American Business Law Journal
Volume 44, Issue 4, 571–601, Winter 2007

When Fraud Pays: Executive Self-Dealing and the Failure of Self-Restraint

*Daniel T. Ostas**

I. Introduction

Fraud is a generic term that encompasses the multifarious and often ingenious means by which one individual can gain an advantage over another through deliberate false suggestion, concealment, or misrepresentation of the truth.[1] Fraudulent acts include the submitting of false claims, tampering with scales and measures, false bookkeeping, tax evasion, and intentionally lying in contractual negotiations. In ethical terms, fraud combines deliberate falsehoods with a conscious willingness to prey on the trusting nature and reliance needs of others; hence, fraud carries strong moral disapprobation.[2] In law, fraud constitutes a defense to a breach of contract action, an affirmative cause of action in tort, and a crime.

---

*Professor of Legal Studies and Harlow Chair in Business Ethics, Michael F. Price College of Business, University of Oklahoma; B.S., Purdue University; J.D., Indiana University School of Law; Ph.D. (Business Economics), Indiana University School of Business.

[1] Black's Law Dictionary 685 (8th ed. 2004) (defining fraud as a "knowing misrepresentation of the truth or the concealment of a material fact to induce another to act to his or her detriment").

[2] For a practical discussion of the ethical dimensions of fraud in a common law context, see G. Richard Shell, *When Is It Legal to Lie in Negotiations?* 32 Sloan Mgmt. Rev. 93, 99 (1991) (noting that, if a negotiation seems unethical, it is likely to be illegal as well). *See also* Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 Tex. L. Rev. 375, 409–20 (1999) (offering an ethical analysis of insider trading as a guide to understanding several vagaries incumbent in insider trading law).

© 2007, Copyright the Author
Journal compilation © 2007, Academy of Legal Studies in Business

Although difficult to measure, a significant amount of fraud seemingly touches every American industry and commercial endeavor.[3] The Department of Justice estimates that fraud in the health care industry alone—including such practices as phantom billing, double billing, illegal kickbacks, and the prescription of unneeded medical procedures—amounts to between three and ten percent of total public and private health care expenditures, or as much as $210 billion annually.[4] The annual cost of tax fraud tallies even higher. The Internal Revenue Service (IRS) recently estimated that tax fraud for the year 2001 totaled $290 billion, or more than 13% of all taxes owed.[5] Most of these frauds involved the underreporting of self-employment income and the illegal use of offshore tax shelters.[6] In addition, the recent Enron scandal brought the many forms of "executive fraud,"[7] including fraudulent self-dealing, falsification of financial information, and illegal market manipulations, to the center stage of public awareness. At Enron and elsewhere, corporate executives

---

[3]*See generally* DAVID CALLAHAN, THE CHEATING CULTURE: WHY MORE AMERICANS ARE DOING WRONG TO GET AHEAD (2004) (surveying and discussing fraudulent behavior in a wide variety of settings). Callahan maintains a Web site, www.cheatingculture.com (last visited Feb. 23, 2007), providing information on cheating as an American cultural phenomenon.

[4]*See* U.S. D.O.J. FEDERAL BUREAU OF INVESTIGATION (FBI), FINANCIAL CRIMES REPORT TO THE PUBLIC, C-1 (2005) (noting that health care expenditures totaled more than $2.1 trillion in 2004 and estimating fraud at 10%); *see also* Blue Cross Blue Shield Association Anti Fraud Report at www.bcbs.com/antifraud (last visited Feb. 23, 2007) (estimating health care fraud at about three to five percent of total expenditures).

[5]*See* U.S. GOVT'S ACCOUNTABILITY OFFICE, GAO-05-753, TAX COMPLIANCE: BETTER COMPLIANCE DATA AND LONG-TERM GOALS WOULD SUPPORT A MORE STRATEGIC IRS APPROACH TO REDUCING THE TAX GAP 3 (2005), http://www.gao.gov/new.items/d05753.pdf. The IRS Report took several years to complete and was released in July 2005. It was the first comprehensive government assessment of tax fraud since 1988. *See generally* Robert E. Brown & Mark J. Mazur, *IRS's Comprehensive Approach to Compliance Measurement* 1 (June 2003), http://www.irs.gov/irs-soi/mazur.pdf (discussing the methodology of the study).

[6]*See* Richard Wolf, *Some See Unpaid Taxes as $400B Deficit Miracle Cure*, USA TODAY, Mar. 1, 2006, at A1.

[7]As used herein, the term "executive fraud" is roughly synonymous with the term "corporate fraud" as defined internally within the Department of Justice. These frauds include: (1) falsification of financial information, (2) self-dealing by corporate insiders, (3) abusive trading practices including market and transaction timing schemes, and (4) obstruction of justice with regard to the first three categories. *See* Corp. Fraud Task Force Rep. No. 2, at 3.2 (2004). Because these frauds are perpetrated by high-ranking corporate executives rather than by the corporations themselves, with stockholders typically the victims, the term executive fraud seems apt.

abused their positions of trust to cheat the stockholders who employed them. These scandals eroded investor confidence and contributed to a $1.5 trillion decline in the New York Stock Exchange in the year following the initial public disclosures.[8]

This article examines the causes of fraud in American society, with particular emphasis on frauds committed by corporate executives to cheat their own stockholders. Part II offers a theoretical framework. It begins by exploring the somewhat paradoxical proposition that corporate executives are selfish and interested in their own pecuniary gain but that they are also capable of acting selflessly out of a sense of fiduciary obligation to stockholders. The discussion develops a trade-off between pecuniary self-interest and moral self-restraint that predicts the likelihood of executive self-dealing in any given setting. Part III uses this framework to understand executive fraud. It first focuses on recent Enron court proceedings to examine issues associated with insider trading, financial reporting fraud, and the breach of fiduciary obligations. It then places Enron in a historical context of executive frauds generally. The analysis highlights the importance of moral self-restraint and illustrates the factors that are most likely to generate (or to inhibit) self-restraint in executive settings.

II. Why People Obey (or Disobey) Law

Human motivation and behavior is multifaceted and varied. In some contexts a person may appear ruthlessly self-interested, calculating, and conniving. In other contexts that same person may demonstrate a capacity for totally selfless behavior, apparently sacrificing self gain for the good of others. This complexity of human motivation and behavior suggests that there is more than one reason that a person may obey or disobey the law, including the laws regarding executive fraud. This part of the article examines two sometimes conflicting human motivations: pecuniary self-interest and moral self-restraint. It first examines the notion that corporate executives are solely concerned with maximizing their own pecuniary interests. It then considers the role of self-restraint. This part closes by

---

[8] *See* Klaus Schwab, *Foreword*, *in* Corporate Governance and Capital Flows in a Global Economy ix, ix (Peter K. Cornelius & Bruce Kogut eds. 2003) (providing a foreword to a collection of works addressing the effects of managerial misconduct on world capital flows).

constructing a model that suggests how the motivations of self-interest and self-restraint interact.

A. Pecuniary Self-Interest

Traditional economic analysis assumes that people, including corporate executives, are motivated by pecuniary, or material, self-interest.[9] Hence, according to economic theory, corporate executives are more likely to commit fraudulent acts when it is in their pecuniary interest to do so than when it is not.[10] For example, suppose an executive is considering whether or not to engage in the fraud of insider trading.[11] The executive calculates the potential gains from the illegal behavior and compares those gains to the potential costs associated with criminal and/or civil sanctions and loss of business reputation.[12] When the projected costs exceed the projected benefits the executive has no pecuniary incentive to break the law and legal

[9]*See generally* GARY S. BECKER, THE ECONOMIC APPROACH TO HUMAN BEHAVIOR (1976) (articulating the central neoclassical thesis of rational self-interest and applying it to a variety of human activities). Of course, one does not have to be an economist to recognize that people are motivated, at least in part, by pecuniary incentives. Conversely, the economics discipline has always recognized that people value things other than money. *See generally* GARY S. BECKER, ACCOUNTING FOR TASTES (1996) (exploring the genesis of utility preferences).

[10]The proposition that criminal behavior reflects a rational decision to pursue pleasure and avoid pain can be traced to Jeremy Bentham. *See generally* JEREMY BENTHAM, THEORY OF LEGISLATION (1896). It was not until the 1960s, however, that economists began to systematically explore the economic logic of crime. *See* DAVID J. PYLE, THE ECONOMICS OF CRIME AND LAW ENFORCEMENT 5–6 (1983) (discussing the genesis of the economic approach to understanding criminal behavior). Pyle cites Gary Becker's 1968 article as the "launching pad" for modern economic analyses of crime. *Id.* at 6. *See generally* Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968) (applying a utility-maximizing framework). Since publication of Becker's 1968 article, a large body of both theoretical and empirical work examining the so-called "economics of deterrence" has emerged. Overviews of this literature can be found in the *Encyclopedia of Law and Economics*. *See generally* Erling Elde, *Economics of Criminal Behavior, in* 5 ENCYCLOPEDIA OF LAW AND ECONOMICS 345 (Boudewijn Bouckaert & Gerrit de Geest eds. 2000) (providing an extended bibliography); John R. Lott, Jr., *Corporate Criminal Activity*, *in* 5 ENCYCLOPEDIA OF LAW AND ECONOMICS, *supra*, at 492 (same).

[11]Pursuant to federal securities regulations, particularly the Securities and Exchange Act of 1934, Rule 10b-5, it is a criminal offense for corporate officers, executives, directors, and other insiders to trade securities on the basis of material nonpublic information. *See* 15 U.S.C. § 78j(b) (2005). *See generally* Strudler & Orts, *supra* note 2, at 375 n.3 (citing relevant statutes and regulations).

[12]*See generally* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 242 (5th ed. 1998) (linking crime to a rational calculation that expected benefits will exceed expected costs).

obedience is probably forthcoming. On the other hand, if the executive concludes that fraud pays (perhaps the likelihood of conviction is low), then he or she is more likely to engage in the criminal act.

Although the economic logic of pecuniary self-interest is relatively straightforward (people like money), predicting the effects of illegal behavior can be both complicated and embedded in uncertainty.[13] Consider, for example, the calculations and information necessary for a corporate executive to assess the profitability of an act of insider trading. First, the executive would need to assess the likelihood of detection. Detection depends, in part, on the measures taken to conceal the crime, which in turn have both direct costs and opportunity costs associated with them. Second, the executive would need to predict the consequences of getting caught, including the market effects of a damaged reputation, the direct costs and the opportunity costs of litigation, and the likely outcomes at trial, both civil and criminal. Finally, the executive would need to predict the likely gains from the proposed insider trades. Because the executive would not have all the information necessary to make these calculations with precision, it would be necessary to project dollar values for relevant variables and to assign a range, or variance, to these projections. Some of these projections are likely to be little more than guesses. For example, how would a corporate executive quantify the pecuniary effect on his or her business reputation from being indicted for, but not convicted of, the crime of insider trading?

A growing body of behavioral literature suggests that the rational calculations described above offer only a crude approximation of reality.[14] This literature emphasizes the limitations on the human capacity to cope

---

[13] *See* Pyle, *supra* note 10, at 9–25 (discussing a series of economic models each of which employs an increasingly complex and nuanced decision-making calculus).

[14] The recent growth in behavioral decision theory derives in part from the seminal work of Amos Tversky and Daniel Kahneman. *See generally* Judgment Under Uncertainty: Heuristics and Biases (Daniel Kahneman et al. eds. 1982) (providing a series of classic papers and several surveys of empirical works). Decision theory combines insights from cognitive psychology with techniques drawn from behavioral sciences, including the field of experimental economics. *See generally* Richard H. Thaler, Quasi-Rational Economics (1993) (exploring a series of paradoxes in economic behavior with reference to cognitive science and the techniques of experimental economics). Decision theory has made significant inroads in the legal literature as well. *See, e.g.*, Behavioral Law and Economics (Cass R. Sunstein ed. 2000) (applying behavioral insights to a variety of law and economics topics); Donald C. Langevoort, *Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review*, 51 Vand. L. Rev. 1499, 1500–02 (1998) (surveying the impact of decision theory on legal literature).

with the complexities and uncertainties of life. Drawing on the field of cognitive psychology, recent research provides evidence that people routinely resort to certain heuristics and biases that prevent them from reasoning as one might presume rational people would.[15] For example, facing a complex and uncertain computation, an executive may be over-confident in his or her ability to make accurate judgments, and if it appears that a particular act may be very lucrative, a self-serving bias may take hold and negative information may be subconsciously suppressed.[16] Hence, behavioral insights suggest that in some situations an executive may engage in criminal activity even when a purely rational calculation would dictate restraint.[17] Miscalculations can occur in the other direction as well. For instance, behavioral research shows that people tend to display a conformation bias, in that they seek out and process information in ways that tend to confirm preexisting beliefs.[18] Pursuant to this bias, an executive who is generally inclined to obey financial regulations and who is predisposed to believe that insider trading is highly risky may not

---

[15]Both heuristics (mental shortcuts) and biases (mental tunnels) provide means of coping with what Herbert Simon called "bounded rationality"—people wish to be rational, but they are limited in their ability to process information rationally. *See* HERBERT A. SIMON, ADMINISTRATIVE BEHAVIOR xxiv (2d ed. 1961) (noting that economic actors are "intendedly rational, but only limitedly so"). *See generally* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 44–50 (1985) (combining a behavioral assumption of "opportunism" with Simon's notion of "bounded rationality" to examine the economics of organizations).

[16]The tendency to interpret ambiguous information in a self-serving fashion and to be overconfident in one's own cognitive powers are two, among more than a dozen, cognitive biases and heuristics identified in the behavioral literature and supported by experimental results. *See* Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. REV. 113, 143–80 (2000) (discussing more than a dozen biases and heuristics and providing thorough citation to the behavioral literature); *see also* Donald C. Langevoort, *The Organizational Psychology of Hyper-Competitions: Corporate Irresponsibility and the Lessons of Enron*, 70 GEO. WASH. L. REV. 968 (2002) (identifying overconfidence and a "commitment bias" to continue along a chosen path as two factors leading to managerial crimes in highly competitive cultures); Geraldine Szott Moohr, *An Enron Lesson: The Modest Role of Criminal Law in Preventing Crime*, 55 FLA. L. REV. 937, 958–59 (2003) (suggesting that over-confidence can suppress the ability to perceive risk and can help explain, though not excuse, criminal behavior).

[17]*See* Robert Prentice, *Enron: A Brief Behavioral Autopsy*, 40 AM. BUS. L.J. 417, 427–33 (2003) (explaining decisions made by Enron executives with reference to various cognitive inabilities to calculate accurately); *see also* Christine Jolls et al., *A Behavioral Approach to Law and Economics, in* BEHAVIORAL LAW AND ECONOMICS 13, 45–46 (Cass R. Sunstein ed. 2000) (discussing the "availability heuristic" and "bonded willpower" as factors tending to increase illegal behavior).

[18]*See* Prentice, *supra* note 17, at 145–47.

properly calculate the pecuniary gain available from a particular illegal trade. Here, cognitive limitations may inhibit, rather than foster, illegal behavior.

Notwithstanding the insights offered by the behavioral literature, interesting questions remain whenever a corporate executive does a calculation and becomes convinced that it is in his or her pecuniary self-interest to engage in illegal activity.[19] In other words, an executive does a risk-adjusted cost–benefit analysis and becomes convinced, correctly or incorrectly, that in the given case fraud pays.[20] When this occurs, does the executive break the law or does he or she exercise restraint? It would seem that the answer to this question depends on at least two factors. Most obviously, it would depend on just how profitable the particular fraudulent activity appears to be: the greater the expected return, the more likely the crime. But the decision also would seem to depend on the person's sense of public duty to obey the law in general and commitment to the moral underpinnings of the particular law or regulation in question. It is to this sense of fidelity to law and a corresponding sense of moral self-restraint that the discussion now turns.

B. Moral Self-Restraint

Even casual observation reveals that people do not always break the law just because they believe it is in their pecuniary interest to do so.[21] After all,

---

[19]People do not always calculate; they often behave out of habit without calculating anything. Calculation seems more likely in some contexts than others and may be particularly common in instances of executive fraud. In fact, it would seem unlikely to find instances of executive fraud where a calculation had not been done ex ante. *See* Darryl K. Brown, *Street Crime, Corporate Crime, and the Contingency of Criminal Liability*, 149 U. PA. L. REV. 1295, 1325 (2001) (noting that the deterrence theory of criminal law seems most appropriate in the context of corporate crime); George E. Lynch, *The Role of Criminal Law in Policing Corporate Misconduct*, 60 LAW & CONTEMP. PROBS. 23, 45 (1997) (commenting that calculation is more likely in white-collar settings than in other criminal settings). *See generally* Sally S. Simpson & Nicole Leeper Piquero, *Low Self-Control, Organizational Theory, and Corporate Crime*, 36 LAW & SOC'Y REV. 509, 539–44 (2002) (giving an extensive bibliography of works applying a rational model to white-collar crime).

[20]There is a substantial literature suggesting that various forms of white-collar crimes are underdeterred. *See, e.g.*, Peter Fridirici, *Does Economic Crime Pay in Pennsylvania? The Perception of Leniency in Pennsylvania Offender Sentencing*, 45 VILL. L. REV. 793, 797 (2000) (arguing that a "combination of sparse prosecution and lenient sentencing acts as a double incentive that practically promotes economic crime").

[21]*See* PAUL H. ROBINSON & JOHN M. DARLEY, JUSTICE, LIABILITY, AND BLAME: COMMUNITY VIEWS AND THE CRIMINAL LAW 201 (1995) (noting that "[m]ost people obey the law not because they fear punishment but because they see themselves as persons who want to do the right thing").

people are capable of restraining themselves.[22] Two explanations suggest themselves. First, perhaps people are completely selfish and self-interested, but they value things other than money.[23] For example, a person may feel a sense of shame from blatant criminal activity such as arson and insurance fraud even if his or her guilt were to remain completely undetected.[24] If this is true, then it is in this person's *nonpecuniary* self-interests to obey laws regarding this crime. Alternatively, people may be capable of profound forms of altruism.[25] Perhaps a person has respect for the rule of law in general or a respect for the purposes that underlie the particular law in question.[26] An altruistic person does things for others unmotivated by personal reward. As a practical matter, however, it matters little whether one assumes that people are motivated by nonpecuniary self-interest, by altruism, or by both. Under either assumption, people will sometimes obey the law even when it is in their pecuniary interest to disobey.

Most empirical studies addressing the issue of legal obedience confirm the importance of self-restraint.[27] For example, in an oft-cited work, Tom Tyler reviews and assesses more than thirty empirical studies of

---

[22]The idea of self-restraint is entirely consistent with economic theory; in fact, the idea traces to the stoic tradition embraced by Adam Smith. *See* AMARTYA SEN, ON ETHICS AND ECONOMICS 22–28 (examining Smith's conception of "prudence" and noting that Smith's ideas are commonly mischaracterized). *See generally* ADAM SMITH, THE THEORY OF MORAL SENTIMENTS (D.D. Raphael & A.P. Macfie eds., Liberty Fund 1984) (1790) (articulating a comprehensive theory of human motivation including a thorough discussion of self-restraint and self-imposed limits on pecuniary self-interests).

[23]*See* BECKER, *supra* note 9, at 12 (discounting altruism while simultaneously noting human desires, or "utility preferences," for "respect, recognition, prestige, acceptance and power").

[24]*See generally* ROBERT H. FRANK, PASSIONS WITHIN REASON: THE STRATEGIC ROLE OF THE EMOTIONS 53 (1988) (noting that emotions such as shame and guilt can alter pecuniary incentives and that people with an aversion to guilt tend not to cheat).

[25]*See* SEN, *supra* note 22, at 15–22 (critiquing and ultimately rejecting the proposition that economic rationality implies the selfish pursuit of self-interest); Amartya Sen, *Rational Fools: A Critique of the Behavioral Foundations of Economic Theory*, 6 PHIL. & PUB. AFF. 317 (1976) (same).

[26]The notion of altruism is consistent with both a deontological ethic that posits social duties and a utilitarian ethic that admonishes people to behave in ways that generate good consequences for others. *See generally* ETHICAL THEORY AND BUSINESS 21–32 (Tom L. Beauchamp & Norman Bowie eds., 4th ed. 1993) (providing an introduction to Kantian and utilitarian philosophies).

[27]*See* Moohr, *supra* note 16, at 961–63 (citing social science research supporting the notion that most people are instinctively law abiding).

legal obedience.[28] Many of these works distinguish between "instrumental" and "normative" motives for obeying law.[29] Instrumental motives correspond to the cost–benefit calculus of deterrence and pecuniary self-interest. The studies show that people obey the law, in part, because they perceive it to be in their economic interests to do so. But the empirical evidence also shows that people obey law for normative reasons, that is, because they believe that obeying the law is the right thing to do.[30] Tyler writes:

> One important and striking finding of the [empirical studies] is the high level of normative commitment found among the public to abiding by the law. People generally feel that law breaking is morally wrong, and that they have a strong obligation to obey laws even if they disagree with them.[31]

A moral duty to obey law has been confirmed by most if not all moral philosophers who have addressed the issue.[32] The duty to obey law has been grounded to the utilitarianism of Bentham and Mill, to the social contract ideas of Locke and Hobbes, and to a "natural duty to support just institutions" associated with the ideas of John Rawls.[33] It seems that in a reasonably just society if one takes the benefits of that society, one owes deference to the legitimate rules of that society.

Empirical studies also demonstrate that businesspeople will temper their drive for pecuniary gain in systematic ways. In particular, the greater the respect for a particular law or regulation a businessperson has, the less likely is the crime.[34] This level of respect, in turn, is likely to vary with reference to the moral content, moral saliency, and moral poignancy of the

---

[28]*See* Tom R. Tyler, Why People Obey the Law 3–4 (1990) (providing a useful bibliography and discussion of empirical works examining the causes of legal obedience/disobedience).

[29]*Id*. at 3.

[30]*Id*.

[31]*Id*. at 64.

[32]*See* The Duty to Obey the Law: Selected Philosophical Readings (William A. Edmundson ed. 1999) (collecting a series of fourteen philosophical writings examining the moral duty to obey law).

[33]*See* M.B.E. Smith, *Is There a Prima Facie Obligation to Obey Law?*, *in* The Duty to Obey Law: Selected Philosophical Readings, *supra* note 32, at 75, 77–93 (discussing each view).

[34]Reviewing the empirical evidence Tom Tyler concludes: "The most important influence on compliance with the law is the person's assessment that following the [particular] law accords with his or her sense of right and wrong; a second factor is the person's feeling of obligation to obey the law [in general] and allegiance to legal authorities." Tyler, *supra* note 28, at 64.

particular law in question.[35] For example, compare an environmental regulation intended to reduce instances of human birth defects with one designed to protect the habitat of migratory birds. It would seem, ceteris paribus, that a businessperson would be more likely to intentionally violate the latter than the former.[36] This is true, at least in part, because a law protecting unborn children has a higher degree of moral saliency than a law protecting birds does.

Laws that appear effective in achieving social ends are also likely to garner more respect than laws that appear misconceived, ineffective, and potentially inane. For example, when comparing a sensible environmental regulation that protects babies to a misguided regulation intended to protect birds, most people are unlikely to intentionally cause human birth defects regardless of how cost effective it might be; respect for bird regulation, by contrast, probably has a price.[37] In short, it seems reasonable to assume that, for any given level of expected pecuniary gain, the stronger the moral underpinnings of the law, as perceived by the businessperson, the less likely the crime.

C. A Hierarchy of Law

Drawing upon the above discussion, Table 1 ranks various business crimes with reference to the degree of moral content, or "moral saliency," as

---

[35]The proposition that law has, or should have, "moral content" reflects a natural law perspective. It is also consistent with most instrumental legal philosophies and certain forms of sociological jurisprudence as well. The former asserts that positive law is an instrument to achieve social (including moral) purposes; the latter views law as a reflection of social mores. Hence, under all three legal philosophies, natural law, instrumentalism, and sociological jurisprudence, law has moral content. *See* Daniel T. Ostas, *Deconstructing Corporate Social Responsibility: Insights from Legal and Economic Theory*, 38 Am. Bus. L.J. 261, 264–77 (2001) (examining a businessperson's legal obligations with reference to several distinct jurisprudential views). It is only under extreme forms of positive formalism that law is essentially denied moral content. *Id.*

[36]*See generally* Tom R. Tyler & John M. Darley, *Building a Law-Abiding Society: Taking Public Views About Morality and the Legitimacy of Legal Authorities into Account When Formulating Substantive Laws*, 28 Hofstra L. Rev. 707 (2000) (noting that people are more willing to obey laws that accord with their personal sense of morality than to obey laws void of moral content).

[37]*See generally* Tom R. Tyler, *Compliance with Intellectual Property Laws: A Psychological Perspective*, 29 N.Y.U. J. Int'l L. & Pol. 219 (1997). Reporting public views on the wrongfulness of violating various intellectual property laws, Tyler notes that "[t]he law can have an important symbolic function if it accords with public views about what is fair, but it loses that power as the formal law diverges from public morality." *Id.* at 226.

Table 1: Perceived Duty to Obey Law

Crime	*Moral Saliency*
Murder for Profit	10
Arson and Insurance Fraud	9
Environmental Regulation Useful to Reduce Human Birth Defects	8
Workplace Safety Regulation	8
Embezzlement	6
Financial Reporting Fraud	6
Insider Trading	6
Larceny	5
Tax Evasion	3
Environmental Regulation Useful to Protect Migratory Birds	3
Antitrust Violation	3
Environmental Regulation Purporting to Protect Migratory Birds	0

might be perceived by a business executive.[38] The table depicts a hierarchy of law, with some crimes carrying more moral disapprobation than others. The ranking assumes that each act is committed knowingly with a motive to make money; hence, the distinction in moral terms does not depend on the criminal's state of mind or motive, but rather on the type, degree, and scope of the harm caused and on the social stigma attached to the particular crime as perceived by the perpetrator. The numbers are merely illustrative and based on a priori assessments. The basic idea is that, for any level of expected pecuniary return, the lower the perceived moral saliency of the crime, the more likely is the criminal conduct.

Consider first the moral saliency of laws prohibiting murder and arson. Both murder and arson are considered *mala in se*—each is morally wrong in and of itself, without reference to law.[39] Murder is completely taboo; one does not commit murder just because one can get away with it. Similarly, arson cannot be justified. Even with all precautions, fires can spread and people can get hurt. Engaging in arson demonstrates a reckless disregard for the welfare of innocent people. In terms of the present discussion, both murder for profit and arson-for-insurance fraud carry

---

[38]All crimes have both *mens rea* and *actus reus* elements. The present discussion seeks to hold the *mens rea* constant, distinguishing the crimes based on the act committed.

[39]*See* Steven H. Gifis, Law Dictionary 123 (1975) (identifying actions as *malum in se* if they are "naturally evil, as adjudged by the sense of a civilized society").

high degrees of moral saliency. Table 1 identifies murder as a ten and arson as a nine. These crimes provide an outer bound with which to compare other business crimes. One would hope that businesspeople would exercise self-restraint and not commit murder or arson even when ex ante it appears to be profitable to do so.

Most environmental and workplace safety regulations also have high moral content. Although a corporate executive may resent an environmental regulation or safety regulation that appears ineffective, that same executive typically will recognize the need for industrial safety and clean air and water. In fact, it would seem that a corporate executive would have a fairly robust affirmative social duty to cooperate with both safety and environmental regulators, to take steps to assure that regulations reflected the proper level of precautions, and to cooperate with the implementation of those regulations.[40] Regulations concerning issues directly affecting human health and safety call upon a spirit of cooperation, not mere compliance, and certainly not evasion.[41] Table 1 lists the moral saliency of such regulations as an eight.

The next four crimes—embezzlement, financial reporting fraud, insider trading, and larceny—are crimes against property. Because these crimes do not threaten human life and limb, they do not evoke the degree of moral saliency of murder or arson, nor do they evoke the sense of moral wrongfulness associated with risking human birth defects or exposing workers to the risks of preventable injuries. Nonetheless, these four property crimes generate a strong sense of moral disapproval. The first three constitute executive fraud as that term is used here, and each has a moral saliency of six. Executive frauds combine the sin of theft with the sins of betrayal and deceit. Embezzlement involves a breach of fiduciary obligations where the fiduciary (corporate executive) intentionally misappropriates property entrusted to him by another (stockholder). A similar breach of fiduciary obligation informs Enron-style financial fraud and insider trading. If ordinary larceny (theft without betrayal) carries a moral saliency of five, then larceny combined with a breach of fiduciary obligation would seem to merit a six.

---

[40]*See generally* Daniel T. Ostas, *Cooperate, Comply, or Evade? A Corporate Executive's Social Responsibilities with Regard to Law*, 41 AM. BUS. L.J. 559, 566–70 (2004) (distinguishing between "compliance" and "cooperation").

[41]*Id.*

Regulations with progressively less moral content would elicit less respect.[42] Consider, for example, a general tax regulation, the purpose of which is to generate revenues for the government and to assure that everyone pays an equitable share.[43] Although these social purposes are important, they do not carry the moral saliency of health and safety on a factory floor or the social stigma of arson. In fact, in the general tax arena, the executive probably could ethically defend most decisions to exploit tax loopholes[44] and to lobby for reduced levels of taxation.[45] In addition, whereas embezzlement, financial reporting fraud, and insider trading involve breaches of fiduciary obligations to shareholders, tax evasion has a much more diffuse victim: society itself.[46] In short, if the businessperson

---

[42]Laws forbidding the unauthorized downloading of music may provide a useful example of a crime that is not viewed as wrongful by many who commit it. *See* Geoffrey Neri, Note, *Sticky Fingers or Sticky Norms? Unauthorized Music Downloading and Unsettled Social Norms*, 93 GEO. L.J. 733, 734–36 (2005) (citing evidence that only a small percentage of people who download music from the Internet without paying consider it wrongful and suggesting that this helps to explain the prevalence of free downloading); *see also* I. Trotter Hardy, *Criminal Copyright Infringement*, 44 WM. & MARY L. REV. 305 (2003) (discussing the social norms governing copyright infringement).

[43]Oliver Wendell Holmes Jr. once noted: "Taxes are what we pay for civilized society." Compania de Tobaccos v. Collector, 275 U.S. 87, 100 (1904). Notwithstanding this truism, Americans have a contentious history with paying taxes. *See* DAVID F. BURG, A WORLD HISTORY OF TAX REBELLIONS 264 (2004) ("Taxation often simply provides the ostensible cause for protest and insurrection especially since taxes afford a ubiquitous, detested, and identifiable target of opposition.").

[44]Interestingly, IRS guidelines permit a tax advisor to exploit an ambiguity in the law so long as there is a one third chance that the aggressive and self-serving interpretation will be upheld in a court. *See* Treas. Reg. § 1.6694-2 (1991). *See also* Michael Roberts, *Impartiality in Audit Judgment* (unpublished manuscript on file with author) (contrasting the relatively conservative interpretation norms expected of public auditors in providing attestation services with the more aggressive tax-advocacy norms permitted for tax advisors). *See generally* LEO KATZ, ILL-GOTTEN GAINS: EVASION, BLACKMAIL, FRAUD, AND KINDRED PUZZLES IN THE LAW 84–86 (1996) (discussing a tax loophole and considering whether exploitation of that loophole would be legal).

[45]*But see* WOODSTOCK THEOLOGICAL CENTER, THE ETHICS OF LOBBYING: ORGANIZED INTERESTS, POLITICAL POWER, AND THE COMMON GOOD 84 (2002) (arguing that a lobbyist must seek legal reforms that promote the "common good" of society as opposed to narrow self-interest).

[46]Insider trading laws may rest on less certain moral grounds than prohibitions against embezzlement and reporting fraud. Whereas the latter two crimes are uniformly considered wrong, insider trading is defended by some as not inherently wrong. *See* Strudler & Orts, *supra* note 2, at 382 n.22 (citing but not endorsing the scholarly proposition that insider trading is not morally wrong).

believes that tax evasion pays (perhaps due to low likelihood of detection and conviction),[47] then he or she is very likely to evade.[48]

Tax regulations, regulations designed to protect migratory birds, and antitrust laws would be considered *mala prohibita*, and each is listed as a three in Table 1. The term *malum prohibitum* refers to matters that are wrong solely because the law says they are wrong.[49] For example, consider a tax regulation that distinguishes between expenditures that can be deducted in full from ones that must be depreciated. From the perspective of the taxpayer, whether he or she should deduct or depreciate can only be determined with reference to the law itself. There simply are no external referents. Similarly, destroying migratory bird habitat is probably not inherently wrongful in a moral sense.[50] Legitimate environmental laws, like tax laws, require compliance simply because they are the law, not because they address inherently wrongful acts. The same is likely true of various forms of antitrust laws.[51] For example, there is nothing inherently wrong with seeking to monopolize a market and using that position of advantage to generate profits.[52] Such an act is wrong solely because the law says it is wrong.[53] Reflecting the nature of *malum prohibitum*, violations of tax laws, violations of bird habitat regulations,

---

[47]For a general survey of literature on the causes of tax evasion, see James Andreoni et al., *Tax Compliance*, 36 J. ECON. LITERATURE 818 (1998).

[48]*See supra* notes 5–6 and accompanying text (discussing a recent IRS study estimating federal tax fraud at about $300 billion annually).

[49]*See* GIFIS, *supra* note 39, at 124.

[50]People differ on this point. A "deep ecologist" would probably label the knowing destruction of bird habitat as *malum in se*; people committed to the notion of "environmental dominion" would likely label the same regulatory crime as *malum prohibitum. See generally* TERRY HALBERT & ELAINE INGULLI, LAW & ETHICS IN THE BUSINESS ENVIRONMENT 202–04 (5th ed. 2006) (contrasting the competing views).

[51]*See generally* JOHN R. MUNKIRS, THE TRANSFORMATION OF AMERICAN CAPITALISM: FROM COMPETITIVE MARKET STRUCTURES TO CENTRALIZED PRIVATE SECTOR PLANNING 3–51 (1985) (discussing the evolution of antitrust law and policy and emphasizing the ambivalent nature of governmental commitment to enforcement).

[52]*See generally* ROBERT H. BORK, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF (1978) (arguing that the use of monopoly power can sometimes increase productive efficiencies making society better off).

[53]*See generally* James A. Sagner, *Antitrust as Frontier Justice: Is It Time to Retire the Sheriff?*, 111 BUS. & SOC'Y REV. 37 (2006) (suggesting that antitrust may have outlived its usefulness and large sections of antitrust law may need to be repealed).

and antitrust violations are each listed in Table 1 with a moral saliency of three.

At the end of the continuum, one finds that some business regulations have no moral content whatsoever.[54] For example, consider the moral duty to comply with a misconceived environmental regulation intended to protect the habitat of migratory birds.[55] Suppose that obedience to the letter of this law actually harms bird habitat rather than helps it. In such a situation, the executive would seem to have little or no moral duty (though he or she probably has a legal duty) to follow the law. In fact, he or she may have a moral duty to engage in an act of civil disobedience and knowingly disobey demonstrably unjust and harmful laws. Reflecting the potential justification for civil disobedience of harmful and misguided laws, Table 1 lists the moral saliency of knowingly violating such laws as zero.

D. The Interplay Between Self-Interest and Moral Self-Restraint

The above discussion emphasizes that businesspeople are motivated by pecuniary self-interest. Therefore, to achieve legal obedience and deter crimes, regulators need to increase the likelihood of detection and/or increase the severity of legal penalties. Yet, the analysis also suggests that there is more to legal obedience than mere deterrence. Legal obedience also depends on the amount of respect the businessperson has for the law or regulation in question. This respect, in turn, depends on the perceived moral saliency of the particular law. Most commonly, one's sense of public duty to obey the law and one's pecuniary self-interest correspond, that is, legal obedience typically is cost effective. When this is true, it is difficult to assess whether legal obedience is motivated by pecuniary gain or by self-restraint. The true test of character arrives when pecuniary self-interest and the duty to obey the law diverge.

Figure 1 uses the hierarchy of law expressed in Table 1 to illustrate a trade-off between public duty and pecuniary self-interest in graphical

---

[54]Philosopher M.B.E. Smith notes that "every legal system contains a number of pointless or even harmful laws, obedience to which either benefits no one, or worst still causes harm." Smith, *supra* note 33, at 82–83. He concludes that "in a great many instances the obligation [to generally obey law] will not require that we obey specific laws." *Id.* at 83.

[55]*See* Ostas, *supra* note 40, at 578–79 (considering the social obligation to obey two misconceived workplace safety regulations).

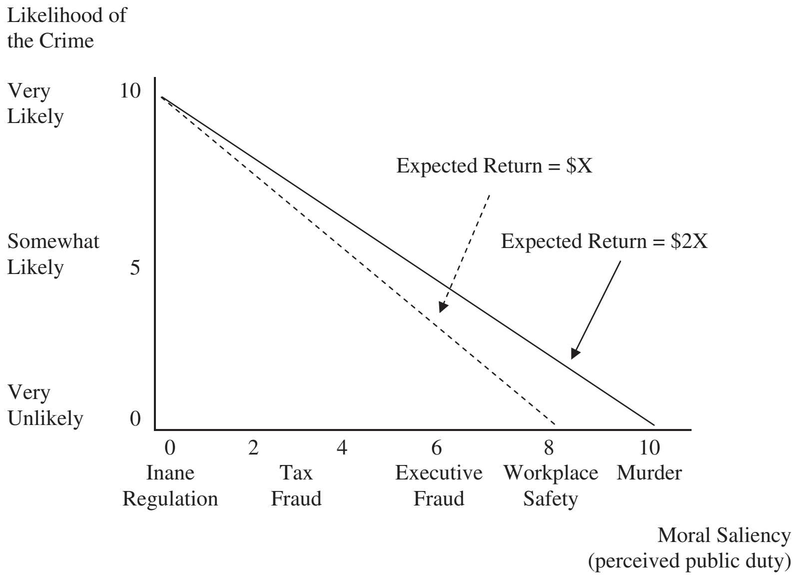

Figure 1: Relationship Between Self-Interest, Public Duty, and Legal Obedience

form. The horizontal axis captures the moral saliency of the crime; the vertical axis reflects the likelihood that the crime will be committed. The dotted line depicts the likelihood of a crime for each level of perceived moral saliency *given an expected return of X dollars*. Comparing the solid line with the dotted line illustrates the effect of doubling the expected return from illegal activity. Of course, the numbers reflected on the graph are presented for clarity of the presentation and are mere conjectures.

The graphical representation provokes several insights. For example, note that, as the expected return to criminal conduct doubles, the dotted line rotates out. If the returns are sufficiently high, even murder becomes possible. On the other hand, reduce the expected return sufficiently and embezzlement, financial reporting fraud, and insider trading become very unlikely. The graph also illustrates that the likelihood of white-collar crime varies directly with the expected return and inversely with the perceived public duty to obey the law in question.

The question, of course, is whether this framework helps to explain Enron and similar scandals involving executive fraud. Perhaps the poten-

tial pecuniary gains from embezzlement, fraud, and insider trading were so large that the corporate executives could not resist. Or was it a case where the regulations concerning the financial disclosures and the common law precepts regarding fiduciary responsibilities did not receive sufficient respect? Was fraud seen as taboo like murder, or was it perceived as closer to a knowing violation of an inane bird regulation? As will become apparent below, the explanation probably lies in both factors: the projected payoff was too high and the level of respect for the law was too low.

III. Understanding Executive Fraud

The analysis now turns to executive fraud, using the entrails of the Enron scandal to examine issues of insider trading, financial reporting fraud, and the breakdown of fiduciary obligation. The discussion first examines the various trials that resulted from Enron and then considers Enron in a historical context of U.S. corporate crimes generally. Employing the above framework, the analysis highlights the potential profits earned in the commission of executive frauds. It also considers the evidence these crimes provide of a general lack of respect for the law. The analysis closes with a brief summary.

A. Enron Directors and Insider Trading

At the close of 2000, *Fortune* magazine listed Enron as the seventh largest U.S. corporation, with annual revenues in excess of $150 billion.[56] When Enron filed for bankruptcy on December 2, 2001, it set a record for size. The collapse triggered additional governmental scrutiny and sparked a general public awareness of what was to become a wave of financial reporting frauds. Since that filing, scores of executives, including eight associated with the Enron case, have been sentenced to prison for various

---

[56]For a useful and thorough rendition of the basic facts involved in the Enron case, see Faith Stevelman Kahn, *What are the Ways of Achieving Corporate Social Responsibility? Bombing Markets, Subverting the Rule of Law: Enron, Financial Fraud, and September 11, 2001*, 76 Tul. L. Rev. 1579, 1580–605 (2002); *see also* Bethany McLean & Peter Elkind, The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron (2003).

forms of executive fraud.[57] Many of the tainted firms and high-profile executives have become virtual household names, including Bernie Ebbers at WorldCom, the Rigas family at Adelphia, Dennis Kozlowski at Tyco, and Ken Lay at Enron.

Although the investing public lost billions in the recent scandals,[58] many people associated with these tainted firms, at least initially, seem to have made out quite handsomely. For example, according to a class action lawsuit filed in December 2001,[59] in the months immediately prior to Enron's collapse, twenty-nine Enron insiders consummated $1.1 billion in illegal trades.[60] These executives took advantage of artificially high stock

---

[57]The Houston Chronicle maintains an Enron "Prosecution Scorecard," which updates the status of ongoing trials related to Enron and provides many useful links to Enron-related documents. *See* http://www.chron.com/news/specials/enron/ (last visited Aug. 10, 2007) [hereinafter Prosecution Scorecard]. When last visited, the site listed thirty-four criminal defendants, fifteen guilty pleas, five jury convictions, two acquittals, three convictions overturned, two dismissals, two in limbo, and eight awaiting trial. The list includes former Enron executives as well as David Duncan, the partner-in-charge of the Enron account for Arthur Andersen LLP, and several bankers who had dealings with Enron.

[58]Investor losses at WorldCom alone approached $175 billion. *See* William S. Laufer, Corporate Minds and Guilty Bodies: The Failure of Criminal Corporate Liability 96 (2006).

[59]Complaint, Amalgamated Bank et al. v. Kenneth L. Lay et al., Case No. H-01-4198 (D.C.S.D. Tex., Houston, Dec. 4, 2001) [hereinafter Civil Complaint]. Each plaintiff in the class action had purchased Enron stock during the period of the alleged frauds. In February 2002 the University of California was named lead plaintiff. In April 2002 the university moved to amend the complaint by joining additional defendants and counts. In April 2003 the district court granted the motion and the amended complaint was filed in May 2003. The original complaint had 116 pages, emphasized insider trading, and listed Enron directors, Enron executive officers, and Arthur Andersen as codefendants. The 485-page amended complaint added two law firms and nine large banks as codefendants, alleging that these firms and banks facilitated many of the Enron frauds. In January 2005 most of the Enron directors and executives entered into a $168 million joint settlement. In September 2006 the law firm of Kirkland & Ellis settled for $13.5 million and Arthur Andersen LLP settled for $77.5 million. The largest sums have come from the banks. Five of the nine banks have settled for a combined total of $6.8 billion. As of February 2007 only Skilling, the law firm of Vinson & Elkins, and four banks remain in the class action suit. The University of California maintains a Web site providing links to press releases, newspaper accounts, and court documents pertaining to the Enron class action. *See* http://www.universityofcalifornia.edu/news/enron/welcome.html (last visited Feb. 22, 2007) [hereinafter Class Action Press Releases].

[60]*See* Civil Complaint, *supra* note 59, at 94–95 (listing the defendants and the amounts and dates of the allegedly illegal trades).

prices caused, in part, by fraudulent financial reports.[61] According to the lawsuit, Lou Pai, former Chief Executive Officer (CEO) of an Enron subsidiary, illegally sold $353.7 million of Enron stock; CEO Ken Lay, "trading almost daily" in the months preceding Enron's collapse, cashed in for $101.3 million; director and former Enron executive Rebecca Mark-Jurbache netted $79.5 million; director Ken Harrison received $75.2 million; Jeffrey Skilling, Enron CEO from February 2001 through August 2001, allegedly sold 10,000 shares per week, netting $66.9 million; and Andrew Fastow, Chief Financial Officer (CFO) and alleged mastermind of the accounting scams received $30 million.[62]

The sheer size of the above payouts suggests that these executives may have done a calculation. Perhaps Fastow, Lay, Skilling, and others calculated how much personal gain could be achieved through fraudulent insider trades and then compared this gain to the likelihood of being caught and the likely consequences of detection. Perhaps the promise of incredible wealth was just too hard to resist.

At first glance, it appears that some of the insiders at Enron may have miscalculated. After all, Fastow is currently serving a six-year prison term after pleading guilty to two counts of fraud, and in October 2006 Skilling was sentenced to twenty-four years after a jury convicted him on nineteen counts of fraud and conspiracy.[63] In addition, the twenty-nine Enron executives mentioned above were listed as codefendants in the civil action seeking full disgorgement of all ill-gotten gains.[64]

Notwithstanding the criminal convictions and civil lawsuits, whether the various Enron executives miscalculated is not necessarily clear. First, of the twenty-nine codefendants in the civil case, only seven were indicted for a crime;[65] twenty-two were not. Of the seven indicted, only three have

---

[61]*See* Leslie Wayne, *Before Debacle, Enron Insiders Cashed in $1.1 Billion in Shares*, N.Y. TIMES, Jan. 13, 2002, at A1.

[62]*Id.*

[63]*See generally* Prosecution Scorecard, *supra* note 57 (providing links to newspaper accounts of both trials).

[64]*See* Civil Complaint, *supra* note 59.

[65]Comparing the list of defendants accused of insider trading in the class action lawsuit, *see* Civil Complaint, *supra* note 59, at 116, with the list of defendants indicted of crimes, *see* Prosecution Scorecard, *supra* note 57, one finds seven common names: Lay, Skilling, Fastow, Chief Accounting Officer Richard Causey, Enron Broadband co-CEOs Ken Rice and Joe Hirko, and Enron's Director of Investor Relations Mark Koenig.

been sentenced to prison terms of more than eighteen months.[66] Second, in January 2005 eighteen of the civil defendants settled the civil insider trading lawsuit, collectively agreeing to pay defrauded shareholders $168 million.[67] Yet, $155 million of this sum was paid out of various director and officer insurance policies, and only ten of the insiders actually dug into their own pockets, contributing $13 million.[68] The $13 million figure was calculated to reflect 10% of the pretax profits from their illegal trades.[69] In addition, just because one gets caught in white-collar crime does not mean the gamble was not cost effective ex ante. Sometimes one gambles and loses, but that does not mean that the gamble was a negative sum game. And it seems that for some unindicted coconspirators, insider trading may be profitable, even when caught.

B. Andrew Fastow and the "Cuiaba Transaction"

Although insider trading was an issue, at its core Enron was about financial reporting fraud.[70] Ultimately, thirty-four people were criminally indicted for their roles in these frauds.[71] Fastow was the first. Federal prosecutors filed a criminal complaint against the former CFO in October 2002.[72] The complaint alleged multiple counts of three types of fraud (securities fraud, mail fraud, and wire fraud), multiple counts of money laundering, and multiple counts of conspiracy to commit, aid, and abet those crimes.[73] In

---

[66]Lay died before sentencing and his conviction was vacated. Skilling received twenty-four years, Fastow got six, Causey is serving five years and six months, and Koenig got eighteen months. Rice and Hirko are awaiting sentencing. *See* Prosecution Scorecard, *supra* note 57.

[67]*See* Rebecca Smith & Jonathan Weil, *Ex-Enron Directors Reach Settlement*, WALL ST. J., Jan. 10, 2005, at C3.

[68]*Id.*

[69]*Id.*

[70]*See* Moohr, *supra* note 16, at 940–51 (discussing the various federal crimes charged in the Enron litigation including mail fraud, wire fraud, securities fraud, insider trading, and obstruction of justice).

[71]*See* Prosecution Scorecard, *supra* note 57.

[72]Complaint, U.S. v. Andrew S. Fastow, Case No. H-02-889-M (D.C.S.D. Tex., Oct. 1, 2002) [hereinafter Criminal Complaint]. The complaint was followed by a grand jury indictment. United States v. Andrew S. Fastow, Case No. H-02-0665 (D.C.S.D. Tex, Grand Jury Indictment: Oct. 31, 2002) [hereinafter Criminal Indictment].

[73]*See* Criminal Complaint, *supra* note 59, at 1–2.

January 2004 Fastow pleaded guilty to conspiracy to commit wire fraud and conspiracy to commit securities fraud; he is currently serving a six-year prison sentence.[74] The complaint against Fastow was supported by an affidavit filed by the FBI agent in charge of the criminal investigation. This affidavit set forth with particularity how the frauds were allegedly perpetrated. In September 2006 Fastow signed, under oath, a twenty-five page declaration that confirmed the FBI affidavit and provided further details regarding the frauds.[75]

At the heart of the Enron financial frauds were a series of now quite notorious "special purpose entities" (SPEs).[76] A SPE is an accounting device many companies use to access capital and/or manage risk.[77] A SPE, typically structured as a limited partnership or limited liability company, is created by a company that wishes to transfer an asset.[78] Literally hundreds of Enron's approximately 3,500 subsidiaries and affiliates were SPEs.[79] The indictment asserts that, beginning in the early 1990s, Enron used many of its SPEs, not to access capital or manage risk, but to manipulate its balance sheet and deceive investors.[80] According to the indictment, some of the SPEs created by Enron did not meet the criteria of independence established by Generally Accepted Accounting Principles (GAAP);[81] thus, transfers to these SPEs should not have removed the assets from Enron

---

[74]*See* Kristen Hays & Tom Fowler, *Some Shocked at Sentence*, HOUSTON CHRON., Sept. 28, 2006, *available at* http://www.chron.com/disp/story.mpl/special/enron/4220305.html (noting that many observers expected Fastow to receive a sentence of ten years and were surprised at the leniency showed).

[75]*See* Andrew S. Fastow, Declaration of Andrew S. Fastow, Sept. 26, 2006, *available at* http://www.universityofcalifornia.edu/news/2006/fastow.pdf.

[76]*See* Criminal Complaint, *supra* note 72, at 9–10.

[77]*See* Financial Executives International, *Special Purpose Entities: Understanding the Guidelines* (Jan. 2002) (explaining GAAP rules regarding SPE independence in effect in 2001 and detailing how Enron executives allegedly violated those rules).

[78]*Id.*

[79]*Id.*

[80]*See* Criminal Indictment, *supra* note 72, at 3.

[81]*Id.* According to GAAP, a party independent to the firm must control an SPE. To qualify as independent, the party must place its own assets at risk and that risk must be at least 3% of the value of any asset transferred to it. If these and other conditions of independence are met, then a firm can transfer an asset to an SPE, record the proceeds of the transfer, and remove the asset from the firm's balance sheet. *See* Financial Executive International, *supra* note 77.

books. Because the assets transferred were losing money, the inappropriate accounting had the effect of inflating both the income statements of Enron and its balance sheets. The systematic use of inappropriate SPEs artificially supported Enron's stock price.[82]

Reading the indictment, it becomes impossible to believe that Fastow and others at Enron did *not* know that what they were doing was illegal. Some of the SPEs created and exploited by Fastow and others were not even close to the independence requisites specified by GAAP and the intent to defraud was obvious. Consider, for example, the "Cuiaba Transaction."[83] Enron was building a power plant in Cuiaba, Brazil. The project was facing a $120 million cost overrun that threatened Enron's quarterly financial targets. Fastow crafted a solution: In September 1999 he sold the project to an SPE called LJM for $11.3 million.[84] This sale enabled Enron to improve its balance sheet and avoid millions of dollars in operating expenses as it struggled to meet market expectations. In 2000, Enron repurchased the plant from LJM for $13.75 million, and LJM declared the capital gain.[85]

The FBI refers to the Cuiaba Transaction as a "parking scam."[86] Neither the $11.3 million sales price, nor the $13.75 million repurchase price reflected the true value of the plant. In fact, no one was really interested in buying the project at all. LJM was a SPE created and controlled by Fastow as its managing partner.[87] It was never independent as required by GAAP because none of its owners had any of their own money at risk. The 1999 sale contained an oral side agreement between Fastow and Enron Managing Director Michael Kopper in which Enron agreed to buy back the asset.[88] When Enron repurchased the project, Fastow, Kopper, and other insiders misappropriated the $2.45 million gain

---

[82]*See* Criminal Complaint, *supra* note 72, at 9–10.

[83]*Id*. at 28–31.

[84]*Id*. at 29.

[85]*Id*. at 31.

[86]*Id*. at 27.

[87]The letters "L," "J," and "M" are the first initials of Fastow's wife and two sons. *Id*. at 23 n.7.

[88]*Id*. at 31–32.

at shareholders' expense.[89] The asset had never really been sold, it had been "parked," enabling Fastow and others to manipulate Enron's earnings statement while simultaneously generating fees and profits for Enron insiders.

The Cuiaba Transaction is only one of a dozen or more accounting scams detailed in the criminal indictment and admitted to by Fastow in his plea agreement, his declaratory statement, or both.[90] Many of the scams carry exotic and imaginative names such as "Talon," "Raptor," and "Nigerian Barges."[91] In each instance, it is difficult to believe that the perpetrators of the fraud did not know that what they were doing was illegal. This suggests that Fastow and others did a calculation and concluded that fraud pays. It also suggests the relative impotence of moral self-restraint when pecuniary temptations are high.

C. An Amended Complaint and the Breach of Fiduciary Obligations

In May 2003 the aforementioned 2001 civil class action against twenty-nine Enron executives and Arthur Andersen was amended to include claims against two law firms and nine banks.[92] Whereas the 2001 complaint had 116 pages and claimed $1.1 billion in damages, the amended complaint in 2003 was 484 pages and sought $40 billion.[93] Thus far, the named plaintiffs, each of whom had purchased stock during the period of alleged

---

[89]According to the Criminal Complaint, "the proceeds of the repurchase of the Cuiaba project were used by Kopper to enable him to purchase Fastow's partnership interest in LJM." *Id.* at 32 n.9.

[90]Fastow admitted that the others knew that they were committing crimes. In his September 2006 declaration, he writes: "As stated in my plea agreement, while CFO, I and other members of Enron's senior management fraudulently manipulated Enron's publicly reported financial results. Our purpose was to mislead investors and others about the true financial position of Enron and, consequently, to artificially inflate the price of Enron's stock." Fastow, *supra* note 75, at 2.

[91]Discussion of these various frauds is beyond the scope of the present discussion. *See generally* Prosecution Scorecard, *supra* note 57 (providing useful links to newspaper accounts of the various scams); Criminal Complaint, *supra* note 72, at 32–34, 39–41 (detailing the frauds).

[92]*See supra* notes 59–62 and accompanying text (discussing the original complaint). The amended complaint included the law firms of Kirkland & Ellis and Vinson & Elkins and listed nine banks—Citibank, J.P. Morgan Chase, Canadian Imperial Bank of Commerce, Credit Suisse First Boston, Barclays, Merrill Lynch, Royal Bank of Scotland, Royal Bank of Canada, Toronto Dominion Bank, and Deutsche Bank. *See* Class Action Press Releases, *supra* note 59.

[93]*Id.*

frauds, have recovered more that $7 billion in settlements.[94] Most of this money has come from the banks, including Citigroup ($2 billion), J.P. Morgan Chase ($2.2 billion), and Toronto-based Canadian Imperial Bank ($2.4 billion).[95] In settling, none of the banks admitted any wrongdoing. As of February 2007 only Skilling, four banks, and Enron's former lawyers, Vinson & Elkins, remain in the case that is currently scheduled for trial on April 9, 2007.[96] There is some speculation that the few remaining defendants will settle as well.[97]

Much like the criminal complaint against Fastow, the amended civil complaint details a rather tawdry set of frauds. Of particular note is the role played by the defendant banks. Certain of the defendant banks allegedly set up false investments in clandestinely controlled Enron partnerships, used offshore companies to disguise loans, and facilitated phony sales of Enron assets.[98] This enabled Fastow and other Enron executives to deceive investors by reporting increased cash flow from operations and by moving billions of dollars of debt off Enron's balance sheet, thereby artificially inflating stock prices.[99]

In his sworn declaration made public in September 2006, Fastow testified that the bankers with whom he dealt were often fully aware of and willing participants in various schemes to defraud investors.[100] The

---

[94]*See* Tom Fowler, *Other Trials Likely; Shareholder Suit on Tap*, HOUSTON CHRON., Oct. 24, 2006, *available at* http://www.chron.com/disp/story.mpl/business/4282428.html.

[95]*See* Bob Van Voris & Jef Feeley, *Firms Request Enron Class Action Be Voided*, HOUSTON CHRON., Feb. 5, 2007, *available at* http://www.chron.com/disp/story.mpl/special/enron/4528846.html.

[96]*See* Kristen Hays, *Plaintiffs Are Eager to Pare Defendant List*, HOUSTON CHRON., Jan. 20, 2007, *available at* http://www.chron.com/disp/story.mpl/special/enron/4484679.html (suggesting that all parties may settle prior to trial).

[97]*Id*.

[98]*See* Trey Davis, *UC Reaches $2 Billion Settlement with Citigroup in Enron Securities Class Action*, Press Release of the University of California, June 10, 2005, *available at* http://www.universityofcalifornia.edu/news/2005/jun10.html.

[99]*Id*.

[100]*See* Trey Davis, *Former Enron Chief Fastow Testimony Makes it Clear that Enron's Banks Were the Real Masterminds Behind the Schemes to Defraud Investors*, Press Release of the University of California, Sept. 26, 2006, *available at* http://www.universityofcalifornia.edu/news/2006/sep26.html.

"Nigerian Barges" deal provides an example.[101] This deal, much like the Cuiaba Transaction, was a parking scam, but this time the asset was not parked with a SPE controlled by Enron executives, but rather with a bank, Merrill Lynch (Merrill). Fastow testified that executives at Merrill agreed to "purchase [the barges] temporarily so that so that Enron could report the transaction in 1999."[102] Merrill had nothing at risk. Fastow had assured Merrill executives, including Merrill's former head of investment banking, Daniel Bayly, that "the bank's investment would be repaid within six months and that the bank would receive its pre-determined rate of return."[103] Fastow also testified that "Merrill understood the impact this transaction would have on Enron's financial statement [and also understood] that the only reason for the transaction was to receive the desired accounting and financial-reporting treatment."[104] In July 2004 a jury convicted Bayly and three other Merrill executives of fraud and conspiracy to commit fraud with regard to the Nigerian Barges and related Enron scams.[105]

The allegations contained in the $40 billion class action appear all the worse because of the fiduciary context in which these frauds were perpetrated and concealed.[106] Directors and senior executives of publicly traded companies are fiduciaries and, as such, they owe fiduciary duties of loyalty and care to investors. Enron's lawyers (Vinson & Elkins), its public accountants (Arthur Andersen), and its bankers (Merrill and others) were also fiduciaries. Hence, in Enron, the claim is not simply one of deception and self-dealing; it is about deception and self-dealing within a context of

---

[101]*See* Fastow, *supra* note 75, at 12–13.

[102]*Id*. at 12.

[103]*Id*.

[104]*Id*. at 12–13.

[105]*See* Kristen Hays, *Barge Ruling Won't Be Appealed*, Houston Chron., Feb. 16, 2007, *available at* http://www.chron.com/disp/story.mpl/special/enron/4558309.html. In addition to Bayly, Merrill defendants were James A. Brown, former head of the bank's asset lease group; William Fuhs, former Merrill executive; and Robert Furst, Merrill's former liaison with Enron. *Id*. In 2005 the Fifth Circuit Court of Appeals reversed most of the convictions against Bayly, Brown, and Furst, citing faulty jury instructions. The three had already served more than one year when released and each could be retried on alternative grounds, though retrial seems unlikely. *Id*.

[106]*See generally* Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. Pa. L. Rev. 1735, 1780–96 (2001) (providing background on the notion of fiduciary duties in a corporate context).

trust. With regard to self-dealing in a fiduciary context, Justice Cardozo wrote:

> Many forms of conduct permissible in the workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the *punctilio of honor the most sensitive*, is then the standard of behavior.[107]

Cardozo's poetic phrasing reminds one that the law of fiduciary obligations rests on a strong moral underpinning. Fiduciaries are supposed to obey the law, not simply because it is in their own pecuniary interest to do so, but out of a sense of public duty and moral self-restraint.

D. Assessing Enron in Historical Context

There was a time when the presumed purpose of manipulating earnings reports, or engaging in what accountants euphemistically call "earnings management," was to attract external financing at lower rates so as to advance shareholder interests.[108] Although the practice of managing earnings has always been somewhat tainted, in the decades preceding Enron, aggressive accounting practices were often defended as relatively benign and understandable reactions to market pressures.[109] The traditional assumption was that the interests of executives and shareholders coincided and executives engaged in earnings management to smooth out fluctuations in income so as to present the firm in its best light.[110] It was also commonly assumed that, in the long term, no one got hurt.

The recent collapse of Enron and the ensuing tidal wave of earnings restatements have suggested something far more sinister—seemingly widespread and systemic criminal fraud aimed at the shareholders of

---

[107]Meinhard v. Salmon, 164 N.E. 545, 547 (N.Y. 1928) (emphasis added).

[108]*See* John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 276 (2004) ("Even prior to the 1990s, earnings management was a pervasive and longstanding practice [that was commonly used as a means] to reduce the volatility of the firm's cash flows and present a simple, steadily ascending line from period to period.").

[109]*See* Patricia M. Dechow & Douglas J. Skinner, *Earnings Management: Reconciling the Views of Accounting Academics, Practitioners, and Regulators*, 14 ACCT. HORIZONS 235, 235 (2000) (noting that accounting academics were generally less critical of the practice of earnings management than were practitioners and regulators).

[110]*See* Coffee, *supra* note 108.

many of the most highly regarded U.S. firms.[111] Between January 1997 and June 2002, market capitalization losses due to earnings restatements surpassed $100 billion.[112] During these five years, approximately ten percent of all companies listed on the New York Stock Exchange or NASDAQ announced at least one restatement.[113] Earnings restatements have long been used by commentators as a proxy for fraud.[114] The prevalence of these restatements suggested a game mentality that said it was okay to bend and potentially break accounting rules. It also suggests that Enron and WorldCom were not alone in their malfeasance.

Speculating on the causes of the recent spate of accounting frauds, John Coffee points to the failure of various "gatekeepers" to uncover and report financial chicanery.[115] Coffee uses the term to refer to "intermediaries who provides verification and certification services to investors."[116] Gatekeeper services include "verifying a company's financial statements (as the independent auditor does), evaluating the creditworthiness of the company (as the debt rating agency does), assessing the company's business and financial prospects vis-à-vis its rivals (as the securities analyst does), or appraising the fairness of a specific transaction (as the investment banker does)."[117] For Coffee, Enron provided a classic example of undue deference paid to large clients by auditors, debt-rating agencies, security analysts, and investment bankers.[118]

---

[111] *See id*. at 282–84 (citing evidence that the number of financial statement restatements spiked from 1999 to 2002, increasing over 270% over the five years ending in 2002).

[112] *See* U.S. Gen. Accounting Office, GAO-03–138, Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses, and Remaining Challenges 26 (2002), *available at* http://www.gao.gov/new.items/d03138.pdf [hereinafter GAO Report]; *see also* Huron Consulting Group, 2004 Annual Review of Financial Matters, March 25, 2005 (documenting a surge in financial restatements).

[113] *See* GAO Report, *supra* note 112, at 4.

[114] Coffee, *supra* note 108, at 282 ("During the 1990s, earnings restatements, long recognized as a proxy for fraud, suddenly soared.").

[115] *See* John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid*," 57 Bus. Law. 1403 (2002).

[116] *See* Coffee, *supra* note 108, at 279.

[117] *Id*.

[118] Coffee offers two explanations for what he perceives as a sudden increase in gatekeeper failures during the 1990s: (1) an increased financial incentive for gatekeeper malfeasance caused in part by legal changes reducing gatekeeper liability and (2) an irrational market

Although gatekeeper failure undoubtedly contributed to the recent scandals, blaming the wayward watchdog for the burglary threatens to divert attention from the primary culprit—the burglar. Ultimately, Enron-type frauds reflect a failure of moral self-restraint by corporate executives. Some commentators have attributed the executive frauds in the 1990s to changes in the structure of executive pay, particularly the increased use of stock options.[119] Options tied executive pay to short-term swings in stock price and drove a wedge between long-run shareholder interests and an executive's interest in short-run price spikes.[120] Of course, even with increased pecuniary temptations, and even without effective gatekeepers, corporate executives can restrain themselves if they choose to do so.

Viewing Enron in a historical context, one finds that the temptation to commit fraud has always been prevalent.[121] During the Civil War, President Abraham Lincoln complained of defense contractors who sold faulty war supplies to the Union Army, including "broken rifles, rancid food, useless ammunition, and lame horses and mules."[122] At the turn of the century, President Teddy Roosevelt bemoaned the "malefactors of great wealth" and pushed for a federal war "combating corporate deviance" and the abuses of the great trusts.[123] Documenting fraud in the 1920s, Wharton Professor William Laufer writes: "Throughout the 1920s there were bank frauds by a host of well-known corporations and stock frauds by top-tier investment firms; even some fraud examiners were accused of fraud."[124]

---

euphoria that reduced the need for gatekeeper services to attract investors and rendered gatekeepers largely irrelevant. *See* Coffee, *supra* note 115.

[119]*See, e.g.*, Coffee, *supra* note 108, at 275–77.

[120]As of 1990, equity-based compensation of CEOs at Fortune 500 companies was about five percent of total compensation; by 1999 the portion had grown to sixty percent. *Id.* at 275 n.20. Coffee attributes the growth to pressures from "institutional investors" and to changes in the law. *Id.* at 274.

[121]*See* LAUFER, *supra* note 58, at 3–44 (tracing changes in criminal law while documenting the prevalence of corporate crimes throughout the twentieth century).

[122]*See* Corporate Crime Reporter, *The Top 100 False Claims Act Settlements*, Dec. 30, 2003, *available at* http://www.corporatecrimereporter.com/fraudrep.pdf (discussing the history of the False Claims Act initially passed in 1863 to battle frauds committed against the government).

[123]*See* LAUFER, *supra* note 58, at 69. Laufer notes that "high profile prosecutions of demonized corporations were front-page news in the early 1900s, as much as, if not more so than, today." *Id.*

[124]*Id.* at 22.

He continues: "The list of swindles and schemes reveals thousands of individuals and hundreds of corporations. By 1925, the annual loss due to stock fraud, insurance fraud, credit fraud, and embezzlement in the United States was estimated at $3 billion."[125] In an oft-cited study of crimes of the seventy largest U.S. industrial corporations of the first half of the twentieth century, Edwin Sutherland reported that "[e]very one of the seventy corporations has a decision against it, and the average number of decisions is 14.0."[126] Although Sutherland included some civil and administrative law decisions in this counting, the data is nonetheless striking.

Although fraud has always been prevalent, one relatively distinctive aspect of the Enron scandal was the target. In most previous scandals—defense frauds, secret collusions, bribes of foreign officials—the interests of the executive and the firm aligned. In Enron they diverged, causing a sort of cannibalism that ultimately destroyed the firm. The closest parallel can be found in the relatively recent savings-and-loan crisis of the late 1980s and early 1990s.[127] Described as the largest "collective embezzlement" in history,[128] the scandal involved executives and insiders who systematically stole from investors. Ultimately taxpayers had to pay for these frauds. The bill totaled about $500 billion.[129] In the end, Enron appears neither new, nor unique.

---

[125] *Id.*

[126] EDWIN H. SUTHERLAND, WHITE COLLAR CRIME: THE UNCUT VERSION 85 (1983). Interestingly, Sutherland's work was originally published in 1949 without naming the corporations reviewed. *See* William J. Chambliss, *White Collar Crime and Criminology*, 13 CONTEMP. SOC. 160, 161 (1984) (citing pressure from Professor Sutherland's publisher and academic institution to conceal the names). The unedited version was published posthumously, in 1983, complete with names. *Id.*

[127] The Federal Deposit Insurance Corporation maintains a very useful Web site devoted to the crisis. *See generally* The S&L Crisis: A Chrono-Bibliography, *at* www.fdic.gov/bank/historical/s&l (last visited Feb. 20, 2007).

[128] *See generally* Henry N. Pontell & Kitty Calavita, *White Collar Crime in the Savings and Loan Scandal*, 525 ANNALS 31 (1993) (employing the term "collective embezzlement").

[129] In his 1988 campaign President George H.W. Bush promised "no new taxes; read my lips." He later recanted, citing a growing budget deficit generated in no small part by the savings and loan bailout. His recantation contributed to his reelection failure. Ironically, the President's son, Neil, was implicated in the crimes. *See generally* STEVEN K. WILMSEN, SILVERADO: NEIL BUSH AND THE SAVINGS AND LOAN SCANDAL (1991).

E. Summary

The Enron case provides a context with which to assess executive frauds generally. The May 2006 convictions of Lay and Skilling marked a symbolic end to the saga. The Enron Task Force charged with prosecuting the crimes disbanded in October 2006, and the civil class actions are all but settled. Though a few retrials, sentencing hearings, and appeals remain, it is no longer necessary to speculate on the outcome of the legal cases. Discovery and sworn testimony have unequivocally demonstrated a host of willful and precalculated violations of law, not mere oversight or inadvertences. The evidence also shows a tangled web of professional misconduct by bankers, lawyers, and public accountants. Placed in historical context, Enron provides the latest example of the relative impotence of moral self-restraint when pecuniary temptations get too large.

IV. Conclusion

This article began by discussing two reasons why people obey law: pecuniary self-interest and moral self-restraint. The first reason reflects the somewhat crass logic of deterrence—people obey law to avoid the negative consequences associated with law breaking. The second embodies some good news—people are capable of restraining themselves even when the logic of deterrence fails. Empirical evidence shows that people acknowledge a general duty to abide by the law even if the law is not effectively enforced. Of course, most people would not commit murder even if there were no law against it, and even at the crest of the recent wave of financial frauds, restatements were filed by only a relatively small percent of publicly traded companies. Notwithstanding Enron and related scandals, there seems to be no need for cynicism.

This article's primary scholarly contribution resides in the idea of moral saliency coupled with the notion of a hierarchy of law. The article develops the idea that a businessperson's willingness to voluntarily obey law varies with the perceived moral saliency of the law in question. Depicting a hierarchy of laws ranging from murder on one end to a misguided environmental regulation on the other, the discussion focuses on the perceived moral saliency of an executive's fiduciary obligations to avoid self-dealing and fraudulent deception. The article asks to what extent is the law of fraud perceived as inviolate like murder, and to what

extent is compliance perceived as completely dependent on the logic of deterrence. The article also offers an answer. It poses a trade-off between moral self-restraint and pecuniary self-interest, suggesting that the violation of various financial regulations, including those pertaining to tax, antitrust, and insider trading, are to be anticipated when expected payouts become too high.

Finally, the article offers a retrospective on Enron now that the data are in. Enron provides a case study where corporate executives seemingly concluded that fraud paid. It also highlights a lack of moral self-restraint by a host of fiduciaries, including lawyers, accountants, bankers, and corporate executives. Placed in historical context, Enron is neither unique nor atypical. It reflects what happens when one combines too little respect for one's legal obligations with a perception that fraud pays.