Boyden

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Board of Directors Series

The Changing of the Board

Part Three: **Why Ethics Are Not Optional**

When boards go easy on ethics, stakeholders and markets are betrayed. Trust is eroded.

Now, however, less forgiving conditions have made it difficult to ignore the extent to which directors and boards fail to consider the ethical implications of their decisions. The requirement today is for directors to refocus on ethics in order to rebuild market trust and restore corporate reputation. The new opportunity is to utilize "ethical search" to find and recruit truly independent board members who recognize the importance of ethical behavior – especially when operating in global markets. Raising the bar for recruiting opens the door to reinvigorating and transforming the board of directors.

Boyden global executive search

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"Why Ethics Are Not Optional" is the third of four publications in Boyden's new series on ***The Changing of the Board.*** Each provides a critical perspective on the emerging issues around recruiting directors and building boards for the 21st Century.

The Changing of the Board is part of a broader Boyden initiative to redefine Board Search and Board Services. It offers answers to important questions. How can my organization find the best directors for complex business environments? What are the problems of practicing corporate governance in a time of change? These issues are critical to the global client community Boyden serves. Making boards work is now a priority for all participants in today's increasingly virtual enterprises, including shareholders, stakeholders, customers, and corporations.

The four working papers that constitute ***The Changing of the Board*** offer fresh insight on constructing boards that are better suited to today's challenging world.

"Boards in Crisis" began the series by focusing on the board of directors of the past, present and future. While many boards have been successful in improving corporate performance, the continuing global crisis indicates the need for deeper and more thoughtful corporate governance.

This paper begins with a concise overview of why boards fail. It explores historical factors that discount shareholder interests, and it explains the importance of "board independence." The paper includes a section on new strategies that are proving effective in moving boards from performing compliance to creating competitive advantage.

"Better Directors for Better Boards," second in the series, focuses on the changing world of the director. Traditionally board membership was largely a well-paying ceremonial job reserved for friends of management.

Since new legislation and listing regulations were introduced in 2002 and 2003, directors are now expected to do real work. Workload continues to grow as directors are assigned additional responsibilities such as serving on board committees like auditing or compensation; consequently, many board members are choosing to leave boards early as the pressure piles up. This paper includes a special interview with "Director X," an experienced board member serving as a Director of two high-profile companies. This Director provides a surprising and unique look at what really takes place in the boardroom in a crisis. Director X describes how the responsibilities of directors changed the day Sarbanes-Oxley became law.

In the future, boards will need different kinds of members than those who served in the past; there will be fewer celebrity directors. Instead, boards will seek to recruit members more likely to provide expertise in relevant business domains. Every board will seek candidates who are tech-savvy or have expertise in new areas such as risk management and business continuity. With director liability increasing, and more directors resigning early, it is becoming more difficult to recruit qualified candidates willing to do the job. As "The War for Talent" comes to the boardroom, retained search will become the preferred way to find the new directors who can transform a board into a competitive advantage.

"Why Ethics Are Not Optional," third in the series, reveals the critical role ethics plays in guiding directors and boards. The work of a board member always begins with a deep understanding of the unique duties of directors, both legal and ethical. The board is responsible for understanding, defining and maintaining ethical frameworks to guide all employees and agents of the company, as well as circumscribing company business practice. Creating an ethical "tone at the top" turns out to be one of the most important duties of directors.

At the end of the paper is an interview with John F. Levy, CEO of Board Advisory, on the intimate connection between corporate ethics and shareholder trust. Levy, who was an important contributor to ***"The Changing of the Board,"*** emphasizes that the value of rebuilding customer trust and company reputation always exceeds the cost it may require. It is clear that good ethics is good business.

"New Board Opportunities and Obligations," the final paper will explore new board resources and requirements mandated by Sarbanes-Oxley. Boards can now use independent resources to do audits and oversight. Inaccurate reporting of business results erodes the trust of shareholders and capital markets. Any attempts to "cook the books" in regard to employee bonuses need to be detected. (Nearly 1,200 public companies had to restate their business results in 2005.)

Boards bear legal responsibility for preventing and investigating fraud associated with company employees, agents or customers. Independent resources can aid board committees that need support for internal investigations, provide fraud training for board members, as well as help corporate governance reviews.

I Introduction: Why Ethics Are *Absolutely Not Optional*

"Ethics are essential for boards. Without boundaries, companies slip to 'the dark side."

Thomas Flannery, Leader Boyden North America Board Services Practice

Why are ethics not optional in the boardroom?

Some have wondered if ethics are now a luxury corporate boards can no longer afford. When times get tough and global competition mounts, wouldn't it be better to let market forces define what's right and wrong for companies?

"Ethics are never optional," says John Levy. Unethical board behavior invariably leads to bad decisions and disastrous results. At a minimum, it risks reducing shareholder value. And too often it destroys trust.

Why is trust so important?

We live and do business in a world that is more connected and interdependent every day. Levy describes trust as "the engine and lubricant that enables everything to work together." As trust erodes, so does cooperation and collaboration. Without trust, the center cannot hold.

Political economist Francis Fukuyama, who wrote ***"The End of History,"*** identifies trust as the fundamental condition necessary for successful global competition. Fukuyama suggests that only societies with a high degree of social trust are capable of creating the kind of flexible, large-scale business organizations and markets that are needed to compete and win in global economies. His book ***"Trust: The Social Virtues and the Creation of Prosperity"*** makes the case that cultural values (ethics) and economics are always deeply connected.

Too many board members have considered ethics as a "nice to have" rather than a "must have." Today this is changing. It is becoming difficult to ignore the huge price tag associated with not doing the right thing.

"Ethical capital is capitalism's new cornerstone," writes Umair Haque, Director of the Havas Media Lab and an influential blogger for the Harvard Business Review. The kind of capital we needed in the past, Haque says, won't do the job in the 21st Century. It is a challenging hypothesis in which ethics become an irreplaceable asset for businesses that would rule in more transparent global economies.

The traditional imperative for the practice of ethics in the boardroom, however, remains. And so do the legal requirements. *Ethics are essential for boards,"* says Thomas Flannery, who leads Boyden's North American Board Services Practice. *"Without boundaries, the best of companies can slip to the dark side."* Flannery, who is also Managing Director of Boyden Pittsburgh says the way to assure ethical boards is to introduce "ethical search," which can improve the recruiting of truly independent directors who are up to the task of serving on an ethics-driven board.

Ethical search means breaking with traditional board practices. Until recently, most boards have preferred that new directors be recruited from a close circle of acquaintances, insiders, and allies. Today, ethical search requires finding the best candidates, rather than choosing among the best-known candidates. To do this, however, boards must make greater use of professional search, with a more independent, disciplined and thorough process.

With this new strategy comes a great new opportunity. The value of improving the recruiting process is not limited to improving ethical compliance. This new strategy has the potential to find and attract a new generation of directors who are more open to the future.

Boyden believes this will serve to reinvigorate, update and even transform the board of directors. Ultimately, this is what "the changing of the board" is all about.

The Changing of the Board

"Boards are looking harder at who they need versus who they have."

Trina Gordon
Chairman, Boyden World Corporation

"Board members used to work 40 hours a year," says Richard McCallister at Boyden Chicago *"Now it's often up to 180 hours."* Boards used to meet quarterly; the average is now eight meetings a year. On top of that, there are travel time, conference calls and preparation, which entails studying stacks of "pre-reads" and reports before every meeting.

In addition, there are the committee assignments, which sometimes require more time than participating in full board meetings. Many board functions are carried out at the committee level. The Audit Committee, for example, is responsible for auditing company financials, generating budgets and investigating financial malfeasance. The Compensation Committee deals with executive compensation, including controversial bonuses whose increasing size has resulted in "say on pay" initiatives to give shareholders a vote on executive compensation agreements.

Many boards are adding risk management committees as well. Whenever companies have special problem areas, boards may establish new committees to assure issues are resolved. The board of Microsoft, for example, has added a permanent committee on Antitrust Compliance.

Many consider that the most important tasks for directors are the hiring (and sometimes firing) of CEOs. According to a 2009 Board Practices Study published by the RiskMetrics Group, a provider of corporate governance services, 88 percent of boards surveyed now have a board committee responsible for CEO succession. While CEOs may be reluctant to help plan their departure and replacement, the number of such committees has increased 48 percent since 2006.

Surprisingly, fewer companies are changing CEOs at present. Richard Jacobitz of Liberum Research, which tracks changes in C-Suite assignments, says boards are currently playing it safe and retaining CEOs longer to assure stability in these difficult financial times. Similarly, CEOs may be staying in jobs because they don't have better alternatives. This is not, however, true of board members. Dissatisfaction with corporate performance, share price, and executive compensation has increased shareholder activism, and increased turnover in board positions is expected.

The job of director is less financially attractive than in the past, due to a shift in the balance of risks versus rewards. Compensation of directors is expected to drop until general business conditions improve. But legal exposure of directors appears to be increasing. Many directors are covered by Directors and Officers (D&O) insurance, but policies exclude coverage for situations involving fraud or other criminal activities. Directors are paying more attention to the reporting and compliance regulations for companies on whose boards they sit.

Many board members are having second thoughts about board service. Some are declining to run for re-election, while others are choosing to resign even before their term ends. Microsoft Word now includes a template for a board resignation letter.

The good news is boards have an opportunity to rethink their membership strategy. With more openings inevitable, says Trina Gordon, Chairman of Boyden World Corporation and Managing Director, Boyden Chicago, *"boards are looking harder at who they need versus who they have."* Have things changed so much that they should look for a new generation of directors?

II Ethics 101 for Directors

Any person who becomes a member of a board of directors undertakes one of the most uniquely challenging jobs in the world. Every director, when he or she joins a board, accepts significant responsibility for all activities: financial planning, executive compensation (including the hiring and firing of CEOs), business results, and sustainability of an organization – no matter how large and complex that organization may be. Thirteen directors are responsible for overseeing General Motors. Google has ten directors on its board. Microsoft has nine.

While the breadth of a director's responsibility is wide, the time available to most directors is limited. And so is the information provided to them. Many directors are already busy working at other organizations, where they may already serve as CEO or CFO. The majority of information that directors receive comes as "pre-read"; compiled and prepared for them by senior management. Directors are expected to read and absorb all reports, comprehend trends, review strategies, and evaluate risks before board meetings. At board meeting, they must discuss critical issues, negotiate consensus, and make final decisions within a tight schedule. Neither the difficulty of these tasks nor the limited time allowed to complete them relieves directors of full responsibility for what happens to corporations and shareholders as a result.

Each director is expected to act at all times for the sole benefit and interests of another, i.e. the shareholders and stakeholders. A director must do this with the highest standard of care. This requires that a director always be ethical and trustworthy in the execution of his or her duties.

The duties of a director are fully described in state and federal legal codes, as well as rules of oversight agencies. Corporate law specifies that members of the board serve as fiduciaries of the company and its shareholders. Fiduciary comes from the Latin "fides," which means faith, and "fiducia," which means trust. A director who does not live up to his or her duties is liable under the law. But the rule of ethics in the boardroom extends well beyond the letter of the law.

Staying within the letter of the law does not relieve a director of responsibility to perform all board of director duties ethically. This is because the director and the board are ultimately responsible for all aspects of corporate behavior, not just for the legality of business practices. Boards behaving unethically potentially compromise the viability and longer-term profitability of companies.

Directors are ultimately responsible for both legal behavior and ethical behavior. You can make decisions that are completely legal, but are not ethical. For example, during the recent economic upheaval, most of what financial services companies did was legal. But it was not ethical. It's not ethical to sell an adjustable rate mortgage to someone with a limited income who will never be able to afford the increases in the long run. It is completely legal to enable someone to buy a house they will inevitably lose to foreclosure. But it is certainly not ethical.

Why are the legal and ethical guidelines for directors so demanding? Every director enjoys unusual power to affect large numbers of families and organizations. With great power comes great responsibility. (Many will recognize the provenance of these words as the fictional Spiderman's Uncle Ben, but their truth is undeniable.)

Shareholders, markets, and economies rely on directors acting ethically when fulfilling their duties. Yet historically and even now, directors are pressured to be loyal to those who chose them and to be lenient when ethical considerations threaten profitable business practices. Boardroom culture requires teamwork, consensus-building, and flexibility in understanding the perceptions and priorities of other directors.

The Changing of the Board

Governance is designed to ensure that directors do their ethical duty without exception. Assuring conditions conducive to ethical behavior is one of the most important reasons for strengthening the role of independent directors. Ethics are essential for moderating the risks of potential misuse of the enormous power wielded by today's CEOs and other managers of public corporations.

"Ethical principals have the ability to cut across national boundaries, in ways beyond the scope of legislation."

According to Schwartz, Dunfee, and Kline

There is an ethical dimension to virtually every activity of the board and its directors, according to ***"Tone at the Top: An Ethics Code for Directors,"*** a paper by Schwartz, Dunfee, and Kline in the Journal of Business Ethics. In addition, many experts define ethical codes for organizations and generally recognized principles of business behavior. These guidelines inform how companies deal with shareholders, employees, customers, vendors and others.

Tim McNamara, Managing Director of Boyden Washington DC, emphasizes that no exceptions are acceptable when it comes to putting ethics first. *"Ethics have to be tied to everything, both short-term and long-term."* And that is up to the directors. Members of the board have ultimate responsibility for ethics in a firm, including disciplining of senior management in corporations and extending to business practices of joint ventures in extended enterprises.

The most important source for defining ethical obligations and behavior of directors, according to John Levy, is Delaware's legal description of fiduciary duties of corporate directors:

- First, the *duty of care* requires directors to act with appropriate attention and to be fully apprised of all reasonably available information.
- Second, the *duty of loyalty* requires directors to act in the best interest of the company, in good faith, and to do so in an objective and independent way.
- Third, the *duty of disclosure* requires full and fair disclosure of pertinent information when directors seek shareholder action. Directors must disclose any personal interest they may have in board transactions, along with material facts concerning transactions to other directors. They are prevented from using special knowledge to their own advantage or to the disadvantage of shareholders.

Most importantly, all of these duties must be performed in "good faith", meaning with honest intent to do the right thing for the shareholders and the company.

Ethics can provide guidance in areas not addressed by laws and regulations. According to Schwartz, Dunfee, and Kline, *"ethical principals have the ability to cut across national boundaries, in ways beyond the scope of legislation."* This has proven especially useful as businesses become increasingly globalized.

Levy points out that ethics standards change from geography to geography. Different cultures have different business models. Ethical consideration and discussion provide a way of negotiating the problem of what is acceptable business practice when doing business across cultural fault lines.

The most important area of ethical concern for every director, however, remains his or her own behavior. Directors are in the position to use corporate power for mischief, as well as good. David Gergen, Director of Harvard's Center for Public Leadership, said in his interview in Boyden's ***Leadership in a Time of Crisis,*** that people who intend to lead others must begin, in effect, by learning to lead themselves.

"If a company wants to consistently practice ethical business behavior, it better have an ethical board"

Chris Clarke,
CEO Boyden World Corporation

"If a company wants to consistently practice ethical business behavior, it better have an ethical board", says Chris Clarke, President and CEO of Boyden World Corporation, It is the ethical "tone at the top" which is most important in influencing the behavior of lower level employees. The process by which directors assure ethical awareness and behavior must begin with members of the board performing active self-assessment of their own ethical attitudes and behaviors.

By actively and visibly practicing ethical behavior, directors create a viral effect that communicates beyond company walls to all its "agents" who act on its behalf. A company's reputation determines how successful it will be in recruiting new talent. An ethical reputation is also relevant to a company's access for financing.

Despite the recognition of the importance of leading by example, statistics indicate the need for improving execution of this principle. A 2003 study by the US Conference Board revealed that while 81% of firms have conducted ethics and compliance training for employees, only 27% have conducted the same kind of training for directors.

III The Ethics Crisis in the Boardroom

Is there is an ethics crisis in today's boardrooms? How would we know?

What happens in the boardroom stays in the boardroom. Shareholders, regulators, and the rest of us are left in the dark about events that may have occurred in executive session. Non-directors can't know if ethics were fully considered in making a decision – or even which issues were raised and which were unresolved. "Transparency is not always useful in governance," says John Levy. The confidentiality of the contents of executive sessions is necessary in order for directors to feel free to fully express themselves. This is where directors let it all hang out, explained Director X in his interview in "Better Boards For Better Directors." Keeping boardroom discourse private is essential.

It is only when things go wrong later that we can be certain things weren't done right in the boardroom. The more disastrous the results, the greater the likelihood that directors failed to consider the ethical underpinning of a decision.

Historically, governance has evolved and improved only occasionally, one reluctant step at a time. The reality is that no person or agency ever undergoes the pain of increasing protection of shareholder interest or market viability unless given no choice.

It took the collapse of Enron to force widespread reform of governance in the US. In the 90s, Enron leveraged the deregulation of markets to capture and transform the utilities-dominated business of supplying energy. Enron reshaped it into a commodities market in which the cost of energy became a function of the perception of scarcity. Secretly Enron began gaming the market to do just that. Later it employed risky "off-book" accounting practices to hide its losses and become a superstar in the capital markets. As Enron consistently reported excellent business results, investment flowed in, much of it from retirement funds. Employees were encouraged to put all available capital in Enron stock. The company had a well-written corporate code of ethical conduct, and a distinguished (and well-rewarded) board of directors. By 2000 the Enron Board of Directors was ranked as one of the best in the US.

Inside Enron's boardroom, however, ethical guidelines were being eroded. On three separate occasions, senior management asked the board to suspend its code of ethics to allow executives to violate conflict of interest principles for personal gain. And each time, without questioning, Enron's board did so. This was emblematic of a "go along to get along" culture that surprisingly was accommodated by "big five" accounting firm Arthur Andersen.

When Enron collapsed, investors lost all their money, including money meant to pay for retirement. Eventually, wide-spread fraud by senior management was discovered. Some were sentenced to significant jail time. Arthur Andersen's decision to put client relations before ethical due diligence destroyed that firm's reputation. What had been "the big five" accounting firms became "the big four." Ultimately, however, what happened at Enron was caused by a failure of Enron's directors and board to ask two critical questions. Were Enron's results accurate? Were Enron's business practices ethical?

Enron's collapse occurred in late 2001 as the Internet bubble was bursting. A year later in 2002, Tyco and WorldCom also fell as a result of unethical corporate practices. Sarbanes-Oxley was passed as a result. Sarbanes-Oxley gave boards of directors elevated responsibilities and resources for tighter financial reporting and corporate oversight.

For the first time boards had the right and the responsibility to ask the hard questions and to get real answers. But culture is a powerful thing. Many boards were slow to step up to the new circumstances. Charismatic CEOs continued to believe they should have the final say. So despite the dramatic changes legislated by Sarbanes-Oxley and a tightening of governance by regulatory agencies, a financial crisis began in 2008. Nobody knows when the recovery will come.

Today, boards need to have a more on-going and proactive concern with ethics.

It does appear that this economic "perfect storm, "as many termed it, could have been mitigated or even prevented, had more boards of directors asked senior executives and themselves the hard questions about the ethics of business practices. There was a troubling lack of concern about the inevitable consequences of offering sub-prime mortgage products to families who could not afford the house they bought, which would lead to high foreclosure rates, and ultimately to increased homelessness. This is, of course, only one of the many dramatic betrayals of corporate trust. And despite the inevitable consequences waiting ahead, many businesses continue to violate the most common of ethical standards. It is thus irrefutable that an ethics crisis continues in the boardroom. Not in all boardrooms, but in enough to significantly impact the trust upon which the capital markets have been built.

"Many board members were too compliant," explains Tim McNamara. *"And some boards simply haven't changed. The financial crisis has failed to alert them to the danger of not following ethical guidelines. As a result, those boards are probably at risk."* Typically boards will set aside time every year to review ethical guidelines and potential issues, but he says directors cannot wait for an annual review to ask the tough questions. Today, boards need to have a more on-going and proactive concern with ethics.

"Directors really have to push the envelope," McNamara adds *"They need to find out, for example, if any family members married, or have children who married a spouse in a business that could create a conflict of interest."* Acknowledging the velocity with which mergers and acquisitions can occur, he asserts that directors need to assure they themselves haven't unexpectedly become an investor in a company that, for example, has a subsidiary that would become a conflict of interest.

Why is it so difficult for some companies, especially large successful companies, to practice better compliance with ethical practices?

Enterprises that have built a profitable business model, achieved ongoing commercial momentum, and whose executives have managed to negotiate high levels of compensation, often resist being reined in by their boards. Although management is supposed to report to the board, two strategies are sometimes employed to limit control by boards.

The first management strategy – one that is often employed – is to "edit" the information and analysis directors receive from internal sources. Historically directors have been dependent upon information provided by management to understand the complex and dynamic forces at play in virtually any organization. While Sarbanes-Oxley gave the directors the right to hire independent resources for the first time, senior management can still filter what directors receive by making unfavorable information less visible and more difficult to analyze.

The second strategy is to maintain control of board agendas and succession. Insiders typically seek leadership of the board in order to reduce opposition to their leadership of the business. As an example, the Chairman controls board agendas, and the agenda controls the board. Directors have only a limited amount of time and focus to commit to board work. However independent a director is, he or she depends on the agenda to set priorities and gauge effort.

Even more critical, however, is having a leading role in guiding and approving the recruitment of new directors who may define the future of that board. When inside management controls recruiting of new directors it becomes more likely that the next generation of independent directors will be loyal to existing management – and less likely to oppose the strategies and initiatives developed by senior executives. This is why the struggle between CEOs and advocates of independent boards is so fiercely fought, especially in the US.

IV How "Ethical Search" Reinvigorates Boards

"Boards consider managing CEO succession to be their most important duty," says Sarah Stewart, an expert in board practice and a Principal of Boyden Pittsburgh. *"But managing board succession can be as important as any change in senior leadership."*

Thomas Flannery believes board succession is something that should be viewed strategically. *"If you want a great board,"* says Flannery, *"you need to begin with a great search strategy. It's just like building a championship team in sports."*

The best strategy for assuring an ethical board of directors is to utilize "ethical search" when recruiting new members. The search team must use ethical guidelines in recruiting – just as boards do in recruiting new directors.

Historically, this has not been the case. In fact, it was almost the opposite. Management looked for candidates who would impress shareholders as being trustworthy and experienced enough to watch out for shareholder interests. But managers would never choose a candidate who might cause them problems, i.e. criticize the company, its executives or their decisions. When it came to boards of directors, management wanted no surprises. That meant recruiting directors who were known quantities. There was recruiting, but ethics had nothing to do with it.

"Even a few years ago," Stewart says, *"boards were hesitant to recruit anybody that someone on the board didn't personally know."* If a name was suggested from outside their network, they would ask, *"If we've never heard of that person, how could he or she possibly be any good?"*

There is value to having members who know each other. Boards have a unique requirement for members to work together and to enjoy a collegiality reinforced by sharing common backgrounds and world views. But Stewart points out that *"today it is more useful for boards to seek more diversity in their rosters of directors. They want people from different industries, with different skills, different emotional experiences. So they need to recruit beyond their existing network in order to reach a wider universe of potential candidates."* Changing the search process can invigorate boards, or even transform them.

"Today it is more useful for boards to seek more diversity in their rosters of directors. ... So they need to recruit beyond their existing network."

Sarah Stewart,
Boyden Pittsburgh

Ethical search requires taking a more independent approach to recruiting independent directors. It also means recognizing that board searches are as important as searches for senior executives. It assumes a more transparent process, with more time for meetings and learning about candidates over time.

The unique requirements for the role of director mean that both sides need a certain flexibility to examine diverse situations and, on some occasions, possess an ability to back away without burning bridges. The new focus should be on recruiting directors who are truly independent and committed to increasing shareholder value (as opposed to seeking CEO favor).

Above all, as John Levy explains, being ethical should be the first requirement for any board candidate. It must be part of their DNA because ethics are fundamentally about how we behave to others. Ethics provide the compass that enables directors and boards to navigate complex and dueling priorities in order to "do the right thing."

No director, however qualified in other ways, should be recruited without it. That goal requires finding a new generation of experienced candidates who implicitly understand the importance of ethical behavior today.

Ethical behavior is the price of trust. Companies must be ethical to be trustable.

Interview with John Levy: Ethics and Rebuilding Trust

John F. Levy, CEO of Board Advisory, consults with boards on ethics, accounting, and governance. He teaches courses on board ethics and corporate governance, and is currently Chairman of one public company and lead director of another. Levy also served on the board of Take Two Interactive Software, where he was chairman of the audit committee.

Formerly a CFO for both public and private firms, Levy began his career as a certified public accountant for national public accounting firms Ernst & Young, Laventhol & Horwath, and Grant Thornton. He is a graduate of the Wharton School of the University of Pennsylvania.

Why are ethics important in recruiting directors and running boards?

When you want to improve governance, you begin with ethics.

The biggest failures of corporate governance – from Enron and WorldCom to Bear Stearns and Lehman Brothers – all resulted from the fundamental failure of boards of directors to follow core ethical principles. Damage done to shareholders and markets could have been reduced or avoided if boards had been more diligent in considering the ethical issues before making decisions.

You are saying ethics has a huge impact.

I'm saying that everybody involved in board service needs to look in the mirror and ask themselves "am I performing ethically." Because what can happen is that companies fail and people's fortunes get wiped out. But even more fundamental than that is the destruction of trust.

Why is "trust" so important in this context?

Trust is really the central issue. What keeps our society running and everything going is trust. When you drive through an intersection with a green light, the only reason you do that is you can trust that other people are going to stop at the red light. If you couldn't trust other drivers to behave and observe laws, you couldn't drive on the street. If you couldn't trust pilots and airlines, you wouldn't fly. When you can't trust companies and/or markets, you don't become a shareholder.

Every time someone behaves unethically – and what we've seen over the past decade is many corporate boards behaving badly – it is a violation of trust. Putting people in mortgages they can't afford is unethical. Rating securities as Triple A when the value's not there is unethical. Selling those securities to people who can't afford to have them default is unethical. And – it was unethical for boards of directors to approve those activities.

But can ethics in the boardroom halt the erosion of trust?

Returning to ethical behavior rebuilds trust. And right now, rebuilding trust is the most important thing we need to do to survive. Trust in each other. Trust in our businesses. Trust in our institutions. Trust in our government.

How did you come to focus on ethics in the boardroom?

After Enron and WorldCom, public companies needed financial experts to serve on their boards and specifically their audit committees. With 30 years experience as a CPA and CFO, I thought I could help. But as I got more involved with corporate governance, I found a surprising number of directors didn't understand the responsibilities they had signed up for.

What were directors failing to understand?

Directors have a remarkable opportunity to help create jobs, create wealth, and encourage innovation. But with that opportunity comes significant duties and responsibilities. When people become members of a board, they are not always prepared for the fact that every decision they make will involve ethics. To be a good board member, you need to pause for a moment to consider the ethical underpinnings on every decision, no matter how big or small.

That's one thing directors need to do. And many don't.

Is the ethics issue on boards finally being addressed?

Often boards will fail to see the ethical issues until they have reached a crisis. Or issues may have been concealed from them by a self-serving CEO or management team.

The Changing of the Board

Most directors are not trained to look for ethical issues. There are no educational requirements to serve as a director and no ethics training. Many directors avoid looking for problems. They may not want to "rock the boat."

When a director looks for ethical issues, he or she runs the risk of causing problems and ill will. Many have close relationships with CEOs, and shared backgrounds can lead to difficulty in independent thought and action by directors.

If a director points out an ethical conflict with a company policy, isn't there the potential to cause a real business issue?

Making ethical decisions creates long-term shareholder value, but it can definitely result in negative consequences in the short-term. American businesses have been criticized as focusing too much on the short-term.

What's the solution?

As board selection becomes a more professional process rather than a networking process – I think Boyden calls it practicing "ethical search" – boards will become more diverse.

I am not talking specifically about gender or race. Boards need their members to bring a diversity of experience, so they can be more representative of the customers of the business, and of society as a whole.

How does diversity change boards and ethics?

As the composition of a board becomes more diverse, the dialogue in the boardroom gets healthier and more open. People are given greater ability to consider the ethical components of their decisions. As long as shareholder value remains a priority, decision-making improves.

The new proxy rules specifically state the kind of skills board members must bring to a board. For example, you need directors who have a human resources and compensation background. That's a critical factor on boards. You want directors who understand information technology because every company now relies on IT. And if your company sells to the Hispanic community, you want a director who understands the market they're selling into.

What have you learned from the years you've served on boards?

The longer I do this, the more aware I am of the critical ethical components hidden in every decision the board makes.

A director must consider the components of a decision differently than, say, an executive worrying about making payroll.

Delaware law requires directors to exercise "the duty of due care." They are expected to "inform themselves, prior to making a business decision, of all material information reasonably available to them."

Directors are also required to take sufficient time to assess the information. You take more time, because the decisions you make as a director tend to be more critical.

Is board independence really required to assure ethical board behavior?

In terms of ethics, boards and directors need to be independent. By "independent" I mean in terms of their thought process and decision-making. Every board member must be willing – and must be able – to stand up and say when something is not right. At the same time, board work is primarily about teamwork, building consensus and brokering compromises. So this is not easy.

What you don't want is a board dominated by a single individual…whether it's the CEO or somebody else. That's always an unhealthy situation. It will lead to bad decisions.

Who leads the board if not the CEO?

Boards need leaders. But boards should not report to the CEO. The CEO should report to the board.

The person who leads the board must have the time to give the board the special attention and consideration it requires. This is essential.

And…the person who leads the board must be someone who lives an ethical life. Organizations reflect the values and behavior of their leaders. That is how you end up with a great board. In my experience, that's true for big companies, small companies…for all companies.

Can companies always afford to behave ethically when times are tough?

The times when a company needs the best in ethical behavior is usually when it's the hardest to do that.

It is when things are tough, and decisions are hard, that directors are most tempted to excuse an unethical decision because "there's a greater good," or because "I can look past this because we need to get through this crisis."

That's when board members really have to step up. Ethical behavior works, but that doesn't mean it's always easy.

Final words?

People need to lead ethical lives. Whether as a board member or as a family member, people have to make ethical decisions every day in every aspect of their life.

We can all think of individuals whose lives would be happier if they'd made ethical choices. We all know companies that have experienced major setbacks or gone out of business because of unethical behavior.

Ethical behavior and ethics-driven decisions are always the way to go.

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