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Another View: Sarbanes-Oxley and the Legacy of Enron

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Time for a little boardroom quiz: What do Chewco, Whitewing and JEDI have to do with corporate governance? If the answer is, "Those awful Enron ventures," you win another term. If the answer is, "They're 'Star Wars' characters," some enhanced board education might be in order. Why? Because 10 years later, the lessons of Enron may have a more lasting boardroom legacy than the Sarbanes-Oxley Act they prompted in 2002.

A new generation of corporate leaders has entered the boardroom since Enron's bankruptcy in December 2001. Their related memories are likely to be dim. And a cosmic recognition of corporate accountability is no substitute for awareness of the brutal governance failings that led to the Sarbanes-Oxley legislation. So, the coming 10th anniversary of Enron's colossal corporate collapse offers a classic governance "teaching moment": to be mindful of the limits of Sarbanes-Oxley.

The incuriosity, inattentiveness and unresponsiveness of the Enron board were staggering failures of conduct that no law can fully prevent. And it is the ultimate weakness of the seminal Sarbanes-Oxley legislation that it is perceived by so many as the end-all, be-all cure for deficient governance. The powerful "Powers Report" — the Enron board's self-investigation — places a personal face on oversight weakness in a way that Sarbanes cannot. Today's board members must be challenged on how they might act under similar circumstances. It may be a tutorial that few will forget.

This is not to diminish the enormous contribution that Sarbanes-Oxley has made to corporate responsibility. But the significance of the law must be viewed in context. Sarbanes-Oxley incorporated six main statutory themes, only some of which directly affect corporate governance and the exercise of fiduciary duties of both directors and officers. Those governance-specific themes relate to the independent composition of audit committees, the disclosure of the audit committee financial expert, preserving the independence of the external auditor, increased conflict-of-interest provisions prohibiting loans to officers, officer certification of financial reports, when certain incentive compensation and bonuses are subject to forfeiture and the adoption of a code of ethics for senior financial officers.

The other, nongovernance themes of Sarbanes-Oxley relate to the establishment of the Public Company Accounting Oversight Board, improving corporate financial disclosure, establishing new criminal penalties related to obstruction of justice and addressing conflicts of interest of securities analysts, among other provisions.

These are highly substantive provisions, intended to support public confidence in the financial markets through new controls to prevent corporate malfeasance and enhance the integrity of financial reporting. But Sarbanes-Oxley does not constitute the much-feared federalization of corporate governance, nor does it pre-empt state and common law relating to board conduct.

Rather, the more lasting impact of Sarbanes-Oxley has been as the torch that lit the corporate responsibility movement, not in the collective substance of its governance provisions. When viewed from that lens, the law has been spectacularly successful; Sarbanes-Oxley has changed the landscape of corporate governance, not only for public companies, but also by extension for nonprofit and other nonpublic companies.

Sarbanes-Oxley has raised the public consciousness of corporate governance. The center of corporate direction has shifted back to the boardroom from the C-Suite. Useful statements of "best practices" have arisen to guide the conduct of the primary participants in the governance system: directors, officers, accountants and counsel. It has helped to shape the focus of state courts and regulators on the proper application of fiduciary duty laws.

Looking forward, corporate boards face two principal Sarbanes-related challenges. The first is how best to address the remaining consequences — intended or otherwise — of the law. These include the continued ascent in organizational importance of the "whistle-blower" (thank you, Sherron S. Watkins, a former Enron vice president); variations on the focus of director independence , e.g., as it may relate to a corporate chairman and other directors; preserving the independence of the external auditor that continues to diversify its services; the increased costs of internal control and corporate compliance mechanisms; the expanded risk of executive compensation "clawbacks"; and the government's new willingness to pursue obstruction of justice allegations in corporate investigations.

The second, more significant challenge relates to the loss of board awareness of the contributing factors to Sarbanes-Oxley: the governance failures of the Enron board. Ten years is a long time in the life of a governing board. Lots of turnover. Going forward, who will be left to remember "the Raptors" (as some of the more notorious Enron ventures were known) — and why they should be remembered? The flame of the Sarbanes-Oxley movement may turn to embers unless it is continually stoked in boardrooms. And this can be done in blunt, direct and effective manner with the help of a history lesson.

Read directly from the source material: the Enron board's admission of its oversight failures. The litany includes inadequate and poorly implemented internal controls, failure to exercise sufficient vigilance, an additional failure to respond adequately when issues arose that required a prompt and serious response, cursory review of critical matters by the Audit and Compliance Committee, failure to insist on a proper information flow and an inability to fully appreciate the significance of some of the information with which it was provided.

And, perhaps most compelling, the failure to question the legitimacy of the related-party transactions for which so many internal controls were required. These deficiencies served to bring a once-great company and its officers to their collective knees.

This is not a law school hypothetical. These were real people. They were accomplished. It was a real boardroom. Their oversight failures were very real. And while the Sarbanes-Oxley Act has made a significant fraud-prevention difference, its focus is not on boardroom conduct — that remains the province of the courts. Going forward, that is the real challenge for Sarbanes-Oxley

— whether you call it negligence, gross negligence or bad faith, there is nothing so unique about the Enron board's failings that cannot reoccur in another boardroom, in another locale, at another time.

And the challenge becomes steeper as "the smartest guys in the room" begin to make their appearance, chafing to "strut their stuff" without board interference after a decade of being held on a very tight governance leash.

What is it they say about those who ignore the lessons of the past?

Happy 10th anniversary!