THE PERILS OF DISMISSING ENRON AS "DIFFERENT"

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INTRODUCTION

Prior to its collapse in late 2001, Enron was one of the most admired companies in America. Many commentators—not to mention class action attorneys—have argued that Enron's quick collapse proves that Enron was merely a sham, "a house of cards." The view that "Enron was different" because it was a sham has provided justification for the harsh treatment of its executives and for the aggressive prosecutorial tactics aimed at them. But it is a view that flies in the face of uncontroverted evidence presented at the criminal trial of Ken Lay and Jeff Skilling. At trial, it was undisputed that Enron's wholesale trading business comprising 90% of the company's profits was indeed extremely profitable.[1] The government argued that the profits were derived from speculative trading but did not contest that they were real. The defense also presented compelling evidence that Enron succumbed to a crisis in confidence that drained its otherwise sufficient liquidity in a very short time.[2] Some recent articles have acknowledged that Enron alumni have been very successful pursuing the Enron business model elsewhere.[3] Moreover, scores of outside accountants, lawyers, and investment bankers—not to mention tens and even hundreds of Enron employees and executives—participated in or reviewed most of the conduct at Enron that prosecutors and plaintiffs' attorneys have contended was fraudulent. No matter what one believes about the guilt or innocence of various individuals who have been

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[1] Trial Testimony of Paula Rieker at 4160-4161, *U.S. v. Jeffrey K. Skilling and Kenneth L. Lay* (No. 04-025SS); Trial Testimony of Tim Belden at 5354, *U.S. v. Jeffrey K. Skilling and Kenneth L. Lay* (No. 04-025SS); Trial Testimony of Mark Koenig at 2337-2338, *U.S. v. Jeffrey K. Skilling and Kenneth L. Lay* (No. 04-025SS); Trial Testimony of Ben Glisan at 9897, *U.S. v. Jeffrey K. Skilling and Kenneth L. Lay* (No. 04-025SS). All citations hereinafter to the record, motions, or briefs are to *U.S. v. Jeffrey K. Skilling and Kenneth L. Lay* (No. 04-025SS) unless otherwise indicated.

[2] *See, e.g.,* Trial Testimony of Ben Glisan at 9906-9911, 9935-9942, 9958-9963, 9966-9968 (testifying about numerous analyses, board presentations and other statements indicating sufficient liquidity and about a marked reduction in liquidity, specifically in Enron's commercial paper, beginning sometime in the afternoon of October 23, 2001 or later); Trial Testimony of Mark Koenig at 2440-2441 (testifying as to his belief that Andy Fastow had stated at a meeting of Enron senior management on September 6-7, 2001 that Enron's balance sheet was adequate and there were no liquidity concerns).

[3] Ann Davis, *Trading on the Enron Mystique*, The Wall Street Journal, November 14, 2006, at C1; Kurt Eichenwald, *Enron: Beyond the Verdicts*, Newseek, http://www.msnbc.msn.com/id/16299634/site/newsweek, January 27, 2007.

accused, pleaded guilty, or been convicted in connection with Enron, it strains belief to assert that they were all actually engaged in a Ponzi-like fraud, devoid of any real business purpose or merit. Accordingly, policymakers, judges, lawyers, corporate actors, and advisors dismiss Enron as "different" at the peril of missing important lessons to be learned from Enron's collapse and the subsequent investigation and prosecution of many of its executives.

COMPLEXITY

Enron's extensive use of complex structured finance arrangements ultimately worked to its own detriment. Part of the harm resulted from shortcomings in the design and implementation of certain transactions. But the mere complexity of the transactions was detrimental in itself because of the negative public perception it created. This was so despite the fact that Enron's use of structured finance was widely understood and praised in the financial community and was believed to fully comply with the law and SEC regulations as to financial reporting and public disclosure.[4] Rating agencies such as Standard & Poor's and Moody's were aware of and approved the primary purpose of Enron's use of structured finance, which was to reduce the amount of debt on Enron's balance sheet and thus improve Enron's financial ratios and credit rating.[5] And Enron's independent accountants, Arthur Andersen, reviewed both the accounting and disclosure for complex structured finance vehicles such as the FAS 125 and FAS 140 transactions, prepay commodity transactions, minority interest transactions, share trust transactions, Raptor vehicles, and others that have since been criticized.

Even when a company acts within the law, complexity can be a problem merely because it gives the appearance of impropriety. The board and management of Enron itself recognized this reputational risk as "Wall Street Journal risk,"[6] and Sherron Watkins' famous warning memoranda were concerned more with how the Raptor transactions would look to the "man on the street"[7] than with whether the transactions complied with GAAP. Nonetheless, a highly sophisticated board and management concluded that the benefits of the transactions outweighed the risks, a decision that would come back to haunt them when the Wall Street Journal—relying principally on Enron's own disclosures—published a string of highly critical articles about the self-interested role of Enron's Chief Financial Officer in these transactions. When a company as large and as apparently successful as Enron declares bankruptcy or experiences a significant reversal, the mere appearance of impropriety can be sufficient to convince many people that its management, directors, accountants, lawyers, and other advisors must have committed fraud. A great deal of modern business necessarily involves a high degree of

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[4] *See, e.g.*, Ronald Fink, *Balancing Act, Will a New Accounting Rule Aimed at Off-Balance Sheet Financing Trip up Enron?*, CFO Magazine, June 1999 ("Ronald M. Barone, an analyst for S&P, adds back into Enron's debt anywhere from 10 percent to 15 percent of its loan guarantees, 10 percent to 20 percent or more of its nonrecourse debt, and the present value of its operating leases and syndications. All told, he says, that adds up to roughly another $3 billion in debt obligations, bringing Enron's total to around $10.4 billion. That's a far cry from the additional $10 billion in long-term debt and other liabilities that would be found on Enron's balance sheet if the company were deemed to control all of its unconsolidated subsidiaries."); Russ Banham, *The Finest in Finance, Andrew S. Fastow-Enron Corp., Category: Capital Structure Management, How Enron Financed its Amazing Transformation from Pipelines to Piping Hot,* CFO Magazine, October 1, 1999 ("'[Fastow] has successfully financed billions of dollars in a manner that has held credit quality' says S&P's Barone. 'And that is not an easy thing to do. It is a testament to Andy's focus on cash flow and his ability to think outside the box.'").

[5] Banham, *supra* note 4.

[6] Defendants' Trial Exhibit 37694A at EVE 1384210.

[7] Defense Exhibit 1820.

complexity, for example, where the use of derivative financial instruments is a key part of a company's business. At the same time, reputational risk should be weighed very seriously, particularly when a company's involvement in the financial markets makes it vulnerable to reputational risk. In the words of Ken Lay in October 2001, "Vanilla is just fine."[8] Unfortunately, his words came too late for Enron.

It should also be noted that even normal accounting practices that are not overly complex can be construed as sinister by prosecutors and jurors. For example, prosecutors charged Ken Lay with hiding "embedded losses" because Enron reported its long-lived assets such as international energy projects at book value, and an internal evaluation showed that the liquidation value was billions of dollars below the book value. Undisputed expert accounting testimony made it clear, however, that Enron was required to carry its assets at book value regardless of their liquidation value and that the phrase, "embedded losses," was terminology manufactured by the prosecutor.[9] It is difficult to defend against concerted efforts by prosecutors to criminalize normal corporate activities. Jurors are typically not familiar with accounting and disclosure rules that may often appear confusing or counter-intuitive, and expert witnesses for the defense may be dismissed as paid witnesses, particularly in light of the substantial hourly fees they normally charge. We believe that the courts need to actively monitor and, where appropriate, limit prosecutorial tactics that play on the lack of sophistication of the jury to give sinister overtones to standard corporate practices.[10]

CONFLICTS OF INTEREST

Conflicts of interest similarly should be approached very cautiously even when those conflicts are properly approved and disclosed and appear to be in the company's best interest. One of the primary factors causing investors, lenders, and trading counterparties to lose confidence in Enron in 2001 was negative media attention focused on the involvement of Enron's CFO, Andrew Fastow, in transactions with Enron through the LJM investment funds established by him. Fastow's involvement with the ventures drew significant negative attention despite having been approved by Enron's board of directors, with what they thought were substantial safeguards in place, and having been disclosed in Enron's public financial statements since 1999.[11] Moreover, Fastow's wrongful conduct was more easily hidden and exacerbated by one of the very procedures legal advisors implemented to protect Enron from claims that it controlled the LJM investment funds, the "Chinese wall" intended to prevent certain information from being shared between Enron and the LJM funds. That procedure prevented Enron's board, including Ken Lay, from knowing the amount of Fastow's LJM profits prior to late 2001 when the company was in crisis and it dispensed with the "Chinese wall." Enron's experience

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[8] Government's Trial Exhibit 4397 at 16.

[9] Trial Testimony of Jerry Arnold at 16453-16454.

[10] *Cf. Arthur Andersen LLP v. U.S.*, 544 U.S. 696 (2005) (reversing Arthur Andersen's conviction for obstruction of justice in connection with shredding of Enron documents holding that jury instruction was defective for allowing a jury to render a guilty verdict based on following a standard document retention policy with no finding of intentional wrongdoing). "[T]he jury instructions at issue simply failed to convey the requisite consciousness of wrongdoing. Indeed, it is striking how little culpability the instructions required. For example, the jury was told that, 'even if [petitioner] honestly and sincerely believed that its conduct was lawful, you may find [petitioner] guilty.'" *Id.* at 697.

[11] Trial Testimony of Mark Koenig at 2311-2324.

with the LJM investment funds demonstrates that it is very difficult to implement procedures that prevent abuse of conflicts, particularly conflicts involving senior executives, and even more difficult to contain the reputational risk associated with such conflicts.

INTERNAL INVESTIGATIONS

When Sherron Watkins told Ken Lay she thought he needed to investigate potential problems with Enron's accounting, he promptly provided her materials to Enron's general counsel and asked him to have the matter investigated. The subsequent decision to have Enron's regular outside counsel conduct the initial internal investigation has been heavily criticized. As a result, many companies, when in doubt about a whistleblower complaint, default to a decision to hire outside counsel who is not regular counsel to conduct a very costly and disruptive investigation. The decision to hire such counsel should not be reflexive, but should be weighed carefully, taking into account the gravity of the offense charged and the credibility of the complaint. Nevertheless, it is a fact of life that the choice of regular outside counsel to conduct an internal investigation is likely to be viewed skeptically by the SEC and the Department of Justice. As a result, the safest course today is to use outside counsel who is not regular counsel to investigate serious claims of wrongdoing. Such investigations do not come without a price, however. As noted above, these investigations tend to be long, costly, and disruptive. For example, after the Enron board committee that hired new outside counsel to investigate the Fastow transactions decided to employ another accounting firm to evaluate Andersen's conclusions, Andersen would not sign off on Enron's financial statements until the conclusion of the independent review. That review took three months, and was not concluded until long after Enron had gone into bankruptcy. The resulting delay in issuing certified financial statements, necessary or not, exacerbated the general loss in confidence in the company, and prevented access to the capital markets at a critical time. It was not a step to be taken lightly or prematurely.

Regardless of one's view of the criticism of the initial Watkins investigation, the Enron case teaches that the conduct of an internal investigation will be subject to intensive second-guessing if it fails to uncover wrongdoing that is ultimately discovered. Accordingly, the following critical issues should be addressed when conducting an investigation.

- Structure the Investigation Appropriately

  - Do not under-react or overreact
  - Consult with counsel, including outside counsel where appropriate, before reacting
  - Preserve documents
  - Conduct a thorough and fair investigation at the appropriate level and with the appropriate personnel, including outside counsel who is not regular counsel where appropriate
  - Match the substance and the depth of the investigation to the nature of the whistleblower complaint
  - Avoid positive or negative predetermined results in appearance or actuality
  - Deal appropriately with the accused and the whistleblower

- Establish a Clear and Appropriate Record

  - Appropriately document the investigation

- Obtain findings of fact and recommendations from investigators

n Report any findings of wrongdoing and take appropriate, proportionate remedial action

- Make appropriate public disclosures of material information
- Notify regulatory agencies at the appropriate time
- Decide whether to waive privilege at the government's request
- Evaluate control and reporting procedures
- Evaluate the actions of existing management in an even-handed way
- Evaluate reprimands, sanctions, and termination in a prudent way in light of existing legal authority

PROSECUTION TACTICS

Securities fraud actions may generate multi-track litigation with parallel civil, criminal, and regulatory proceedings. Effectively dealing with such multi-track litigation requires an understanding of the policies and practices of the Department of Justice. This is particularly so in cases like those stemming from Enron's collapse where the defendants were publicly vilified and there was significant pressure on the Department of Justice to obtain convictions.

The Department of Justice has established aggressive policies for the prosecution of white collar criminal cases, some of which have been recently criticized by courts, legislators, commentators, and bar associations. Many of these policies are embodied in Department of Justice memoranda outlining the factors to consider in determining whether a corporation should be indicted. A key factor is whether the corporation is deemed to be "cooperating" with the Department of Justice. These memoranda include the Holder Memorandum promulgated in 1999, the Thompson Memorandum effective January 20, 2003, and most recently, the McNulty Memorandum effective December 12, 2006. The most controversial provisions penalize companies that advance attorneys' fees to "culpable" agents and companies that refuse to waive their attorney-client privilege.

In two opinions in the recent case of *United States v. Stein,* U.S. District Judge Kaplan held that the Department of Justice had violated the Constitution by coercing KPMG to cut off payment of legal fees for suspected employees and by pressuring employees into giving the DOJ one-sided access where the employees waive their Fifth Amendment rights and talk to the government without the benefit of counsel. "[T]he government here coerced KPMG to apply pressure to...individual defendants in order to secure waivers of constitutional rights that the government itself could not obtain. That goes beyond the bounds of appropriate government action."[12] As to attorneys' fees, the court bluntly stated:

> *KPMG refused to pay because the government held the proverbial gun to its head. Had that pressure not been brought to bear, KPMG would have paid these defendants' legal expenses. Those who commit crimes—regardless of whether they*

[12] *U.S. v. Stein*, 440 F. Supp. 2d 315, 333 (S.D.N.Y. 2006).

> *wear white or blue collars—must be brought to justice. The government, however, has let its zeal get in the way of its judgment. It has violated the Constitution it is sworn to defend.*[13]

In so holding, the court delivered a harsh rebuke of aggressive government policies that deprive defendants of a right to a fair trial:

> *As a unanimous Supreme Court wrote long ago, the interest of the government 'in a criminal prosecution is not that it shall win a case, but that justice shall be done.' Justice is not done when the government uses the threat of indictment--a matter of life and death to many companies and therefore a matter that threatens the jobs and security of blameless employees--to coerce companies into depriving their present and even former employees of the means of defending themselves against criminal charges in a court of law. If those whom the government suspects are culpable in fact are guilty, they should pay the price. But the determination of guilt or innocence must be made fairly--not in a proceeding in which the government has obtained an unfair advantage long before the trial even has begun.*[14]

In apparent response to criticism of such policies, the McNulty Memorandum changes some of the policies outlined in the Thompson Memorandum. But these changes appear to elevate form over substance. For example, the McNulty Memorandum provides that if a corporation declines to waive the privilege for certain categories of attorney-client privileged information, prosecutors must not consider this declination against the corporation in making a charging decision. The next sentence goes on to provide, however, that "[p]rosecutors may always favorably consider a corporation's acquiescence to the government's waiver request in determining whether a corporation has cooperated in the government's investigation" (emphasis added).[15] The McNulty Memorandum also instructs prosecutors not to consider a corporation's advancement of attorneys' fees as non-cooperation, but carves out an exception for "extremely rare cases" where the totality of the circumstances show that it was intended to impede a criminal investigation.[16] It expressly notes that prosecutors can still ask about payment of attorneys' fees. They just cannot consider the answer in determining whether a corporation is cooperating.[17] These modifications will not likely change the behavior of targeted corporations because defense counsel will almost always advise companies to take whatever action is likely to please prosecutors to avoid a crippling indictment, whether characterized as gaining a positive or avoiding a negative. Nor are counsel likely to believe that prosecutors will erase from their minds knowledge about advancement of fees when making highly discretionary charging decisions.

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[13] *U.S. v. Stein,* 435 F. Supp. 2d 330, 336 (S.D.N.Y. 2006).

[14] *Id.* at 381-82.

[15] Memorandum from Paul J. McNulty, Deputy Attorney General, on Principles of Federal Prosecution of Business Organizations, to Heads of Department Components, United States Attorneys (December 12, 2006) (available at http://www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf) at 10. The McNulty Memorandum's failure to address the concerns of prominent critics is further evidenced by Senator Arlen Specter's re-introduction of his "Attorney-Client Privilege Protection Act" as Senate Bill 186 following the promulgation of the McNulty Memorandum.

[16] *Id.* at 11 n.3.

[17] *Id.* at 11-12.

The prosecutors of the Enron Task Force in the criminal case against Ken Lay and Jeff Skilling employed aggressive tactics consistent with the approach taken in the Thompson Memorandum. To begin with, the Enron Task Force secured a blanket waiver of the attorney-client privilege from Enron early in the case. The waiver applied to all privileged communications including real-time advice on contemplated business transactions as well as after-the-fact communications with investigative counsel, who represented to executives at the time that their interviews were protected by the attorney-client privilege. The waiver of privilege did not apply to communications after the bankruptcy as the new Enron management that granted the blanket waiver thought enough of the privilege to keep it for their own communications.

Prosecutors also effectively maintained one-sided access to witnesses through a variety of measures. They convinced the trial judge in the parallel civil proceedings to stay depositions sought by defense counsel of witnesses the prosecution planned to call at the criminal trial. Prosecutors also obtained immunity as needed for their witnesses while successfully opposing immunity for witnesses with favorable testimony for the defendants, who were therefore unavailable to testify because they elected to invoke their Fifth Amendment rights. For example, the government was able to prevent David Duncan, lead partner of Arthur Andersen, from testifying for the defense. Mr. Duncan broadly defended Enron's accounting at Arthur Andersen's trial even after pleading guilty to obstruction of justice. While the prosecutors dismissed the charges against Arthur Andersen after the Supreme Court reversed its conviction and allowed Duncan to withdraw his plea agreement, they labeled Duncan as a target so that he would take the Fifth Amendment and not testify on behalf of Lay and Skilling.

Witnesses were also discouraged from talking to defense counsel in the Enron cases or testifying on behalf of defendants for reasons described in a motion filed by defense counsel for Ken Lay and Jeff Skilling.[18] One of the starkest examples was revealed in the testimony of a software engineer in the trial of executives in Enron's broadband division. Larry Ciscon, an important defense witness, testified that twice in the month before his trial testimony the Enron Task Force contacted his lawyer to reiterate that Ciscon was a target of the Enron investigation and might still be indicted. Ciscon testified that he interpreted this "[a]s a warning . . . . [a]s a threat . . . . [t]hat I could be prosecuted."[19]

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[18] Defendants' Joint Motion to Dismiss, or for Alternative Relief, Based on Prosecutorial Misconduct (citing Declarations of Attorneys A-F (submitted in camera and under seal)). It should be noted that prosecutors contested Defendants' assertions and the trial court found no prosecutorial misconduct.

[19] Trial Testimony of Larry Ciscon at 8935-8936, *U.S. v. Joseph Hirko, Kevin Howard, Scott Yeager, Rex Shelby, and Michael Krautz* (No. 03-93-105):

> Q Over the past month or so has the government taken steps to remind you of your status as a target in this investigation?
>
> A Yes.
>
> Q What have they done?
>
> A They've called my lawyer to remind me.
>
> Q More than once?
>
> A Yes.
>
> Q How did you interpret that action?
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> MR. CAMPBELL: Objection, argumentative.
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> THE COURT: Overruled.
>
> A As a warning.

Lawyers for Skilling and Lay also contended that the prosecution chilled potential witnesses from talking to defense counsel and from testifying by claiming over 100 alleged co-conspirators in the indictment against their clients. Since the criminal trial of Lay and Skilling, no indictments have been brought against any of the alleged co-conspirators and the Enron Task Force has been disbanded. By keeping the grand jury in session during the trial and claiming over 100 co-conspirators, the prosecutors undoubtedly understood that any Enron executive who deigned to testify for the defense would hesitate out of fear that he could be next.

Prosecutors made extensive use of the plea bargain system to reward cooperating witnesses for testifying against Ken Lay and Jeff Skilling. Under the standard plea agreement used by prosecutors, a cooperator can be rewarded with a request by the prosecutors that the court reduce the cooperator's sentence, but only if the prosecutors determine that the cooperator has rendered them "substantial assistance" in their case and, in the prosecutors' sole judgment, has told "the truth." The federal sentencing guidelines, if followed by the court, impose a crushing penalty on corporate executives of public companies for going to trial and losing. The guidelines will often produce a sentence in the 20-30 year range. By cooperating, however, a corporate executive can normally keep his sentence under five years. For example, Michael Kopper, an Enron executive who worked closely with Andrew Fastow to steal millions of dollars from Enron through fraudulent schemes, is serving a sentence of three years and one month. Jeff Skilling, on the other hand, who was never charged with stealing any money from Enron, is serving a sentence of 24 years and 4 months. This extraordinary trial penalty creates overwhelming pressure for a targeted executive to make a deal and to give whatever testimony the witness believes will please the prosecution.

Unless the sentencing guidelines are modified to mitigate this severe trial penalty, and other steps are taken to monitor and effectively police the use of plea bargains and other aggressive tactics in white collar cases, prosecutors will continue to aggressively use their leverage over corporate executives to secure plea deals and to shape and limit the evidence presented at trial in a way that maximizes the chances of convicting executives, particularly those targeted by the media, public officials, and the public in high profile cases.

Summary of Lessons for Defending Multi-Track Securities Actions With Civil, Criminal, and Regulatory Proceedings:

- Understand prosecutors' tremendous advantage when evaluating and building your defense.
- As quickly as possible, obtain deposition testimony when available in parallel civil actions, and obtain interviews from potentially favorable and unfavorable witnesses.
- Prepare to expend significant financial resources over the course of a protracted fight when opposing government agencies and plaintiffs' attorneys.

Q A warning of what?

A That -- okay. Rephrase it. As a threat.

Q A threat?

A That I could be prosecuted. That I could be prosecuted.

- Gauge cooperation with government agencies and waiver of privilege in light of potential civil and criminal actions.
- Carefully consider assertion of Fifth Amendment by client and its impact on civil and regulatory proceedings.

HARDENED JURY PERCEPTIONS

The dominant media message was that Enron was riddled with fraud and that the executives at the top, the "kingpins," had to pay.[20] Once the trial began, the drumbeat continued with a running commentary on the evidence at trial that had a decidedly prosecutorial bent, and with continuing calls for Ken Lay and Jeff Skilling to be convicted.[21] The result was a deeply tainted jury pool with predispositions that were impossible to change, and a trial conducted in a community that had an overwhelming expectation of guilty verdicts.

In any high-profile case following a long period of media coverage, defendants will often find themselves facing a jury pool that has formed strong opinions about their guilt or innocence. This was particularly true in the Enron case where, despite requests for a change of venue, Ken Lay and Jeff Skilling were tried in Houston, Texas. Many in Houston suffered financially from the loss of jobs and business when Enron collapsed and most felt betrayed by the transformation of one of the city's most admirable institutions into a world-wide symbol of corporate fraud. The press coverage was negative toward Lay and Skilling nationwide, but it was particularly harsh in Houston. While there was some objective coverage, the prevailing theme was a presumption of guilt. In the weeks leading up to the trial, when defense attorneys received and began to review the questionnaires returned to the court by potential jurors, it became clear just how poisoned the jury pool had become. At that time, defense

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[20] *See, e.g.,* Bethany McLean, Fortune staff writer and author of "*Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron*," *The Enron Case*, *Charges Against Former Chairman*, July 9, 2004 online chat at 1:00 p.m. E.T. (available at washingtonpost.com) (writing about the criminal case against Ken Lay: "[A] few things are clear. Enron was a fraud, and Ken lay [sic] was the company's CEO for almost all of its history. I think it would be a travesty if he could just proclaim his cluelessness and walk away, leaving junior people to bear the consequences of a culture he created."); *Editorial, Law Catches Up with Ken Lay*, San Francisco Chronicle,http://www.sfgate.com/cgi-bin/article.cgi?f=c/2/2004/07/09/EDGG37I3871.DTL&hw=Law+Catches+Up+With+Ken+Lay&sn=0 &sc=1000, July 9, 2004 ("The sight of Ken Lay in handcuffs sure was a long time coming."); Lorey Steffy, *What of Lay's Claims? Answers Lie in Valhalla,* Houston Chronicle, July 8, 2004 at Business, pg 1 ("Lay's lawyers are among the best in the country. When their smoke screen clears, they may have succeed [sic] in arguing Lay was not guilty by reason of ignorance. We all know better."); Loren Steffy, *Task Force Needs to Refocus After Wishy-Washy Verdict*, Houston Chronicle, July 22, 2005 at Business, pg 1 ("Were the broadband defendants criminals? Not in some cases, according to the jury. In others, it remains an open question. Were they drawn into a larger scheme? Perhaps. In the end, it really doesn't matter. What matters is what comes next. From the beginning, the Enron prosecution has had one true measure of success: Lay and Skilling in a cold steel cage. Now, as it prepares for its defining moment, the task force is left holding a losing hand. When the September hearing rolls around, the task force needs to tuck its pride under its arm and walk away. The real trial, the true measure of justice in the Enron saga, begins in January. Let the small fry swim free if need be. We've got bigger fish in need of frying."); Mary Flood, *Lay Describes Time in Cell, Reveals Hopes for Future*, Houston Chronicle, http://www.chron.com/disp/story.mpl/special/enron/2672127.html, July 10, 2004.

[21] *See, e.g.,* February 27, 2006 Excerpt from Loren Steffy's Commentary on his Houston Chronicle Blog (available at http://blogs.daron.com/lorensteffy/) entitled "Remember the Lies." ("The problem is that Enron executives, including Lay and Skilling, repeatedly misled investors. You can hear that on the conference calls played in court. You can see that in the company's financial statements. You can find that in the way Enron monetized future -- and ultimately non-existent -- revenue as profit. And it's reflected the way Enron executives valued their business."); Anthony Bianco, Special Report/Commentary: *Ken Lay's Audacious Ignorance*, Business Week Online, http://www.businessweek.com/magazine/content/06-06/63970082.htm?chan=search, February 6, 2006.

attorneys filed a renewed motion to transfer venue[22] describing the raw percentages of responses indicating prejudice and negative pre-trial publicity:

- *Over 86%* have heard of or read about Enron-related cases, and *one out of every eight* jurors has chosen to read an Enron-related book or see an Enron-related movie.
- *Exactly 80%* of the jurors, or 224 out of 280, expressed preexisting negative views toward defendants, indicated they had opinions about the perceived role defendants played in Enron's collapse, or expressed anger about what happened to Enron's "victims."
- *60%* have an opinion about the cause of Enron's bankruptcy, and nearly all of these believe Enron was brought down by "greed," "accounting fraud," "lie[s]," "scheming to increase profits," and other "criminal" and "illegal activities" by upper management.
- *Over 40%* openly admit to being "angry" about Enron.
- *Over 40%* either admitted outright that they could not be fair or expressed reservations about whether their preconceived opinions would prevent them from impartially considering the evidence at trial.
- *Over 40%* have an opinion about Lay, and *over one-third* have an opinion about Skilling—virtually all of which are emotionally-charged and hostile.
- Approximately *40%* also said they have an opinion about Lay and Skilling's guilt or innocence, and the open-ended responses overwhelmingly indicate that these jurors believe Lay and Skilling are guilty.

The motion[23] also quoted some of the potential jurors' more hostile responses, which provide a chilling picture of the depth of bias that existed, only a few of which are reproduced here:

- "I believe that the rape of Enron and its [employees] and stock holders could not have happened without their knowledge."
- "They're guilty—criminally and morally."
- "Guilty without any doubt."
- "They are all guilty as sin—come on now."
- "Guilty as hell."
- "Based on news reports they all appear to be guilty of basically a 'Ponzi scheme' and misleading investors and investigators."
- "[Lay is] guilty as sin. Career Enron leader who conveniently looked the other way as his lieutenants bent and broke laws in pursuit of profits and ever greater stock prices."
- "It is a shame that a lot of innocent people worked so long to end up with nothing while the top executives and their families are continuing to [enjoy] the lifestyle of the rich."
- "I find it morally awful that these people are still running loose. I believe this should be a nice short trial, all of them go to jail, and not a country club."
- "[The government] should hang Ken Lay and his underlings."
- "Mr. Lay and Mr. Skilling shouldn't get away with bringing down Enron. Someone needs to be held responsible for the fall of this company."

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[22] Defendants' Renewed Motion for Change of Venue and Related Relief (citations omitted).

[23] *Id.* (citations omitted).

- "[T]hese guys are guilty, they don't even deserve a trial. Let all the people they ruined have at them."

In such an environment, if venue is not moved, defense attorneys are left to try to open jurors' minds with dramatic evidence early in the case that disproves some of the engrained mythology and misperception or casts doubt on the reliability of prosecution witnesses. But even if some jurors are then able to approach the case with an open mind, they are still subject to the tremendous pressure from their fellow jurors and neighbors to return a guilty verdict. Indeed, it is hard to imagine them going home to a peaceful life in their community without having done so. Sadly, defendants and their counsel must seriously evaluate the likelihood of overcoming such bias and community pressure in considering whether to enter a plea bargain rather than proceeding to trial.

PROSECUTION APPEALS TO JURY PREDISPOSITION

The prosecutors effectively tailored their case to take advantage of the jurors' pre-disposition in the trial of Ken Lay and Jeff Skilling. From the opening statement, the prosecutors worked to draw jurors' attention away from the specific charges in the indictment, and to push emotional buttons that reminded the jurors of what they already knew when they entered the box: these men are guilty. For example, throughout the trial, the defense was in the unusual position of having to fight repeated prosecution objections to showing the indictment that they drafted to the jury, so that the jury could see what was actually charged and contrast it with the lack of proof.[24] In another example, although the indictment alleged repeatedly that Ken Lay and Jeff Skilling committed accounting fraud,[25] the prosecution proclaimed in its opening statement "This is a simple case. It is not about accounting."[26]

On the flip side, even though Ken Lay was not charged with insider trading, the government concentrated most of its case against him on his trades in Enron stock. This aspect of the government's case against Mr. Lay also demonstrates how legal conduct may nonetheless be viewed negatively by a jury. The defense showed that Mr. Lay was sufficiently confident in Enron that he kept approximately 90% of his liquid net worth in Enron stock in the years leading up to its collapse in 2001. When his advisors encouraged him to diversify his investments, he refused to sell Enron stock to truly diversify, but rather, posted his Enron stock as collateral to obtain loans that he used to purchase other investments. This had the opposite effect of diversification and increased his overall investment risk. During 2001, as the value of Enron stock that constituted approximately 90% of Mr. Lay's net worth fell, he obtained cash to meet the resulting margin calls by repeatedly drawing down his Enron line of

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[24] *See* United States' Motion to Preclude Use of Indictment in Cross-Examination; Defendants' Opposition to United States' Motion to Preclude Use of Indictment on Cross-Examination; United States' Motion to Preclude Misleading Use of the Indictment in Questioning Defendants; Trial Testimony at 2460-2461, 9796-9798.

[25] *See, e.g.*, Defense Exhibit 22249, Indictment at ¶ 23 ("manipulating accounting standards in order to conceal additional writedowns"), ¶ 26 ("fraudulently circumventing accounting standards applicable to the sale of financial assets in order to conceal the amount of Enron's debt and to create the false appearance of greater earnings and cash flow" and fraudulently circumventing accounting standards applicable to the disclosure and recognition of impairments to goodwill"), ¶ 66 ("LAY described the losses as 'nonrecurring,' that is, a one-time or unusual earnings event. However, as LAY knew, the losses were not properly characterized as non-recurring."), ¶ 67 (Enron's $1.2 billion "reduction in equity resulted not from the termination of the "Raptor" structures, but principally from a huge accounting error by Enron").

[26] Prosecution's Opening Statement at 347.

credit and repaying the line by selling Enron stock back to the company. This procedure indisputably complied with the law and was authorized by his employment contract, which was approved by the Compensation Committee of Enron's board. But under SEC rules, these stock sales to the company were disclosed after the end of the year instead of monthly, as sales on the open market would have been disclosed. There was evidence at trial, including expert testimony, that even taking into account such stock sales, the overall pattern of Mr. Lay's transactions and holdings in Enron stock indicated extreme confidence in Enron and a desire to hold as much Enron stock as possible. That evidence included the overall forced nature of the sales and undisputed evidence that Mr. Lay maintained an overwhelming portion of his net worth in Enron stock all the way into Enron's bankruptcy, taking affirmative steps in 2001 to maintain his concentrated position, including a $10 million debt payment made to prevent further forced sales.[27] Nonetheless, prosecutors juxtaposed the stock sales with examples of extravagant spending and other sources of money from which to pay his margin calls, and urged that they were discretionary sales that proved Mr. Lay knew Enron was in trouble. Prosecutors further contended that Mr. Lay misled employees when he truthfully stated in an employee online discussion that he had recently purchased some Enron stock because he did not also disclose his sales. In support of this theory, they fostered a false impression that Mr. Lay should have provided more complete information about his stock sales in his SEC filings, and that he violated the law and his obligations to Enron when he sold shares back to the company. At the same time, the prosecutors promoted jury prejudice irrelevant to the actual charges by dwelling on Mr. Lay's wealth and lifestyle.

In another example, prosecutors made much of Mr. Lay's decision to cancel Enron's Christmas party in view of its ongoing financial crisis in late 2001. Prosecutors juxtaposed this conduct against Mr. Lay's entirely legal draw down of $1 million on his Enron line of credit in the same time frame, and portrayed this draw as callously taking money away from a cash-starved company—that could not afford a Christmas party—despite the fact that Enron indisputably still had hundreds of millions of dollars in cash at that point. Defendants objected without success to this evidence.

Executives will often be vulnerable to prosecutorial tactics that inflame class prejudice and that mislead the jury into believing that legal conduct is illegal or, at a minimum, ethically questionable. Courts should be vigilant to limit such evidence, particularly in high profile cases where community prejudice is already inflamed.

Counsel for defendants in securities fraud actions with parallel civil and criminal proceedings should also be aware that prosecutors may charge their clients with criminal fraud based on statements that would ordinarily be dismissed in a civil case as non-actionable corporate puffery or cheerleading. Take for example, the indictment allegation that Ken Lay committed fraud when he said that a Brazilian electricity distribution company owned by Enron was "a good asset."[28] This statement is a matter of subjective opinion and can be interpreted multiple ways. Accordingly, in civil cases, such statements are routinely held insufficient to state a claim of securities fraud as a matter of law. In a criminal case, however, where motions to dismiss are rarely granted, it may be left to a jury (often one that is not sophisticated in the nuances of corporate disclosures) to determine whether such an opinion was

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[27] Trial Testimony of Chris Barry at 17145-17171.

[28] Defense Exhibit 22249, Indictment at ¶ 69.

misleading, and therefore, criminal. In criminal cases, courts should be more vigilant, not less, to protect defendants from having to defend lawful activities that may be given a criminal spin by prosecutors.

CONCLUSION

History's view of Enron may evolve from a "house of cards," riddled from top to bottom with fraud, to a valuable and innovative but flawed company brought down by mistakes in judgment and by the fraud of a few. Unfortunately, in highly publicized cases, the easier storyline of corporate greed and guilt at the top takes hold of the public imagination immediately, provoking outrage and cries that the culprits pay. These cases therefore present particular challenges to our justice system to ensure that criminal defendants receive a fair trial. The intensity of the reaction to Enron's collapse does make this case different. But in many fundamental ways, the issues presented by Enron's collapse and the prosecution of Ken Lay and Jeff Skilling are not unique to Enron. The Enron criminal prosecution exposed--to the eyes of these civil trial lawyers--serious flaws in the way in which our criminal justice system deals with complex business cases. We were struck by the disparate protections afforded civil and criminal defendants. In a civil case, unlike a criminal case, defendants have the right to depose witnesses. In civil cases, favorable testimony cannot be secured from witnesses coerced into plea bargains by threatened prosecution and enticed by the prospect of a lower sentence. The opposing party cannot dispose of favorable witnesses for the defense through the expedient of calling them a target, or by sending a message that no one in the corporation is safe from prosecution. The attorney-client privilege is not routinely waived for the benefit of the opposing party. The opposing party does not have the power to cut off the defendant's ability to pay an attorney. In civil cases, fraud allegations undergo careful scrutiny by the court as a threshold matter, taking into account standard corporate practices and nuanced disclosure rules and policies. Due to fundamental differences between our criminal and civil justice systems it may be impossible to make the playing field perfectly level in white collar cases, but it is time to question whether the playing field is tilted so far in favor of the prosecution that, without concerted action by policymakers, judges, and lawyers to right it, it would be foolhardy for any corporate executive of a public company in the United States to trust his fate to a jury trial.

ABOUT THE AUTHORS

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Mr. Collins is a partner at Carrington Coleman in litigation with primary emphasis on securities litigation. He also handles a variety of other business litigation matters.

Mr. Collins handles a variety of major securities matters, including class action lawsuits, shareholder derivative lawsuits, insider trading actions, and securities fraud actions. Mr. Collins has also represented companies and directors and officers sued in class actions brought in connection with mergers or company failures, including recent high profile company failures. He represented Ken Lay in the civil and criminal litigation following Enron's failure, and was a lead trial counsel in his criminal trial. Mr. Collins also has significant experience representing Special Litigation Committees.

As a result of his regular representation of securities firms and brokers, Mr. Collins has developed significant expertise in securities arbitration. He routinely represents firms and brokers in arbitration brought by customers of the firm and in arbitration between brokerage firms and employees. He has also handled a variety of regulatory matters ranging from insider trading investigations to major regulatory actions brought against broker dealers and their supervisory personnel.

Mr. Collins' litigation practice also involves a variety of business disputes, including corporate governance and partnership disputes, real estate litigation, contract cases, non-compete suits, employment disputes, construction litigation, and oil and gas litigation. Among the significant matters he has handled are two complex court battles over governance and taxation involving the Las Colinas development; a high profile non-compete case in the reinsurance industry; and a case closely followed in the oil and gas industry due to its impact on oil and gas recovery in Texas. Mr. Collins has also handled significant arbitration in the real estate, health care, and consumer product fields and has successfully litigated enforcement of international arbitration agreements.

Mr. Collins has been recognized by Texas Monthly magazine as a "Super Lawyer" in business litigation each year since that award began in 2003.

Mr. Collins was admitted to practice in Texas in 1978.

Speeches / Publications

- Speaker, SIA, NASD, and NYSE forums.
- *Enron: A post-verdict panel discussion with the lawyers who tried the case*, Dallas Bar Association, September 27, 2006.
- *Of Enron and the Thompson Memo*, State Bar of Texas Antitrust and Business Litigation Section, November 3, 2006.

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Mr. Cleveland is an associate at Carrington Coleman with primary emphasis on securities litigation. He has represented senior corporate officers and directors in securities cases including multi-track litigation with concurrent class action cases, derivative cases, and SEC and DOJ investigations.

Before entering law practice Mr. Cleveland was a certified public accountant and conducted financial statement audits for a national accounting firm as a senior staff accountant. Mr. Cleveland's accounting background provides an extremely valuable perspective in business litigation and securities cases where it is essential to integrate accounting and SEC disclosure principles and expert testimony into an effective legal defense.

Mr. Cleveland represented Ken Lay in the civil and criminal litigation following Enron's failure, and was a member of Mr. Lay's criminal trial team, cross-examining prosecution witnesses and conducting the direct examination of the defense's accounting expert. He has represented clients in a variety of other securities and general business litigation matters. Mr. Cleveland has been named by Texas Monthly magazine as a "Rising Star" for 2006 and 2007. Mr. Cleveland was admitted to practice in Texas in 1999.