Banking Law

Enron’s Collapse 20 Years Later—Lessons Not Learned

By Victor B. Flatt

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Enron, once touted as the most innovative American company, declared bankruptcy in Dec. 2001, exposing massive accounting and corporate fraud. University of Houston Law Center’s Victor B. Flatt says the lesson that effective government regulation aids wealth creation rather than hinders it remains largely unheeded, despite law such as Sarbanes-Oxley and other post-scandal reforms.

Twenty years ago in December 2001, the wunderkind energy company Enron collapsed spectacularly, destroying $67 billion in assets held by mutual funds, retirees and individual stock investors. Some commentary 20 years later has focused on how Enron heralded the first of companies making money by “disruption"—even as some of this disruption also led to negative impacts on society.

There is no doubt that, like Facebook, even Enron’s legitimate money-making enterprises had some negative spillovers as a side effect of wealth creation by innovation. But the problem isn’t with the idea of seeking innovation or testing disruptive ways of doing things; the problem is that government regulators, then and now, have been starved of their ability to effectively channel market forces and private innovation to wealth creation while avoiding negative externalities.

Truly supporting the private sector, innovation, and wealth creation, requires more government regulation, not less.

Laws Must Ensure That Cheating Is Not Incentivized

The seeds of Enron’s debacle were planted through new wealth-maximization incentives proposed by accounting services in the 1990s. Beginning with the creation of the Securities and Exchange Commission in the 1930s, the SEC had the statutory authority to set accounting principles, and for the next 60 years it relied on the accounting industry to primarily police and regulate itself, through rules and standards adopted by the Financial Accounting Standards Board (FASB).

This worked reasonably well, primarily because there was no incentive for the private sector accounting industry to misreport, and competitors would likely rat out cheaters. However, in the 1990s when deregulation allowed the accounting industry to begin offering other financial services, the SEC failed to recognize the inherent incentive problems this created, such as the conflict in auditing and consulting functions.

The use of large accounting firms simultaneously to perform auditing and non-auditing services created a huge conflict of interest between auditor independence and company pressures. During 2000, Enron paid a total of $52 million to Arthur Andersen: $25 million for auditing services and $27 million for non-auditing (consulting) services. The consulting services provided Enron with advice for structuring its business deals.

Andersen estimated that keeping Enron as a client would generate $100 million a year in revenues. In order to satisfy auditing standards, auditors must remain independent.

But the $27 million that Andersen received from Enron in 2000 could easily have compromised Andersen's independence and its judgment in determining the nature, timing, and extent of audit procedures. Further, these sums may also have deterred Andersen from asking Enron to revise its financial statements.

The Enron and related Arthur Andersen accounting scandals did prompt new laws and regulations, such as the Sarbanes-Oxley Act and even produced new attorney ethical regulations through the American Bar Association Model Rules of Professional Conduct.

But while this may have helped avoid another specific Enron or Arthur Andersen (if properly enforced) and put attorneys on notice of their own responsibility, it was too specific to this crisis and missed the bigger lesson of making sure that any incentives to cheat in the marketplace are not rewarded.

Capitalism asks the private sector to make money. This will lead to exploitation of legal loopholes, such as what was seen in the California energy deregulation crisis, and exploitation of illegal gains if they aren't disincentivized.

This means that laws must align profit making with incentives not to cheat or to police others in the industry, and/or have adequate enforcement resources to penalize cheating. Since the collapse of Enron, we have not done this.

Good Regulation Enhances Wealth Creation

Deregulating is not the same as creating wealth. In general industries will not police themselves, and we have seen the hard lesson played out in multiple failures, such as the Macondo Well explosion (Deepwater Horizon drilling platform) in 2010 up to the foreign political influence of Facebook and other "new industry" social media services. The answer is enacting is more nuanced laws and much more effective enforcement.

Not deregulation, but good regulation. Such regulations enhance wealth creation by ensuring that open and fair market players only gain rewards for actual, non-harmful innovations. Actually designing statutes that avoid perverse market incentives can be hard, but if those drafting the laws are made aware of the pitfalls, they can avoid some of the worst possibilities.

What can be done more easily (if there were the political will) is making sure the laws that we do have to ensure fair and equitable markets are adequately enforced. This requires increasing funding for enforcement agencies such as the SEC and the Environmental Protection Administration, and adequate penalties when wrongdoing is detected.

Twenty years ago, we were just coming out of the Clinton cooperative enforcement phase, and while that had some good points, the blithe assumption that companies would make more money and do it honestly without enforcement was wrong. Enron was the result. If we focus on correct enforcement, we can avoid the next Enron, and other things we can't yet imagine. That is the lesson from Enron.

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