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The consequences of managerial indiscretions: Sex, lies, and firm value☆

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ABSTRACT

Personal managerial indiscretions are separate from a firm's business activities but provide information about the manager's integrity. Consequently, they could affect counterparties' trust in the firm and the firm's value and operations. We find that companies of accused executives experience significant wealth deterioration, reduced operating margins, and lost business partners. Indiscretions are also associated with an increased probability of unrelated shareholder-initiated lawsuits, Department of Justice and Securities and Exchange Commission investigations, and managed earnings. Further, chief executive officers and boards face labor market consequences, including forced turnover, pay cuts, and lower shareholder votes at re-election. Indiscretions occur more often at poorly governed firms where disciplinary turnover is less likely.

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1. Introduction

In 2012, the *Wall Street Journal* (*WSJ*) reported that Scott Thompson, Yahoo! Inc.'s chief executive officer (CEO), lied about obtaining a computer science degree. In 2007, the *WSJ* reported that Chris Albrecht, the head of Time Warner's HBO unit, assaulted his girlfriend outside a Las Vegas, Nevada, casino following the Oscar De La Hoya versus Floyd Mayweather Jr. boxing match. These revelations no doubt were personally embarrassing to Mr. Thompson and Mr. Albrecht, but were they important for Yahoo! and Time Warner? Do these personal indiscretions imply firm-level consequences and are signals of personal integrity important for firm value?

Despite the simplicity of this question, strong a priori arguments exist for and against an affirmative answer. Prior research indicates that illegal or opportunistic behavior affects firm value only when it results in significant legal penalties or affects the firm's contracting with counterparties in an unanticipated manner. Personal indiscretions, however, are not generally associated with significant legal penalties to the firm. The lingering economic question then is whether personal indiscretions of managers affect the firm's reputation in ways that impact counterparty transactions. If they do, the implication is that private market forces work to discipline personal misconduct.

It is possible that there is no link between a manager's personal indiscretions and the firm's operations and business relationships. Previous research finds that environmental violations tend to result in substantial legal and regulatory costs, and that the revelation of an environmental violation is associated with a significant loss in share value, but not reputational losses (Jones and Rubin, 2001). Presumably, environmental infractions do not significantly impact the firm's counterparties, i.e., its customers, suppliers, employees, and investors (Karpoff et al., 2005). Other examples of misconduct that do not correspond to reputational losses are minor regulatory violations and foreign bribery (Murphy et al., 2009; Alexander, 1999; Cheung et al., 2012; Karpoff et al., 2015). In this regard, personal indiscretions could be similar to environmental violations or foreign bribery, in that they do not affect contracting with counterparties (i.e., no reputational effect). Thus, the contention that a manager's personal life has no effect on firm operations and firm value is entirely plausible. We term this the separate affairs hypothesis.

In contrast, some argue that there is spillover from a manager's personal indiscretions to job performance and firm value, which we term the integrated affairs hypothesis. The theoretical links for spillover effects are reputational losses to the manager and the related impact on counterparty transactions. Erhard and Jensen (2014) and Erhard et al. (2014) argue that management's reputation for integrity is a factor of production. To the extent that these personal indiscretions signal low integrity, their revelation can impact the firm.[1]

[1] Spanos and Angelis (2016) summarize evidence that suggests that even events such as information systems security breaches can engender a lack of trust at certain companies.

Consider four potential sub channels for this impact. First, personal managerial guarantees can be important to the formation of profitable business relationships. Johnson et al. (2015), Cen et al. (2015), and Cremers et al. (2014) focus on how takeover defenses support such personal guarantees. Personal misconduct plausibly undermines the credibility of implicit and explicit agreements with strategic partners, employees, suppliers, customers, and owners of financial capital. A joint venture partner, for example, could decide to back out of a deal to co-locate a manufacturing facility if it infers that the cheating manager is more likely to act opportunistically. The indiscretion manager's firm would lose business, creating a reputational cost.

Second, and related, the managerial indiscretion could increase the probability that the manager will be replaced, putting any implicit guarantees of the manager in jeopardy. As Shleifer and Summers (1988) argue, the business relationship between two firms is bonded in part by the manager's personal guarantees. If the manager leaves, that bond disappears and the exposed counterparty could be less willing to conduct business with the company.

Third, the indiscretion could signal a shift in the firm's culture to one that now implicitly condones opportunistic behavior. The likelihood of engaging in questionable behavior should decline with the manager's expected costs from being caught, costs that increase with enforcement actions by the firm. Thus, a firm's counterparty could infer from a managerial indiscretion that the firm does not penalize opportunistic behavior as strictly as previously anticipated and reevaluate its business relationship with the company.

Fourth, the managerial indiscretion could reveal an increased likelihood that the managers are willing to sacrifice long-term relationships for short-term gains. The models of Shapiro (1983) and Klein and Leffler (1981) suggest that firms do not cheat their counterparties in equilibrium. An unexpected change in the costs and benefits of cheating, however, can make the benefits of short-term cheating increase relative to the long-term costs. Therefore, a managerial indiscretion could indicate the manager's benefits of cheating are higher than previously anticipated.

We argue that the revelation of an executive's personal indiscretion serves as a proxy for his lack of personal integrity and signals the value he places on his reputation. Under the integrated affairs hypothesis, this revelation decreases counterparty trust in the manager and the firm, which subsequently affects corporate relationships. Firm value is lowered either because a loss of trust damages the firm's relationships with strategic partners, financiers, and other stakeholders or because the indiscretion imposes direct costs as the firm adjusts to minimize the damage.

The importance of personal integrity to firm value has received little empirical attention. One reason for this is the difficulty in measuring the impact of integrity. Identifying executives with low integrity before corporate misdeeds are committed is challenging. In addition, measurements of losses around bad corporate behavior are intertwined with the impact of the acts themselves. An important literature focuses on allegations of fraud, shareholder lawsuits, and earnings management, and a general presumption is that executives committing these acts have