Testimony of

The Honorable Patrick Leahy

February 6, 2002

On November 8, Enron announced that it had overstated earnings over the past four years by $586 million and was responsible for $3 billion in obligations that were never reported to the public. Upon these disclosures, Enron stock fell to $8.41 a share. Less than a month later Enron filed for bankruptcy - the largest corporate bankruptcy ever. Enron's sudden collapse left thousands of Enron investors holding virtually worthless stock, and most Enron employees lost out. Those who profited appear to be the senior officers and directors who cashed out while assuring others that Enron was a solid investment, as well as the professionals from accounting firms, law firms and business consulting firms, who were paid millions to advise Enron on these practices.

How did this happen?

It appears that Enron, with the approval and advice of its accountants, auditors and lawyers, used thousands of off-the-book entities to overstate corporate profits, understate corporate debts and inflate Enron's stock price. Some Enron executives ran these entities, reaped millions of dollars in salary and stock options, and received conflict-of-interest waivers from Enron's Board of Directors.

With the help of these professionals, both inside and outside of Enron, the company wove an elaborate web of corporate deceit. This chart shows just a few of the secret Enron entities used to hide debt, to fake profits and to inflate stocks. Being fanciful was not limited to bookkeeping. Some of this same corporate imagination was unleashed in naming these hidden Enron entities. Some were named after Star Wars films characters- Jedi, Obi-One, Kenobi and Chewco (as in Chewbacca). Some were named after birds and fish - Condor, Egret, Peregrine, Blue Heron, Osprey, Dolphin and Marlin. And some were named, perhaps the most aptly of all, after the Wild West - Rawhide, Ponderosa, Cactus, Mojave and Sundance.

Despite their different names, all these Enron-related entities had one thing in common: They were never honestly disclosed to the investing public. Much about these partnerships is still secret, including who participated in them and who benefitted from these corporate manipulations.

Enron's web of deceit caught more than just its employees. In addition to thousands of Enron employees losing their life savings in the company's 401(k) pension plan, many other investors suffered losses because of sudden collapse of Enron's stock price. Across the nation, pension funds for union members, teachers, government employees and other workers lost more than $1.5 billion from investments in Enron stock. State attorneys general, individual investors and Enron employees have filed private class action lawsuits against Enron executives, Arthur

Andersen and others for securities fraud to recover their losses. The Department of Justice and the SEC are also investigating.

Enron's web has also ensnared our financial markets. Last week and again this week, the Dow Jones index fell hundreds of points as doubts emerged about the trustworthiness of balance sheets for other public companies that may have dabbled in creative financing similar to Enron's. With more than half of Americans' households invested in the stock market today, the integrity of our financial markets is critical to the nation's economy.

During his State of the Union Address, President Bush declared that "corporate America must be made more accountable to employees and shareholders and held to the highest standards of conduct." I agree with the President and hope that this hearing and our work in this Committee and in the Senate can contribute to increasing accountability.

Enron Chairman Kenneth Lay was questioned about the use of off-the-book arrangements during a company e-mail chat on September 26, 2001, and he assured Enron employees that he and Enron's Board of Directors "were convinced both by all of our internal officers as well as our external auditor and counsel that they [the off-the-book arrangements] were legal and totally appropriate."

Mr. Lay's accountability remains to be seen. Having said for weeks that he would testify before the Senate, he abruptly cancelled his appearance on Monday. Except for his part in a carefully orchestrated media campaign, he is not talking. No one has been able to get him to answer questions that test the accuracy of his statements from last fall, just before the fall of Enron. Nor have Mr. Skilling or Mr. Fastow, or several others, yet testified. Tragically, one senior Enron executive has apparently taken his own life.

What we do know is that the actions of Enron's professional advisors raise serious ethical questions for the legal and accounting professions and questions of professional accountability. The actions of Enron and its advisors also raise serious questions about the current legal environment - where auditors and outside counsel enjoy special legal protections forced through Congress in the 1990s. Whether this legal environment serves to encourage lax corporate governance, questionable accounting and undisciplined legal practices is among the questions we explore today.

A 5 to 4 majority decision of the United States Supreme Court gave accountants and lawyers a big break from liability in private securities fraud actions in 1994. Chief Justice Rehnquist and Justices Scalia, Thomas, Kennedy and O'Connor overturned decades of well-settled law that allowed private fraud suits against a person, such as an auditor or attorney, who aids and abets the principal in accomplishing the fraud.

Aiding and abetting liability is especially important in securities fraud cases. First, it provides incentives for accountants and lawyers to police corporate fraud and helps overcome the profit incentive that can otherwise motivate complicity in questionable conduct. Second, as the Enron experience shows all too well, securities fraud schemes are often very complex. The assistance of experts and professionals is necessary to carry out fraud in complicated schemes. Instead of setting up huge financial incentives for these experts to assist in structuring corporate fraud, our

laws must enlist the assistance of these professionals as guardians of the honesty of our corporate financial disclosures. They should be helping stop fraud before it causes harm to the public and undercuts public confidence in the transparency and honesty of our markets.

The Supreme Court was not alone in chipping away at legal protection for investors and creating an environment in which creative accounting can morph into off-the-books maneuvering that is destroying pensions and savings and threatens to cut the heart out of investor confidence. In 1995, Congress passed the Private Securities Litigation Reform Act - over President Clinton's veto. This version of "reform" contributed to the loss of professional discipline and enacted restrictions making it more difficult for the victims of securities fraud to bring civil actions and recover their losses.

This legislation prevents a defrauded investor from using the Racketeer-Influenced and Corrupt Organizations Act (RICO) and its remedies in almost all securities fraud cases. Securities fraud is the only exemption to our civil RICO laws. I recall that Senator Specter and I, along with other members of the committee, voted against the Private Securities Litigation Reform Act when it was on the floor of the Senate and warned that its special legal protections might lead to future financial scandals. Beginning with Enron, the chickens have come home to roost.

In fact, the accounting industry liked the special legal protections in the Private Securities Litigation Reform Act so much that Andersen Worldwide made a trophy out of the conference report by shrinking it and encasing it in plastic. What the law did was shrink the rights and protections of American investors. Well, at least you can't shred it.

There were contributions to this disaster, large and small, from the corporate officers and directors whose actions led to Enron's failure, from the well-paid professionals who helped create and carry out the complicated corporate ruse when they should have been raising concerns, from the regulators who did not protect the public and our public markets, from Congress and from the courts. Now we must contribute to making the Enron situation right and making sure that this does not happen again. This travesty will be compounded if we do not now learn from it and try to prevent it from happening again. Unfortunately, as we were reminded again during the savings and loan failures of the 1980s, without discipline, professionalism, an effective legal structure, and accountability, greed can run rampant, with devastating results. And unfortunately, business failures during a permissive era rarely happen in isolation.
Congress can do more to make sure that our laws help deter corporate fraud and we should help defrauded investors to recoup their losses. In fact, by forcing through special exemptions for securities fraud, accountants and others made Congress a contributor to the Wild West mentality that came to be reflected in Enron's hidden partnerships. The time has come for Congress to re-think and reform our laws in the other direction in order to prevent corporate deceit, to protect investors and to restore full confidence in the capital markets.

I should also comment briefly on the relevance of the Enron bankruptcy to bankruptcy reform legislation that is now in conference between the House and Senate. I recently received a letter from 35 law school professors regarding Section 912 of both the House-passed and Senate-passed bankruptcy reform bills. This section amends the Bankruptcy Code to provide a safe harbor from bankruptcy court review for certain asset-backed securitizations - a type of complex, off-the-books financial transaction. These bankruptcy experts believe that the provision "would

encourage more companies to recast liabilities so that they no longer appear on balance sheets, much to the detriment of the investing public and other creditors of the business." I have asked the Department of Justice for its views on this controversial provision in light of the Enron matter and intend to work with the other conferees to get this matter right.

I am also concerned that Enron executives who made millions of dollars in sweetheart corporate deals could abuse Texas's unlimited bankruptcy homestead exemption by shielding any unjust enrichment from defrauded investors. Last week on national televison, the wife of Enron's former Chairman and former CEO, disclosed that her husband is considering filing for bankruptcy protection. Under Texas law there are no limits on the dollar amount that debtors may plow in their personal residences and then shield from creditors in bankruptcy. The Enron demise underscores the need for Congress to enact a nationwide cap on homestead exemptions, such as the cap that Senator Kohl and Senator Feinstein authored in the Senate-passed bankruptcy reform bill.

Accountability and transparency help our markets work as they should, in ways that benefit investors, employees, consumers and our national economy. The Enron experience has arrived on our doorstep, and our job is to make sure that there are adequate doses of accountability in our legal system to prevent such debacles in the future, and to offer a constructive remedy if there are not.

I look forward to the comments and questions of the Senators participating today and to hearing from our panel of witnesses. I will introduce them after we hear from our distinguished Ranking Republican Member, Senator Hatch.

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