The Enron Collapse – The Aftershocks

William A. Bottiglieri
Iona College

Patrick J. Reville
Iona College

Donald Grunewald
Iona College

The financial collapses of Enron had substantial and far-reaching ramifications throughout the financial investment field, tax compliance professions and the accounting profession. Intense Congressional scrutiny resulted in a new era of transparency in financial reporting, stricter reporting standards as provided in Sarbanes-Oxley and substantial penalties for failure to comply with new financial reporting and tax compliance standards in the Internal Revenue Code.

In late 2001, Enron Corporation, a Texas-based publicly held company, filed for bankruptcy protection. For the several years prior to this filing Enron employed over twenty thousand people and was one of the world's leading utility, paper and communications companies with reported revenues of over one hundred billion dollars in 2000. There had been a series of allegations throughout the 1990's involving Enron and its accounting firm, Arthur Andersen, involving irregular accounting procedures bordering on fraud. These allegations, of course, proved true; the scandal caused the price of Enron shares to drop from over $90 per share to just pennies, and the scandal caused the dissolution of Arthur Andersen which at that time was one of the largest accounting firms in the world.

It was revealed that much of Enron's revenue was the result of transactions with entities which Enron controlled and that many of its debts and losses were not reported in its financial statements. Offshore entities were used which provided Enron's management with the ability to shift losses that the company was suffering. This, of course, made Enron appear more profitable than it actually was and the effect over time was cumulative. In each reporting period management would need to step up its manipulation to continue to create the illusion of profits while in actuality losses were being suffered. Financial reports during this period contained no indication of this serious financial threat or of the on-going accounting irregularities. During this

period the price of Enron stock increased dramatically leading to insider trading and criminal prosecutions which were well publicized.

In the initial and almost immediate response to this monumental financial collapse and underlying fraud, the Sarbanes-Oxley Act was signed into law on July 30, 2002 by President Bush and was approved by the House by a vote of 423 to 3 and by the Senate by a vote of 99 to 0. The Act is generally considered to be the most significant change to Federal securities legislation in the country in over fifty years. The purpose of the Act was to protect investors by improving the reliability of corporate disclosures, and establishing new guidelines for corporate responsibility and auditor independence. The Act also enforced the prohibition on audit firms from providing ancillary services to their clients such as actuarial services, legal consulting or other work unrelated to their audit.

The congressional report underlying the legislation (HR3763, The Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002) was that the Act “will protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws. The bill achieves this goal through increased supervision of accountants that audit public companies, strengthened corporate responsibility, increased transparency of corporate financial statements, and protections for employees access to their retirement accounts”. Alleged abuses at Tyco and Global Crossing LLC also helped increase the public support for the passage of this new Legislation.

The more pertinent compliance obligations contained within Sarbanes-Oxley are the following:

> Corporate responsibility for financial reports – Section 302 of the Act provides certification by members of management that they have reviewed the report, it does not contain any material untrue statements or omissions or are misleading, the officers signing their reports are responsible for internal controls, have evaluated these controls with 90 days prior to signing the report and have reported their findings;
>
> Enhanced financial disclosures – Section 401 of the Act provides that financial statements must include all material off-balance sheet liabilities and transactions;
>
> Corporate and criminal fraud accountability – Section 802 of the Act imposes fines and penalties and/or up to 20 years imprisonment for altering, destroying, mutilating, concealing, falsifying records or documents with the intent to obstruct, impede or influence a legal investigation. Accountants face similar penalties and fines and imprisonment of up to 10 years if they knowingly and willfully violate the requirements to maintain all audit or review work papers for a period of 5 years.

Congress’ reaction to the financial collapse of Enron, followed shortly by those of Tyco and Global Crossing LLC, was almost immediate. Enron had filed its petition in bankruptcy in the Southern District of New York in December, 2001. By July 30, 2002 the Sarbanes-Oxley Act became law and accountants had drawn the attention of Congress. The repercussions of these financial collapses did not stop there however. A year later Congress again directed its attention to accountants and other financial professionals and found another area which it felt required scrutiny and regulation. Their focus here was on abusive tax shelters and the pervasive role of

accountants in connection with these abusive schemes. Congress was about to unleash another salvo against accountants practicing in this area.

THE (FIRST) AFTERSHOCK

"The ethical standards of the legal and accounting profession have been pushed, prodded, bent, and in some cases broken for enormous monetary gain."[1]

And so began the 2003 U.S. Senate hearings investigating the roles of accountants, attorneys, and other financial professionals in abusive tax shelters. The Permanent Subcommittee on Investigations had uncovered how those shelters worked; how they were first structured to avoid scrutiny by the Internal Revenue Service and then marketed to potential investors. The emphasis of the committee's report was unique in that most of the tax shelter products which were investigated were not technically illegal, yet they were found to be ethically questionable in that they demonstrated a deliberate effort on the part of the creators of these shelters to avoid detection and scrutiny by the Internal Revenue Service. Countless Americans, "average working families would bear the brunt of lost (tax) revenues so that a handful of rich lawyers, accountants, and their clients could manipulate legitimate business practices to make a profit."[2]

In the forefront of this discussion was the government's case against KPMG and some of its partners and managers who were accused of developing and promoting tax shelters which deprived the government of tax revenues. The indictment focused on KPMG's strategies in intentionally designing these tax shelters to avoid detection by the IRS. Tax shelters are generally tax-savings devices and can range from tax planning that is allowable and even encouraged under the law to achieve certain social and economic objectives, including, for example, retirement plans such as 401(K) and IRA accounts, to abusive tax shelters such as business arrangements which take advantage of ambiguities or inconsistencies in the tax code by, for example, establishing offshore companies to avoid or evade taxes.

The Senate Hearings

In 2001 the accounting profession had already drawn much attention because of the well known, dishonest and fraudulent business practices conducted by Enron, Global Crossing, Tyco International and other companies. Financial failures, bankruptcies and criminal prosecutions followed, including the indictment of Enron's auditors, Arthur Andersen LLP, which resulted in the dissolution of the firm. Not long after, the President established a corporate fraud task force under the auspices of the Office of the United States Attorney General. At the same time the Internal Revenue Service began investigating tax shelters and targeted the accounting firm of KPMG for its role in structuring and marketing certain abusive tax shelters. The Senate Committee on Governmental Affairs through its Permanent Subcommittee on Investigations then began a similar investigation, and subpoenaed several KPMG partners and former partners to testify.

As indicated by Senator Coleman's opening remarks the firm did not receive a warm welcome. At one point during the proceedings, Senator Carl Levin of Michigan prompted a witness to "try an honest answer"[3]. At this hearing, it was acknowledged that given the complexity of the tax law, the interpretation of the Internal Revenue Service is not legally binding on taxpayers. While it serves to memorialize the government's interpretation of the Code, it is only an opinion and taxpayers have every right to disregard this interpretation provided they have a reasonable basis for doing so. However, as the government's enforcement

agency, the Internal Revenue Service has the right to challenge any interpretation that it does not agree with. Such challenges might ultimately result in a suit that would be settled by a court. Before being able to challenge the interpretation of a taxpayer however, the IRS must first be *aware* of a taxpayer's position. The committee uncovered evidence that certain strategies employed by KPMG in its design of the subject tax shelters were intended to avoid detection by the IRS and further that the accounting firm had knowingly circumvented certain reporting and disclosure requirements which deprived the IRS of the opportunity to challenge them. In addition, while lauding the accounting and legal professions for generally holding themselves up to high ethical standards, it was the clients of these not so forthright professionals who would suffer by placing their trust and confidence in individuals who are not upholding these ethical standards.

Tax Shelters

Tax shelters are generally strategies which permit taxpayers to shelter income from tax by taking advantage of allowable tax deductions or by having their income taxed at lower than ordinary tax rates. Although not generally referred to as such, Individual Retirement Accounts (IRAs) and 401(K) plans which enable individuals to invest pre-tax earnings as part of their pension savings plans, are types of tax shelters. Home ownership can also be viewed as a type of tax shelter because of the allowable deductions for mortgage interest and real estate taxes as well as the tax credits available for certain types of home improvement expenditures such as those using solar energy. Congress encourages these types of activities by providing for the related tax benefits. However, tax savings resulting from innovative tax-planning strategies that wealthy individuals and companies use to take advantage of loopholes in the tax system run counter to Congressional intent.

Section 6662 of the Internal Revenue Code defines a tax shelter as a "partnership or other entity, an investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax". Such shelters include measures aimed at offsetting income from one source with losses from another source, manipulating ordinary income (generally subject to tax rates as high as 35%) to have it treated as capital gains (which are subject to the more favorable 15% rate), or transferring gains offshore in order to minimize taxes. Accounting firms aggressively promoted these types of tax shelters, especially in the 1990s, because of the substantial fees that they generated. These were abusive tax shelters which were created and structured primarily to maximize the amount of deductions for tax purposes, and they cost the government billions of dollars of lost revenues each year. Examples are the BLIPS (Bond-Linked Issue Premium Structure), FLIPS (Foreign Leveraged Investment Programs), and OPIS (Offshore Portfolio Investment Strategy) shelters, which allow wealthy clients with large capital gains to generate substantial ordinary rather than capital losses in order to eliminate or drastically reduce taxable income. For instance, a taxpayer with a BLIP, would borrow money from an offshore bank to invest in foreign currency sold by the same bank. When the value of the currency declines, the taxpayer could then sell the currency back to the bank and claim an ordinary tax loss on the transactions at a time when such a loss would conveniently fit in to the taxpayer's tax plan.

The nature of the tax shelter industry had changed significantly over the recent past. Legal and accounting professionals had formerly been sought for tax planning advice but it seemed that certain professionals were now developing these complex schemes and were marketing these schemes not only to their clients, but also to the general public in mass marketing efforts. These

included a massive telemarketing center maintained by KPMG staff with individuals trained to make cold calls to find buyers for specific tax products.

Evidence at the hearings also disclosed that KPMG refused to follow the advice of some of its own professionals within the firm to register certain of its tax products as tax shelters as required by the Internal Revenue Service. Finally, the hearings uncovered the willingness of many other professionals and institutions such as banks, investment advisory firms and law firms to join in the structuring of these complex financial instruments and tax shelters which added to the illusion of economic substance and added an appearance of legitimacy.

Resulting Legislation

As a result of these hearings, several provisions of the Internal Revenue Code were enacted in an attempt to curtail the attempts at abuse by these tax professionals. Some of these newly enacted provisions were as follows:

- IRC Section 6707A imposes penalties of up to $200,000 for failure to disclose certain elements of tax shelter activity on related tax returns; this penalty would be subject to administrative review but not judicial review. In addition, if the penalty is imposed on an entity which is required to file reports with the SEC, the fact that a penalty was imposed would have to be reported to that agency;
- IRC 6662A imposes accuracy-related penalties of up to 30% of the understatement of tax relating to a tax shelter investment;
- IRC 7525 eliminates the common law protection of confidentiality privileges for any communications relating to the promotion of participation in tax shelters;
- IRC 6111, as amended, creates a new designation, referred to as a "material advisor", for those who provide assistance or advice in organizing, promoting, selling or carrying out any reportable tax shelter transaction and imposes disclosure requirements regarding these transactions; and
- IRC 6112, as amended, requires material advisors to maintain advisee/client lists available for inspection by the government.

THE (SECOND) AFTERSHOCK

Government Misconduct in the KPMG Case

Shortly after the spate of financial reporting deficiencies which contributed to the collapse of Enron and other public corporations in 2001 and the congressional hearings which followed, KPMG was involved in a related suit in which several of its partners and former partners were indicted for alleged violations of Internal Revenue Code provisions regarding tax shelters[4]. The defendants moved to dismiss the indictment on the grounds that both their Fifth Amendment constitutional right to a fair trial and their Sixth Amendment constitutional right to counsel were violated. The central theme of these alleged constitutional violations was the misconduct of the government in exerting influence over the KPMG firm to cut off funds it would have made available to these defendants to pay for their legal defense of this action. The government's position was that in certain cases the payment of legal fees by a company whose employees were charged with a crime would be indicative of an obstruction scheme, and would prevent these firms from cooperating with the government. It was alleged by these individual defendants that the government's action effectively cut off their right to the counsel of their choosing and thus would prevent them from receiving a fair trial.

Several of the defendants in this action had previously testified before the Congressional hearings and the IRS proceedings concerning tax shelters. The defendants who were still active partners at KPMG were asked to leave the firm and were granted very generous severance packages, including being promised indemnification against any legal costs incurred by reason of this pending action. This had been a longstanding practice of KPMG and, in fact, many companies followed this policy of reimbursing an employee for legal expenses incurred in connection with their employment.

In pre-trial discussions, the government negotiated with counsel for KPMG. The firm, although not a defendant, retained counsel in an attempt to negotiate a favorable settlement of the entire matter and avoid being indicted itself. During these negotiations the prosecution indicated that the government might view the payment by KPMG of employee legal fees as rewarding misconduct[5]. The message delivered, and clearly understood by KPMG, was that its adherence to its longstanding practice of paying employee legal defense fees might hurt it in its position regarding the government's decision to possibly indict the firm. The court's view of this not so subliminal message was not favorable, to say the least. It found that although government representatives "did not say in so many words that it did not want KPMG to pay legal fees, no one at the meeting could have failed to draw that conclusion"[6].

Further along in these negotiations, KPMG relented to this government pressure and made the decision to abandon its longstanding practice of reimbursing employees' legal defense fees. Its newly adopted position was that it did not see that it had any binding legal obligation to pay these fees. Ultimately, an agreement that was reached between KPMG and the government, which in and of itself revealed government influence over the defense side. The agreement was that it would put a limit on legal fees and would condition the payment of legal fees for any given employee on that employee cooperating fully with the government in its investigation. One indication of the effect of the government's influence on KPMG and, indirectly, on the defendants' ability to mount a defense, was a statement by counsel for KPMG to the attorney for one of the employee-defendants. KPMG would pay the defendant's legal fees so long as the defendant cooperated with the government and did not, for example, invoke her privilege against self-incrimination under the Fifth Amendment by refusing to testify[7]. The government's influence on the defendants' ability to retain counsel was thus very clear and the court did not like it.

The agreement between KPMG and its employees who were subject to investigation was that unless the employees cooperated with the government in a prompt and truthful manner, legal fees would cease immediately. They would also terminate if an indictment were in fact issued against an individual. The government took full advantage of its controlling position and repeatedly notified KPMG counsel when any of its personnel failed to comply with government demands. This notification resulted in counsel for KPMG reminding the attorney for the non-compliant employee that payment of legal fees would be terminated unless the employee cooperated with the government in its investigation. KPMG did not make any effort to hide its motivation in cooperating with, and in fact being controlled by, the government; its only real concern was avoiding an indictment against the firm even at the cost of pressuring its employees to cooperate, sometimes against their own personal interests[8].

Ultimately KPMG benefited from assisting and cooperating with the government. In August 2005, KPMG and the government entered into a Deferred Prosecution Agreement under which it agreed to admit wrongdoing, pay a substantial fine, and accept an indictment on one charge, which would later be dismissed. KMPG thus avoided criminal conviction.

In making its determination in dismissing the indictments against the affected KPMG employees, the court thoroughly reviewed many of the notes of meetings and discussions among the government, KPMG counsel, and counsel for various defendants. Its conclusions were easy to reach. Threats were inherent in the government's relationship with all parties concerned. It wielded significant power in its ability to indict KPMG and used this power to affect the legal representation which *might* be available to KPMG's employees and former employees. In other words, it stacked the deck against these defendants. The government's actions subverted the defendants' right to be represented by an attorney of their own choosing free of any government regulation or threats, and unfettered by any restrictions imposed by its adversary. "In short, fairness in a criminal proceeding requires that the defendant be firmly in the driver's seat, and that the prosecution not be a backseat driver"[9]. The government's action here deprived the defendants of due process in denying them their fundamental right to protection of liberty and justice.

The court further found that there was more than a mere procedural error in this case, which might or might not affect the outcome of the proceeding. The acts committed by the government here were so pervasive that they were considered structural defects in that the defendants were constructively denied counsel for the entire proceeding. The court thus found that the entire proceedings were contaminated by the government's conduct and that there was no need to show specific prejudice. The government's interference in these defendants' ability to mount a defense created the appearance of impropriety, which diminished the faith in the fairness of the criminal justice system in general[10].

The court agreed with the defendants' claim that they were denied their rights to choose their own counsel and receive a fair trial, and granted their motion to dismiss the indictment on these grounds. The defendants' motion for monetary sanctions against the government was however denied.

On appeal the appellate court found of the prosecution's conduct that "Their deliberate interference with the defendants' rights was outrageous and shocking in the constitutional sense because it was fundamentally at odds with two of our most basic constitutional values -- the right to counsel and the right to fair criminal proceedings."[11] In affirming the dismissal of the charges, the court stated that it "has reached this conclusion only after pursuing every alternative short of dismissal and only with the greatest reluctance. This indictment charges serious crimes. They should have been decided on the merits as to every defendant…But there are limits on the permissible actions of even the best prosecutors."[12]

Still More

The inquiry into the roles of professionals in the tax shelter industry did not end with the 108th Congressional session. The Senate Committee Report of the 109th session of Congress stated in its introduction:

> The abusive tax shelters investigated by the Subcommittee were complex transactions used by corporations or individuals to obtain substantial tax benefits in a manner never intended by the Federal tax code. While some of these transactions may have complied with the literal language of specific tax provisions, they produced results that were unwarranted, unintended, or inconsistent with the overall structure or underlying policy of the Internal Revenue Code. These transactions had no economic substance or business purpose other than to reduce taxes. Abusive tax shelters can be custom-

> designed for a single user or prepared as a generic tax product sold to multiple clients. The Subcommittee investigation focused on generic abusive tax shelters sold to multiple clients as opposed to a custom-tailored tax strategy sold to a single client.[13]

The committee also reported in its Findings and Recommendations that "…numerous respected members of the American business community were heavily involved in the development, marketing, and implementation of generic tax products whose principal objective was to reduce or eliminate a client's U.S. tax liability. These tax shelters required close collaboration between accounting firms, law firms, investment advisory firms, and banks."[14] The result of this session of Congress was to amend certain of the reporting and penalty provisions enacted by the previous Congressional session.

FINAL SHOCKS

One of the authors of this article served as a public director of a NASDAQ listed public corporation for several years after the passage of Sarbanes-Oxley. Based upon his experience in serving as a public director and the experience of the other authors in working with corporations, it seems that the reforms resulting from the Sarbanes-Oxley Act have quickly changed some procedures and policies in public corporations. In areas such as transparency of financial records and other financial matters including compensation of top executives and conflict of interest policies affecting both corporate boards of directors and employees of the corporation the reforms resulting from this legislation have changed corporate practices. Many persons who have studied this new law believe that these changes will benefit the public, shareholders, employees and other stakeholders in the modern corporation by increasing the reputation of these organizations for integrity and transparency. There are also some disadvantages to this effort to increase transparency and to increase the responsibility of the CEO and the CFO of the corporation by requiring their written personal certification of financial statements of the corporation. To help protect both the CEO and the CFO and the corporation from lawsuits and government regulators, it has been necessary to require corporations and senior executives to use additional services from both lawyers and accountants. This compliance with Sarbanes-Oxley has resulted in significant increase in costs to many corporations in legal and accounting fees. Because of timing requirements for disclosure of financial results for public corporations, pressures on accountants and lawyers to help their clients achieve accurate results and report them quickly have also required both accounting and legal firms them to spend more time on reviewing corporate financial data at higher levels in their firms at extra cost to their clients. These resulting increased costs may be onerous especially to smaller clients.

The apparent success of Sarbanes-Oxley in increasing transparency in for profit corporations has begun to affect other organizations. Public attention is now swinging toward greater scrutiny of non profit organizations such as colleges and universities, large charities and hospitals. There is as yet no federal law or regulation requiring many non profit organizations to provide audited financial statements to the public nor to require the CEO and the CFO to personally certify that their financial statements of the charitable organizations are accurate and complete nor to require public reporting of financial results similar to what Sarbanes-Oxley requires for public for profit corporations.

Despite the reforms provided by Sarbanes-Oxley, scandals continue to occur in both for profit and non profit organizations. The alleged multi-billion dollar Ponzi scandal by Madoff is one example. Because of such additional scandals, it is likely that Congress will try to amend or add to Sarbanes-Oxley in the future.

---

[1] Opening remarks, U.S. Senator Norm Coleman, MN; U.S. TAX SHELTER INDUSTRY: THE ROLE OF ACCOUNTANTS, LAWYERS, AND FINANCIAL PROFESSIONALS; HEARINGS before the PERMANENT SUBCOMMITTEE ON INVESTIGATIONS of the COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE; 108th Congr. 2 (2003)

[2] Id, at 4
[3] Id at 43
[4] US v Jeffrey Stein et al, 435 F supp. 2d 330, US District Court for the Southern District of New York
[5] Id at 29
[6] Id at 32
[7] Id at 33
[8] Id at 44
[9] Id at 71
[10] Id at 118
[11] 495 F. Supp. 2d 390, at 414
[12] 495 F. Supp. 2d 390, at 427
[13] THE ROLE OF PROFESSIONAL FIRMS IN THE U.S. TAX SHELTER INDUSTRY; R E P O R T prepared by the PERMANENT SUBCOMMITTEE ON INVESTIGATIONS of the COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS UNITED STATES SENATE; 109th Congr. 2 (2005)
[14] Id