Rating Management Behavior and Ethics:
A Proposal to Upgrade the
Corporate Governance Rating Criteria

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I. INTRODUCTION

Corporate governance rating agencies currently do not, but should, include in their rating criteria an employee assessment of managerial behavior and ethics. Governance rating agencies strive to distinguish themselves from their competitors by establishing governance rating criteria that are indicative of whether directors and officers are serving shareholder interests instead of management prerogatives. Adding a rating criterion that is based on a company’s implementation of, and the results from, periodic assessments of managerial behavior and ethics would provide insight into whether the company’s directors and officers are performing their responsibilities to advance shareholder interests.

Governance rating agencies are for-profit providers of corporate governance ratings. These governance rating agencies have experienced tremendous growth in size as well as influence during the past decade. There is a wide range of users and uses for the corporate governance ratings. Some of the users include investors, insurance companies, financial and securities analysts, lawyers, accountants, financial institutions, and the rated companies themselves. These users utilize the data compiled and the ratings assigned by governance rating agencies to make investment and voting decisions, determine premiums, prepare financial and stock reports, provide governance advice, determine credit risk, and benchmark governance practices. Knowing that there is a broad base of clients for and users of corporate governance ratings, public companies pay close attention to the governance ratings assigned to their companies by governance rating agencies. The rated companies strive to adopt governance practices advocated by governance rating agencies in order to garner favorable governance ratings.

Governance rating agencies develop rating criteria that mirror disclosure obligations and operational measures required under law or for listing on stock markets. Rating agencies also establish standards of governance that extend beyond legal and listing requirements or dominant corporate practices to include governance mechanisms that may not be prevalent but that are perceived by rating agencies to be conducive to enhancing directors’ and officers’ performance of their responsibilities to advance shareholder interests.

Empirical evidence has not established a strong correlation between corporate financial profitability and the structural mechanisms relied upon by rating agencies in their rating systems. The rating criteria also do not provide assurance that officers and directors of the corporation are performing their respective responsibilities of management and oversight. The lack of strong linkage between governance rating criteria and corporate performance, financial or otherwise, may be due to the rating agencies’ focus on observable, structural mechanisms as indicators of corporate conduct. Structural mechanisms such as board composition and charter provisions neither indicate the board’s fulfillment of its responsibility to monitor managerial performance nor ensure management’s fulfillment of its responsibility to apply fundamental business precepts. Missing from the current governance rating criteria is an evaluation of the actual conduct and decision-making of the management group, an evaluation that would provide necessary data for the board to perform its oversight responsibility and enhance shareholder value.

Assessment of management’s business standards and conduct can be implemented
through a company-wide survey of employees, the internal stakeholders with daily and direct access to the actual conduct and decision-making of the management group. Employee assessments can provide valuable information to the board in carrying out its fiduciary duty to monitor management performance. Employee assessments can also provide information that is of interest to investors, customers, and other stakeholders, but which is currently unavailable, about management’s affinity for ethical behavior or inclination for ethical lapses.

Part II of this Article examines the governance rating industry, focusing on three prominent rating agencies, their rating scales and criteria, and their influence in the corporate governance arena. Part III discusses the lack of correlation between governance rating criteria and corporate performance, on both financial and nonfinancial dimensions. Part IV demonstrates that management behavior and ethics affect shareholder value. Investors, customers, and other stakeholders are interested in information about management’s actual decision-making process and behaviors. With insider access and opportunity to witness managerial conduct on a routine basis, employees constitute a unique source of nonpublic information about the realities of the company’s governance.

This Article proposes that corporate governance rating agencies include an employee assessment of managerial behavior and ethics as part of the rating agencies’ governance rating criteria. A rating criterion that focuses on management’s behavior and ethics may correlate more closely with the corporation’s performance on both financial and nonfinancial measures.

This Article concludes that governance rating agencies should utilize their strong influence in the realm of corporate governance to motivate companies to conduct employee assessments of management’s behavior and ethics. By utilizing public companies’ implementation of, and results from, employee assessments of managerial conduct as a rating criterion, governance rating agencies can employ their authority in the corporate governance arena to improve the transparency of managerial behavior and ethics, which in turn can enhance corporate integrity and financial performance. Employee assessments can provide information that is of interest to the investing public and potential employees, thereby attracting investors, customers, and employees to the company. In addition, the employee assessments of managerial behavior and ethics will provide the board with information to enhance the board’s performance of its oversight function and to promote management’s business ethics and corporate integrity. As we have learned from the notable corporate events of the past decade, companies can collapse because of poor managerial behavior and ethics. Employees constitute a unique source of information about management conduct, and gathering and evaluating that information for the use of the board and the stakeholders may ultimately act to preserve the company’s financial performance and existence.

II. CORPORATE GOVERNANCE RATINGS

A. Growth of Governance Rating Agencies

The growth in number, size, and influence of corporate governance rating agencies may be attributed to the rise of institutional investors, the implementation of regulatory requirements governing the voting of proxies by investment advisers and money managers, and the continual revelation of financial scandals and governance weaknesses
since the beginning of this millennium. Corporate governance rating agencies’ services include compiling, comparing, and assigning scores on various governance practices deemed significant in determining company performance and shareholder value. These private, profit-making rating agencies also provide research services, advise on proxy voting, and consult with clients on corporate governance matters.

The largest and most influential corporate governance rating agency is Institutional Shareholder Services (ISS), which launched its corporate governance research and advisory business in 1985 and began to rate companies’ governance in 2002. The rise

1. See Peter F. Drucker, Managing in the Next Society 80–82 (2002) (discussing the rise of institutional stock owners and the consequent effect on corporate governance); Matthew Brown, Companies Must Seek to Avoid the “Junk” Governance Rating, CORP. GOVERNANCE ADVISOR, May–June 2003, at 28, 28 (describing the growth of the governance rating industry); Dale A. Oesterle, Year 2002: The Year of the Telecom Meltdown, 2 J. TELECOMM. & HIGH TECH. L. 413, 427–28 (2003) (discussing regulatory and market changes following the financial fiascos in the telecommunications industry in 2002).

2. Brown, supra note 1, at 28; see GovernanceMetrics Int’l, Overview, http://www.gmiratings.com/about/index.html (last visited Sept. 18, 2008) [hereinafter GMI Overview] (“Our premise is straightforward: companies that emphasize corporate governance and transparencies will, over time, generate superior returns and economic performance and lower their cost of capital.”).

3. The Corporate Library, Products, http://www.thecorporatelibrary.com/index.php?f=Std&p=products&x=psba (last visited Sept. 18, 2008) [hereinafter TCL Company Information]; GMI Overview, supra note 2; RiskMetrics Group, About ISS, http://www.issproxy.com/about/index.html (last visited Sept. 18, 2008) [hereinafter About ISS]. There are various other organizations that collect governance data or assign scores to companies on a number of governance measures. See Ken Brown & Robin Sidel, Scoring Boards on Governance Has Its Risks, WALL ST. J., Oct. 2, 2002, at C1 (reporting Moody’s Investor Services’ plan to “incorporate governance analysis into its credit reports”); Louis Lavelle & Amy Borns, . . . And a New Early-Warning System for Investors, BUS. WK., Oct. 28, 2002, at 101 (discussing the inception of Standard & Poor’s corporate governance rating service, for which Standard & Poor’s plans to charge up to $100,000 for a company to be rated); Phyllis Plitch, Moving the Market—Trading the Numbers/Street Sleuth: S&P Quits Rating Corporate Governance in U.S.; Business is Hurt by Costs from Sarbanes-Oxley Law; It Withdraws Fannie Score, WALL ST. J., Sept. 13, 2005, at C3 (reporting on Standard & Poor’s termination of its rating service while continuing to monitor governance practices as part of its credit rating service); Council of Institutional Investors, About the Council, http://www.cii.org/about/benefits/htm (last visited Sept. 18, 2008) (consisting of public, labor, and corporate pension funds with combined assets exceeding $3 million, this organization collects and provides to its members information regarding governance practices and proxy votes); Davis Global Advisors, Inc., Client Services, http://www.davisglobal.com/services.html (last visited Sept. 18, 2008) (specializing in international corporate governance, this organization monitors governance developments and advises in drafting governance guidelines). These organizations, however, are not discussed further in this Article because they either do not provide governance ratings as one of their primary products or do not provide ratings for a comprehensive set of governance practices.

4. See Stephen J. Choi & Jill E. Fisch, How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries, 113 YALE L.J. 269, 294 (2003) (proposing that issuers fund the activities of securities intermediaries, including governance rating agencies, while allowing shareholders to allocate the funding to their preferred intermediaries through vouchers); Martha McNeil Hamilton, Player in the Proxy Wars; HP-Compaq Merger Has Brought a Shareholder-Services Firm out of Obscurity, WASH. POST, Apr. 1, 2002, at E01 (describing ISS’s growth in the 15 plus years since its creation); Monica Langley, Making the Grade: Want to Lift Your Firm’s Rating on Governance? Buy the Test—ISS Ranks Corporations—and Sells a Road Map For Improving Their Score—Drop the Poison Pill: 10 Points, WALL ST. J., June 6, 2003, at A1 (noting that “ISS carries the most clout” in the governance rating arena).


of ISS’ role in the corporate governance arena is evident in the growth of its market value, from $40 million in 2001 to $550 million in 2006. As it owes its growth to the rise in number and activism of institutional investors, ISS has committed to conducting “its entire business in the best interests of its institutional clients.”

ISS rates more than 8000 companies in 31 countries. ISS charges a subscription fee ranging from $10,000 to $17,000 per year for access to its governance ratings of companies. In addition to providing governance rating services, ISS also performs research and provides advice regarding proxy issues in order to assist shareholders cast their votes.

Another well-known name in the governance rating industry is GovernanceMetrics International (GMI), which was formed in 2000 as a corporate governance research and rating agency. GMI counts among its clients the large pension funds TIAA-CREF and the New York State Retirement Fund, in addition to other pension funds, investment managers, banks, insurance companies, credit rating agencies, regulatory agencies, public companies, lawyers, accountants, and consulting firms.

GMI rates over 4100 companies throughout the world and the subscription fee to view the governance ratings issued by GMI starts at $18,000 per year. In addition to providing governance rating services, GMI also performs research and consulting services on governance matters. GMI does not provide advice on proxy issues.

The third main provider of governance ratings is The Corporate Library (TCL), which was formed in 1999 as an adviser on corporate governance matters and a source of


11. Brown, supra note 1, at 36 n.4.

12. Sidel et al., supra note 9. ISS’s voting recommendations cover more than 20,000 shareholder meetings each year. Choi & Fisch, supra note 4, at 294. ISS also provides a service whereby ISS performs the physical tasks of receiving the ballots and casting votes for its clients. Id. Clients who have delegated their voting opportunity to ISS may provide specific voting instructions for ISS to follow, or the clients may allow ISS to cast the votes according to ISS voting guidelines. Id.; Hamilton, supra note 4.

13. GMI Overview, supra note 2.


16. Brown, supra note 1, at 36 n.5.

17. GMI Overview, supra note 2.

18. Brown, supra note 1, at 36 n.5.

19. GMI Overview, supra note 2.

20. Rose, supra note 7, at 903.
information about corporate directors and executives. TCL began to issue governance ratings in 2003. TCL’s founders, Robert Monks and Nell Minow, are former executives of ISS. TCL focuses on corporate governance in the United States, and its clients include insurance brokers and underwriters, institutional investors, lawyers, investment banks, academic researchers, consultants, and director and executive search firms.

TCL’s ratings cover more than 1500 companies. Access to TCL’s Board Analyst database, which contains TCL’s governance ratings, costs from $8000 to $35,000 per year. In addition to providing governance rating services, TCL performs custom research services and compiles an extensive database of information about director and executive compensation, insider trading, takeover defenses, shareholder proposals, securities class action litigation, mergers and acquisitions, and governance policies.

B. Governance Rating Process

1. Rating Scales

ISS’s name for its governance ratings is the Corporate Governance Quotient (CGQ). The CGQ is a comparative rating in that it ranks a company against other rated companies within a stock index (e.g., S&P 500, Fortune 1000, or Russell 3000). The CGQ also ranks a company against other rated companies that are industry peers within Standard & Poor’s sector groupings. CGQ ratings range from 0% to 100%. Thus, a rating of 75% indicates that the rated company has “better governance” than 75% of the company’s industry peers.

GMI reports its governance ratings on a scale from one to ten, with the higher number signifying a better governance structure. GMI ratings are comparative in that they compare the rated company against all other companies rated by GMI in the world and against all other companies rated by GMI in the same country of domicile.

22. Brown, supra note 1, at 28.
23. Rose, supra note 7, at 903.
24. TCL Questions, supra note 21.
27. Brown, supra note 1, at 36 n.6.
30. Brown, supra note 1, at 29.
31. Id.
32. Id.
33. See Langley, supra note 4 (explaining that a rating of 30% means that 70% of the company’s industry peers had “better governance”).
34. GMI Overview, supra note 2.
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TCL rates companies on a scale from A to F, assigning an A to those companies that TCL believes have the lowest level of governance risk and designating an F to those companies that TCL believes represent the highest level of governance risk. 36 The letter grades signify the varying degrees of board effectiveness relating to board composition, compensation practices, takeover defenses, and accounting concerns. 37

2. Rating Criteria

ISS, GMI, and TCL have each developed their own rating criteria 38 and scoring methodology 39 to arrive at the governance ratings. Although ISS, GMI, and TCL have their own collection of rating criteria, each governance rating agency focuses on several common areas and variables of corporate governance.

One common area of focus in the rating criteria is the board of directors’ composition and structure, which seeks to address the board’s ability to effectively monitor management activities. 40 For this area, rating agencies evaluate governance measures such as the independence of the board and key committees, director term and age limits, and directors’ service on other boards. 41

ISS, GMI, and TCL each reviews the company’s audit and accounting processes for purposes of assessing the independence, effectiveness, and transparency of the company’s financial and audit procedures. 42 Rating criteria for this topic include the financial expertise of audit committee members, the relative amounts of audit and nonaudit fees, and audit and accounting practices at the company. 43

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38. See Brown, supra note 1, at 30 (stating that GMI ratings are based on more than 600 criteria); Institutional Shareholder Services, Rating Criteria, http://www.iss.com/RatingCriteria.htm (last visited Sept. 18, 2008) [hereinafter ISS Rating Criteria] (listing ISS’s 61 rating criteria); TCL Ratings, supra note 37 (declaring that TCL examines “more than 1,100 individual data points” to perform their ratings).

39. See GMI Overview, supra note 2 (declaring that GMI’s proprietary scoring algorithm assigns numerical value to each rating criteria and weights the criteria according to investor interest); ISS Corporate Governance Quotient, supra note 29 (stating that some rating criteria are analyzed in combination, such that a company with both a majority-independent board and an all-independent audit committee would receive a higher rating for each of these criteria than the company would receive if it had only one of the criteria); TCL Ratings, supra note 37 (proclaiming that TCL’s “unique quantitative ratings formula identifies and highlights certain key ‘red flag’ indicators of board ineffectiveness”).

40. See Brown, supra note 1, at 34 (describing the purpose underlying Standard & Poor’s rating criteria).


42. See Brown, supra note 1, at 34 (describing the purpose underlying Standard & Poor’s rating criteria).

43. GMI PIONEERING ACCOUNTABILITY, supra note 41, at 3; ISS Rating Criteria, supra note 38; see TCL Rated Companies, supra note 41 (specifying that TCL’s rating criteria include an accounting component, which analyzes a company’s financial statements for potential earnings management and accounting irregularities).
Another common area of interest to all three primary governance rating agencies is the directors’ and officers’ stock ownership in the company and the company’s compensation system for directors and officers. Rating agencies believe stock ownership and compensation systems should be designed to motivate directors and officers to advance the long-term interests of the company.\footnote{44} For this governance category, rating agencies evaluate the amounts and forms of compensation and the extent to which compensation is related to clearly articulated performance measures.\footnote{45}

ISS, GMI, and TCL each measures the rated company’s protection of shareholder interests, particularly in relation to voting rights and takeover defenses. With respect to shareholder voting, rating agencies believe shareholders should be empowered with the ability to voice their opinions and make decisions on certain corporate issues in order to protect their interests.\footnote{46} With respect to takeover defenses, rating agencies believe that directors and executives should be open to changes in leadership and ownership structures that would increase shareholder value.\footnote{47} Governance features affecting shareholder interests include whether all directors on the board are subject to election on an annual basis, the amount of votes required for shareholders to take action, and the types of anti-takeover provisions adopted by the company.\footnote{48}

\section*{C. Influence of Governance Ratings}

\subsection*{1. Wide Range of Clients and Users}

Governance rating agencies have developed a large client base in the marketplace. Following the financial and accounting scandals in the early years of this millennium, investors, stakeholders, industry and professional groups, and regulatory agencies voiced their desire for more information about the governance practices of American corporations.\footnote{49} The increasing concentration of stock ownership in the hands of institutional investors, and the interest of these institutional investors in the governance of public companies, have also fueled the need for information about corporate governance practices.\footnote{50}

Moreover, regulatory requirements have contributed to the demand for corporate governance ratings and other governance advisory services. Regulations under the Employee Retirement Income Security Act require pension fund managers to establish procedures for proxy voting, to vote proxies in the best interests of fund beneficiaries,}

\footnote{44. See Brown, supra note 1, at 34–35 (describing the purpose underlying Standard & Poor’s rating criteria).
45. GMI PIONEERING ACCOUNTABILITY, supra note 41, at 4; ISS Rating Criteria, supra note 38; TCL Rated Companies, supra note 41.
46. See Brown, supra note 1, at 33–34 (describing the purpose underlying Standard & Poor’s rating criteria).
47. See id. at 34 (describing the purpose underlying Standard & Poor’s rating criteria).
48. GMI PIONEERING ACCOUNTABILITY, supra note 41, at 3–4; ISS Rating Criteria, supra note 38; see TCL Rated Companies, supra note 41 (specifying that TCL’s governance ratings favor companies that provide shareholders with a vote in the event of a takeover attempt).
49. See Brown, supra note 1, at 28 (describing the growth of the governance rating industry); Oesterle, supra note 1, at 426–28 (discussing regulatory and market changes following the financial fiascos in the telecommunication industry in 2002).
50. See infra notes 106–11 and accompanying text.}
and to maintain proxy voting records. In addition, the Securities and Exchange Commission (Commission) has promulgated rules to require investment advisers to adopt policies and procedures to reasonably ensure that the advisers vote proxies in their clients’ best interests, to disclose those policies and procedures to the clients, to inform clients how to obtain the voting records for the clients’ proxies, and to maintain records relating to the advisers’ proxy voting.

The Commission has also adopted rules requiring mutual funds to disclose in their registration statements the policies and procedures that the mutual fund uses to determine how to vote proxies, to file with the Commission and to make available to shareholders the mutual fund’s records of proxy votes, and to disclose to shareholders the methods by which shareholders may obtain information about the mutual fund’s proxy voting. These regulatory requirements may have motivated investment funds and investment advisers to purchase access to the corporate governance ratings.

Reviewing the governance ratings of companies in which the funds invest in order to determine how to vote the proxies that the funds and their advisers hold may assist the funds and advisers to demonstrate compliance with their legal obligations to establish procedures for proxy voting and to vote proxies in the best interests of beneficiaries.

Although there are questions about the accuracy and validity of the governance ratings, which will be discussed later in this Article, governance ratings influence a wide group of clients and users. In addition to the investment funds and advisers discussed above, the clients and users for the governance ratings include the following: investors, insurance companies, financial and securities analysts, lawyers, accountants, financial institutions, and the rated companies themselves.

Investors, both individual and institutional, utilize the governance ratings to make investment and voting decisions. Governance ratings reflect the philosophies and
perspectives of rating agencies regarding various governance practices, and these philosophies and perspectives are also incorporated into the consulting and advisory services that rating agencies provide to their investor clients. In addition to directly influencing the investment and voting decisions of investors who subscribe to the ratings, governance rating agencies may also indirectly influence investment and voting choices when stock analysts incorporate governance ratings into their stock research reports. Investment banks Prudential Securities, Solomon Smith Barney, and Goldman Sachs, for example, include in their research reports the governance rating assigned by ISS to the companies analyzed in the stock research reports.

Governance ratings are being used for more than just investment and voting purposes. Insurance companies, for example, analyze the governance ratings to determine a company’s risk of being sued by shareholders. Such analysis assists the insurance companies to determine directors’ and officers’ liability insurance premiums.

Financial and security analysts use governance ratings to gain governance information about the companies, industries, markets, countries, and regions for which the analysts cover or advise. Lawyers, accountants, and other professional advisers may use the governance ratings in their practice of advising corporate clients and benchmarking governance policies and compensation practices. In addition, banks and other financial institutions use the ratings to adjust for governance risks in their capital asset pricing and credit risk models.

58. Rose, supra note 7, at 898; see Choi & Fisch, supra note 4, at 272, 294–95 (discussing the role of securities intermediaries, including governance rating agencies, in providing information to the marketplace and improving shareholder monitoring of management).

59. See Prudential Research Cites Corp Governance Ratings, REUTERS NEWS SERVICE, Apr. 2, 2003 (reporting that according to ISS, “Wall Street investment bank Prudential Securities has begun to include corporate governance ratings in its stock research reports”).

60. See id. (naming Prudential Securities); Brown, supra note 1, at 30 (naming Solomon Smith Barney and Goldman Sachs).

61. See Brown & Sidel, supra note 3 (reporting that few organizations “have more to lose from weak corporate governance than those that sell liability insurance that covers corporate directors and officers”); Sean J. Griffith, Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors’ and Officers’ Liability Insurance Policies, 154 U. Pa. L. Rev. 1147, 1155 (2006) (stating that “[g]ood governance ought to lead to less litigation”). Not all would agree, however, that good governance leads to less litigation. See Brown & Sidel, supra note 3 (citing an internal memo of insurance giant American International Group which concludes that although “it may seem intuitive that poor corporate governance leads to greater claim activity, and that good corporate governance leads to less claim activity, the reality of the situation does not bear this out”).

62. TCL Company Information, supra note 3; see GMI EVIDENCE, supra note 35, at 9 (suggesting that a company with a good governance rating may be able to reduce its directors’ and officers’ liability insurance costs); Griffith, supra note 61, at 1180 (observing that insurance companies adjust their insurance rates for corporate governance attributes such as ownership structures, management experience, and constituency relationships).

63. See GMI Overview, supra note 2 (providing access to subscriptions based on companies, geographic regions, countries, market sectors, and industries).


65. GMI EVIDENCE, supra note 35, at 9; see GMI RATINGS, supra note 16, at 1–3 (citing studies that demonstrate “the market is becoming more adept at applying governance factors into pricing models and discount rates”).
Public companies use governance ratings to benchmark their governance practices with industry peers and competitors. In order to attract investors, especially pension funds, mutual funds, and other institutional investors, public companies closely monitor the governance practices that will garner favorable marks from corporate governance rating agencies. Rated companies may also strive for good governance ratings in order to lower their capital costs, reduce the risk of shareholder actions, and increase the chance of attracting director and executive candidates. A good governance rating may enable a company to reduce its insurance premium costs. In addition, public companies may monitor the ratings of their governance practices in order to avoid or manage potential negative publicity.

2. Deep Impact on Governance Practices

Corporate governance rating criteria not only reflect, but in many cases extend, the requirements under securities laws, stock market listing standards, and codes of corporate governance promulgated by industry and professional groups. For example, the Sarbanes-Oxley Act requires public companies to have an audit committee composed entirely of independent directors. The listing standards of the NYSE and the Nasdaq

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66. GMI EVIDENCE, supra note 35, at 9; TCL Company Information, supra note 3; see Langley, supra note 4 (noting that when Aetna’s corporate secretary informed the board that the company had received a favorable governance rating of 99.7%, several directors asked: “What about our competitors’ grade?”).
67. See Rose, supra note 7, at 898 (explaining that governance rating agencies advance their governance positions through giving higher ratings to companies that have, and downgrading companies that do not have, the preferred governance practices).
68. GMI EVIDENCE, supra note 35, at 9; TCL Company Information, supra note 3.
69. See Griffith, supra note 61, at 1181 (suggesting that companies may reduce their insurance costs by improving their governance structures).
70. Brown, supra note 1, at 28.
71. GMI OVERVIEW, supra note 2. Industry and professional groups that issue codes of corporate governance include the Organisation for Economic Cooperation and Development, The Commonwealth Association for Corporate Governance, the International Corporate Governance Network, and the Business Roundtable. Id. The American Law Institute has also issued guidance on corporate governance. See generally AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1994) (providing analysis and recommendations on corporate governance).
72. Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1(m)(3) (Supp. V 2005). Being “independent” means the audit committee member may not be an affiliate of the company and may not receive fees from the company, other than fees for service on the board or board committees. Id. An “affiliate” of the company is a person controlling, controlled by, or under common control with the company. 17 C.F.R. § 240.10A-3(e)(1)(i) (2007). Having “control” means having the power to direct or cause the direction of the management and policies of the company through the ownership of voting securities, by contract, or otherwise. Id. § 240.10A-3(e)(4).
73. N.Y. STOCK EXCH., FINAL NYSE CORPORATE GOVERNANCE RULES 4–10 (2003), available at http://www.nyse.com/pdfs/finalcorpgrules.pdf. Under NYSE requirements, a director is not independent if the director receives compensation of more than $100,000 per year from the company, other than board fees, or if the director is doing business with the company in excess of the greater of $1,000,000 or 2% of the other company’s gross revenues. Id. In addition, a director is not considered independent unless the board determines affirmatively that the director and the company have no material relationships, whether in the nature of commercial, industrial, banking, consulting, legal, accounting, charitable, or familial relationships. Id. Material relationships may occur directly between the director and the company, or indirectly through the director being a partner, shareholder, or officer of an organization that has a relationship with the company. Id.
Stock Market require public companies to have a majority of the board composed of independent directors and to have the entire nominating, compensation, and audit committees composed of independent directors.

The reasoning for the director independence requirement is that outside directors may be more effective than inside directors in monitoring management conduct, as the outside directors’ financial dependence on the corporation in most cases is limited to a fixed director’s fee instead of a variable management compensation package that is subject to fluctuation depending on the financial performance of the corporation. Adhering to this philosophy, governance rating agencies give strong emphasis to director independence, defining independence more strictly than the Commission and the securities markets do. GMI, for example, explains its director classification system as “simply, an independent director is someone whose only connection to the company is his or her board seat.” Rating agencies also assign favorable ratings to a company’s board only when a majority or supermajority of the board is composed of independent directors, and each of the audit, compensation, and nominating committees is composed entirely of independent directors.

The influence of governance ratings on corporate governance practices extends beyond reiterating legal and listing standards and documenting the currently dominant governance practices. In addition to comparing rated companies’ governance practices to regulatory and stock market listing standards and against the practices of industry peers, governance rating agencies also establish rating criteria to promote governance

74. SEC Adopts Final Nasdaq Listing Standards on Corporate Governance, SEC UPDATE (Hogan & Hartson LLP, Washington, D.C.), Nov. 6, 2003, at 2–4, available at http://www.realcorporatelawyer.com/pdfs/10603nasdaq.pdf. Nasdaq’s standards for director independence are similar to the NYSE standards discussed above, but Nasdaq’s cut-off for nonboard related compensation is $60,000 per year and the cut-off for the director’s business payments to or income from the company is greater of $200,000 or 5% of the other company’s gross revenues. See id. (explaining Nasdaq’s listing requirements).


76. See supra notes 72–74 and accompanying text for the definition of “independence” as used by the Commission, the NYSE, and Nasdaq Stock Market.


78. See GOVERNANCE METRICS INT’L, GMI GOVERNANCE AND PERFORMANCE ANALYSIS 6 (2004) [hereinafter GMI PERFORMANCE ANALYSIS] (stating that “companies with greater than 50% independent directors received higher overall governance ratings than companies with less than 50% independent directors”).

79. See Rose, supra note 7, at 900–01 (pointing out that having over 90% independent directors or between 75%-90% independent directors on the board are two of the most important factors in the determination of ISS’s governance ratings).

80. See GMI PIONEERING ACCOUNTABILITY, supra note 41, at 3–4 (including fully independent nomination, audit, and remuneration committees in the governance rating criteria); Carol Silverman, MERCER HUMAN RESOURCE CONSULTING ARTICLES, in ADVANCED DOING DEALS 2003: DEALMAKING IN THE NEW TRANSACTIONAL MARKETPLACE 731, 762 (Practising Law Inst. 2003) (observing that “ISS continues to press companies to have only independent directors on the audit, compensation, and nominating committees”); The Corporate Library, MASTER FIELD DEFINITIONS LIST, http://www.boardanalyst.com/helpcenter/FlashHelp/Master_Field_Definitions_List.htm (last visited Apr. 9, 2007) (classifying an audit, compensation, or nominating committee as independent only if it is comprised wholly of independent directors).
mechanisms that are not common or prevalent in practice but that are viewed by business leaders, governance experts, and professional groups as indicative of strong corporate governance.  

Although no legal or listing standards require companies to have two different individuals in the roles of board chair and chief executive officer, governance rating agencies assign strong ratings to companies that separate their board chair and chief executive positions.  

The reasoning behind the preference for splitting the posts of chief executive and board chair is to enhance the board’s role as an independent monitor of management’s performance.  

The rating agencies also advocate that companies impose limits on the term and age of directors and prohibit their retired chief executive from serving on the board.  

There is no regulatory or stock exchange limit on the number of boards on which directors can serve, but rating agencies look unfavorably upon and will lower the ratings of boards with over-committed directors.  

Governance rating agencies perceive that a director who serves on many boards will spend less time and effort in serving the rated company’s shareholder interests.  

Rating agencies also disfavor “board interlocks,” which entail chief executive officers of different companies serving on each other’s boards of directors.  

Board interlocks give rise to issues of independent oversight because interlocked directors may lack the independence to objectively evaluate the company’s chief executive officer, as that same chief executive officer sits on the board of directors.

81. See R. William Ide, Post-Enron Corporate Governance Opportunities: Creating a Culture of Greater Board Collaboration and Oversight, 54 MERCER L. REV. 829, 831–32, 845–46 (2003) (discussing the efforts of regulatory and self-governing organizations to empower independent directors post-Enron); Amir N. Licht, The Maximands of Corporate Governance: A Theory of Values and Cognitive Style, 29 DEL. J. CORP. L. 649, 742 n.363 (2004) (observing that rating agencies derive their rating criteria from codes of corporate governance promulgated by business and professional groups); Sidel et al., supra note 9 (observing that ISS “has built its reputation as an advocate for good corporate governance”); GMI Overview, supra note 2 (declaring that the GMI rating model was developed in consultation with governance experts, legal advisors, institutional investors, and business leaders).

82. See GMI PIONEERING ACCOUNTABILITY, supra note 41, at 3 (reviewing whether the company has a combined board chair and chief executive officer); Silverman, supra note 80, at 748 (stating that ISS assigns a lower rating to companies that have combined their chairman and chief executive officer positions).

83. See Joann S. Lublin, Splitting Posts of Chairman, CEO Catches On, WALL ST. J., Nov. 11, 2002, at B1 (explaining that the CEO and Chair roles should be split to protect the board’s ability to monitor management’s performance).

84. See Silverman, supra note 80, at 748 (stating that ISS regards a mandatory retirement age and term limits as favorable to a company’s governance rating).

85. See GMI PIONEERING ACCOUNTABILITY, supra note 41, at 3 (reviewing whether the former chief executive officer should serve on the board).

86. See Silverman, supra note 80, at 748 (explaining that ISS considers as negative those directors who are “over-committed by serving on too many boards”).

87. See Robert Charles Clark, Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too, 22 GA. ST. U. L. REV. 251, 273 (2005) (explaining that “heavily committed directors cannot do a good job”); Lynn A. Stout, On the Proper Motives of Corporate Directors (or, Why You Don’t Want to Invite Homo Economicus to Join Your Board), 28 DEL. J. CORP. L. 1, 17–18 (2003) (observing that directors who have fewer demands may be more willing to altruistically devote time and efforts to overseeing the corporation’s business).

88. See Silverman, supra note 80, at 754 (stating that shareholders are “sensitive to board interlocks”).

89. Id.; see Lublin, supra note 83 (quoting a report by the National Association of Corporate Directors which states that it is “difficult . . . to see how an active CEO, already responsible for the operations of the
boards of companies for which the interlocked directors serve as chief executives.

Governance ratings assist investors to evaluate information that is required to be disclosed under laws, but which the investors might not have time or knowledge to obtain and analyze. For example, public companies are required to disclose the audit and nonaudit fees that the companies pay to their external auditors.90 The rationale underlying this requirement is that auditors who also offer nonaudit services91 may be tempted to be lax in auditing a company’s financial statements in the hope that management will reward the agreeable auditors with contracts for more lucrative nonaudit services.92

Governance rating agencies assist investors to evaluate audit fee information by assigning a rating to the relative amounts of audit and nonaudit fees that a company pays its auditors, giving a lower score to companies that pay their external auditors more nonaudit fees than audit fees.93 Thus, an investor who has particular concerns about audit fees can review the rating for that governance criterion in making investment decisions. Other investors with no interests or concerns about audit fees may simply look to the overall governance rating for the corporation when making their investment decisions. The audit fee rating also may have influence beyond the investment decision, in that it may encourage investors to sponsor shareholder resolutions requesting the board to reduce or even completely eliminate nonaudit services from the company’s external auditors.94

Although there is no legal or listing requirement regarding the amount of company stock that directors or executives should own, governance rating agencies take a definite stand on the matter of directors’ and executives’ stock ownership. Rating agencies regard as highly favorable the ownership by corporate directors and officers of substantial amounts of company stock.95 The rationale is that stock ownership provides an incentive for directors and officers to serve the corporation’s long-term interests.96 A substantial

91. Registered public accounting firms are prohibited from providing the following services to the public companies that the firms audit: bookkeeping, financial information systems design and implementation, appraisal or valuation services, fairness opinions, actuarial services, internal audit services, human resource services, broker or dealer services, investment adviser or banking services, and legal services. Sarbanes-Oxley Act of 2002 § 201, 15 U.S.C. § 78j-l(g) (2004).
92. Silverman, supra note 80, at 754; see Clark, supra note 87, at 261 (explaining that accounting firms may fear losing profitable consulting engagements if the firms do not present audit results agreeable to company management).
93. See GMI PROVING ACCOUNTABILITY, supra note 41, at 3 (reviewing whether the company “paid auditors less for audit services than for other services”); Silverman, supra note 80, at 734 (explaining that ISS will downgrade a company’s governance rating if the fees the company pays to its external auditors for nonaudit services are greater than for audit services).
94. See Clark, supra note 87, at 261 (citing the example of CalPERS, California’s state pension fund for public employees, sponsoring shareholder resolutions asking companies to cease using accountants for nonaudit services); Silverman, supra note 80, at 753–55, 763 (reporting that shareholders have initiated proposals on auditor independence, and companies have been pressured by shareholder activism to not hire accounting firms for nonaudit services); Claudia H. Deutsch, Revolt of the Shareholders, N.Y. TIMES, Feb. 23, 2003, § 3, at 1 (listing shareholder resolutions calling for companies to limit consulting fees to auditors).
95. See GMI PERFORMANCE ANALYSIS, supra note 78, at 7 (stating that “one of the hallmarks of good corporate governance is significant share ownership by Directors and Officers of the company”).
96. See James H. Cheek III, Recent Developments Affecting Compensation Committees, in FIRST ANNUAL
stock ownership may thus temper management’s incentives to make short-term decisions such as propping up stock prices in order to exercise stock options or manipulating earnings reports in order to pump up variable compensation payouts. Based on this rationale, governance rating agencies assign high ratings to companies with meaningful stock ownership by directors and officers. The rating agencies’ clear preference for director and officer stock ownership in the company influences public companies’ establishment of stock ownership guidelines and implementation of stock-based compensation practices.

State laws permit companies to hold director elections on a staggered, instead of annual, basis. Staggered elections, which permit a company to have only some of its directors stand for election each year, provide a takeover defense that governance rating agencies believe may lower shareholder investment returns. Thus, despite explicit statutory authorization for staggered elections, rating agencies are strong advocates of annual elections and will downgrade a company’s governance rating if the company does not provide for annual elections of the entire board. Governance rating agencies’ disdain for staggered elections may motivate shareholders to propose resolutions to eliminate staggered terms for corporate directors. Such shareholder proposals have received strong support from shareholders and consequently have prompted a number

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97. Id.
98. See GMI PERFORMANCE ANALYSIS, supra note 78, at 7 (citing evidence that companies with more than 50% of the shares held by directors and officers have higher shareholder returns than companies with less share ownership by directors and officers); Silverman, supra note 80, at 749 (stating that stock ownership guidelines and stock-based compensation for directors and officers will contribute to a favorable ISS rating).
99. See Cheek, supra note 96, at 351, 353–54 (indicating that governance ratings impact compensation committees’ decisions regarding compensation practices).
100. See DEL. CODE ANN. tit. 8, § 141(d) (2006); MODEL BUS. CORP. ACT § 8.06 (2006).
101. See Steven A. Ramirez, The Special Interest Race to CEO Primary and the End of Corporate Governance Law, 32 DEL. J. CORP. L. 345, 376 (2007) (explaining that “a staggered board may be a powerful antitakeover device that operates to frustrate the ability of outsiders to seize control of a corporation”); Mark Hulbert, Who Best Protects Shareholders? The Shareholders, N.Y. TIMES, Nov. 4, 2001, § 3, at 8 (citing an empirical study by Paul Gompers, Joy Ishii, and Andrew Metrick that shows a decrease in shareholder value in companies that hold staggered director elections and impose other restrictions on shareholder rights). Not everyone agrees that a staggered board decreases shareholder value, however, as “conventional wisdom [holds that staggered boards] enhance [shareholder] value by forcing hostile bidders to pay higher prices for their targets.” Robin Sidel, Staggered Terms for Board Members Are Said to Erode Shareholder Value, Not Enhance It, WALL. ST. J., Apr. 1, 2002, at C2.
102. See GMI PIONEERING ACCOUNTABILITY, supra note 41, at 3 (including annual director election by shareholders as a rating criterion); Silverman, supra note 80, at 734, 748 (explaining that ISS gives a higher score to companies that have annual elections of all directors).
103. See CalPERS’ Annual List Targets 11 Companies; Resistance to Corporate Changes Cited, 12 CORP. COUNS. WKLY. (BNA) 96, 96 (Mar. 21, 2007) (noting CalPERS’ shareholder resolution at Kellogg Corporation to eliminate the company’s staggered board); Deutsch, supra note 94 (discussing shareholder resolutions calling for the elimination of staggered director elections).
104. See Deutsch, supra note 94 (reporting that shareholders of Airborne Express approved a resolution asking the company to eliminate staggered director elections); Gretchen Morgenson, FirstEnergy Shareholders Suffer a Power Failure, Too, N.Y. TIMES, Aug. 24, 2003, § 3, at 1 (noting that 65% of shareholders of FirstEnergy Corp. voted to put the company’s entire board to annual elections).
of companies to change their board election practices.105

Corporate share ownership has been increasingly concentrated in the hands of institutional investors.106 Along with the concentrated ownership has been the rise of activities by institutional shareholders in publicly asserting their viewpoints and initiating shareholder proposals on a variety of governance issues, ranging from director qualification and independence to executive compensation plans.107 The influence of governance rating agencies on the activities of institutional shareholders has been highlighted in high profile proxy contests over director elections,108 merger transactions,109 and hostile takeover bids.110 The influence of governance rating agencies on corporate governance matters is difficult to dispute as institutional investors rarely act contrary to, but instead often blindly follow, the governance positions advocated by the rating agencies as reflected in the governance rating criteria.111

The prominent role and growing influence of corporate governance rating agencies have not come without questions about the value or validity of the governance ratings.112

105. See Deutsch, supra note 94 (reporting that Airborne Express conceded to shareholders’ demand to eliminate staggered director elections); William J. Holstein, Raising Labor’s Hand at Annual Meetings, N.Y. TIMES, Oct. 22, 2006, § 3, at 1 (quoting the director of pension and benefit policy at American Federation of State, County and Municipal Employees as saying that “five of the six companies we had filed resolutions with ultimately agreed that they would hold annual elections”).

106. See Choi & Fisch, supra note 4, at 279 (noting that institutional investors hold almost 60% of the capital stock of the largest public companies in the United States); Press Release, Pfizer, Pfizer Board of Directors to Initiate Face-To-Face Meetings with Company’s Institutional Investors on Corporate Governance Policies and Practices (June 28, 2007) (on file with author) (disclosing that Pfizer’s largest institutional shareholders own approximately 35% of the company’s shares).

107. See DRUCKER, supra note 1, at 80–82 (discussing the rise of institutional stock owners and the consequent effect on corporate governance); Choi & Fisch, supra note 4, at 280 n.35 (citing examples of institutional shareholder activism on issues of executive compensation, mergers, and derivative litigation); Melvin A. Eisenberg, Corporate Law and Social Norms, 99 COLUM. L. REV. 1253, 1283–87 (1999) (attributing the rise in institutional shareholder activism to regulatory developments, economic changes, and the growth of infrastructures that facilitate shareholder activity); Skeel, supra note 57, at 1836–38 (observing that “[w]hen CalPERS talks, corporate America listens,” and discussing the success of CalPERS in inducing companies to make governance changes by publicly releasing its “focus list” of low performers on economic and governance measures); Sidel et al., supra note 9 (noting shareholder activism in the areas of executive compensation and shareholder rights plans); Press Release, Pfizer supra note 106 (announcing Pfizer’s intention to initiate a regular meeting between its board of directors and the company’s largest institutional shareholders to discuss Pfizer’s governance and compensation policies).

108. See Rose, supra note 7, at 890 (pointing to the ousting of Michael Eisner from the Walt Disney board).

109. See Tom Johnson, Proxy Analysts Take Spotlight in Merger: Compaq, HP Await Recommendation, HOUS. CHRON., Mar. 5, 2002, at B1 (describing the influence of ISS’ recommendation on the outcome of the highly contested Hewlett-Packard merger with Compaq); Sidel et al., supra note 9 (reporting that institutional investors looked to ISS for voting guidance in the contentious proxy fight over the Hewlett-Packard merger with Compaq); Paul Taylor, HP–Compaq Vote to Test Adviser’s Influence, FIN. TIMES (London), Mar. 8, 2002, at 24 (noting that approximately 23% of the Hewlett-Packard stock was owned by companies who were clients of ISS).

110. See Hamilton, supra note 4 (recounting ISS’s support for Weyerhaeuser Company’s takeover bid for a competitor in the forest-products business).

111. See Sidel et al., supra note 9 (explaining that institutional investors often blindly follow ISS positions when voting in “more-mundane proxy fights”); Rose, supra note 7, at 898 (noting that “[p]roxy advisers generally base their decisions on corporate governance standards that are derived from the same policies as those used to formulate governance ratings and related governance advice”).

112. In addition to the issues raised about governance ratings that are discussed in this article, another
Concerns have been raised about governance rating agencies’ conflicts of interest. Rating agencies rely for much of their revenue on the research and advisory services that they provide to institutional investors, including mutual funds, pension funds, and other investment managers.\textsuperscript{113} As investment managers are hired by the very same companies that are rated by governance rating agencies, the investment managers may be inclined to steer away from buying research and advisory services from rating agencies that are critical of the companies’ governance practices, lest the companies stop hiring the money managers for investment management services.\textsuperscript{114} Thus, rating agencies may have incentives to be lenient in rating these companies so as to not alienate the investment managers on which the governance rating agencies rely for much of their revenue.

Another area of conflicting interests is the rating agencies’ provision of governance consulting services to the very same companies that the agencies also rate.\textsuperscript{115} A company that disagrees or is unhappy with the governance ratings given to it by a rating agency is unlikely to purchase further governance consulting services from that same rating agency.\textsuperscript{116} Thus, rating agencies may have strong financial incentives to give good governance ratings to their governance consulting clients.\textsuperscript{117}

113. Choi & Fisch, supra note 4, at 298. None of the rating agencies charge the rated companies to prepare the governance ratings, but GMI charges companies that request GMI to do a “comprehensive rating.” GMI EVIDENCE, supra note 35, at 9; Brown, supra note 1, at 31. In a comprehensive rating, GMI goes beyond the “basic rating” process of reviewing a company’s public information to also reviewing the company’s internal documents and interviewing company directors and executives about the company’s governance philosophy and practices. Brown, supra note 1, at 31. GMI charges the rated company $50,000 for a comprehensive rating. Id. at 36 n.5. Standard & Poor’s, which offered governance rating services from 2002 to 2005, rated only companies that were willing to pay between $20,000 and $100,000 for a governance rating; Standard & Poor’s not only left it up to companies to decide whether they would be rated but also whether they would publicly disclose their ratings. Lavelle & Borrus, supra note 3, at 101; Plitch, supra note 3. In Standard & Poor’s short history of providing governance rating services, only a few companies purchased a governance rating, which may have been the reason why Standard & Poor’s terminated this line of service. Plitch, supra note 3.

114. Choi & Fisch, supra note 4, at 298.

115. To avoid this conflict of interest, GMI and TCL do not provide corporate governance advisory services to the companies that they rate. GMI EVIDENCE, supra note 35, at 8; TCL Ratings, supra note 37. This perceived conflict of interest may have caused some large institutional investors to stop purchasing advisory services from ISS. See Rose, supra note 7, at 907 (citing examples of clients that have terminated their relationships with ISS).

116. Choi & Fisch, supra note 4, at 298.

117. This conflict of interest is similar to the conflicts that accounting firms face in their provision of consulting services to the same companies that the accountants audit. See Clark, supra note 87, at 261 (explaining that accounting firms may fear losing profitable consulting engagements if the firms do not present audit results agreeable to company management). See generally John C. Coffee, Jr., \textit{Understanding Enron: \textquotedblleft It's About the Gatekeepers, Stupid,	extquotedblright} 57 BUS. LAW. 1403 (2002) (discussing the failure of gatekeepers such as auditors, credit rating agencies, and securities analysts in verifying and assessing corporate disclosures); John H. Stout & Ruilin Li, \textit{Corporate Governance and Organizational Integrity,} 1 U. ST. THOMAS L.J. 925, 930 (2004) (stating that more than half of the $52 million that Enron paid to Arthur Andersen was for consulting services, and the large consulting fees created conflicts of interest that led to the accounting firm’s lax audit of Enron’s financial statements). As discussed above in note 113, rated companies do not pay governance rating agencies for the governance ratings. Although rated companies do not compensate governance rating agencies for the governance ratings in the way that audited companies compensate accounting firms for financial audits, a conflict of interest may still exist because the rated companies may exert some influence on the ratings by
Some rating agencies also allow rated companies to purchase from the rating agencies information on how to improve the companies’ governance ratings. For example, ISS sells subscriptions to ISS’s rating system so that companies being rated by ISS can preview their governance ratings and learn how to improve those ratings before ISS releases the companies’ ratings to ISS clients. Such practice may undermine the validity of governance ratings because it essentially allows companies to “game” the system and “buy” the ratings.

III. DISCONNECT BETWEEN GOVERNANCE RATING CRITERIA AND CORPORATE PERFORMANCE

A. The Lack of Correlation Between Rating Criteria and Corporate Financial Performance

Empirical studies have not found a correlation between governance ratings and stockholder returns. Companies with high governance ratings from ISS, GMI, and TCL do not achieve higher stock returns for their shareholders than companies that receive lower governance ratings. In addition, the reliability of governance ratings is called into question when one company receives drastically different ratings from different rating agencies. For example, while Aetna, American Express, Home Depot, Coca-Cola, Maytag, and Verizon Communications garnered highly favorable ratings from ISS, these same companies received an embarrassing “D” or “F” grade from TCL. On the other hand, while Berkshire Hathaway was awarded an “A” from TCL, the company was put in the bottom 1.5% rating by ISS, indicating that 98.5% of Berkshire Hathaway’s peers had better governance.

Empirical studies have also shown mixed results on the correlation between the various factors included in the governance rating criteria and the company’s financial performance. There is no strong empirical evidence to show that the structural mechanisms of corporate governance, as measured by governance rating agencies, improve shareholder wealth.

Studies focusing on the correlation between director independence and financial performance have resulted in findings on both ends of the spectrum as well as in

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118. Brown, supra note 1, at 29.
119. Choi & Fisch, supra note 4, at 298; Langley, supra note 4. For example, insurance giant Aetna paid $17,000 to ISS to learn how to improve the insurer’s governance rating from a dismal 30% to an impressive 99.7%. Langley, supra note 4. General Electric was able to improve its ranking by an even bigger margin, moving from an abysmal rating of 10% to a near-perfect rating of 99.7%. Id.
120. Rose, supra note 7, at 906.
121. Langley, supra note 4.
122. See Larcker et al., supra note 56, at 3 (concluding that “an investment strategy based on the governance ratings was not a profitable one”).
123. Id.
124. See Langley, supra note 4 (identifying several companies that received high governance ratings from ISS but low ratings from TCL, and vice versa).
125. Id.
126. Id.
127. See infra notes 128–39 and accompanying text (discussing results from empirical studies).
between: outsider dominated boards correlate to increased shareholder wealth, director independence has no effect on profitability, and companies with insider dominated boards perform better on profitability measures. Results from empirical studies also have not shown that there is a relationship between a completely independent audit committee and corporate profitability. Furthermore, whether the company has an independent nominating or compensation committee has not been found to affect corporate financial performance. With respect to other board structures, such as board size, term and age limits, over-boarding restrictions, and stock ownership guidelines, no empirical research has decisively shown that these features enhance corporate profitability.

Governance rating agencies review the relative amounts of audit and nonaudit fees that public companies pay to their external auditors, for the purpose of assessing auditor independence and the quality of the companies’ reporting of their financial performance. However, the vast majority of empirical studies have found no negative effect between the accounting firms’ provision of nonaudit services to their clients and the quality of the accounting firms’ audits of those same clients. In these empirical studies on nonaudit services, audit quality is measured by “abnormal accruals, measures of earnings conservatism, earnings surprises, financial statement restatements, and issuance of qualified audit opinions.” Given the strong evidence that the provision of nonaudit services does not endanger audit quality or auditor independence, the governance rating agencies’ inclusion of the relative amounts of audit and nonaudit fees in the rating criteria does not appear to provide much value to investors in signaling the quality of either the auditors’ work or the company’s financial reporting.

The strongest correlation between governance structure and enhanced shareholder value has been in the area of shareholder empowerment. Empirical studies have indicated that shareholder wealth increases when corporate charters and bylaws provide shareholders with enhanced voting rights, such as allowing shareholders to elect directors annually instead of staggering elections over several years and requiring only a majority instead of a supermajority shareholder vote to amend the corporation’s charter and bylaws. Empirical studies have also shown that shareholder value decreases when...
corporations deprive shareholders of rights through limiting director liability for breach of the duty of care or implementing anti-takeover provisions.

Overall, very few of the corporate structures and mechanisms that comprise the governance rating criteria have been demonstrated to be related to corporate profitability. Receiving high ratings based on the current governance rating criteria does not indicate that the company is financially profitable. An example illustrates that lack of correlation between governance rating criteria and financial performance. In 2006, ISS ranked General Motors first in corporate governance among all automotive manufacturers, and third in corporate governance among all S&P 500 companies. At that same time, General Motors posted a loss of more than $10 billion.

B. The Lack of Correlation Between Rating Criteria and Management Behavior and Ethics

In addition to lacking empirical support that governance ratings are strong indicators of corporate financial performance, governance rating criteria are also not indicative of corporate performance on nonfinancial measures. A basic tenet of American corporate law is that the board of directors is entrusted with the dual role of management and oversight of the corporation. The management role entails the board providing insights

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137. See Ramirez, supra note 101, at 370 n.143 (citing Michael Bradley & Cindy A. Schipani, The Relevance of the Duty of Care Standard in Corporate Governance, 75 IOWA L. REV. 1, 43 (1989)).


139. Governance rating agencies themselves appear to acknowledge that their rating criteria do not correlate to corporate profitability, but are instead meant to be used as a risk management tool because companies that have weak governance are more likely to fail. See Brown & Sidel, supra note 3 (quoting ISS’s director of corporate programs as saying: “This is a risk tool”). GMI, however, cites its own research as well as studies done by other parties to show that companies with higher GMI ratings generally perform better than companies with lower GMI ratings with respect to return on equity, return on assets, return on capital, and cost of equity capital. GMI RATINGS, supra note 16, at 1–3. That data, however, only demonstrate the relative financial performance of companies rated by GMI; the data do not establish that a company with a high GMI rating will be profitable for its shareholders.

140. Barnard, supra note 131, at 18.

141. Id.

142. See DEL. CODE ANN. tit. 8, § 141(a) (2006) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of the board of directors . . . .”); MODEL BUS. CORP. ACT § 8.01 (2006) (“The business and affairs of the corporation shall be managed by or under the
in setting corporate policies and providing authority in making enterprise decisions.\textsuperscript{143} The oversight role includes ensuring that the appropriate officers have been hired to operate the business, and that these business leaders are performing satisfactorily.\textsuperscript{144}

Although there has been disagreement over whether the board’s primary role is management or oversight,\textsuperscript{145} it is well settled that a corporate board is empowered to delegate its management authority to corporate officers.\textsuperscript{146} It is the officers who in fact manage most public corporations on a day-to-day basis.\textsuperscript{147} Having delegated their management responsibilities to the executives, directors retain the important responsibility of oversight in order to monitor and respond to the progress and performance of the corporation.\textsuperscript{148}

The oversight function requires the board to monitor management’s performance in achieving the company’s business and financial objectives.\textsuperscript{149} The oversight function
encompasses more than financial metrics, however. The board must also monitor performance from the perspective of management conducting the company’s business free of fraud, conflicts of interest, personal enrichment, and other unethical or illegal behaviors that jeopardize shareholder value.150

A board can monitor management’s performance with respect to reaching the company’s financial goals by analyzing various financial measures. Governance rating agencies likewise collect and analyze information about the company’s financial performance, information which is readily available from regulatory filings, press releases, corporate websites, analyst reports, industry studies, and other public sources. The public financial data reveal the company’s financial performance, performance trend, performance compared to industry competitors and the overall market, and the compensation that the board bestows upon company management.

It is unclear what information a corporate board has or utilizes in carrying out its responsibility to oversee management’s performance on non-financial measures. How does the board monitor whether management is conducting the company’s business free of fraud, conflicts of interest, personal enrichment, and other unethical or illegal behaviors that jeopardize shareholder value? What data is available to the board to assess management’s actual, instead of merely espoused, values and ethics?

Data currently collected and analyzed by governance rating agencies likewise do not provide any means of evaluating whether the management group is performing its duties in accordance with fundamental business precepts. The governance rating criteria do not include an analysis of the action and behavior of the management group. This lack of information is due to the rating agencies’ unfamiliarity with, and lack of access to, the daily activities and behavior of corporate executives. Being outside of the organizations that they rate, rating agencies do not have access to the management group’s decision-making and actions other than through the anecdotes gleaned from a lone insider or the occasional exposé by the press. Governance rating agencies lack a comprehensive source and database of information about the standards of behavior and ethics of the corporate officers in charge of the rated companies.

Faced with informational limitations about the behavior and ethics of corporate executives and how the board monitors management’s decision-making and conduct,
governance rating agencies’ approach is to rely on simple, objective yardsticks in their rating criteria. Many of the criteria employed by governance rating agencies relate to the board’s management function, such as adopting charter and bylaw provisions, setting policies and procedures, and establishing committees and compensation. The governance rating criteria do not relate much to the board’s oversight function over management.

One of the rating criteria used by ISS, GMI, and TCL is the number of independent directors on the board.151 Although the expectation is that an outside board member will be more likely to exert oversight and to challenge the conduct of an inside manager, there is no consensus that having an independent board will result in better monitoring of management conduct.152 One argument casting doubt on the monitoring ability of an independent board is that when most of a board’s members are independent, the board’s ability to monitor corporate misconduct may in fact be weakened because most of the board’s members are not involved in the daily operation of the company and are thus unlikely to be able to discover management misconduct.153

Governance rating agencies’ primary methodology is to measure the presence or absence of observable, structural mechanisms that can be identified and quantified, such as the composition of the board, the amounts of audit and nonaudit fees, the compensation paid to corporate executives, and whether the company’s charter and bylaws provide shareholders with various voting rights.154 While most rating criteria focus on readily verifiable governance structures and practices, hardly any rating criteria focus on the actual decision-making and behavior of those individuals managing or monitoring the corporation.

The very few governance rating criteria that focus on the action and decision-making of the corporation are limited to the board level. Some governance rating agencies assign positive value to boards that conduct performance self-assessments.155 These self-assessments involve each director completing questionnaires to evaluate the performance of fellow board members and the performance of the board as a whole.156 Governance rating agencies may review the board’s reaction to shareholder proposals, with high responsiveness to shareholder proposals signifying a board that is furthering shareholder interests instead of management pursuits.157 Rating agencies may also consider whether the board has approved mergers or acquisitions that have resulted in

151. See supra notes 40–41 and accompanying text (describing rating criteria relating to the board’s composition and structure).
152. See Cheryl L. Wade, Corporate Governance Failures and the Managerial Duty of Care, 76 St. John’s L. Rev. 767, 771 (2002) (observing that directors cannot monitor corporate legal compliance without information reporting from corporate officers who are involved in the day-to-day running of the company).
153. See id. (stating that outside directors have less information about the company because those “in the corporate trenches are the ones best positioned to discover wrongdoing”).
154. See id. (including observable, structural mechanisms in its rating criteria).
155. See supra note 38 (including board performance review as a rating criterion).
156. See Kathryn Tyler, Sizing Up Board Members, HR Magazine, July, 2007, at 68, 70 (noting that these assessments can occur by use of survey forms or by third-party interviews); see also Silverman, supra note 80, at 735, 755 (noting that as a result of shareholders and regulators demanding governance changes, directors are conducting assessments of their own effectiveness). According to ISS, the percentage of companies that conducted board reviews jumped from 18% in 2003 to 68% in 2006. Tyler, supra, at 68.
157. TCL Rated Companies, supra note 41.
significant positive or negative financial impact on shareholder value. Note that even this evaluation focuses on the verifiable financial end results of the board’s decision-making, rather than the process and ethical dimensions of the decision-making.

Governance rating criteria do not include any assessment of the conduct and decision-making of the management group. The governance structures and processes used in the rating criteria are weak indicators of managerial behavior and ethics. Receiving high scores on the rating criteria, similar to complying with structural mechanisms required by law and listing standards, does not signify that the highly rated company’s leaders are operating with high standards of business conduct. The collapse of prominent corporations in recent years provides ample evidence of the ability of management to tout structures and processes that align with governance “best practices,” while at the same time carry out corporate conduct that are the antithesis of good management. The fact that the current rating criteria do not tell us anything about managerial behavior and ethics should cause concern, as poor management ethics can destroy a company’s financial value and lead to its ultimate collapse.

Although a high governance rating may confirm the presence of mechanisms that are claimed to be indicative of good governance, structures and processes such as independent directors and board committees, codes of ethics, and whistleblower hotlines do not assure the board, the shareholders, or other stakeholders that management conduct at companies with those governance structures will be consistent

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158. Id.
159. See Oesterle, supra note 1, at 426 (concluding that investor and market pressure will do more than the Sarbanes-Oxley Act’s structural requirements to improve business practices); Brown & Sidel, supra note 3 (quoting an internal memo of insurance giant American International Group as stating that a business “can have great corporate governance on paper but have horrendous corporate governance in reality”).
160. See Note, The Good, the Bad, and Their Corporate Codes of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behavior, 116 HARV. L. REV. 2123, 2124 (2003) (observing that “a corporate code of behavior is only as good as the directors and officers responsible for implementing it”).
161. See Duane Windsor, Business Ethics at “The Crooked E,” in ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 659, 660 (Nancy B. Rapoport & Bala G. Dharan eds., 2004) (noting that Enron executives’ motives and conduct were contrary to their publicly professed high ethical standards).
162. See Brown & Sidel, supra note 3 (emphasizing that “Enron . . . had a solid-looking board of directors before it blew up”); Dale A. Oesterle, Illusions of Board Reform, DAILY CAMERA (Boulder, CO), May 6, 2002, at 2 (observing that the Enron audit committee was composed of “independent directors, including an ex-business school dean of a top 10 school”); Jeffrey A. Sonnenfeld, What Makes Great Boards Great, HARV. BUS. REV., Sept. 2002, at 106, 108 (noting that “no meaningful distinction emerge[d]” as to the director independence of the “most- and least-admired companies”).
163. See Lynne L. Dallas, Enron and Ethical Corporate Climates, in ENRON CORPORATE FIASCOS AND THEIR IMPLICATIONS, supra note 161, at 187, 198–99 (noting that Enron had a code of ethics that the company required its employees to sign, and the company’s espoused values of “Respect, Integrity, Communication, and Excellence” were displayed on banners at company headquarters and printed on inspirational gifts to employees); Mark S. Schwartz, The Nature of the Relationship Between Corporate Codes of Ethics and Behavior, 32 J. BUS. ETHICS 247, 249 (2001) (citing the following results from 19 studies of whether codes of ethics influence behavior: 8 studies found that codes are effective in influencing behavior, 2 studies found that codes have a weak influence on behavior, and 9 studies found that codes are not effective in influencing behavior).
164. See Dallas, supra note 163, at 199 (noting that Enron had an anonymous whistleblower hotline). On the same day that whistleblower Sherron Watkins was explaining her concerns about the company’s accounting irregularities to Chairman and CEO Kenneth Lay, Enron received a memo from its outside attorneys explaining the risks of discharging employees who report concerns about the company’s accounting practices. Id.
with fundamental business ethics. Take the case of Fannie Mae, a federally chartered company that operates in the secondary mortgage market, which received a highly favorable governance rating of nine on a ten point scale in 2003. Shortly after the positive governance score was publicly disclosed, problems regarding Fannie Mae’s accounting and executive compensation became public headlines, which prompted the governance rating agency to downgrade the score and then to eventually withdraw its governance rating of the troubled company.

Governance ratings are primarily based on public data, namely regulatory filings such as prospectuses, annual reports, and proxy statements. Rating agencies also monitor company press releases and review corporate websites for information. In addition, companies may submit data directly to rating agencies for consideration in the rating process. For most of the information that rating agencies look to in determining the governance ratings, it is the management group that decides the information to be disclosed, whether that disclosure is mandatory or voluntary.

The quality of the information that management discloses to the public or to the rating agencies should be examined with a keen eye. Many CEOs have an unwritten policy that all communication of information from inside the corporation to the public or to the board must first be approved by the CEO. The potential conflict of interest in this system of disclosure is easily discernable. The CEO has an incentive to highlight information that reflects favorably on the corporation’s performance and ultimately on the CEO’s performance, while downplaying information that has the potential to cast the corporation and the CEO’s performance in a negative light.

The foregoing is not meant to imply that all information prescreened by the CEO is tainted by self-interest or is unreliable. Instead, it is meant to suggest that the oversight role dictates that directors maintain a healthy skepticism for information that management provides to the board. Similarly, rating agencies should analyze with a keen eye the information that management provides to the public or directly to the rating agencies.

IV. CONNECTING GOVERNANCE RATING CRITERIA TO CORPORATE PERFORMANCE

A. Management Behavior and Ethics Affect Financial Performance

Boards of directors and governance rating agencies need an independent source of

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166. Plitch, supra note 3.
167. Id.
168. GMI Overview, supra note 2; ISS Corporate Governance Quotient, supra note 29; TCL Questions, supra note 21.
169. See supra note 168 (sources explaining rating agencies’ methodologies).
170. See id. (sources explaining rating agencies’ methodologies).
171. See Ide, supra note 81, at 838–39 (suggesting that the leaders of major business divisions and administrative functions should provide information directly to the board); Stout & Li, supra note 117, at 928 (observing that “in many cases all business information provided to the board flows through, or is vetted by, the CEO”). For criticism of this practice, see Ide, supra note 81, at 838–39 (noting that the board needs key information directly from managers).
172. See Ide, supra note 81, at 840 (describing the CEO-focused corporate culture).
information about whether corporate executives are performing their management duties free of unethical or illegal behavior that may jeopardize shareholder value. Corporate boards and governance rating agencies need information about the behavior and ethics of corporate executives from sources other than regulatory filings, public documents, and other information provided by the corporate executives themselves. Employees within the corporation can serve as that source of information.

In order to connect corporate governance ratings to a measure that is more reflective of whether directors and officers are performing their responsibilities to advance shareholder interests, governance rating agencies should include a criterion relating to the implementation of employee assessments of managerial behavior and ethics. Employee assessments can provide information valuable to the board, shareholders, customers, and other corporate stakeholders. As evidenced by the increasing use and influence of governance ratings on investors, insurers, investment advisers, legal and accounting professionals, financial institutions, and the rated companies themselves, there is a strong interest in and desire for information about managerial behavior and ethics.

As discussed in this Article, corporate America has seen a tremendous rise in institutional shareholder activism in recent years. The institutional activity has not only increased but has also changed in focus. Institutional shareholders first directed their attention to making informed voting decisions, and then shifted their activity to evaluating corporate governance structures. The current focus of institutional shareholders is to assess management’s performance as well as management policies. Internal employees can provide the information about management performance that institutional shareholders are seeking.

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173. See ANTIFRAUD PROGRAMS & CONTROLS TASK FORCE, AM. INST. CERTIFIED PUB. ACCOUNTANTS, MANAGEMENT OVERRIDE OF INTERNAL CONTROLS: THE ACHILLES’ HEEL OF FRAUD PREVENTION 6, 11 (2005) [hereinafter ANTIFRAUD TASK FORCE], available at http://www.aicpa.org/audcommctr/download/achilles_heel.pdf (suggesting that the company’s audit committee should be routinely furnished with the results of employee surveys regarding corporate behavior, and encouraging audit committee members to establish communication with employees below the senior management level in order to monitor senior management behavior and control management overrides).

174. See Id., supra note 81, at 861 (suggesting that independent directors develop a process for interested parties to voice their concerns to the board, including allowing interested parties to meet with the board or a designated board member).

175. As used in this article, “stakeholders” include employees, customers, and creditors of the corporation. As used in other scholarly work, “stakeholders” may also include the community and the environment. See Licht, supra note 81, at 742 (explaining various features of the debate over whether corporate fiduciaries should maximize the interests of shareholders or of other stakeholders). The concept of a “stakeholder” has also been defined broadly as “any group or individual who can affect or is affected by the achievement of the organization’s objectives.” Id. at 722 (quoting R. EDWARD FREEMAN, STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH 46 (1984)). Based on that broad definition, the list of stakeholders may be expanded to include “governments, competitors, consumer advocates, environmentalists, special interest groups, and the media.” Id.

176. See Brown, supra note 1, at 28 (observing that the well-publicized collapse of various public companies due to management misbehavior has increased investors’ interest in corporate governance and has resulted in the growth of rating agencies).

177. See Eisenberg, supra note 107, at 1283–87 (discussing the shift from passivity to activism by institutional shareholders).

178. Id. at 1287 n.99.

179. Id.
Investors’ interest in corporate integrity is also shown in their increased investment in portfolios that pick companies based on ethical or social reflection towards issues such as employment opportunity, diversity, religion, human rights, health and safety, and environmental protection. In the ten years between 1995 and 2005, assets involved in “socially responsible” investing rose four percent faster than all professionally managed investment assets in the United States. In addition, the number of socially responsible investment choices increased from 55 mutual funds in 1995 to 201 mutual funds in 2005.

The heightened concern about corporate ethics is also reflected in the increased popularity and attention to corporate rankings on ethical and social responsibility scales, such as Business Ethics Magazine’s annual ranking of the top 100 companies for corporate social responsibility and stakeholder accountability. Various organizations and the press also conduct annual evaluations and rank companies on other ethical and social dimensions such as gender and racial equality, family care, and environmental stewardship.

Prompted by frequent revelations of management fraud and corporate scandals, various industry and professional groups have crafted guidelines for ethical corporate conduct. The American Law Institute’s Principles of Corporate Governance, for example, provides that a corporation may take into account “ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business” even if corporate profits and shareholder gain are not thereby enhanced. The Business Roundtable, an association of chief executive officers from major American companies, also issued a corporate governance statement that the board’s principal duty is to select a chief executive officer and to monitor the management group for competent and ethical operation of the corporation. Examples of other guidelines for ethical corporate conduct include the Caux Round Table Principles for Business, the Interfaith Center on

181. See id. at 2–3 (defining social investing, ethical investing, mission-based investing, or socially aware investing as an investment approach focusing on “open and transparent business practices that are based on ethical values and respect for employees, communities, and the environment” (quoting the Prince of Wales Business Leaders Forum)).
182. Id. at 1. In 2005, socially responsible investment portfolios constituted $2.3 trillion of the total $24.4 trillion under professional management. Id.
183. Id. at 1, 7.
185. See id.; 3 State Companies Make Working Mother Magazine’s Top 100 List, Star Trib., Sept. 25, 2007, at 2D (discussing Working Mother magazine’s issuance of its list of the top 100 places to work, based on workforce diversity, family-friendly programs, and company culture).
186. 1 Am. Law Inst., supra note 71, at 55 (quoting section 2.01(b)(2) of the Principles).
Corporate Responsibility’s Principles for Global Corporate Responsibility, the Consumer Charter for Global Business, and the OECD Guidelines for Multinational Enterprises. While these guidelines may differ in focusing on particular industries or protecting specific constituencies, they all reflect the same concerns about organizational integrity and the apparent need to clarify fundamental standards of business ethics.

In addition to the investing public and industry professionals, customers and employees are interested in a company’s ethical business conduct. Customers’ purchasing decisions are influenced by a company’s ethical reputation. In an opinion survey, nearly 75% of people expressed a preference for making purchases from companies with ethical business practices rather than from companies with questionable business conduct, even when the prices of the ethical company are higher than the prices of the company with questionable practices. Similarly, employees are interested in the organizational integrity of their company, as 94% of employees expressed that it is “critical” or “important” that their employer is ethical. In addition, 82% of employees indicated they would prefer to be paid less but work for a company with ethical business practices than receive higher pay at a company with questionable business conduct.

B. Employees as a Source of Information About Management Behavior and Ethics

Employees and investors have a common concern and a mutual financial interest in the company’s ethical corporate behavior. Investors are interested in shareholder profits undiminished by management self-enrichment or corporate bankruptcy, and employees are interested in job continuity and pension benefits unaffected by management self-enrichment or corporate bankruptcy. This common concern and mutual

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189. See id. at 126–28 (discussing the differences among the various guidelines).
190. See Skeel, supra note 57, at 1823 (explaining that consumers avoid the products of businesses that violate social norms).
193. Id.
194. See generally ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS, supra note 161 (collecting works by various scholars and experts in the field of corporate governance).
195. See ETHICS RES. CTR., NATIONAL BUSINESS ETHICS SURVEY 2003: HOW EMPLOYEES VIEW ETHICS IN THEIR ORGANIZATION v (2003) [hereinafter BUSINESS ETHICS SURVEY] (stating young employees’ concerns that “unethical actions of top executives will jeopardize their job security”); Steven Harson Wilson, Malefactors of Great Wealth: A Short History of “Aggressive” Accounting, in ENRON CORPORATE FIASCOS AND THEIR IMPLICATIONS, supra note 161, at 41 (noting that Enron’s collapse resulted in thousands of employees losing their jobs).
196. See Daniel Altman, Experts Say Diversify, but Many Plans Rely Heavily on Company Stock, N.Y. TIMES, Jan. 20, 2002, § 1, at 26 (reporting that Enron employees who participated in the company’s 401(k) plan invested their money mostly or entirely in Enron stock); Gretchen Morgenson, Beware Those One-Note 401(k)’s, N.Y. TIMES, Dec. 2, 2001, § 3, at 1 (noting that about 12,000 Enron employees participated in the company’s 401(k) retirement plan, which was loaded with Enron stock and which became virtually worthless upon the company’s collapse).
financial interest provide powerful incentives for employees to supply investors with information on the ethical standards and behavioral manifestations of senior management. As internal stakeholders, employees can provide the board, investors, customers, and other stakeholders with information about whether senior management’s behavior and decision-making comport with fundamental business ethics.

Employees, with their insider access and opportunity to witness management action and decision-making on a routine basis, can provide information about the way corporate leaders view their fiduciary duties and obligations to the company, their perspective on personal entitlement and public good, and their philosophy about legal compliance and business ethics. Senior leaders send signals to employees through their everyday conduct of managing and operating the organization, and the day-to-day actions and decision-making of the management group are good indicators of their propensity for ethical behavior or inclination for ethical lapses.197

Employees who are carrying out the directives and implementing the wishes of senior management are familiar with the business standards of company executives. Often, whether because of formal supervisory reporting structures or informal social norms in the company, employees who have access to and information about management’s standard of business ethics lack the means to communicate this information to the board.198 Through an employee assessment, employees can provide the board of directors, investors, customers, and other stakeholders with a more accurate assessment of whether management’s business practices are consistent with the ethical values that the corporation embraces and that the corporate officers publicly espouse.199

Employee surveys can be an effective tool to evaluate management conduct.200 Employee surveys are more effective and comprehensive in evaluating management behavior than the whistle-blowing structure that federal securities laws require public companies to implement. The procedures required under federal securities laws are not a comprehensive ethics reporting mechanism as they focus only on accounting and auditing matters and not other kinds of wrongdoing.201 In addition, the accounting and audit

197. See Stout, supra note 87, at 21–23 (suggesting that an individual’s past history and behavior is evidence of her character and whether she is likely to act for others’ interests without regard to her own payoffs).
198. See Ide, supra note 81, at 858 (explaining that “fiefdoms” within corporate divisions may prevent employees from reporting information up the corporate ladder).
199. See id. at 838–39 (stating that information the board receives directly from non-CEO managers who are responsible and familiar with major business divisions can provide the board with a more accurate assessment of corporate performance and CEO performance).
200. See Lynne L. Dallas, A Preliminary Inquiry Into the Responsibility of Corporations and Their Officers and Directors for Corporate Climate: The Psychology of Enron’s Demise, 35 RUTGERS L.J. 1, 57 (2003) (recommending that organizations make periodic self-assessments of their ethical climate by conducting employee surveys, exit interviews, employee focus groups, and other stakeholder surveys and interviews). See generally Thuy-Nga T. Vo, Lifting the Curse of the SOX Through Employee Assessments of the Internal Control Environment, 56 U. KAN. L. REV. 1 (2007) (positing that an employee assessment and reporting of managerial behavior and ethics would be more effective and efficient in detecting financial reporting fraud and improving corporate behavior than the current implementation of the Sarbanes-Oxley requirement that management assess and report on internal controls over financial reporting).
201. See Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1(m)(4) (Supp. V 2005) (requiring the audit committee to establish procedures for “the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters” and “the confidential, anonymous
whistle-blowing mechanism is not as effective as a company-wide survey of employees to assess senior management’s general business practices and the overall ethical environment of the organization.\textsuperscript{202}

To be effective in obtaining information about illegal or fraudulent activities, a whistle-blowing structure relies on employees to take the initiative in reporting information about events or circumstances that lead the employees to believe an illegal or fraudulent activity has occurred. Taking such individual initiative, however, is often difficult for employees as they are likely to experience social pressures to remain silent when witnessing wrongdoing by their colleagues or supervisors.\textsuperscript{203} As studies have shown, employees are unlikely to go out of their way to volunteer (such as through a whistleblower program) their views or perceptions about colleagues and senior management’s questionable behavior, unless the employees are specifically asked to provide the information (such as through an interview or survey).\textsuperscript{204}

Employee assessments are preferable to other types of ethics reporting programs because with the latter, employees often do not know whether conduct or activity that they have witnessed violates any internal requirements or external regulations such that it should be reported or how it should be reported.\textsuperscript{205} An employee questionnaire, on the

\textsuperscript{202} In addition to the mechanism for anonymous reporting, the Sarbanes-Oxley Act also provides protection for corporate whistleblowers. 18 U.S.C. § 1514A. The statute prohibits employees from taking retaliatory action against employees who provide information or assist in an investigation of conduct that the employees reasonably believe constitutes a violation of federal securities laws. \textit{Id.} Although the statute purports to provide protection to employees who report fraudulent activities, the likely success of a whistleblower’s retaliation lawsuit against an employer under the Sarbanes-Oxley Act remains to be seen. \textit{See} Leonard M. Baynes, \textit{Just Pucker and Blow?: An Analysis of Corporate Whistleblowers, the Duty of Care, the Duty of Loyalty, and the Sarbanes-Oxley Act}, 76 ST. JOHN’S L. REV. 875, 890–91 (2002) (citing success rate of 25%–33% for reprisal lawsuits under federal whistleblower statutes). Moreover, the Sarbanes-Oxley Act’s goal of promoting employee reporting of fraudulent activities may be modest because of the limited substantive nature of the statute, which protects only the reporting of securities fraud and not other kinds of wrongdoing. \textit{See id.} (stating that a whistleblower in a case involving a non-securities related offense must “rely on the vagaries of state law”). In addition, the statute requires whistleblowers to fulfill numerous procedural steps in order to receive protection from an employer’s retaliation, including the showing of adverse employment action and the filing of an administrative claim with the Secretary of Labor within 90 days of the discriminatory act. \textit{Id.} at 890. Some scholars and practitioners also believe that regulatory officials raise the whistleblower’s burden of proof beyond what is required in the statute. \textit{See} Some Employees Might Feel a Little Grumpy or Dopey if They Whistle While They Work, \textit{TREASURY & RISK}, Sept. 25, 2007, available at http://www.treasuryandrisk.com/Newsletters/Pages/09-25-2008.aspx (citing opinions that whistleblowers under the Sarbanes-Oxley Act have been required to show “unequivocal evidence” of misconduct and also that the misconduct would “ultimately hurt share value”).

\textsuperscript{203} \textit{See} BUSINESS ETHICS \textit{SURVEY}, supra note 195, at 39, 42, 45–46 (citing as reasons why employees do not report misconduct to include fear of not being viewed as “team players” and instead being labeled as “snitches” or “troublemakers”).

\textsuperscript{204} \textit{See} ANTIFRAUD TASK FORCE, supra note 173, at 11–12 (stating that employees may be reluctant to communicate through the whistleblower program); Dov Seidman, \textit{The Case for Ethical Leadership}, http://www.lm.com/index2.php?option=com_content&task=view&id=129&pop=1&page=0&Itemid=174 (registration and login required) (last visited Aug. 17, 2007) (observing that unless specifically asked, employees are unlikely to volunteer their opinions about senior management’s ethical lapses).

\textsuperscript{205} \textit{See} BUSINESS ETHICS \textit{SURVEY}, supra note 195, at 27, 42–43 (citing “cynicism that nothing will be done” and lack of knowledge about whom to contact or how to report the misconduct as reasons why employees do not report misconduct).
other hand, presents employees with concrete questions about whether they have observed specific behavior on the part of management. Employees respond to the specific survey questions by culling from their experience inside the company and their exposure to management’s decision-making and actions. Because the survey’s aim is to solicit information about management conduct that the employees Witnessed or perceived, instead of soliciting the employee’s legal conclusion about the behavior, the employees can provide information without having to know whether those behaviors indicate legal improprieties or ethical missteps. Survey administrators have learned from experience that when survey questions are phrased in general or conclusory terms, employees often respond that they have not observed management participating in the generalized category of misconduct. However, when the survey questions are phrased to identify the specific act of illegality or unethical behavior, employees often respond that they have observed management taking such illegal or unethical action.

Very few companies perform a self-evaluation of the organization’s integrity, and those companies that do attempt to gauge the business standards and ethics of their senior management do so by having internal employees interview the executives of the company. It is unlikely that such an interview process will provide reliable information about management’s inclination for fraudulent conduct or unethical behavior. The information that can realistically be expected to come out of such evaluation process is the executives’ professed adherence to high standards of business ethics. Whether the executives’ conduct actually measures up to the espoused standards will only be revealed over time.

Instead of having employees interview senior management to determine whether the executives have the propensity to engage, or have already been engaging, in illegal or unethical conduct, this Article proposes that governance rating agencies survey the employees themselves to gain information about management’s conduct. Employees have the responsibility to carry out directives from company executives. Employees have access to the decision-making and actions of company executives on a routine basis. Employees are the internal stakeholders that can provide other stakeholders, the board, and corporate governance rating agencies with information for the purpose of assessing, predicting, and preventing management misconduct that jeopardizes shareholder value.

C. Benefits of Employee Assessments as a Corporate Governance Rating Criterion

By advocating for the implementation of employee assessments of managerial behavior and ethics, corporate governance rating agencies can use their influence in the governance arena to facilitate the board’s fulfillment of its fiduciary duty to monitor management’s performance on qualitative, nonfinancial measures that may ultimately
impact the financial performance of the company.\textsuperscript{209} As discussed in this Article, governance rating agencies exert tremendous influence over governance decisions, such as adopting annual director elections and eliminating takeover defenses that public companies undertake in order to achieve favorable ratings from governance rating agencies.\textsuperscript{210} Governance rating agencies also use their influence to enhance board effectiveness through continuing director training by giving a boost in governance ratings to those companies whose directors attend director education programs.\textsuperscript{211} Similarly, rating agencies can encourage companies to implement employee assessments of management’s behavior and ethics by recognizing in the ratings those companies that conduct employee assessments.

Conducting employee assessments of management behavior and ethics can be beneficial in many respects. One benefit relates to the evolution of the board’s monitoring role from a reactive to a more affirmative obligation to gather information about management conduct.\textsuperscript{212} In 1963, the Delaware Supreme Court held that:

[D]irectors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong. . . . [A]bsent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.\textsuperscript{213}

In 1996, however, the Delaware Chancery Court pronounced that “relevant and timely information is an essential predicate for satisfaction of the board’s supervisory and monitoring role,”\textsuperscript{214} adding that “a director’s obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists.”\textsuperscript{215} In 2006, the Delaware Supreme Court revisited the issue and affirmed the obligation of the board of directors to proactively implement and

\textsuperscript{209} See Silverman, supra note 80, at 735 (noting that as a result of shareholders and regulators demanding governance changes, directors are “evaluating their decisions in light of corporate performance on a broad array of both quantitative and qualitative metrics, not just shareholder return”).

\textsuperscript{210} See Langley, supra note 4 (noting the efforts of Aetna to raise its governance ratings by eliminating the company’s poison pill, reducing the shareholder votes required for mergers from supermajority to simple majority, granting shareholders the right to call special meetings with votes from two-thirds of outstanding shares, and reducing the shareholder votes to change the company’s bylaws from 80% to two-thirds).

\textsuperscript{211} ISS Corporate Governance Quotient, supra note 29.

\textsuperscript{212} See Skeel, supra note 57, at 1822, 1825 (observing that corporate governance norms have changed from low expectations of director oversight to high expectations of active and meaningful director monitoring of management behavior). Some scholars have explored the questions of whether directors and officers have the fiduciary duty to proactively identify, monitor, modify, and disclose those corporate cultures and ethical climates that support unethical conduct. See generally Dallas, supra note 200 (explaining the possibility that an organization is responsible for fostering an ethical climate). Corporate culture is the shared beliefs and expectations of the corporation, which are derived from the organization’s values and norms. Id. at 3. Ethical climate refers to the ethical influence of the corporation’s policies, procedures, and practices on the employees’ behavior. Id. A corporation’s ethical climate describes the employees’ perceptions about how the policies and procedures actually apply and what practices actually take place at the organization, instead of how the employees feel about those policies, procedures, and practices. Id. at 22–23.


\textsuperscript{214} In re Caremark Int’l, Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996).

\textsuperscript{215} Id.
oversee an information monitoring and reporting system within the company.\footnote{216} Implementing employee assessments of managerial behavior and ethics may enhance directors’ performance of their fiduciary duties under state law. By conducting employee surveys of management’s conduct, directors are carrying out their fiduciary duty under corporate law to implement a system to gather and communicate meaningful information to the board such that it can monitor management’s performance.\footnote{217} In addition, asking employees to provide information about managerial behavior and ethics may fulfill the directors’ duty of reasonable inquiry as a prerequisite to the directors’ protection under the business judgment rule.\footnote{218}

Collecting and disclosing information about management behavior also furthers the goal of federal securities laws to equalize information between corporate insiders and public investors.\footnote{219} The main objective of federal securities laws is to provide information to the investing public, as reflected in the federal laws’ focus on disclosure requirements.\footnote{220} Federal disclosure laws, however, depend on corporate management to gather and determine the information that the corporation discloses to the public. As discussed in this Article, there is a disincentive for senior management to publicly reveal any weakness in their management style and ethics. Governance rating agencies that can motivate rated companies to conduct employee assessments of management’s behavior and ethics can provide a countermeasure to management’s reluctance to disclose unflattering information about their own performance. Gathering and disclosing results from employee assessments can further federal laws’ disclosure goals by providing investors with otherwise unavailable information about management’s standards of conduct and business integrity.

Evaluating management behavior and ethics through employee surveys can provide directors with the means both to create external reputational value and to satisfy internal altruistic motives. Some scholars have suggested that monetary and stock rewards do not provide strong incentives for directors to serve the interests of the corporation, as these forms of director compensation are often insignificant when compared to the directors’ other earnings as business professionals.\footnote{221} Similarly, legal sanctions are regarded as

\footnote{216} See Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006). In Stone v. Ritter, the Delaware Supreme Court held that:

\textit{Caremark} articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.

\textit{Id.}

\footnote{217} See Wade, supra note 152, at 771–72 (suggesting that a corporation can have a better informed board by establishing a process for company officers who are not serving on the company’s board to communicate potential corporate malfeasance to the company’s independent directors).

\footnote{218} See Smith v. Van Gorkom, 488 A.2d 858, 872–73 (Del. 1985) (explaining the purpose and application of the business judgment rule).

\footnote{219} See Seligman, supra note 144, at 450 (stating that a primary policy of the federal securities laws is to alleviate information asymmetry between investors and insiders).

\footnote{220} See Ide, supra note 81, at 834 (explaining that state laws regulate the substance of corporate governance, and federal securities laws regulate the public disclosure of corporate governance).

\footnote{221} See Eisenberg, supra note 107, at 1268 (observing that the increase in the level of care exercised by directors cannot be accounted for by financial incentives); Stout, supra note 87, at 4 (discussing the deficiencies
deficient in explaining why directors are motivated to do a good job for the corporations they serve, as directors are unlikely to be driven by the fear of personal liability in light of the protection available under the business judgment rule, statutory and contractual indemnification provisions, and insurance policies.  

Some researchers have theorized instead that directors can be trusted to do their best for the corporation because they have internalized social norms, or they want to avoid other social sanctions such as professional shaming and judicial criticisms.  Yet other scholars propose that directors are motivated to fulfill their fiduciary responsibilities in part because of altruism, in that the directors feel internal pressures such as a sense of honor, a feeling of obligation, and a desire to do the right thing.  Whether corporate directors are motivated to act because of external social sanctions or internal altruistic pressures, having information from employees regarding the behavior and ethics of corporate managers may provide directors with more data to perform their monitoring function and consequently enhance their social and professional reputations as fiduciaries and also fulfill their internal altruistic desire to do their best for the organization.

Evaluating management behavior through employee surveys may also create reputational value for the corporation’s management group.  Executives are interested in cultivating their reputation as business leaders, especially in the areas of personal attributes such as ethics and integrity.  Receiving a low corporate governance rating because the company has a large board, the company’s directors are of advancing age, the company utilizes its external auditors for a large number of nonaudit services, or the

of director compensation as explanation for director performance).

222. See Eisenberg, supra note 107, at 1266–67 (stating that the increase in the level of care exercised by directors cannot be accounted for by an increased threat of liability); Stout, supra note 87, at 6–7 (discussing the deficiencies of legal punishment as explanation for director performance).

223. See Eisenberg, supra note 107, at 1253–55 (defining social norms as “all rules and regularities concerning human conduct, other than legal rules and organizational rules”).

224. See Bainbridge, supra note 128, at 391 (explaining that independent directors’ reputations will likely suffer if the company fails during their watch); Skeel, supra note 57, at 1812 (quoting shareholder activist Nell Minnow as saying that directors are “the most reputationally sensitive people in the world”).

225. Skeel, supra note 57, at 1813, 1836–50 (citing examples where shareholder activists and the business media attempt to shame corporate directors).


227. See Stout, supra note 87, at 8–12 (citing social dilemma studies as evidence that corporate directors may be motivated by altruism, instead of compensation or legal liability, to serve the interests of the corporation).

228. See BUSINESS ETHICS SURVEY, supra note 195, at 39 (paying more attention to employee reporting of wrongdoing can reduce unethical conduct and financial losses while protecting corporate reputation).

229. See Eisenberg, supra note 107, at 1257–58 (stating that social norms motivate actors to behave in certain ways because the actors fear reputational sanctions or desire reputational gains).

230. See id. at 1268–69 (attributing the increase in the level of care exercised by directors to the shift in social norms resulting from the media’s increased exposé and shaming of careless or irresponsible directors, and the business community’s increased expectations of the directorial role); Timberly Ross, Buffett Memo Preach Ethics, ST. PAUL PIONEER PRESS, Oct. 11, 2006, at 3C (reporting Warren Buffett’s reminder to top executives at his company, Berkshire Hathaway, and other corporate executives that “‘You can lose a reputation that took 37 years to build in 37 seconds.’ . . . ‘And it might take more than 37 years to build it back.’”).
company’s officers do not own a large amount of company stock does not call into question the personal integrity of the executives in charge of the company.

On the other hand, receiving a weak corporate governance rating because the company refuses to conduct an assessment of management’s behavior and ethics, or because the results from an employee assessment suggest patterns of or propensity for mismanagement, points directly to the executives’ failure to follow fundamental business precepts.231 A corporate governance rating based on an employee assessment can serve as a certification of senior management’s business integrity. In such role, the employee assessment can motivate businesses to focus on ensuring that the action of one or more of its officers will not taint the reputational rating of the management group as a whole.232 As one scholar succinctly noted, “a firm that is required to disclose misbehavior may not engage in it in the first instance.”233

An employee assessment of management’s conduct may enhance the ethical decision-making of the management group. Studies have shown that performance evaluation systems that focus only on the financial end results, such as revenues and profits, can engender pressure for management to engage in dishonest business practices.234 On the other hand, evaluation systems that consider the methods used, instead of focusing solely on financial results achieved, can result in more ethical decision-making by corporate management.235 By evaluating management’s methods of making decisions and conducting business, the employee assessment supplements the current focus on management’s achievement of financial returns. Although data on financial performance are widely available for corporate directors and stakeholders to evaluate, information about senior management’s ethical behavior is scarce. Results from the employee assessment of management’s conduct can provide the data that are needed, but that are not currently available, to evaluate and enhance management’s ethical business practices.

The influence that governance rating agencies have gained in the corporate governance field can be utilized to enhance corporate integrity. When corporate governance agencies use employee surveys of management behavior and ethics as a governance rating criterion, the governance rating agencies send a message to corporate directors that monitoring management conduct is a desirable and worthwhile initiative to implement. Such a message can be a powerful motivation for directors to step up their oversight measures and scrutinize the organization’s integrity. Directors, as fiduciaries, may be motivated to assess organizational integrity as a part of the directors’ oversight duties if they perceive that an influential source is expecting, encouraging, or requesting

231. See Ross, supra note 230 (reporting Warren Buffett’s warning to executives of his company against improper behavior and his reminder that the company’s “reputation is in your hands”); Linda Klebe Treviño, Out of Touch: The CEO’s Role in Corporate Misbehavior, 70 BROOK. L. REV. 1195, 1208 (2005) (noting that the image of an organization is linked more closely to the chief executive officer’s personal identity than to other employees’ identities).
232. See Dallas, supra note 200, at 9 (citing the damage to the reputation of London’s Barings Bank as a result of the unethical action of one of the bank’s traders in a small branch office).
233. See Skeel, supra note 57, at 1857.
234. See Dallas, supra note 200, at 34–35 (referencing studies that show that a behavior-based evaluation system results in more ethical decision-making than an outcome-based system).
235. Id.
the directors to implement such oversight measure. Moreover, when directors implement the employee assessment, the directors in turn communicate their expectations of high organizational integrity to corporate officers. This communication enhances moral awareness and cultivates an environment that supports ethical management behavior and discourages questionable management conduct. By advocating for the assessment of management’s performance on ethical dimensions, governance rating agencies can influence board directors to be diligent in overseeing, and executives to be diligent in managing, the corporation free of the ethical improprieties and management excess that can jeopardize shareholder value.

D. Conducting Employee Assessments

Businesses have used employee surveys to assess their own companies from various dimensions. The range of topics covered in currently available employee surveys is broad, including the assessment of the organization’s management structure, leadership style, employee satisfaction, health and safety standards, compensation and benefits practices, employee diversity, customer loyalty, and community relationships. Although very few companies conduct an assessment of their own executives’ ethical behavior, ethics organizations and consulting firms have used employee surveys to assess the ethical climate of corporate America across different companies. Despite the reluctance of senior executives to implement assessments and to disclose information about their own ethical standards and actual business practices, an employee survey of

236. See Stout, supra note 87, at 14–15 (citing social dilemma studies, as well as judicial opinions in fiduciary cases, as evidence that people are likely to act for others’ benefits when a respected authority expresses and encourages fiduciary behavior).

237. See Stout & Li, supra note 117, at 948 (observing that corporate directors must be “conscious of the signals they send to the organization with respect to the importance of a culture which values ethics, fairness, and doing the right thing”).

238. See Dallas, supra note 200, at 8–12 (citing various theories and research relating to the effect of the corporate context as a guide to ethical behavior).


240. See generally Wagner & Dittmar, supra note 208.

241. See generally BUSINESS ETHICS SURVEY, supra note 195; KPMG FORENSIC, supra note 239 (measuring corporate integrity); LRN ETHICS STUDY, supra note 192 (examining the impact of ethics on purchase and investment decisions).

242. See supra notes 171–72 and accompanying text (describing the “CEO-centric” nature of business
the decision-making and conduct of the company’s management group can be an appropriate methodology to ascertain whether the company’s executives are adhering to fundamental business values.\footnote{243} The various surveys being offered or utilized by consulting firms and survey providers supply a good template of the types of questions that should be included in the employee assessment of management’s behavior.\footnote{244} Identifying the specific number and wording of the questions that should be included in the employee survey is beyond the scope of this Article, and such task can be left to the knowledge and experience of survey writers, behavioral scientists, and ethics experts.

Without attempting to articulate the precise wording of the questions or to be exhaustive about the behavioral manifestations to be explored, the employee assessment should be designed to obtain information, from the internal employees’ perspective, about the attitudes, values, decision-making, and practices of the company’s management group.\footnote{245} The list of areas to explore in the employee survey should include: whether management tolerates, rewards, or punishes illegal or unethical behavior;\footnote{246} the company’s awareness and treatment of management’s conflict of interest transactions;\footnote{247} the likelihood of management’s retaliation against employees who voice dissenting views\footnote{248} or who raise concerns about questionable conduct;\footnote{249} management’s system

\footnote{243} See Dallas, supra note 200, at 23, 43 (explaining that the ethical climate of the organization can be determined through employee questionnaires and stating that ethicists recommend using surveys of employees and other stakeholders to monitor the companies’ ethical compliance programs).


\footnote{245} See Dallas, supra note 200, at 57 (recommending that organizations make periodic self-assessment of their ethical climate by conducting employee surveys, exit interviews, employee focus groups, and other stakeholder surveys and interviews).

\footnote{246} See id. at 34 (citing empirical studies showing that reward systems can affect the likelihood of ethical or unethical behavior). Enron’s reward system encouraged unethical behavior because it failed to consider the means by which employees made money or booked profits for the company. See id. at 45–46, 49, 53 (discussing Enron’s failure to control unethical behavior).

\footnote{247} See id. at 43 (indicating that paying attention to conflicts of interests helps to ensure an ethical climate). The Enron board’s waiver of the conflict of interest provisions regarding related-party transactions in the company’s code of ethics has been regarded as a major contributor to the demise of that company. Id. at 43–44, 51–52, 54.

\footnote{248} See Dallas, supra note 200, at 37 (discouraging dissenting views within an organization decreases the quality of decision-making and increases the likelihood of unethical decisions). Enron’s reporting structure discouraged dissenting views because its managers had to align themselves and be loyal to the members of the Personnel Review Committee who had the ability to protect the managers in the performance review process. Id. at 46–48, 54.
and practices of rewarding themselves and other employees;\textsuperscript{250} the amount of pressure that employees perceive from management to carry out questionable action;\textsuperscript{251} whether corporate executives proceed with speed to investigate or instead to cover up the warning signs and red flags of wrongdoings;\textsuperscript{252} the frequency with which employees witness management overreaching or opportunism;\textsuperscript{253} the consistency between management’s public statements and their conduct;\textsuperscript{254} the company’s truthfulness and fairness in dealing with its employees and customers;\textsuperscript{255} the level of communication and information sharing from senior leaders to the rest of the organization;\textsuperscript{256} the timeliness, completeness, and accuracy of information that the company discloses externally; and the executives’ adherence to internal company policies and procedures as well as external laws and regulations.\textsuperscript{257}

Accounting firms, ethics organizations, business and industry groups, and other consulting organizations have developed management behavior and ethics questionnaires that governance rating agencies can use as templates in formulating a uniform employee assessment of management’s behavior and ethics.\textsuperscript{258} It would be preferable to have all corporate governance rating agencies utilize the same employee assessment. But if there is disagreement among governance rating agencies about the questions to be included in the questionnaire or how to evaluate and rate the employee responses, then each governance rating agency can develop and market its own proprietary employee assessment to distinguish itself from its competitors, in the same way that rating agencies currently develop their own rating criteria and rating methodologies to assess whether directors and officers are performing their duties to enhance shareholder value.\textsuperscript{259}

\textsuperscript{249} See id. at 38 (explaining that an ethical climate is enhanced when employees do not expect management retaliation for the employees’ reporting of ethical violations). Enron employees were afraid to criticize the corporation’s executives for fear of retaliation. Id. at 47–48.

\textsuperscript{250} See id. at 38 (observing that the employees’ perception of compensation disparities and unreasonable expectations by the corporation can contribute to unethical corporate behavior). Compensation disparities and unfair reward practices were exemplified by Enron’s hiring of CEO Jeffrey Skilling’s fiancée as company secretary and paying her an annual salary of $600,000. Dallas, supra note 200, at 46 n.279.

\textsuperscript{251} See id. at 49–50, 53 (indicating that Enron employees faced intense pressure from senior management to conceal losses and overstate profits).

\textsuperscript{252} See id. at 49 (explaining Enron’s culture of covering up problems and mistakes).

\textsuperscript{253} See id. (referencing Enron employees’ observations about management’s accounting and financial manipulations).

\textsuperscript{254} See id. at 56 (recommending that top management model ethical behavior by being consistent in words and actions). Although Enron’s stated values included “Respect, Integrity, Communication, and Excellence,” the company’s employees believed that their executive leaders’ commitment was limited to profit making. See Dallas, supra note 200, at 51 (citing statements made by Enron’s Chairperson and former CEO).

\textsuperscript{255} See id. at 56 (encouraging organizational leaders to demonstrate ethical behavior by being truthful with the organization’s stakeholders). The self-serving and intimidating behaviors of Enron’s Chairman Kenneth Lay, CEO Jeffrey Skilling, and CFO Andrew Fastow have been well documented. See id. at 45–52 (reviewing the general practices of Enron up until its demise).

\textsuperscript{256} See id. at 56 (suggesting that corporate executives model ethical behavior by promoting communication throughout the organization about good news as well as bad news).

\textsuperscript{257} See id. at 45, 52 (indicating that Enron’s culture did not encourage ethical behavior because company employees believed top management expected the employees to work around external laws and internal policies if those rules hindered the employees’ job of making money).

\textsuperscript{258} See sources cited supra note 244 (listing examples of corporate ethics surveys).

\textsuperscript{259} See Rose, supra note 7, at 915 (noting that governance rating services “continually update and retool
Employee assessments of management’s behavior and ethics should be conducted on a company-wide basis. Inclusion of the entire employee base in the survey population is necessary to gather information about the decision-making and conduct of management throughout the various functions, divisions, and hierarchical levels of the organization. Also, the survey needs to cover the entire employee population in order to separate employee perceptions that are idiosyncratic and particular from those that are more reflective of the company as a whole.

A company-wide employee assessment solicits information from the entire employee base, without asking individual employees to step forward. This broad coverage of the employee base provides an advantage over the ethics reporting mechanisms that rely on individual employees to take the initiative to step forward and volunteer information about management misbehavior. Because employees risk ostracism and retaliation if they are identified as providers of information that implicates management misconduct, participation in a broad-based survey provides some ease to those employees who fear identification. Instead of being the only ones expressing their opinions to a designated source such as a human resources representative, a compliance officer, or a whistleblower hotline, the company-wide survey provides a measure of anonymity to the employees as they are surveyed at the same time with all other employees of the organization.

Employee assessments should be conducted as a written questionnaire instead of as an interview. The logistics of administering a written questionnaire are not complex given today’s availability of online survey tools. A written survey provides more anonymity to employees and also provides the respondents with more time for retrospection and recall. Governance rating agencies should review the survey responses and prepare a composite rating of the company’s management group as a whole. Acting as outside parties to administer the employee assessments and compile the employee responses, governance rating agencies can provide a comprehensive view of the organization that is untainted by supervisory pressure, internal agendas, and office politics.

As discussed in this Article, including the entire employee population in the survey strengthens the anonymity of the responding employees. Having an outside party receive their services, in part to remain competitive and be at the cutting edge of governance knowledge, but perhaps also because it is simply good business”.

260. See Dallas, supra note 200, at 57 (suggesting that employee surveys of the organization’s ethical climate should be conducted by the organization as a whole and, when appropriate, in accordance to subunits, job classifications, and hierarchical levels); Ide, supra note 81, at 858 (explaining that “fiefdoms” within corporate divisions may prevent employees from reporting information up the corporate ladder).

261. See BUSINESS ETHICS SURVEY, supra note 195, at 39, 45 (concluding that younger employees are most likely to feel that management will retaliate or view them negatively if they report misconduct); KPMG FORENSIC, supra note 239, at 8 (reporting that approximately half of the employees believed they would not be protected from retaliation for reporting a violation of company standards); Treviño, supra note 231, at 1209 (stating that employees are hesitant to report unfavorable information because they fear retaliation).

262. To prevent a conflict of interest arising from receiving fees for administering the employee assessment and assigning a rating based on the employee responses, governance rating agencies should not charge the companies that agree to conduct employee assessments.

263. See Dallas, supra note 200, at 43 (using outside consultants to conduct exit interviews of departing employees facilitates unbiased feedback).
and compile the written survey responses also provides greater assurance of anonymity to employees. Maintaining the anonymity of the employee making the assessment encourages frank reflection and disclosure. By ensuring confidentiality, the survey is more likely to be successful in soliciting details that can identify general patterns of misconduct and convey the ethical tone of the management group as a whole. With such information, the board of directors and other stakeholders are more able to detect whether management misbehavior or excess has occurred, assess the risk that such management misconduct will continue, and take corrective action to prevent the occurrence of behavior that can erode shareholder value or cause the corporation to collapse.

Potential limitations on utilizing employee surveys to assess management behavior and ethics include the risks of over-reporting and under-reporting by employees. An employee may over-report management misconduct out of personal grievances against specific managers or against the management group in general. Some employees may also lack a long-term relationship or a financial investment in the company that would discourage the employees from attempting to sabotage the reputation of the company.

The risk of over-reporting may be ameliorated by administering the survey to the company’s employee population as a whole. A broad-based survey allows governance rating agencies, while compiling the employee responses, to note the atypical or idiosyncratic comments and to also identify patterns and parallels that would provide a more accurate view of management’s conduct and ethical standards.

Conversely, employees may under-report mismanagement out of fear that they will jeopardize the success of the company by speaking out on management misdeeds. As discussed in this Article, employees may also fear retaliation from disclosing what they know or experience social pressure to keep quiet about what they know. If fear or social pressure discourages employees from fully reporting management’s illegal or unethical conduct, results from the employee assessment may also not reflect an accurate picture of the organization’s integrity.

A counterweight to the potential for under-reporting is that the employees have to assess the perceived risks from disclosing management improprieties against the risks from nondisclosure. Instances of management misconduct are revealed daily in the press, and the collapse of major corporations in the past ten years has heightened employees’ awareness of the role they can play in revealing information that they have about management excess. Employees, when hesitating to expose management improprieties, will have to evaluate the risk that keeping the information untold will allow management opportunism to deplete shareholder value and lead to the demise of the company such that not only the employees’ current source of livelihood but also their accumulation for retirement will vanish.

264. See BUSINESS ETHICS SURVEY, supra note 195, at 43 (concluding that the top two reasons employees do not report misconduct are the belief that no corrective action will be taken and the fear that their identity will not be kept confidential).

265. See Dallas, supra note 200, at 34, 58 (citing a study showing that the existence of a code of ethics or a hotline to report misconduct is less effective in reducing unethical behavior than ensuring that there is consistency between the organization’s ethics policies and actual conduct, that management rewards ethical behavior and punishes unethical behavior, and that the company engages in internal discussions of ethics).
V. CONCLUSION

Corporate governance rating agencies exert strong influence over the governance practices of public companies. Through their governance rating criteria, rating agencies motivate public companies to adopt governance practices that are perceived by rating agencies to be conducive to enhancing officers’ and directors’ performance of their respective management and oversight responsibilities. Missing from the current governance rating criteria is an evaluation of the behavior and ethics of the management group—an evaluation that would provide information that the board of directors needs to assure that management’s decisions and conduct uphold the integrity of the organization and do not undermine the financial performance of the company.

To enhance performance of the board’s oversight function and improve management’s conduct, governance rating agencies should include a rating criterion relating to the company’s assessment of management’s business standards and behavior. Conducting assessments of management’s behavior and ethics will provide information that can enhance the board’s monitoring function and that is of interest to the investing public and other stakeholders of the company. Gathering and providing that information may also enhance the financial performance of the company by attracting investors, employees, and customers who are interested in affiliating themselves with a company that exhibits high standards of business ethics.

Employees have the best access to corporate executives’ actual decision-making process and behavior, and the employee group constitutes a unique source of nonpublic information about management’s performance. By promoting the use of employee assessments of management’s business practices and utilizing such assessments as a rating criterion, governance rating agencies can exercise their influence in the area of corporate governance both to enhance directors’ performance of their oversight function and to promote management’s business ethics and corporate integrity. As we have seen in the notable corporate events of the past decade, companies can collapse because of poor managerial behavior and ethics. Gathering and evaluating information about management conduct for use by the board, shareholders, and other stakeholders may ultimately act to preserve the company’s financial performance and existence.