaction calls for secured financing treatment instead. The motivation for and temptation to account for these transactions as such is apparent; higher reported income numbers from recording the transfer as a gain-on-sale and lower reported debt obligations due to the transaction being off-balance sheet. The details of when and under what circumstances sale treatment for the asset transfer is proper will be discussed next. At the outset, however, it is important to appreciate that this is an area that can inherently lend itself to abuse. But again, it is also important to appreciate that it is not the accounting rules that are the root of the problem but the decision to follow or not to follow those accounting rules as they currently exist.

e. Financial Accounting Standard 140—Sales Recognition—A Sale or a Secured Financing?

As will always be the case, the threshold question that arises when an originator transfers assets in connection with a securitization is the appropriate accounting treatment at the juncture where the asset is transferred from the originator to the SPE. The two alternatives are: (1) recording the asset transfer as a sale or (2) recording the asset transfer as a secured financing. Again, to understand the competing tensions, if the asset transfer qualifies for sales recognition, then the sponsor can record the proceeds from the transfer as revenue, which in turn increases net income, an overall financial statement enhancement.

On the other hand, if the asset transfer does not qualify for sales recognition, the transaction is then a secured financing. Under this scenario, proper accounting treatment would be to record the proceeds received in exchange for the transferred assets as a debt obligation on its balance sheet. Also, the originator would be required to record those proceeds as proceeds from financing activities on the originator's cash flow statement.⁶³

f. Sales Treatment versus Secured Financing

What determines sales versus secured financing treatment are the terms that the asset transfer occurs under. Under Financial Accounting Standard (FAS) 140, sales treatment versus secured financing is premised upon control, i.e., who acquires or retains control of the transferring as-

63. This is a concept under GAAP, which requires that proceeds from financing activities be recorded as such in the company's Statement of Cash Flows. See, DONALD E. KIESO ET AL., *INTERMEDIATE ACCOUNTING* 1275 (John Wiley & Sons, Inc. New York, 7th ed. 1992).

set.⁶⁴ If the originator retains some form of control over the transferred asset, then sales treatment is not proper.⁶⁵ The idea is that the ties between the originator and the assets must be severed before sale treatment is proper.

Under this set of accounting rules, the potential for abuse is evident. The originator is looking to reduce his financing costs by isolating a discreet set of assets. The third party lender is looking for a profitable investment by purchasing assets at a relative discount and realizing the profit once collection on the transferred assets occurs and is realized. When structured as designed, everything works well. The originator enjoys an infusion of needed capital, and the investor enjoys a profit when the revenues from the transferred assets are realized.

But what happens when the motivation for such transactions change? What happens when the motivation for such transactions is merely to achieve accounting results versus real business objectives? What happens when the transferred assets aren't credit worthy at all, but the transferor still wants to conduct such transactions to enhance financial statement presentation through improper sales and revenue recognition? What would induce a lender into financing an SPE based on assets whose realizations were questionable? This is the backdrop that sets the stage in exploring Enron's SPE abuse.

III. ENRON AND ITS SPE ABUSE—PAINTING A (FALSE) FINANCIAL PORTRAIT WITH THE SPE BRUSH

Almost overnight, the fall of Enron wiped out \$70 billion of shareholder value and resulted in default on tens of billions of dollars of debt.⁶⁶

A. HOW DID THIS HAPPEN? THEIR CORPORATE CULTURE—A CLIMATE FOR PUSHING THE ENVELOPE

The Enron story began with the merger of two gas pipeline companies, Houston Natural Gas and InterNorth. Its purpose was to be an interstate natural gas pipeline company.⁶⁷ Deregulation in the utilities industries created significant challenges for the new company. Enron was losing its exclusive rights to distribute its products. Kenneth Lay, the first CEO, believed Enron needed to develop a new business strategy to remain

64. SUMMARY OF STATEMENT NO. 140: ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES-A REPLACEMENT OF FASB STATEMENT NO. 125 (2000), available at <http://www.fasb.org/st/summary/stsum140.shtml> (last visited Feb. 23, 2006) [hereinafter STATEMENT 140].

65. *Id.*

66. Charles J. Tabb, *The Enron Bankruptcy*, in ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 303 (Nancy B. Rapoport & Bala G. Dharan eds., 2004).

67. *Enron Timeline*, HOUS. CHRON., Dec. 13, 2005, available at <http://www.chron.com/cs/cda/printstay.mpl/special/Enron/timeline/2342585.html>.

competitive.⁶⁸ Lay hired McKinsey & Company, management consultants, to help develop a new business strategy. Jeffrey Skilling was one of the consultants who began to work with Enron.⁶⁹ Skilling proposed a radical plan. Enron would buy gas from suppliers and resell it to users, charging a small fee for handling the transactions. Deregulation would allow Enron to take the role of middleman, matching supply and demand for gas.⁷⁰ Enron would buy gas from a network of suppliers, sell it to a network of consumers, and contractually guarantee both the supply and the price. In doing so, Enron created a new product and a new paradigm for the industry: the energy derivative.⁷¹ Skilling's plan was successful, and Lay hired him from McKinsey to work for Enron. It is claimed that Skilling changed the corporate culture at Enron. Skilling adopted an employee ranking system, the Performance Review Committee (PRC).⁷² The PRC gained the reputation of being the harshest employee-ranking system in the country.⁷³ They ranked everyone against their peers. There was no limit on the bonuses paid to the top performers. But up to 15 percent of the bottom performers were fired each year.⁷⁴ Fierce internal competition prevailed, and immediate gratification was prized above long-term potential. Secrecy became the order of the day. The performance review process created incentives to do the deal at all costs.⁷⁵ Enron had a mandate. That mandate was to make sure that Enron's stock price continued to rise by ensuring that key financial ratios remained on a steady climb. Such was the corporate culture. The breeding ground that spawned the innovative and creative use of the SPE, that was later revealed to be mere fraud, only exacted at a very high level and was done in a manner that no one had seen before.

B. HOW THE ENRON SPEs WERE STRUCTURED, HIGHLIGHTING WHERE ENRON DEPARTED FROM GAAP

By this point, those who are even remotely interested in what happened with Enron have read the well documented accounts of the LJM1 and LJM2 partnerships, Chewco, Raptors, etc. These are the SPEs that made the headlines and were the entities that the casual observer is most

68. Jeffrey D. Van Niel, *Enron—The Primer*, in ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 3, 11 (Nancy B. Rapoport & Bala G. Dharan eds., 2004).

69. *Jeffrey K. Skilling Timeline*, HOUS. CHRON., Feb. 20, 2004, available at www.chron.com/cs/cda/printstay.mpl/special/enron/2412024.

70. Van Niel, *supra* note 68, at 11.

71. Lynne L. Dallas, *Enron and Ethical Corporate Climates*, in ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 187, 196 (Nancy B. Rapoport & Bala G. Dharan eds., 2004).

72. *Id.*

73. Anastasia Kurdina, *The Collapse of Enron: Managerial Aspect*, <http://www.personal-writer.com/enron/> (last visited July 25, 2006).

74. Dallas, *supra* note 71, at 196.

75. *Id.*

familiar.⁷⁶ But those SPEs merely scratched the surface. Enron's SPE abuse was pervasive, covering a period from approximately 1999 through 2001 where Enron consummated hundreds of SPE transactions of various forms and sizes, which accounted for a significant portion of their reported revenue during that same period, right up until Enron filed for bankruptcy in December 2001.⁷⁷

1. *The FAS 140 Transaction in General*

This part of the piece examines a specific SPE transaction type that Enron used repeatedly, which, in the year 2000, "(i) increased its reported net income by \$351.6 million (36% of its total reported net income); (ii) increased its reported funds flow from operations by \$1.2 billion (38% of its total reported funds flow from operations); and (iii) [improperly] kept \$1.4 billion of debt off its balance sheet."⁷⁸ This transaction type was referred to as the FAS 140 transaction, patterned after and designed to comply with FAS 140, which sets forth the accounting guidelines related to asset transfers in connection with structured financings.⁷⁹

In sum, the FAS 140 technique involved Enron's purported sale of an asset to an SPE that was not consolidated in Enron's financial statements. "In most cases, the SPE financed its acquisition of the asset by borrowing 97% of the purchase price and issuing equity for the remaining 3%" (thus attempting to comply with the 3 percent equity investment rule discussed earlier).⁸⁰ "Enron obligated itself to repay the loan through [what is referred to as] a Total Return Swap."⁸¹ "Through the Total Return Swap and the other agreements employed in this technique, Enron retained substantially all of the economic benefits and risks of [asset ownership], notwithstanding the purported sale to the SPE."⁸² In the following section, the FAS 140 transaction will be dissected in detail, highlighting where Enron's accounting treatment departed from GAAP.

2. *The Structure of a Typical FAS 140 Transaction Dissected*

"A typical Enron FAS 140 Transaction began with the contribution by

76. See generally REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. (2002), available at <http://news.findlaw.com/hdocs/docs/enron/sicreport>.

77. See Second Interim Report of Neal Batson, Court-Appointed Examiner at 48-49, *In re Enron Corp.*, No. 01-16034 (A.J.G.) (Bankr. S.D.N.Y. Jan. 21, 2003), available at <http://www.enron.com/corp/por/pdfs/examiner2/InterimReport2ofExaminer.pdf> [hereinafter Batson II]. For example, the chart shows a 96 percent downward net income adjustment for the year 2000 once the inflated effects of the SPE transactions are deducted from net income. *Id.* at 49.

78. *Id.* at 39.

79. *Id.* at 38.

80. *Id.* at 40.

81. *Id.* at 40, n.100.

82. *Id.* at 40.

the [s]ponsor⁸³ of an asset to an Asset LLC.”⁸⁴ The Asset LLC would then issue two classes of stock: Class A and Class B. The Class A stock represented the Asset LLC’s voting interests, whereas the Class B shares represented the economic interest in the LLC.⁸⁵ The Class A interests would be issued to the Enron subsidiary that the asset was transferred from, and the Class B economic interests would usually be issued to an SPE, generally a Share Trust (the Trust), which Enron would also have a hand in forming.⁸⁶ The Class B interests sold to the Trust were entitled to no voting rights but were entitled to substantially all of the economic interests in the Asset LLC. In exchange, a payment in the amount of the special distribution was to be made by the Asset LLC to the sponsor.⁸⁷

The Trust financed the purchase price of the Class B [i]nterest by selling an equity interest in itself to a third party, often an affiliate of one of its [l]enders, and by borrowing under a [c]redit [f]acility provided by those [l]enders. The equity was generally entitled to be repaid the amount of its investment plus an annual rate of return. Generally, the amount of the equity was equal to at least 3% of the purchase price for the Class B [i]nterest, plus the amount of fees due to the [l]enders. The right of the equityholder to receive payment with respect to its equity was subordinated to the right of the [l]enders to receive [the] payment [that was advanced] under the [c]redit [f]acility. . . . [T]he amounts due to the equityholder were not supported by the Total Return Swaps.⁸⁸

At the closing of the FAS 140 transaction, upon the Trust’s payment to the Asset LLC of the purchase price for the Class B interests, “the Asset LLC would typically use those funds to make the special distribution to the [s]ponsor, thus immediately conveying the full proceeds of the transaction to the [s]ponsor.”⁸⁹ A diagram detailing the typical FAS 140 transaction is set forth in Appendix A.

In looking at the transaction as a whole, perhaps the most important part of the equation is the movement of money from the lenders through the conduits of the Trust and the Asset LLC on through to Enron or an Enron subsidiary. And even more interesting is how Enron accounted for and disclosed that movement in its financial statements. On the other end of these FAS 140 transactions were the lenders. Typical participants loaning money in these FAS 140 transactions were institutions such as Canadian Imperial Bank of Commerce, JP Morgan Chase & Co., Ci-

83. The terms sponsor and originator mean the same thing in this context and thus can be used interchangeably.

84. First Interim Report of Neal Batson, Court-Appointed Examiner at 59, *In re Enron Corp.*, No. 01-16034 (AJG) (Bankr. S.D.N.Y. Sept. 21, 2002), available at <http://www.enron.com/corp/por/pdfs/InterimReport1ofExaminer.pdf> [hereinafter Batson I].

85. *Id.* at 59–60.

86. *Id.* at 60.

87. *Id.*

88. *Id.* at 60–61.

89. *Id.* at 61.

tiGroup, and Morgan Stanley (Lenders).⁹⁰

The Lenders would transfer money into the Enron-formed Trusts, who would in turn transfer the proceeds from the Trust to the Asset LLC, who would in turn transfer the money and the Class A interest in the Asset LLC in exchange for the transferred asset (again see diagram at Appendix A).⁹¹

3. *Forensics of the FAS 140—Keeping the Lenders Comfortable*

It is at this juncture where we stop and do a forensic analysis of the FAS 140 transaction. In a typical FAS 140 transaction, the values that Enron would assess these transferred assets at would be anywhere from \$10 million to \$500 million.⁹² Accordingly, with these FAS 140 transactions exists a situation where you have a financial institution loaning an Enron-formed Trust up to \$500 million based on the strength or creditworthiness of a transferred asset whose realization is doubtful at best.

The logical inquiry that follows is what would then induce a financial institution to lend money to an Enron-formed Trust under these circumstances? The answer is in the final piece of the FAS 140 puzzle, the Total Return Swap. The Total Return Swap in this context is, in essence, a guarantee. With the FAS 140 transactions, Enron would guarantee, on behalf of the Trust, the payments the Trust was obligated to pay the Lenders. Thus, whatever short-fall stemmed from the transferred asset, which was not generating the requisite cash to service the debt obligation, Enron, through the Total Return Swap, guaranteed those payments to the Lenders.⁹³ In even the most general of terms, under GAAP, where one party obligates itself to a debt obligation, GAAP requires that the obligor record and disclose that financial obligation. With Enron, in most of the transactions structured in this manner, they did not.

4. *Improper Revenue Recognition*

Next is Enron's accounting treatment in connection with the transferred asset. With its FAS 140 transactions, Enron would record these asset transfers as sales, thereby improperly inflating revenue on its income statement.⁹⁴ Also, depending upon the assets involved, Enron would recognize cash flow from these activities as cash flows from operating activities.⁹⁵ With structured financings, for such accounting treatment to be proper and in accordance with FAS 140, the transferring entity must

90. BNA, Inc., *CIBC to Pay \$2.4 Billion to Settle Enron Stockholder Suit*, <http://pubs.bna.com/ip/BNA/srlr.nsf/is/a0b1e4x0z4> (last visited Feb. 24, 2006).

91. Batson I, *supra* note 84, at 59-60.

92. For example, in a FAS 140 transaction referred to as the Cerberus Transaction, Enron transferred a block of stock it owned of EOG Resources, Inc. worth approximately \$500 million. *Id.* at 67.

93. *Id.* at 64-65.

94. *Id.* at 53.

95. *Id.*

completely relinquish itself of any rights to profits that could be realized from the transferred asset once the presumptive sale occurs. Likewise, the transaction must be structured in a way such that the sponsoring entity is absolved from any potential liability if the SPE fails to realize the payments from the transferred assets.⁹⁶

A look at a conventional structured finance will illustrate this point. In the conventional structured finance, once the transferring entity sells the account receivables, for example, to the SPE, it is only proper for the sponsor to record the transfer as a sale if and only if the SPE has no recourse against the sponsor related to the transferred assets. If a structured finance is designed in this manner, the sponsor may record the asset transfer as a sale and likewise record the cash proceeds from that sale as either cash received from operations (depending on whether this was something they did in the normal course of its operations) or cash proceeds received from investing activities. Only where the transferring entity has relinquished both the risks and rewards of ownership is accounting for the transferred assets in this manner proper.

But in Enron's case, accounting for the asset transfers as sales was not proper for several reasons. First, Enron maintained control of the transferred asset through its ownership of the Class A voting membership interests in the LLC, which the asset was transferred to. Second, Enron guaranteed payment through the Total Return Swaps in the (likely) event the payment streams from the transferred assets were insufficient to repay the Lenders. The underlying point here again being that the rules were clear, and Enron merely chose to depart from those rules to report the financial results they desired, despite the fact that their reported results veered significantly from what was actually occurring.

5. *(Improper) Valuation of the Transferred Assets*

Another aspect of Enron's accounting treatment related to its FAS 140 transactions is the questionable circumstances surrounding some of Enron's valuation of the transferred assets. Enron's asset valuations were designed to maximize the gain on sale accounting treatment for those transferred assets. As was discussed earlier, in many instances, the assets Enron transferred were atypical for use in a structured financing, as these were assets not normally traded on any open market where a fair market value for those assets could be derived, nor were they your garden variety trade or account receivables where the time line for payment and valuations are discernible.⁹⁷ Accordingly, Enron would make its own valuation and attach that Enron-assessed value to those transferred assets. Upon the asset's transfer, Enron would take the difference between the

96. See STATEMENT 140, *supra* note 64.

97. For example, typical asset types used in these FAS 140 transactions were common stock warrants, partnership interests, membership interests in limited liability companies, or interests in trusts formed in connection with other financial transactions undertaken by Enron. Batson II, *supra* note 77, at 110-11.

Enron-assessed value and the actual proceeds from the asset and record the difference as a gain on sale.⁹⁸ Therefore, through improper asset valuations coupled with improper revenue recognition, Enron was able to paint a picture of steady earnings and cash flow in operations that did not reflect the true financial position of its operations.

C. COMPLICIT FRAUD RATHER THAN AMBIGUOUS ACCOUNTING RULES

With these transactions viewed through a transparent lens, the conclusion one arrives at is that Enron's improper SPE reporting had little to do with ambiguity or lack of accounting literature and guidance in the area. The improper accounting treatment was intentional, and the SPE abuse was merely the method of choice.

Enron tried to structure and conform these transactions to justify its desired accounting treatment. But their desired accounting treatment didn't reconcile with the true economic substance of these transactions. Sale treatment and revenue recognition were inappropriate because Enron still maintained both control of and residual obligations for the transferred assets by virtue of Enron's ownership of the Class A voting interests and the Total Return Swaps. But the Total Return Swap guarantees were the only way that the Lenders would be convinced to loan money to the Trusts due to the poor quality of the assets involved in the transfers.

In concluding this portion of the piece, the overarching point to appreciate is that Enron's mis-accounting had nothing to do with ambiguities in the accounting literature and everything to do with the complicit and coordinated efforts of Enron and those involved with its financial reporting process to achieve the accounting results that were a departure from the true economic substance of the underlying transactions that Enron's financial reporting purported to reflect.

IV. THE ACCOUNTING AND LEGISLATIVE RESPONSE— TREATING THE SYMPTOM VERSUS TACKLING THE PROBLEM

The accounting and interpretive guidance that has been enacted in the post-Enron era are rules that merely treat the symptoms of SPE abuse but fail to address the actual problem. There have been a number of significant events related to financial accounting and disclosure since the passage of the Sarbanes-Oxley Act. The two most relevant pieces of accounting guidance that address these issues are (1) FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, which gives guidance on when a transaction may be recognized as a sale versus a secured borrowing or financing;⁹⁹ and (2) Consoli-

98. Batson I, *supra* note 84, at 53.

99. STATEMENT 140, *supra* note 64.

dation of Variable Interest Entities (revised December 2003)—an interpretation of Accounting Research Bulletin No. 51 (FASB Interpretations (FIN) 46(R)), which requires a risks and rewards approach to consolidation of variable interest entities (VIEs) as opposed to an approach based on control by ownership of legal authority.¹⁰⁰ FIN 46(R) was designed to address, among other things, some of the concerns with the failure of issuers under earlier guidance to consolidate certain SPEs.

This portion of the piece will focus on these two bodies of accounting literature and interpretive guidance. First, it will explain how FAS 140 and FIN 46(R) work and then highlight the goals these two pieces of accounting guidance are trying to achieve. Finally, it will show that, in spite of their intentions, these two pieces of accounting guidance, which in theory seem well meaning and hopefully effective, still fail to address the core problem that is at the root of Enron and similar SPE abuse cases that have been or will be perpetrated.

A. FAS 140

As alluded to earlier, FAS 140 deals with that situation where a corporation (the originator or sponsor) transfers assets to an SPE. The key issue to resolve is whether the transfer can be treated as a sale, which bolsters financial reporting, or as a secured financing, which would prevent the originator from not only recording the asset transfer as a sale but also requiring the originator to recognize a debt obligation as well.¹⁰¹ In essence, in accordance with FAS 140, the originator may record the asset transfer as a sale if and only if all the following conditions are met:

a The transferred assets have been isolated from the transferor-put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

b Each transferee . . . has the right to pledge or exchange the assets . . . it receive[s], and no condition both constrains the transferee . . . from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.

c The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) the ability to unilaterally cause the holder to return specific assets.¹⁰²

Cutting through the accounting verbiage, the key question to determine is whether or not the originator has relinquished both the risks and rewards of ownership of the transferred assets. Only when the bond be-

100. STATUS OF INTERPRETATION NO. 46: CONSOLIDATION OF VARIABLE INTEREST ENTITIES—AN INTERPRETATION OF ARB NO. 51 (2003), available at <http://www.fasb.org/st/status/statpg-fin46.shtml> (last visited Feb. 24, 2006) [hereinafter INTERPRETATION 46].

101. STATEMENT 140, *supra* note 64.

102. *Id.*

tween the assets and the originator has been severed is it proper for the originator to recognize such transfers as sales. When using these accounting principles as the backdrop for assessing a representative Enron transaction, what results is accounting guidance that is clear as to its criteria and a corporation, irrespective of such clarity, recording transactions in direct contravention of such guidance and clarity.

As discussed at length in the previous section, Enron transferred assets to the Asset LLC and improperly recorded such assets as sales, in spite of the fact that Enron failed to relinquish both the risks and rewards of ownership in two ways. First, Enron guaranteed the Trust's payment obligations to its Lenders through the Total Return Swaps entered into in connection with these transactions,¹⁰³ and second, Enron maintained voting control through its ownership of the Class A membership interests.¹⁰⁴ Where the originator of the transferred asset guarantees payment against the collection or realization of the transferred assets, the risks and rewards of ownership have not been relinquished, and recording the transaction as a sale is not proper. Again, the key point to emphasize here is that the problems with the transactions had nothing to do with ambiguities or gaps in the accounting literature and everything to do with Enron management being narrowly focused on distorting its financial picture.

B. FIN 46(R)—THE NEW CONSOLIDATION CRITERIA—CHANGES IN
THE FINANCIAL REPORTING REGIME SINCE THE PASSAGE OF THE
SARBANES-OXLEY ACT—AN ATTEMPT TO CLOSE THE 3 PERCENT
LOOPHOLE AND REQUIRE CONSOLIDATION BASED ON ECONOMIC
SUBSTANCE VERSUS LEGAL FORM

FIN 46(R) in essence deals with the situation where Company A has a financial interest in Company B. FIN 46(R) outlines when and under what circumstances the relationship between Company A and Company B is such that GAAP would require the two to be reported on a consolidated basis. The usual investment that we are most familiar with would be Company A's investment in Company B through stock ownership. Prior to guidance that was developed in the SPE arena, entities would be required to consolidate only in the instance where Company A had majority ownership in Company B through A's ownership of B's stock. This test was generally treated as a bright-line test where consolidation would be required only at the point where Company A was a majority owner of Company B's stock (i.e., greater than 50 percent).¹⁰⁵

As a result of this bright-line test, corporations would avoid the consolidation requirement by controlling the entity through some means other than stock ownership and would avoid consolidation, thereby keeping both the assets and, more importantly, any underlying liabilities off Cor-

103. Batson II, *supra* note 77, at 38.

104. Batson I, *supra* note 84, at 59.

105. HERWITZ & BARRETT, *supra* note 16, at 521.

poration A's books.¹⁰⁶ As discussed earlier, with respect to SPEs, the consolidation criteria was loosened further with EITF Issue 90-15, where the sponsoring corporation could avoid consolidation if the SPE equity owner made an initial substantive residual capital investment that is at risk during the entire term of the lease.¹⁰⁷ FIN 46(R), among other things, is aimed at closing this loophole.

VIEs include SPEs and can be generally described as entities where the equity investment at risk does not provide its holders with the characteristics of a controlling financial interest or is insufficient for the entity to finance its activities without additional subordinated financial support.¹⁰⁸ These characteristics are meant to identify arrangements where control of the entity would not be achieved through voting stock ownership but through some other method.¹⁰⁹ FIN 46(R) requires consolidation of a VIE by a party that has a majority of the risks and rewards associated with the entity.¹¹⁰ FIN 46(R) also establishes a methodology for determining what party associated with a VIE should consolidate the VIE. Essentially, the requirement is that the party exposed to a majority of the variation in the outcome of the performance of a VIE, both positive and negative, should consolidate the VIE because such exposure is likely to be indicative of control.¹¹¹ FIN 46(R) refers to such a party as the primary beneficiary of the VIE.¹¹²

An issuer's involvement or interest in a VIE can manifest itself in debt instruments, guarantees, service contracts, written put options, Total Return Swaps, or other instruments.¹¹³ These arrangements with a VIE can put the issuer in a position akin to an equity holder in that the issuer bears the same risks and rewards of the VIE as an equity holder would. For example, consider an issuer that owns 49 percent of the voting stock of another entity and is the sole guarantor of debt of the entity. Before FIN 46(R), such an issuer may not have been required to consolidate the other entity based upon voting control. But subsequent to the promulgation of FIN 46(R), if this same entity is deemed to be a VIE, then the issuer would likely be required to consolidate due to the issuer's additional risk of loss from the outstanding guarantee.¹¹⁴

106. For example, the sponsoring company may control the SPE by narrowly defining the scope of the SPE's permitted activities and placing such limitations in the SPE's chartering documents, such as its Articles of Incorporation.

107. EITF 90-15, *supra* note 21. Although not stated specifically in EITF 90-15, industry practice had evolved to the point where 3 percent equity investment was sufficient at-risk equity investment to avoid consolidation.

108. INTERPRETATION 46, *supra* note 100, at 4.

109. *See id.* at 5.

110. *Id.* at 13.

111. *See id.*

112. *See id.* at 8.

113. *See id.* at 12.

114. *See id.* at 13.

C. MOVING FORWARD WITH THE NEW ACCOUNTING—LACK OF
ACCOUNTING RULES WERE NOT THE PROBLEM

Having set the salient accounting guidance out in some detail, an assessment can now be made as to how effective such new guidance would have been or will be in preventing Enron-like SPE abuse. The crux of FIN 46(R) is a redefining of the criteria where an entity should be reported on a consolidated basis. FIN 46(R) switches the criteria from requiring consolidation only when the SPE in question did not have at least a 3 percent equity investment from an outside third party to now requiring the entity that has the majority of risk or rewards related to that SPE to report that SPE on a consolidated basis.¹¹⁵

In theory, such a change has merit. Arguably, with a broadened set of criteria where consolidation would be required, financial reporting in this area would be more transparent as entities that would have avoided consolidation prior to FIN 46(R) would now be pulled onto the balance sheet on a consolidated basis, thereby resulting in a more transparent and accurate representation of a corporation's true financial picture. In practice, however, there is evidence suggesting that such measures as expanding the consolidation criteria would be an exercise in futility.

First, Enron's failure to consolidate or otherwise disclose its obligations had nothing to do with any ambiguity or shortcomings in the accounting literature. What Enron did with most of the SPEs it used was simple fraud.¹¹⁶ For example, as shown by the FAS 140 example discussed earlier, Enron violated the then existing accounting guidance on a number of fronts. Contrary to FAS 140, Enron recorded the asset transfers as sales even though Enron retained control of the transferred assets through their Class A voting membership interests. Moreover, Enron failed on several occasions to record the debt obligations related to the FAS 140 transactions, which was in fact Enron's obligation. Again, the failure to disclose had nothing to do with shortfalls in the accounting literature but more so with Enron's intent on obfuscation and omission. The Total Return Swaps that Enron entered into in connection with these transactions were Enron's unequivocal guarantee to repay the debt in the event the cash value of the monetized assets was not realized. The major point to emphasize here is that no accounting guidance is going to counteract the deliberate intent to obfuscate and defraud.

Further, there is evidence to suggest that new accounting guidance will only cause issuers to restructure their transactions to avoid the new accounting criteria.¹¹⁷ In anticipation of FIN 46(R) being implemented, a number of entities restructured their arrangements with potential VIEs

115. *Id.* at 11, ¶ 9 (explaining that, at a minimum, the equity investment must be at least 10%, instead of the previous 3%).

116. For example, for the year 2000, 96 percent of Enron's reported net income was due to improper reporting of funds channeled to Enron through SPEs. Batson II, *supra* note 77, at 47.

117. SEC REPORT 401(c), *supra* note 39, at 94.

such that they would not require consolidation.¹¹⁸ The SEC notes anecdotally that many arrangements with potential VIEs were restructured such that the entity either would not be considered a VIE or such that no party would be required to consolidate the VIE. The effect of such changes is difficult to measure. But in some cases, it appears that the changes made involved substantive changes to the economics of the variable interests or to the decision-making capabilities of the investors, while in other cases, the changes may have been less substantive.¹¹⁹

D. IMPLEMENTATION COSTS

Although FIN 46(R) arguably constitutes an improvement over the previously existing consolidation guidance, a number of interpretive questions remain. Many users of FIN 46(R) find it theoretically and practically challenging to apply.¹²⁰ In fact, the actual application of FIN 46(R) is complicated and time-consuming to implement. Further, the calculations under FIN 46(R) have to be recalculated each reporting period as one's variable interests in an entity may change between financial reporting periods.¹²¹ Currently, the FASB is considering ways to resolve an issue originally discussed by the EITF in Issue 04-07, determining whether an interest is a variable interest in a potential variable interest entity. A consensus on this EITF Issue may change how some issuers apply FIN 46(R).¹²² But in its current form, properly applying FIN 46(R) will be a winding maze that issuers are now being forced to navigate through.

The resulting situation is that company resources will be diverted toward making sure their VIE transactions are in compliance with FIN 46(R). Although not quantified in this piece, the added burden upon a corporation's internal accounting functions in calculating and accounting for its VIEs already exists. Likewise, the issuer will incur additional costs to be paid to the issuer's public accountants as they will require additional man hours to sort through and determine whether the issuer's VIE disclosures are proper.

It is understood that proper financial reporting should not be compromised or sacrificed just because additional costs will be incurred. The additional costs would be justified, however, if the additional burdens were focused on the identified problem. But here, it is arguable whether FIN 46(R) is or will effectively address the problem of SPE abuse.

V. A STEP BACK—A TIME TO ASSESS

When we find something that we perceive as broken, it is human nature to utilize the most expedient measures at our disposal to fix the

118. *Id.*

119. *Id.* at 92.

120. *Id.*

121. INTERPRETATION 46, *supra* note 100.

122. SEC REPORT 401(c), *supra* note 39, at 92.

problem. Here is no exception. But what happens when the focus of the problem has been redirected from the weapon (meaning the SPE) to the entities pulling the trigger? Quite naturally, what should come from a refocusing of the problem is a refocusing of the means as to that problem should be addressed.

It is understandable that during the rising tide of public outcry in the wake of the Enron debacle there was a collective call for action to be taken. Congress and the relevant standard-setters in the accounting world, in their quest to stem that tide and restore investor confidence in our public markets, reacted quickly with the passing of the Sarbanes-Oxley Act. Likewise, the FASB followed suit by revamping its rules on consolidation with the issuance of FIN 46(R). But now that the investing public's collective memory of the Enron sting has faded, we have the luxury of taking a thoughtful look at what is really happening in cases like Enron and, accordingly, can take a more focused approach at trying to prevent future Enrons from occurring.

A. SCOPE OF THE PROBLEM

First and foremost, the standard-setters need to make a more focused assessment of the problem. Is Enron-like SPE abuse widespread and prevalent, or was Enron a unique and isolated set of circumstances? How widespread is SPE use in its various forms? And, more importantly, how widespread is the abuse of SPEs? Narrower still, is anyone, other than Enron, engaging in the type of deliberate, contrived, prevalent, proprietary, and abusive use of SPEs that Enron used to misrepresent its financial position? Answers to these questions would go a long way in crafting a more pointed and tailored response to curtailing SPE abuse. Research reveals that there are some instances of SPE abuse occurring in the post-Enron era but nothing as widespread, complex, and contrived as what occurred with Enron.¹²³

123. For example, an online LexisNexis search for companies engaging in SPE abuse yielded the following:

PNC Financial, a leading U.S. bank, . . . agreed to pay [\$115 million] in penalties and restitution to spare itself from prosecution over its efforts to hide hundreds of millions of dollars in non-performing assets.

. . .

[The] agreement mark[s] the SEC's first enforcement action involving the misuse of special-purpose vehicles.

Joshua Chaffin & Gary Silverman, *PNC Pays Fine to Escape Threat of Prosecution*, FIN. TIMES (USA), June 3, 2003, at 18.

T[he] world's largest insurance company, American International Group, [was] facing a criminal investigation by the US Justice Department into allegations that it helped a major banking client move bad loans off its books.

. . .

[The allegations were that] PNC . . . avoided consolidating \$762 million . . . in bad loans on to its balance sheet, effectively inflating its profit by \$155 million.

. . .

B. THE SEC ATTEMPTS TO ADDRESS THE PROBLEM

To its credit, the SEC set out to do something along these lines in an attempt to quantify the extent that public companies are utilizing SPEs. But their research did not take it as far as trying to determine SPE abuse. In 2005, the SEC issued a report (the Report) that addressed two primary questions: (1) the extent of off-balance sheet arrangements, including the use of SPEs and (2) whether current financial statements of issuers transparently reflect the economics of off-balance sheet arrangements.¹²⁴ The Report was informative and insightful and shed light on a number of different and important aspects as they relate to SPEs and how they are being disclosed amongst the approximately 10,100 publicly-held companies in the United States.¹²⁵

Regarding the first question, the mandate was to assess the extent that public companies were using off-balance sheet arrangements, and more to the point, SPEs. The idea being, if the use was widespread and pervasive versus narrow and hardly used, that assessment would drive, to some extent, the necessary approach to effectively enforce the use of, accounting for, and disclosures of SPEs. The SEC did a number of empirical studies, collecting data through looking at a stratified sample of publicly-held companies and then publishing the results of those empirical studies in their Report.¹²⁶

It was hoped that the Report would uncover the types of off-balance SPEs being structured by public issuers. In other words, the hope and expectation was that the Report would convey either yes, there are a myriad of corporations that are using SPEs in a fraudulent and abusive manner similar to Enron or no, the abuse of the SPE structure is not widespread such that we need not be alarmed nor enact more legislation to address the problem. But the Report, not surprisingly, did not yield such clear results or conclusions.

Instead, the Report was broader in nature. Data on these issues were reported in a number of different ways, which different conclusions could be drawn from. But before discussing and analyzing the data itself, it is important to point out that at the point in time that the study was done, FIN 46(R) was still in its fledgling stages. Therefore, a number of the studies' participants at the time they were picked as part of the sample

[The allegation was that] AIG sold PNC on the idea of creating special-purpose entities for these bad loans.

PNC . . . agreed . . . to pay \$90 million to compensate shareholders and \$25 million in penalties to settle related charges after the Justice Department said that the special purpose entities in question did not qualify for nonconsolidation and therefore should have been included in its financial statements.

Charlie Gibson, *AIG Facing Criminal Probe Over Loan Deal*, EVENING STANDARD (LONDON), Sept. 30, 2004, at A40.

124. SEC REPORT 401(c), *supra* note 39, at 27.

125. *Id.* at 32.

126. *See generally id.* at 27.

may not have fully matriculated the mandates of FIN 46(R) into their financial reporting. That notwithstanding, the Report itself gives us some interesting information.

One of the first empirical studies outlined in the Report was the "Anticipated Effects of Adoption of Interpretation No 46 Presented in Annual 10-K Filings."¹²⁷ The Report took a stratified sample of large and small issuers. Of the stratified sample comprised of 200 large and small issuers, the study revealed that 38 percent of those sampled reported that the effect of adopting FIN 46(R) was not material or not expected to be material.¹²⁸ The study also revealed that less than 4 percent of the 200 issuer sample reported that the impact of adopting Interpretation No. 46(R) was not material or not expected to be material.¹²⁹ An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that less than 1 percent of the issuers in the population would expect the effect of FIN 46(R) to be material.¹³⁰

Statistical data can often be interpreted in a number of different ways. The data revealed in the Report is no exception. As stated earlier, roughly 38 percent of the 200 issuers sampled stated that the impact of FIN 46(R) was either not material or not expected to be material. Only 3.5 percent of the sample reported that the impact of adopting FIN 46(R) was material or was expected to be material for any VIEs.¹³¹

Among other things, a few possible inferences can be drawn. First is the distinct possibility that improper corporate use of SPEs is not pervasive, especially to the point where revamping the criteria for consolidating such entities is required. Second, and perhaps the more plausible explanation, is the fact that FIN 46(R) will just be another accounting guideline that corporations will structure their transactions around to achieve their desired results, those being either consolidation or non-consolidation. The new accounting guidance related to consolidating VIEs is a continuation of the cycle that has brought us to this juncture in the first place. The SEC and the FASB enacts accounting guidance and interpretations to shore up perceived weaknesses or shortfalls in financial reporting, and then corporations in response merely restructure their transactions to circumnavigate the matter. A better mousetrap is built followed by a better mouse to avoid the trap.

From such a pattern, the inferential leap would not be so large to suggest that public companies will react the same way to FIN 46(R). Corroborating this assertion are sentiments the SEC expressed in its Report. The Report suggests that some of the low numbers related to corporate consolidations in response to FIN 46(R) are attributed to issuers being preemptive in their financial reporting and restructuring their off-balance

127. *Id.* at 93.

128. *Id.*

129. *Id.*

130. *Id.*

131. *Id.*

sheet or VIE transactions to avoid reporting such entities on a consolidated basis.¹³² Although the report does note that if issuers are changing the way their SPEs are structured such that they no longer control the SPE or are not the primary beneficiary of the expected returns or losses, FIN 46(R) will have improved financial reporting even if there is not a significant increase in the frequency of consolidation of SPE consolidation.¹³³

These are just possible inferences that the data might suggest and not definitive conclusions. But what is certain is that the Report did not reveal, and purposely did not try to reveal, the extent that potential SPE abuse similar to Enron was being practiced by other issuers. Understandably and arguably, this would be hard information to ferret. Now, however, finding such information should be much easier given that we now know what to look for.

Bringing the analysis full circle, the question is begged—does such legislation move the ball any further down the field in addressing the type of SPE abuse similar to Enron? Though unclear, the answer is likely to be no. As stated earlier, what we saw with Enron was not a situation where accounting guidelines were written such that Enron could follow the letter of the law while breaking the spirit of the law. Enron made intentional efforts to circumnavigate the accounting rules then in existence with the specific intent of achieving accounting results while obfuscating the true underlying substance of those transactions. Accordingly, the main point to emphasize here is that in Enron's case, accounting guidance or lack thereof was not the problem. It is therefore counterintuitive to think that additional accounting guidance would then be the solution. Arguably, those persons set on breaking the prior rules will break any new legislation or guidance as well if that is in fact their intent.

Of course, the counter-argument would then be that revised accounting guidelines now make it more difficult to perpetrate the accounting fraud that Enron perpetrated because the criteria and circumstances that consolidation is required are much broader with higher thresholds for non-consolidation, which means a lot less wiggle-room. One may speculate how the use of SPEs under FIN 46(R) will work. More than likely, those corporations that are in the grey area with respect to SPEs may err on the side of caution and decide either to comply with the rule or not do the transaction at all. On the other hand, it is not a stretch to conclude that those corporations that are intent on committing financial fraud will do so, regardless of what the rules are. Once the intent to circumnavigate the rule is there, the how is merely a formality.

132. *Id.* at 92.

133. *Id.*

VI. SEC INITIATIVES TO IMPROVE FINANCIAL REPORTING
TRANSPARENCY—A CRITIQUE—BETTER
MOUSETRAP, BETTER MOUSE

The difficulties in improving financial reporting related to SPEs notwithstanding, merely because the task or problem at hand is formidable does not mean that attempts should not be made to fix them. Instead, it is quite the contrary. In fact, in the later part of the Report cites a number of proposed and current initiatives aimed at improving accuracy and transparency in financial reporting. Whether or not such attempts will meet their desired objectives remains to be seen. But evidence suggests that while these efforts may enjoy success in the short run, the long-term prospects for success may be minimal if any. This section looks at some of the proposed initiatives and will critique their likelihood of success, pointing out some of the challenges that the proposed effort will face.

A. SEC RECOMMENDATION: ELIMINATE OR AT LEAST REDUCE
ACCOUNTING-MOTIVATED STRUCTURED TRANSACTIONS

The Report's first suggestion is to eliminate or reduce accounting-motivated structured transactions. Accounting-motivated structured transactions normally involve transactions that are structured in an attempt to achieve accounting results that do not mirror the underlying economics of the transaction.¹³⁴ The very glaring example is the accounting-motivated transactions Enron structured to boost its earnings and cash-flow numbers but that were quite different in economic substance. The Report discusses the need to eliminate or at least reduce the extent that issuers are engaging in accounting-motivated transactions.

The goal of eliminating accounting-motivated transactions is, in theory, a sound one. Recording accounting results that are contrary to their true economic substance threatens one of the foundational bricks that the capital markets are built upon. So, in theory, the extent that such practices could be reduced, if not eliminated altogether, is a step in the right direction. But in practice, eliminating or even reducing accounting-motivated transactions is a difficult task in part due to the reasons discussed below.

One of the big obstacles to fair financial reporting that either seems to be underappreciated, merely accepted as a given, or perhaps not considered at all, is the discordant incentives between management that is tasked to report accurate financial information within material respects and the potentially adverse consequences that management may suffer personally or individually as a result of reporting such adverse financial information.

When we look at the compensation structure of upper-level management at many large publicly-held companies, we see some recurring themes. Most of these upper-level managers receive a large part of their compensation in the form of bonuses based on the company's profitabil-

134. *Id.* at 99.

ity or the performance of its stock.¹³⁵ The stock awarded may be incentive based, performance based, or on another basis.¹³⁶ Also, bonuses and, more importantly, continued employment can be tied to the earnings numbers their respective companies report.¹³⁷

Given such a dynamic, we can see the competing tensions being put on the financial reporting process. The resulting situation is one where you have management dealing with the difficult situation of disclosing adverse financial information that could have a direct adverse impact on their own personal situations. In an ideal world, we would like to think that these officers, in adhering to their fiduciary duties of care and loyalty, would not let such possible personal consequences compromise their professional integrity. But the reality of the situation is that it can and often does.¹³⁸ With this dynamic present each and every reporting period, we see the inherent vulnerability in the reporting process, which was likely integral to some of the incredibly large-scale accounting scandals that have occurred to date.

It is these divergent incentives that create the competing tensions between standard-setters looking for more transparency in financial reporting and management that is sensitive to how such transparent information, when such information is negative, will affect the company's share price in general and, more specifically, the impact that such negative information will have on their own personal financial situations, as they relate to the corporations that they preside as fiduciaries over.

As long as these tensions exists, standard-setters will in large part be relying on management to do the right thing even in those instances where doing the right thing could have an adverse effect on them personally. Granted, we would like to think that one's commitment to one's fiduciary duties as an officer or director, one's personal and professional integrity, or even one's moral compass would place the requisite checks and balances on doing the right thing. But a cursory glance at the *Wall Street Journal* and the inundation of corporate scandals tells us otherwise.¹³⁹ Until this dynamic of divergent incentives is remedied, it is logical to conclude that accounting-motivated transactions will continue.

135. *Id.*

136. A look at the executive compensation of any publicly-held company will likely have some incentive-based form of compensation tied to the company's stock performance or earnings per share. See, e.g., Home Depot, Proxy Statement and Notice of 2006 Annual Meeting of Stockholders 33 (2006), <http://ir.homedepot.com/downloads/hd2006proxy.pdf>. Bonuses and additional payouts to executives were contingent on the company meeting certain specified levels of average diluted earnings per share. See *id.*

137. *Id.*

138. For example, the *Houston Chronicle* printed an article that summarized some of the more recent and high-profile scandals. Listed among them were Adelphia Communications Corporation, WorldCom Inc., Tyco International Ltd., and HealthSouth Corp. *Enron Began a Wave of Scandals: Collapses Changed the Way that Companies do Business*, HOUS. CHRON., Jan. 27, 2006, available at <http://www.chron.com/cs/cda/printstory.mpl/special/enron/3616142>.

139. *Id.*

B. SEC RECOMMENDATION: IMPROVE COMMUNICATION FOCUS IN
FINANCIAL REPORTING

The SEC also calls for a paradigm shift in the whole idea behind communicating through financial reporting. The Report notes that the current climate is replete with a large volume of complex financial reporting requirements. As a consequence, accountants and lawyers are less concerned with communicating effectively to investors through their financial reports, as long as they are technically compliant with the disclosure rules.¹⁴⁰ The Report further notes that if somehow reporting companies were able to make a shift in this paradigm away from focusing on mere technical compliance and move toward the principled objective of effective communication to investors, then significant improvements in financial reporting would occur even if few or none of the recommendations outlined in the Report were adopted.¹⁴¹ Conversely, the Report notes that without this paradigm shift, the onus or burden of effective communication will remain with the standard-setters, where case improvements in financial reporting will only stretch to the cross-roads where the laws outlining financial reporting and lawyer/accountant interpretation meet.¹⁴² In other words, a continued formula where the investor will remain saddled with the burden of deciphering cryptically drafted reports.¹⁴³

Technical compliance versus clear, concise, and meaningful communications is the crux of the matter when talking about improved communication in financial reporting:

Full and fair disclosure is one of the cornerstones of investor protection under the federal securities laws. If a prospectus fails to communicate information clearly, investors do not receive that basic protection. . . . A major challenge facing the securities industry and its regulators is assuring that financial and business information reaches investors in a form they can read and understand.¹⁴⁴

But again, the dynamics involved make this proposition for financial reporting a difficult one. Take, for instance, the following example. Something of an adverse nature occurs within a corporation. Depending on the gravity of the event, a meeting is called and the CEO, the CFO, the Board of Directors (if they are available), corporate counsel, the company's outside counsel, as well as their public accountants, have assembled in the company's war room to discuss how such news should be handled. The securities laws mandate that material information related to the corporation must be disclosed. In any number of these meetings that occur across the country with publicly-held companies, the discussion can be interesting. What goes on is a sort of verbal ballet, where the very

140. SEC REPORT 401(c), *supra* note 39, at 103.

141. *Id.* at 104.

142. *Id.*

143. *Id.*

144. *Id.* at 103-04.

smart lawyers, CEOs, and other attendees try to determine ways to disclose the information without really disclosing the information. The end result of these meetings and deliberations are tepidly worded phrases, buoyed by mitigating facts, and whitewashed in superfluous verbiage. The goal is to meet the technical disclosure requirements, while at the same time burying the essence of such information in tersely worded phrases or dispersing the information throughout the filing, such that while the information may technically be there, effective communication of what is actually occurring is not.

As alluded to earlier, the practice of obfuscation through lack of clarity stems from the competing dynamics. Management understands that they have to comply with the disclosure rules under the federal securities laws. But at the same time, management is aware of the possible adverse affects such information may have on the corporation's stock price and the implications this may have on them personally once the news is disseminated. The competing incentives create the tension that results in technical compliance versus real true meaningful communication.

Once again, this dynamic puts tension on the free flow of material information. It is understood that there are disclosure laws in place and new legislation, such as the Sarbanes-Oxley Act, that stiffens penalties for violators, resulting in jail time for offenders.¹⁴⁵ Not to mention the fiduciary duties for directors and officers and, finally, the mere moral and ethical obligations about simply doing the right thing. In theory, all these layers of legal protections, inhibitors, and moral obligations should insulate financial reporting from the problems that have occurred. But more than likely, the problems that we are seeing with financial reporting are likely to continue as human decision-making is not always based on the unyielding obligation to follow both the letter and the spirit of the law but on a more deeply rooted desire for self-preservation. The emotional reaction to self-preservation is akin to how we handled matters in our youth when we did something we weren't supposed to do. If we didn't tell our parents what we did, then we wouldn't get in trouble.

But just as our parents eventually became aware of the offending conduct then, such is the case now as adults. And just as the consequences were exacerbated then by our attempt at a cover-up, so too is the case as adults when the truth eventually comes to light. In hindsight, almost inevitably, upfront disclosure likely would have been the better choice for self-preservation both as children and as adults. But again, the emotional response of self-preservation is to cover up the truth and hope nobody (ever) finds out about it.

Sometimes, both as children and as adults, the truth stays buried indefinitely, and the consequences are avoided. From a self-preservation standpoint, the choice of non-disclosure makes most sense where the offense is non-recurring, i.e., a one-time instance. But where the offenses

145. White-Collar Crime Penalty Enhancement Act of 2002, 18 U.S.C.A § 1341 (West 2006) (part of the Sarbanes-Oxley Act).

are recurring or ongoing, such as Enron's fraudulent reporting that occurred on both a quarterly and an annual basis, it would seem like the long-term goal of self-preservation would be to confess and accept the consequences that hopefully would be mitigated by the forthright behavior. All of this makes sense from a hindsight, logical, and unemotional perspective. But putting one's self in the shoes of an Enron executive, the pressure put upon them by their constituencies, the ramifications of reduced shareholder value, and other pressures, the gut reaction prevailed, and the obfuscation continued until it snowballed so large that discovery of their improprieties was inevitable.

The overall point to understand here is that as long as the current dynamic of leaving the responsibility of financial reporting in the hands of those who may be adversely affected personally remains, the competing tensions of discordant incentives will continue to put pressure on clear and meaningful financial reporting and the issues of fraud, obfuscation, and omission of material financial information are likely to continue until this misalignment is somehow rectified.

C. SEC AGENDA ITEM: CONTINUE WORK ON CONSOLIDATION POLICY

As was discussed earlier, the consolidation decision is typically based on whether or not control exists, with the determination of control generally based on legal ability to control the entity. But it is possible to effectively control an entity without having legal control. An issuer that owns 49 percent of the voting shares of an entity whose shares are otherwise widely distributed would almost certainly be able to set policy for that other entity but currently would not be deemed to control that other entity for accounting purposes.¹⁴⁶

While the FASB discontinued its broad project on effective control, FIN 46(R) is an attempt to deal with SPEs by creating a consolidation test for those entities that is meant to identify what entity has the majority of the exposure to variations in performance and, in turn, effective control. But because that test is so different from the test used to determine consolidation of other entities, a new series of structures that straddle the lines between consolidation approaches has sprung up, and various structures have been designed to work around the guidance in FIN 46(R). The EITF and FASB staff believes that more time should be taken to evaluate the results of FIN 46(R) and to allow the development of interpretive guidance that may assist in its application. Several projects currently being undertaken by the EITF and the FASB staff may provide such guidance.¹⁴⁷

The current consolidation guidance is complicated, despite the consistent objective of requiring consolidation when an investor controls an-

146. SEC REPORT 401(c), *supra* note 39, at 109.

147. *Id.*

other entity. The SEC believes additional standard-setting efforts related to consolidation should be focused on whether there are ways to achieve the objectives with less complex guidance. In addition, once the questions regarding FIN 46(R) have been more fully addressed, the FASB may also wish to consider whether it should again explore the use of effective, rather than legal, control to guide all consolidation decisions. Finally, additional work holds the promise of promoting further convergence between consolidation guidance in the U.S. GAAP and the consolidation guidance in the International Accounting Standards Board's standards.¹⁴⁸

It is without question that the more changes the standard-setters make, which causes issuers to account for their off-balance sheet transactions in such a way that the form of those transactions reflects the structure's economic substance, the better off theoretically we will be. Such efforts are to be applauded as they are well-intentioned and could lead to better and more accurate financial reporting in the future.

But at the same time, we must not let such changes create a sense of false euphoria and lull us into thinking that those efforts will be the panacea to the issues related to SPE abuse. Within the depths of all of this empirical data and intellectual discussion surrounding the issues related to SPEs, what seems to get only minimal attention is the fact that the SPE abuse Enron perpetrated was simply fraud with the SPE being the entity of choice, in part due to its inherently complex nature. But in spite of their complexity, if the true economic substance and nature of these entities had been disclosed properly and in accordance with GAAP, analysts, investors, and shareholders alike all would likely have seen that such transactions were problematic, and investors could have reacted and altered their investment decisions accordingly. Again, lack of sufficient accounting guidance was not the problem.

VII. SUGGESTIONS FOR AN ALTERNATIVE APPROACH— HOW TO PREVENT ANOTHER ENRON

How to prevent another Enron is quite literally the billion dollar question. Before a discourse even commences on this subject, we must first acknowledge that any efforts to prevent another Enron would be just that, an effort. When we weigh the resources of the SEC against the some 10,000 plus publicly-held companies out there, abuses such as this and others will continue to happen.

One maxim that we as an investing public have had is the notion that we can legislate people into doing the right thing, when the fact of the matter is that it is difficult, if not impossible, to do so. No matter what type of law, regulation, or statute that is put in place, if an individual or a group of people are intent on breaking that law, they will. When we look at Enron and examine in detail what was going on with its use of SPEs,

148. *Id.*

the problem had nothing to do with ambiguities in the accounting or statutory literature. The problem was with unethical and criminal behavior. The problem was that you had people in positions of power and public trust that made deliberate decisions to abuse that power and violate that trust. At the time, those people knew quite well what the law was and what it was they needed to do to comply with that law. Lack of clarity in the law was not the problem.

If we take the above assessment and analysis as true, the natural inquiry then is what should be done or what should we have done in response to the Enrons, Adelphias, and WorldComs of the world? How could they have been prevented? And how do we make sure that another Enron, WorldCom, or Adelphia doesn't occur again? Well, that is the question that lawmakers have been contemplating for the better part of four and a half years as they carefully examine Sarbanes-Oxley's effectiveness with its provisions taking a foot-hold and matriculating themselves into corporate America's collective culture. Observations from high-ranking officials involved with standard-setting and regulation suggest that Sarbanes-Oxley's provisions have been effective in improving financial statement disclosure, corporate governance, and auditor independence.¹⁴⁹

The response to this empirical data though is whether financial statement disclosure, corporate governance, and auditor independence improved because of Sarbanes-Oxley or in spite of Sarbanes-Oxley? The argument here could go either way. Some would say that Sarbanes-Oxley's provisions were instrumental in bringing about much-needed reform in corporate governance, auditor independence, and financial statement disclosure. On the other hand, others contend that the improvement in these areas were merely due to the fact that issuers are now operating in the post-Enron environment of heightened scrutiny. The only real response to either school of thought is that time will tell.

It is at this juncture that we can acknowledge that the efforts that the standard-setters are making may prevent those issuers who may be tempted to straddle the financial reporting fence from actually doing so. In the post-Enron climate where we find ourselves, everyone for the most part seems to be minding their Ps and Qs. That alone may be enough to keep issuers from even coming close to the line. But eventually, the bright lights of public scrutiny will dim. The memory of Enron will likely be there for some time, but the pain from its sting will eventually subside. And, when the bright lights do dim and the climate again reverts back to one where issuers for the most part will be left to their own recognizance, what decisions will be made then? As we have seen, when smart people wish to circumnavigate the rules, they will find a way to do so. Money

149. See generally William H. Donaldson, SEC Chairman, Testimony Concerning the Impact of the Sarbanes-Oxley Act, Before the House Committee on Financial Services (Apr. 21, 2005), available at www.sec.gov/news/testimony/ts042105 whd.htm.

and power are opiates proven to succeed in clouding judgment and eroding the core values and ethical judgment of otherwise law-abiding people.

There is no set of accounting guidance and literature out there that will prevent this type of occurrence from happening, and this is the very type of accounting abuse that we do want to avoid and prevent. But as much as we want to convince ourselves otherwise, the making of better mousetraps likely will not do that. All better mousetraps will likely do is cause the evolution of better mice that will be genetically improved to avoid such traps. As the SEC has already noted, there is evidence that many issuers were preemptive with respect to FIN 46(R) and already commenced to restructuring their off-balance sheet transactions to avoid consolidation under the new guidance.¹⁵⁰

If there is any good that came from a situation like Enron, it's that collectively as an investing public, we are better versed on accounting fraud of this nature. The financial markets, the analysts, the SEC, and the public accountants have all by now absorbed many of the intricacies of SPE abuse. In short, we now know what to look for, and efforts can be focused accordingly.

So, how do we prevent another Enron from happening again? The standard-setters and the gatekeepers, in spite of all the accounting and disclosure reform, need to appreciate what they are dealing with. A deficiency or a perceived deficiency in the accounting rules is not the problem. The problem is persons that seek to obfuscate, omit, and fraudulently report financial information. Accordingly, focus on ferreting out SPE abuse should be primarily placed on the abusers themselves, not on the SPEs formed to perpetrate such abuse. Widespread legislation and accounting reform merely casts a broad net with the hopes that the abusers will get snared along with the rest of the fish. But, in the meantime, those fish are burdened with the added cost of complex and complicated compliance when they weren't doing anything wrong under the old regime nor had problems complying under the old regime.

So what is the alternative? The forefront of the approach should be a narrow and isolated focus on SPE abusers. Although the matter has not been completely resolved, the evidence suggests that actual SPE abusers represent a small pool of companies relative to the total population of public companies. A resolution could be achieved by the SEC and/or other related gatekeepers taking a risk-based approach toward the problem. First, the gatekeepers should narrow their scope by first focusing on those companies or industries that lend themselves or could potentially lend themselves toward SPE abuse. Those industries that tend to deal heavily in derivatives and intangible assets, such as the buying and selling of futures contracts, etc. would be good places to start. Additionally, there are those industries or companies that stand to come under earnings pressure—having trouble reaching financial forecasts or earnings

150. SEC REPORT 401(c), *supra* note 39, at 92.

targets or seem to be engaging in creative ways at maintaining earnings and revenue growth.

The overarching idea is that since we have seen it before (ala Enron), the accumulated knowledge is taken and applied going forward. It could very well be possible that in terms of SPE abuse, the proprietary abuse that Enron perpetrated was a local and isolated event. The SEC Report, though useful in the information it contained, did little to address the question of whether or not there is widespread SPE and off-balance sheet abuse. The Report merely focused on SPE and off-balance sheet use, which is helpful but doesn't tell the whole story or tell the most important part of the story.

With all of this collective knowledge and insight as to the accounting fraud that Enron perpetrated, it is reasonable to conclude that the SEC could derive some sort of search criteria or corporate profiling of either industries or particular companies that show indicia for potential SPE abuse. Those companies could then be targeted and special attention and focus could be placed on those companies. Understand that the initial stages of such action would be non-intrusive. The initial stages of the focus would merely involve a close and scrutinizing look at those companies' annual and periodic reports for evidence of SPE abuse or any other type of financial reporting irregularities. If such scrutiny raises red flags, then the SEC could then perform an escalated inquiry into the matter.

If the escalated inquiry yields problematic accounting, then the next step would be for the SEC to initiate a more aggressive fact-finding inquiry. If accounting irregularities are found, the indictment, prosecution, and ultimate conviction should be a high-profile event. Then a clear and unequivocal message would be sent to other similarly-situated offenders to make the proper adjustments in their financial reporting or face the same fate.

VIII. CONCLUSION

The issues dealt with in this paper are complex, and trying to resolve these issues poses an even greater challenge. But before real effective change can be achieved, we must first be able to target the root of the problem. Complex problems tend to involve complex solutions. The band-aid of legislation, more guidance, or clearer guidance will more than likely result in nothing more than the tug and pull between standard-setters and issuers to continue along this move-countermove approach that has gotten us to where we are today. Until we are able to focus more narrowly on the problem and deal with it from that more directed approach, we'll probably be seeing more of the same. Better mousetrap, better mouse.

APPENDIX A



