

DM *EXTRA!*

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## The Enron Code: The Hidden Lesson

The May 25, 2006, jury convictions of **Kenneth Lay** and **Jeffrey Skilling** for conspiracy and fraud brought the long-running Enron story to a close. Although both former CEOs will appeal the decision, the Houston jury's guilty verdict brought with it a sense of finality.

Enron-related trials and reforms are largely concluded. And Enron itself is no more. Operating under Chapter 11 of the bankruptcy code, Enron today has only a small board of directors and a modest set of assets to be liquidated on behalf of creditors. In short: following Enron's errors, thunder rolled, lightning struck, and now the storm is over. To be sure, other Enron-sized governance storms may well arise to capture the attention of directors. But this temporary calm is a good time to reflect on Enron's story.

The Enron verdict has already been the subject of extensive commentary in the business press. DMX traditionally derives "lessons learned" from every event, but in the case of Enron, we have already expressed them.

**For this reason, this DMX departs from our usual format to be an "Enron recap" for the convenience of directors who want a summary of what they need to learn from Enron.** We recap what happened at Enron, and

summarize what NACD recommended to boards and regulators at the time—recommendations that still hold true and that bear repeating. We close with a single new "hidden lesson" that needs to be brought to the light and into action now.

### Enron: What Really Happened

Was Enron just an empire built and destroyed by a handful of bad guys? Some current press reports would lead readers to believe that, but NACD has always taken a more careful look. As noted in an early DMX about Enron (excerpting text verbatim), causes of failure were legion:<sup>1</sup>

For many years, Enron's financial reporting practices gave the impression that the company was larger, more profitable, less leveraged, and more secure than it really was. (Company revenues included funds flowing through from transitory transactions, company losses and debts were hidden in partnerships that did not appear on any financial statements, and the company did not disclose prominently enough its total exposure to risks.)

Compounding the problem was an excessive degree of complexity in the company's finances and basis structure. When third quarter 2001 financial disclosures stated that the company had

### Director > Summary

### About NACD

**National Association of Corporate Directors (NACD)**, an independent not-for-profit organization founded in 1977, is the country's only membership organization devoted exclusively to improving corporate board performance. The NACD conducts educational programs and standard-setting research, and provides information and guidance on a variety of board governance issues and practices. Membership comprises board members from U.S. and overseas companies ranging from large publicly held corporations to small over-the-counter, private, and closely held firms. NACD lists all interested members on The Director's Registry, which is used by member companies and others that seek qualified directors. With chapters in many major cities providing educational programs and networking opportunities, NACD operates at both a national and local level. To educate the corporate community and to provide networking links among NACD members, the NACD holds an annual Corporate Governance Conference, where it presents a Director of the Year Award.



Two Lafayette Centre  
1133 21st St. NW, Suite 700  
Washington, D.C. 20036

202-775-0509 • [www.nacdonline.org](http://www.nacdonline.org)

Research: Alexandra R. Lajoux

been significantly overstating revenues, stock prices fell, hurting investors, including Enron employees via the company's retirement plans. Those looking for someone to blame had no lack of candidates. Some Enron senior executives had a personal interest in certain risky transactions, and sold their stock even while encouraging employees to hold theirs, raising conflict of interest and insider trading issues. The major auditing firm that approved Enron's financial statements also provided internal auditing consulting services, raising auditor independence issues. Employees of the audit firm shredded documents believed to be material, reportedly in violation of the firm's own document retention policy. [Note: The firm, Arthur Andersen, was later exonerated for the shredding in a U.S. Supreme Court ruling, but it was too late; the reputational and financial harm to the firm from long litigation was done, and it had collapsed.]

Finally, the board members and audit committee members, including some who had apparent conflicts of interest, did not always provide vigorous oversight of the auditing and reporting process. Indeed, the board had a code of ethics but the audit committee, which met less often than the compensation committee, voted to suspend it in order to approve certain transactions. The errors of the board were detailed in the report of a special Enron board committee chaired by William Powers Jr., referred to as the Powers report.<sup>2</sup>

### **NACD Responds: Early Action Points for Directors**

In the January 31, 2002, DMX, we recommended "action points for directors."<sup>3</sup> Among them were:

- Protect retirement plans.
- Set and follow policies and rules pertaining to conflict of interest.
- Refrain from improper insider trading.
- Ensure auditor independence.
- Issue, improve, and enforce internal document retention policies.
- Educate and empower the board to detect and ensure correction of inappropriate financial reporting.
- Embrace corporate ethics by creating a climate of disclosure and a culture of integrity, expressed in both written codes and living example.

It is notable that many of these principles became enshrined in the Sarbanes-Oxley Act of 2002.

### **Next: Congressional Testimony**

NACD President and CEO **Roger Raber** testified before the House Energy and Commerce Committee on February 6, 2002. Concluding his brief remarks, he stated:

I believe that there are three keys to board effectiveness: independence, information, and integrity—especially the courage to ask the tough questions.

- **Independence.** NACD commends the SEC and stock exchanges for requiring "independent" audit committees. Meanwhile, independent nominating and compensation committees are now on the rise. Unless

this beneficial trend continues, we anticipate stock exchange requirements mandating the independence of these committees.

- **Information.** Directors need to be well informed about governance, and about the companies and industries they serve. A vital source of information is financial statements. Overall, the financial statements of U.S. companies do a good job of disclosure, keeping up with new challenges of financial reporting, but we want to make sure that oversight groups for accounting standards remain free from undue influence by any particular constituency. Ongoing education for directors is also important. A number of major institutional investors actively encourage director education in their portfolio companies. The late Jean Head Sisco, in her speech as NACD Director of the Year in 2000, went so far as to suggest that the stock exchanges require newly listed companies to provide evidence of ongoing director education.
- **Integrity.** Last but not least, there is integrity. Directors should have the "duty of curiosity" to ask difficult questions, such as, "Do these numbers reflect our true profitability?" "What will this policy do for the employees in our 401-k plan?" "Isn't it risky to have our auditors do some of our internal auditing work?" After Enron, more directors will be asking such questions. We will do our part to make sure that they do.

In summary, directors play an important role in the governance of corporations. Whatever actions you recommend as a committee, I ask you to remember that in the long run, corporate directors can be an important part in helping your actions succeed.

### **NACD Recommendations to the SEC and NASDAQ**

After hearing this testimony, Committee Chairman **W. J. "Billy" Tauzin** (R-LA) asked NACD and its board of directors, then chaired by the late **B. Kenneth West**, to submit recommendations to the Securities and Exchange Commission, the New York Stock Exchange, and NASDAQ. The NACD board made the following recommendations on a "comply or disclose" basis.

#### *Core Recommendations*

- **Boards should be composed of a substantial majority of "independent" directors.** At a minimum, these directors should meet the definition of "independent director" as defined under relevant SRO standards, although boards may consider adopting even more stringent standards of independence. Furthermore, boards should formulate and adhere to clear conflict of interest policies applicable to all board members.

- **Boards should require that key committees—including but not limited to audit, compensation, and governance/nominating—be composed entirely of independent directors**, and are free to hire independent advisors as necessary.
- **Each key committee should have a board-approved written charter detailing its duties.** Audit committee duties, at a minimum, should include two key elements: a) oversight of the quality and integrity of financial reports and the process that produces them; b) oversight of the management of risk. Compensation committee duties should include performance goals that align the pay of managers with the long-term interests of shareholders. Governance/nominating committee duties should include setting board and committee performance goals and nominating directors and committee members with the qualifications and time to meet these goals.
- **Boards should consider formally designating an independent director as chairman or lead director.** If they do not make such a designation, they should designate, regardless of title, an independent member to lead the board in its most critical functions, including setting board agendas with the CEO, evaluating CEO and board performance, holding executive sessions, and anticipating and responding to corporate crises.
- **Boards should regularly and formally evaluate** the performance of the CEO, other senior managers, the board as a whole, and individual directors. Independent directors should control the methods and criteria for this evaluation.
- **Boards should review the adequacy of their companies' compliance and reporting systems at least annually.** In particular, boards should ensure that management pays strict attention to ethical behavior and compliance with laws and regulations, approved auditing and accounting principles, and with internal governing documents. In addition to meeting the current requirements for disclosure of management compensation, boards should disclose the total value of each director's compensation, including the value of any stock options or grants awarded during the year.
- **Boards should adopt a policy of holding periodic sessions of independent directors only.** These meetings should provide board and committee members the opportunity to react to management proposals and/or actions in an environment free from formal or informal constraints.
- **Audit committees should meet independently with both the internal and independent auditors.**
- **Boards should be constructively engaged with management** to ensure the appropriate development, execution, monitoring, and modification of their companies' strategies. The nature and extent of the board's involvement in strategy will depend on the particular circumstances of the company and the industry or industries in which it is operating.
- **Boards should provide new directors with a director orientation program** to familiarize them with their companies' business, industry trends, and recommended governance practices. Boards should also ensure that directors are continually updated on these matters.

I believe that there are three keys to board effectiveness: independence, information, and integrity—especially the courage to ask the tough questions.

*Roger W. Raber*

These recommendations proved influential. All but one of them parallel—and no doubt helped to shape—the subsequent revised listing standards for the NYSE, NASDAQ, and American Stock Exchange, published November 4, 2003.<sup>4</sup>

The only NACD recommendation that did not become a listing standard was number 9, advocating constructive board engagement in strategy. This is not surprising. Strategy is not the stuff of rulemaking. Nonetheless, it is important part of the governance puzzle—and will be increasingly important as boards get back to work following the Enron era.

### Into the Future: The Importance of Strategy

NACD members continue to look to the NACD's Blue Ribbon Commission Report on the Role of the Board in Corporate Strategy for guidance. The 2006 edition of the Commission's report notes: "It could very well be argued that Enron and WorldCom failed in part because of poor performance brought about by bad strategy. To be sure, the companies had bad systems—compensation structures and internal controls that may have inspired and enabled fraud. And such systems should be discouraged. But let us not forget strategy."<sup>5</sup>

The 2006 edition of the report (available later this summer) will offer guidance on how directors can achieve or resume a strong role in strategic oversight.

### And The Lesson

Now that the Houston jury has spoken its verdict, it is time to scale back on the recent high-beam focus on loss prevention. Directors should also concentrate on how to build value. As auditor-turned-director **J. Michael Cook** said at the May 2006 Section 404 Roundtable, "It's time to move on."<sup>6</sup> ■

### Endnotes

1. [http://www.nacdonline.org/members/dmx/dmextra\\_0202.pdf](http://www.nacdonline.org/members/dmx/dmextra_0202.pdf).
2. <http://news.findlaw.com/hdocs/docs/enron/sicreport/>
3. For the full text of these points, go to [http://www.nacdonline.org/members/dmx/dmextra\\_0202.pdf](http://www.nacdonline.org/members/dmx/dmextra_0202.pdf).
4. For a chart showing all final rules, see Report of the NACD Blue Ribbon Commission on Director Professionalism (2005), or contact ExpresSource at NACD. <https://secure.nacdonline.org/scriptcontent/ExpresSource.cfm>
5. This edition contains references to numerous new books and articles on the board and strategy, including recent articles in Directors Monthly—freely available to members as downloads. [https://secure.nacdonline.org/scriptcontent/DM\\_Search.cfm](https://secure.nacdonline.org/scriptcontent/DM_Search.cfm)
6. <http://www.nacdonline.org/dm/DMX060515.pdf>

