

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is a light blue color. The hourglass is centered on the page.

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*Enron: Selected Securities, Accounting, and Pension Laws
Possibly Implicated in its Collapse*

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Abstract. This report examines some of the federal statutes concerning finance that the Congress and the Executive Branch may focus on in their investigations. It considers three major areas: the federal securities laws, the federal pension laws, and accounting standards.

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Enron: Selected Securities, Accounting, and Pension Laws Possibly Implicated in its Collapse

Summary

On December 2, 2001, Enron Corporation filed the largest corporate bankruptcy in United States history. Both the Congress and the Executive branch have begun investigations into whether Enron may have defrauded investors by deliberately concealing important information about its finances and whether it may have violated federal pension laws. A number of civil suits have also been filed. Major federal financial statutes and policies which Congress and the Executive branch will likely focus on include the federal securities laws, accounting standards, and the federal pension laws.

The prevailing philosophy of the federal securities laws is that reporting companies must disclose all material information to the investing public so that the public will have the necessary information to make investment decisions. In accordance with this philosophy, the two major federal securities statutes, the Securities Act of 1933 and the Securities Exchange Act of 1934, have a number of provisions concerning the registration of securities and information which must be disclosed.

Among the disclosures of publicly traded companies are accounting statements. Since financial information is of little use to investors unless all firms use comparable accounting methods, the securities laws give the Securities and Exchange Commission broad authority to establish standards for financial reporting. The SEC has delegated the task of writing accounting standards to private sector bodies, and since 1973 the Financial Accounting Standards Board has been charged with formulating accounting and financial reporting standards.

Federal pension laws are designed to encourage private sector employers to provide retirement plans for their employees and to regulate the administration of those plans so that the funds in them are used exclusively for the benefit of plan participants and their beneficiaries. The rules are contained in the Employee Retirement Income Security Act and enforced by the Department of Labor and the Internal Revenue Service. Plan fiduciaries who violate these rules may be subject to personal liability under ERISA section 409(a) and/or subject to excise taxes under ERISA section 502 or the Internal Revenue Code's section 4975.

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On December 2, 2001, Enron Corporation filed the largest corporate bankruptcy in United States history. Both the Congress and the Executive branch have begun investigations into whether Enron may have defrauded investors by deliberately concealing important information about its finances and whether it may have violated federal pension laws. Several congressional committees, the Department of Justice, the Securities and Exchange Commission, the Department of Labor, and the Internal Revenue Service have begun separate investigations. In addition, a number of civil suits have been filed against current and former Enron executives and directors and against its accounting firm, Arthur Andersen LLP, by attorneys for Enron employees, investors, and retirees who lost billions of dollars in the Enron collapse. This report takes a brief look at some of the federal statutes concerning finance that the Congress and the Executive branch may focus on in their investigations. The report considers three major areas: the federal securities laws, the federal pension laws, and accounting standards.

Federal Securities Laws

Enron was subject to the major disclosure requirements of the federal securities laws. The prevailing philosophy of these laws is that reporting companies must disclose all material information to the investing public so that the public will have the necessary information to make investment decisions. In accordance with this philosophy, the two major federal securities statutes, the Securities Act of 1933¹ and the Securities Exchange Act of 1934,² have a number of provisions concerning the registration of securities and information which must be disclosed. In addition, every state has disclosure requirements, referred to as blue sky laws.

The Securities Act of 1933 makes it illegal to offer or sell securities³ to the public unless the securities have been registered with the Securities and Exchange Commission (SEC or Commission).⁴ A registration statement becomes effective

¹15 U.S.C. §§ 77a *et seq.*

²15 U.S.C. §§ 78a *et seq.*

³The term “security” is defined very broadly in 15 U.S.C. section 77b(1).

⁴15 U.S.C. § 77e.

twenty days after it is filed with the Commission, unless it is delayed or suspended.⁵ Registration under the 1933 Act covers only the securities actually being offered and only for the purposes of the offering in the registration statement. The registration statement consists of two parts: the prospectus, which must be provided to every purchaser of the securities, and Part II, which contains information and exhibits which do not have to be provided to purchasers but which are available for inspection by the public at the Commission. Section 7 of the 1933 Act,⁶ referring to Schedule A,⁷ sets forth the information which must be contained in the registration statement. This schedule requires a great deal of information, such as the underwriters, the specific type of business, significant shareholders, debt and assets of the company, and opinions as to the legality of the issue. Section 10(a) of the 1933 Act⁸ specifies the information which the prospectus must contain. There are also numerous regulations issued by the Commission which provide further details about the registration process under the 1933 Act.⁹

Certain transactions and securities are exempted from the registration process. The exempted transactions include private placements, intrastate offerings, and small offerings.¹⁰ Among the exempted securities are government securities, bank securities, and short-term commercial paper, all securities for which it is believed that other, adequate means of government regulation exist.¹¹ It does not appear as though Enron Corporation would have been able generally to utilize these exemptions from registration.

The Securities Exchange Act of 1934 is concerned with many different areas, one of which is the ongoing process of disclosure to the investing public through the filing of periodic and updated reports with the Commission.¹² Any issuer which has a class of securities traded on a national securities exchange or has total assets exceeding \$1,000,000 and a class of equity securities with at least 500 shareholders must register under the 1934 Act with the SEC.¹³ Enron fit within these reporting criteria. Every issuer required to register under the 1934 Act must file periodic and other reports with the SEC.¹⁴ Section 12¹⁵ requires the filing of a detailed statement

⁵15 U.S.C. § 77h(a).

⁶15 U.S.C. § 77g.

⁷15 U.S.C. § 77aa.

⁸15 U.S.C. § 77j(a).

⁹*See, e.g.*, 17 C.F.R. Parts 230, 231, and 239.

¹⁰15 U.S.C. § 77d.

¹¹15 U.S.C. § 77c.

¹²15 U.S.C. § 78m.

¹³15 U.S.C. § 78l. As stated earlier, the 1933 Act requires the registration of a particular *offering* of securities. The 1934 Act requires the registration of a *class* of securities.

¹⁴15 U.S.C. §§ 78l, 78m, and 78n.

¹⁵15 U.S.C. § 78l.

about the company when the company first registers under the 1934 Act. Section 13¹⁶ requires a registered company to file annual and quarterly reports with the SEC. These reports must contain essentially all information, financial and otherwise, about the company which the investing public would need in making a decision about whether to invest in the company. Section 14¹⁷ contains information about proxy solicitation. Some exemptions from these reporting requirements are provided.¹⁸ The Commission has issued extensive regulations to specify information which these reports must provide.¹⁹

Failure to disclose material information is actionable. For example, section 18(a) of the Securities Exchange Act²⁰ grants an express private right of action to investors who have been injured by reliance upon material misstatements or omissions of fact in reports which have been filed with the SEC. Section 10(b) of the 1934 Act,²¹ the general antifraud provision, and Rule 10b-5,²² issued by the SEC to carry out the statutory fraud prohibition, provide for a cause of action for injuries which have been caused by omissions, misrepresentations, or manipulations of material facts in statements other than those filed in documents with the SEC.²³

In addition, the Insider Trading Sanctions Act of 1984,²⁴ codified throughout 15 U.S.C. sections 78a *et seq.*, imposes fines of up to three times the profit gained or loss avoided upon anyone who trades stock while in the possession of material nonpublic information. It has been alleged that some of Enron's current and former executives and directors engaged in such trades.

Accounting Standards

Among the disclosures required of publicly traded corporations are accounting statements – balance sheets listing assets and liabilities, and income statements detailing revenues and expenses – which must be certified by an independent auditor. Since financial information is of little use to investors unless all firms use comparable accounting methods, the securities laws give the SEC broad authority to establish standards for financial reporting.

¹⁶15 U.S.C. § 78m.

¹⁷15 U.S.C. § 78n.

¹⁸15 U.S.C. § 78l.

¹⁹*See, e.g.*, 17 C.F.R. Parts, 240, 241, and 249.

²⁰15 U.S.C. § 78r(a).

²¹15 U.S.C. § 78j(b).

²²17 C.F.R. § 240.10b-5.

²³*See, e.g., State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843 (2d Cir. 1981), and *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977).

²⁴P.L. 98-376.

Although it has statutory authority to do so, the SEC (which was created in 1934 by the Securities Exchange Act) has never attempted to write accounting standards itself. Instead it delegates this laborious task to private sector bodies within the accounting profession. Since 1973, the Financial Accounting Standards Board (FASB) has been charged with formulating accounting and financial reporting standards. FASB is supported by membership dues and private donations and is independent of all other business and professional organizations. Its standards are adopted through a procedure similar to that of a federal agency rule-making: a proposed standard is published; hearings may be held; comments are solicited and considered; and the proposal may be revised before it is finally put to a vote of FASB board members. Because there is no way for affected corporations to appeal a FASB standard once it is adopted, the standard-setting process may be contentious and prolonged.

FASB standards are recognized as definitive by the SEC and therefore must be followed by companies that file financial disclosure statements with the SEC. However, SEC reporting and auditing is only part of what accountants do. Other major areas of practice include accounting and bookkeeping services for privately held firms, attest services (including but not limited to auditing), consulting, personal financial planning, and tax services (preparation of tax returns and planning for future tax liabilities). Practitioners in these fields are generally regulated, not at the federal level (although federal tax accountants must of course follow the rules and regulations of the Internal Revenue Service), but by state licensing boards and by a variety of private professional associations.

The most important private accounting organization is the American Institute of Certified Public Accountants (AICPA), which has operated under various names since 1887 and today has over 330,000 members. AICPA members not only must be certified as CPAs by a state board, but must pass an examination, practice in a firm with AICPA-approved performance monitoring programs, participate in continuing education programs, and agree to abide by the AICPA bylaws and code of professional conduct.

The AICPA formulates accounting standards and rules of practice. In the area of SEC accounting, the AICPA defers to FASB, recognizing its standards as definitive. Together, the AICPA and FASB standards are known as generally-accepted accounting principles (GAAP).

The AICPA's structure includes a governing council, with 260 members, a board of directors, which acts as an executive committee to the council, and a joint trial board, which handles disciplinary proceedings against members. In addition, there are 10 senior technical committees and boards, which may issue public statements related to their areas of practice without clearance from the council or board of directors. One of these is the SEC Practice Section Executive Committee (SECPS). In January 1990, AICPA members adopted a bylaw requiring firms auditing one or more SEC clients to belong to SECPS.

The Public Oversight Board (POB), established in 1977 by the AICPA, is an independent private group whose mission is to assure regulators and investors that audited financial statements of publicly traded corporations can be relied upon to

provide an accurate picture of those firms' true financial condition. The POB oversees and reports on the activities of the SECPS.

Accountants in SEC practice, including auditors of public companies, are subject to a variety of disciplinary sanctions from the AICPA, the SECPS, state CPA societies and licensing boards, and the SEC itself. The private accounting bodies, although they do have a self-regulatory role, do not have the same formal relationship to the SEC as do the National Association of Securities Dealers (NASD) and the stock exchanges. These latter institutions are explicitly recognized in the securities statutes as self-regulatory organizations (SROs), and are charged with specific responsibilities and duties to maintain fair and orderly markets. The SEC must approve major changes in NASD or exchange rules, and may impose new rules upon them if it sees fit. No federal agency exercises this degree of control over private accounting organizations.

In practice, accountants and auditors of publicly traded firms are more likely to face private lawsuits than disciplinary proceedings. Under the securities laws, investor plaintiffs may seek damages by attributing their losses to reliance on financial statements that contained either false information or material omissions of fact.

ERISA: Federal Pension Laws

Federal pension laws are designed to encourage private sector employers to provide retirement plans for their employees and to regulate the administration of those plans so that the funds in them are used exclusively for the benefit of plan participants and their beneficiaries. The rules are contained in the Employee Retirement Income Security Act²⁵ and enforced by the Department of Labor and the Internal Revenue Service. The fiduciary and prohibited transaction rules contained in ERISA § 404, et seq. are enforced by the Department of Labor. The prohibited transaction rules contained in Internal Revenue Code § 4975 are enforced by the Internal Revenue Service. The general requirements for a tax-qualified plan are contained in IRC § 401, which refers to numerous other sections of the Code.

Enron appears to have had a number of retirement plans, but the plan in three class action lawsuits²⁶ that were filed in the U.S. District Court for the Southern District of Texas in 2001 is a 401(k) plan, an individual account plan, called the "savings plan." The savings plan permitted the employees to contribute between 1 and 15% of their base pay, and Enron matched their contributions at certain percentage levels with Enron stock. The plan required the Enron stock matching payment to be held until the employees reached age 50. Employees could choose among a number of investments for their own contributions, including Enron stock. Nearly 60% of the savings plan assets consisted of Enron stock.

²⁵P.L. 93-406 (1974), as amended.

²⁶*Tittle v. Enron Corp.*, No. H-01-3913, (11/13/01); *Rinard v. Enron Corp.*, (11/20/01); and *Kemper v. Enron Corp.*, No. H-01-4089(11/26/01).

ERISA requires that the assets of the plan never inure to the benefit of the employer and be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries.²⁷ Plan fiduciaries are required to discharge their duties solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan.²⁸ Fiduciaries are expected to use the “care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matter would use in the conduct of an enterprise of a like character and with like aims.”²⁹ Fiduciaries are supposed to diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.³⁰ Fiduciaries are to follow the plan documents insofar as the documents are consistent with ERISA.³¹

Generally, a retirement plan may not hold more than 10% of its assets in employer stock.³² This requirement does not apply to Employee Stock Ownership Plans; individual account plans, such as 401(k), profit-sharing, stock bonus, thrift, or savings plans; and certain grandfathered plans. The individual account plan exemption does not apply to plans that require elective deferrals of over 1% of an employee’s eligible compensation to be invested in qualifying employer securities at the direction of a person other than the participant. There are numerous exceptions to these rules, many hinging on effective dates. There are a number of prohibited transaction rules in ERISA § 406. These rules seem to be designed to prevent a party in interest from having any dealing with the plan or plan assets. ERISA § 408 provides certain statutory exemptions from the prohibited transaction rules, and provides a procedure whereby a fiduciary may apply for a specific exemption where it is in the interests of the plan and the participants and beneficiaries and provides protection for the rights of the participants and beneficiaries.

A fiduciary who breaches any of the responsibilities imposed upon fiduciaries by ERISA is, under § 409, personally liable to make good to the plan any losses resulting from each such breach.³³ There is an exception to this rule, under ERISA § 404(c), for plans which permit participants or beneficiaries to exercise control over assets in their individual accounts. Participants or the Secretary of Labor may bring a civil action to enforce ERISA § 409; to recover benefits due a beneficiary under the terms of the plan; to enforce rights under the terms of a plan; to enjoin any act or practice which violates any provision of ERISA or the terms of the plan; or to obtain any

²⁷ERISA § 403(c), 29 U.S.C. § 1103(c).

²⁸ERISA § 404(a), 29 U.S.C. § 1104(a).

²⁹ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B).

³⁰ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C).

³¹ERISA § 404(a)(1)(D), 29 U.S.C. § 1104(a)(1)(D).

³²ERISA § 407, 29 U.S.C. § 1107. The 10% restriction and the exemption for individual account plans were in ERISA, as enacted in 1974. The limitation on plans that require over a 1% investment in employer stock, which does not apply to ESOPs, was added in 1997 by P.L. 105-34, § 1524(a).

³³ERISA § 409(a), 29 U.S.C. § 1109(a).

appropriate equitable relief.³⁴ The Secretary can also collect civil penalties equal to 5% of the amount involved where a “party in interest” engages in a prohibited transaction, or 20% of the amount recovered where a fiduciary breaches a fiduciary duty and pays restitution. These penalties are reduced or not imposed if the IRS imposed a similar penalty. The penalties may be waived in certain circumstances.

Internal Revenue Code § 401 et seq. describes the characteristics that tax-qualified retirement plans must have. The term “401(k) plan” derives from the code subsection where the requirements for this particular type of plan are described. With one exception, the relevant Internal Revenue Code provisions are similar to the ERISA provisions described above. Although qualified plans must make it impossible to use any part of the plan trust for purposes other than for the exclusive benefit of employees or their beneficiaries, the Internal Revenue Code does not appear to have a specific diversification requirement limiting (or penalizing) excess investment in employer stock.³⁵ The prohibited transaction rules in IRC § 4975 parallel those in ERISA § 406, but they are enforced through a set of excise taxes on the disqualified persons, with an initial tax of 15% of the amount involved, and a second tax of 100% if the transaction is not corrected or undone. The Internal Revenue Code definition of “disqualified person” is broader than the term “fiduciary” under ERISA § 3(21). A fiduciary is anyone who exercises discretionary authority or discretionary control respecting management or administration of a plan; who exercises and authority or control respecting management or disposition of plan assets; or who renders investment advice for a fee or other compensation. Under IRC § 4975, a disqualified person includes a fiduciary; a person providing services to the plan; an employer whose employees are covered by the plan; an employee organization whose members are covered by the plan; a 50% (or more) owner; family members of the above list, except for family members of the employee organization; and officers, directors, 10% shareholders, and certain highly compensated employees of the employer, employee organization, or controlling shareholder.

³⁴ERISA § 502, 29 U.S.C. § 1132.

³⁵IRC § 401(a)(2), 26 U.S.C. § 401(a)(2).