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SCARLET LETTER: ARE THE CEOs AND DIRECTORS OF FAILED COMPANIES “TAINTED”?

There is a vast research literature that chronicles the impact when a company suffers a major governance failure (which might be due to an ethical or accounting violation or to insufficient risk management and oversight). First, stock prices fall around the initial announcement period, with the magnitude of the decline commensurate with the severity of the failure.¹ Second, stock price underperformance tends to persist well past the announcement period, suggesting that the damage to the company is of potential long-term consequence.² Third, the companies (and their officers and directors) often face lawsuits from shareholders and regulators, who seek to be compensated for their losses.³ And finally, there is elevated turnover in both the executive suite and the boardroom, as companies signal to the market that they are serious about reform.⁴

The impact on the long-term careers of the former executives and directors of these companies, however, is less clear. Recent experience suggests that many CEOs and directors of failed companies are able to retain outside directorships—and even obtain new ones—following their forced departures. For example, after resigning from Citigroup in 2007, former chairman and CEO Charles Prince was elected to the board of Xerox. Stanley O’Neill, former chairman and CEO of Merrill Lynch, was not only named a director of Alcoa but was also appointed to that company’s audit committee. Nonexecutive directors at Lehman Brothers, Wachovia,

¹ Zoe-Vonna Palmrose, Vernon J. Richardson, and Susan Scholz, “Determinants of Market Reactions to Restatement Announcements,” *Journal of Accounting & Economics* (2004).

² Mark Grothe and Poonam Goyal, “Trend Report Restatements: Restatement Dust Settles,” Glass Lewis (March 19, 2009).

³ Approximately 200 class-action lawsuits are filed each year against public companies for federal securities violations. See Stanford Law School and Cornerstone Research, “Securities Class Action Clearinghouse.” Available at: <http://securities.stanford.edu/>.

⁴ Marne L. Arthaud-Day, S. Trevis Certo, Catherine M. Dalton, and Dan R. Dalton, “A Changing of the Guard: Executive and Director Turnover Following Corporate Financial Restatements,” *Academy of Management Journal* (2006).

Professor David F. Larcker and Brian Tayan prepared this material as the basis for discussion. Larcker and Tayan are co-authors of the book *Corporate Governance Matters*. The Corporate Governance Research Program is a research center within the Stanford Graduate School of Business. For more information, visit: <http://www.gsb.stanford.edu/cgrp/>.

Washington Mutual, Bear Stearns, and AIG all gained new directorships after their companies failed (see **Exhibit 1**).⁵

Clearly, circumstance plays a role in determining whether leaders of failed companies are fit to serve as directors of other organizations. For example, the opinions might be based on the degree to which these individuals were associated with wrongdoing. They might also depend on the individual’s capacity to learn from error. In these cases, companies might benefit from the knowledge and experience gained firsthand by individuals who have been involved with a crisis or failure.

On the other hand, there are reasons why the executives and directors of failed companies might not be fit to hold future directorships. First, governance failures are not the same as managerial failures. Executives are hired with the express purpose of taking strategic risk to increase shareholder value, some of which might not work out as hoped. Corporate monitors, by contrast, are hired with the express purpose of detecting malfeasance. While “failure” is an expected part of a managerial job, it is not an expected part of a monitoring job.⁶ Second, governance failure might reveal underlying character flaws in the leaders themselves. If executives and directors were not sufficiently engaged in their duties (or, worse, if they exhibited low levels of integrity), these shortcomings might manifest themselves again in other settings. Third, companies that retain such individuals in the future might be subject to heightened scrutiny. Rightly or wrongly, these individuals have incurred reputational damage simply through their association with a failed firm. Companies that subsequently employ them are likely to face pushback from shareholders and stakeholders.⁷

There is some evidence that the executives of failed companies are treated more strictly than the directors of those same companies. According to a recent survey of executives and directors, only 37 percent believe that the former CEO of a company that experienced substantial accounting and ethical problems can be a good board member at another company. By contrast, 67 percent of respondents believe that directors of such a company can be a good board member elsewhere. When asked to elaborate, respondents tend to suggest that the CEO is held to a higher standard of accountability, given his or her position of leadership. By contrast, directors are presumed to have less involvement in potential violations and are also seen as able to learn from mistakes of this nature. However, these opinions are not universal (see **Exhibit 2**).⁸

⁵ Suzanne Craig and Peter Lattman, “Companies May Fail, but Directors Are in Demand,” *The New York Times* (Sep. 14, 2010); and Joann Lublin, “Staying on Boards after Humble Exit,” *The Wall Street Journal* (Jun. 6, 2011).

⁶ For this reason, the cause of a corporate failure must be clearly diagnosed and managerial failures distinguished from governance failures.

⁷ For example, in 2002, the AFL-CIO circulated a letter urging all public companies to remove from their board any directors who had also served on the board of Enron. See Reed Abelson, “Endgame? Some Enron Board Members Quit or Face Ouster at Other Companies,” *The New York Times* (Feb. 9, 2002).

⁸ Heidrick & Struggles and the Rock Center for Corporate Governance at Stanford University, “2011 Corporate Board of Directors Survey,” (2011). Available at: <http://www.gsb.stanford.edu/cgrp/>.

WHY THIS MATTERS

1. In recent years, there have been many large- and small-scale corporate failures, driven in part by ethical, accounting, or risk management improprieties. However, the executives and directors of these companies have in many cases gained employment as directors of other firms. Should this be a concern for shareholders of these firms?
2. Executives and directors often suffer reputational damage from their association with a failed company. What is the standard by which their “culpability” should be judged? When are these individuals fit to hold future directorships, and when are they “too tainted” by their experience?
3. How plausible is the argument that an officer or director involved in an accounting or ethical problem “should have learned valuable lessons from the experience” that makes them a valuable board member for other companies?

Exhibit 1

Former and Current Directorships (Selected)

Former Director (2007)	Current Directorships (2011)
American International Group	
Marshall A. Cohen	Barrick Gold, Gleacher, TriMas, TD Ameritrade
Martin S. Feldstein	Lilly
Fred H. Langhammer	Central European Media, Estée Lauder, Walt Disney
Stephen F. Bollenbach	KB Home, Macy's, Time Warner
Ellen V. Futter	Con Edison, JPMorgan Chase, NYC
Michael H. Sutton	Krispy Kreme
Bear Stearns	
Henry S. Bienen	Gleacher, Onconova
Michael Goldstein	4 Kids, Charming Shoppes, Medco, Pacific Sunwear
Paul A. Novelly	Boss Holdings, Bond Street Holdings, FutureFuel
Frederic V. Salerno	Akamai, CBS, IntercontinentalExchange, Natural Fuel Gas, Viacom
Vincent Tese	Cablevision, IntercontinentalExchange, MSG, Mack Cali Realty
Lehman Brothers	
Marsha J. Evans	Huntsman Corp, Office Depot, Weight Watchers
Roland A. Hernandez	MGM Mirage, Ryland Group, Sony, Telemundo, Vail Resorts
Wachovia	
John D. Baker	Patriot Transport, Progressive Energy, Texas Industries, Wells Fargo
John T. Casteen III	Altria
Maryellen Herringer	ABM Industries, PG&E
Robert A Ingram	Allergan, Cree, Edwards Lifesciences, Lowe's, and Valeant
Donald M. James	Southern Co., Vulcan Materials, Wells Fargo
Mackey McDonald	Bernhardt Industries, Hyatt, Kraft, VF Corp, Wells Fargo
Joseph Neubauer	Aramark, Macy's, Verizon
Ruth G. Shaw	DTE Energy, Dow Chemical
G. Kennedy Thompson	BNC Bancorp, Hewlett-Packard
Dona D. Young	Foot Locker
Washington Mutual	
Stephen I. Chazen	Occidental Petroleum
Stephen E. Frank	Aegis Insurance, Southern Cal Edison, NV Energy
Charles M. Lillis	Medco, Supervalu
Orin C. Smith	Nike, Walt Disney

Source: The Securities and Exchange Commission.

Exhibit 2
2011 Corporate Board of Directors Survey (Selected Data)

	All Respondents	Female Only	Male Only	Active CEO/Chair Only	Retired CEO/Chair Only
<i>Can an ex-CEO of a company that experience substantial accounting and ethical problems be a good board member at another company?</i>					
Yes	37.2%	31.4%	38.3%	42.9%	35.0%
No	62.8%	68.6%	61.7%	57.1%	65.0%
<i>Can a board member (not the CEO) at a company that experience substantial accounting and ethical problems be a good board member at another company?</i>					
Yes	67.1%	61.1%	68.2%	65.9%	67.6%
No	32.9%	38.9%	31.8%	34.1%	32.4%

Regarding the CEO:

“The CEO may only know what he/she has been presented.”

“A good CEO learns why he missed the flaws, and does not drop the ball twice...”

“As long as their integrity is not compromised, experience can be valuable / add a new perspective.”

“As the CEO, he or she clearly must have had some lapse in leadership and oversight for there to be a substantial accounting or ethical issue in his/her tenure.”

“Ethical problems are not caused by a lack of knowledge, they are caused by character flaws (and character doesn't change).”

“Even if they learned valuable lessons the reputational risks are too high and their credibility with other board members is a problem.”

“Once tainted, it is impossible to regain confidence in their integrity.”

“Tone at the top is a key driver of corporate culture and the CEO is the most influential person in setting tone at the top. Accounting and ethics issues at his / her company are usually the result of problems with CEO performance.”

Regarding directors:

“Assuming the board member was not involved in the irregularities, he or she should have learned valuable lessons from the experience.”

“At the end of the day it is the board that shareholders place trust in, and they must have and show understanding of the company's accounts.”

“Board members can be misled by management and learning to be skeptical from such an experience can make for a better board member.”

“If it happened on their watch, you have to question how engaged they are in good governance.”

“Board members are more effective generally if they have experienced difficulties in their own careers.”

Source: Heidrick and Struggles and the Rock Center for Corporate Governance at Stanford University, “2011 Corporate Board of Directors Survey.”