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<u>Corporate Governance: Some Lessons from Enron</u>

Based on published reports, the most favorable assessment of the Enron Board of Directors is that it failed to appreciate the financial condition of Enron because it did not insist on complete, clear explanations of the transactions it approved and the financial statements the company issued. Prior to mid-2001, Enron's reported earnings were growing steadily, its price-to-earnings ratio was extraordinary, its stock was regularly reaching new highs, and the best names on Wall Street were competing to provide funding. Enron was widely touted as the new paradigm for the energy industry and a model for other companies to emulate. Enron's outside accountants issued no warnings to the Board or the Audit Committee. Under these circumstances, and in the absence of formal corporate governance procedures designed to assist the Board in overseeing and monitoring the situation, it is not unusual that the Board failed to insist upon detailed information or to consult outside advisors.

In the particular circumstances of Enron, even well-designed, formal corporate governance procedures might not have led to timely discovery of the problems and successful intervention to mitigate them. Nonetheless, there are lessons to be learned; improvements to all companies' corporate governance procedures should be made in response to Enron. It is crucial that these reforms be implemented in a way that does not harm a company's ability to find qualified directors who are willing to serve on its board.

As the Enron story has unfolded, we have issued several memos recommending policies and procedures for boards and audit committees, and we have revised our Audit Committee Model Charter. (Copies of these memos and the revised Model Charter are attached.) Unless boards improve their ability to exercise oversight, monitor performance, maintain compliance and ensure the accuracy of financial reporting, the nascent efforts by activist institutional investors to impose the English system of separating the roles of the CEO and the chairman of the board on American companies will become a major campaign, one that will take advantage of the current political focus on Enron in order to enact legislation or regulation requiring this reform and include a major increase in proxy solicitations seeking shareholder support for such change.

I have long opposed efforts to mandate separation of the roles of CEO and chairman of the board. Together with Professor Jay Lorsch of the Harvard Business School, I published *A Modest Proposal to Improve Corporate Governance* in the November 1992 issue of *The Business Lawyer*, which, along with a supplement in the January-February 1993 issue of the *Harvard Business Review*, set forth comprehensive guidelines for corporate governance and recommended against separation of the two roles. We suggested instead that boards designate one of their members as the "lead director." The lead director should (1) be available to consult with the CEO about the concerns of the board of directors, (2) be available to be consulted by any of the senior executives of the company as to any concerns the executive might have and (3) preside at executive sessions of the board — without the CEO being present — prior to and following certain of the regular meetings of the board. In order to be effective, he or she must be a senior person who is highly respected and regarded by the CEO and the other directors. The lead director is not an officer and would not have any of the formal duties of a chairman of the

board,butheorsheisthedirectorwhowouldassumeleadershipoftheboardifaneedtodoso shouldarise.Mostcompaniesalreadyhaveadirectorwhosubstantiallyperformsthisrole,but manyhavenotarticulatedapolicy encouragingexecutivestoinitiatedirectcontactwiththis directoriftheybelievethatthereisamatterthatshouldbediscussedbytheboardbutisnot beingbroughttoitsattention,andmanyhavenotadoptedthepracticeofexecutivesessionsof theboardpriortoandfollowingcertainoftheregularmeetings.

Inadditiontoformalizingtheroleoftheleaddirector,boardsandaudit committeesshouldadoptapolicyrequiringthecompany’sfinancialofficerstocompletely explaintherisksinherent inanysophisticatedfinancial -engineeringtransaction.Therisksto, andtheimpacton,thecompany’sfinancesmustbefullyunderstoodbyallthedirectors,and capableofbeingclearlydescribedinthecompany’sfinancialstatementsanddisclosure documents,asaprerequisiteforboardapproval.

Enronhascreatedaclearandimmediatecrisisinaccounting.However,wemust avoidconfusingwhatisneededtoreformaccountingpracticeswithwhatisneededtoimprove corporategovernance.Wideadoption oftheenhancedroleoftheleaddirectorshouldblunt incipienteffortstoseparatetherolesoftheCEOandthechairmanoftheboardandtoimpose newdutiesandliabilitiesonboardsandauditcommittees.Adoptionofthelead -directorpolicy, alongw ithourpreviousrecommendations,shouldhelptoquietthecallsforunneededlegislation andregulationthatwouldmakeitevenmoredifficultforcompaniestorecruitcompetentpeople toserveasdirectors.

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