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Risk Management and Corporate Governance: The Case of Enron

ROBERT ELI ROSEN*

The challenge facing...[us] today is the adaptation of an outdated corporate legal system to serve contemporaneous needs.¹

The Role of the Board of Directors in Enron’s Collapse, which was prepared by the United States Senate’s Permanent Subcommittee on Investigations² (the “Subcommittee”) and based on an exhaustive review of evidence,³ found that the Enron Corporation’s (“Enron”) Board of Directors (the “Board”) “failed to monitor...ensure...or halt abuse.”⁴ Sometimes the Board “chose to ignore” problems, other times it “knowingly allowed Enron to engage in high...risk practices.”⁵ The Board also “approved an unprecedented arrangement.”⁶ In so doing, the Board breached its duties “to safeguard Enron shareholders.”⁷

* Professor of Law, University of Miami. Email: rrosen@law.miami.edu. This Article received speedy reads from my colleagues to whom I am most grateful. In particular, William Widen spent a great deal of time discussing the Enron deals. I also am indebted to Caroline Bradley, Steven Diamond, Michael Froomkin, Pat Gudridge, Gary Minda, Elliot Manning, George Mundstock, and Jonathan Simon.


² PERMANENT SUBCOMM. ON INVESTIGATIONS, COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., REPORT ON THE ROLE OF THE BOARD OF DIRECTORS IN ENRON’S COLLAPSE (Comm. Print 2002) [hereinafter ENRON’S COLLAPSE].

³ Id. at 3 (noting that evidence “includ[ed] over one million pages of subpoenaed documents”).

⁴ Id.

⁵ Id.

⁶ Id.

⁷ Id. The Subcommittee also found unsurprisingly that there were “financial ties between the company and certain Board members” and that the Board “approved excessive compensation for company executives.” Id. They also criticized Enron for its “extensive undisclosed off-the-books activity.”
This short Article briefly explains these findings as instances of more general problems of corporate governance. These problems derive from the now dominant strategies of "progressive" corporate organization, which I will name the "redesigned corporation." Enron was a redesigned corporation.  

First, in corporations that are redesigned, projects flow bottom-up, not top-down. In such companies, executive monitoring means analyzing risk management reports. The Powers Report concludes that Enron's Board "can and should be faulted for failing to demand more information, and for failing to probe and understand the information that did come to it." If so, the Board is being faulted for its reliance on risk management reports. It is not that Enron's Board was not a monitoring board, but that it poorly monitored risk management reports.

Second, companies are redesigned to foster innovation. Such companies will take high risks, hedge or retain others risks, and seek unprecedented projects. Enron was "consistently voted the most innovative large company in America in Fortune's Most Admired Companies survey." The governance project for redesigned companies is to manage "high risk . . . practices." With the benefit of hindsight, some of Enron's projects were too risky. "Too risky", in the redesigned company, means that project risks were either improperly mitigated or unfortunately retained. It does not mean that risks, including legal risks, are eliminated. Enron poses the question of what duty of care attaches to the choices of mitigating and retaining risks.

Third, in redesigned companies, borders are porous, so that providers, suppliers, and even competitors are understood as potentially part of the company. Redesigned companies integrate guest workers, such as down-
sized employees rehired on a temporary basis and outside consultants. In redesigned companies, loyalties to other companies create conflicts of interests. Loyalties to self do not create conflicts of interests. The redesigned company uses self-interest to spawn entrepreneurial workers. Perhaps it was "unprecedented," but it was predictable that Enron's Board would approve the arrangement with Andrew Fastow despite the "clear conflicts of interest" that the Subcommittee recognized.

Enron is not the best evidence for these arguments. At Enron, looting, bribery, egotism, and other dramas of greed appear to such an extent that Enron may be a distinctive organization. Yet, for an armchair professor, it is an appealing example because others have done so much research. This Article will avoid discussing the skullduggery that has attracted so much attention. Instead of examining the manipulation of the organization that makes Enron such a dramatic example, this Article addresses how the redesign of corporations challenges corporate governance, even when it is not manipulated by evil-doers.

The Subcommittee described Enron as a company that redesigned itself to become "a high tech total global enterprise that traded energy contracts like commodities, launched into new industries like broadband communications, and oversaw a multi-billion-dollar investment portfolio." The Subcommittee labels the change at Enron "a transition." Its report does not address the organizational redesign that accompanied this transition. Its report also ignores that Enron was a corporate model. Enron was the energy industry innovator. Enron's organization was understood as an

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13 Like its guest workers, Enron's employees "labored under tremendous pressure to take significant risks... Enron's whiz kid recruits entered a perpetual tournament," which they called "rank or yank." William W. Bratton, Enron and the Dark Side of Shareholder Value, 76 TULANE L. REV. 1275, 1292-93 (2002); see also BODILY & BRUNER, supra note 8, at 48. But see id. at 49 (discussing team structure).


15 ENRON'S COLLAPSE, supra note 2, at 6.

16 Id. at 24.

17 It has been argued that Enron is not the best evidence because "Enron's governance structure was sui generis." John C. Coffee, Jr., Understanding Enron: "It's About the Gatekeepers, Stupid," 57 BUS. LAW. 1403, 1403 (2002). Enron's governance structure is the governance structure of the redesigned company. See, e.g., id. at 1404. What may be sui generis about Enron is its drama of human frailties.

18 ENRON'S COLLAPSE, supra note 2, at 6.

19 Id.
ideal idea generating structure. To analyze Enron is to analyze the now dominant corporate organizational strategies.

Adopting an organizational focus, as does this Article, expands concern. An organizational focus can help answer the regulatory question of “Why didn’t we catch them sooner?” It also can help answer the question of “How did they get away with it?” In so doing, it can help explain how corporations are governed.

Corporate law contains an organizational focus. It focuses on a chain of command. Its corporation is a bureaucracy. Corporate law is concerned with Generals and leaves it to the Generals to command the troops. Corporate law’s focus does not capture the governance structures of innovative corporations. Corporate redesign attacked bureaucracies for stifling innovation. Redesigned corporations flatten hierarchy. Rather than directing the troops, redesigned corporations energize the zeal of the troops. In such corporations, Generals will find hierarchical commands insufficient to govern their troops.

In the redesigned corporation, management and the board do not review, let alone direct, the substance of most transactions. They review risk-management reports on the transactions. Good governance means getting the right information to the actors charged with decision-making. That did not happen at Enron. Good governance also means creating mechanisms of accountability. In redesigned corporations, risk management is the key internal control mechanism. At Enron, risk management neither provided accurate information nor ensured accountability.

To explain Enron as an example of the governance problems of redesigned corporations, Part I briefly summarizes the intra-corporate governance process in the redesigned corporation. Part II examines Enron as a redesigned corporation. Part III discusses the risk management process at Enron, drawing particularly on the process in which Enron’s Board approved the Special Purpose Entities (“SPEs”) of the off-the-books transactions that are the focus of the Senate Subcommittee and Powers Reports. Part IV discusses the Enron Board’s approval of the Fastow conflicts of interest in terms of the redesigned corporation’s understanding of conflicts.

20 With hindsight, it is difficult to imagine how a Board member could have told Fastow “that Enron ought to get ‘a patent’ on the Raptor structures to sell them to other companies.” Id. at 21. But, at that time, it was reasonable for a Board member to believe that other companies would imitate the Raptors, as they had so many other of Enron’s innovations.

21 At Enron, there was a maximum four-level chain of command. BODILY & BRUNER, supra note 8, at 26.
I. ACCOUNTABILITY IN THE REDESIGNED CORPORATION\(^{22}\)

Managers cannot bring out the intelligence of everyone in the organization if they pretend they can do better thinking in a few hours than a project team that has wrestled with the problem for months. Instead of issuing arbitrary orders, they need to raise concerns and trust the project team to find a way of handling them that integrates with all the other issues guiding the design.\(^{23}\)

Redesigned corporations are among us. "Throughout much of the economy, and especially among new firms, hierarchies are flatter, headquarters staff smaller . . . [and employees experience] more fluid job definitions, and more ambiguous reporting relationships."\(^{24}\) An objective of redesign is to free innovation from the constraints of hierarchical control.\(^{25}\) Redesigned organizations lack "the rules of clarity and commitment" of "bureaucratic organizations."\(^{26}\)

There is a worldwide cultural and political movement attacking bureaucracy.\(^{27}\) In the public sector, governments are privatizing and dismantling bureaucracies. Corporate groups and networks are utilizing markets instead of hierarchies. Within corporations, headquarters' staffs and "middle-management" are downsized. In redesigned corporations, instead of bureaucrats, employees are innovators.

Proponents of redesign disparage specialization, the self-sufficiency of technical competence, uniform policies as well as standardized proce-

\(^{22}\) This section derives from Robert Eli Rosen, "We're All Consultants Now": How Change in Client Organizational Strategies Influences Change in the Organization of Corporate Legal Services, 44 ARIZ. L. REV. 637 (2002). In that Article, I provided a description of the organizational strategies from which this governance structure emerges. At any company the effects of organizational design will depend on the organization's "unique history, power players, and power games." Denis Collins, \textit{A Socio-Political Theory of Workplace Democracy: Class Conflict, Constituent Reactions and Organizational Outcomes at a Gainsharing Facility}, 6 ORG. SCI. 628, 641 (1995). Nonetheless, like organizational and management studies, this Article generalizes.


\(^{26}\) DiMaggio, \textit{supra} note 24, at 5.

\(^{27}\) This larger movement might be named the "Critique of Bureaucracy Movement." Robert Eli Rosen, \textit{Breaking Through Bureaucracy and Democratic Participation} (Apr. 1993) (unpublished manuscript, on file with author).
dures. They also target a hierarchical accountability structure, where "coordination" is "done from a level or more above the work being coordinated." Employees had to be downsized (i.e., fired), we are told, so that the remaining employees would become "empowered."

Corporations are redesigned to better realize "the obligation of an employee to deliver all elements of the value that he or she is being compensated for delivering." Corporate redesign accepts that agents will engage in opportunistic behaviors. Unlike bureaucracies, redesign does not reduce agency costs by supervision. In redesigned corporations, agent opportunism is managed indirectly and covertly.

First, incentive structures are established to align employee and corporate interests. Employees learn the operating rule of redesigned corporations: "You will be employed by us as long as you add value to the organization, and you are continuously responsible for finding ways to add value." Management by objectives is one strategy for this control: Management supplies numbers to hit and compensation is based on hitting these numbers. Such forms of hierarchical control are indirect mecha-

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28 Before redesign, companies affirmed the "bureaucratic 'art of separation.'" The bureaucratic divisions of office and hierarchy enable role-differentiation: This is my office in this place in the hierarchy. Paul du Gay, Making Up Managers: Enterprise and the Ethos of Bureaucracy, in THE POLITICS OF MANAGEMENT KNOWLEDGE 19, 31 (Stewart R. Clegg & Gill Palmer eds., 1996). After redesign, roles lack clarity and are subject to reinvention, so that it will be difficult to understand where decisions were made.

29 PINCHOT & PINCHOT, supra note 23, at 23. "[T]he traditional hands-on role of the senior manager is disappearing. The message seems to be: Get the processes right, and the company will manage itself." Thomas M. Hout & John C. Carter, Getting it Done: New Roles for Senior Executives, HARV. BUS. REV., Nov.-Dec. 1995, at 133 (criticizing this message because it ignores the need to manage political conflicts); see also Kurt Eichenwald, Another Quality of the Corporate Titan: Ignorance at the Top, N.Y. TIMES, Mar. 3, 2002, § 4, at 3.

30 The literature on redesign usually fails to distinguish between empowered workers and professionals. At least for this reason, empowerment is a deceptive concept. Empowered professionals are by definition unprofessional, for empowerment is understood to be a process that separates workers from any "distinctive personal [or professional] values." Knights & Willmott, supra note 14, at 12. Redesign affords corporate superiors plausible deniability. See infra pp. 23-24. When officers and directors are sued or prosecuted, those in redesigned companies will argue: "We empowered the workers. We treated them like adults. We dismantled the bureaucracy in good faith in pursuit of innovation. And the workers betrayed us."

31 KRAINES, supra note 25, at 15; see also Raymond E. Miles & W.E. Douglas Creed, Organizational Forms and Managerial Philosophies: A Descriptive and Analytical Review, 17 RES. IN ORGANIZATIONAL BEHAV. 333, 362 (1995) (noting that all team members are expected to have "responsibilities with bottom-line implications." To meet these, "they become partners in designing their own roles and expanding the nature of their contributions.").


33 For a discussion of current scandals resulting from an emphasis on hitting the numbers, see Joseph Fuller, A Letter to the Chief Executive, HARV. BUS. REV., Oct. 2002, at 64. For a discussion of compensation based on the numbers hit, see JAMES O'SHEA & CHARLES MADIGAN, DANGEROUS COMPANY: THE CONSULTING POWERHOUSES AND THE BUSINESSES THEY SAVE AND RUIN 296 (1997)
nisms of control. For example, Enron’s management may have set targets, but teams and employees initiate, plan, and implement projects to hit the numbers.

Second, redesigned corporations utilize various motivational strategies. For example, Enron’s management may have set targets, but teams and employees initiate, plan, and implement projects to hit the numbers.

Rather than imposing hierarchical controls, redesigned corporations heavily rely on horizontal (e.g., peer) controls. In the redesigned company, managers have a hands-off attitude toward teams. The “transmission belt” delegation of powers from principal to agent is replaced by one that emphasizes “network coordination.” Instead of transparent bu-


Richard W. Woodman & William A. Pasmore, The Heart of It All: Group- and Team-Based Interventions, in ORGANIZATION DEVELOPMENT: A DATA-DRIVEN APPROACH TO ORGANIZATIONAL CHANGE 164, 166 (Janine Waclawski & Allan H. Church eds., 2002). “[T]eams...are typically...collections of individuals whose working relationships require close coordination, higher levels of cooperation, greater cohesiveness, and the like.” Id. at 176 n.1; cf. David Hechler, Enron’s legal staff battered, confused, NAT’L L.J., Feb. 4, 2002, at A1 (noting that two lawyers said “[t]here was a real esprit de corps” and “[y]ou just walked into the lobby and you felt electrified”). Others describe the esprit at Enron as highly individualistic. See Dallas, supra note 33, at nn. 277-83.

One risk of these fired-up, cohesive teams is that when team members assert their professional ethics, they may be treated as engaging in “ethiscuity,” the “taking of refuge in ethics in order to protect oneself from potentially threatening and anxiety-producing relationships.” GORDON LIPPITT & RONALD LIPPITT, THE CONSULTING PROCESS IN ACTION 74 (1978). At Enron, Lynne Dallas’s argument is that a climate was created in which any commitment to ethics was inappropriate. Dallas, supra note 33, at 6. Although an accurate description, the climate argument fails to capture intra-corporate transactions. As a description, an organization’s climate fails to recognize that in any corporation there are multiple cultures and multiple mini-climates. The problem with deriving policy prescriptions from describing climates is the assumption that particular acts create cultures or set climates. The relationships between the cultures and practices of an organization are much more complex and intertwined than Dallas presents. Agent reflexivity creates more than noise in the transmission of culture. The relations of organization and culture are complex and need not be resolved for the analysis in this Article.

With teams, “supervision, responsibility, and even discipline, is...shifted from managers to peers.” Powell, supra note 32, at 58. In the redesigned company, “[e]mployee accountability shifts from hierarchy to collegiality.” Knights & Willmott, supra note 14, at 5.

For example, Enron’s General Counsel James Derrick was praised by his legal staff for his “honesty, intelligence and affability,” but criticized for being “a hands-off manager” who “doesn’t even know the names of his lawyers.” Hechler, supra note 35, at A1. What did he do instead of supervising lawyers? Derrick was “involved” in Enron board decisions. Id.

Teams, for example, invent projects [an executive function]. The teams also are responsible for these projects’ design and production [the legislative and administrative functions].

This term has many meanings. It is used here to focus on the use of horizontal controls. For example, in the redesigned corporation, professionals, inside or outside the corporation, often become members of teams. They primarily report to the team. This splinters professional control. In response,
reaucratic controls, redesigned companies employ covert motivational controls.

Business transactions in redesigned companies are not managed hierarchically, but typically by self-managing project teams. Standardized procedures and policies are replaced by a commitment to aligning incentives. Coordination by the hierarchy is constrained by a commitment to the teams being self-managing.

Hierarchical supervision of the projects that are developed is conducted through reviews of risk-management reports, which project originators write, at least in part. In redesigned companies, teams develop “[r]isk management plans . . . to deal with unresolved issues and project risks, negotiate their allocation and sharing, and create ways to deal with them so as to mitigate the impact or eliminate the risks completely.”

Senior executives decide on whether or not to go forward with the project by assessing these risk management plans, sometimes requiring that independent assessments be made.

In sum, in the redesigned corporation, markets are created within firms...
and competition occurs through risk management reports. In many respects, redesigned firms are combinations of intrapreneurial teams. A sociologically accurate, but legally metaphorical, image of the redesigned corporation is that of a holding company of intrapreneurial teams (metaphorically, dominated subs). The incentive structure is manipulated so that to each team, their project is a bet-your-company deal.

Of course, corporate redesign may be a passing fad. Scandals may result in redesigned organizations becoming “more centralized.” The market might induce companies to reinvigorate bureaucratic “command and control” systems. Professional firms may learn the costs of letting their project managers and their client relations partners overrule home office judgments. But, as Enron reveals, today organizational redesign is a significant fact.

Bureaucratic corporate management not only governs agency costs, but also responds to regulatory threats. Bureaucratic organization generates seemingly trustworthy companies, capable of rational and accountable decision-making, minimizing the need for intrusive regulatory policies. Today, our challenge is to make corporations without bureaucracy worthy of public trust.

II. ENRON

Enron is a good case through which to explore the accountability structures of redesigned corporations. Before its fall, Enron was known as an exemplary redesigned corporation. Before its fall, Enron was lauded for its sophisticated financial risk management tools. Before its fall, Enron

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44 As is well known, corporate actors do not maximize, they satisfice. For the same reasons that there are incomplete contracts, corporate actors can only satisfice. For example, the impossibility of any corporate actor completely discovering all relevant information means that maximizing solutions may not be found, even by the most loyal agent.

45 This is “the most drastic change” of Paul Volcker’s report on Arthur Andersen. Floyd Norris, Andersen Told to Split Audits and Consulting, N.Y. TIMES, Mar. 12, 2002, at C1.

46 As they did at Andersen. See, e.g., POWERS REPORT, supra note 9, at 120 n.57. For a discussion of client relations partners, see Rosen, supra note 22, at 672-75.

47 Michael Power, Auditing and the Politics of Control in the UK Financial Services Sector, in CORPORATE CONTROL AND ACCOUNTABILITY, supra note 1, at 188-89.


49 New Dynamics of Strategy in the Knowledge Economy, FIN. TIMES (London), Oct. 11, 1999, at 6; see also supra note 11 and accompanying text.
was seen as a supply source for the best risk management experts and processes. After Enron's fall, it was accused of using weak risk management processes.

With hindsight, we know Enron was not such an exemplary company. Enron's commitment to innovation was so great that teams could commit significant resources, yet not include experts needed for their implementation. Consider Enron Online. This project began bottom-up with a natural gas trader. Although the project was not within his group's purview, before contacting management outside his group, his team invested $15 million, exclusive of salaries, of Enron's money to the project. The Enron Online team had employed 25 outside law firms and 380 Enron employees before it was approved. As the project team leader said: "It never crossed my mind that we had to go talk" to executives prior to finalizing the project. When the Enron Online project was presented, Jeffrey Skilling and Kenneth Lay, Enron's top managers, were "surprised." Enron Online demonstrates that Enron was a corporation in which self-managing teams initiate and design projects. Employee innovations are not bureaucratically directed. Professionals are not retained by management and their work is managed by a bottom-up process.

One problem in redesigned corporations is how, in the absence of hierarchical control, one team can capture the necessary resources from other groups, many of whom may have over-filled plates, perhaps as a result of their downsizing. This appears to have been a problem at Enron. When the Enron Online project was approved, it was turned back to the project team for implementation. But the project team did not obtain the cooperation of other Enron operations groups who were necessary for its success. Enron Online required "such services as settlements of deals, credit, risk management, back-office paper-handling, etc." But when the project was launched, these operations were not in place. As a result, Enron Online both overcharged and undercharged its clients. Other project teams also proceeded to implementation without being sufficiently integrated with other corporate operations.

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51 *Maxon, supra* note 11, at 1H ("We were off. 'This is a great idea and we're going to do it.' There was no way anybody was going to say it wasn't a great business idea. It was.").
52 *Id.*
53 *Id.*
55 *Id.* (noting that the growth of Enron Energy Services "far outpaced the company's information management infrastructure," and that "Enron's computer system was . . . scattered and poorly managed"); see also Kathy Thacker, *Project Teams Laboring at Warp Speed Often Hit the Wall, Author Says*, DALLAS MORN. NEWS, May 14, 2002, at 3D.
Another problem at Enron appears to be how it managed risks in the implementation of its projects. With hindsight, it now appears that "Enron always bragged that it was state of the art in risk management, but here's a company that didn't really do its risk-management homework."56 Deals were approved that had "poor profit and loss projections," resulting in "unprofitable contracts."57 Because of risk management failures, Enron apparently made bad business deals.

Examining Enron produces conflicting stories. The whole industry was using off-the-books vehicles58 and Enron's were the most sophisticated. Enron could innovate in capital management because it combined its sophistication with that of the leading law and accounting firms in that field.59 On the other hand, Enron was an uncontrolled mess where high-flyers cared nothing for the consequences of the transactions that yielded them bonuses. At Enron, projects emerged that were implemented without basic operational controls. Risk management was Enron's claim to fame, as well as its weakest link. In Part III.B of this Article, these conflicting stories are enacted when Enron's Board approves the SPEs that were the proximate cause of its bankruptcy, the Raptor Project.

III. RISK MANAGEMENT60

A. Law and Accounting as Profit Centers

Traditionally, corporate funds expended for legal and auditing services were seen as losses, payments for side-constraints on the corporate mission. Today, tax departments, accounting firms, corporate legal departments, and law firms claim they are profit centers. They "add value" to the corporation.61 One, in fact, could argue that it was through the finance department that Enron principally added value. Enron's transition was
from physically delivering natural gas products to offering financial products and then bundling physical delivery to the financial products.

The Subcommittee found that high risks were assumed because of "Enron's ordering its tax department to produce billions of dollars in company earnings through the use of complex tax shelters." More accurately, Enron's tax department developed and bought, from accounting and law firms, products to increase company earnings. In redesigned companies, tax departments will seek innovations to add value (produce earnings) to the company. The problem is not that they do so, but that these innovations may not be adequately assessed. The problem is not that "Enron was using accounting practices that 'push limits' and were 'at the edge' of acceptable practices" and "approved an unprecedented arrangement." That is called innovation. The problem is that the risks of these innovations to Enron were not properly addressed.

Enron's financial team was composed of the firms that sold themselves as leaders (and innovators) in the use of derivatives and other complex financial solutions to corporate problems. Vinson & Elkins marketed themselves as "in the forefront of . . . capital markets, project finance and structured finance solutions for . . . energy initiatives." Arthur Andersen also emphasized its technical expertise, innovative approach and commitment "to help the client emphasize the best strategies" to succeed in the energy and utilities market. In particular, Arthur Andersen's energy and utilities group praised Enron for "rethinking business models" and for developing a "value dynamics" model for "the valuation of a company's assets." Enron was the "leading edge."

Beyond the self-dealing, a lesson of Enron are the dilemmas of monitoring risks when finance and law are seen as profit centers. In the redesigned company, such monitoring is especially difficult because professionals work on and for teams. As an outside lawyer put it, "We were giving advice to the people we were instructed to give it to under their protocol" and they were aware of the risks. The lawyers were there to help teams

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62 ENRON'S COLLAPSE, supra note 2, at 11.
63 Robert Eli Rosen, As the Big 5 Become Multi-Disciplinary Practices, Opportunities Abound For Tax Executives, TAX EXECUTIVE, at 147 (Mar. 1, 1999).
64 ENRON'S COLLAPSE, supra note 2, at 12.
65 Sanderson, supra note 58, at 29 (quoting Bruce Bilger, co-head of Vinson & Elkins' business and international section).
66 Id. (quoting Victor Burk, Andersen's managing partner of the energy and utilities industry group).
67 Id.
68 Id.
69 Id.
69 ENRON'S COLLAPSE, supra note 2, at 20.
develop projects so their exposures were reduced. For risk management purposes, at least, teams treat lawyers like hired guns. They are there to advance the project by mitigating, transferring, and hedging risks. As one energy and utilities company senior executive said: “From a [transactional] lawyer, what I want is quality of work: bringing up good issues and pertinent points to defend our side of the equation.”

In the redesigned corporation, not all risks are eliminated. Projects will be funded that have legal risks. Executives confront many risks and legal risks are just one among many others. Legal non-compliance is a possibility. The corporate decision depends on the management of risks, not only the removal of risks. For example, Arthur Andersen decided to retain Enron as a client because they believed, incorrectly in this case, that they “had the appropriate people and processes in place to . . . manage our engagement risks.” In work-outs due to risks eventuating, lawyers have an important but confidential role. Then, lawyers’ work on risk management “must be invisible” to those outside the corporation because the presence of lawyers suggests that risks have not been eliminated, but just hedged, transferred, or retained.

Professionals in redesigned corporations add value by advancing projects that may realize benefits, while mitigating the projects’ risks. Professionals also add value by using their expertise to develop projects that increase corporate earnings. Law and auditing groups are profit centers. Their projects, as well as the projects of the teams for whom they work, are monitored by risk management reports. The next part of the Article, discussing SPEs, describes an instance in which a redesigned corporation did not appropriately monitor its professionals.

B. The Raptor Project and Enron’s Board

The Subcommittee found that:

Enron’s high-risk accounting practices, for example, were not hidden from the Board. The Board knew of them and took no action to prevent Enron from using them. The Board was briefed on the purpose and nature of the Whitewing, LJM, and Raptor transactions, explicitly approved them, and received updates on their operations. Enron’s extensive off-

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70 Id.
71 Cris Williams et al., Interfacing the Assessment, Management, and Communication of Risk, in RISK-BASED ANALYSIS FOR ENVIRONMENTAL MANAGERS 90 (Kurt A. Frantzen ed., 2002) [hereinafter RISK-BASED ANALYSIS].
72 Maxon, supra note 11; see also sources cited in Dallas, supra note 33, at nn. 236, 242.
73 ENRON’S COLLAPSE, supra note 2, at 19.
74 Samuel D. Ostrow, Risk Communication Basics, in RISK-BASED ANALYSIS, supra note 71, at 175.
the-books activity was not only well known to the Board, but was made possible by Board resolutions.\textsuperscript{75}

The Board members interviewed by the Subcommittee replied that they "had met their obligation to provide reasonable oversight of company operations."\textsuperscript{76} The Subcommittee finds instead that Enron's Board should have investigated the transactions, overseen company operations, and hesitated before approving "new business ventures and complex transactions."\textsuperscript{77} With hindsight, the Subcommittee was probably right. But, hindsight is twenty-twenty. More important, the Subcommittee's recommendations are so generic that a corporate board would be hard-pressed to know where to begin. And if they did so, they would be reorganizing the corporation, undoing the benefits of redesign.

Corporate boards have a duty to "assur[e] themselves that information and reporting systems exist in the organization that are reasonably designed to provide . . . timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments."\textsuperscript{78} At Enron, as at other redesigned companies, the principal assurance derived from the company's use of "one-risk management system."\textsuperscript{79}

In the redesigned company, risk management groups govern critical decisions.\textsuperscript{80} Risk management manages the borders between the corporation and its environment. In analyzing Enron, analyses have focused on its interface with the regulatory environment. For financial firms, which Enron had become, this interface is critical and is normally assigned to its risk managers. For example, the risk manager's report to the board of one financial institution "is organized by the regulators' risk categories: credit, compliance, operational, interest rate, liquidity, legal, reputational."\textsuperscript{81} In response to Enron, she will "be adding strategic risk to the report."\textsuperscript{82} Her response recognizes that Enron demonstrated not only a legal compliance failure, but also a business failure. To the business community, Enron's failure is only partly that of inadequate legal and accounting gatekeepers. More important, it demonstrates a business failure. The SPEs were bad business deals. It is the business failure that an analysis of risk management with respect to the SPEs especially demonstrates.

\textsuperscript{75} ENRON'S COLLAPSE, supra note 2, at 13.
\textsuperscript{76} Id. at 14.
\textsuperscript{77} Id.
\textsuperscript{78} In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996).
\textsuperscript{79} BODILY & BRUNER, supra note 8, at 26.
\textsuperscript{80} See Rosen, supra note 22, at 651-60 (exploring how redesigned companies view legal work as part of the risk management process).
\textsuperscript{81} Ann Hengel, Effecting Sound Risk Management Practices, 10 RISK MGMT. J. 62 (July 1, 2002).
\textsuperscript{82} Id.
Risk management was crucial to Enron not only because of its regulatory environment, but also because of its business plan. In response to price and supply volatility risks in the energy industry, Enron placed long-term fixed commitments which needed to be hedged. At least, in response to the expected emergence of competition, which would increase the likelihood of non-performance of these commitments, Enron’s strategy was to increase its purchases in the highly leveraged energy and financial product markets. This increased Enron’s debt-to-equity ratio, thereby increasing Enron’s financial exposure. In addition, Enron attempted to diversify its products lines. To realize these growth opportunities, Enron required significant internal financing. Enron’s Risk Assessment and Control Group’s principal task was to manage Enron’s market risk exposures.

The Subcommittee found that:

Andersen regularly informed the Audit Committee that Enron was using accounting practices that, due to their novel design, application in areas without established precedent, or significant reliance on subjective judgments by management personnel, invited scrutiny and presented a high degree of risk of non-compliance with generally accepted accounting principles. Replace “accounting” with “business,” and this is a description of innovative business strategy.

Andersen’s presentations to the Board, like other project presentations, normally consisted of “a risk profile analysis.” Andersen rated these risks and some of the risks were “rated as high risk.” The Subcommittee decries Enron for taking these high risks.

Andersen’s presentation differed only in substance from the other risk profiles that the Board received from project teams. Finance, like other profit centers, suggested projects that were risky. It is with hindsight, and a

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85 ENRON’S COLLAPSE, supra note 2, at 15.
86 Id. at 16.
87 Id.
88 See id. At many points in the report, Enron’s Board is lambasted for approving “high risk” strategies. See, e.g., id. at 20, 24. I write this Article as a war with Iraq is being debated. I don’t hear the Senate lambasting the President for advocating high risk strategies.
focus on legal risks segregated from all the other risks that Enron faced, that permits the Subcommittee to rely on the presence of high accounting risks to discover intentional breaches of the Board's duty of care. The Subcommittee approves the idea that "high risk activities by the company's outside auditor 'is a giant red flag.'" Replace "outside auditors" with "project teams" and red flags would be flying all over the place at redesigned companies.

The redesigned corporation accepts the adage, "no risks, no gain". A simplifying, but accurate description of innovation is that it is "intelligent gambling." Gambling is intelligent if a corporation has in place processes and people to manage risks. Andersen told the Board, "[t]he Company's personnel are very sophisticated and enter into numerous complex transactions . . . ." Andersen told the Board that Enron had employees who were capable of intelligent gambling.

In the redesigned company, risk management decisions are the executive decisions. Consider the Board decisions with respect to the SPEs. The presentations of the SPE transactions to the Board concluded with their risk management profiles. The minutes of the meeting of Enron's Finance Committee that approved the SPE "Talon," developed by the Project Raptor team, are publicly available, so Project Raptor will be used to illustrate this point.

The Talon presentation was made by Ben Glisan, who was promoted to be the presumptive Enron Corporate Treasurer earlier in the meeting. The presentation discussed five slides. The first slide has the project name and a description of this as a "Hedging Program." The second slide, titled "Purpose," describes Raptor as a "risk management program." The Finance Committee was told that it was being presented another of the innovations for which Enron had become so famous.

The next two slides describe Talon's structure. The first one, labeled "Structural Highlights," has five bullets. Two are Talon's benefits to Enron. Talon was to be a hedge counterparty for Enron's investment losses and yet allow Enron to receive gains from the hedging activities. The middle three bullets indicate that Raptor will develop an increasingly large

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89 Id. at 15.
90 Id. at 19.
91 Id. at 18.
93 Id. at 2.
94 Id. at 21.
95 Id. at 22.
96 See supra notes 49-50.
97 See Finance Committee, supra note 92, at 23.
financial base and thereby a growing capacity to provide Enron P&L volatility protection. The next slide is of the "Vehicle Structure." On the available copy of the Minutes, on this slide, it is noted that Andersen's "Mr. Causey joined the discussion and stated that Arthur Andersen LLP had spent considerable time analyzing the Talon structure and the governance structure of LJM2 and was comfortable with the proposed transaction." The presentation concluded with a discussion of "Project Raptor’s risk and potential mitigants to those risks." The risk management slide on the Project included three risks and three mitigants. The first risk is "Accounting scrutiny." Its mitigant is that the "[t]ransaction [was] reviewed by CAO [Chief Accounting Officer] and Arthur Andersen." This statement is accurate. If the transactions do not stand up to accounting scrutiny, this risk to Enron may be mitigated by its reliance on Arthur Andersen. Does this reliance eliminate the risk? No. But this reliance does make Arthur Andersen an insurer, at least, of the moral aspects of the risk. What this risk mitigant doesn’t guard against is the risk that Arthur Andersen will decide to shed risks. And this risk eventuated. Arthur Andersen decided that it could no longer insure the SPEs. Andersen decided that in this case “in for an inch” didn’t mean “in for the mile.” Without Andersen’s insurance, Enron produced a consolidated balance sheet that assumed responsibility for the note receivable in Raptor. Representatives of Enron have evidence that they complied with the law and obeyed when their accountants told them what financial data needed to be published.

Did the Board breach the duty of care by assuming the risk that Andersen would not withdraw its support for the SPEs? The SPEs were “vehi-
ties" to reach certain goals, the vehicles reached their goal because of their "structure.")\textsuperscript{103} Andersen had told the board it was "comfortable" with the structure.\textsuperscript{106}

The second risk is "[s]ubstantial decline in the price of ENE stock."\textsuperscript{107} This risk creates two risks, that the "Program terminates early" and "increases [in] credit risk."\textsuperscript{108} The mitigant for both risks is "Negotiation of early termination with LMJ2."\textsuperscript{109}

To the extent that LJM2 is able and willing to maintain and increase its investments in Talon, these risks are mitigated. The Board was told at this meeting that LJM2 had $386 million of capital, of which $139 million had already been invested in Enron.\textsuperscript{110} More important, Enron’s board had some reason to believe that LJM2 would show loyalty to Enron because it was managed by "Our Man Fastow." Is it a breach of the duty of care to assume the risk that Fastow would be cooperative? Certainly not in Delaware.\textsuperscript{111}

On Glisan’s risk management slide, the third risk is "Counterparty credit" and its mitigant is "Assets of vehicle subject to a master netting agreement."\textsuperscript{112} This statement is false. Netting does not protect Enron from the risks of counterparty credit, of its being able to collect its net money position against Talon. Netting protects Enron from Talon “cherry picking” among its investments during Talon’s bankruptcy. Netting arrangements do not prevent Talon from becoming bankrupt, nor do they protect the net revenues due Enron from Talon.\textsuperscript{113}


\textsuperscript{105} Finance Committee, supra note 92, at 24.

\textsuperscript{106} Id. at 23.

\textsuperscript{107} Id. at 25.

\textsuperscript{108} Id.

\textsuperscript{109} Id.

\textsuperscript{110} Id. at 20.

\textsuperscript{111} If it is not a breach of the duty of care for a board to retain and shower with bonuses an officer against whom there is evidence that demands at least a probable cause hearing for sexual harassment, it cannot be a breach of the duty of care to rely on an unblemished officer, although it was a drastic mistake. See \textit{White v. Panic}, 793 A.2d 356 (Del. Ch. 2000).

\textsuperscript{112} Id. at 25.

\textsuperscript{113} As my colleague William Widen taught me:

Netting arrangements address “what is known in the industry as ‘cherry picking’ and it was a widespread problem that was one of the first addressed by ISDA when lobbying for changes in the bankruptcy code. Anyone conversant with swaps knew about the problem. It simply is this. Suppose that I have 11 swap transactions with a single counterparty – assume the counterparty is Raptor. Make them all interest swaps. In 6 I am a floating rate payor. In 5 I am a fixed rate payor.

Now, the interest rate environment is such that the 6 transactions in which I am a floating rate payor all are in the money to me. The five in which I am a fixed rate payor are out of the money. Suppose Raptor files for bankruptcy. Raptor would reject all 6 of the transactions in which I am a floating rate payor since Raptor is losing money on all of those. Raptor would accept all 5 of the transactions in which I
It was the lack of creditworthiness of the Raptor Project's SPEs that forced Arthur Andersen to withdraw its endorsement. This resulted in Enron's restatement of its financial reports, showing significant charges against earnings and reductions in shareholder equity. This "triggered Enron's credit rating downgrades and its eventual bankruptcy."\textsuperscript{114}

Because of the creditworthiness risk, this was a bad business deal. Even had they not been the product of legal and accounting evasions, and even if Enron was not covering the SPEs losses, "the Raptor SPEs had a structural defect."\textsuperscript{115}

The Finance Committee approved Talon on the basis of an inaccurate and deceptive risk management report. That the Committee approved a bad business deal on the basis of this risk management report raises important questions not unique to this transaction.

First, it asks whether the Board had the capacity to know when it was not making informed decisions on risk management reports. Professor William H. Widen concludes that corporate problems are "enhanced when board members in a complex industry are generalists without any connection to the details of particular lines of business."\textsuperscript{116} He notes that:

Even though Enron was running a derivatives business, it seems that those on the Finance Committee and, more generally on the Board, did not have a sufficient derivatives background to understand and evaluate what they were being told in the presentation. If they had this background, the identified risk mitigants would not have been accepted.\textsuperscript{117}

The Raptors were bad business deals. "Why did no one understand this on the Enron Board?"\textsuperscript{118} Of course, members of the Board might have

\footnotesize{am a fixed rate payor as Raptor is making money on them. This illustrates cherry picking. The simple fix to the bankruptcy code was to permit netting of the collective positions so that, at worst, Raptor rejects a single contract. Various scenarios are possible along the above lines.

It [netting] simply allows a reduction in credit exposure by preventing disaggregation of net credit exposure. Note what netting does not do -- it does nothing to protect my net in the money position against Raptor. Yet, a huge net in the money position is exactly what was reported in footnote 16 in Enron's 10-K. ( ... footnote 16 to the annual financial statements ... indicated a net in the money position held by Enron against the Raptors for $500 million). Memorandum from William H. Widen to Robert Eli Rosen (Jan. 20, 2003) (on file with author) [hereinafter Widen Memo].}

\textsuperscript{114} ENRON'S COLLAPSE, supra note 2, at 42.
\textsuperscript{115} Id. at 41.
\textsuperscript{116} Widen Memo, supra note 113.
\textsuperscript{117} Id.
\textsuperscript{118} Id.
understood and are just pleading ignorance. The courts will decide this. Regardless of what the courts find, the policy prescription remains. The Board must have the capacity to analyze risk management reports in order to avoid the question of “Where was the Board?”

The Board’s bad business decision raises a more basic question. Why was a deceptive risk management report presented to them? Had an adequate report been presented, the Board might only have approved a vehicle in which sufficient outside capitalization was committed before swaps took place. If this had been done, the SPEs, at least formally, would have had sufficient credit quality. More important, it would have been a good business deal.

One answer for the deceptive risk management slide may be collusion. The pseudo-mitigant of master netting might have been a deliberate evasion to get the assent of an unsophisticated board, rather than a mistake by the risk management assessment team. This is not difficult to imagine as Glisan, the presumptive Enron treasurer, who made the presentation, also was head of the Enron Corporation’s business unit, from which the project emerged, and was designated as Enron’s negotiator with LJM. Collusion is also possible because the risk managers may have feared retaliation should they have refused to approve the deals.

The SPE deals were signed off on by a variety of individuals, including Rick Buy, the Chief Risk Officer. Since the problem with Talon was that its credit risks were not appropriately managed, Buy’s signature raises the question, “Where were the risk managers?” As Buy admits, “he viewed his role as being primarily to evaluate Enron’s [credit] risk.” Yet, the Powers Report seems to give a pass to Buy, concluding that Buy had not “ignored his responsibilities.” Buy is not charged with dereliction of duty.

119 The Subcommittee’s report finds knowledge of the deceptive accounting, hence the Finance Committee had intent to deceive, at least to the extent that no reasonable person would have left this presentation without knowing that it was a scam. See ENRON’S COLLAPSE, supra note 2, at 45–48, 51.
120 LJM2 was described to the Board as “an alternative, optional source of private equity.” Minutes, Meeting of the Board of Directors of Enron Corporation, at 17 (Oct. 11–12, 1999), at http://news.findlaw.com/hdocs/docs/enron/bd10111299min.pdf (last visited Feb. 22, 2003) (on file with the Connecticut Law Review). The motion approving the Raptor Project described LJM2 as “a potential ready purchaser of the Company’s businesses and assets.” Id. at 18.
122 Dallas, supra note 33 at n.255. But see supra note 84.
123 LJM2 Approval Sheet, supra note 121, at 11-12. Mr. Buy heads the Company’s Risk Assessment & Control Group (“RAC Group”). Minutes, supra note 120, at 3.
124 POWERS REPORT, supra note 9, at 168.
125 Id.
Professor Coffee speculates that the pace of developments at Enron “outdistanced the development of risk management systems.”126 The Powers Report offers a different interpretation. The Powers Report argues that the risk management failure at Enron resulted from Buy’s role being “more narrow than the Board had reason to believe, and Buy did not act affirmatively to carry out (or ensure that others carried out) a careful review of the economic terms of all transactions between Enron and LJM.”127

Rather than focusing on the deceptive risk management report, the Powers Report’s mild condemnation of Enron’s risk management group seems to be based on a misunderstanding of risk management’s role, which is not to eliminate risks, but to manage them. Consider its discussion of Enron’s Research Group, which “handles sophisticated option pricing and modeling issues” and was a sub-group of Enron’s Risk Assessment and Control Group.128 The Powers Report emphasizes that the Research Group recommended against one of the SPE transactions because “the structure was unstable from a credit capacity standpoint because the SPE was capitalized with Enron stock.”129 Buy reported “that at some point his group evaluated the credit capacity, found that it was too low, and recommended changes in the structure that improved it.”130 The Powers Report treats this as conflicting evidence about whether Buy knew that the deal should have been stopped and Buy’s version that he mitigated some of the credit risks. If the role of risk management is not to eliminate risks, but mitigate them, then Buy might have properly responded to the Research Group’s report. When the Powers Report finds that Buy understood his role too narrowly,131 it seems to demand an elimination of risk role. The Report more profitably should have asked why the risk management report that emerged didn’t mitigate the credit risks.

A similar story unfolds when the Powers Report presents evidence on RAC Research Group’s employment by Enron’s internal accounting staff. The Research Group analyzed the SPEs’ structure “and determined there was a 68% probability that the structure would default.”132 Like Buy, the Chief Accounting Officer did not decide to abandon the project, thereby

126 Coffee, supra note 17, at 1404.
127 POWERS REPORT, supra note 9, at 22. The Powers Report blames Skilling with the risk management failure. Id. at 20-21.
128 Id. at 84.
129 Id. at 85. It also is reported that Buy was told that “the payout was skewed against Enron” by the head of the option pricing and modeling group. Id. at 84. The import of this evidence is little different from the evidence discussed in the text.
130 Id. at 84.
131 Id. at 22.
132 Id. at 87.
eliminating the probable result, but thought about creating "a credit reserve" to mitigate it.\textsuperscript{133}

Both the Subcommittee and the Powers Reports do indirectly reveal a significant problem in redesigned companies. Redesigned corporations rely on risk management groups, but they don't always back up this reliance. For example, with respect to the SPEs, Enron's Board believed that "numerous groups monitor compliance with procedures and controls and regularly update . . . Mr. Buy."\textsuperscript{134} Yet in all the meetings of the Board and its Committees whose minutes have been reviewed, Mr. Buy has a very limited role, reporting on trading limits, commercial credit, and market risks.\textsuperscript{135} Although the SPEs were fraught with risks and the Board had given Buy the responsibility to "review all transactions between the Company and LJM funds,"\textsuperscript{136} it was consistent with Enron's delegation to the risk management group, its normal tasks, that Buy's group would interpret its involvement with the SPEs as primarily one of verifying that "the sale price was consistent with the acquisition price."\textsuperscript{137}

The responsibilities redesigned corporations assign to risk management often far exceed their tasks. Like legal departments in bureaucratic corporations, risk management is seen as a side-constraint.\textsuperscript{138} Risk management groups often are not included in significant transactions and their recommendations are ignored.\textsuperscript{139} Risk managers often have too much of a sit-in-the-office-until-called strategy. Risk managers may not be on teams, but rather take piecework from teams. Piecework does not provide complete information to risk managers and assessment of risks consequently may be distorted.\textsuperscript{140}

\textsuperscript{133}Id. at 87.
\textsuperscript{135}The Audit and Compliance Committee meeting that described Buy's important role ran out of time before they heard Buy's "Credit and Market Risk Update." Id. at 5. In the meeting that approved Talon, Buy made an extensive presentation on Enron's trading limits policy and the risks of Enron's merchant, commodity, market and currency portfolios. Finance Committee, supra note 92, at 2-4. In another meeting he discussed violations of the trading limit policy and "noted that the RAC group was working with the business units to reduce the number of violations, and discussed the reasons for the violations." Minutes, supra note 119, at 4 (emphasis added). At this meeting Mr. Buy's presentation began with his discussion of "the Company's Top 25 [commercial] credit exposures." Id. at 3. In the various meetings whose Minutes have been reviewed, Buy never demonstrates that his group had the capacity to accomplish the tasks the Board expected of it in the SPE transactions.
\textsuperscript{136}POWERS REPORT, supra note 9, at 169.
\textsuperscript{137}Id. at 168.
\textsuperscript{139}POWERS REPORT, supra note 9, at 169.
\textsuperscript{140}The Risk Management Research Group was not told important facts about a transaction and therefore produced an inaccurate analysis. See id. at 124-25; cf. Robert Eli Rosen, Problem-Setting and
To exemplify risk management's limited role at Enron, consider its failures to establish adequate procedures for approving projects and ensuring that all projects enter the approval process. The Board required that the SPE transaction could not proceed without a Deal Approval process. Not only does the Powers report criticize Buy for not making sure that these procedures were followed in all cases, but the Report also concludes that the approval process "was not well-designed" and that the "LJM Deal Approval Sheets were a formality that provided little control."

The Approval Sheets did not require any documentation of efforts to find third party, unrelated buyers for Enron assets other than LJM1 or LJM2. Some of the questions... were framed with boilerplate conclusions ("Was this transaction done strictly on an arm's-length basis?), and others were worded in a fashion that set unreasonably low standards or were worded in the negative ("Was Enron advised by an third party that this transaction was not fair, from a financial perspective, to Enron?").

These are the problems of a group that knows it lacks power within the corporation. An important conclusion from the Enron case is that redesigned corporations need risk management teams that can accomplish their assigned responsibilities. Furthermore, given current composition standards for risk-management reports, it is likely that they will not explain their mitigation of risks in sufficient detail so as to allow significant review. As a result, companies will make improvident decisions. Furthermore, given corporate law's lack of focus on the risk management process, it is unlikely that decisions made on the basis of inadequate risk management reports will breach officers' and directors' duties of care. Boards of redesigned corporations must assure themselves that risk management systems produce reports that allow for informed and reasoned board decisions.

Two more subtle problems emerge from considering the Enron case. First, there are moral hazard problems. Teams have incentives to shape risk management reports so that their project will be selected. When bad business deals result, officers and directors will say, "We were aware of this moral hazard problem and responded to it, albeit inadequately as this legal action demonstrates. But, we are able to respond to agency costs. If not, the market will. No second-guessing is needed from outsiders. For the current case, we have no liability because we didn't order it nor did we..."

Serving the Organizational Client: Legal Diagnosis and Professional Independence, 56 U. MIAMI L. REV. 179, 201-02 (2001).

\[141^{1}\] POWERS REPORT, supra note 9, at 22, 90.
\[142^{2}\] Id. at 170-171.
\[143^{3}\] GAAP requires substantiation of this claim. See id. at 198-99.
\[144^{4}\] See id. at 170.
fail to respond to clear signals which were (not) present.”

Officers and directors are unlikely to mention the moral hazard problem that emerges from their “empowerment” of workers. In a bottom-up strategy, executives attain plausible deniability. “We treated them like adults and they betrayed us.” In shifting responsibility down the line, executives are all too likely to engage in risky behavior.

Consider a director’s or officer’s testimony that, “We knew there were these very significant risks, but we did it anyway. It was a cost-benefit weighing.” This is music to a tort lawyer’s ears. On the other hand, in a corporation with a properly functioning risk management system, this is a choice that officers and directors must make for the benefit of the shareholders. For officers and directors, this creates a double-bind. The redesigned corporation, in allowing executives to attain plausible deniability through self-managing employees, resolves this double-bind. But, it imposes agency costs on shareholders when the corporation is liable or suffers financial losses from actions that were never directed, but worked their way up from the bottom.

Second, as a result of corporate redesign, compliance officers have become risk-managers. Compliance officers’ zeal is re-shaped. A crucial consequence is that noncompliance becomes an option. Risks are not always eliminated; they often are transformed, hedged, and insured.

This change in the understanding of corporate compliance is reflected not only within the corporation, but also in multi-disciplinary auditing firms. Post-Enron, the big news is that consulting partners exited from their partnerships with auditors. This news fails to emphasize that compliance consultants, and tax consultants, stayed with the auditors. That compliance and tax consultants remained with the auditors reflects that these consultants’ added value derives in large part from their organizational link with auditors. A tax product, for example, is easier to sell when your partners are going to audit the books. Compliance decisions similarly increase in value when your audit partner decides what needs to be reported. As compliance decisions are understood as risk management decisions, serious conflicts of interest emerge between the normative idea of auditors and the reality of their business, in which compliance partners sell risky compliance. Nonetheless, the SEC has not implemented Sarbanes-Oxley

145 Another way in which directors and officers attain plausible deniability is by relying on experts. Directors are entitled to reasonably rely on experts. See, e.g., DEL. CODE ANN. tit. 8, § 141(e) (2002). When boards delegate decisions to experts, they fragment corporate governance. Corporate redesign, by providing boards with other bases for plausible deniability, further fragments the governance of corporations from being centralized in the board.

146 The exiting consultants needed auditors mainly for solicitation. Having solicited the world, Big 5 Management Information Systems (“MIS”) consultants, among others, decided that the cross-selling opportunities of partnerships with auditors were outweighed by the cross-compensation demands and other risks of the partnership and decided to exit.
in such a way as to require the tax and compliance partners to exit accounting firms.

IV. CONFLICTS OF INTEREST

A troubling aspect of the Enron story is the Enron Board’s decision to waive its own policy and permit Fastow to be both Enron’s CFO and the manager of credit counter-party SPEs “[d]espite clear conflicts of interest.”147 Reportedly, even in the Risk Assessment and Control Group there was discomfort because of Fastow’s conflict of interest.148 An Andersen partner wrote: “Why would any director in his or her right mind ever approve such a scheme?”149

One might also ask how in its right mind could Andersen be both an inside and an outside auditor? Yet, Andersen, and other Big 5 accounting firms, sold this arrangement to companies, including Enron.150 One also might ask how in its right mind could Vinson & Elkins review transactions in which it had been engaged?151

This Part suggests an answer to these questions based on organizational redesign. Its argument is that redesigned organizations have a different basic understanding of conflicts of interest. Conflicts are understood to emerge not from loyalties to self, but to other organizations.

In the redesigned corporation, self-interest creates dynamism, not a conflict of interest. High-powered incentives supposedly align the individual with the company. Bonuses for successful projects often are exorbitant in dollar terms, but are aligned with the gains to be realized. The redesigned company presumes conflicts between self and corporate interests.

The excessive compensation that Fastow received from the SPEs did not concern the Board. Although Fastow took more, the Board was apparently content that, from LJM1, Fastow would receive a twenty-five percent return on his invested capital and fifty percent of asset appreciations (except for that in Enron stock).152 The conflict between Fastow’s self-interest

147 ENRON’S COLLAPSE, supra note 2, at 24.
148 POWERS REPORT, supra note 9, at 84-5.
149 See ENRON’S COLLAPSE, supra note 2, at 25 (citing Andersen’s Exhibit no. 763).
150 See id. at 57-58 (discussing Enron & Andersen).
151 Vinson & Elkins apparently saw no conflict in using its client relation partner for Enron as one of the two investigators. POWERS REPORT, supra note 9, at 173. Even if this partner had not been involved in designing the deal, he was involved in selling other V&E lawyers to Enron. For a discussion of the emergence of client relationship partners in law firms, see Rosen, supra note 22, at 672-75; Coffee, supra note 18, at 1411-12, 1415.
152 POWERS REPORT, supra note 9, at 69 n.24. Similarly, Enron’s Board did not see a conflict of interest being created by the Board compensating outside directors through “stock and option packages, worth more than $80,000 in the year 2000.” Leo E. Strine, Jr., Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle, 57 BUS. L.J. 1371, 1378 n.24 (2002).
and Enron’s interest was understood by the Board as a problem of public relations, not substance.\textsuperscript{153}

In the redesigned corporation, a conflict of interest is created by loyalty to a company not within the corporation’s porous borders. The managerial conflict of interest problem, in the redesigned company, is to manipulate the self-interest of its employees and guest workers so that they are unlikely to act on their loyalties to other organizations, such as the SPEs, Andersen, and Vinson & Elkins.

Enron’s basic business strategy exemplifies this understanding of conflicts of interest. In its trading operations, for example, Enron’s counterparty “was simultaneously a customer, supplier, and competitor.”\textsuperscript{154} This arrangement is made possible by assuming self-interest and manipulating it by breaking down borders between companies. It was understood as sufficient to avoid conflicts of interest to ensure that none of these parties competed on trades with Enron.

With respect to transactions with the SPEs, as with respect to the work of Andersen and Vinson & Elkins, Enron did not understand them as cross-border transactions. The Board trusted its executives to make sure that Enron’s interests were advanced in transactions with such self-interested organizations. For example, the Board was told that LJM1 was an “Investment Management Company.”\textsuperscript{155} Enron’s conflicts of interest solution, not its conflicts problem, was to use Fastow’s self interest as fund manager and Enron stock holder to advance Enron’s interests.

The Subcommittee criticized the Board because it “relied on Enron management to develop and implement the day-to-day controls needed to monitor LJM.”\textsuperscript{156} It also criticized the Board for not taking swift action when proper controls were over a year behind schedule.\textsuperscript{157} In so doing, it presumed a hierarchical method of control on which the redesigned organization does not primarily rely. It also presumes that the self interest of LJM needed to be directly, not indirectly or covertly,\textsuperscript{158} controlled.

Similarly, the Subcommittee does not understand the redesigned corporation’s understanding of conflicts of interest when it finds that “No Board member expressed any concern that Andersen [as external auditor] might be auditing its own work [as internal auditors], or that Andersen auditors might be reluctant to criticize Andersen consultants for the LJM or Raptor structures that Andersen had been paid millions of dollars to help de-

\textsuperscript{153} POWERS REPORT, supra note 9, at 151-52.
\textsuperscript{154} BODILY & BRUNER, supra note 8, at 51.
\textsuperscript{155} ENRON’S COLLAPSE, supra note 2, at 26 n.63.
\textsuperscript{156} Id. at 29.
\textsuperscript{157} Id.
\textsuperscript{158} See supra Part I.
The Subcommittee does not take seriously the Board’s understanding of why this created no conflict. It is incredulous that the Audit Committee, at least, appears to have “taken great comfort in knowing that Andersen was more than Enron’s outside auditor, but also provided Enron with extensive internal auditing and consulting services.”

The Subcommittee does not take seriously that allowing Andersen to be within the company’s borders “on a day-to-day basis . . . was a significant benefit to Enron” and a solution to the conflict of interest it found. Putting a positive spin on it, Andersen’s place on the innovating project teams gave assurances that accounting (tax and compliance) risks were noticed and managed early. Less positively, bringing Andersen within Enron’s borders allowed Enron to manipulate Andersen professionals to favor their own interests and Enron’s interests. Making Andersen employees Enron guest workers “help[ed] the company design its most complex structures from the start.”

For those structures that failed, Andersen employees’ independence from Enron might have been a preferable alternative. But for those structures whose innovations did indeed add value to Enron, bringing Andersen employees within the company may have advanced the freedom and energized the zeal on which redesigned companies rely.

As a normative matter, the Subcommittee may be right that Enron should never have approved the conflicts of interest that it did. As a practical matter, the conflicts the Subcommittee reviewed did not work out for Enron’s benefit. But one ought to be cautious about generalizing from the Enron case. Many, if not most, transactions in which Enron implemented its view of conflicts—divorcing employees from loyalties except to themselves—may have been responsible for Enron’s successes. Most certainly, if the Subcommittee and Powers Reports are right, then they not only judge Enron, but they also negatively judge the strategies of all redesigned corporations.

V. Conclusion

The analysis in this Article differs from most other analyses of Enron because it is not focused on the deceptiveness of Enron’s balance sheets and its improper accounting practices. Rather, it focuses on Enron’s bad business deals. If change is necessary in corporate law, it is not just because of corporate non-compliance, but also because corporations need to protect themselves from entering bad business deals.

159 ENRON’S COLLAPSE, supra note 2, at 57.
160 Id.
161 Id. They were described as “close to Enron management.” Id.
162 Id. at 57.
This Article differentiates itself from other analyses because it interprets Enron's problems as problems of redesigned corporations generally. In focusing on the risk management function, this Article's hope is to raise concerns, not resolve them. If corporations without bureaucracy can be worthy of public trust, their risk management systems need to offer assurances of accountability.

In criticizing corporate law's reliance on the model of an organization as a bureaucracy, this Article is useful as much in criticizing present policy initiatives as in suggesting where to look for alternatives. Consider Sarbanes-Oxley's requirement that executives sign financial statements. What did this accomplish? "Top management is signing off based on reports certified by their immediate subordinates, who are in turn signing off based on reports certified by their subordinates, down the chain of command." Treat the corporation as a bureaucracy and one gets meaningless bureaucratic responses that will not alter the behavior of redesigned corporations.

One way of looking at redesigned corporations is to imagine them in a European context, understanding that they rely on work councils, rather than including employee (including working professional) representatives on their boards. Instead of having officers and directors direct transactions, self-managing teams do. A basic lesson of corporate organizations is that the more reliable corporate internal controls are, the less there is a need for intrusive auditing. The task for redesigned corporations, and the law to the extent it is able, is to govern these work councils by improving internal risk management controls. To do so, risk management groups need to be understood. This Article hopes to begin the process of seeking such understandings.

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