

*Abstract:* This essay examines what, if anything, differentiates Enron's destructive use of off-balance-sheet special purpose entities, or SPEs, from the trillions of dollars of supposedly "legitimate" securitization and other structured finance transactions that use SPEs. The inquiry is important because the absence of meaningful differences would call all these transactions into question, whereas the presence of meaningful differences may inform regulatory schemes by providing a basis to distinguish which structured finance transactions should be allowed. This essay also introduces the dilemma that some structured finance transactions are so complex that disclosure to investors in the sponsoring company is *necessarily imperfect* – either oversimplifying the transactions, or providing detail and sophistication beyond the level of most investors. The essay argues that the company's investors must rely, to some extent, on the business judgment of management in setting up these structures for the company's benefit.

### ***Essay: Some Thoughts on the Enron Bankruptcy***<sup>1</sup>

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It now appears that Enron engaged in a range of manipulative accounting transactions, devoting much more energy to creative accounting than to making a profit to account for.<sup>3</sup> Its primary motivation was to minimize financial-statement losses and volatility,<sup>4</sup> accelerate profits,<sup>5</sup>

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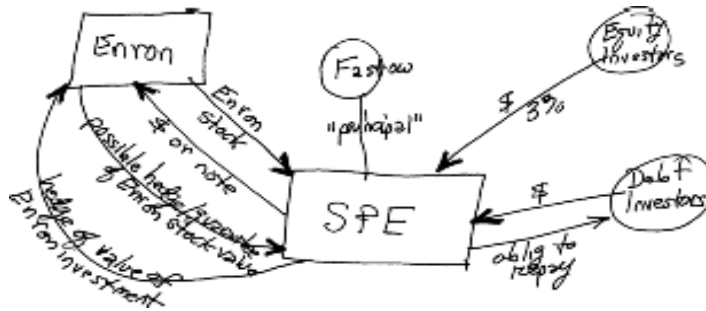
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<sup>3</sup> Cf. James Gordley, *Mere Brilliance: The Recruitment of Law Professors in the United States*, 41 AM. J. COMP. L. 367, 374 (1993) (criticizing the time away from research spent by law professors in evaluating appointments candidates, Prof. Gordley caustically observed, "No loyal and hardworking management bankrupts a company by putting more effort into accounting than into making profits to account for").

<sup>4</sup> Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. [William C. Powers, Jr., Chair] 4, 68, 78, 97 (Feb. 1, 2002) (the "Powers Report"). According to Professor Jennifer Francis, "the hedge transactions seemed to have been motivated by the volatility of the underlying merchant investment accounts, which under US GAAP [generally accepted accounting principles] must be fair valued each period. The fair valuing process causes the value of the merchant investment (an asset on Enron's books) to go up when the value of the equity in the [investment] goes up, and to go down when the value of the equity in the [investment] goes down. The key is that the change in the fair value of the merchant investment is an unrealized gain/loss that goes to income in the period. Hence, if fair values of these merchant investments swing about, so will Enron's income." E-mail from Jennifer Francis, Associate Professor of Accounting, The Fuqua School of Business, to the author (Apr. 8, 2002) (on file with author).

and avoid adding debt to its balance sheet which could have hurt Enron's credit rating and thereby damaged its credibility in the energy trading business.<sup>6</sup>

A common factor in these manipulations was the use of non-consolidated special purpose entities, or SPEs, to hedge certain Enron investments. In a typical transaction, Enron would transfer its own stock to an SPE in exchange for a note or cash,<sup>7</sup> and also directly or indirectly guarantee the SPE's value.<sup>8</sup> The SPE, in turn, would hedge the value of a particular investment on Enron's balance sheet, using the transferred Enron stock as the principal source of payment.<sup>9</sup>



Because of its historically rising stock price, Enron apparently judged the risk that it would have to pay on its guarantees as remote. But undue reliance on historical price information is, of course, precisely what got Long Term Capital Management into trouble.<sup>10</sup>

When Enron's stock price subsequently fell, the SPE's value also fell, triggering the Enron guarantees; these guarantee payments in turn apparently further reduced Enron stock value, triggering additional guarantees.<sup>11</sup> Where the value of Enron's investment and Enron's stock price simultaneously fell, the SPE would lack sufficient assets to perform its hedge. Moreover, these drops in value,<sup>12</sup> or in some cases the ab initio lack of sufficient SPE third-party equity,<sup>13</sup> caused

<sup>5</sup> *Id.*

<sup>6</sup> Powers Report at 36.

<sup>7</sup> *See, e.g.*, Powers Report at 13.

<sup>8</sup> Powers Report at 36-37.

<sup>9</sup> *See, e.g.*, Powers Report at 13. Although not used in the original "Chewco" SPE transaction, hedging was used in virtually all subsequent SPE transactions. *Id.*

<sup>10</sup> LTCM was engaged in making highly leveraged bets on the historical interest rate spread between risky bonds and US Treasury securities; but it lost these bets when, as a result of the implosion of Russia's financial markets, investors fled high-risk investments for the safety of US Treasuries. Steven Lipin, Matt Murray & Jacob M. Schlesinger, *Bailout Blues: How a Big Hedge Fund Marketed Its Expertise And Shrouded Its Risks*, WALL ST. J., Sep. 25, 1998, at A1.

<sup>11</sup> *Cf.* Powers Report at 125 (noting that Enron unwound the Raptor transactions because, under its guaranties, it would have to "deliver so many shares of its stock to the Raptors that its reported earnings per share would be diluted significantly").

<sup>12</sup> E-mail from Jennifer Francis to the author, *supra* note XX (observing that "[t]he insufficient assets to meet the hedge was also biting into the SPE's equity, causing the SPE to fall below the 3%" requirement").

the SPEs to breach the 3% independent equity requirement for non-consolidation, thereby bringing the SPEs's debt onto Enron's balance sheet.<sup>14</sup>

The "Rhythms" transaction is illustrative. Enron transferred its own stock to an SPE in exchange for a note.<sup>15</sup> The SPE also hedged the risk that Enron's substantial investment in Rhythms NetConnections, an internet service provider, might decline.<sup>16</sup> When the price of the Rhythms stock and the Enron stock simultaneously declined, the SPE could not satisfy its hedging obligation.<sup>17</sup>

These manipulations thrived because of a tangled web of conflicts of interest: senior Enron executives, most notably Andrew Fastow, served as the SPEs' principals, receiving such massive amounts of compensation and returns as to potentially skew their loyalty in favor of the SPEs.<sup>18</sup> These and other senior Enron executives also seemed to have a somewhat casual approach towards compliance with Enron's Code of Conduct.<sup>19</sup> The required Board approval of

<sup>13</sup> See Powers Report at 41-42, 49-50, 52 (observing that the financing structure Enron created for the Chewco SPE was at least 50% short of the required third-party equity need for non-consolidation because a portion of such equity was protected by reserve accounts funded by Enron; and expressing uncertainty whether this "failure to qualify for non-consolidation resulted from bad judgment or negligence, or whether it was caused by Enron employees putting their own economic or personal interests ahead of their obligations to Enron"). See also Powers Report at 83-84 (noting that the Andersen accounting firm admitted that it made an error in computing the outside equity of the SPE in the Rhythms transaction).

<sup>14</sup> In some cases, such as the Raptor transactions, Enron itself decided to unwind the SPE structures (thereby triggering the consolidation) in order to avoid diluting its stock. Powers Report at 125.

<sup>15</sup> Powers Report at 77, 79.

<sup>16</sup> Powers Report at 78, 80.

<sup>17</sup> From an accounting standpoint, if the price of Rhythms shares rose, so would the fair value of Enron's merchant investment in Rhythms; but the fair value of the SPE's hedge (in the form of a put option, which gave Enron the right to require the SPE to purchase the shares of Rhythms stock at \$56/share) would decline because, as Rhythm's price increased, it would become less likely that Enron would want to exercise the put. The fair value gain on the merchant investment and the fair value loss on the put option would offset each other. E-mail from Jennifer Francis to the author, *supra* note XX. The price of Rhythms shares fell, however, and Enron wanted to exercise the put option; but, as noted above, because the value of Enron's shares was also falling, the SPE had insufficient funds to buy the Rhythms shares at the option price.

<sup>18</sup> Powers Report at 41, 60, 77, 102. These Enron executives also may have received financial windfalls in connection with the termination of SPEs. *Id.* at 60-61. For example, the unwinding of the Rhythms transaction (with respect to which "Enron did not seek or obtain a fairness opinion") "resulted in a huge windfall" to that SPE, and thus to the Enron executives associated with it. *Id.* at 89.

<sup>19</sup> Enron's Code of Conduct provided, in relevant part, that no officer or employee should "[o]wn an interest in or participate, directly or indirectly, in the profits of any other entity which does business with ... the Company, unless such ownership has been previously disclosed in writing to the Chairman of the Board and Chief Executive Officer of Enron Corp. and such officer has

these types of conflicts was not always obtained.<sup>20</sup> Moreover, even where approval was obtained, the monitoring required as a condition to approval was not always properly implemented.<sup>21</sup>

These abuses have given rise to a host of troublesome and confusing issues. The central accounting issue, for example, is whether the incestuous hedging substantively transferred economic risk, thereby justifying off-balance sheet financing. The answer isn't always black and white, as the Powers Report sometimes appears to suggest.<sup>22</sup> For example, although that Report states that the "hedging" transactions did not involve substantive transfers of economic risk<sup>23</sup> and thus disputes that the financial accounting was proper,<sup>24</sup> it inconsistently concludes that the hedges merely raise "substantial accounting questions."<sup>25</sup> One might even view Enron's attempt to use the "embedded" value of its own stock, increases in which could not be reflected on its balance sheet under generally accepted accounting principles, as ingenious because the stock *does* create real value for the hedging entities. Indeed, Enron even obtained independent fairness opinions on at least some of these transactions.<sup>26</sup> In perspective, therefore, Enron and its accountants were (in many cases) making exquisitely fine judgment calls – shades of grey that, for accounting, must be rendered as black or white.<sup>27</sup> Although Enron, in retrospect, may have misjudged, the culpability of its actions must be assessed *ex ante*, not *ex post*.

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determined that such interest or participation does not adversely affect the best interests of the Company." Powers Report at 44 n. 8.

<sup>20</sup> Neither Fastow nor other participating Enron employees obtained Board permission for the conflict in the Chewco transaction, for example. Powers Report at 41.

<sup>21</sup> For example, Fastow obtained appropriate permission for his participation as general partner in the LJM SPEs, based on the understanding that transactions between Enron and those SPEs be subject to approval by Enron's Chief Accounting Officer and Chief Risk Officer and also be annually reviewed by Enron's Audit and Compliance Committee. *Id.* at 68-69, 71, 154. These controls, however, if implemented, "did not accomplish their intended purpose." *Id.* at 150.

<sup>22</sup> Although the Powers Report states, at 14, that these "hedging" transactions did not involve substantive transfers of economic risk" and, later at 129, that "[p]roper financial accounting does not permit" such hedges," it perhaps inconsistently observes at 83 that such hedges merely raise "substantial accounting questions."

<sup>23</sup> Powers Report at 14.

<sup>24</sup> *Id.* at 129.

<sup>25</sup> *Id.* at 83.

<sup>26</sup> *See, e.g.*, Powers Report at 79, 81, referring to PriceWaterhouseCoopers fairness opinion (regarding exchange of the Enron shares for the SPE-put and note) on the Rhythms transaction.

<sup>27</sup> For example, a central question was whether Fastow's position as general partner of the SPEs constituted, for accounting purposes, sufficient "control" by Enron to require the SPEs to be consolidated with Enron, even though the SPE partnership agreements permitted the limited partners to remove Fastow as general partner. The Powers Report admits, in these circumstances, that "the criteria for determining control with respect to general partners are subjective [and that there are] substantial questions whether Fastow was in effective control." Powers Report at 75-76. In certain cases, however, Enron's accountants seems to have clearly misinterpreted GAAP accounting. *See* e-mail from Jennifer Francis to the author, *supra* note XX (arguing that, in cases where Enron received a note receivable rather than cash in exchange for transferring its common stock to an SPE, Enron reported the note "as an asset. This had the effect of overstating both assets (because the note receivable should not have been an asset) and equity (because the note

Certainly Enron can, and as we learn more will continue to, teach us many lessons. Because humans are fallible, mistakes are inevitable; and conflicts of interest make them more likely, especially where there are judgment calls. In this context, Enron illustrates that even extensive controls cannot always moderate the effect of these conflicts.<sup>28</sup> Indeed, the Powers Report notes that “a conflict ... that could be managed only through so many controls and procedures should not have been approved in the first place,<sup>29</sup> explaining that

perhaps the most basic reason that controls failed was structural. Most of the controls were based on a model in which Enron’s business units were in full command of transactions and had the time *and* motivation to find the highest price for assets they were selling. In some cases, transactions were consistent with this model, but in many of the transactions the assumptions underlying this model did not apply.<sup>30</sup>

These concerns over conflicts are not limited to Enron; they arguably extend to its accountants, whose auditing judgments allegedly were biased by their lucrative consulting business with Enron.<sup>31</sup> It is therefore a very positive step that accounting firms are now, in response to Enron, beginning to separate their consulting from their auditing businesses.<sup>32</sup> Another lesson is the importance of taking corporate codes of conduct seriously and carefully thinking through their implementation.<sup>33</sup>

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receivable should have been countering the increased common equity they reported). ... To the best of my understanding, this was simply bad accounting. That is, US GAAP has a prescribed accounting treatment for notes receivable received in connection with common stock transactions; there is no ambiguity surrounding the rule”).

<sup>28</sup> As discussed, *supra* note XX, Enron’s controls failed completely.

<sup>29</sup> Powers Report at 156.

<sup>30</sup> Powers Report at 171. I later raise the separate question of whether Enron’s governance, even absent the conflicts, was adequate. *See infra* note XX.

<sup>31</sup> Deborah Solomon, *After Enron, a Push to Limit Accountants to...Accounting*, WALL ST. J., Jan. 25, 2002, at C1 (discussing “concerns that accounting firms have a financial incentive to sign off on overly aggressive accounting practices at companies that simultaneously pay them large sums for nonaudit work”).

<sup>32</sup> In response to Enron, auditing firms PriceWaterhouseCoopers and Deloitte Touche Tohmatsu have both announced plans to separate their auditing and consulting businesses. Rachel Emma Silverman, *Questioning the Books: Deloitte to Separate Consulting Services From Audit Business*, WALL ST. J., Feb. 6, 2002, at A8; Jonathan Weil & Rachel Emma Silverman, *Consulting Unit Of Accountant To Go Public*, WALL ST. J., Jan. 31, 2002, at A3.

<sup>33</sup> Although Enron’s SPE transactions were not necessarily specific to a service economy, the Financial Accounting Standards Board, which promulgates GAAP standards (*see* <http://www.FASB.org>), also might wish to consider using the Enron publicity as a catalyst to critically reexamine these standards, which originated at a time when manufacturing was the corporate paradigm, in light of the fact that financial services is increasingly the paradigm. *Cf.* Wayne S. Upton, Jr., *Business and Financial Reporting Challenges from the New Economy*, [http://www.fasb.org/sr\\_new\\_economy.pdf](http://www.fasb.org/sr_new_economy.pdf) (noting, at 1, that despite assertions that current financial reporting paradigm cannot accurately reflect the modern business world, “there has been little change in financial reporting”). In this context, Professor Francis argues that “the challenge ... for financial accounting standard setting is the pace of innovation in financial instruments and

Enron's potential abuse of SPEs also raises fundamental questions about the legitimacy of the trillions of dollars of non-Enron structured finance transactions, of which securitization transactions constitute the bulk.<sup>34</sup> In a typical securitization transaction, a company transfers rights to payment from income-producing financial assets, such as accounts receivable, loans, or lease rentals, to an SPE, which in turn issues securities to capital market investors and uses the proceeds of the issuance to pay for the financial assets. The investors, who are repaid from collections of the financial assets, buy the securities based on their assessments of the value of the financial assets.<sup>35</sup> What, if anything, differentiates Enron's abuse from these types of transactions? This inquiry is important because the absence of meaningful differences would call all these transactions into question:

The same financial tools used to create asset-backed securities were also used to construct the elaborately camouflaged and booby-trapped partnerships that have been blamed for Enron's collapse. . . . Consequently, whatever courts, regulators, lawmakers, accountants and investors decide about the permissible uses of special-purpose entities could have far-reaching and unintended consequences for Wall Street's highly profitable structured-finance business. And that, in turn, will affect the companies that rely on structured finance to solve legitimate credit and cash-flow problems.<sup>36</sup>

On the other hand, the presence of meaningful differences may inform regulatory schemes, perhaps providing a basis to distinguish structured finance transactions that should be allowed from those that should be restricted.

One difference is that securitization is normally used by a company to obtain lower-cost financing through disintermediation, or removal of intermediaries such as bank lenders between the company and the ultimate source of funds, the capital markets.<sup>37</sup> This avoids the mark-up charged by a middleman of funds, and also enables the company to raise funds cheaply based on

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their application, coupled with the preference (by preparers) for bright line rules as opposed to more subjective guidance"). E-mail from Jennifer Francis to the author, *supra* note XX.

<sup>34</sup> See, e.g., Diana B. Henriques, *The Brick Stood Up Before. But Now?*, N.Y. TIMES, Mar. 10, 2002, at B\_ (referring to SPEs used in securitization transactions as "the most common special-purpose entities"). See also STRUCTURED FINANCE § 1:1, at 1-2 n. 2 (discussing the relationship between structured finance and securitization).

<sup>35</sup> Steven L. Schwarcz, *The Inherent Irrationality of Judgment Proofing*, 52 STANFORD L. REV. 1, 6 (1999). For a more complete analysis of securitization, see Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STANFORD J. L. BUS. & FIN. 133 (1994); STEVEN L. SCHWARCZ, STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION (3d. ed. 2002) (hereinafter "STRUCTURED FINANCE").

<sup>36</sup> Henriques, *The Brick Stood Up Before. But Now?*, *supra* note XX.

<sup>37</sup> The capital markets are "markets where capital funds—debt and equity—are traded. Included are private placement sources of debt and equity as well as organized markets and exchanges." JOHN DOWNES & JORDAN GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS 59 (3d ed. 1991). For an introduction to how the disintermediation is implemented, see STRUCTURED FINANCE § 1:1.

an allocation of risks that are assessed by parties having the most expertise.<sup>38</sup> This is markedly different from mere balance-sheet manipulation.

To the extent securitization is used to keep debt off a company's balance sheet,<sup>39</sup> it superficially resembles Enron's use of SPEs. But there are important differences because securitization, unlike the Enron-SPE transactions, unambiguously transfers risk from the company to the SPE and its investors; and transfer of risk is central to the accounting determination of non-consolidation.<sup>40</sup> In Enron's SPE transactions, it was at least debatable whether risk was shifted on the hedged assets owned by Enron; although Enron had the right to require the SPEs to buy these assets at a pre-determined price should their values fall, that right was precarious because the SPEs were capitalized solely with Enron stock. Thus, when Enron's asset and stock values simultaneously fell, the SPEs were unable to perform their hedges.<sup>41</sup> In contrast, a company originating a securitization transaction transfers actual risk by selling financial assets – including the risk of non-payment or delayed payment associated with such assets – to the SPE.<sup>42</sup>

Another important difference arises from the impact on disclosure of the conflicts of interest that pervaded Enron's SPE structures. Although the *existence* of the SPEs was generally disclosed to Enron's investors,<sup>43</sup> the disclosure was ultimately said to be

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<sup>38</sup> *Cf.* STRUCTURED FINANCE Appendix A: Is Securitization a Zero-Sum Game? (explaining the economic rationale for securitization).

<sup>39</sup> STRUCTURED FINANCE § 1:1, at 1-5 to 1-6 (illustrating the balance sheet impact of securitization).

<sup>40</sup> *Supra* note XX and accompanying text.

<sup>41</sup> *Supra* note XX and accompanying text. The fact that Enron itself guaranteed the value of the Enron stock would not, of course, shift risk away from Enron. Moreover, a fall in Enron's stock value might signal (as indeed occurred) Enron's failing financial condition and consequent inability to perform this guarantee.

<sup>42</sup> *See, e.g.,* Henriques, *The Brick Stood Up Before. But Now?*, *supra* note XX (quoting law firm partner David Eisenberg that "securitization is about transferring risk to others – and Enron only appeared to be doing that, when in reality they were retaining the risk themselves"). In contrast, SPE-investors in securitization transactions evaluate and accept this risk. *Cf.* STRUCTURED FINANCE § 2:1, at 2-1 ("[a]n essential element of securitization is that the receivables being sold consist of a payment stream as to which there is a reasonable predictability of payment"). It should be noted, however, that although securitization deals do shift actual risk, they always require the company originating the deal to retain sufficient first-loss risk on the transferred assets, usually in the form of "overcollateralization," to minimize the investor risk to an investment grade level. *See, e.g.,* Schwarcz, *The Alchemy of Asset Securitization*, *supra* note XX, at 141 (observing that "'overcollateralization' is needed to assure investors ... that they will not suffer losses from delayed collections or defaults" on those assets). I am not suggesting there is anything misleading or inappropriate about the company retaining first-loss risk – it logically follows from the asymmetric information between the company (whose assets are being transferred) and the SPE's investors.

<sup>43</sup> *See* Powers Report at 200-01: "[W]hile it has been widely reported that the related-party transactions connected to Fastow involved 'secret' partnerships and other SPEs, we believe that is not generally the case. ... [T]he fact remains that the LJM partnerships, the Raptor entities, and

inadequate.<sup>44</sup> This inadequacy may have two possible explanations, both stemming from conflicts of interest. One explanation is that the disclosure was intentionally minimized<sup>45</sup> in order to avoid revealing the extent to which Fastow and other top Enron executives were enriching themselves by engaging in non-arm's length deals (through SPEs) detrimental to Enron.<sup>46</sup> To this extent, Enron simply represents fraud.

The other explanation, however, is more fundamental and goes to the heart of Enron's governance (and indeed of corporate governance): Enron's structured finance transactions were so complex that disclosure is *necessarily imperfect* – either oversimplifying the transactions, or providing detail and sophistication beyond the level of an ordinary investor in Enron's securities. Enron's investors therefore must, to some extent, rely on the business judgment of Enron's management in setting up these structures for Enron's benefit. The catch, however, is that such reliance failed in Enron because of the conflict.<sup>47</sup> Indeed, there's evidence that Fastow and the other conflicted Enron executives either overruled or intimidated employees under them who felt the transactions were detrimental to Enron.<sup>48</sup>

This latter explanation may well raise broader issues for structured finance. Although securitization and other legitimate structured finance deals can be disclosed with sufficient depth and detail to adequately inform a sophisticated investor in the *SPE's securities*, such disclosure may sometimes go over the head of an ordinary – or even sophisticated – investor in, for example, *equity securities of the company originating* the structured finance transaction; whereas a lower level of disclosure is likely to oversimplify the transaction. In these cases, as with Enron, ordinary investors must rely on the business judgment of the company's management in setting up the structured

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transactions between Enron and those entities all were disclosed to some extent in Enron's public filings.”

<sup>44</sup> See Powers Report at 197, contending that notwithstanding disclosures of the *existence* of the SPEs to Enron's investors, such disclosures “failed to achieve a fundamental objective: they did not communicate the essence of the transactions in a sufficiently clear fashion to enable a reader of [Enron's] financial statements to understand what was going on.” *Accord id.* at 17, 192.

<sup>45</sup> See Powers Report at 201, contending that the description of the transactions between the SPEs and Enron was minimized.

<sup>46</sup> See *supra* notes XX-XX and accompanying text (describing enrichment of these executives).

<sup>47</sup> Some are using the failure of Enron's board to stem the abuses as a general rallying cry for corporate-governance reform, especially to require increased director diligence. See, e.g., Matthew Benjamin, *Cardboard Board: Too Often, Corporate Directors are Mere Decoration*, U.S.N.&W.REP. 28 (Apr. 8, 2002) (arguing, *id.* at 30, that Enron's board of directors was “typical” in that it was “too often willing to take company management at its word and approve its proposals – however unorthodox – with little or no scrutiny whatsoever”; and also quoting Harvard Business School Professor Jay Lorsch that “the lesson from Enron to bad boards is, you better change”). My essay doesn't examine this issue because it appears to be a widespread problem of boards, even absent conflicts of interest.

<sup>48</sup> Powers Report at 18, 21, 144, 166-67 (discussing allegations that Enron-CFO Fastow, on behalf of the LJM-SPEs, pressured Enron personnel to give favorable terms to such SPEs, even though such terms are not in the best interests of Enron shareholders).

financing transactions for the company's benefit.<sup>49</sup> This reliance requires that management be free of material conflicts of interest stemming from the transactions.<sup>50</sup>

In securitization transactions, management would indeed be expected to be free of material conflicts. These transactions typically involve two SPEs,<sup>51</sup> of which the first is wholly-owned by the company originating the deal<sup>52</sup> and managed by directors – who may include employees of the company originating the transaction.<sup>53</sup> These directors receive compensation of \$5-15,000 per year,<sup>54</sup> hardly a material sum relative to corporate salaries. Even the Powers Report recognizes that it was the magnitude of the conflict that was most problematic in the Enron structured finance transactions.<sup>55</sup> The second SPE in a securitization transaction (*i.e.*, the SPE that issues securities to capital market investors) is typically owned and managed completely independently of the company originating the deal,<sup>56</sup> so conflicts again should not arise.

These distinctions are important because they show that, to the extent Enron is a catalyst for regulatory re-examination of structured financing transactions, the focus should be on preventing the material conflicts of interest that allowed, and indeed encouraged, the Enron abuses to thrive.<sup>57</sup>

Any regulatory re-examination, however, must take a long-term perspective because excessive safeguards can stifle business innovation. Ultimately, the greatest danger of the Enron debacle is our possible overreaction, and consequent over-regulation. It's human nature to

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<sup>49</sup> *But cf.* Henriques, *The Brick Stood Up Before. But Now?*, *supra* note XX, which quotes Prof. Ronald Gilson as emphasizing disclosure: “Companies that want to use complicated structured-financing techniques should be prepared to explain them completely [and] in plain English....” I am questioning, however, whether such disclosure is always practical, and am arguing that, even in cases where it is not, investors should be able to rely on the judgment of management so long as the structured financing creates no material management-conflicts of interest.

<sup>50</sup> In reality, conflicts of interest cannot be entirely eradicated. Corporation law recognizes this and permits transactions in the face of conflicts of interest if decisions are made or ratified by non-conflicted parties. In Delaware, for example, although courts can review the fairness of interested-party transactions, *Oberly v. Kirby*, 592 A.2d 445, 466 (Del. 1991), ratification by independent directors or shareholders reinstates the traditional business judgment rule, under which courts will not undertake to second-guess the expediency of business transactions so authorized. *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997); *Orman v. Cullman*, 2002 WL 416957, at 6 (Del. Ch. 2002).

<sup>51</sup> *See* STRUCTURED FINANCE § 3:2.2 (describing the so-called FINCO, or two-tier structure).

<sup>52</sup> *Id.* at 3-14

<sup>53</sup> *Id.* at 3-3.

<sup>54</sup> These salary figures derive from the author's personal experience.

<sup>55</sup> Powers Report at 148.

<sup>56</sup> *Id.* at 3-15.

<sup>57</sup> Indeed, the Powers Report itself concludes, at 9, that the arrangement under which Fastow participated in the Enron SPEs notwithstanding the conflict of interest was “fundamentally flawed.”

overreact to dramatic events, like air crashes or, in this case, a landmark bankruptcy. Enron does not, however, represent a systemic problem; conflicts of interest can be managed, and the existence of isolated cases of fraud and bad judgment should not, in and of itself, be a basis to change the legal, financial, and accounting infrastructure of business that has – Enron aside – served us so well. To remain competitive in a global economy, we must favor flexibility over rigidity, innovation over consistency – even at the risk of another Enron.