РАЗДЕЛ 3
УГОЛОК ПРАКТИКА

SECTION 3
PRACTITIONER'S
CORNER

CORPORATE GOVERNANCE IS DIRECTORS MAKING DECISIONS: REFORMING THE OUTWARD FOUNDATIONS FOR INSIDE DECISION MAKING*

*Michael Useem***

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** Wharton School, University of Pennsylvania, Philadelphia, PA 19104-6370, USA
(E-mail: useem@wharton.upenn.edu)

1. Introduction

For more than a decade now, investors have been struggling with the outward foundations that promise sound leadership inside in boardroom. A waive of hostile takeovers and executive shakeups in the late 1980s and early 1990s pointed to the performance shortcomings of conventional boardroom decorum, which had given management the upper hand and directors little hand. The leveraged buyout of RJR Nabisco in 1987 and the executive dismissals at General Motors in 1992 and IBM in 1993 sparked a vigorous debate on the inadequate governance practices at many corporations. How could the board of RJR Nabisco have allowed chief executive F. Ross Johnson to fly his personal German Sheppard on a separate corporate jet whenever the CEO traveled on company business? Why had the boards of GM and IBM permitted CEOs Robert Stempel and John Akers to let their companies spiral into such decline? What explained why Salomon chief executive John Gutfreund allowed an illegal transaction in government securities by his bond traders in 1991 to go unreported for months?

The failures at Enron and other U.S. companies a decade later further intensified the demands by investors for better outward foundations of governance. The widespread corporate malfeasance in 2001–2002 sparked the New York Stock Exchange to recommend a new set of governance rules for its more than 2,700 listed companies in 2002, and the Sarbanes-Oxley Act of 2002 to do the same for the audit function at all publicly-traded companies. Their provisions and the still unresolved debate about whether to separate the roles of chair and CEO and reward directors with stock all revolve around what outward foundations are required for un-biased, thoughtful, hard-hitting, and timely decisions when the board convenes behind closed doors.

And directors rarely venture outside their closed doors. Shareholders learn from a company's annual report and proxy statement who the directors are and a little about how the board operates. If shareoldersattend the annual meeting, they might also spot the directors on a dais. Yet owners can almost never speak with their directors directly. Boardroom etiquette and company rules call for all investor communication to go though the office of the executive. During performance crises boards have occasionally retained outside counsel to serve as back channels with the investment community. Otherwise the owners have virtually no first-hand information with which to judge the actions of the governing group that they have elected to represent them – no speeches, no reports, no votes – until the firm's financial performance is disclosed a year later.

In the absence of direct data, then, outward appearances become critical: The board should have the right people, the right committees, the right rewards. But it is well to keep in mind that what transpires behind the boardroom's closed doors is what ultimately counts: Do the directors select the right strategy, recruit the right executives, and set the right compass? Such actions themselves are just way stations of course to what investors ultimately want: superior, predictable, and everimproving financial performance. But it is ultimately those private decisions that yield the public results, for better or worse.

Corporate governance is usually treated as a subject largely apart from company leadership, and that too has further limited our understanding of how governance works. Company leadership as a separate field of study has long focused on what makes for effective executives: Is it their vision, their communication, or their execution? In seeking answers to such questions, the spotlight has thus focused mainly on the management stage, with directors left standing in the shadows behind. That's understandable since executives are always on stage: presiding at events, talking with investors, receiving business writers, and conferencing with analysts. But the spotlight has really been too narrowly focused since it is the directors who placed the executives on the stage in the first place (see endnote 1). Company leadership, then, should be seen as encompassing the directors as well, though their leadership is peculiarly narrow in scope. There are no masses to excite, no troops to align, no vision to spread. Rather, the board's leadership is limited to picking the right agents and guaranteeing their good actions. Viewed this way, investors should not fret over the trappings of governance for their own sake. They should worry instead about the outward foundations that promise sound leadership inside the boardroom.

2. Board composition and policies

If we view outward governance principles as those practices that optimize directors' decisions for ultimate shareholder benefit, and if we keep in mind that investors are increasingly demanding great decisions from within, then companies should increasingly focus on two visible foundations of good governance in the years ahead: board composition and board policies. Both are vital; neither is sufficient.

The composition of the governing board revolves around how many seats are in the boardroom and who fills the chairs. Once those seats are numbered and then occupied, much of the decision-making to follow has already been pre-determined. This is analogous to asset allocation in investing: once a money manager has divided his or her funds between equities and fixed-income and then more finely among the sub-species, the fund's rates and risks of return are relatively pre-set. Active trading within the asset allocations modestly raises or lowers the rates and risks, but most of the outcome was pre-ordained by the initial allocations. The size of the board and the identity of the directors will similarly pre-determine much of the quality and timeliness of the decisions made therein. Governance policies also shape the quality and timeliness of the board's decisions. Contemporary standards set forward by the U.S. Securities and Exchange Commission and New York Stock Exchange – and comparable organizations in a host of other countries – stress such policies as full disclosure; independent audit, compensation, and nomination committees; and either separation of the chair from the chief executive or appointment of a lead director if not. Such policy prescriptions are intended to focus directors on critical challenges and provide them with full and unbiased information for reaching decisions, regardless of how many directors and who they are (see endnote 2). While the U.S. has spearheaded the reforms for better decision making in the boardroom, comparable initiatives have emerged in most advanced economies in recent years. Companies in the United Kingdom, for example, have benefited from several such waves of reform, dating from a 1992 commission headed by Adrian Cadbury to two commissions formed in response to the Enron catastrophes: One headed by Derek Higgs urged greater director independence from management, and the other lead by Sir Robert Smith recommended stronger audit committees. Similar sets of recommendations were issued in 2002–2003 by commissions in Brazil, Canada, France, Germany, Spain, and elsewhere (see endnote 3). The change initiatives for better board composition and policies are even coming to the developing economies. A World Bank report in 2002 on governance in China, for example, warned that although "corporate governance has moved to the center stage of enterprise re-form in China," relative to "practices in other countries, boards are less independent" and "Chinese capital markets lack mature users of financial information, such as institutional investors and analysts" (see endnote 4).

3. Enron: when governance decisions fail

The consequences of poor governance decisions were evident in the bankruptcy of Enron – an energy trading business that had become the nation's seventh largest company with $100 billion in revenue and 20,000 employees – on December 2, 2001. The fact that it was a governance malfunction and not just an executive failure becomes all the more evident when Enron's decisions are compared with actions that Salomon's board took a decade earlier when it too was faced with imminent demise because of malfeasance in the ranks. On August 22, 2001, Enron vice president Sherron Watkins visited chief executive Kenneth Lay in his Houston headquarters and warned him that the company could "implode in a wave of accounting scandals." At that moment, Lay could have taken specific actions that might have prevented bankruptcy and saved the jobs of thousands of Enron employees. But that would have required a top management team that recognized the gravity of the moment. Yet Lay barely had a top team at all. Chief executive officer Jeffrey Skilling had quit the company a week before. Chief financial officer Andrew S. Fastow had devised the improper accounting schemes. Outside auditor Arthur Andersen had been approving the schemes' special features (see endnote 5).

Still, this failure of executive leadership at the eleventh hour might have been averted if Enron's board had not been malfunctioning over the several prior years. When faced with critical decisions, the company's directors repeatedly opted for paths that led directly to the firm's demise. This emerges from a record of the board's decisions that has come to light because of Enron's special stardom in the black holes of corporate collapses. The post-bankruptcy Enron board assigned a special committee, chaired by William C. Powers, Jr., to investigate, and the U.S. Senate assigned a subcommittee to investigate as well. Both groups were able to command access to board records and company directors that is virtually unprecedented in corporate post-mortems.

For starters, it is conceivable that the outside directors were relatively uninformed of the risks that Enron executives were taking under their noses. If so, it would be arguable that the governance failure was more a matter of ignorance and inadvertence than overt decision-making. The board's deliberations brought to light by the two investigations, however, reveal that the directors were actually very well informed of the company's emergent strategy, the attendant financial risks, and the illicit steps it was taking to hedge against those risks.

Enron's emergent strategy came with the firm's aggressive move several years earlier into energy trading. For this it had required larger and larger lines of credit to have the funds available for daily settlements of the energy contracts that were traded online. But the trading itself created another problem that made it more difficult for Enron to secure those credit lines: Enron's earnings began to fluctuate more and more from quarter to quarter, and as the credit agencies became wary of such unpredictability, they cut Enron's credit ratings, which in turn raised the cost of borrowing. To make matters worse, Enron was also building large power plants that required vast cash outlays long before they could produce a watt, and the resulting additional indebtedness further impaired its credit standing.

To resolve this credit crunch, Enron executives decided to reduce its debt by off-shifting some to third parties. But since few independent parties were ready to step forward, chief financial officer Andrew Fastow began creating his own special purpose entities for doing so. The resulting partnerships – partnerships in name only since the company was in effect partnering with itself – were not disclosed in Enron's public financial statements. But Enron executives logically treated them as part of the c ompany – and they were so described to the board.

Interviews of Enron directors by staff of the Senate subcommittee confirmed that the directors were well aware of this "asset light" strategy of shifting debt to the special purpose entities, the special risks they entailed, and the questionable accounting practices they required. On at least a dozen occasions over the three years prior to August, 2001, directors were so warned by executives. In February, 1999, for example, the board's audit committee met with CEO Kenneth Lay, CFO Jeffrey Skilling, and the outside auditor, Arthur Andersen. The head of the Andersen engagement team, David Duncan, reviewed Enron's 1998 finances with the committee, and he informed its members that in four major accounting areas, Enron's auditing practice was "high" risk. The audit committee also learned that the company's accounting had reached "the edge" of acceptability.

Enron executives themselves frequently informed the directors just how close to the edge of the court they were playing. In mid-1999, chief financial officer Fastow sought board endorsement of a partnership called LJM. That presented a problem since the board-approved ethics code stipulated that "even the appearance of an improper transaction must be avoided," nor should an employee receive any "financial gain separately derived" from service with the company. Chief executive Kenneth Lay reminded all employees in a foreword to the code that "it is absolutely essential that you fully comply with these policies in the future." Also, the board's charter called for the audit committee to oversee company compliance with the firm's ethics code, and Enron's governance policies would thus have dictated that the audit committee receive Fastow's request for review – and then promptly reject it since the transaction would certainly give the appearance of impropriety and Fastow himself stood to gain separately from it. Yet the audit committee, the best positioned to make a fine-honed decision on the request, did not vet the request before it went to the full board. Nor had the finance committee reviewed the financial implications of Fastow's request. In fact, the proposal arrived in the directors' fax machines just three days before a special board meeting that was to be held by teleconference on June 28, 1999 to consider it. The agenda for that meeting was filled with other important matters as well: Authorization of a stock split, placement of more shares in a compensation plan, purchase of a corporate jet, and investment in a Middle Eastern power plant. CEO Kenneth Lay also intended to review an important reorganization of the company already underway. The conference-call was completed in just an hour. With no real discussion of the ethics suspension feasible, a motion seconded by the audit committee chair for approval was swiftly ratified by the directors. The board would vote again for similar ethics suspensions for new LJM entities in October of 1999 and 2000. The board depended upon management to devise controls for monitoring against potentially damaging management decisions in the wake of the ethics-code suspension – since CFO Fastow and his subordinates would now sit on both side of the table in negotiating transactions between the LJM entities and Enron. The board dictated several specific controls, including preparation of a "Deal Approval Sheet" that was to detail the transactions and then require signatures from two or more top executives, such as Jeffrey Skilling, before proceeding. On at least thirteen separate occasions managers who were to represent both sides of a transaction reported directly to Fastow, making those deal sheets particularly important. Yet for many deals the sheets were never prepared, or never signed, or never written until after the transaction was done. Enron executives did withhold vital information at times from the directors that might explain the board's laxness. On November 5, 1997, for instance, CFO Fastow presented the case for an Enron transaction with one of the partnerships to the executive committee of the board. An Enron subordinate, Michael Kopper was serving on both sides of the transaction – simultaneously representing both the company and the nominally independent partnership – but this was not revealed by Fastow nor Kopper, who was also present.

Similarly, at a time when Fastow was seeing his personal assets in the partnerships grow by more than $30 million in 1999–2000, he did not disclose this to the board. The directors became at least vaguely aware of his huge personal windfall but failed to probe far enough into what should have looked like a red flag. The board's finance committee asked the compensation committee to review Fastow's personal gains. The chair of the compensation committee, Charles A. LeMaistre, well understood the request since he had attended the finance committee meeting, and he subsequently asked Enron's top compensation official, Mary Joyce, for data on the outside income of all of Enron's top officers. To avoid setting off alarm bells within the company, LeMaistre did not single out Andrew Fastow in his request, yet it was Fastow's partnership earnings that drove the request. But Mary Joyce, the seniormost compensation executive at the firm, did not forward the requested data, and when LeMaistre asked her again and failed to receive the data a second time, he simply dropped the query (see endnote 6).

Nor were directors fully cognizant of the consequences of all their decisions, and management did little to help them out. In 2001, for example, the compensation committee approved pay plans that gave 65 Enron executives a total of $750 million for their work in 2000, a year in which Enron's total net income was $975 million. When directors were asked by the Senate subcommittee staff why they had approved such exceedingly generous packages, they responded that the $750 million had come from several distinct incentive programs and nobody on the compensation committee had thought to add up the numbers. The chair of the compensation committee added that he "did not worry" about the decisions in any case since he had checked with the board's compensation consultant, Towers Perrin, and was told the company's compensation was "right on track."

Despite the many signs that Enron's asset-light strategy was pushing it to the edge – and maybe well beyond – of acceptable accounting practices, on February 12, 2001, just ten months before bankruptcy, the board's audit committee approved a fresh set of Enron partnership transactions without demurral.

The board's governance policies thus left much to be desired if the criterion is whether they fostered good decision making inside the boardroom. The directors had appreciated and approved Enron's risky solutions to its credit squeeze, but they proved incapable of securing the information that they needed to ensure that their agents implemented the strategy within the law, did not enrich themselves in the process, and did not put the entire enterprise at risk. The directors allowed themselves to enter meetings relatively unprepared to make informed choices, and they permitted deliberation time to be so brief as to negate any chance of taking an informed decision during the meeting. When setting executive compensation, the directors relied upon under-analyzed data, over-relied on consulting opinion, and pursued little follow-up on vexing questions.

Aside from the board's flawed governance policies, its flawed composition no doubt played a role as well in its faulty decisions. Consider the six-person audit committee. All were nominally independent directors. Yet two members were not entirely un-entangled withmanagement. JohnWakeham, a member of the House of Lords, was receiving $72,000 per year from Enron for advising its European operation; John Mendelsohn was president of the University of Texas M.D. Anderson Cancer Center which had been receiving Enron gifts totaling some $1.6 million.

Moreover, three of the audit committee members resided abroad, making for dis-attention if not skewed attention. John Wakeham lived in London, and Paulo Ferraz Pereira, an investment banker and former president of the State Bank of Rio de Janeiro, resided in Brazil. Ronnie Chan, a real estate developer based in Hong Kong, had missed more than a quarter of the board and committee meetings in 1996, 1997, and 2000.

Finally, the chair of the audit panel, Robert K. Jaedicke, a former accounting professor and dean of the Stanford Business School, had served as audit chair since 1985. Because of his long-standing service, when Kenneth Lay, Jeffrey Skilling, and Andrew Fastow began their methodical but incremental descent down the fatal asset-lite path, his gaze may not have been as vigilant as a fresh eye in the chair's role might have been.

The board's composition thus left much to be desired if the directors were to take the right decisions when nobody was watching. It is was an accounting scandal, as Sherron Watkins had warned CEO Kenneth Lay, that brought down the house, and it was thus the audit committee that was most strategically positioned to avert the disaster on behalf of the board. As its six members watched the unfolding train wreck in slow motion, they could have summoned the nerve to challenge their engineers before it was too late.

Yet their remote locations, their dependence on management, and the chair's duration at the helm all contributed to an audit committee whose decisions proved lethal.

One final aspect of the Enron's governance policies is notable for its damaging consequences in the company's final days. After vice president Sherron Watkins wrote CEO Kenneth Lay on August 15, 2001 and then met with him on August 22, an obvious audit committee policy to have had in place would have been to require immediate CEO notification of the audit committee chair.

Yet the chief executive sought outside legal advice instead from the Houston law firm of Vinson & Elkins, which Watkins herself has warned against since it had already reviewed and approved some of the Fastow partnerships.

Vinson & Elkins reported back to Enron on October 15 that its auditing was "aggressive" but not "inappropriate" and only then did the chair of the audit committee finally learn of the Watkins memos and the outside review. And even then, neither the memos nor the identity of their author were revealed to the outside directors. Enron executives would only refer to the messenger as an anonymous employee.

Similarly, a company's outside auditor should report directly to the board, with the audit committee the main point of contact.

Yet even though analysts at Andersen had concluded by October 9 that "a heightened risk of financialstatement fraud" prevailed a Enron, it was not until November 2 that the board learned from Andersen of "possible illegal acts within the company."

Enron directors had raised too few questions and challenged too few assumptions during its many meetings with management. It was a board that routinely relied on Enron executives and Andersen partners for information but took scant effort to verify it. The board quickly approved management's risky steps and illicit partnerships, and then exercised too little oversight of the execution that followed.

4. Salomon: when governance decisions succeeded

The Enron CEO and board still might have averted bankruptcy had they cleaned house once the improper partnerships and the risks they posed became evident by mid-2001. At that point, the company required an outside director with the resolve, credibility, and character to get the job done, and a board whose crisis leadership would be equally vigorous.

A decade earlier, that was precisely what the Salomon board provided to save itself from the life-threatening damage brought on by a rogue manager and a chief executive who failed to take timely action again him. Salomon bond trader Paul Mozer had made an illegal $3.2 billion bid for U.S. treasury securities on February 21, 1991. His boss, John Meriwether, reported the transaction to top management on April 28, but CEO John Gutfreund did not take the infraction seriously and failed to report it for more than three months (see endnote 7).

Gutfreund was so discredited by the delay when it finally became public knowledge on August 15 – the *Wall Street Journal* headlined its article, "Top Salomon Officials Knew About Illegal Bid" – that he knew his 38-year career with Salomon was finished. He called upon Salomon outside director Warren Buffett to step in to resurrect the company and its shattered credibility.

Two days later Buffett flew to New York to take the reigns of Salomon with the board's vigorous backing. The new CEO quickly forced out the old management team and installed his own. Instead of shredding evidence, he turned it all over to investigators. Rather than delegating enforcement to others, Buffett named himself the chief compliance officer. Instead of suspending the code of ethics, Buffett insisted that any violation of any ethical standards, federal regulation, or public statute be brought to his immediate attention. Just three days after taking office, Buffett told all Salomon officers, "You are each expected to report, instantaneously and directly to me, any legal violation or moral failure on behalf of any employee." He furnished his home telephone number and added that parking tickets were among the few exceptions to his reporting requirements.

Warren Buffett asked employees to apply the "newspaper test" to their every decision: Would they be prepared to see whatever they were about to do described in a local paper, "there to be read" by "spouse, children, and friends"? Buffett warned that they would only succeed by "playing aggressively in the center of the court, without resorting to close-to-the line acrobatics."

Though Salomon paid dearly – customers fled, shares dropped, fines topped $290 million – the firm survived, prospered, and was later sold for $9 billion. Had outside director Buffett with the board's support not cleaned house, 9,000 Salomon employees almost certainly would have lost their jobs and thousands of investors their equity.

By contrast, no Enron director stepped forward to avert what was to become the nation's largest bankruptcy, a stark reminder that the leadership of directors is essential. The primary function of Enron's board was to protect investors' equity – and to pick great managers who would responsibly husband and grow that equity. The directors, however, approved a chief financial officer who hid critical information from them, appointed a chief executive who failed to supervise the CFO, and accepted flawed partnerships that they did not fully understand. When it unraveled, none stepped forward to spearhead a housecleaning or restoration.

5. Building the right composition and right policies for the right decisions

The Enron disaster is a potent reminder that good governance comes down to directors making good decisions. With the rare glimpse into those decisions afforded by the hard-hitting post-mortem investigations, we can now work backwards to the outward foundations of governance that should be evident if good decisions are to be taken in the privacy of the boardroom.

Table 1. Members of the Boards of Directors of Enron in 2001 and 2003

2001	2003
Belfer, Robert A.	Ballantine, John W.
Blake, Norman P., Jr.	Haddock, Ron W.
Chan, Ronnie C.	McNeill, Jr., Corbin A.
Duncan, John H.	Troubh, Raymond S.
Foy, Joe H.	
Gramm, Wendy L.	
Jaedicke, Robert K.	
Lay, Kenneth L., Chairman	
Lemaistre, Charles A.	
Skilling, Jeffrey K., CEO	
Urquhart, John A.	
Walker, Charles E.	
Winokur, Herbert S., Jr.	

The first foundation is the composition of the board. The new management team brought into resurrect Enron in the wake of its bankruptcy adopted the view that the failure of its directors to protect the company was partly a product of those who had been meeting in the boardroom. Thus, the company completely replaced its entire incumbent slate:

The second foundation is the policies of the board, and the New York Stock Exchange recommended and the Sarbanes-Oxley Act imposed new policy provisions in 2002 that, had they been in place two years earlier, might well have forced the directors to avoid the missteps they had chosen to take. For example, the New York Stock Exchange's new rules for listed companies will require that:

Non-executive directors must regularly meet without management: Had Enron's outside directors met without Kenneth Lay and Jeffrey Skilling from time to time, their occasional private misgivings about the aggressive accounting schemes might well have congealed into a board rejection of them.

Companies must have audit, compensation, and nominations/governance committees that are comprised of independent directors: If Enron's audit committee had not included two directors who were not independent, it might have earlier questioned the purpose of the company's increasingly questionable special purpose entities. If the chair of the compensation committee, Charles A. LeMaistre, had not formerly served as president of University of Texas M.D. Anderson Cancer Center which had received so many Enron donations, he might have more vigorously followed-up on the indications that the chief financial officer was enriching himself at company expense. Companies must conduct annual performance evaluations of the board and each committee: Had Enron conducted such reviews, the board might have required periodic turnover in the chairs of its committees to ensure fresh perspectives in their deliberations. That could have forced out the audit committee chair, who had been serving in that capacity for more than 13 years when Enron faltered, and rotated in a chair who might have been more alert to the many warning signals that were coming from below. Companies must adopt a code of conduct and disclose any waiver of the codefor directors and officers: If Enron had publicly disclosed that it had waived its ethics code three times to allow the chief financial to sit on both sides of the partnership transactions, investors and analysts would have had more forewarning of the calamity ahead.

The ultimate arbiters of whether companies have established good compositions and good policies for good decisions inside the boardroom are the investors themselves. Some institutional investors have developed their own internal capacity for the systematic appraisal of governance, but most have chosen until recently to ignore company governance or only glance at it because of the high cost of obtaining the right information about it (see endnote 8).

As a sign of the times, however, three intermediaries have stepped into the fore to provide systematic appraisals of the company governance for investors: Institutional Shareholder Services, Standard and Poor's Governance Services, and Governance Metrics International.

Institutional Shareholder Services had long provided institutional investors with independent advisory and appraisal services on company proxy proposals, and it added the "Corporate Governance Quotient" to its proxy advisories. The governance quotient rates a company's governance compared with that of other companies, and four of its seven main criteria focus on the board's composition: who the directors are, how they are paid, what stock they hold, and what continuing education they are receiving. Two criteria concern the board's policies: its bylaw provisions, and the laws of its incorporating state. Standard and Poor's has traditionally provided credit and debt ratings of larger companies, and now it issues a "Corporate Governance Score" as well that evaluates boards on their composition and policies. Newly formed in 2002, Governance Metrics International builds its governance rating from more than 600 points of data, and it too places a premium on appropriate board composition and policies (see endnote 9). Investors have needed all the help they can get in appraising company governance because so much of it occurs behind closed doors – and because it is what the directors do behind those doors that so determines the company's future performance. Investors cannot directly control those decisions, nor should they want to do so. After all, they have elected the directors to do precisely that. Corporate governance is representative democracy, not a Vermont town meeting. But investors must therefore know when companies have the right composition and right policies to assure that the right decisions are made when the boardroom doors are locked.

If companies do have the right directors and practices in place, they will benefit from board leadership along with executive leadership. Great leadership is required of the top management team, but it is equally essential from those who are ultimately responsible for the team and the fate of the firm. Good decisions premised on strategic thinking and followed by timely execution will give the board what it needs to give the investors what they deserve.

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Notes

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5. The Enron account draws upon Enron Corporation, 2000; Lay, 2000; Gillan and Martin, 2002; Lublin, 2002; Powers et al., 2002; U.S. Senate Subcommittee, 2002.
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