The Need for Ethics in Corporate Boardrooms:

An Analysis of Current Ethical Issues in the Context of Legal Requirements

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This paper will focus upon the actions of corporate directors, who are responsible for managing corporate activities. To place this discussion in the proper framework, the legal duties and responsibilities of directors will be outlined in the first portion of this paper. The legal standards, developed over the years through legislation and judicial opinions, only provide a floor, or minimum guidelines. Corporate boards and individual directors also face many ethical issues which the legal guidelines do not resolve or which provide wide latitude for directors' decisions. The second portion of this paper will describe certain ethical issues directors may confront and discuss their resolution and the effects on the corporation, its shareholders, employees and other constituencies. It will be shown that ethical standards may have a greater impact on corporate activities than legal requirements. Corporations and their constituencies clearly benefit from directors and leaders who exhibit and promote high ethical standards.

I. Legal Rights and Responsibilities of Corporate Directors

A. Activities of Directors and Delaware Corporate Law

The ethical issues facing directors cannot be understood completely without first placing them in the context of the governing legal standards. "The business and affairs of every corporate organized under [Delaware law] shall be managed by or under the direction of a board of directors. ..."[1]Corporations are incorporated primarily in individual states. With approximately 50% of the largest corporations incorporated in Delaware, Delaware corporate law has become America's de facto corporate legal standard. Thus, the corporate governance standards described herein will be drawn primarily from Delaware law.

Delaware law requires annual shareholder meetings to elect directors.[2] Directors of larger corporations typically meet more often, usually monthly or quarterly, and are available by phone and fax at other times. They review financial and other corporate documents, meet with executives and receive presentations and updates. Directors may be required to establish, review and/or approve executive hiring decisions; major business/strategic decisions, such as acquisitions or divestitures or the introduction of a new product or service; company goals and policies (including compensation policies); dividend levels, etc. They also have to determine where and when to delegate authority to board subcommittees and management. The duties and decisions of directors require deliberation, prudence and discretion. Thus, these decisions are not easily susceptible to an immediate determination of whether they were "right" or "wrong." Over time, it may be possible to conclude that a better decision could have been made. However, courts generally do not use the availability of such hindsight review to hold directors financially responsible or liable for the best

[1] 8 Del. C. sec. 141(a).
[2] 8 Del. C. sec. 211.

possible outcome, assuming directors follow minimal legal requirements in their decision-making process.[1]

B. General Legal Standards Governing Directors' Conduct

While directors are not expected to control directly daily corporate affairs, they do have ultimate responsibility for the activities of their corporation. Generally speaking, directors assume a position of responsibility for other people's assets. Therefore they are required to act as trustees or fiduciaries on behalf of the corporation and its shareholders.[2] Directors are required to manage the corporation with unselfish loyalty and the utmost concern for the corporation and its shareholders. There can be no conflict between the director's duty and self-interest. Directors must also protect the corporate enterprise and shareholders from injury or harm. However, directors are "expected to take reasonable economic risks and, moreover, if one takes the authorities literally, rather than being held to a [trustee's] high degree of prudence, directors fulfill their fiduciary duty of care by merely avoiding being 'grossly negligent.'"[3] Unfortunately such general standards, even when interpreted leniently by the courts, often provide little guidance to help explain duties and responsibilities in specific situations.

Governing standards for specific factual situations are beyond the scope of this paper. These answers are found in the large body of judicial opinions which have been crafted from the lawsuits accusing directors of misconduct. To vastly oversimplify this case law, directors will not be held liable unless they profit personally at the corporation's expense (violate the duty of loyalty) or breach the duty of care by failing to manage corporate affairs with the proper level of skill or diligence. This duty of care is concerned primarily with the process behind the underlying decisions. In general, directors are "bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances."[4] Directors will not be held responsible for ordinary mistakes in judgment made on an informed basis with due care, absent bad faith or self-dealing.[5]

C. The Business Judgment Rule

Judges, not schooled in the vagaries of business, will *not* question most directors' decisions made after a review of the available information, after prudent consideration of alternatives and in "good faith furtherance of a rational corporate purpose."[6] If directors act in good faith, without self-interest and with due care a Delaware court "will not substitute its judgment for that of directors, either to hold them liable or to invalidate a transaction that they have approved."[7] This judicial deference is described as the "business judgment rule" or "BJR." Deference is not extended to illegal, egregious or irrational conduct, but judicial deference is necessary for smooth continuation of daily commerce. Constant judicial second-guessing by judges who have neither business experience nor expertise would seriously hamper the pace of business.

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[1] Balotti & Hanks, Jr., Rejudging the Business Judgment Rule, 48 *The Business Lawyer* 1337, 1341-43 (Aug. 1993).
[2] Gottlieb v. McKee, 107 A.2d 240 (Del. Ch. 1954).
[3] Drexler, Black & Sparks, *Delaware Corporation Law & Practice*, sec. 15.02 (Matthew Bender, Jan. 1991 ed), hereinafter "DCLP."
[4] Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125,130 (Del. 1963).
[5] Hanson, The Duty of Care, the Business Judgment Rule, and the American Law Institute Corporate Governance Project, 48 *The Business Lawyer* 1355, 1356-58.
[6] DCLP sec. 15.03.
[7] Balotti at 1339.

"[I]n practice the business judgment rule in Delaware stands for nothing more than the proposition that if directors perform their management functions properly they will not be held liable for losses caused by their decisions or failures to act, nor will the courts otherwise interfere with their activities. Conversely, the rule provides no shield against inadequate performance."[1] Under the BJR, courts will not substitute their judgment for board decisions which are attributed to a rational business purpose and made in good faith by independent directors upon adequate information.[2] Decisions which are irrational or egregious or exhibit deliberate disregard for corporate/shareholder interests will not be upheld. While businesspeople do not like it, be aware, however, that one Delaware judge has conceded that courts will look at directors' business decisions "to some extent from a quality of judgment point of view."[3] Thus, in addition to a review to determine if directors acted independently and in good faith, courts also employ a rationality standard of review. Directors are independent when they make decisions "based on the corporate merits of the subject before the board rather than extraneous considerations or influences."[4] Directors lose the protection of the BJR when they attempt to perpetuate themselves in office or defraud the corporation (self-dealing) or make decisions without taking steps to obtain appropriate information or giving the decision sufficient consideration (lack of due care).[5]

D. Corporate Activities and the Business Judgment Rule

Delaware courts carefully scrutinize decisions which appear to involve directors' rubber stamping of management actions. For example, directors who approve a buy-out offer with approximately a 50% premium to shareholders were found personally liable for failing to provide adequate review or obtaining adequate information, in violation of the duty of due care.[6] Conversely, in another case where a buy-out was made at 40% of book value, the court applied the favorable BJR presumption and found no directorial liability.[7] Directors who use their position of trust for their own benefit (self-dealing) are not entitled to the benefit of the BJR. Taking a corporate opportunity, say a potential new product, for personal gain would be self-dealing. Similarly, stock profits based upon insider information have to be disgorged back to the company since these arose from a breach of fiduciary duty.[8]

Directors fix their own compensation as well as that of executives. Restrictions on the amounts may be placed in the company's certificate of incorporation or by-laws.[9] Courts review compensation issues under a relatively lenient reasonableness standard. It is unlikely that Delaware courts will interfere with directors' self-designated compensation arrangements, "even those pegging the compensation at apparently high levels, so long as the recipients can demonstrate that services of value are actually being rendered, and the level of compensation is within the ballpark of either industry standards or compensation at corporations of similar size and levels of profit."[10]

In completing their corporate tasks, directors are entitled to rely upon employee recommendations and corporate documents, assuming again that directors are acting in good faith.[11] To summarize

[1] DCLP sec. 15.03.
[2] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-58 (Del. 1985).
[3] Quillen, Trans Union, Business Judgment and Neutral Principles, 10 Del. J. Corp. Law 465, 492 (1986).
[4] Aronson v. Lewis, 473 A. 2d 805, 812 (Del. 1984).
[5] See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-58 (Del. 1985).
[6] Smith v. Van Gorkom, 488 A. 2d 225 (Del. 1985).
[7] Cottrell v. The Pawcatuck Co., 128 A.2d 225 (Del. 1957).
[8] DCLP sec. 15.10[2].
[9] 8 Del. C. sec. 141(h).
[10] DCLP sec. 15.09[2]. See also Wilderman v. Wilderman, 515 A. 2d 610 (Del. Ch. 1974).
[11] 8 Del. C. sec. 141(e).

the legal standards for specific board activities, while directors have been found liable for various erroneous acts, the legal standards and BJR do provide directors with favorable presumptions. Generally directors need to exercise the degree of care which an ordinarily prudent person would exercise under the same circumstances. Assuming that directors act independently, in good faith, with a rational corporate purpose, and with sufficient information and care, the courts will not substitute their judgment for the directors'.

E. Shareholder Derivative Litigation

Much has been written about shareholder derivative litigation, which may arise from claims that directors breached the duties of care or loyalty outlined above. These exhaustive discussions will not be rehashed here. Derivative litigation is worth touching upon briefly since many directors are wary of such litigation, with good reason since they face personal liability. However, this threat is not as worrisome as it may seem. First, as will be shown, indemnification statutes and insurance provide directors with a great deal of protection, both legal and financial. Second, courts give directors additional protection through the BJR and its favorable inferences. Directors should not be overly cautious due to fears of litigation--they need to have sufficient conviction and self-esteem to make the proper decisions.

Since courts presume that directors acted properly, when the BJR applies, the plaintiff in a lawsuit challenging such a directional decision has the burden to show the erroneous behavior. Plaintiffs who cannot meet this initial burden will have their lawsuits dismissed. If the favorable BJR presumption does not apply, say in a situation where directors gained personally or had a personal "interest" in the challenged transaction, the directors may still avoid liability if they can show that the transaction was intrinsically fair to the corporation. Note the shift in the burden of proof to the directors when self-dealing is involved.[1]

Empirically, approximately half of the derivative lawsuits are settled and the average settlement approximates $6 million. The settlement is paid back to the corporation, minus attorney fees, which average 24% of the settlement, since the corporation was the party wronged. These lawsuits are brought by shareholders on behalf of the corporation (hence the "derivative" name). The actual monetary gain to the corporation may be negative since it has to pay the insurance premium for directors' insurance and/or may have to indemnify the directors for losses or attorney fees.[2] What cannot be measured is the deterrent value of derivative litigation. In light of the media coverage and protests by businesspeople against these lawsuits, it is safe to assume that directors are conscious of the availability of derivative lawsuits to mitigate harm to the corporation caused by directors' breach of fiduciary duties.

F. Indemnification

The recent increase in the number of lawsuits filed against directors and the amounts at issue have elevated the importance of indemnification, which is the process of reimbursing directors for losses and attorneys fees arising from litigation against directors in connection with their corporate duties. Indemnification is necessary to a point. Directors should be able to oppose unjustified lawsuits with the understanding that the corporation will reimburse their expenses, assuming vindication. Indemnification for every possible loss goes too far since it eliminates any punishment for improper conduct. This is referred to as the circularity problem. Plaintiffs in derivative suits prevail

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[1] DCLP sec. 15.05.

[2] Coffee, Jr. New Myths and Old Realities: The American Law Institute Faces the Derivative Action, 48 *The Business Lawyer* 1407, 1436.

on behalf of the corporation but any funds awarded (and paid to the corporation by directors) would then have to be paid back to the directors if the corporation was required to provide complete indemnification. The corporation loses financially since it also has to pay attorneys fees.

For these reasons in Delaware indemnification of judgments or settlements from derivative suits alleging breach of the duty of loyalty are prohibited, although they may be covered by insurance. Indemnification is also prohibited for acts/omissions not in good faith or which provide personal gain to directors, as well as unlawful dividend or stock payments.[1] Directors are indemnified for attorneys fees and expenses when they successfully defend against lawsuits arising from their duty as directors. In economic terms, indemnification may be thought of as cost allocation between the corporation and the directors, for the cost of directors' acts or omissions. Be aware that indemnification is worth little to the director if the company has no insurance or assets to back it up.

II. The Importance of Ethical Standards

A. Whose Interests Should Receive Paramount Consideration From Directors?

You will notice that the discussion thus far has mentioned only the responsibility of directors to the corporation and its shareholders. When the corporation is solvent the directors act as the agents for the corporation and its residual risk bearers, the shareholders. Corporate finance professors teach that shareholders in a company facing insolvency will have a great financial incentive to pursue high risk/high reward behavior. Since their equity would be substantially worthless in that situation shareholders would elect to pursue opportunities which may yield high returns. They have little downside risk. Therefore, the courts obligate directors to consider as well the interests of the company's creditors when the corporation enters the "vicinity ofinsolvency."[2]

It is unclear how this standard will be applied in practice, but ethical directors who act independently and in good faith should possess the prudence and discretion to craft a reasonable course of action for the corporation in all situations. Directors should be selected for their judgment, experience and expertise. An ethical director will not be beholden to any particular corporate constituency but rather make decisions based upon the long-term interests of the corporation. Courts will support such prudent leadership. "[I]n managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act."[3]

Commentators are now pressing for the ethical and social obligations of corporations to be explicitly stated. Turn of the century judicial decisions strictly reviewed utilization of corporate assets for philanthropic or social activities. Modern opinions have relaxed the standard of review to a question of whether the asset utilization was reasonable. Thus, corporate gifts for philanthropy, education or other public welfare purposes will only be overturned if they are unreasonable.[4] This would allow unethical directors to benefit their favorite social or charitable causes with little likelihood of judicial disapproval.

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[1] 8 Del. C. sec. 102(b)(7).
[2] Credit Lynonnais Bank Nederland N.V. v. Pathe Communications Corp., 17 Del. J. Corp. Law 1099, 1155 n.55 (Del. Ch. Dec. 30, 1991).
[3] Id.
[4] Eisenberg, An Overview of the Principles of Corporate Governance, 48 *The Business Lawyer* 1271, 1277.

One legal organization, the American Law Institute, explicitly placed social and ethical considerations in its recently approved Principles of Corporate Governance. Section 2.01(a) states that corporate business activities should be conducted "with a view to enhancing corporate profits and shareholder gain" 2.01(b) then states that

> …the corporation in the conduct of its business…
>
> (2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and
>
> (3) May devote a reasonable amount of resources to public welfare, humanitarian, educational and philanthropic purposes.

Many states have adopted "other constituencies" statutes which allow directors to consider the impact of corporate actions on constituencies other than shareholders. For example, directors of Illinois corporations "may, in considering the best long term and short term interests of the corporation, consider the effects of any action upon employees, suppliers and customers of the corporation, communities in which offices or other establishments of the corporation are located and all other pertinent factors."[1] Delaware, which has the most incorporations, has yet to adopt a statute which explicitly allows consideration of these factors, although under the case law reasonable directorial actions will be entitled to deference.

Whether ethical and social considerations are explicitly stated or implicitly recognized, we arrive at the same conclusion revealed above--directors receive deference from the judiciary .The legislation and case law essentially boils down to general, minimal thresholds; reasonable decisions will be approved while irrational ones will be overturned. Judges will not substitute their judgment for the judgment of directors who reached a rational decision after a reasonable decision making process, whether the decision involves social, ethical, strategic or monetary factors.

The fact that ethical and social considerations are receiving explicit mention is positive from a public welfare viewpoint. Theoretically, corporations will show more concern, and devote more assets, toward social and philanthropic purposes since courts will be less likely to consider these activities as misuses of corporate assets. However, this trend also clarifies the need to elect ethical directors. Unethical ones may try to use the judicial leniency and deference to benefit their personal social causes and/or themselves, directly or indirectly. Regardless of whether directors think of themselves as serving primarily on behalf of shareholders and, to a lesser extent, other constituencies (the traditional judicial interpretation), or the more modern, socially conscious service on behalf of all "stakeholders," what every corporation needs is a group of directors who make independent decisions with a long-term focus toward expanding the wealth created by the corporation. Directors who bring this focus, and experience and integrity, will be the most likely individuals to achieve corporate success, and avoid the problems which arise from skirting legal and ethical boundaries. Despite the potential glamour and financial rewards, a more short-term focus may lead to lawsuits and accompanying negative publicity, or avoidable conflicts between constituent groups that harm long-term value.

B. Does Compensation Alter Directors' Behavior?

A recent Forbes article questioned whether the lavishness of directorial compensation and other rewards make directors more beholden to the CEO and top management. A directorship also provides prestige and social/peer recognition which status-conscious individuals may not wish to

[1] Id. at 1278.

lose. In addition to compensation and status, the directorial selection process inhibits independent behavior. The most influential person in the selection process is typically the CEO who is, in effect, hiring his supervisors. All these factors combine to reduce the likelihood of strong, early, independent board actions which is precisely what corporations need to prosper. Forbes recently asked “[b]ig corporations have been showering more and more goodies on their boards of directors. Is it any wonder some of these boards have dithered in the face of obvious mismanagement?”[1] Corporations should seek directors who possess the independence and integrity, and perhaps even financial independence, to do the right thing, regardless of the misguided incentive system. As shown above, courts give directors wide latitude in establishing their own compensation. Critics contend that certain companies pay their directors excessively high compensation and this produces “a band of loyal, financially beholden directors who [will resist] efforts to tamper with their private kingdom.”[2]

For example, over the past decade W.R. Grace & Co. directors, their relatives or corporate interests received over $60 million from consulting and other fees, in addition to compensation for serving as directors. Grace directors were also bound together by family ties, common investments and memberships until turmoil finally forced changes. Grace now has a more independent Board.[3] Grace is not the only corporation where directors have not been assertive in the past. Locally, Westinghouse's board received criticism for not asserting itself sooner and for failing to have the necessary banking and real estate expertise to anticipate its problems.[4] Recently the directors at Morrison Knudsen have been accused of being “asleep at the switch.”[5]

Directors at the 200 largest industrial companies receive $68,300 in average pay or about $700 an hour.[6] One consultant who sits on 16 boards receives over $650,000 in annual pay. While meeting fees and stock options are relatively common, many directors also receive medical, insurance and retirement benefits. Some even receive lucrative golden parachutes in the event of a takeover. Locally, Mellon Bank has a charitable giving program which entitles directors to donate up to $250,000 (funded by Mellon insurance) to a charity, payable after death.[7] The SEC is considering requiring additional disclosure of directors’ compensation.[8] The trend toward increasing pensions for directors has received strong criticism for the improper motivation it implies. A pension encourages a director to remain and collect it, as opposed to asserting independence and actively engaging management.[9]

Perhaps the worst example of directorial conflict of interest occurs in the mutual fund industry. Some fund directors can earn over $300,000 for service as a director for a number of affiliated funds.[10] Mutual fund directors, like the directors discussed above, are given the task of acting on behalf of the interests of the shareholder/investors. However, these directors have presided over increases in annual fees as fund assets under management grew. You would expect the opposite result from economies of scale. Paying large fees to directors certainly raises the appearance that directors would be beholden to the fund manager. Again the incentive system and selection process make it unlikely that directors would vigorously oppose a management-supported increase in the

[1] “The cosseted director” at 168.
[2] “Fall from Grace,” Business Week, May 29, 1995, p. 62.
[3] Id.
[4] “In pursuit of perks,” Pittsburgh Business Times, May 15, 1995, p. 28.
[5] “The cosseted director,” Forbes, May 22, 1995, p. 169.
[6] Id. at 169.
[7] “In pursuit of perks” at 28.
[8] “The cosseted director” at 172.
[9] “Big Bucks on the Board,” Pittsburgh Post Gazette, p. Bl, July 16, 1995.
[10] “Squeak, squeak,” Forbes, May 22, 1995, p. 258, 260.

expense ratio. Mutual fund shareholders, due to their relative unsophistication and widespread geographic location, may not even realize their interests are not being give the protection they deserve. Overall, one must question what value mutual fund directors add and whether greed in this area is more prevalent than ethical behavior.[1]

As shown above, the legal standards do little to solve the conflict of interests present in the director selection and compensation area. Unethical directors can do quite well for themselves without crossing the line and making irrational decisions which courts will overturn. There is a wide gulf between the most ethical conduct and the egregious conduct which courts quash, due in part to the BJR and the deference provided by the courts. Unethical directors can thrive in this area with little risk of punishment. It is for this reason that ethics should be a paramount consideration of shareholders involved in the director election process.

The latest compensation trend is to align directors compensation with the value created for shareholders. Scott Paper Co. now pays its directors solely in stock. Scott's CEO stated that he put the stock-only compensation in place so that the board would have the same goals and objectives as its owners, the shareholders.[2] Scott's directors will now be encouraged to focus on increasing its stock price and corporate performance. Critics say that the stock market is separate from making the company function as a long-term entity, it encourages a short-term outlook and enables directors to profit in bull markets regardless of their contribution.[3] Shareholders today have a large amount of influence on many corporations. As institutional ownership has increased these institutions have begun to pressure boards and executives, which helps to offset the natural influence the CEO holds over the board. However, it may not be in the corporation's best interests to follow automatically the wishes of shareholders.

Again, a long-term, prudent outlook is what a director needs to bring. According to New York City's deputy controller for pensions, "[t]he dirty little secret is that institutions are just as greedy as everybody else."[4] Institutions will not object to CEO or director compensation as long as they are making money also. This becomes a conflict where a short-term focus may help the stock price temporarily while hurting certain corporate constituencies and long-term corporate value. Restructurings, layoffs and divestitures may increase the stock price temporarily but do little to add future value. To counter the tendency to consider short-term effects, Procter and Gamble Company will reward executives for financial and non-financial performance, such as "a commitment to integrity, doing the right thing, maximizing the development of each individual, developing a diverse organization, and continually increasing the environmental quality of our products and operations."[5] Other companies counteract the short term financial results mentality by linking compensation to the interests of "stakeholders," including shareholders, employees, communities and customers.[6]

It is not easy to determine who would make a superior director. Peter Lynch, reputed stock-picker, was on the Board of Morrison Knudsen (MK) during its recent decline. While he was apparently a diligent director who asked numerous questions, Lynch and the other directors did not spot the flaws in MK's strategic and management direction. Bill Agee, MK's CEO, placed like-minded people on the board and developed friendships with directors. The Agees had vacationed with the Lynchs, which also probably made Lynch more likely to support Agee past the time that Agee

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[1] See *id.* at 258-260.
[2] "Money Talks," The Wall Street Journal, April 12, 1995, p. R11.
[3] "Think Short," The Wall Street Journal, April 12, 1995, p. R6.
[4] "Raking It In," The Wall Street Journal, April 12, 1995, p. R4.
[5] "I feel your pain," The Wall Street Journal, April 12, 1995, p. R6.
[6] Id.

merited such support, regardless of the compensation arrangements. Agee provided "scrubbed" books to give the board positive news and held board meetings outside Idaho, where MK was headquartered, which diminished the likelihood that board members would receive independent information.[1] Directors need to maintain a detached and objective understanding of the corporation.

C. Prudence and Ethics Will Be Rewarded

In general you would expect the directors and company to have goals and objectives similar to those of long-term shareholders. What is the best way to align these interests? Ignore the argument over whether compensation should be cash or stock and focus instead on a company policy of increasing long-term corporate value while stressing the highest ethical standards. Corporations which do not adhere to high ethical standards, over time, will lose customers as well as high-quality employees who desire to work within a corporate culture based upon mutual trust and respect. Corporations beset by this form of "moral rot" will be unable to recruit effectively, and will not prosper. A reputation for integrity, while perhaps hard to define specifically, is the foundation of corporate goodwill. "Successful enterprises are inevitably based on a network of trust binding management, employees, shareholders, lenders, suppliers and customers--akin to the network that Japanese call keiretsu."[2] As our business world becomes more competitive and fast-paced, the pressures to perform, satisfy short-term goals and skirt ethical guidelines become more intense. Corporations cannot allow the competitive environment to diminish the importance of ethics. Incentives need to be aligned to reward admirable behavior, both financial and non-financial. Employees who advance the company's social interests and reputation should also be rewarded. Incentives focused on short-term results, especially those achieved by cutting corners, are worse than no incentives at all.

For those who believe that financial considerations overcome all other factors, perhaps the strongest argument for ethical behavior is found in long-term stock market results, The stock prices of the large companies which took the lead in announcing a commitment to high ethical standards have outperformed the market over the past 40 years.[3] A recent example is Weyerhauser, which traditionally resisted environmental regulations. It recently reorganized most every part of its business and adopted a policy to minimize environmental damage and exceed legal environmental requirements. Shareholders have reaped lucrative rewards as the stock price steadily climbed, but at the same time environmentalists applaud its new, responsible attitude.[4]

Shareholders and all other corporate participants stand to gain, in the long run, from ethical behavior. Looking at it from the opposite perspective, unethical corporations will end up in court defending the lapses of their employees, agents for whom the corporation is responsible, and they may face punitive damages for outrageous conduct. There is also the threat of derivative litigation. The proper response is not to incorporate in the state with the most lenient indemnification laws or to purchase large quantities of insurance for directors. Rather, directors who bring diligence and integrity should be sought, not those whose first concern is self-advancement or the size of their compensation package. Certainly directors who perform well and improve company value should be rewarded, but the focus on ethics and integrity needs to begin at the top to achieve long-term financial and social rewards.

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[1] "Agee in Exile," Fortune, May 29, 1995 at 70.
[2] "The New Crisis in Business Ethics," Fortune, April 20, 1992, p. 173.
[3] "The New Crisis in Business Ethics," Fortune, April 20,1992, p. 167, 172.
[4] "The New Growth at Weyerhauser," Business Week, June 19, 1995, p. 63.

D. Development of Ethical Standards

It is not easy to determine quickly who possesses the principles and values that we recognize as ethics and integrity. Thus, any discussion in this area also needs to focus on the historical development of ethical standards and attitudes. In the past, individuals obtained their ethical guidelines from parents, peers (social activities), education and religious institutions. If, as is commonly argued, institutions such as churches and schools, which formerly instilled a sense of ethics in their members and students, are seeing their influence diminish then, society will look to other entities for guidance. Politicians have provided little moral leadership recently. These societal change will push corporate ethical leadership to the forefront.

The question then becomes, which corporations will set the ethical tone? Will it be those focused on the short-term or, as described above, those which recognize the value in a long-term strategy premised upon integrity? Will independent corporate boards assert themselves and perform their assigned function of directing the corporate policy, or will they merely follow corporate executives whose personal aspirations may not be consistent with the long-term best interests of the corporation or society? Will the boards act proactively or react after the crisis arrives, like the Grace, MK and other boards described above?

Corporate boards, along with the leaders of other institutions, need to establish high standards of conduct and insist upon ethical behavior. Granted, ethical issues are unlike mathematical questions with only one correct answer. In a multicultural society like we have in the U.S., with its many diverse and divergent constituent groups, it would be hard to define the “correct” ethical response for every issue. Nevertheless, this cannot be used as an excuse--it is possible to establish the basics of ethical behavior.

Employees act in accordance with the written *and* unwritten standards of conduct. Corporations need to develop codes of conduct which require compliance with all legal standards and, in addition, adherence to the highest ethical standards. Once such a code is published, it needs to be followed zealously by corporate directors and officers. Employees will soon learn whether the corporation honors its own policies. High ethical standards include concepts such as fair and equitable treatment of employees, a prohibition against bribes and improper payments, established policies which are consistently and impartially followed, accurate books and records, reporting of all income, an objective policy to resolve conflicts of interest, etc. As an example, the Hughes Aircraft Code of Conduct states its commitment to integrity and then states:

> The Company's policy has always been to abide by all laws of this country and of all other countries where we do business. But our commitment to integrity goes far beyond observing the letter and spirit of the law. Even when there is no law, rule or regulation covering a given situation, we take personal pride in knowing that the Company expects us to do what is right.[1]

E. Recent Corporate Ethical Lapses

Senator Bob Dole recently denounced the entertainment industry's focus on gratuitous violence and sex, contending that this is contributing to the decline in America's moral fiber. While many denounced this as a political ploy to help his presidential campaign, there is a serious corporate issue behind it. Dole singled out Time Warner's distribution of certain movies and records/CD's by rap artists who glorify violence without justification and sex without love. This “cultural revulsion” complaint should be analyzed by Time Warner's board, not as a political issue or a call for

[1] Hancock, Corporate Counsel’s Guide to Business Ethics & Policies, BLI, p. 2202.

censorship or an attempt to limit creative freedom but, rather, the board needs to recognize that it does have a social responsibility.

The content of the movies and records Time Warner decides to distribute is an ordinary business decision, in judicial terms. If it decides to distribute a movie such as "Natural Born Killers" this decision would be entitled to judicial deference under the BJR. It is for this reason that the ethics of corporate directors are critically important. The majority of business decisions will never be reviewed by courts and, if they were, would be approved in light of the deference provided. Thus, it is ethics, not laws, which guide the majority of corporate decisions.

The recent negative publicity has apparently prodded Time Warner into enacting a code of ethical standards. This action should have occurred years ago. The Time Warner board is ultimately responsible for corporate policy and they are clearly responding to the publicity here, instead of proactively instilling ethical guidelines. As Time magazine acknowledged, "How many rap songs about slicing women's throats does the world really need?"[1]

Merrill Lynch was involved in another ethical lapse when it profited from the high-risk lending strategy of the Treasurer of Orange County, California. Certain Merrill employees in the risk-management and repurchase areas were urging caution from possible losses based upon collateral which was illiquid and volatile. Senior Merrill executives ignored these warnings and continued to reap millions from selling bonds to Orange County, which suffered a $1.7 billion loss and entered bankruptcy in December, 1994. Merrill is now defending a $3 billion lawsuit accusing it of wanton and callous selling of risky investments.[2]

Even assuming, as Merrill contends, that it did not lose any money when Orange County entered bankruptcy, it may lose in the lawsuit and it already has suffered a loss of goodwill from the bad publicity. Merrill knew of the excessive risk which Orange County had taken and the extreme sensitivity of its portfolio to interest rate fluctuations. Yet, it continued to sell billions in volatile securities to Orange County and reap hefty commissions. The Merrill board is ultimately responsible for establishing security sales policies. Should it continue to allow sales to a client, like Orange County, whose leverage was described inside Merrill as ten times what Merrill allowed on its own portfolio?[3] Even if that customer was a public entity investing on behalf of unsuspecting employees or taxpayers? Should Merrill have continued to allow its salesmen to use Hawaiian golf vacations and other inducements to encourage additional sales?

III. Conclusion: Corporate Boards Should Require Ethical Behavior

The first part of this paper showed that the laws and judicial opinions provide a wide degree of latitude for corporate directors' decisions. Generally directors will satisfy legal standards and receive judicial deference by acting rationally, independently and for a good-faith, corporate purpose. Corporations that succeed in the long term will be managed by directors who exhibit prudence and accept reasonable levels of risk. The availability of indemnification and the statutorily-limited liability of directors should lessen the fear of derivative lawsuits and encourage rational levels of risk. Of course, irrational decisions may be corrected by the courts, but only unethical decisions which go so far as to violate legal boundaries will be overturned in court. The second portion of this paper showed the need for, and benefit from, adherence to the highest ethical standards.

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[1] Leo, "Stonewalling is not an option," U.S. News & World Report, June 19, 1995 at 19.
[2] "In-House Battle," The Wall Street Journal, April 5, 1995, p. Al.
[3] Id.

Modern corporate leadership begins at board level where independent and proactive directors are needed. The best directors will not be beholden to the CEO, regardless of the compensation and selection arrangements, and will agree to replace the CEO when necessary, in a timely manner. The best directors will be guided internally by a strong code of ethics and will not take advantage of the deference provided by the courts for ordinary business decisions.

Successful corporations will be those which develop a reputation for integrity, which may sound like an amorphous concept, but which is actually a valuable source of corporate goodwill. Ethical corporations will retain customers and employees and avoid derivative lawsuits and litigation over the actions of employees fixated on short-term incentives. Principled corporations will comply with legal obligations but also go beyond by adhering to the highest ethical standards. These corporations and their stakeholders will be rewarded financially over the long run.