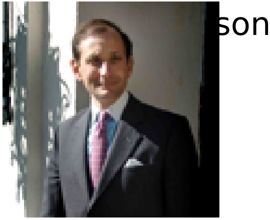
Editor's Note: Enron at 20



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This fall marks the 20th anniversary of the collapse of Enron, perhaps one of the most significant and far-reaching corporate scandals of the last few decades. No similar corporate downfall has had so much impact on the regulatory framework affecting corporate boards. It led to major changes in audit committee and audit firm structure and practice and to the basic functioning and composition of U.S. boards of directors. I have taught the sad tale of Enron to my students each semester since that time. However, in recent years, I have found that few, if any, in my classroom have any actual recollection of the events that led to the scandal. To them, Enron is a story of long ago and far away.

Similarly, while most board members are old enough to actually remember the downfall, the passage of time has lessened its impact on the thought processes of many. This is a mistake. The lessons to be learned from Enron are critically important to anyone serving on a public company board.

Enron’s untimely and catastrophic demise was the result of three separate but interrelated factors. First, the company was operating under a flawed business model. The energy trading business was simply not viable. Second, management, recognizing this failure, responded completely inappropriately and attempted to hide it from the public while they exited the scene. Third, the board failed to recognize both the strategic failure of the model and management’s problematic response, rendering their service to shareholders essentially worthless.

So what lessons can we as directors take from this sordid story? There are essentially three takeaways that should be discussed at every board orientation session and retold periodically in various forms to the national directorship community. As has often been noted, those who fail to heed the lessons of the past are destined to repeat them.

The first lesson is quite simple. If results seem too good to be true, they probably are. In a now-legendary Fortune article written shortly before the scandal broke,

Bethany McLean questioned how exactly Enron made money. She couldn't find a good explanation, and neither should have the board. As a director, one should always function as a respectful skeptic. That is your job. A healthy dose of skepticism may have helped this board recognize something was terribly wrong before the situation got wildly out of control. This leads to the second lesson.

Director independence from management, so lacking in the Enron story, is a critical element in the appropriate monitoring function of the board. Independence gives a director the necessary objectivity in reviewing managerial proposals and performance. In the case of Enron, the board's infamous waiver of the company's code of ethics to allow the creation of "special-purpose entities," whose actual goal was to mask Enron's failing performance from the public, was perhaps the board's ultimate error in judgment. But why would any board waive an ethical code to do something that by their own definition was unethical? Here the answer is sad but simple. The board's lack of detachment from management and, more specifically, from Ken Lay meant that while most would see such a move as a bright red flag, calling for much questioning and investigation, these directors had great faith in him. The flag before them didn't seem red at all. Independence from management is critical to doing one's job. The Enron board's lack of independence not only led to a disastrous decision that destroyed the company, but also damaged their own reputations and exposed them to all kinds of legal and reputational consequences.

The final lesson is equally straightforward. There is really almost no such thing as any appropriate conflict of interest. Allowing a senior corporate officer — in the Enron case, the CFO — to be on two sides of a transaction was an error of the first order. Regrettably, in our "tech"-inspired dual-class stock era, this lesson seems to be lost on a number of boards. Conflicts of interest rarely breed happy results for a company either financially or reputationally. They should be generally avoided at all costs.

The Enron story should be as vibrant to directors today as it was 20 years ago. Never forget it, because to do so will be at your own peril.

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