The 'Enron Effect:' Lessons for Trustees

Hospital trustees who think strategically understand that the Enron and Allegheny Health debacles hold a number of lessons for boards. In both these cases of corporate scandal, boards failed to meet their fiduciary requirements with disastrous results. A proactive stance will position a hospital to weather the current climate, which will cast a brighter spotlight on governance than in years past.

"With the extensive media attention, the public may be more willing to scrutinize a hospital board than before, and this particularly is true for a taxing entity. Allegheny Health, Education and Research Foundation, and Enron should serve as wake-up calls for everybody on a board," says Fletcher Brown, J.D., shareholder with the Austin law firm, Davis & Wilkerson, P.C.

The board plays a crucial role in ensuring sound, ethical business practices and would do well to protect itself from potential liability through careful remedial and preventive action. "The biggest lesson from Enron is that 'trustee' is not just a title that you acquire. You have to exercise ethical, prudent business judgment and inquiry so that you can exercise your fiduciary duty of oversight of the organization in the appropriate manner," Brown says.

Citizens or an inquisitive reporter now may be more inclined to ask specific questions about ethics, such as why the board awarded an equipment contract to a particular vendor, or why it made the choice to purchase rather than lease. A tax rate increase also may embolden people to question boards. The Enron case is complex, and many are asking the question, "Where was the board?"

Inevitably, Enron's board will be judged for its actions. And while the final outcome is to be determined, prudent boards will seize this opportunity to prepare for the likelihood of increased scrutiny. A willingness to apply the lessons of Enron and other corporations puts a board and its members in the best position to face accountability demands.

By carefully evaluating current governance practices and potential areas of liability exposure, a board can determine what steps need to be taken. After prioritizing the identified risk areas, the board can develop a strategy to assure the governance and leadership skills of the board and its members are appropriate. An active campaign to do so can protect the health care institution and the board from potential risk.

Possible pitfalls include:

- monitoring the Code of Ethics;
- the oversight of executives; and
- appropriately separating the financial responsibilities of the board.

Ethics

"Responsibility for monitoring the hospital's Code of Ethics rests with the board. Effectively carrying out this duty may be the single most important strategy for avoiding an Enron situation," says Brown, who adds that the Enron board waived its ethical policy to do some of the things it did, such as off balance sheet transactions.

Most public hospitals are subject to Texas nepotism and conflict of interest statutes. Boards always have been aware of these requirements, but since Enron, the need for better education and monitoring has increased.

Boards in small communities must pay particular attention, simply because of the increased likelihood of a board member's relative working for or doing business with the hospital. Does that mean that a board member's relative no longer can work for the hospital? What about a board member who owns a company that sells to the hospital? A potential conflict doesn't mean anything is wrong.

"Doing the deal is not bad – what is bad is if it's done in secret, or not in compliance with the statute," Brown says. For clarification, boards may want to contact an attorney or the Texas Healthcare Trustees.

The board should issue an annual disclosure statement, regularly review contracts, and abstain from decision-making where there exists any hint of a conflict of interest.

Oversight

The board has a duty of inquiry as it relates to the oversight of executives. "Oftentimes, management makes a report to the board, and a board member doesn't understand – yet he doesn't ask any questions. Board members must be willing to ask questions," Brown says, or risk the consequences of inaction.

Particularly challenging to a board can be the issue of how to deal with a rogue executive. For example, such an individual may create off balance sheet financing to secure goods or services in a way that does not serve the best interest of the facility. "These can be hard people to detect, by virtue of the fact that they're trying to cover up their actions. For that reason, it's critical to have audit and finance committees that will ask questions about transactions, purchases and contracts to see if there is any impropriety. "It all comes back to a willingness to ask questions," Brown explains.

Financial Separation

Any criminal penalties that may be levied on Enron's board remain to be determined, but hospital boards must establish a clear separation of the audit and finance committees. To avoid potential complications, board members should limit their service to either the audit or finance committee – but not both. Similarly, outside auditors should not be performing both functions. "The board ought not to let the fox watch the henhouse," Brown says.

For more information, contact Fletcher Brown, J.D., shareholder with Davis & Wilkerson, P.C., in Austin at 512/482-0614.

CREATING A CODE OF ETHICS

All hospital organizations should work with their hospital counsel to draft an appropriate Code of Ethics. Whether a facility is a nonprofit, public or for-profit hospital, the Code of Ethics should address such items as conflicts of interest, with emphasis on business interests; real estate interests; self-dealing; usurpation of corporate opportunity; competition with or against the organization; the interests of board member relatives; and nepotism. The code also should provide for an annual "Conflict Statement" as well as an acknowledgment of receipt and review of the code for new board members as part of their orientation. Once a draft is prepared, the full board should participate in the discussion, approval and implementation of the code.

Board Ethics 'Check-Up'

- ❑ Does the board appropriately monitor senior executives?
- ❑ Does the board maintain a vigilant awareness of conflict of interest and nepotism concerns?
- ❑ Is the finance committee functioning in the best interest of the organization, and does it function separately from the audit committee?
- ❑ Are the actions of the board and its members within ethical parameters that can stand up to public scrutiny?

Source: Fletcher Brown, J.D., shareholder, Davis & Wilkerson, P.C., in Austin, 512/482-0614.