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Sorry, But the CEO's Divorce Is the Board's Business

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by Corporate Counsel | June 10, 2014

Case Digest Summary

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An important new survey serves to further erode the traditional executive compact in corporate America; *i.e.*, the notion that what CEOs do on their own time is their business, as long as they are not violating any laws. To the contrary, governing boards—mindful of the need to protect the corporate reputation—are now extending their review of executive conduct to a 24/7 cycle. But not without some controversy.

Over the last several years there have been numerous instances of boards taking action against otherwise productive CEOs for matters of personal conduct outside the workplace—see, for example, the cases of Stephen P. MacMillan, the former CEO of Stryker Corp. (http://online.wsj.com/news/articles/SB10001424052970203833004577249812320223298); ex-Best Buy Co. Inc. CEO Brian Dunn (http://money.cnn.com/2012/05/14/news/companies/best-buy-ceo/); and Ken Melani, former CEO of Highmark Inc. (http://pittsburgh.cbslocal.com/2012/03/29/highmark-ceo-facing-charges/) These and many similar instances have included illicit interpersonal relationships, offensive or harmful communications, public positions on political matters that are contrary to the corporation's mission and physical confrontations. Now, add divorce to the list.

The "Separation Anxiety: The Impact of CEO Divorce on Shareholders" (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2331605) survey, conducted by Stanford University professor David F. Larcker, a nationally recognized corporate governance expert, argues that CEO divorce can impact the corporation and its shareholders in at least three potential ways:

- The *first* point of impact relates to the decline in influence of the CEO when forced by the divorce settlement to relinquish a substantial portion of his/her ownership position in the company. With no, or a reduced, stake in the company, the CEO may be less able to exert control over the organization and affect decision making. Shareholder reaction will depend upon their pre-existing perceptions of the effectiveness of management.
- The *second* point of impact is with respect to CEO productivity, concentration and energy. Larcker's survey cites studies that suggest a notable decline in corporate productivity following a CEO divorce. Indeed, in extreme circumstances, the distraction of divorce may prompt the CEO to retire prematurely. In either situation—lack of productivity or premature retirement—the organization can suffer materially.
- The *third*—and potentially most alarming—point of impact is the potential effect of divorce on the CEO's approach to risk. A board-driven executive compensation program and related oversight guidelines are normally intended to provide appropriate incentives for informed risk taking. The concern, as identified by Larcker's study, is that the sudden change in wealth that often accompanies a divorce could, without careful board oversight, affect the CEO's attitude towards risk, and thus affect his or her judgment.

Thus the conclusion is that CEO divorce can affect corporate value because of its potential impact on the CEO's "control, productivity and economic incentives." According to Larcker's study, significant personal developments affecting the CEO—such as divorce—have a direct impact on the interests of shareholders (and other corporate constituents). For that reason, CEO divorce must be a matter of importance to boards. In this regard, it should be noted that these concerns with respect to CEO divorce extend across industry lines and, at least with respect to Larcker's second and third factors, are applicable as well to large nonprofit corporations.

Yet, that could be a difficult "sell" to many boards. Otherwise aggressive board leaders may be reluctant to address matters associated with CEO divorce. To some, it is one thing to take action against an executive whose personal conduct brings disrepute upon the corporation, as would be the case with actions that may seem immoral, unethical, unseemly or outrageous. But it may be an entirely different thing to take action with respect to a CEO for divorce, given that incidents of marital discord or an actual divorce are not, in and of themselves, likely to generate scorn or public controversy. The necessity for intervention may not be immediately clear to the board, which may understandably think that doing so would violate that traditional "compact" with the CEO.

Yet, the board may have no choice. While some personal conduct developments may "only" affect corporate reputation, the Larcker study makes clear that divorce may have more fundamental implications on corporate value and on shareholder/constituent interests. So, in some respects, it's an easier call. The question then becomes: What to do about it? Provide a foundation of support, counseling and assistance? Adjust the compensation arrangement when it is appropriate to do so? Monitor performance for evidence of the "telltale" concerns identified by Larcker's study? Crank up the executive succession process, just in case?

The proper answers will depend upon the actual facts and circumstances at each company, and most certainly will require close focus by the board and general counsel. And—in doing so—board leadership will need to balance the benefits of confidentiality that can be gained from restricting knowledge to the executive or similar committee against the benefits of full transparency that can be gained from sharing knowledge with the full board, and making such public disclosures as may be advisable.

The answer may also be found in guidelines that more explicitly set forth board expectations concerning CEO conduct. As boards have become more proactive concerning the personal conduct of their senior executives, many have found such guidelines to be helpful in resolving thorny issues involving the CEO's personal life that could affect the corporation's reputation. (This is as opposed to issues involving business ethics, which typically are covered by the organization's code of conduct.) For example, a corporate code of executive personal conduct might provide guidelines to executives with respect to use of their discretionary allowances; assuring expense account review by an independent board member or committee; and turning to outside counsel to resolve sensitive concerns involving personal ethics. They could also provide the basis from which the board could become involved in highly personal matters such as CEO divorce.

Such guidelines can serve to support fair, balanced and informed board decisions about executive employment status when confronted with evidence of material personal indiscretion. They also establish a baseline of expectations between the board and senior leadership.

It used to be the case that the CEO's personal life was off-limits to corporate governance; that what the CEO did (or did not do) on his own time was his/her own business. As events of the last several years have demonstrated, that old compact no longer applies. Boards more clearly recognize the need to take action with respect to CEO conduct that can negatively affect the corporate reputation, its operations and its productivity. As Larcker's study persuasively makes clear, divorce falls into that category of personal conduct that must become the board's business—as distasteful as it may seem at first. It really *is* the board's business.

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