Journal of Business Ethics (2005) 58: 79–100
DOI 10.1007/s10551-005-1390-y
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Tone at the Top: An Ethics Code for Directors?

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ABSTRACT. Recent corporate scandals have focused the attention of a broad set of constituencies on reforming corporate governance. Boards of directors play a leading role in corporate governance and any significant reforms must encompass their role. To date, most reform proposals have targeted the legal, rather than the ethical obligations of directors. Legal reforms without proper attention to ethical obligations will likely prove ineffectual. The ethical role of directors is critical. Directors have overall responsibility for the ethics and compliance programs of the corporation. The tone at the top that they set by example and action is central to the overall ethical environment of their firms. This role is reinforced by their legal responsibilities to provide oversight of the financial performance of the firm. Underlying this analysis is the critical assumption that ethical behavior, especially on the part of corporate leaders, leads to the best long-term interests of the corporation. We describe key components of a framework for a code of ethics for corporate boards and individual directors. The proposed code framework is based on six universal core ethical values: (1) honesty; (2) integrity; (3) loyalty; (4) responsibility; (5) fairness; and (6) citizenship. The paper concludes by suggesting critical issues that need to be dealt with in firm-based codes of ethics for directors.

KEY WORDS: Boards of directors, ethics, law, codes, corporate governance

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Introduction: where were the directors?[1]

The number and extent of recent corporate scandals (e.g., Enron and their auditor Arthur Andersen, WorldCom, Tyco International, Global Crossing, Adelphia, Fannie Mae, HealthSouth, and the New York Stock Exchange, with the number growing steadily), have provoked interest in corporate governance on the part of the media, shareholders, legislators, regulators, creditors, mutual funds and pension funds. "...(T)oday, [directors] are under the microscope as everyone from bondholders to the smallest retail investor looks to boards of directors to restore confidence in a shaken market" (Gray, 2003, p. 59). The growing interest and concern is not surprising, given the significant financial and social harm these scandals have caused society.

As noted by U.S. President George W. Bush (Guardian, 2002):

> [These] high-profile acts of deception have shaken people's trust. Too many corporations seem

> disconnected from the values of our country. These scandals have hurt the reputations of many good and honest companies. They have hurt the stock market. And worst of all, they are hurting millions of people who depend on the integrity of businesses for their livelihood and their retirement, for their peace of mind and their financial well-being.

According to U.S. Federal Reserve Chairman Alan Greenspan (2002), "infectious greed" had simply "gripped the business community." The magnitude of these 21st century scandals, in contrast to earlier ones limited to specific industries (i.e., savings and loan firms, defense contractors) or activity (i.e., insider trading) is reflected in their variety across industries and the type of fraud perpetrated. Corporate agents at the most senior levels, including several CEOs and chairs of boards of directors,[2] have been accused of being key players in the corporate malfeasance.

Enron and WorldCom symbolize the ways in which greed penetrated corporate governance. Enron involved "...a systematic and pervasive attempt by Enron's management to misrepresent the company's financial condition...self-enrichment by employees, inadequately designed controls, poor implementation, inattentive oversight, simple and not-so-simple accounting mistakes, and overreaching in a culture that appears to have encouraged pushing the limits" (Cohan, 2002, p. 277). In the case of WorldCom the drivers included (Directors' Report, 2003): "...a perceived need to meet unrealistic securities market expectations" (p. 35); a culture "...emphasizing making the numbers above all else" (p. 18); the keeping of "...financial information hidden from those who needed to know" (p. 18); "...a systematic attitude conveyed from the top down that employees should not question their superiors, but simply do what they were told" (p. 21); and the provision of few "...outlets through which employees believed they could safely raise their objections" (p. 18).

It is instructive that these scandals might have been reduced or avoided but for board failures. In the case of Enron, the U.S. Senate's Permanent Subcommittee on Investigations found that "while the primary responsibility for the financial reporting abuses...lies with Management...those abuses could and should have been prevented or detected at an earlier time had the Board been more aggressive and vigilant" (Senate Report, 2002, p. 13). In the case of WorldCom, the Special Investigative Committee of the Board of Directors found that "WorldCom's collapse reflected not only a financial fraud but also a major failure of corporate governance...although the Board, at least in form, appeared to satisfy many checklists of the time, it did not exhibit the energy, judgment, leadership or courage that WorldCom needed" (Directors' Report, 2003, p. 29). In other words, the failures were not merely the result of senior executives engaging in inappropriate activity, but the fact that boards and directors responsible for monitoring senior management appear to have failed in their responsibilities. A defining question is: "Where were the directors?" (Nofsinger and Kim, 2003, p. 89).

The Enron board included many highly competent and accomplished individuals. In fact, shortly before its collapse, Enron was ranked by *Chief Executive* magazine as having one of the nation's five best boards in 2000 (NACS, 2002). The board included among others John Duncan, who held "extensive corporate and Board experience," Herbert Winokur, Jr., who held "...two advanced degrees from Harvard University [with] extensive corporate, Board and investment experience," Dr. Robert Jaedicke, Dean emeritus of the Stanford Business School and a former accounting professor, and Dr. Charles LeMaistre, former President of the Anderson Cancer Center, "a large and well respected and complex medical facility in Texas" (Senate Report, 2002, p. 2). The U.S. Senate Subcommittee found that the Directors possessed "...a wealth of sophisticated business and investment experience and considerable expertise in accounting, derivatives, and structured finance" (Senate Report, 2002, p. 8).

Yet at the end of the day, according to the U.S. Senate Subcommittee:

> The Enron Board of Directors failed to safeguard Enron shareholders and contributed to the collapse of the seventh largest public company in the United States, by allowing Enron to engage in high risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, and excessive executive compensation. The Board witnessed numerous indications of questionable

> practices by Enron management over several years, but chose to ignore them to the detriment of Enron shareholders, employees and business associates (Senate report, 2002, p. 3).

WorldCom's board also appeared highly competent: "Before WorldCom Inc.'s fall, its board of directors included a seasoned group of leaders, members such as the former head of the National Association of Securities Dealers, several company chief executives, the chairman of Moody's Corp., even the dean of the Georgetown University Law Center." Yet despite the apparent quality and competence of the board: "An investigative report...concluded that while its top executives mismanaged the company disastrously, WorldCom's directors 'served as passive observers' and 'did not exert independent leadership'" (Hilzenrath, 2003).

Even the venerable New York Stock Exchange, an organization charged with regulatory oversight for member broker-dealer firms and companies with listed securities, fell victim to charges of inadequate internal corporate governance. Its Board of Directors included many of the most sophisticated and experienced financial executives in the country. Yet they were criticized for inadequate performance of their fiduciary duties. The issue that received the most publicity and outcry was the disclosure that the former CEO, Richard A. Grasso, had an unprecedented generous retirement plan that dwarfed retirement plans for CEO's of many of the largest companies in the world.

In order to examine and better understand the underlying reasons for the various corporate governance failures, in particular Enron and WorldCom, and to potentially work towards avoiding such scandals in the future, we argue that the legal system underlying corporate governance, although necessary, is inherently insufficient as a means of ensuring essential levels of ethical behavior on the part of corporate directors. The identification of, and adherence to, ethical obligations constitute a critical complementary responsibility for corporate directors.

Much has been written on the legal obligations of directors (Akula, 2000; Fairfax, 2002; Iwan and Watts, 2002; Schreurs, 1999; Wade, 2002; Walsh, 2002), as well as board "best practices" (Daily et al., 2003; Westphal, 1999; Zahra and Pearce, 1989). Surprisingly little however has been written specifically on the ethical obligations of directors. Other than descriptive studies that have been conducted on directors and their involvement in their firms' ethics programs (e.g., Felo, 2001), a review of ABI/Inform and LexisNexis using the search terms "ethics" and "directors" did not reveal any formal normative study dedicated to the subject of directors' ethical obligations. One text on corporate governance neglects to explicitly discuss the ethical obligations of directors (Monks and Minow, 2001). Another corporate governance text which lists "Business, Legal and Ethical Challenges Faced by Boards of Directors" on its cover, devotes only a few pages to a discussion of the ethical obligations of directors (Colley, Doyle, Logan and Stettinus, 2003). In terms of practical application, a review (as of August 1, 2003) of several national directors' associations including the United States' National Association of Corporate Directors (NACD), Britain's Institute of Directors (IoD), and Canada's Institute of Corporate Directors (ICD), did not find any offering training that specifically addressed the ethical as opposed to legal obligations of directors. These findings might appear surprising given the extensive literature discussing the ethical obligations of other non-professional groups including: marketing managers (O'Boyle and Dawson, 1992); public relations managers (Bivins, 1993; Pratt, 1991, 1994); project managers (Nixon, 1987); scientists (Rapoport, 1989; Schinin, 1989); bank managers (Rideout, 1989); real estate agents (Allmon, 1990); property managers (Sharplin et al., 1992); purchasing professionals (Forker, 1990); property/liability underwriters (Cooper and Frank, 1990); financial managers (Ang, 1993; Freeman et al., 1992; Nemes, 1992); and computer professionals (Oz, 1993).

To address the paucity of research in the literature on the explicit ethical obligations of directors, we begin by exploring whether directors have unique ethical obligations and, if so, what these obligations might be comprised of. In part one of our paper we argue that the legal framework for directors, while necessary, is insufficient as a means of encouraging appropriate levels of ethical behavior on the part of directors. To do this, we: (a) summarize the current state of the U.S. legal framework for directors and discuss limitations restricting enforcement of the law; and (b) examine the current corporate scandals as illustrations of ethical failures. Part two discusses the

key bases for the ethical role of directors. Directors have overall responsibility for the ethics and compliance programs of the corporation. The tone at the top that they set by example and action is central to the overall ethical environment of their firms. This role is reinforced by their legal responsibilities to provide oversight of the financial performance of the firm. Underlying this analysis is the critical assumption that ethical behavior, especially on the part of corporate leaders, leads to the best long-term interests of the corporation. Part three examines formal sources that can be used to derive ethical obligations for directors, including: (a) corporate codes of ethics for employees; (b) corporate codes of ethics for directors; (c) companies' corporate governance principles or guidelines; (d) ethical standards from national corporate directors' associations; (e) national and international corporate governance codes or principles; and (f) generally recognized business ethics principles. Part four proposes a basic framework for a firm-based "Code of Ethics for Directors" based upon a convergence of the formal ethical standards discussed in part three into six core ethical values. Part five discusses specific issues that would have to be addressed in any firm-based code of ethics for directors.

Part one – corporate governance law, necessary but inherently insufficient

Our basic claim is that the U.S. law of corporate governance has proven insufficient to encourage appropriate ethical behavior on the part of corporate directors. We believe this is the case in spite of the apparently widely held impression that there is significant personal liability for individual directors. Although there may be contexts in which directors' potential liability becomes a motivator, in fact it is only for the most extreme malfeasance, leaving the law impotent as a means of encouraging day-to-day ethical behavior. To clarify our argument, we are not claiming that the failure of boards was the sole, or even necessarily the most significant factor in the perfect storm that brought down so many firms. We agree with Coffee (2002) that the failure of other, also inadequately deterred gatekeepers such as auditing and law firms was also important. We disagree, however, with Coffee's (2002, p. 1419) claim that "Enron is more about gatekeeper failure than board failure." Instead, we see corporate boards as the gatekeeper of last resort when it comes to preventing massive ethical failure.

Limitations of ability of law to ensure director's performance of duty

Corporate governance has been defined as (Weil et al., 2002, p. 28):

> ...the mechanisms by which a business enterprise, organized in a limited liability corporate form, is directed and controlled. It usually concerns mechanisms by which corporate managers are held accountable for corporate conduct and performance."

The mechanism by which companies are ultimately directed and controlled is through the actions of the board of directors, as elected by the corporation's shareholders. As detailed in the U.S. Senate Subcommittee Report on Enron:

> ...the Board of Directors sits at the apex of a company's governing structure. A typical Board's duties include reviewing the company's overall business strategy; selecting and compensating the company's senior executives; evaluating the company's outside auditor; overseeing the company's financial statements; and monitoring overall company performance. According to the Business Roundtable, the Board's 'paramount duty' is to safeguard the interests of the company's shareholders (Senate Report, 2002, p. 5).

To help ensure that directors carry out these critical duties, national legal systems around the world have established specific obligations for directors. The legal responsibilities "...date from the introduction of publicly traded companies in the 19th century" (Vinten, 1998, p. 37). They often impose individual liability upon directors who breach their legal obligations. Directors can be sued by many parties including: "...the company itself, liquidators, shareholders, creditors, third parties, and government authorities" (Iwan and Watts, 2002, p. 67). Legal obligations for directors derive from the principle that "all corporate affairs must be managed under the direction of the board of directors" (Fairfax, 2002, p. 2).

The U.S. Senate Subcommittee examining Enron summarized directors' legal obligations as follows:

> Directors operate under state laws which impose fiduciary duties on them to act in good faith, with reasonable care, and in the best interest of the corporation and its shareholders. Courts generally discuss three types of fiduciary obligations…namely, the duties of obedience, loyalty, and due care. The duty of obedience requires a director to avoid committing…acts beyond the scope of the powers of a corporation as defined by its charter or the laws of the state of incorporation…the duty of loyalty dictates that a director must act in good faith and must not allow his personal interest to prevail over the interests of the corporation. [T]he duty of care requires a director to be diligent and prudent in managing the corporation's affairs (Senate Report, 2002, p. 5).

The breach of these essential duties would appear to address most of the improper conduct on the part of directors involved in the recent scandals. The question thus arises why the legal regulatory scheme proved insufficient to bring about proper behavior and oversight on the part of boards. The following phenomena contributed to the failure of the potential for legal liability to sufficiently motivate boards and individual directors: (i) the business judgment rule; (ii) corporate constituency statutes; and (iii) charter/by-law limitations/elimination of liability. Due to these provisions, and despite what many suggest is ever broader potential legal liability for directors (Olijnyk, 2003, p. 51), it is still very difficult to enforce the law against directors. The result is that directors may not have sufficient motivation in terms of potential legal liability to engage in appropriate (or avoid inappropriate) behavior. The limitations to the law and liability are as follows:

Business judgment rule. The New Jersey Business Corporation Act (the "NJBCA") is representative of modern state corporate statutes that have endeavored to define an objective standard for business judgment. The NJBCA provides the following: "Directors and members of any committee designated by the board shall discharge their duties in good faith and with that degree of diligence, care and skill which ordinarily prudent people would exercise under similar circumstances in like positions"[3] [s. 14A: 6–14]. However, this type of relatively simple statutory construction of the standard for conduct of directors has been modified in many states in recent years, often to broaden the protections for directors and provide for considerable flexibility in their permissible actions.

The business judgment rule provides an important limitation of liability with respect to a director's duty of care. The rule establishes a presumption that: "…the directors acted on an informed basis, in good faith and in honest belief that the action was taken in the best interest of the corporation" (Iwan and Watts, 2002, p. 68). In other words, courts are not permitted to "second-guess" boards (Akula, 2000, p. 33), and are only able to consider the board's decision-making process and not the substance of the decision (Hanewicz, 2003, p. 217).

Under the business judgment exception, the oft-invoked claim of "ignorance" by directors or their reliance on the honesty of the executives reporting to them or on the opinions provided by their auditors or lawyers appears to be a major obstacle to finding directors liable for their actions or inaction (Hanewicz, 2003).

> For example, the Delaware General Corporation Law ("DGCL") provides the following: A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation [s. 141(e)].

Similar provisions are contained in the Pennsylvania Business Corporation Law ("PBCL") [s. 512(a)] and the NJBCA [s. 14A: 6–14].

Corporate constituency statutes. In recent years a number of states, such as New Jersey, have enacted provisions designed to give directors greater latitude in carrying out their fiduciary duties by allowing them to consider a wider range of statutorily-sanctioned

factors in making decisions. The expansion allows directors to justify their actions on more ambiguous grounds such as acting on behalf of stakeholders when they are attacked by shareholders or others. For example, the NJBCA provides the following:

> In discharging his duties to the corporation and in determining what he reasonably believes to be in the best interest of the corporation, a director may, in addition to considering the effects of any action on shareholders, consider any of the following: (a) the effects of the action on the corporation's employees, suppliers, creditors and customers; (b) the effects of the action on the community in which the corporation operates; and (c) the long term as well as the short-term interests of the corporation and its shareholders, including the possibility that these interests may best be served by the continued independence of the corporation [s. 14A: 6–1(2)].

This New Jersey provision in effect acts to redefine and expand the meaning of "best interests of the corporation" and the "effects of any actions on the shareholders" with the effect of providing greater protection for directors from liability for decision-making. This gives directors much greater latitude in setting corporate policy by permitting them to consider factors that were not traditionally deemed to be within the scope of determination. It is at least mildly ironic that the corporate constituency statutes that have been favored by many business ethicists (e.g., Fort, 1997, O'Connor, 1991, Van Wezel Stone, 1991) may have contributed to a more permissive legal environment resulting in ethical lapses by boards.

Charter/by law limitations/elimination of liability. In recent years a number of states have gone even further to authorize exoneration of directors from personal liability to the extent that the articles of incorporation or bylaws adopted by the shareholders specifically so provide. For example the PBCL (s. 513) adopted in 1990 provides the following:

(a) General rule. – If a bylaw adopted by the shareholders entitled to vote or members entitled to vote of a domestic corporation so provides, a director shall not be personally liable, as such, for monetary damages for any action taken unless:

(1) the director has breached or failed to perform the duties of his office under this subchapter [which includes the provisions described above relative to Section 512(a) of the PBCL]; and
(2) the breach or failure to perform constitutes self-dealing, willful misconduct or recklessness.

Although New Jersey also permits elimination or limitation of the personal liability of a director [NJBCA s. 14A: 2–7(3) and s. 14A: 6–14(3)], such provisions must be contained in the certificate of incorporation (which automatically requires shareholder approval), rather than the bylaws of the corporation as in Pennsylvania. As a result, it is extremely difficult to find directors liable.

In addition to the defenses and liability limitations identified above, many states "...permit corporations to indemnify their directors from liabilities associated with civil, criminal or administrative proceedings against the company" (Senate Report, 2002, p. 5).[4] As a further protection, "...most U.S. publicly traded corporations, purchase directors' liability insurance that pays for a director's legal expenses and other costs in the event of such proceedings" (Senate Report, 2002).[5]

Beyond these limitations and protections from civil liability, other difficulties exist in order to find directors criminally liable. The standard of proof required is to prove criminal intent beyond a reasonable doubt. This often necessitates the need to find a whistleblower willing to testify against his or her superiors, which is not an easy task. If directors are prosecuted, they tend to have access to high quality legal counsel (France and Carney, 2002, p. 34). Although additional criminal penalties with respect to fines and jail sentencing have been imposed through the enactment of the *Sarbanes-Oxley Act of 2002*, whether the *Act* will have any effect on changing the behavior of executives or directors is yet to be seen:

> So does this mean that the rogue's gallery of irresponsible execs who have populated the business pages over the past several months will finally go to jail? Will the little guy finally be avenged? Don't count on it. While there will certainly be more prosecutions – and some of them will bear fruit – criminal enforcement is a risky game. The laws regulating companies are ambiguous, juries have a hard time grasping abstract

financial concepts, and well-counseled executives have plenty of tricks for distancing themselves from responsibility (France and Carney, 2002, p. 34).

Ethical failures were key to most of the major scandals

Closer attention to ethical concerns should have short-circuited some of the behaviors that ultimately brought down entire firms in the recent scandals. The Enron disaster occurred in the face of Board ratification of waivers of the firm's Code of Ethics and its conflict of interest rules on three separate occasions. Jennings (2003) suggests that the firm's auditor had requested the board's action in the belief that the board would step up, refuse to go along, and thereby save the audit team. As is well known, the board did not do so. As Jennings notes (Id.) "another important safety tip for directors emerges: if the CEO asks you to waive provisions in the Code of Ethics, you perhaps, have a problem."

The directors involved in Enron did not appear to believe that they were doing anything that was legally problematic.

As noted above, Enron's board of directors voted three times to suspend the conflict of interest provisions in Enron's code of ethics to permit CFO Andrew Fastow to establish and operate entities that transacted business with Enron and profited at Enron's expense. The Senate Committee found that the waiver of the code was "highly unusual and disturbing [as it] allowed inappropriate conflict of interest transactions" (Senate Report, 2002, p. 24). Two other senior financial officers were able to profit from the entities, neither of whom obtained a waiver of the code of conduct (Senate Report, 2002, p. 28). Yet, during the congressional hearings, the directors indicated that they believed they were acting in the best interests of Enron, that there were sufficient safeguards in place, and that they would make the same decision again in the future (Senate Report, 2002, p. 29). Although the new *Sarbanes-Oxley Act* will now require disclosure of code waivers, at the time, disclosure of the waiver by Enron's board was not legally necessary.

Many directors appeared to have had direct or indirect conflicts of interest. Two directors received payment for consulting services to Enron (Senate Report, 2002, p. 55). One director was a CEO of a company that had engaged in tens of millions of dollars of transactions with Enron (Senate Report, 2002, p. 55; Shmitt and Barnett, 2002). Other directors were directly associated with organizations that received substantial charitable donations from Enron (Berenbeim, 2002, p. 3). Even if technically legal, such actions were viewed by the Subcommittee as ethically inappropriate in terms of creating potential conflicts of interest and thus affecting the board's independent judgment vis-à-vis Enron management (Senate Report, 2002, p. 56).

Enron's board simply did not sufficiently probe into the financial situation (Cohan, 2002, p. 277). The egregious falsification of financial data leads one to ask: "Were there times that Enron directors noticed an anomaly but chose to ignore it because it conformed to GAAP and did not violate securities laws?" (NACS, 2002, p. 4).

Despite all of the above concerns, Enron's directors "...explicitly rejected any share of responsibility for Enron's collapse." They argued that "the Board worked hard" and "asked probing questions." The directors all viewed their actions as appropriate and legal in nature and blamed Enron management and the auditors, Arthur Andersen, for "not telling the truth" (Senate Report, 2002, p. 14).

WorldCom's directors also appear to have engaged in a number of acts that while technically legal, are arguably unethical through an appearance of impropriety.

Two directors, Bernie Ebbers and Scott Sullivan, gave significant financial gifts and loans of hundreds of thousands of dollars to other managers at WorldCom, creating "...conflicting loyalties and disincentives to insist on proper conduct" (Directors' Report, 2003, p.24). The board of directors authorized significant loans and guarantees ($400 million) to CEO Bernie Ebbers (Directors' Report, 2003, p. 32) so that he could avoid selling his own WorldCom stock to meet his personal financial obligations. Nobody on the board challenged Ebbers with respect to his use of WorldCom stock. The investigative committee felt that these loans and guarantees, although legal, were "...a major failure of corporate governance" (Directors' Report, 2003, p. 32). The board also approved one of WorldCom's airplanes being leased by one of the directors, potentially affecting his independence (Directors' Report, 2003, p. 34). The board did not seriously

question Bernie Ebbers in relation to his extensive outside business interests. According to the investigative committee: "We do not believe most properly run Boards of Directors would permit a Chief Executive Officer to pursue an array of interests such as these, certainly not without careful examination of the time and energy commitments they would require" (Directors' Report, 2003, p. 32). According to the Bankruptcy Examiner's Report of WorldCom, the board appeared to "rubber stamp" management's decisions, in one case spending only 35 minutes during a telephone meeting reviewing the take-over of a company worth $6 billion that ultimately cost WorldCom billions in losses. No documents were provided to the board (Business Times, 2002). Many other steps could have been taken by the board "...to increase the chances of detecting acts of corporate wrongdoing including: maintaining enough involvement in the Company's business to enable the Board to exert some control over the agenda, ensuring the presence of strong 'control' functions within the company; communicating throughout the Company the value of high ethical standards; having some familiarity and direct contact with people throughout the Company (as well as suppliers and customers); and keeping a close and open relationship with the outside auditors" (Directors' Report, 2003, p. 283).

In summary, the law as it presently stands remains insufficient to encourage appropriate behavior on the part of directors. While more stringent corporate governance laws regulating director behavior along with enhanced enforcement and potential penalties might help improve the situation somewhat, we argue that the law is inherently insufficient. Experience has demonstrated that potential loopholes will always exist in the legal framework for corporate governance, providing one with the opportunity to merely comply with the letter as opposed to the spirit of the law. Part two will now further develop the rationale for emphasizing the ethical obligations of directors.

Part two – the need for emphasis on the ethical obligations of directors

Directors' ethical obligations derive from the nature of their role and are reinforced by their primary legal obligation to provide oversight of the financial performance of the firm and their secondary obligation to ensure an effective corporate compliance program. Directors truly set the "tone at the top" for their organizations.

The critical role of directors

As professionals and fiduciaries, boards are ultimately responsible for the protection of corporate assets. Directors hold ultimate responsibility for the selection, retention, and discipline of senior management, they help ensure the accuracy of financial reports, and they decide whether to approve major organizational changes such as mergers and acquisitions. A high degree of trust is placed in the hands of directors by shareholders. As a result, directors of companies might be considered to be some of the most important fiduciaries in society. They are subject to formal expectations concerning their knowledge and their responsibilities to others. In that sense, they are similar to doctors, lawyers and accountants who are subject to professionally prescribed ethical responsibilities. By undertaking a formal commitment to enter into this professional role, and often being paid substantial compensation, individuals serving as directors should be considered bound by professional ethical obligations beyond mere compliance with the law.

Although directors have not yet been recognized as a professional group, this may be changing as education, training, and director certification courses are beginning to be offered in several jurisdictions (e.g., Britain and Canada). Companies are becoming much more concerned about the level of competence (including financial expertise) of their board members and appear to be increasing the level of due diligence used in the screening process of potential board members (Olihnyk, 2003, p. 52). Such due diligence includes: "...reference checks, criminal checks, and education verification" (Olihnyk, 2003, p. 52). Establishing financial expertise for the audit committee's "financial expert" has become a legal requirement under the *Sarbanes-Oxley Act* (s. 407).

Failure by directors to fulfill their role properly for companies of all sizes can lead to disastrous consequences for many stakeholder groups, and potentially affect thousands of people. In some cases, decisions

(or inaction) by boards can involve life or death consequences (e.g., non-recall of the Ford Pinto, non-recall of Goodrich tires, Dow Corning and breast implants, Union Carbide in Bhopal India), or involve significant financial harm (e.g., Barings Bank, Enron, WorldCom). Based on the moral duty of non-malfeasance, or the avoidance of unnecessary harm, as well as based on utilitarian arguments, the potential negative consequences of directors' actions or inaction suggests that reference to the law alone for standards is simply not sufficient. The Directors' Report (2002) on WorldCom reflects this by emphasizing that had the Board been concerned with communicating the value of high ethical standards throughout the company, it might have detected and/or forestalled the financially disastrous scandal.

One might respond that unlike other professional groups, the role of a director is part-time in nature and therefore not comparable to lawyers or accountants. According to one Enron director, Herbert Winokur, the former Chairman of the Finance Committee, Enron's catastrophe was ''a cautionary reminder of the limits of a director's role'' which is by nature ''a part-time job'' (Senate Report, 2002, p. 14). When one considers the substantial responsibility that directors have in monitoring their corporations, however, it is hard to imagine that directors should not be considered professionals without additional ethical obligations, regardless of the part-time nature of their role. One would not argue that a part-time lawyer or accountant is any less a professional. In addition, despite the part-time nature of directors, their significance is emphasized due to the fact that directors are required to ''. . .be available to drop everything for any special situation or crises'' (Olijnyk, 2003, p. 53).

Setting the tone at the top; ensuring effective compliance and ethics programs

Boards sit at the top of the corporate hierarchy. Along with senior management, directors set by their words and deeds the ethical tone for the organizations (Schroeder, 2002). All others involved with the firm look to the top for guidance. Whether or not they actively seek the responsibility, boards serve as role models for ethical tone. The organizational literature documents the importance of the role of senior executives (Treviño and Weaver, 2003) and board members in influencing the ethical behavior of lower level employees. For example, large accounting organizations have long emphasized ''tone at the top'' as a means of ensuring that their members act ethically and professionally (McGrath et al., 2001).

Beyond the general role of directors in setting the tone at the top, recent changes in law and practice are expanding the responsibility of boards for their firms' corporate compliance and ethics programs. Boards are increasingly being asked to ensure that their companies have implemented compliance or ethics programs. Under the U.S. Federal Sentencing Guidelines for Organizations (1991), a company found to have an ''effective compliance program'' in place prior to a violation of federal law may have fines reduced substantially. An effective compliance program includes, among other elements, a code of conduct or ethics, ethics training, an ethics officer, and a reporting system. The guidelines were bolstered by the case, *Caremark International* (1996). While referring to the Federal Sentencing Guidelines' minimum requirements for an effective compliance program, the court emphasized the board's responsibility to adopt systems that help keep it adequately informed of compliance problems (Akula, 2000). 'Directors' responsibilities with respect to a firm's compliance and ethics program as outlined in *Caremark* appears to have been enhanced by recent amendments to the Sentencing Guidelines (2004). The Sentencing Guidelines now require organizations to ''...promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.'' In addition, the Sentencing Guidelines require the organization's ''governing authority'' (i.e., directors) to be: ''...knowledgeable about the content and operation of the compliance and ethics program and ...exercise reasonable oversight with respect to the implementation and effectiveness of the compliance and ethics program.''

Following along legal trends, the U.S. National Association of Corporate Directors recommends that: ''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. . .''

(NACD, 2002, p. 2). The *Sarbanes-Oxley Act* [s. 406(a)] requires companies to adopt a code of ethics for senior financial officers, or to indicate the reasons why one does not exist. Directors must also disclose whether they have waived any provision in their codes [s. 406(b)], and can be held liable for any retaliation against whistleblowers (s. 1107).

Corporate practice is changing in a manner congruent with these trends. Some corporate codes of ethics specifically indicate that the code has been adopted by the firm's board of directors: The Code of Business Conduct of Halliburton Company specifically notes, "Policies *adopted by the Board of Directors*" [emphasis added]. Board adoption of a code surely creates an expectation on the part of all employees that individual directors themselves will at a minimum meet relevant ethical obligations set forth therein.

Boards often have special responsibilities relating to the enforcement of existing ethics codes and programs. For example, corporate codes of ethics typically indicate that employees have an obligation to report wrongdoing by others. Morgan Stanley's code indicates: "If your concerns relate to the conduct of the Chief Executive Officer, any other senior executive or financial officer, or a member of the Board of Directors, you may also report your concerns to the Chief Legal Officer. The Chief Legal Officer will notify the Board of Directors if the allegations of unlawful or unethical conduct have merit. Similar concerns involving the Chief Legal Officer should be reported to the Board of Directors." The firm is stating that the board of directors is the final authority even when other board members are acting improperly. As the employees' final resort to potentially address employees' raised concerns over wrongdoing (e.g., code violations), directors can and should be expected to set the ethical tone for the firm.

Acting in the best interests of the corporation

Research suggests that the ethical behavior of a corporation's leaders, including whether actions are taken against unethical behavior, has an impact on the ethical behavior of other corporate agents (Akaah and Riordan, 1989; Baumhart, 1961; Brenner and Molander, 1977; Posner and Schmidt, 1987; Soutor et al., 1994). Potential harm to the company increases if corporate agents view their directors as acting unethically and then become more likely to act illegally or unethically. Manager or employee perceptions of their directors' ethical behavior may also affect the likelihood that illegal or unethical behavior is disclosed through internal whistleblowing, which would provide the company with a potential opportunity to avoid a scandal. In the case of WorldCom, the Special Investigative Committee found that "one of the serious adverse consequences was the message that [the loans and guarantees to CEO Bernie Ebbers] conveyed. Employees will not believe that the Board can be approached with concerns about the Chief Executive Officer or his top management when they see the Board using shareholder funds to bail the Chief Executive Officer out of his financial distress" (Directors' Report, 2003, p. 291). At Enron, Sherron Watkins indicated in her testimony to the U.S. Senate that the company's corporate culture made it difficult for her to come forward (CNN Watkins, 2002).

The ethical behavior of boards of directors can influence both the ethical behavior of corporate agents, and the ability to have unethical behavior disclosed and addressed. In both cases, the likelihood of a corporate scandal causing significant harm to the company only increases if directors are perceived as acting unethically. There may be all sorts of additional costs that can be avoided if corporate directors fulfill their ethical obligations (Dunfee, 1999). For example, in addition to legal and public relations costs, corporate scandals that occur due to directors' ethical lapses can affect a company's ability to retain and attract talented managers and employees. Corporate governance practices perceived as being problematic may also affect the firm's ability to raise capital from ethically sensitive investors or lenders (Baue, 2002; CalPERS, 2003; Gray, 2003). If it is accepted that directors have an obligation to act in the best interests of their companies, then based on the evidence, directors have an obligation to behave ethically.

In summary, directors need to emphasize their ethical obligations because: (1) recent corporate scandals involved serious ethical failures at the board level; (2) the nature of boards requires observance of ethical obligations; (3) boards, charged with the ultimate responsibility of ensuring the ethics of their organizations, are thereby obligated to act as ethical

role models themselves; and (4) it is simply good for corporate business success for directors to be ethical. Part three will now examine the formal sources available for establishing the parameters of ethical obligations for boards and directors.

Part three – formal sources of directors' ethical obligations

We have seen that ethical dimensions are critical to the operation of boards and in the performance of individual directors. This is reflected in trends in corporate practice with more firms explicitly recognizing the need for ethical standards and guidance for directors. At the same time, complementary principles of emerging corporate law either actively encourage consideration of ethical dimensions by directors, or are open to such considerations (Dunfee, 1999).

The multiple sources of standards that exist or potentially exist complicate the process of determining which ethical principles are relevant for a particular board and its constituent directors. The potential sources for ethical obligation for directors and/or boards include: (a) corporate codes of ethics; (b) director-specific corporate codes of ethics; (c) company corporate governance principles; (d) ethical codes for members of national director associations; (e) international and national corporate governance principles; and (f) generally recognized principles of business ethics. Each has its own focus and purpose. Taken together they point the way toward core principles for directors' ethical obligations.

Corporate codes of ethics

Directors of companies having a code of ethics for their employees may be explicitly required to comply with relevant portions of their corporation's code of ethics. For example, AT&T Corp. indicates that: "The Company's Code of Conduct applies to *all directors* and employees of the Company..." [emphasis added]. Even if directors are not specifically mentioned, they may implicitly be required to abide by the code if the code defines "employees" as including all directors.

Companies' director-specific codes of ethics

A number of companies have established codes of ethics specifically for their directors in addition to their codes of ethics for their employees. For example, Pitney Bowes (2003) has a "Code of Business Conduct and Ethics for Members of the Board of Directors." The topics covered include: conflict of interest; corporate opportunities; confidentiality; compliance with laws, rules, and regulations; fair dealing; encouraging the reporting of any illegal or unethical behavior; and compliance procedures.

Companies' corporate governance principles

Many companies, rather than establishing a distinct code of ethics for their directors, have developed firm-specific corporate governance principles or guidelines. This phenomenon should continue as, on November 4, 2004, the SEC approved changes (SEC Release 34-48745) to the listing standards of the New York Stock Exchange (the "Listing Standards") and the NASDAQ that impose greatly increased governance, business conduct and ethics requirements on listed companies and their officers, directors and employees. The new Listing Standards require a code of business conduct and ethics for directors, officers and employees. They further require listed companies to disclose any waivers of the code for directors of executive officers." It remains to be seen the extent to which the Exchange's approach will serve as a model for all United States companies or the extent to which it will encompass ethical considerations. Although corporate governance guidelines typically are intended to provide "guidance" concerning governance procedures and the operation of boards, some guidelines go beyond and mention ethical expectations. For example, AT&T Corp.'s guidelines indicate that: "Each member of the *Board of Directors* shall at all times exhibit high standards of integrity and ethical behavior" [emphasis added].

National director associations' codes of conduct

A number of countries have national director associations, some of which have developed codes of

ethics for their members. These codes tend to emphasize ethical principles as opposed to general corporate governance principles. For example, the U.K. Institute of Directors (IoD) has a "Code of Professional Conduct" (2003) which indicates that: "This Code has been written in order to help directors simultaneously meet high standards of professionalism and ethics." The code demands that a director avoid conflicts of interest, respect confidentiality of information, observe "a duty to respect the truth and act honestly" in business dealings, and "exercise responsibilities to employees, customers, suppliers, and other relevant stakeholders, including the wider community."

International and national corporate governance principles

A number of countries or international organizations around the world have established their own corporate governance standards for their corporations. These standards have been referred to as governance "codes," "principles," or "guidelines" (Weil et al., 2002). As one example, the OECD Principles of Corporate Governance (1999) discuss the following topics: rights of shareholders; equitable treatment of shareholders; role of stakeholders in corporate governance; disclosure and transparency; and the responsibilities of the board. The OECD Principles mention the importance of various ethical values such as honesty, responsibility, rights, and equitable treatment.

General principles of business ethics

Increasingly, scholars and managers alike recognize the existence of core standards of business ethics applying to all commercial activities. They encompass factors such as acting honestly and in good faith. They stress avoidance of conflicts of interest, require the exercise of due care, and emphasize fairness and just results. Senior managers speak time and time again of their importance. The major media stress their centrality to capitalism. Corporate codes make general reference to them. Legal principles embrace them. Scholars seek to document and justify specific examples. Across the active domain of business ethics, one dimension is crystal clear; these general principles of business ethics apply to everyone, including all constituents of the corporation. They are not just the concern of lower-level employees or of those who belong to formal professional associations. They apply to senior managers and directors with full force.

Part four – elements of a code of ethics for directors

As we have seen, codes may either be internal to a firm or they may, instead, derive from an external source that is intended to guide directors in general. Firm-specific directors' codes need to cover topics and issues unique to the firm's operations, nature, and history. Although there are many aspects of operation and performance expectations common to all boards, boards may also differ substantially depending on the structure of the firm and the nature of the business. Those differences need to be covered in firm specific codes.

If one were to attempt to construct a firm-based code of ethics for directors, what would it encompass? Fortunately, one does not need to start from scratch. Building on the vast array of sources of ethical standards and principles, discussed in part three, a basic framework for a directors' code of ethics can be developed. We recognize that a one-size fits all, "cookie cutter" approach is impractical. Instead, we seek to determine the basic core values and critical issues that should guide the adoption of individualized codes of ethics by specific corporations. We envision that those responsible for developing corporate codes would use the framework as a pattern for the development of the design for their specific code. This framework or pattern should be capable of serving as a broad outline and also as a checklist for developing a code reflecting the special history and experience of the firm and its board.

We first seek to identify the general values that should guide and be reflected throughout a code of ethics of directors and boards. Significantly, we could only identify one prior attempt to establish a code for directors in the literature. Siebens (2002) proposes five principles for an "ethical code for directors." These principles include: the duty of loyalty; the duty of care; the duty to formulate its ultimate goal; openness of direction (transparency);

and the duty to give account of all actions taken (accountability). Driscoll (1995), while not setting out an actual code of ethics for directors, does suggest four activities that lead to an ethical director: acting with diligence (e.g., meeting attendance, reviewing materials); providing oversight (e.g., oversee procedures, test assumptions); making policy (e.g., setting standards, engaging in self-assessment, acting with candor); and remaining educated.

If one attempts to converge the various ethical standards currently in existence, as well as the primary legal obligations for directors, one finds that six core ethical values emerge. They include: honesty; integrity; loyalty; respect; responsibility; fairness; and citizenship. The values are consistent with those universal core ethical values identified by others (Josephson, 1997, pp. 26–27; Schwartz, 2002).

These six core ethical values then become the organizing framework for any legal or ethical obligations for directors. Table 1 below provides an illustration of how the standards converge.

Based on the convergence of the various sources of ethical standards, the values that should underpin every code of ethics for directors can be constructed. These values should be relevant anywhere around the world, for all corporate boards. We identify six core ethical values, which then lead to the more specific ethical principles to be followed.

(1) *Honesty*: Directors have an ethical obligation to act with honesty. The hallmark of honesty is truthfulness and forthrightness. It requires speaking up frankly when required to prevent a false impression. The honest director eschews half-truths and other linguistic devices intentionally used to create misunderstandings.

Commentary: Honesty can affect all actions of directors, including the provision of accurate reports of the companies activities. The importance of honesty has been commented on: "...honest corporate directors acting in good faith are the key to proper corporate governance and stockholder welfare" (Veasey, 2003, p. 450).

(2) *Integrity*: Directors have an obligation to act with integrity.

Commentary: The obligation to act with integrity requires that directors act with honor, always ensuring that they are acting in accordance with their firms' espoused principles and values. Virtually every corporate code of ethics mentions the importance of acting with integrity, indeed some codes include the word integrity in their titles (e.g., EDS – "Acting with Integrity: Code of Business Conduct"). Associations such as the Institute of Directors in Southern Africa and the U.S. NACD include the notion of integrity in their core values. According to Siebens (2002, p. 112): "Corporate governance, in short, is based on integrity; the integrity to be expected from each individual director and the integrity expected from the board as a whole. Integrity means constantly being inviolable, which makes decision making and acting predictable and certain."

(3) *Loyalty*: Directors have an obligation to act with loyalty, in the best interests of the corporation as opposed to one's personal interests.

Commentary: In order to be considered acting with loyalty, directors should avoid: self-dealing; taking advantage of corporate opportunities; engaging in potential or apparent conflict of interest transactions; and insider trading. They should maintain objectivity in decision-making and protect confidential and proprietary information.

(4) *Responsibility*: Directors must fulfill their responsibilities as established by the company and corporate law in a transparent manner by which they can be held accountable.

Commentary: Being responsible involves the fulfillment of a number of designated roles as a director. It is based on the legal principle of duty of care. It involves regular attendance at meetings, being informed and maintaining an appropriate level of competence (e.g., continuing education), and expressing dissent when necessary. It requires appropriate supervision of management without micro-management of the firms operations. It also involves being accountable, which requires an adequate degree of transparency and disclosure. It furthermore requires self-assessment of whether one is properly doing one's duties as a director, as well as disclosure of any failures to abide by any other provision in the code.

Being accountable is often referred to in the various standards of corporate governance. According to William Patterson (2003), Director of the Office of Investment for the AFL-CIO, "...good governance hangs on the independence and *accountability* of directors" (Murray, 2003, p. R. 8,

TABLE I

Convergence of Core Ethical Values for Directors

Source	Examples	(1) Honesty	(2) Integrity	(3) Loyalty	(4) Responsibility	(5) Fairness	(6) Citizenship
Law	U.S. system	Business Judgment Rule: Presumption directors acted in honest belief action taken was in best interest of corporation.	Obligation as fiduciary to act consistently	Duty of loyalty	Duty of care Duty of disclosure	Stakeholder statutes: Fairly take into account interests of other constituencies	Duty of obedience Ensure legal compliance
Corporate Codes for Employees	BellSouth	"We will deal with customers honestly." (p. 4)	"We interact with our customers, our employees and our shareholders with... integrity." (P.4)	Avoid "conflicts of interest" (p. 4)	"Each person at BellSouth is responsible for his or her own behavior... When we err, we will make things right."	"Vendors and suppliers must know we will be fair." (p. 5)	Comply "...with all laws and regulations." (p. 4) "Strive to make our communities better places to live, work and grow." (p. 4)
Corporate Codes for Directors	Pitney Bowes, Bank of Ann Arbor, Amgen	"Help foster a culture of honesty..." (P-B, intro)	"...integrity will not be compromised by Amgen [Directors] anywhere at any time." (Amgen, 2003 p. 1)	"avoid any conflicts of interest..." (P-B) "Loyalty, fidelity, and good morals are assumed qualities [of the] Board of Directors..." (BAA, p. 2)	Accountability (P-B)	"Directors should endeavor to deal fairly with the Company's customers, suppliers, competitors and employees." (P-B, s. 4)	Compliance with laws (P-B, s. 4) "Community activities by directors is encouraged..." (BAA, p. 2)

Corporate Governance Principles	Colgate-Palmolive, AT&T, Sara Lee, Pinnacle West Capital Corp. (2003)	"The Board shall seek to foster a culture of honesty..." (Sara Lee, s. 6)	"Each member of the Board of Directors shall at all times exhibit high standards of integrity..." (AT&T)	Independence (C-P)	Functions of board to be fulfilled (C-P)	Shareholder rights CEO Evaluation (C-P)	"The Board recognizes the importance of the Company operating as an ethical and law-abiding company." (PWest, s. 2)
Director Associations	Singapore Southern Africa	"a director shall at all times act honestly" (Sing.)	"This Code embraces the value of...integrity..." (Sing.)	"a director shall...avoid placing himself in a position of conflict... (Sing.)	"A director shall act with due diligence in the discharge of his office as director." (Sing.)	"directed by people of fairness" (SA)	"A director shall ensure...he and the company he serves observe all laws..." (Sing.)
National Governance Codes	OECD (1999) Commonwealth Principles (1999)	"Directors have a duty to act honestly..." (Common-wealth, principle 5)	"The board should exercise integrity..." (Common-wealth, 1999)	Avoid potential conflict of interest "Exercise objective judgment" (OECD, Part V. Section E)	Responsibility of boards (OECD, p. 24) Disclosure and transparency (OECD, p. 23)	Equitable treatment of shareholders (OECD, Part II)	Role of stakeholders' "awareness of environmental and society interests" (OECD, Preamble)
Business Ethics Principles	Josephson Institute of Ethics	Honesty	Integrity	Loyalty	Responsibility	Fairness	Citizenship

emphasis added). Being responsible goes beyond merely showing up at meetings, but expressing dissent when appropriate. For example: "...directors at many companies touched by scandals, including Tyco International Ltd. and WorldCom Inc., followed most of the accepted standards for boards, such as showing up regularly for meetings and establishing codes of ethics. But they failed to question enough and to think of dissent as an obligation" (Hymowitz, 2003, p. R. 1). In other words, directors should not be "a rubber stamp." In terms of disclosure, one question directors might ask is: "Do you have procedures in place to disclose all material information, information whose omission or misstatement could influence the decisions taken by the users?" (management, shareholders, creditors, etc.) (International Chamber of Commerce, 2003). In addition, there is a world-wide movement supporting corporate disclosure of the societal, environmental, and ethical consequences of decisions (Weil et al., 2002, p. 49). Self-assessment is also an important component of responsibility. For example, Raymond Troubh, appointed Chairman of Enron Corp. following the scandal, believes that boards "...should conduct thorough *performance reviews* of individual directors and disclose them in companies' proxy statements (Lublin, 2003, p. R. 8, emphasis added). Both Enron and WorldCom's boards clearly did not live up to their responsibilities, rather, they blamed everyone else.

(5) *Fairness*: Directors must treat others and make decisions on the basis of fairness.

Commentary: Fairness involves balancing the interests involved in all decision-making including any decisions related to hiring, firing (including the investigatory process), and executive compensation. It also implies ensuring that all classes of shareholders are treated fairly: "Does your board have standards and procedures to ensure equitable treatment of all shareholders, including access to information and the ability of the shareholders to exercise their rights?" (International Chamber of Commerce, 2003). This core value also reflects concerns expressed in the OECD code to: "...deal fairly with stakeholder interests." Enron's board appeared to ignore fairness in terms of its decisions regarding executive compensation which were considered by the Senate Subcommittee to be "excessive" (Senate Report, 2002, p. 3).

(6) Citizenship: Directors must act as good citizens, which includes ensuring that they and their companies are complying with laws and regulations and the standards of the communities in which they operate.

Commentary: Acting as a good citizen means not only individual compliance with the law, but as a director, ensuring that mechanisms are in place, so that all of the company's agents are in compliance with the law and acting ethically. This necessitates ensuring that an effective compliance or ethics program is in place, including a reporting system free from retaliation, and taking appropriate action if wrongdoing is reported or discovered. Citizenship also involves decision-making that protects the environment, and does not involve unnecessary harm to the community.

This core ethical value is emphasized by all of the various sources of ethical standards. It also reflects legislation (e.g., Federal Sentencing Guidelines, the *Caremark* case, and the *Sarbanes-Oxley Act*) putting a focus on the compliance of corporate agents. Bernie Ebbers of WorldCom demonstrated his lack of concern for this core ethical value when he reportedly indicated that the proposed code of ethics was a "colossal waste of time" and never demanded ethical business practices (Directors' Report, 2003, p. 19). The directors also failed to create a safe channel to blow the whistle (Directors' Report, 2003, p. 18). The problem may go beyond WorldCom, as a 1998 Conference Board study found that nearly one quarter of directors were not involved in developing their firm's ethics codes (Barry, 2002).

These six core values should permeate the code and be reflected in all aspects and components of the code. Their presence must extend beyond just a general mention. In the next section, we note some of the specific issues that should be dealt with in the code.

Part five – specific issues to deal with in a director's code

If a firm were to institute a formal code of ethics for its directors, a number of additional specific issues would need to be addressed. The following will discuss these concerns.

Definition of independence for independent directors

Developments such as the *Sarbanes-Oxley Act* and the proposed NYSE rules have extended the traditional definition of independence for so-called "outside" directors. The role of independent directors is being given greater emphasis, particularly in regard to compensation and nomination committees. Because of the growing role for independent directors, firms should consider whether they need to extend the meaning of independence beyond extant legal requirements. Some firms have adopted the concept of a 'lead director' and even provide for the independent directors to retain their own counsel. The circumstances under which independent directors are required to meet independently of management should also be indicated. Explicit rules concerning board compensation and stock holdings/options must be provided. The method and level of compensation for independent directors must be scrutinized so that they have incentives to perform at a high level without making the compensation itself an issue for independence.

Role of the board in the corporate ethics program

Building on the legal obligation to ensure an effective corporate compliance program, the director's code of ethics should specify this obligation in sufficient detail. For example, reporting lines among the ethics officer (or other senior staff responsible for the ethics program), the CEO, senior management, chief corporate counsel outside counsel, and the board of directors must be clarified. Explicit rules pertaining to whistle-blowing options for employees and for the process of response by the board and by individual directors must be specified. A clear process must be established in advance to deal with the situation in which an employee alleges to a board member that a senior executive is acting unethically. The code must indicate how the board member must respond, such as a mandatory reporting requirement to the lead director or other person who chairs the independent members of the board. Protections for whistle-blowers against retaliation by the board itself must be clearly set out.

Policies relating to transparency/accountability

The code must establish policies concerning the board's provision of information to the public. For example, what reports will the board give to shareholders and/or the public? Will there be regular reviews of the ethics program and its operation? Annual reports relating to the overall operation of the board including the number of meetings of the audit and ethics committees should be provided. In the case of multi-nationals, there may be a special need for monitoring and policies relating to foreign payments and the threat of corruption. Consideration should be given to annual reports on the operation of the anti-corruption policies and on audits to ensure no improper payments have been made.

Ethics training for board members

Board members should be required to be aware of the firm's ethical programs and codes and should engage in appropriate ethics training. Reports on the ethics and compliance activities of the firm should be provided at least annually to the board. These involvements are essential in order for the board to carry out its ultimate responsibility for the ethics of its company. A study by the Ethics Officer Association of its members found that while 96 percent of those companies surveyed require their management employees to certify that they have read their companies' code of ethics, only 33 percent require certification from their directors that they have read the code (EOA, 2001). Another study (U.S. Conference Board, 2003) found that the vast majority of U.S. directors have never received training in ethics or compliance issues: "While 81% of firms have conducted ethics and compliance training among their employees, only 27% have held any training sessions for their directors. About 55% of those surveyed say their boards are 'not engaged enough' in major ethical issues involving the company." A U.K. study found that two-thirds of non-executive directors had not received any training or development of any kind, let alone compliance or ethics training (Schmukler, 2003). According to Alexander Keyserlingk, of the World Bank Group: "Everyone gets trained at companies but directors. . .They train the lowest bookkeeper and the lowest truck driver,

but they don't spend any time training directors." (Schmukler, 2003, p. R. 6). Ethics training specifically for directors will provide directors with an opportunity to ensure that they understand their own ethical responsibilities, as well as those of their firm's employees.

Sufficient budget and staff

In order to properly carry out the board's ethical responsibilities, a separate budget and staff should be dedicated specifically for this purpose. Budgetary independence will enable the board to have its own set of consultants and advisors critical to assessing issues such as compensation and reported ethical violations. The board should also ensure that adequate resources and staff are in place to effectively implement the firm's ethics program for employees.

This set of critical issues is intended as a *de minimus* list. All codes for corporate boards should deal with these. There are many others, such as whether there should be specialized codes for senior executives, e.g. the CEO and CFO, that should be considered as well and dealt with if they are relevant to the firm implementing the code.

Conclusion

Boards and Directors play a critical role in overseeing the ethical performance of their organizations. Vigilant boards should be capable of preventing ethical disasters involving their firms. Instead, in the recent scandals there were too many examples where boards were "sleepy-eyed sentries." Much of the focus on reform has been to strengthen and extend legal regulation and liability. Although there is merit to many of the reforms, it is also important to reform critical behavioral and organizational factors.

One of the possible answers is for firms to develop and implement a code of ethics specifically for directors. According to Sempra Energy's Chairman and CEO Steve Baum, boards of directors should be required to have "ethics guidelines for all members" (Baum, 2003). Of course, a code of ethics for directors is not a panacea, and will certainly not guarantee ethical behavior on the part of directors. Enron's code of ethics, referred to on numerous occasions by board members such as Kenneth Lay (1999), did not appear to prevent unethical behavior. A code of ethics and ethics training specifically for directors, based on their unique role in setting the "tone at the top," is, however, one important component of a "portfolio" of initiatives in which companies should engage to help establish an ethical corporate culture.

Ethics, by its very nature, has the ability to capture those activities that the law is unable to address. Ethical values and principles, if formally set out, can also help provide the moral justification for the law, which might lead to greater compliance with the law. Adoption of greater ethical obligations also provides for the ability to anticipate changes in the law. Ethical principles have the ability to cut across national boundaries, in ways beyond the scope of legislation. What is important to note is that we are not proposing that additional ethical obligations for directors are "*in lieu of*" their legal obligations. They should be considered "in addition to" one's legal obligations. Rather than being in conflict with legal obligations, ethical obligations and legal obligations are not mutually exclusive, but reinforce each other.

To date, definitions of an "effective" board of directors appear to focus on those boards that are able to maximize firm performance through effective decision making while complying with their legal obligations. In our view, the definition of a "good" or "effective" corporate board of directors should no longer simply focus on a board that is able to maximize firm performance. If there is anything that the current corporate scandals should have taught us, it is that only those boards that fulfill their ethical obligations will ensure long term financial success. To put it bluntly, a board that must cut ethical corners in order to help its firm maximize financial performance (e.g., Enron's board or WorldCom's board) should not be considered an "effective" board. Corporate governance should no longer be considered distinct from ethics, but instead should be seen as built on an ethical foundation.

Notes

[1] We thank Jennifer Huang for her able research assistance.

[2] (e.g., Bernie Ebbers of WorldCom, John Rigas of Adelphia Communications, Sam Waksal of ImClone

Systems, Dennis Koslowski of Tyco International, Martha Stewart of Martha Stewart Living Omnimedia, Richard Scrushy of HealthSouth, Philip Anschutz of Qwest, Gary Winnick of Global Crossing, and Alfred Taubman of Sotheby's (CNN, 2003; Corporate Library, 2003).

[3] A similar but more expansive provision on the duty of directors is contained in Section 512(a) of the Pennsylvania Business Corporation Law ("PBCL") at Section 512(a) as follows:

Directors. – A director of a domestic corporation shall stand in a fiduciary relation to the corporation and shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation and with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances.

[4] For example Section 145(a) of the DGCL provides the following:

A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in the right of the corporation) by reason of the fact that the person is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by the person in connection with such action, suit or proceeding if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful. The termination of any action, suit or proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner which the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had reasonable cause to believe that the person's conduct was unlawful. Similar provisions are contained in Section 14A: 3–5 of the NJBCA and Section 1741 of the PBCL.

[5] Section 512(g) of the DGCL contains the following language:

A corporation shall have power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against any liability asserted against such person and incurred by such person in any such capacity, or arising out of such person's status as such, whether or not the corporation would have the power to indemnify such person against such liability under this section.

Similar provisions that authorize a corporation to purchase insurance for protection of directors are contained in Section 14A: 3–5(9) of the NJBCA and Section 1747 of the PBCL.

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