

Does the Name “Insull” Ring a Bell?

IT SEEMS WE’VE BEEN HERE BEFORE

BY STEPHEN E. NOWLAN

In the 1920s, when there was little regulation of financial markets, Samuel Insull combined scores of power utilities to create a corporate pyramid. It came crashing down in 1932, and hundreds of thousands of investors lost their savings in the sensational scandal. More than 30 bodyguards protected Insull from angry investors.

Donald P. Horwitz, a partner at Sonnenschein Nath and Rosenthal and former general counsel of McDonald’s Corp., remembers the Insull scandal—his father-in-law, Sidney L. Robin, did the bankruptcy legal work.

Stephen E. Nowlan: What happened?

Donald P. Horwitz: Much of the stock market value of Insull’s companies stemmed from sales of “watered stock.” One of Insull’s companies would sell inflated stock of another Insull company to a third Insull company. A Senate investigation reportedly found that while the holding company reported major profits, its tax filing showed a significant loss. Insull was indicted but acquitted.

Many Insull companies were resuscitated by Arthur Andersen, the founder of Arthur Andersen & Co. He earned a reputation for great integrity and was later offered the presidency of the New York Stock Exchange.

The Insull abuses, among others, led to the creation of the SEC in 1934 to ensure that investors would have complete information about the finances



TODD WINTERS

The Enron situation is not unique. More than 80 years ago, Samuel Insull was involved in a similar debacle. The consequences of both scandals are far-reaching—for investors, accounting firms and general counsel.

of public companies.

Nowlan: What are the parallels between Insull and Enron?

Horwitz: Both Insull and Enron used complexity and transactions involving their own stock to fool the investing public. Newspaper reports indicate that Enron used its own common stock priced at inflated values to satisfy its obligations to partnerships controlled by Enron but not included in the Enron financial statements, while concealing losses. If newspaper reports are correct, it sounds just like a sale of “watered stock,” except Enron used so-called market values for the prices in its transactions with related companies.

Ironically, whereas Insull persuaded state governments to allow utility monopolies, arguing that competition would

drive energy costs up, Enron campaigned for deregulation, arguing that a competitive market would drive energy costs down.

Nowlan: What reforms will Enron trigger?

Horwitz: The most damaging consequence may be that the investing public loses confidence in financial statements and Wall Street. This goes to the heart of our capital markets system.

Audit firms need to improve their personnel rotation programs or else government may require the periodic rotation of auditing firms. Audit firm peer review needs to be strengthened, as does the appearance of independence.

Government may change the role of independent auditors so their duty to the public will more clearly override any duties of confidentiality or other obligations to their clients. CPA firms and all CPAs employed by such firms may be required to report certain matters directly to the SEC.

Nowlan: What is a key lesson for general counsel?

Horwitz: Ethics training must be more carefully designed and formal. Young lawyers tend to learn about ethics by watching senior lawyers on the job. The risk is that early in their careers, lawyers observe the wrong things. General counsel cannot afford to depend on “accidental” or anecdotal training. ●