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CATASTROPHIC FINANCIAL FAILURES:  
ENRON AND MORE

Geoffrey P. Miller†

Over the past few years, a number of firms have suffered catastrophic financial collapse, which resulted in harm to investors and significant spillover effects in the economy. Enron and WorldCom are only the largest and most recent of these disasters.1 The 1989 collapse of Lincoln Savings & Loan (Lincoln Savings) was an equally significant event. The failure of Lincoln Savings eventually cost the U.S. government $3.4 billion and precipitated a political scandal involving five U.S. Senators, including former astronaut John Glenn and 2000 presidential candidate John McCain.

Many non-U.S. corporations also have suffered catastrophic financial collapse. The recent debacle with the HIH Insurance Group (HIH) provides the most salient example of a catastrophic financial failure in Australia. HIH was placed in provisional liquidation in March 2001, with debts of up to AUD$5.3 billion.2 The HIH bankruptcy, which was the largest in Australia’s history, resulted in large losses for investors,3 a government bailout for policyholders,4 and spikes in premiums for governmental and professional liability policies,5 not to mention significant disruption in the building industry because of difficulties builders faced in obtaining compulsory home warranty insurance.6 In addition, in the wake of the HIH fiasco, the insurance industry threatened “to withdraw from public liability and professional indemnity cover” unless the government implemented tort and tax reforms.7

1 See Thor Valdmanis & Andrew Backover, WorldCom in ‘Death Spiral,’ USA TODAY, June 27, 2002, at 1B.
3 See Sue Lecky, Auditors Are Called to Account, SYDNEY MORNING HERALD, June 21, 2001, at (Business) 45.
7 See Allesandra Fabro & Morgan Mellish, Insurers Threaten To Pull Cover, AUSTL. FIN. REV., July 9, 2002, at 1.
In Japan, EIEI International (EIEI), a high-flying conglomerate, controlled some of the most prestigious and prominent real estate properties in the world during the Japanese bubble economy of 1988 to 1990.\(^8\) EIEI failed in 1990, although it was propped up for several years by its main bank, the Long Term Credit Bank of Japan, until the bank itself went under, in large part because of billions of dollars in losses on loans to EIEI.

One of the most notorious failures of all time was that of Luxembourg-based Bank of Credit and Commerce International (BCCI). Despite billing itself as an innovative and public-spirited institution that served the needs of developing economies, BCCI was, in fact, an elaborate financial fraud, whose profits BCCI officials allegedly disguised "by moving millions of dollars in cash through a labyrinth of BCCI accounts."\(^9\) When BCCI collapsed in July 1991, it was hopelessly insolvent, and thousands of small depositors were bereft of their life savings.

The damages caused by these and other fiascos are irreversible. One can only try to understand how the catastrophes happened in the hope of avoiding them in the future. This Article looks across these six cases—WorldCom, Enron, Lincoln Savings, HIH, EIEI, and BCCI—and attempts to identify common threads that might help prevent similar disasters in the future. Each of these six events was a complex phenomenon with its own etiology, development, and resolution. Discussing any one of them in detail, much less comparing all six, is beyond the scope of this Article, which hopes only to touch upon some of the apparent common features that, upon further inquiry, might yield fruitful research and investigation.\(^10\)

The six cases at issue share a number of features. The commonalities are surprising, even remarkable. Each of the features this Article addresses—massive growth spurts, key corporate officers with strong political connections, and domination of the firm by a single individual or small group—is potentially innocuous; indeed, many perfectly safe and well-managed firms display one or more of these features.

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10 Two caveats are in order. First, regarding HIH in particular, this matter is currently under investigation by the Royal Commission. Witnesses who have appeared before the Commission disagree as to what transpired. Accordingly, it is not possible at this stage to make definitive judgments or to assign blame for the fiasco. However, some of the facts about HIH appear to be reasonably well established or undisputed. This Article intends to enlist these facts, without venturing too far into a difficult and ongoing controversy.

Second, I have had personal involvement in two of these matters—BCCI and EIEI—as an expert witness in certain lawsuits. This Article will not address issues on which I was called to testify. All discussion in this Article is based on publicly available documents and information.
What is remarkable is the accumulation of these common features in these six firms. There is a family resemblance among them: there may be no single feature common to all or lacking in all the others, but the combination of a group of features shared by most makes it possible to identify individuals as members of the same clan or kin. This analysis suggests that a bunching of these features in a single firm may be cause for concern.\textsuperscript{11}

1. Massive Growth

An initial, objectively observable category of commonality is the \textit{nova} effect.\textsuperscript{12} Most of the six firms displayed this feature, even though they began life as fairly normal examples of their industry. Before Charles Keating took control of Lincoln Savings, it was a boring, staid provider of home mortgage finance. Similarly, FAI, which was one of the chief components within HIH, was a relatively traditional insurance company. Enron started its life as an unimaginative, regional natural gas pipeline company. WorldCom began in 1983 as a tiny startup provider of discount long distance services, based in Brookhaven, Mississippi, "a small town about an hour south of Jackson."\textsuperscript{13} The company is said to have originated from an idea scribbled on the back of a coffee shop napkin.\textsuperscript{14}

At some point after those inauspicious beginnings, the firms embarked on a course of rampant and radical growth. Usually, this was accomplished by merger; a firm grows faster by eating up other firms than by expanding internally. WorldCom was one of the most remarkable examples of this phenomenon. Known as "one of the most acquisitive companies in corporate history," in just five years WorldCom "bought some seventy firms [for consideration] in excess of $100 billion,"\textsuperscript{15} including a 1998 merger with MCI that allowed WorldCom to leapfrog to second place in the U.S. telecommunication industry.

\textsuperscript{11} Physicians sometimes define disease this way. Certain symptoms might, by themselves, be part of normal bodily functioning, or at least not be cause for alarm. But, when a sufficient number of symptoms appear simultaneously in a patient, the physician may form at least a tentative diagnosis that a particular disease is present.

\textsuperscript{12} The term nova comes from the astrological term for certain stars that function normally for many years, then suddenly heat up and explode in a giant expansion. See \textit{WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY} 1546 (1986).


\textsuperscript{15} See Business Center: Analysis: Jack Grubman's Testimony on Capitol Hill and His Background Regarding WorldCom (CNBC television broadcast, July 8, 2002), available at 2002 WL 5794478.
tions market. In addition, WorldCom proposed a $129 billion acquisition of Sprint in 1999, but that deal was prevented because of objections from U.S. antitrust authorities.

HIH also experienced a major growth spurt in the few years before its failure. It purchased the Cotesworth Group in 1998, the FAI group in January 1999, and World Marine in December 1999. Total assets and revenues for the consolidated firm more than tripled between 1995 and 2000. Lincoln Savings, Charles Keating’s vehicle, grew fivefold in the space of four years, ballooning from $1 billion in assets in 1984 to $5 billion in assets in 1988.

2. Questionable Accounting

After these financial failures come to light, it is easy to see what their problems were. Almost always, these firms manipulated the accounting numbers to disguise problems until they could no longer be hidden, even with the most creative bookkeeping strategies. Unfortunately, accounting manipulation and fraud is difficult by nature to detect and not readily observable. Thus, these disasters are difficult to prevent.

In the case of HIH, the questionable accounting involved the firm’s treatment of certain reinsurance contracts that FAI entered before its acquisition by HIH. It appears that in 1997 or 1998, FAI management realized that the company had failed to make adequate provisions for reserves on various lines, and that the shortfall in reserves would be significant. The performance of several of the company’s longtail insurance portfolios had been far worse than anticipated, and the firm had not been properly reserved. This underperformance placed the company in perilous financial straits. In an effort to avoid financial peril, FAI’s senior managers negotiated agreements with two reinsurance firms that provided coverage for loss exposures against certain ratios. With these reinsurance agreements in place, FAI could avoid provisioning for reserves, thereby avoiding the inevitable hit to the balance sheet and subsequent profit and loss statement. In fact, FAI could book a profit in the early years of the reinsurance contract if it designed the premium structure in such a way that the claims against the reinsurer exceeded the premiums paid. If the deal succeeded, FAI could continue to project the image of

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17 See Endgame, supra note 16.

18 FAI Insurances, whose acquisition in 1999 contributed materially to HIH’s problems, previously had a growth spurt during the Australian share market boom of 1985 to 1987. During those years, it grew at a compound rate of 45% per year. See Kathryn Bice, FAI Looks to Its Younger Blood, AUSTL. FIN. REV., Jan. 13, 1988, at 14.
profitable operations for a substantial period of time, and thus defer recognition of the losses for accounting purposes, even though the firm had discovered a shortfall of as much as AUD$100 million in its reserve provisions. Many insurance companies, not just FAI, played this game. It worked as long as the insurance regulators in the relevant jurisdiction accepted the reinsurance contract as genuine rather than as a charade designed to facilitate a stronger accounting picture.\footnote{This meant that there had to be some element of genuine risk to the reinsurer. The challenge for lawyers, actuaries, and business persons was to minimize the insurance element without going over the line. National Indemnity, one of FAI’s reinsurers, interjected risk into the contract by including an extra AUD$30 million “for earthquake insurance that would take effect if an earthquake in Australia caused AUD$5 billion of losses in one year, and a second earthquake followed in another year during the period of coverage[;]” an exceedingly unlikely series of events. See Leslie P. Norton, \textit{Australian Insurance Scandal Embroils Buffett’s Firm}, \textit{BARRON’S}, Mar. 4, 2002, at MW10.}

In the case of Enron, faulty accounting treatment of partnership transactions caused profits to be overstated by approximately one billion dollars in a single year, according to the Powers Committee.\footnote{See \textit{William C. Powers, Jr. et al., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.} 4, at \url{http://news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf} (Feb. 1, 2002) [hereinafter \textit{Powers Report}].} Enron’s falsifying strategy involved use of “special purpose entities” (SPEs). Generally accepted accounting principles provided that a company doing business with an SPE may treat the SPE as an independent, outside entity if two conditions are met: “(1) an owner independent of the company must make a substantive equity investment of at least [three percent] of the SPE’s assets, and that [three percent] must remain at risk throughout the transaction; and (2) the independent owner must exercise control of the SPE.”\footnote{\textit{Id.} at 5.} If these conditions are met, “the company may record gains and losses on transactions with the SPE” as if the company incurred harm in bona fide third-party transactions, and the company does not have to record the SPE’s liabilities on the books.\footnote{\textit{Id.}}

Enron used SPEs to disguise losses in its investment portfolio. Although the accounting structure was complex, the essential idea was simple. In one typical transaction, the SPE would ostensibly hedge Enron against losses in identified investments by agreeing, for a price, to pay Enron in the event that the investment decreased in value. In this way, Enron could avoid disclosing accounting losses on its investments and could even book a profit if it recognized the payments, but not the losses, for accounting purposes. This would have been legitimate if the SPEs were genuinely independent vehicles, but Enron had
actually funded them with its own stock. Thus, when Enron lost money on investments, it effectively paid itself for the shortfall and claimed a profit for doing so. Furthermore, because the SPEs held their Enron stock rather than selling it, they maintained a nondiversified asset base with which to meet their obligations under the hedging contracts. The likely correlation between losses in Enron’s investments and reductions in Enron’s stock value exacerbated the situation. If both went south at the same time, as in fact happened, the SPEs would lack the funds to meet even their formal obligations. This occurrence forced Enron to recognize the losses in its accounting numbers, and generated a $544 million after-tax charge against earnings and a $1.2 billion reduction of shareholders’ equity.23

Another Enron trick was to use an SPE to book gains on investments in speculative securities, while avoiding the need to account for losses. For example, Enron invested in a startup technology venture, Rhythyms Net Communications (Rhythyms Net), for about ten million dollars. When Rhythyms Net went public at the peak of the dot-com bubble, Enron’s stake was worth hundreds of millions of dollars. Although Enron was prohibited from selling the stock outright for a period of time, the company could pledge the stock. To this end, Enron utilized a purpose vehicle that would lend Enron money using its Rhythyms Net stock as collateral. Enron guaranteed the value of the collateral by promising to compensate for any shortfall by issuing its own stock to the SPE. Enron was able to book the value of its investment without any apparent possibility of loss because if the Rhythyms Net stock decreased in value, Enron would cover the shortfall with its own stock, which the company would not account for as a loss.24

As for EIEI, the Japanese property developer, the accounting scheme was designed to obtain very high appraisals of properties under development. This was usually easy to do because the banks were eager to lend, and accordingly, did not scrutinize the valuations that EIEI placed on the properties. Moreover, appraisers justifiably gave high valuations, especially to Japanese properties, because the enormous bubble in the Japanese equity markets had sent property values to astronomical heights. When the properties turned out to be worth much less than their appraised valuation, banks did not demand a revaluation because that would have required them to ac-

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23 See id. at 2.

knowledge the loans on their books, thus revealing the severe weakness of their own financial condition.

Like EIEI, Lincoln Savings also used ambitious appraisals to shield its balance sheet, and engaged in poor documentation of its loan portfolio.\(^{25}\) Because Lincoln had invested heavily in real estate, an asset notoriously difficult to appraise accurately, it was able to keep these assets on its books at a high valuation even when property values plummeted in 1987.\(^{26}\)

3. Questionable Accountants

Employing questionable accountants to audit a firm’s books is another cause for concern. However, determining whether an accountant is questionable may be difficult: large accounting firms employ thousands of accountants. Perhaps only a few violate ethical standards, and even accountants make mistakes. Accordingly, it might be unfair to label a company as at risk of collapse based solely on suspicions about its accountant unless reliable sources show that the accountant is willing to cut corners in clients’ books.

Frequent changes in accounting firms are a more objective cause for concern. Previous auditors may have raised questions about the financial statements that the company did not want to address. Alternatively, an auditor may have withdrawn from an account because she was unwilling to certify the numbers proposed by the company’s bookkeepers. Frequent changes in auditors—the use of three or more auditors within a ten year period—is therefore behavior that raises a cause for concern, although this charge alone is not evidence of wrongdoing.

4. Poor Underlying Performance

Another warning signal is subpar company performance. However, profit and loss statements often obscure this. A company may inflate its profits by selling appreciated assets or may recognize income before it is received. Nevertheless, generally accepted accounting principles limit a company’s ability to disguise poor performance over the long run. Unless outright fraud exists, analysts skilled at deciphering financial statements should be able to identify persistent periods of poor performance.


As the operating performance of a company deteriorates, the temptation for fraud can become very great. There is evidence, for example, that the financial picture at FAI was substantially overstated as a result of very large under-reserving against policy losses.27

Even market recognition of poor underlying performance may not be enough to trigger a market reaction that disciplines managers and averts disaster. Where sufficient buzz about a company or a lack of strong market discipline exists, the firm may be able to continue undisciplined for a substantial period of time. The dot-coms are a prime example. Most of them never turned a profit and never had a realistic prospect of doing so—at least when analyzed in hindsight. Yet because of the buzz of investor enthusiasm, their poor—perhaps nonexistent—operating performance failed to trigger market correction, and they were able to continue operations unchecked.

Several of our disaster stories displayed poor operating performance. HIH is a case in point. FAI, which HIH acquired in 1998, had a history of losses in its insurance underwriting business. Its actuarial practices appear to have been poor, and it priced its policies very competitively.28 The short-term result was rapid growth in FAI’s portfolio and a temporary period of cheap policies for its customers. In the long term, however, even company insiders considered the performance of the insurance business unsustainable29 because FAI’s profits derived from speculative investments, which had generated abnormal profits for some time.30

Enron, too, experienced poor operating performance in the years prior to its bankruptcy. Its core business of making merchant investments had experienced very large losses. To conceal heavy losses in this core business, management created the illusion that the losses had been hedged by contracts with independent parties, who were obligated to assume the incidence of loss.31

Lincoln Savings also demonstrated poor operating performance. As a thrift institution, its ordinary business would have been to take deposits and make loans, with profit coming from the spread between the cost of deposits and the interest received on the loans. Lincoln Savings, however, chose to invest many of its assets in real estate rather than in loans. During the real estate boom in the sunbelt during the

29 Id.
31 See POWERS REPORT, supra note 20, at 4.
1970s and 1980s, which saw the population of the Phoenix metropolitan area double in fifteen years;\(^{32}\) this would have been an excellent investment. But by 1987, the sunbelt real estate market was quickly souring.\(^{33}\) As of September 30, 1986, Lincoln Savings reported "a $945 million differential between interest-bearing liabilities and interest-earning assets."\(^{34}\) To break even on these assets and liabilities, the firm would have had to earn a positive weighted average interest rate spread of 3.46% on that date, when in fact, it was earning only 0.45%.\(^{35}\)

EIEI never displayed real profits either. Its apparent profitability during the few years of its ascendency was due to the massive increase in the value of its assets that accompanied the bubble economy. Once the firm had embarked on its splurge of investments, EIEI never generated enough cash flow from operations to service its debt, much less to generate a profit.\(^{36}\) If it needed to repay a loan, it could simply sell an asset and reap a huge profit. EIEI was so dependent on appreciating property values that its top managers never even drew up a realistic plan for servicing their debt in the event that the real estate market dropped and the value of its properties plummeted.

5. Political Connections

Another feature common to many of these cases is the presence of a high level of political activism by company leaders. Charles Keating, Jr.'s political powers were legendary.\(^{37}\) Hailing from a well-connected Cincinnati family (his brother had been a Republican congressman),\(^{38}\) Keating also vocally supported Republican politicians and briefly directed Texas Governor John Connolly's 1980 presidential campaign.\(^{39}\) Keating greased the political wheels with large political contributions.\(^{40}\) In 1983, when the Phoenix City Council considered a proposal to ban artificial lakes—a hallmark of Keating's developments—he reportedly gave so much money to candidates that the council changed its election financing rules to preclude such do-

\(^{32}\) See Laing, supra note 26, at 28.
\(^{33}\) See Michael Weiss, Overdone in the Sun: Phoenix Struggles To Rise from Ashes of Building Bust, DALLAS MORNING NEWS, Dec. 13, 1988, at 1D.
\(^{35}\) Id.
\(^{37}\) See Laing, supra note 26, at 28.
\(^{38}\) See Binstein, supra note 25.
nations in the future. Keating also was an early player in soft money donations. According to a study by the Center for Responsive Politics, which examined soft money donations in five states during the 1985 to 1986 election cycle, Keating gave $85,000 through his firm to the California Democratic Party. This was one of the two largest soft money donations in that state. Displaying admirable bipartisanship, Keating also funneled $100,000 of his own money to the Florida Republican Party, thereby making the largest soft money donation identified in the study. Keating also made substantial political contributions to individual candidates. When Lincoln Savings began to experience serious financial problems in 1987, Keating became embroiled in an acrimonious dispute with Edwin Gray, Chairman of the thrift regulatory agency then known as the Federal Home Loan Bank Board (FHLBB). After the FHLBB conducted a yearlong examination of Lincoln Savings, Keating enlisted five U.S. senators—who had all received campaign contributions from Keating and his associates—to meet with federal regulators and pressure them to end their investigation and to complain about alleged over-regulation and unfair treatment. Keating even retained Alan Greenspan, former Chairman of the President's Council of Economic Advisors and future Federal Reserve Board Chairman, to conduct a study favoring Keating's views on deregulation.

Keating also managed to wield indirect influence by employing former government regulators, who could be expected to influence their former colleagues. His sensitivity to political influence extended to choice of counsel: when he needed approval from California officials for a controversial plan to sell uninsured subordinated debentures in the lobbies of Lincoln Savings, he hired a law firm whose senior partner was the chief fundraiser for California Governor George Deukmejian.

EIEI's Harunori Takahashi was also a master at amassing influence by catering to politicians. In Japan, he reportedly spent a consid-

43 See Meddling and Misjudgment, PLAIN DEALER, July 16, 1989, at 2E. One of these senators, Alan Cranston of California, subsequently received $850,000 in contributions from Keating for voter registration drives, which included $400,000 for a project organized by Senator Cranston's son. See Beth Barrett, Cranston Aided S&L, Got Voter Sign-up Funds Lincoln's Parent Company Reportedly Gave $400,000, ORANGE COUNTY REG., July 16, 1989, available at 1989 WL 6217999.  
45 See id.  
erable amount of money entertaining government officials and he eventually purchased a high class restaurant in Tokyo to facilitate this entertaining.47 He bought 60 million yen of tickets to a fundraising party for a leading politician and furnished him with a rent-free apartment in Tokyo.48 Takahashi also lent billions of yen to Toshio Yamaguchi, a leader of one of the Japanese political factions and one-time labor minister.49 He reportedly flew half the ruling junta of Fiji, on one of his private jets, to a junket in Tokyo.50 Further, Takahashi did not ignore the power of Japan’s bureaucracy. He is reported to have wined and dined senior officials of the Ministry of Finance (MOF) and to have catered to junior officials whom he saw as rising stars in the Ministry.51 Two senior MOF officials were actually censured for too-close contacts with Takahashi: “One of them, Hiroaki Taya, had accepted a free ride to Hong Kong on Takahashi’s jet, and enjoyed expensive nights out that reportedly included ‘pricey call girls.’ The other, Yoshio Nakajima . . . also accepted . . . Takahashi’s hospitality and committed [several] other indiscretions.”52

Enron also exercised political connections to the fullest extent possible. According to a 2000 survey of business executives, its chairman, Kenneth Lay, was one of the top fifty individual donors of soft money, with contributions totaling more than $361,000.53 Lay was a major contributor to President George W. Bush’s campaigns, and he was at one time a candidate for Secretary of the Treasury in that administration.54 Although Enron was widely associated with Republican causes, it spread its largesse in bipartisan fashion. At the 2000 Democratic National Convention, Enron sponsored “a lunch honoring [Senator] Bob Kerrey of Nebraska, . . . a breakfast for the California delegation[,] and events for Texas and New Mexico Democrats.”55

48 Id.
49 Id.
50 See id.
53 See Karen Masterson, Businesses Feel Strains of Political “Shakedown”, HOUS. CHRON., Oct. 19, 2000, at 1A.
54 See Campaign Donors Take Seats at Presidential Advisory Table, AUGUSTA CHRON., Dec. 31, 2000, at 9A.
Enron was also savvy at hiring politically connected individuals: "Enron and its affiliates . . . hired . . . former Secretary of State James Baker and former Commerce Secretary Robert Mosbacher," both of whom had served in the administration of President George Bush.56

HIH also sought the benefit of political connections. HIH and FAI together contributed a majority of the insurance industry’s donations to political parties between 1994 and 2000.57 Rodney Adler of FAI is a former president of the Insurance Council of Australia, the industry lobbying group.58

WorldCom has given $7.5 million to politicians since 1989. Republicans received 54%, and Democrats received 46%. “For the 2002 election, the company . . . [reportedly] split $1 million in donations 50-50 between the parties.”59

Of the institutions under study here, BCCI was undoubtedly the most politically active. Its chairman, Agha Hansan Abedi, assiduously courted former President Carter and prominent members of his administration. He accompanied President Carter on a visit to Thailand and pledged $250,000 to Carter’s Global 2000 program.60 Overall, BCCI donated millions of dollars to Carter's pet charity, and it was the largest single donor to the operation.61

One of Abedi’s favorite tactics was to obtain support from someone of impeccable reputation and wide-ranging influence. He found the perfect representative in Clark Clifford, éminence grise of Washington’s political establishment and advisor to numerous former presidents.62 Clifford and his associate, Robert Altman, provided lucrative legal services to BCCI for years. They were also accused of acting as fronts for BCCI in its efforts to infiltrate the American banking industry through the secret acquisition of a controlling interest in First American Bankshares, a medium-sized commercial bank holding company doing most of its business in Virginia, Maryland, and Washington, D.C.63

Abedi also recruited another powerful political insider, Bert Lance, who was a crony of President Carter and former head of

58 See id.
59 See As Business Scandals Mount, Both Parties Share Blame, USA TODAY, July 8, 2002, at 11A.
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Carter's Office of Management and Budget (OMB). After resigning as head of the OMB in the wake of embarrassing disclosures of potential conflicts of interest in his prior service at a Georgia bank, Lance returned to manage the National Bank of Georgia. Abedi retained Lance to assist him in finding ways to enter the U.S. banking market. When Lance ran out of money and needed to sell the bank, Abedi purchased the institution through a nominee, Ghaith Pharaoh. Through Lance, Abedi met Clifford and Altman, who represented Lance in the sale of the Georgia bank.

Abedi’s actions in the United States, catering to President Carter and members of his administration as well as to other influential power brokers, typified his modus operandi.

6. Firm’s Domination by a Single Individual or Small Group

Lincoln Savings, EIEI, WorldCom, FAI, HIH, and BCCI all provide examples of business institutions being dominated by a single individual. For example, Lincoln Savings and its affiliate, American Continental, became the tools of the mephistophelian Charles Keating, Jr., who founded neither institution but molded both to his will. American Continental was a struggling home builder; under Keating’s regime, it became a major developer, investor in financial institutions, and player in corporate takeover markets. Lincoln Savings underwent a similar transformation under Keating’s rule, evolving from a stodgy, traditional savings and loan to a high-flying player in distinctly new and untested markets. Keating maintained control over these firms by holding a forty-nine percent personal stake, appointing family members to high management positions, and surrounding himself with loyal subjects. Keating was an imposing and distinctive figure: At six feet five inches, he towered over the landscape of his companies. He also imposed his personal tastes on his empire, demanding that his employees be neat, well groomed, enthusiastic, and attrac-

64 See generally Bert Lane with Bill Gilbert, The Truth of the Matter: My Life In and Out of Politics (1991).
65 See Bob Kelly, Any Former Cabinet Secretary? Satterfield Again Tries To Put Wheels on Airport Proposal, CHARLESTON GAZETTE, Aug. 2, 2002, at 4A.
66 See id.
67 See id.
68 See id.
69 See id.
70 For example, he enjoyed personal connections with members of the royal families of several Arab leaders. See Kathleen Day, Investors in Bank Tied to Drug Probe Have Local Ties, WASH. POST, Oct. 13, 1988, at C1.
72 One employee gushed, “The guy has always been kind of an idol to me,” and added that Keating “is the most brilliant financial mind in the state, and his generosity is legend.” See id.
tive.73 "[T]he pulchritude of the secretarial pool" at American Continental was legendary in Phoenix.74

EIEI, the Japanese bubble conglomerate, was similarly dominated by Harunori Takahashi. Takahashi was the founder of the firm and the nucleus of all its activities. He was free to act whimsically and to squander EIEI's money because the firm was privately held. In Australia, Takahashi is famous for having purchased the Regent Sydney Hotel for AUD$145 million after he noticed it from his limousine.75 Takahashi was such a prominent figure that the press developed various nicknames for him, including "Baburu Shinshi," or "Bubble Gentleman," which was a reference to the Japanese bubble economy he epitomized.76

Enron, unlike the other five firms, was too large to be dominated by a single individual. At one time, it was the seventh largest firm in the United States for market capitalization. Its public shareholders, including institutional investors, would have objected to control by a single individual. Yet this did not stop Enron from being controlled by a small group. This clique included Kenneth Lay (former CEO and Chairman), Jeffrey Skilling (former President and COO), and Andrew Fastow (former Executive Vice President and CFO).

The dominating figure at WorldCom was Bernie Ebbers. His story, at least as it was embellished prior to his disgrace, has some of the mythic elements one associates with American historical figures such as Abraham Lincoln. Born to a poor family in Edmonton, Alberta, Ebbers took a job delivering milk after graduating from high school, "sometimes in temperatures that reached [thirty] degrees below zero."77 Like Keating, Ebbers, at six feet four inches, was an imposing physical presence. An athlete, he attended college on a basketball scholarship, "graduated... with a degree in physical education, and became a high school [physical education] teacher and basketball coach."78 Like the other CEO's studied here, Ebbers had unshakeable optimism. In fact, it was this optimism that got him into trouble. Ebbers borrowed against his stock in the expectation that it would continue to rise. When the stock fell, he had no means to repay his loans.

73 See id.
74 See id.
75 Buckets of Money, supra note 47.
77 Kaplan, supra note 14.
78 Id.
Rodney Adler, the CEO of FAI, individually and through his family held a controlling stake in the company. Like EIEI’s Takahashi, Adler was the son of the institution’s founder and maintained control over a family company which operated separately from, but in cooperation with, the doomed firm, FAI.

HIH, the insurance company that acquired FAI, also had a dominating figure: Raymond Williams. Williams founded the firm and remained its chief until being forced out shortly before its final collapse.

Of all the firms discussed, perhaps the firm where the leader’s personality was most dominant was BCCI. Abedi, who founded the firm in 1972, undoubtedly masterminded one of the longest frauds in history. Abedi possessed enormous charm, a charismatic personality, and nearly limitless capacities for good or evil that mesmerized those who came into contact with him.

7. Exceptionally Rapid Growth

All of the firms considered here displayed exceptionally rapid growth in a short period of time. Keating’s Lincoln Savings grew five-fold in a four-year span, ballooning from $4 billion in assets in 1984 to $5 billion in 1998. Similarly, HIH went through a major growth spurt in the few years before its failure. It purchased the Cotesworth Group in 1998, the FAI group in January 1999, and World Marine in December 1999. Total assets and revenues for the consolidated firm

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82 See Former HIH Boss Rumoured To Be on Legal Aid for Inquiry, AAP News, Mar. 6, 2002, available at 2002 WL 14574556. Williams and a colleague founded HIH’s predecessor as an underwriter of insurance for two Lloyd’s syndicates, primarily in the area of workers’ compensation. See HIH ROYAL COMM’N, I INDEX TO CORPORATE INFORMATION 4 (2002), available at http://www.hihroyalcom.gov.au/Documents/CIV/011-12.pdf. It was acquired by a public insurance company listed in the United Kingdom in 1971, and thereafter it expanded into other kinds of insurance including public, property, commercial, and professional liability. Id. The firm also started underwriting workers’ compensation policies in California. Id.


84 FAI Insurances, whose acquisition in 1999 contributed materially to HIH’s problems, previously had a growth spurt during the Australian stock market boom of 1985 to 1987. During those years, FAI grew at a compound rate of forty-five percent per year. See Bice, supra note 18.
more than tripled between 1995 and 2000. Most of this growth came from British and American companies, which represented a dramatically increasing share of HIH Groups’ revenues from 1995 to 2000. But these investments were unwise, at least in retrospect; after showing initial profitability, both plunged into debt.

EIEI, the Japanese real estate developer, started as a small firm on a back street of Tokyo’s Ginza district. With about only fifty employees in 1995, EIEI rapidly purchased resort properties and developed golf courses in Japan and around the world. When the Japanese bubble economy collapsed in 1991, EIEI had total debt of more than $11 billion.

BCCI also displayed enormous growth in the years before its collapse. Starting with total assets of $200 million in 1973, BCCI grew to $2.2 billion in 1977 and to more than $20 billion in 1988. Similarly, its geographic reach exploded, growing from nineteen branches in five countries in 1973 to 146 branches in thirty-two countries in 1977, and 417 branches in seventy-three countries in 1990. In 1988, The Wall Street Journal described BCCI as “one of the fastest-growing banks in the world.” In 1989, BCCI was among the top 300 global banks in terms of deposits. BCCI ranked worldwide as the seventh-largest privately owned financial institution in 1998 and the fifth largest in 1990.

8. Lavish Expenditures

Whenever a company becomes insolvent, the press tends to report the excessive expenditures made by senior management in the months or years preceding the insolvency. But, the expenditures displayed by the firms in our sample seem excessive even in hindsight. HIH’s end-of-year parties were known as some of the most lavish in Australia’s business world. Its client appreciation parties, held at Syd-
ney's Regent Hotel, featured entertainment by well-known musicians.97 The media roasted HIH's chief officers Williams and Adler for their allegedly lavish lifestyles and unconstrained expenditures.98 Williams lived in a "palatial Gwanda Bay manor," drove a Rolls Royce, and worked out of a "salubrious office-cum-dining room."99

Keating's generosity was legendary. Like HIH, American Continental had a reputation for hosting extravagant employee parties.100 Keating reportedly gave an executive $100,000 to quit smoking,101 while other employees received bonuses of shopping sprees and luxury cars.102 Keating, like EIEI's Takahashi, used three corporate jets.103

Enron's spending habits were also famous in the corporate world. Its Christmas parties were known as sumptuous affairs. Even in 2001, as the firm headed for bankruptcy, it planned for a $1.5 million Christmas bash at Enron Field.104 Enron rewarded secretaries with spa visits and Waterford crystal.105 No gesture seemed too lavish or extravagant.106 The company flew in more than 300 of its vice presidents from around the globe to a luxury resort in Beaver Creek, Colorado, for three days of skiing.107 For a firm "family picnic, Enron rented the [eighty-five]-acre Astroworld amusement park." One division regularly brought a live elephant to enliven employee meetings. Another division spent hundreds of thousands of dollars to build a mock trading floor, solely to impress equity analysts at a conference.108 When Enron's shares rose over $50 in 1998, "the company left $100 bills on each employee's desk."109 Enron's London headquarters, a sumptuous building in one of the city's toniest neighborhoods, cost $74 million to build.110 Enron also matched these gestures with more substantive actions: it paid salaries at or above the

99 Mychasuk & Lecky, supra note 97.
100 See Harris, supra note 39.
102 See Carson, supra note 41.
103 See id.
105 Id.
106 Id.
108 See id.
109 Id.
110 Id.
top of its market and provided perks to employees such as first-class travel and generous expense accounts. Enron managers were famous in Houston for driving expensive cars and building mansions in the town's best neighborhoods.

9. Disproportionate Compensation for Top Managers

In addition to spending lavishly on perks for all employees, the firms in the sample appeared particularly generous with senior managers. According to data prepared by the Royal Commission, senior executives of HIH consistently received salary increases greater than those given to staff, and those increases were regularly approved by the firm's human resources committee without the benefit of independent advice and in the absence of clear performance criteria.

The situation was similar at Lincoln Savings. Keating was the second highest paid executive in the U.S. thrift industry in 1987, earning $1.95 million, which was 10% more than his compensation the previous year, even though the institution's earnings fell 19.9% during the same period. In 1988, as his companies were collapsing into one of the most notorious bankruptcies in American history, his compensation increased to $2.95 million. Keating was nearly as generous with other senior managers (several of them family relations); in one survey, American Continental boasted six of the ten best paid executives in Arizona.

At BCCI, although the compensation Abedi or his deputy, Naqvi, received will probably never be known, it undoubtedly was large. Clifford and Altman, the Americans alleged to have conspired with Abedi to facilitate his takeover of First American Bankshares, were also richly compensated for their services. Although Clifford himself received the paltry sum of $50,000 for his services as Chairman of the bank—a fact his defenders frequently noted—he allegedly received very generous remuneration from BCCI in the form of beneficial loans and profitable stock transactions.

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111 See Nobody Went Like Enron, supra note 104.
113 For more on Vinson & Elkins, see Powers Report, supra note 20, at 10.
115 See Linda Ellis, Thrift CEO Pay Rose 13% in '87, Am. Banker, July 1, 1988, at 10, available at 1988 WL 6183106. Keating's spokesperson justified the salary on the ground that the parent institution, which had substantial nonthrift profits, paid the salary. Id.
117 See Harris, supra note 39.
Enron's top officials were also exceedingly well compensated. In 2000, three of Enron's executives were among the highest paid in Texas. Lay was the third highest paid executive in the state, with compensation of $5.2 million.\footnote{See Highest-Paid Executives of Public Companies, Hous. Bus. J., June 9, 2000, at 12B, available at 2000 WL 16624707.}

10. Sudden, Drastic Changes in the Nature of the Business

As with several of the spectacular savings and loan failures of the 1980s, Lincoln began and spent most of its corporate life in the sleepy backwaters of home mortgage finance. Prior to the mid-1980s, its main claim to fame was that it was the repository of a draft of Lincoln's Gettysburg Address for two years during the 1960s.\footnote{See U.S. GEN. ACCOUNTING OFFICE, THE GETTYSBURG ADDRESS: ISSUES RELATED TO DISPLAY AND PRESERVATION 2 (1994).} All this changed in 1985, when the California legislature enacted a law permitting state-chartered savings and loans to invest up to all of their assets in real estate development.\footnote{See Joe Cole, Developer-Controlled Thrift Bows to Regulators, Am. Banker, Dec. 8, 1987, at 3.} When Keating bought the company in 1984, in anticipation of the new real estate investment powers, he immediately moved in the direction of nontraditional finance. He abandoned the mainstay of the traditional savings and loan business, which was writing mortgages on single-family homes.\footnote{See David B. Hilder, Lincoln S&L Is Set to Name Hinz Chief; Move May Ease Rift with Bank Board, Wall St. J., Dec. 2, 1987, at 36.} In its place, he substituted real estate development, securities investment, and investment banking. By the end of 1986, Lincoln had more than $900 million invested in real estate.\footnote{Id.} Lincoln became a major purchaser of junk bonds (the market that Michael Milkin had practically created), with about ten percent of its $4.9 billion assets invested in those securities.\footnote{See id.} It also delved into investment banking, supporting leveraged buyouts and other corporate control transactions.\footnote{See, e.g., Wolken, Ex-Kroger Exec, Hungry for Fla. Food, Liquor Business, Drug Store News, Jan. 23, 1989, at 3.}

Similarly, although HIH ostensibly remained an insurance company, the nature of the insurance contracts it underwrote changed dramatically during the period of its rapid expansion. By acquiring FAI in 1998, HIH took over a general insurer that was a major player in investment advice and home mortgage origination. FAI also had major investments in a number of nonfinancial firms, including the largest home security distributor in Australia.\footnote{See Rodney Adler, Witness Testimony Before the HIH Royal Comm'n 7924 (May 6, 2002), available at http://www.hhroyalcom.gov.au/Documents/Transcript/Transcript_2002_06_05.pdf [hereinafter Witness Testimony of Rodney Adler].} HIH became in-
volved, through the purchase of the Cotesworth Group, in the underwriting of Lloyd’s syndicates through limited liability corporate capital vehicles. In addition to plunging into the rocky shoals of Lloyd’s, HIH became involved in unusual lines of insurance that basically made the firm a coadventurer with operating companies in highly risky fields of business. One unusual type of insurance that the firm involved itself with was film finance insurance, under which, for a substantial upfront premium, an insurer essentially guarantees investors that the film revenues will cover production costs. Another new HIH business was stop loss insurance. At the time of its failure, the HIH group dealt in some fourteen classes of insurance.

Enron also shifted its business focus in the years prior to its collapse. Originally, and for most of its corporate life, Enron was a natural gas pipeline company. Even in 1997, the natural gas pipeline business accounted for approximately half of Enron’s revenues. Three years later, pipelines represented only about twenty percent of Enron’s revenues. The change was not due to a reduction in pipeline activities, but rather to Enron’s massive growth in other businesses. Most notably, Enron engaged in the wholesale energy business and online trading, as well as metals trading, risk management services, paper and pulp trading, and broadband services.

An important common feature in the changes of these companies’ business is a shift from receiving income from core operations to receiving income from investments. For example, FAI evolved from about ninety percent insurance income and ten percent investment income in 1988 to about a fifty-fifty split in 1999.

11. Business Combinations That Don’t Appear To Make Sense

Several of the firms in our sample consisted of combinations of functions that appeared to make little operational sense. EIEI is an excellent example. EIEI had a vast network of businesses, many of them concentrated in the real estate and leisure development indus-
During its brief heyday from 1997 to 1999, the firm seemed to acquire anything that interested its Chairman. For example, during his travels throughout the Pacific Rim, Takahashi decided to purchase airlines. He purchased significant stakes in Fiji’s Air Pacific and Air Caledonie, entered talks with the King of Tonga about establishing a flag carrier for that nation, and negotiated for an ownership stake in Air New Zealand.

12. Operational Mystery

Another common feature of these firms is that even informed observers were unclear about how exactly the firms made money. This was particularly true of EIEI. Australian journalist Eric Ellis remarked humorously, but aptly, that EIEI appeared to display “many of the characteristics of the famous Playtex cross-your-heart bra—a unique contraption difficult to undo, with no visible means of support except to those of intimate association.” EIEI operated with one of the largest debt burdens of any firm in the world and had virtually no operational income other than what it could raise by selling assets. Yet Bungo Ishizaki, Takahashi’s flamboyant advisor, blithely portrayed this indebtedness as a strength rather than a weakness. He observed that “[i]n Japan debt is a good thing, it’s a net credit.”

13. Image Management

Each of the firms in our sample was deeply concerned with its corporate image. EIEI’s Takahashi, in particular, was extraordinarily good at generating a favorable corporate image. Unlike other high-flying businessmen of the bubble era, he came from an elite background and thus was able to cut an impressive figure with Japan’s business class. Takahashi was a graduate of Keio University School of Law, the son of a television executive, and his family tree included a former head of a major bank and a Japanese prime minister. Takahashi had little management experience and no experience in property development. Nevertheless, he was excellent at advertising his grandiose schemes, which included creating a massive empire of first-class tourist properties across the Pacific rim. As Takahashi’s firm expanded, he received glowing reviews in the financial press. An article in the Far Eastern Economic Review reported that “Takahashi has had luck purchasing troubled businesses and renovating them into high profit

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135 See Ellis, supra note 36.
137 Id.
138 Buckets of Money, supra note 47.
139 See Hartcher, supra note 89.
ventures.” Nowhere was EIEI’s buzz stronger than in Australia, where the firm was associated with mystery, intrigue, and backroom dealings at the highest level. As one Australian commentator remarked of the firm during its heyday, “[l]et’s just say they have some powerful friends.” Another echoed, “[t]he quality of their contacts is second-to-none in Japan.”

Enron too had an extraordinary corporate image, and it paid much attention to maintaining its favorable appearance. It spent hundreds of thousands of dollars catering to equity analysts whose opinions were important to sustaining stock prices. It generated a sense of dynamism, in part by rotating staff members’ positions with dizzying frequency. The firm won Fortune’s honor of “Most Innovative Company in America” for five years running, and—in what may now seem something of a grim joke—took first place in 2000 for “Quality of Management” and second place for “Employee Talent.” Enron’s stellar stock performance and outstanding growth earned it adulation in the financial community. Financial Times Energy awarded Enron the “Boldest Successful Investment Decision” in 2000 for spending $100 million to create EnronOnline. An article in Fortune referred to Enron as “an “awe-inspiring juggernaut.” Among his peers in the energy business, Lay appeared superhuman—a visionary mastermind whose achievements could only inspire.

Likewise, WorldCom’s rapid growth and high profile acquisitions earned it a reputation as a “world-beater.” American Continental also enjoyed favorable buzz and was known as an innovative, aggressive property developer.

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141 Ellis, supra note 36.
142 See Nobody Went Like Enron, supra note 104.
143 Id.
146 See Margaret Boitano, Is Dynegy the Next Enron?, Fortune, Dec. 18, 2000, at 166.
147 For examples of this awe, see The Energetic Messiah: Face Value: Enron’s Energetic Inspiration: By Bending All the Rules of the Energy Business, Kenneth Lay Has Turned Enron from a Stodgy Gas Concern into a Soaring New-Economy Company, but What Has He Learned Along the Way?, Economist, June 3, 2000, at 68.
148 See Valdmanis & Backover, supra note 1.
14. Charisma

The charisma of the corporate leader also contributes to a corporation's reputation. This was certainly the case with FAI's Adler, who was described as one of Australia's most "flamboyant" business executives.\(^\text{149}\) In the 1980s, Adler and his father participated in some of the most controversial Australian corporate takeover battles of the decade.\(^\text{150}\) Although perennially stretched financially,\(^\text{151}\) Adler was known as an "astute player with a nose for a good deal."\(^\text{152}\) During the Australian bull market of the mid-1980s, FAI showed truly spectacular profits, most of which were derived from speculative positions in stocks.\(^\text{153}\) HIH's Williams, equally prominent in Australian business circles, is well-known for supporting charities and worthy causes. He was awarded the Order of Australia in 1998 for his work as a financial benefactor and supporter of medical research and youth welfare organizations.\(^\text{154}\) Like Adler, he is known to have "moulded the company in his own image."\(^\text{155}\) Although Williams held only a small percentage of the shares, he controlled the firm by the "sheer force of his personality and his status as founder."\(^\text{156}\) Although viewed by some as controlling and autocratic, Williams enjoyed passionate loyalty and support from others.\(^\text{157}\)

Enron's Lay was also charismatic and dynamic. From the early 1980s, when he became chairman of the aging Houston Natural Gas Corp., he appeared to be a man in a hurry.\(^\text{158}\) Within six months, he had doubled the size of his company; within two years, he had pulled off a merger with an even larger firm, InterNorth. This merger would result in his heading the second-largest natural gas pipeline system

\(^{149}\) See The Enron Down Under, supra note 5.


\(^{154}\) See Mychasuk & Lecky, supra note 97.

\(^{155}\) Id.

\(^{156}\) Id.

\(^{157}\) Id.

\(^{158}\) See Houston Natural Gas Corp., InterNorth Inc. To Merge, WASH. POST, May 3, 1985, at D2 [hereinafter Houston Natural]; Matt Moffett, Lay Doubles Houston Natural Gas's Size in Only 6 Months as Chairman and Chief, WALL ST. J., Dec. 4, 1984, at 24 (reporting that in only six months as head of the company, Lay "engineered two major acquisitions that have doubled Houston Natural's size and transformed it from a regional vendor of natural gas into a coast-to-coast power in the interstate natural gas market").
and the first truly nationwide natural gas system in the country. He displayed a hard-charging and competitive management style, a taste for risk, and an eagerness to impose his personal stamp. Lay's attitude was optimistic and bullish: he predicted even better times for his company. He received wide credit for his pioneering approach to the development of interstate gas pipeline networks was widely touted as a “visionary” corporate executive.

The charisma of the firms’ dominating figures is often enhanced by their public involvement in charitable or community activities. Keating’s American Continental sponsored a world-class ten-kilometer run in Phoenix, Arizona. Keating was also a prominent prolife and antipornography activist. Like other charismatic leaders, Adler is also known for his charitable and business activities. He is a cofounder of Australia’s “National Kindness Week,” a former joint chairman of Juvenile Diabetes Australia, and the recipient of the Member of the Order of Australia for his services to the community.

EIEI’s Takahashi was equally charismatic, displaying charm and aristocratic lineage to impress the Japanese and aggressive confidence for overseas consumption. He was known internationally as a “fast mover,” mysterious but well-connected.

15. Easy Access to Capital

Each of the firms in our sample had ready access to capital, without needing to go through the vetting process normally imposed by banks and capital markets. EIEI provides a good example. Because of the bubble economy, Japanese banks willingly extended loans on inadequate collateral without seriously credit screening anyone who appeared to be a serious property developer. Takahashi, EIEI’s dominant figure, joked that getting financing from banks was like

159 Houston Natural, supra note 158; Daniel Rosenheim, Internorth To Buy Houston Natural for $2.3 Billion, Chi. Trib., May 3, 1985, at 1, available at 1985 WL 2511696.
160 See Moffett, supra note 158.
161 See id.
162 See Rosenheim, supra note 159.
163 See Boitano, supra note 146.
164 See Peters, supra note 101.
165 See Arizona, USA TODAY, Jan. 28, 1988, at 8A (stating that properties Keating developed contained deed restrictions against performing abortions); Carson, supra note 41; John Spano, S&L Sues To Close X-Rated Theater After City Drops Fight, L.A. TIMES, Mar. 27, 1987, at II-1.
167 See Japanese Cove Buys Sanctuary, SUN HERALD, Ocl. 2, 1988, at 50.
"taking buckets of water from a running tap and filling a bathtub."\textsuperscript{169} Dr. Bungo Ishizaki, Takahashi's chief advisor, remarked that the banks would simply take EIEI's proposals, put their own cover on them, and provide funding with no pretense of careful credit analysis.\textsuperscript{170} When bank credit began to dry up, EIEI had an alternative source of capital. In addition to controlling EIEI, Takahashi dominated the Tokyo Kyowa Credit Union, a large credit cooperative in Japan. Takahashi also exercised indirect control over another credit union, Anzen Credit Union. Between 1992 and 1994, Takahashi arranged for loans of $18.2 billion from both Tokyo Kyowa and Anzen Credit.\textsuperscript{171}

Keating's American Continental, like other developers of Sunbelt real estate during the 1970s and 1980s, found huge amounts of capital readily available. Banks and savings and loans readily opened their wallets to finance real estate development during this period, and they were joined by other well-endowed lenders such as pension funds and life insurance companies.\textsuperscript{172} However, Keating wanted independence from banks and other lenders, so he turned to public securities markets and raised billions of dollars through public debt offerings.\textsuperscript{173} Later, he turned to what seemed like an even better source of revenues: a federally insured savings and loan. In addition to attracting risk-free deposits, Keating marketed the subordinated debentures of the parent company, American Continental, to customers of the bank.\textsuperscript{174} The bonds were sold through the bank's teller windows.\textsuperscript{175} Customers were steered to the American Continental securities when their insured certificates of deposit matured. The securities appeared attractive because they paid a higher interest rate than the bank deposit.\textsuperscript{176} Priced to sell in the mass market, the securities attracted 14,000 buyers, most of whom lost their investments when American Continental collapsed.

BCCI's capital source was petrodollars. Its principal investor was Sheikh Zayed Bin Sultan Al Nahyan, the ruler of Abu Dhabi.\textsuperscript{177} Sheikh Zayed, described in the Kerry-Brown Report as a simple desert Bedouin, had placed several billion dollars of his personal wealth...
under BCCI's management. He then essentially forgot about the investment, leaving BCCI free to divert the funds to cover operational deficits.

16. **Buoyant Economic Conditions**

Each of the firms in our sample, to one degree or another, took advantage of unusually buoyant economic conditions. Keating's Lincoln Savings owed much to the sunbelt boom of the 1970s and 1980s, which was characterized by mass movement of wealth, industry, and population to the American Southwest, especially Arizona.\(^{178}\) Phoenix, Keating's adopted city, benefited from a huge real estate explosion that lasted from the 1970s until 1987.\(^{179}\) What started as an increase in prices due to economic fundamentals evolved into a full-fledged speculative boom.\(^{180}\) At its peak, development properties in Arizona sold multiple times in a year, with prices rising steeply each time. In one case, a tract sold four times in a year, with the sale price increasing from $3,000 to $11,000 per acre.\(^{181}\) Keating was a major player in Arizona's boom economy. Starting with a faltering home construction company that he purchased for $300,000 in 1976, he created the sixth-largest homebuilder in the country.\(^{182}\) As property values soared and new home construction exploded, Keating's American Continental prospered.\(^{183}\)

HIH, the Australian insurance company, prospered as a result of share market runup in Australia during the late 1980s. HIH's performance was greatly enhanced by increases in share prices of certain stock investments, in particular Anaconda, One.Tel and HIS.\(^{184}\) One.Tel, directed by Adler,\(^{185}\) the head of FAI, displayed the same sort of exceptionally rapid growth as HIH. Its total assets increased 200% from $48 million in June 1998 to $857 million two years later.

EIEI represents a firm whose *raison d'être* was grounded in the enormous speculation that gripped Japan between 1987 and 1990. Japan's bubble economy presents the paradigm of buoyant economic conditions.\(^{186}\)

\(^{178}\) See Laing, *supra* note 26, at 34.

\(^{179}\) See id.

\(^{180}\) See id.

\(^{181}\) See Weiss, *supra* note 33.

\(^{182}\) Carson, *supra* note 41.

\(^{183}\) See Weiss, *supra* note 33.

\(^{184}\) See Witness Statement of Peter John O'Connell, *supra* note 79, at 18–19.


Enron's history is inextricably linked to the U.S. high-tech boom, which occurred during 1997 to 1991. Enron's sophisticated approach to business—heavy use of financial derivatives and corporate dynamism—reflected the corporate ethos of the high-tech boom. Enron eagerly entered this new market. It was a leader in the development of a wholesale market for bandwidths, and opened an e-commerce portal, Enron Online. During the dot-com boom, Enron's broadband assets contributed significantly to its market value.

17. Conflicts of Interest

Each of the firms in our sample was characterized by severe conflicts of interest on the part of senior managers. The Enron fiasco exemplifies the most egregious conflicts of interest for senior managers. That disaster resulted largely from the extreme loss of market confidence following disclosures that the firm had lost millions as a result of investments in partnerships controlled by one of its top executives, Andrew S. Fastow. While the company was incurring very large losses, the insiders were profiting handsomely. Fastow alone received more than $30 million from Enron, his subordinate Kopper received at least $10 million, and several other insiders received at least $1 million. The Powers Committee concluded that Enron's management used these partnerships to "enter into transactions that it could not, or would not, do with unrelated commercial entities." In some cases, accountants or other professionals have the conflicts of interest. For example, Arthur Andersen not only served as Enron's external auditor but also earned more than $5 million for advising on the structuring of the very partnerships that Andersen was asked to bless in the audit.

Conflicts of interest were also present at HIH. Justice Kim Santow of the New South Wales Supreme Court found HIH board member Adler to have breached his fiduciary duties to HIH by effecting transfers between HIH and the companies he personally controlled. The Lincoln Savings scandal involved massive insider transactions in the form of loans and transfers between the thrift institution and its affiliates, which principally involved its corporate par-

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187 See Boitano, supra note 146, at 168.
188 See id.
189 See POWERS REPORT, supra note 20, at 4.
190 Id. at 3.
191 See id. at 5.
ent, American Continental. In the case of BCCI, according to Federal Reserve allegations, Clifford and Altman created conflicts of interest by acquiescing in their use as fronts to disguise BCCI’s secret takeover of First American Bankshares. Clifford and Altman also allegedly created conflicts of interest by their representation of First American Bankshares, arranging for the acquisition of the National Bank of Georgia by First American Bankshares at an above-market consideration to advance BCCI’s interests in maintaining ownership of the Georgia bank.

18. The Danger of Complex Corporate Structures

Each of the firms under review operated with a complex, or even opaque, corporate structure. In itself, a complex structure is not problematic. There are many reasons for a firm to operate with a family of parents, subsidiaries, and affiliates. Firms often handle acquisitions most effectively through specially chartered acquisition vehicles, which remain in the corporate hierarchy thereafter. Subsidiary corporations are desirable to preserve the limited liability of the parent and thus reduce financial risk. Subsidiaries also serve such tax purposes as minimizing sales tax, stamp duty, and capital gains tax. Once a firm creates a separate corporate vehicle, it may be most convenient for the firm to leave it in place, either because of regulatory concerns with liquidation procedures or because the subsidiary structure does no real harm.

However, the firms considered here appeared particularly prone to using complex structures. For example, HIH, at the time of its failure, was comprised of more than 250 companies and included overseas subsidiaries in the United States and the United Kingdom, among other countries. HIH operated five major centers: C&G, FAI Insurances, CIC Insurance Limited, World Marine, and FAI. The groups, however, did not appear to have a rational structure to conduct business. For example, HIH wrote several portfolios across three different companies instead of consolidating them into one. The firm managed and documented various components of business by

195 See id.
197 See id. at 1.
different methods between companies in the group and between different divisions of the same company.\textsuperscript{199}

Enron also illustrates the problem of needless complexity, in the form of convoluted deals with ostensibly independent partnerships. At the time of its collapse, Enron reportedly comprised more than 3,000 off-balance sheet subsidiaries and partnerships.\textsuperscript{200}

BCCI’s corporate structure may be the most arcane and byzantine of any of the cases studied here. At its peak, BCCI operated in seventy-two countries through an array of subsidiaries, divisions, joint ventures, and other corporate vehicles. Senators John Kerry and Hank Brown, in their report on the enterprise, concluded that the business took the form of “an elaborate corporate spider-web with BCCI’s founder, Agha Hasan Abedi and his assistant, Swaleh Naqvi, in the middle.”\textsuperscript{201} BCCI existed as two independent companies regulated by two different jurisdictions: BCCI Holdings, S.A. Luxembourg, and BCCI (Overseas), a Cayman Islands corporation.\textsuperscript{202} Another independent firm, International Credit and Investment Company Overseas (ICIC), also a Cayman Islands corporation, purported to act as an investment vehicle for funds owned by the Sheikh of Abu Dhabi. In practice, according to the Federal Reserve, these corporate distinctions concealed what was in essence a single fraudulent enterprise.\textsuperscript{203}

19. \textit{Corporate Governance Criteria}

One might suppose, given the disasters that occurred in these firms, that they would typify all that is wrong with corporate governance. In fact, however, most of these firms operated under governance structures that appeared to be well-designed, even state-of-the-art.

In the case of FAI, the insurance company whose acquisition contributed to HIH’s collapse, the board of directors appears to have satisfied all the criteria for good corporate governance. Its members included five outside directors, one of whom served as Chairman, and only two inside directors.\textsuperscript{204} FAI maintained specialized committees to deal with key areas of corporate business, including internal audit, compensation, and investment committees.\textsuperscript{205} The board met about

\textsuperscript{199} \textit{Id.} at 11.
\textsuperscript{200} \textit{See Statement of Frank Partnoy, supra} note 24.
\textsuperscript{203} \textit{See id.} at *28-30.
\textsuperscript{205} \textit{See Witness Statement of Peter John O’Connell, supra} note 79, at 3.
eleven times a year. The company operated with a Directors’ Code of Conduct and a code of conduct for senior executives.\textsuperscript{206} The board of directors received comprehensive financial documents, reports, and regular briefings from senior managers.\textsuperscript{207}

In addition to maintaining an active and competent board of directors with a majority of outsider directors, FAI also employed more detailed procedures. It established an audit department with seven full-time employees.\textsuperscript{208} The audit process included circulation of detailed questionnaires to senior managers requesting information about adverse changes or other information relevant to the firm’s business and economic condition.\textsuperscript{209} Although not required to do so, FAI employed the reputable external actuaries Coopers & Lybrand and PriceWaterhouseCoopers.\textsuperscript{210} FAI also adopted an Investment Code delegating authority and responsibility to named individuals as a means of deterring dangerous or unwise investment activities.\textsuperscript{211} However, all these seemingly well-crafted procedures did little to prevent the ultimate fiasco. Senior management at FAI failed to inform the board of directors when they discovered the huge problem of under-reserving and opted instead to obtain reinsurance policies that massaged the balance sheet.\textsuperscript{212}

The problem at FAI was not that the company failed to institute corporate governance protections, but that these protections were not always followed. Adler, the CEO, did not follow proscriptions against trading in the company’s stock during blackout periods; did not insist that compliance officers be appointed as required by the Code; and could not, in his testimony before the Royal Commission, even remember the Code’s adoption.\textsuperscript{213}

Enron, too, implemented what appeared to be highly commendable corporate governance arrangements. It instituted a Code of Conduct of Business Affairs setting forth ethical obligations of senior management towards the company. It established procedures for review of related-party transactions at the highest corporate levels and directed its Audit and Compliance Committee to conduct annual reviews of such transactions.\textsuperscript{214} Under applicable procedures, Enron’s

\textsuperscript{207} See Witness Statement of Peter John O’Connell, supra note 79, at 6.
\textsuperscript{208} See Witness Statement of John Landerer, supra note 80, at 6.
\textsuperscript{209} See Witness Statement of Geoffrey Guild Hill, supra note 30, at 6.
\textsuperscript{210} See Witness Statement of Rodney Adler, supra note 206, at 8996.
\textsuperscript{211} See Witness Statement of John Landerer, supra note 80, at 6.
\textsuperscript{213} See Witness Statement of Rodney Adler, supra note 206, at 8296.
\textsuperscript{214} See POWERS REPORT, supra note 20, at 10.
Compensation Committee was required to review compensation received by Fastow from the partnerships.\textsuperscript{215} Yet these safeguards proved similarly ineffective. One provision of Enron’s Code required the consent of the Chairman and CEO before any senior manager could assume a financial or managerial role in a firm doing business with Enron.\textsuperscript{216} In certain cases, however, this requirement was simply ignored.\textsuperscript{217} Information about the two partnerships that caused the greatest harm to Enron, which were controlled by Fastow, was disclosed to and blessed by the board of directors and senior management in full conformity with internal corporate procedures.\textsuperscript{218} Further, the Compensation Committee was derelict in seeking disclosure from Fastow of his remuneration for the related-party partnerships.\textsuperscript{219}

Capital-adequacy rules also have failed to stave off disaster. Lincoln Savings had positive capital when it was seized by the regulators. In fact, Lincoln Savings had sufficient capital to satisfy, although barely, the capital-adequacy rules then in effect for thrift institutions. Yet within only a few months after its seizure, estimates of the cost of Lincoln’s failure ran as high as $2.5 billion.\textsuperscript{220} One may conclude, at least based on evidence from the cases under review, that good corporate governance systems do not necessarily prevent disaster.

CONCLUSION

Having reviewed and compared each of the above cases, what lessons can be drawn, and what reforms might be considered? The principal causes of these disasters were underlying speculative events in the macro-economy. If these were better controlled, there would be fewer disasters of the type examined above. It is, however, daunting to manage these events. Central banks, even armed with legal independence and the best economic theories, data, and models have not been able to suppress asset price booms. Alan Greenspan’s comment about “irrational exuberance” contributed to our lexicon of catchphrases, but it did not dampen the dot-com bubble.\textsuperscript{221} The government might do a better job at managing speculative periods without

\textsuperscript{215} See id. at 11.
\textsuperscript{216} See id. at 10.
\textsuperscript{217} See id.
\textsuperscript{218} See id. at 4.
\textsuperscript{219} See id. at 11.
suppressing economic progress, but at present, the government lacks fully effective tools to accomplish this task.

What can be done? Assigning blame is not constructive. Moral indignation, however immediately gratifying, will not solve the problem. And greed, however unpalatable, is potentially present in every society. The hasty conclusion is that because deregulation was present in several of our cases, reregulation of the industries in question is the answer. Although deregulation made some of these disasters possible, the problem was related to defects in the design of the deregulation rather than with deregulation per se.

Furthermore, it is important not to overreact. Psychologists observe that people tend to overestimate the severity of risks after some disaster. That, coupled with the natural propensity of politicians to blame everyone but themselves for problems of this nature, could spark an excessive response. This is not to say that the government should not take action to address the weaknesses in corporate management in recent years. However, it must bear in mind the long-term perspective and be sensitive to the costs as well as the benefits of reforms. It is partly for this reason that proposals for corporate governance reform are questionable. Good corporate governance does not prevent disasters if the culture of the boardroom is corrupt. Thus, corporate governance reform can even be counterproductive if it otherwise reduces the government's vigilance.

The multiple overlaps among the six firms examined suggests that regulators, analysts, and providers of financing may usefully study firms with an eye toward detecting undue accumulation of these warning signs. To the extent that they are observable, the presence of a substantial number of the factors identified above is a cause for concern. When multiple factors are present, the regulators and the financial world might appropriately take a stronger interest in the firm and view its results with less complacency and more skepticism.

If a listed firm grows rapidly—twenty percent or more growth in assets for each of three years—we could require the firm to flag this fact in its financial reporting and to explain the reasons for the rapid expansion as well as any risk factors the change might create.

One cause for optimism is that the most important reform may already have occurred. The demise of Andersen, criminal prosecutions expected for several senior executives, huge fines and civil judgments, and raw fear now felt in corporate boardrooms have fundamentally changed the rules of the game, at least in the short term. The relationship between auditors and managers is evolving into a true arms-length interaction, as should be the case. The Sarbanes-Oxley Act, although it did not actually require major changes beyond what was already the practice in many corporations,
carries with it a folklore of stringency that may have already had real effects on the regulatory environment. Thus, a repeat of the sort of cozy manipulations of the balance sheet that has characterized too many of these disasters is unlikely. Ultimately, the boardroom culture is as important as any set of formal rules in safeguarding against abuse. With changes in corporate culture and a more sophisticated awareness of the danger signs that often accompany firms in the midst of fraudulent or reckless conduct, repeats of recent fiascos hopefully may be prevented, and a renewal of investors’ confidence in the honesty of corporate managers and the firms they control hopefully may be triggered.