CHAPTER 1

"I See Nothing, I Hear Nothing"

Culture, Corruption, and Apathy

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In his testimony before the House and Senate investigation of widespread corruption at Enron, former CEO Jeffrey Skilling insisted he had no knowledge of any serious problems in the company before his abrupt resignation six months into his term and six months before the firm's collapse. Similar testimony by board members who chaired the finance and audit committees at Enron led U.S. Congressman Edward Markey to label this response the "Sergeant Schultz" defense. Sergeant Schultz was a fictional character on the 1960s TV comedy series "Hogan's Heroes," a sympathetic prison guard who routinely looked the other way when he observed rule infractions by prisoners.[1] His refrain "I see nothing, I hear nothing!" is widely used by both white-collar criminals and their compliant colleagues who are aware of the corruption but look the other way.

"If only one of the scores of lawyers, accountants, or managers had spoken up, this whole scheme would have unraveled. I just cannot understand how they could stay silent." These were the remarks made to us by a decorated veteran of Silicon Valley tech start-ups, who was recruited in the mid-1990s as the new CEO in an attempt to salvage Informix, once a close rival of Oracle. Despite its path-breaking, often superior multimedia software, Informix was felled by a greedy revenue recognition scheme that deceptively propped up international sales. The turnaround CEO was horrified by

the apathy of those who knew and the timidity of the board to rout out the villains once the fraud was public.

"Either these people are just plain stupid or they don't listen," a CEO cried out to us decades ago at International Paper after the company was embroiled in a large price-fixing conspiracy. Several executives at International Paper were convicted, along with over 40 top leaders from 22 firms, who moved from Babbitt-like middle-class respectability to the stigma of being convicted felons. "We have clear codes of conduct and ethics statements," the CEO continued. "Is it fair to hold the high school principal responsible because some students misbehaved?" Somehow the formal incentive systems, the intended role modeling from top executives, and the overt codes of conduct were inadequate in combating the informal culture that had taken root in this industry. But the patterns we observed in the paper industry decades ago—and the excuses, justifications, and calls for reform—are vaguely familiar today.

Whenever we enter the economic market, whether it is to seek employment, to purchase a product, or to strike a business deal, we are confident that the terms of the transaction—the promise, as it were—are exactly as they appear. It is easy to cheat if we want. Most diners can flee a restaurant, or taxi cab passengers can race into a crowded street, to skip paying—but few operate this way. In business, we rely on the words and actions of the others involved. What people say and do are moral and legal assurances to us that they are as they appear: that is, devoid of fraud and material misrepresentation. We have trust that our laws and regulations protect us against illegal business practices, and we believe violators will be discovered quickly and dealt with appropriately. We're also comforted by the trust and integrity of leaders. We expect our leaders to have high integrity, to do what they say, and to operate within the bounds of the law. We have confidence that commercial activity operates this way. Without such confidence, the economy could never have evolved as it has.

This confidence—or trust—is not always well placed, as the recent series of highly visible cases of corporate wrongdoing and malfeasance tells us. It is sometimes difficult to determine who can be trusted and who cannot. We are not omnipresent. We cannot be sure their business associates have remained within the bounds of the law. We trust that they have. In part, this trust is derived from reliance on others—auditors, lawyers, the board of di-

rectors, internal staff, and the government—to monitor and police commercial activity.

During fiscal year 2002, the Security and Exchange Commission (SEC) filed a record 163 actions for financial reporting and disclosure violations—46 percent higher than the previous year. The Commission attempted to permanently ban 126 unfit officers and directors from corporate boardrooms—a 147 percent increase over the previous year. They filed 48 temporary restraining orders, up 55 percent from 2001, and they filed more subpoena enforcement actions than in previous years, supporting an extraordinary number of criminal prosecutions. Although the SEC cannot bring criminal charges itself, it worked in collaboration with the Corporate Fraud Task Force, established by President Bush, to bring 259 criminal actions by 30 different U.S. Attorney's offices.

A number of well-known companies were implicated in these actions, and several were once the darlings of Wall Street or revered as models of innovation and entrepreneurship. And in many cases, their wrongdoing was conducted over a period of years, under the collective noses of a bevy of outside advisors and internal staff.

The examples of missed opportunities are staggering. On January 9, 2004, the venerable Royal Dutch/Shell Group admitted to the public that its senior management had known for over two years that its petroleum reserves were overstated in excess of 20 percent. In the aftermath a tumble in market value, a shattered corporate reputation, and the ousting of the chairman and other top officers, investors and regulators wondered how this massive fraud was kept secret.[2] In the trial of John Rigas and his sons at Adelphia Communications, prosecutors charged that the family took personal trips on company jets, spent millions of dollars of shareholder money on personal real estate, hid billions of dollars of debt, stole $100 million, lied about revenue, and "borrowed" more than $1 billion to buy Adelphia securities. A decade earlier, one finance vice president questioned extravagant personal expenses, only to be demoted and let go.[3] *Where were the other voices of outrage?* At HealthSouth, five former Chief Financial Officers (CFOs) were convicted after admitting to a $2.5 billion accounting fraud that involved 11 other top executives. Reports show that auditors were tipped off five years earlier, but no investigations followed.[4] Tyco's brazen CEO, Dennis Kozlowski, and CFO Mark Swartz were charged with looting $600 million of corporate funds to

support extravagant lifestyles. Questionable purchases included properties in Manhattan, Florida, and Massachusetts; multimillion-dollar relocation payments; paintings by masters of western art, like a $3.95 million Monet and a $4.7 million Renoir; a now-infamous $6,000 shower curtain; $40,000 draperies; a $2 million birthday party for Kozlowski's wife on the island of Sardinia; and other such waste, all while claiming legendary corporate frugality to investors and the media.[5] It has now been revealed that before Enron's collapse, senior executives at the nation's most prestigious financial institutions joined scams that helped hide debt and inflate earnings through fictional offshore special-purpose entities.[6]

No one knew. *Or did they?* Few if any took action. No one blew the whistle to put an end to the wrongdoing. How can it have been possible for some of the nation's leading institutions to have remained blind to such massive misconduct for so long? There are many shades of awareness and action. We might think of the state of awareness as a continuum ranging from individuals in the know—the criminals themselves, for example—to those in the dark—victims, for instance. In between the states of being fully aware and unaware are situations in which individuals have partial knowledge, a vague understanding or suspicion about the criminal activity happening around them. But what prevents people from seeing criminal acts for what they really are? What prevents people who suspect from learning more? What factors inhibit them from digging deeper?

There is no single answer to these questions, but there are several factors we've observed that interactively create situations in which individuals genuinely do not know enough to take action. In situations where they do know, there are circumstances that allow individuals to easily shift responsibility for taking action to others. First is the diffusion of responsibility for seeing and acting. Bystander apathy, the division of responsibility between specialists and organizations, obedience to the authority, and professional codes of conduct all contribute to this diffusion. These circumstances make it easy for information about and accountability for wrongdoing to slip through the cracks. The second factor is what we call *golden shackles*—a euphemism for the strong financial incentives to look the other way. These are often not explicit payments for complicity but rather a risk to a lucrative business partnership or job if too many questions are raised. Third is the lack of options for individuals who suspect wrongdoing. Where do you turn if you *suspect* but *don't really know*? Finally, there is a widespread tolerance for

illegal and unethical conduct in the business community. This submissiveness to the firm, industry, or profession's culture at all costs has been termed *groupthink.* None of these factors alone explains such behavior, but together they create the conditions for otherwise ethical directors and executives to look the other way. Each of these is discussed in the following sections. Once we understand the conditions, we then turn our attention to the prospects of reform.

Diffusion of Responsibility

The terms *diffusion of responsibility* and *bystander apathy* followed the landmark studies that attempted to understand the 1964 brutal murder of Kitty Genovese in front of her two-story Tudor building in the respectable New York City neighborhood of Kew Gardens. This young woman was stabbed to death at 3:20 am on March 13, 1964. Her screams for help after several stab wounds awakened 38 of her neighbors and initially frightened away her assailant. When none of her neighbors came to her aid, the murderer, Winston Mosley, returned to finish the job. No one called police for over 30 minutes after the initial attack.[7]

The public was naturally more alarmed about the unresponsive neighbors than by the murder itself. To further understand this disturbing phenomenon, social psychologists Bibb Latane and John Darley launched a series of experiments in which participants heard the sounds of people in distress under different conditions. The studies showed that as the number of bystanders increased, the likelihood that anyone would help decreased. People were more likely to help when they were alone. When others are present, people assume someone else will act.[8]

Even individuals operating alone may be reluctant to act under certain circumstances. Research pioneered by Yale's Stanley Milgram demonstrated the willingness of adults to go to almost any extreme if they believed they were being directed or encouraged by a legitimate authority. In his studies, he found that adults of all ages and backgrounds were willing to suspend their own ethics and values and inflict what they thought was great pain on a person at the direction of authorities in a scientific research setting.[9] In extending these studies around the globe, researchers found some cultures where obedience levels were as high as 85 percent.

Financially savvy executives at Enron, Worldcom, HealthSouth, and Andersen surely fell victim to these psychological traps.[10] With so many professional experts endorsing or ignoring what each knew was professionally and ethically wrong, they discarded their own individual sense of responsibility, deceiving themselves into believing that fellow experts who allowed the misconduct might know better than they did about what was right. This diffusion of responsibility demonstrated a collective bystander apathy exacerbated by obedience to the top leaders responsible for initiating the fraudulent schemes. If the misconduct was committed by a senior executive at the top, an aura of legitimacy was wrongly conferred.

Modern businesses necessarily depend on a system of formal authority and many specialists to survive. Operating in our complex global economy can be challenging without the aid of professional and specialist firms to navigate complicated regulations, tax laws, financial and technological matters, accounting procedures, and so on. Under pressure to protect themselves from legal liability and other risks, organizations hire specialists, form alliances to reduce risk and error, and develop structures to maximize efficiency and effectiveness.

Few things are left to chance—at least nothing that really matters. By creating an interlocking network of experts, all the bases are covered. Tax lawyers examine tax shelters and write-offs. Computer specialists appraise our equipment's value and advise us on our purchases. Investment bankers tell us how to finance capital goods and corporate expansion. Auditors suggest how best to present our financial picture. And attorneys try to keep us within the bounds of the law. Suppliers, customers, and employees see these experts' presence as a sign that they approve of the organization and its business practices.

But the very structure that provides comfort creates other difficulties. Certainly, bystander apathy is one: we *assume* someone else will act. But there are other challenges as well. Organizations that come together for a particular project, joint venture, or series of transactions generally have specific and often very narrow concerns. Even within each organization, the aspects of the deal or other business activity that occupy an individual's time are further differentiated. Information is diffused and fragmented. Specialists may have only partial knowledge of a fraudulent deal, just enough to vaguely suspect or easily dismiss the suspect data. Or specialists may not see signals of impending trouble simply because experts do not know enough about the big picture to ask the right questions.

That leads to another reason specialists may not see illegal activities: in some cases, to know or act is not in their best interest, for their reputation or image may be at stake. The possibility of seeing might mean admitting they were wrong in the past. Some potential whistle-blowers may refuse to act because they are benefiting from the current way of doing things. A line from a Kipling poem captures the point: "But I'd shut my eyes in the sentry-box / so I didn't see nothing wrong."

There are times, too, when professionals know about wrongdoing but their professional standards prevent them from revealing what they know to third parties. Lawyers, for instance, would be severely handicapped as advocates for their clients if their clients were uncomfortable about revealing certain information. But more and more in society today other professionals are granting confidentiality to their clients, thereby closing off a major opportunity for outsiders to learn about improprieties being committed by companies. With such standards for support, it is often easy to shut their eyes to illegal activity or, at least, put aside suspicions. A professional standard then becomes nothing more than an ethical pretension.

Under new rules in the Sarbanes Oxley Act, internal auditors, external auditors, and even outside legal counsel must voice their concerns about misconduct. Most notable is Section 309 of this act, which requires an attorney to report evidence of a material violation of the securities law, breach of fiduciary duty, or similar legal violations to the chief legal officer and the CEO of the company. If the executives do not respond appropriately through timely investigations, the attorneys are required to continue to report up the ladder to the company's audit committee, composed of independent directors, or the full board of directors.

Of course, the systems problem is often a weapon for the perpetrators. Paradoxically, when one is surrounded by experts, the likelihood of anyone discovering wrongdoing goes down—at least, for a time.

Golden Shackles: Misleading Financial Incentives

Critics calling for reform have pointed to the widespread use of stock options as encouraging executives' short-term thinking and harmful, win-at-all-costs values. New reforms regarding the use of options outlined by the Financial Accounting Standards Board (FASB), and endorsed by many in the

Senate as well as Federal Reserve Chairman Alan Greenspan and investor Warren Buffet, have helped shine the spotlight on financial incentives for wrongdoing.[11] Executives are under great pressure to perform, and with large dollar amounts at stake, so the theory goes, there are incentives to cheat. Companies are at a much higher risk of corporate crime when business pressures are intensified. In difficult or highly competitive times, signals emanating from top management stress the need to generate more business—and quickly. Employees are recognized for the revenues they bring in and the dollars they save—not necessarily for being careful.

Under these circumstances, employees—even entire organizations—can easily become involved in various forms of cheating. Professionals, particularly those in the highly competitive financial industry, increasingly are compensated for their short-term performance—and the sums at stake can be millions of dollars. Managers, too, get caught up in the short-term numbers and can become dependent on apparently stable, lucrative business relationships with employers or customers.[12] It can become very difficult for managers to abruptly halt practices that contribute directly to their bottom-line performance.

When a manager feels his or her division's survival is in question, the corporation's standards of business conduct are more apt to be questioned. A convicted division vice president explained: "I think we understood it was against the law. The moral issue didn't seem to be important at the time." We found, for example, in historic industrywide price-fixing schemes, managers were encouraged, with a wink and a nod from management, to "do what it takes" to meet predetermined price targets despite difficult conditions.[13]

Investors lost several hundred million dollars in the 1987 E.S.M. Government Securities Corporation fraud. E.S.M.'s outside auditor went along with the ruse because he had missed the scheme in two previous audits.[14] Two officers from the Florida-based firm told him about the fraud two days after the auditor had been made a partner in his accounting firm. He explained his predicament to *The Wall Street Journal:* "I was 31 years old. I felt I had a terrific career path in front of me and a lot of ambition. And I agreed just to think about it. A day or two later, I felt I had gone too far. I also didn't want to face it. I didn't want to face walking in [to his superiors] and saying 'this is what happened.'"

Whenever compensation or promotion is tied directly to objective performance measures, there is a pressure to look good on the books. Suppose

you were responsible for bringing in a client who provided $1 million a year in revenue to your firm. That revenue is now expected as part of your normal performance; any deviation is a reflection on you. Or, to examine another situation, suppose you were responsible for negotiating several multimillion-dollar deals that saved your company hundreds of thousands of dollars. It is quite likely, should any of these deals later backfire, that you would be held responsible.

The implications of such dependencies are clear. Too often, employees are quick to look the other way to avoid pushing hard for compliance—particularly if they are not ultimately responsible anyway. Some individuals become involved in wrongful conduct, but direct complicity in illicit activity—people on the take, for instance—is probably rare. It is far more likely that the people know or suspect illegal activity but have strong incentives to look the other way.

Nowhere to Turn

While heroic employees occasionally do speak out, their courage and integrity are often met with harassment, intimidation, demotion, and even termination. Famed whistle-blowers Sherron Watkins of Enron, Cynthia Cooper of Worldcom, and Coleen Rowley of the FBI were anointed TIME magazine's Person of the Year for 2002 for their selfless internal alerts. Cooper went to the audit committee of Worldcom. Watkins went to Enron CEO Ken Lay and warned him of massive internal accounting frauds, while Rowley sent a memo to FBI Director Robert Mueller alerting him to ignored warnings over Al Qaeda activity in the United States.[15] But in each case, their careers suffered. Policy experts long ago warned that the whistleblower often has nowhere to turn.[16] Our society frowns on the squealer, the rat, the tattletale. We learn very early that such behavior is considered inappropriate. To be sure, blowing the whistle on fraud or other crimes is not the same as telling on a misbehaving sibling or friend. Yet people who know about or suspect improper behavior in organizations are torn between doing what is right and confronting a system that is often not very supportive of blowing the whistle.

One senior executive who revealed a colleague's million-dollar fraud scheme reflects: "The path I chose was brutal on my family and lost me tens

of thousands in income. It also meant that I'd never again work in a corporate environment. You can negotiate a 'golden handshake,' but it doesn't guarantee a reference. There is always the nuance, the raised eyebrow, the inflection that means, 'Well if you really want to know. . . .'" When this emotional tug-of-war is added to other disincentives, such as a lack of accountability and financial considerations, it becomes easy for people to ignore a crime.

MANAGEMENT TOLERANCE: GROUPTHINK CULTURE

Another reason that illegal and unethical activities can continue for years is the culture or environment created by leaders. Sometimes executives may not encourage illegal practices, but they may not actively discourage them either. For instance, managers often neutralize the seriousness of crimes through the use of language. In one case, for example, "double hocking," "double-discounted" loans, and "dipsy-doodle" leases were all euphemisms for fraud and theft. Each of these substitutions effectively lets individuals off the hook by making the subject matter somehow more acceptable.

Many executives also have failed to speak out directly against illegal conduct, thus sending the wrong signal to employees and the public. Following corporate convictions for fraud, stock manipulation, and bribery, the largest shareholder and board member of a Fortune 100 company said, "We didn't do anything wrong, but it wasn't right either." He added, "It was wrong, but it wasn't purposefully wrong." *How should managers and supervisors respond to such statements?*

Speaking in euphemistic terms or otherwise neutralizing illegal conduct hardly sends a strong signal of condemnation to employees or the wider business community. Neither does management's failure to establish mechanisms that will prevent the occurrence of misconduct. Managers who fail to check, to monitor, to audit, to speak out, and to penalize wrongdoers are communicating their values and priorities to others.

Yale psychologist Irving Janis studied group decision making in historic contents like the Bay of Pigs fiasco, the Korean War, Roosevelt's complacency and inaction just prior to Pearl Harbor, and Johnson's escalation in Vietnam. Even 40 years later, Janis's fascinating work on groupthink sheds

light on how intelligent people can make such gross miscalculations and flawed decisions. Janis defined groupthink as "a mode of thinking that people engage in when they are deeply involved in a cohesive group, when the members striving for unanimity override their motivation to realistically appraise alternative courses of action."[17]

These tendencies toward concurrence seeking and poor judgment are manifested by several symptoms, according to Janis: there is often an illusion of invulnerability—Enron's Jeff Skilling believed, for example, in the inherent morality of the group, and the company's leaders were generally hostile toward what was perceived as an anachronistic energy regulation. Another common symptom is a collective rationalization. Price fixers in forest products, for instance, told us that they were only doing for themselves what legislators do for more politically protected industries such as steel and agriculture. Janis also wrote about groups holding stereotypical views of rivals. Worldcom's conventional telecom competitors, for example, were labeled as stodgy and out of step with technological advances. Self-censorship is another symptom identified by Janis. Andersen accountants presumed that a new, efficient relationship with their client Enron resolved suspicious practices. Another symptom of groupthink is the direct pressure on dissenters. In our work on price fixing, resistors to these schemes were threatened by their colleagues with termination and even physical violence.

None of these factors alone can explain why such frauds continue for so long. But when they are taken as a whole, we can begin to understand how segmented responsibilities, pressure to perform, social norms that suggest we should not rock the boat, ambiguous norms about appropriate and inappropriate behavior, and limited options for those in the know make it very easy for managers to look the other way.

The Prospect of Reform

Following the latest wave of corruption, managers, investors, public policy makers, and scholars search for management tools and metrics to guide executives and investors. The search has often led to misguided metrics that fail to address the conditions contributing to misconduct and the lack of oversight. Instead of looking at group psychological factors and cultures that encourage conformity as catalysts to misconduct, researchers have advanced

legalistic and misguided checklists. The yardsticks for measuring potential governance misconduct and the underlying recipes for reform have acquired a large following because they are easy to use, not because they are accurate and reliable.

There are several challenges to the current use of metrics for governance. The first is that some governance scoring systems are provided by institutions with commercial conflicts. A second challenge is that the metrics currently being used do not predict governance breakdowns, or their assumptions about what constitutes good governance are unsupported—or both. Myths regarding board structure, director age, the splitting of the roles of CEO and chairman, the importance of financial expertise to the board, the continued presence of the former CEO, attendance records, size of the board, and the number of independent directors are examples of the reform, but few reforms in these areas have been shown to prevent fraud, much less expose it.[18] Let's take a closer look at the issue of governance metrics and the limitations and myths that attend current proposals for reform.

Hidden Conflicts

Unlike *Consumer Reports,* J.D. Power, epinions.com, and Edmunds, which use objective metrics, many governance raters seem to think its okay to consult for the entities over which they are also providing purportedly independent evaluations to the public.[19] Ironically, this faintly echoes two of the governance problems now prohibited by the Sarbanes Oxley legislation. One is the forbidden practice of accounting firms serving as public auditors for clients of their consulting businesses. The other problem is research analysts at brokerage firms pumping the stocks of their firms' major investment banking clients.

While these governance consultants denied the existence of these conflicts when the subject was first raised, the major firms have since addressed the issue in very different ways. The influential proxy advisor Institutional Shareholder Services (ISS) has now published on web sites its board members and a statement regarding conflicts of interest. In short, they claim that they will not sit on both sides of the table that is advising institutional investors on how to launch a proxy battle while also advising the same target firm's management on how to beat such efforts. They claim to have created

separation in their business by using different staffs for these efforts as well as physical separation—similar to the "Chinese Wall" once claimed by some securities firms.

Strangely, there appears to be no such Chinese Wall protecting their governance consulting services from conflicts with their governance ratings services. Thus, it seems to be the same Corporate Programs staff who rate firms including those client firms for whom "we make recommendations for improving your company's corporate governance policies or establishing a set of corporate governance principles. ISS Corporate Programs has also done advisory services work related to changes to director compensation, the institution of officer and director stock ownership requirements, and changes to a company's state of incorporation."

Some firms feel that in order to decipher the meaning of their ISS ratings they have to become clients and learn how to raise their ISS ratings. ISS CEO Jamie Heard counters, "Many companies have, in fact, significantly improved their scores without making use of our paid services."

That is not convincing enough for ISS competitors. Governance Metrics International (GMI) seems to repudiate ISS policies, although their chief operating officer was formerly the CEO of ISS. GMI claims, "We will not provide corporate governance consulting services to any company that is part of our research universe or is expected to become part of that universe within twelve months." Then, to ensure that ISS feels the slap, they add, "To do so would in our opinion impinge on our reputation for independence and credibility." Other ISS competitors, such as governance pioneer the Corporate Library and the venerable credit analysis bureau Standard & Poor's, also avoid governance advisory services attached to their ratings.

Do the Scores Predict Performance?

While there is irony in all of this, the most important question is: Do these metrics tell us anything? One month after the fanfare of launching their new "Corporate Governance Quotient" (CGQ), ISS proudly announced that the "Adelphia Fraud May Have Been Predicted: Company's Corporate Governance Rating Is in the Lowest Quartile." They confidently proclaimed, "Clearly in the case of Adelphia and others whose poor governance practices have made recent headlines, the CGQ database would have raised a red

flag for an investment manager holding or considering the stock." In fact, the ISS HealthSouth rating states that HRC outperformed 64.3 percent of the companies in the Standard & Poor's 500 and 92.3 percent of the companies in the Health Care Equipment & Services group. They congratulated HealthSouth on the fact that "the board is controlled by a supermajority of independent outsiders; no former CEO of the company serves on the board" (of course, there is no former CEO of this young enterprise).

These are just the sort of speculative dimensions which wrongly bring down several of the most admired U.S. firms that *Fortune* magazine's 10,000 experts and executives rate highest, like Wal-Mart, Southwest Airlines, UPS, Dell, eBay, Goldman Sachs, and Starbucks, which were all shockingly in GMI's "Below Average" categories and elevate purportedly better-governed firms embroiled in recent governance controversy, such as HealthSouth and Tenet Healthcare.

In fact, while ISS and GMI analyze many sensible dimensions, others, such as the presence of the former CEO, the separation of the chairman role from the CEO, and the number of outside directors are not indicators of better corporate governance, nor are they shown to improve company performance. In fact, research in progress suggests little relationship between these items and corporate performance.[20]

Accordingly, Securities and Exchange Chairman William Donaldson recently commented:

"Such a 'check the box' approach to good corporate governance will not inspire a true sense of ethical obligation. It could merely lead to an array of inhibiting, 'politically correct' dictates. If this was the case, ultimately corporations would not strive to meet higher standards, they would only strain under new costs associated with fulfilling a mandated process that could produce little of the desired effect. They would lose the freedom to make innovative decisions that an ethically sound entrepreneurial culture requires."[21]

JUDGMENT OR CHECKING BOXES?

One governance rating firm, the Corporate Library, collects a tremendous amount of data but avoids the lure of conflicting consulting services. Like good financial analysts, they also avoid simplistic quantitative ratings. Once all the numbers are analyzed, companies are assigned a qualitative grade from A to F. The Corporate Library previously gave HealthSouth an F.

Finally, the credit rating agencies Standard & Poor's and Moody's are developing governance practice areas. Moody's claims that its new governance practice area will not publish scores, while it admits to a plan for scoring firms. According to Kenneth Bertsch, head of this new practice area at Moody's, "We do plan to publish written Corporate Governance Assessments, but will not assign a grade. . . . At this point, we also are unconvinced of the value of such a score given the nature of the subject."

Their competitor, S&P, has carefully worked directly with corporate managers of firms to avoid cookie-cutter governance templates based on uniform rules, instead allowing for broad principles that accommodate globally sensitive standards. According to George Dallas, S&P's director of governance practices: "The Standard & Poor's approach to governance analysis benefits from direct interaction with those governing the company. This provides important new information and insights, and allows for more nuanced, and less rigid, weighting of analytical factors . . . to interpret individual company governance structures and practices through the overarching lens of principles such as fairness, transparency, accountability and responsibility."

To James Heard, the CEO of ISS, this intensity, judgment, and customization is not needed. "Our ratings . . . are based on objective criteria. A board either has a majority of independent directors (according to our very strict definition of independence) or it doesn't. It either has independent audit, compensation and nominating committees or it doesn't. . . . Each company is scored . . . on a scale of 1 (low)–100 (high) and all 5000 companies in the database are ranked regardless of whether they want to be or not. . . . The only way for a company to improve its CGQ score is to improve its governance practices."

BEYOND THE RECIPES

If corporate life were only so simple, we could program robots to be our executives. Good leadership is not recipe driven. Again in the words of SEC chief Donaldson,

> I believe we should go slowly in mandating specific structures and committees for all corporations. . . . [T]here are vast differences in the function, structure and business mandate of the thousands of corporations struggling with the issues of good corporate governance. I believe that

> these differences dictate that once the board determines the ethical culture that is to prevail, each company board should be afforded a level of flexibility to create their own approach to its structure . . . . [T]o insist on one rule for all belies the dynamics of the fast changing business and corporate environs and the nature of varied business situations.

In fact, our research on ISS-like governance dimensions confirms Donaldson's caution regarding uniform structures. Utilizing the database of the Corporate Library, we examined the peer-adjusted five-year shareholder returns of 2,000 public firms, comparing them against such dimensions as the following: whether the CEO is also the chairman; the number of independent directors; the existence of ethics codes; the tenure of directors; the number of directors; and Delaware incorporation. No individual or combined relevance was found. In fact, contrary to ISS scoring, the age of directors was actually a positive predictor of corporate earnings!

Even the S&P principles, while less rigid as governance dimensions, are still legalistic and ignore the prevailing impact of the culture or social system of the board. This neglects such issues as director preparation, breadth of board roles, depth of group discussion, the foundation for trust and openness, evidence of tolerance for dissent, and effective evaluation. By contrast, SEC chief Donaldson has pushed for far broader criteria that will "look beyond the traditional methodologies and include not only a study of law and business practices, but also an examination of the interpersonal human dynamics that influence a board and its decision making. One of the most interesting evaluations of a board that I ever read was not done by a lawyer or an MBA, but by an organizational behaviorist."

It seems that the more adaptive approaches of the Corporate Library's data and the interviews of S&P are headed in the right direction. The next stage should include more understanding of the underlying business cultures, leadership styles, and group processes rather than adding easy-to-measure but misleading recipes.

The Human Side of Governance

While groups can pathologically suppress problem-solving skills through diffusions of responsibility, groupthink, and other dysfunctional responses,

they can additionally react pathologically once the resulting crisis breaks, through misguided attempts to contain the damage or circle the wagons. Even after scandals at Enron, Worldcom, and Freddie Mac surfaced, forcing the exit of the chairman and CEO, the sophisticated boards of these firms turned to install the next in line fully knowing that this individual was also tainted.[22] In response to reform-minded calls for greater roles for independent directors, James Minder, 74-year-old independent director of Smith & Wesson, the nation's second-largest gun maker, was elevated to the role of chairman until it was revealed that he had spent 15 years in a Michigan prison for eight armed robberies. This poor choice was possible because the board did not really know each other and Minder merely proudly offered that he did not have any past securities violations. Several directors sought to retain him as chairman, and he remained on the board after stepping down.[23] The challenge of these situations shows that the remedies often have more to do with human processes than simple rules and regulations alone. A critical part of corporate diligence has to do with group process at the top for the culture of the board.[24]

Create a Climate of Trust and Candor

There is a classic asymmetry of information between the management, which has the core facts, and the board, which needs to learn them. Often boards are managed by executives who see them as obstacles to circumnavigate rather than as trusted business partners. Critical information should be shared with directors in time for them to read and digest the facts. Polarizing factions and in-groups should be discouraged. Long-service and newer directors should be mixed together and not allowed to drift into separate circles. This can help break down the illusions of groupthink.

Foster a Culture of Open Dissent

Dissent is not the same thing as disloyalty. One prominent corporate director warned that "no one wants to be seen as the skunk in the lawn party." Safeguarded channels for whistleblowers in management should supplement new Sarbanes Oxley protections and audit committee solicitation of concerns. The CEO and the board can set a tone that welcomes internal feed-

back so that problems can be identified and corrected before they become major integrity, financial, and public relations disasters.

Utilize a Fluid Portfolio of Roles

Managers and corporate directors must avoid getting trapped into rigid or typecast positions. To stimulate debate and avoid the stereotypes of being the fire-the-bastards person, the harmonizer, the big-picture person, or the governance whiner, people should take turns as enthusiasts and devil's advocates. Managers should be asked to develop alternative scenarios to evaluate strategic decisions. This can challenge the blind obedience to authority structures and break the group's tendency to avoid reality testing in favor of preserving group coherence.

Ensure Individual Accountability

To escape the quicksand of bystander apathy, managers and directors can be required to report on strategic and operational issues the company faces. These tasks should involve the collection of external data, interviews with customers, anonymous mystery-shopper visits, and the cultivation of links to outside parties critical to the company's future.

Create More Opportunities for the Board to Assess and Develop Leadership Talent[25]

At the world's top companies, the board is actively involved in assessing talent. At Procter & Gamble, Home Depot, and GE, the board regularly visits facilities and meets with managers and customers to learn and observe operations and talent firsthand. Board members at Procter & Gamble often come in early to board meetings to meet with and coach emerging leaders. Board members at top companies also teach at the company's leadership development initiatives. These boards have a direct, unfiltered feel for the business and are less likely to be blindsided by unscrupulous business practices.

Evaluate the Board's Performance

It is impossible to learn without feedback from the environment on our success, and yet many in top management and half of all boards do not provide

performance appraisals. Everyone else in the enterprise can be assessed, but somehow the more senior players find excuses to not collect this often discomforting information.

While these interventions can help improve the group process of the board collectively, the SEC is encouraging more direct nominations of directors from shareholders, by-passing self-perpetuating board nominating committees. While shareholder activists and corporate executives battle over the legal definitions of the triggering events that should lead to such bypasses of the board, the criteria for identifying more diligent directors have been left on the sidelines. To improve the likelihood of identifying more diligent directors, we suggest the steps outlined in the following sections.

Seek Knowledge Rather Than Names

An excess of enthusiasm for the branded names preferred by directors and search consultants has led to a pathological fixation on marquee names. Many of the prominent public figures on troubled boards, like Enron, Worldcom, and Freddie Mac, probably would have been endorsed by all parties in advance. Corrupt CEOs, such as John Bennett of the fraud-ridden philanthropy New Era, love to hide under the reflected glory of star-studded boards, knowing that investors will be impressed and the directors themselves—like John Whitehead and Sir John Templeton—will be too busy to roll up their sleeves and ask the tough questions.[26] A great chief technology officer from another firm may be more valuable than five former U.S. ambassadors. Imagine how much better off Global Crossing would have been if instead of hiring former U.S. Ambassador of Singapore Steven Green, they had hired lesser-known (at that time) Michael Capellas, then company CEO and formerly its chief technology officer. It's almost a rule of thumb these days that the bigger the scandal, the bigger the director names that have been soiled. Consider Enron, whose board included Robert Jaedecke, the former dean of Stanford's Business School, former top commodities regulator Wendy Graham, and Alliance Capital Chairman Frank Savage; or Worldcom, which included Clifford Alexander, the chairman of Moody's, and Judith Areen, the dean of Georgetown Law School.

Focus on Character More Than Independence

Independent-mindedness is not the same thing as independence, but many shareholder activists are pushing for supermajorities of independent outside

directors with the ultimate goal of having the CEO the only insider. One of the most courageous voices on the Enron board was a renowned scientist, Charles LeMaistre. But today, LeMaistre—despite his courage—would be suspect because his institute, MD Anderson Cancer Center, received Enron funding. Similarly, having some inside directors who know the business can help inform the outside directors by reducing the filtering of knowledge through the sole voice of the CEO. Certainly some insiders can feel intimidated or obligated to echo the CEO. At the same time, independent directors may also lack courage in a desire to be accepted. There is no research that shows greater performance with more independent directors—or fewer scandals, for that matter. Wisely, firms like GE, Berkshire Hathaway, Dell, and UPS are determined to retain inside voices on the board.

Ruthlessly Purge Those with Hidden Commercial or Social Agendas

Boards and management committees should not resemble city council meetings. Sometimes unrevealed conflicts become more apparent in later actions, and sometimes the conflicts are not even financial but rather political and personal. Forest products, pharmaceuticals, and media firms are especially exposed to public-issue advocacy groups. Board candidates who are primarily anchored in single-issue causes are not likely to be legitimate representatives of a broader group of shareholders.

Find People with a Passionate Interest in the Business

Sadly, many people seek board posts for power and the gratification of vanity, but have little interest in the industry or culture of the enterprise they have joined. Sometimes directors will even admit that they do not fully understand the acronyms on the charts in PowerPoint presentations.

Avoid Joiners Who Collect Boards Like Trophies

Until the forceful reform efforts of shareholder activists a decade ago, it was common to find directors serving on more than a dozen boards and frequently attending fewer than 75 percent of the meetings. With a single board post now easily requiring 200 hours per year of preparation and meetings,

four boards is becoming a common limit for otherwise employed directors. Shockingly, in an effort to clean up tainted governance practices, the new and improved NYSE board has selected for its board a Rensaleer university president, Shirley Jackson, who already sits on eight boards.

Ignore False Recipes from Governance Consultants

Many of the proposals put forth go against conventional wisdom, like headhunters who used to screen out those who salt their food before they taste it or those who use handrails walking up stairways. There is a growing witchcraft of good governance that avoids noble directors who may have crossed an arbitrary retirement age. Enterprises such as Corning, Delta, Boeing, and even the SEC have wisely sought energetic elder statespersons, like Jamie Houghton, Jerry Grinstein, Harry Stonecipher, and Bill Donaldson to lead them through troubled times. Similarly, admonitions against former CEOs on the board should be invoked only in those prominent rare situations where the former CEO and the current CEO have unresolved agendas between them. Many former CEOs, such as Andy Grove of Intel, Bill Gates of Microsoft, Michael Dell of Dell, Jim Kelly of UPS, and Herb Kelleher of Southwest Airlines, have hugely helpful roles to play on the board.

For reformers, the situation is akin to the dog that finally caught the car it chased for years: now that we have it, what do we do? It's time to shift the debate from rules and procedures to focus on what we really know about people and their character.

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