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Do Executive Employment Agreements Need Morality Clauses?

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Keeping Talent on the Straight and Narrow

The hyper-scrutiny of the entertainment world has grown increasingly common in the world of board rooms and corporate executives.

Top talents in the business and entertainment worlds have recently suffered the consequences of real and/or perceived moral and ethical transgressions. The examples of Boeing's Harry Stonecipher (consensual love affair issues) and fashion icon Kate Moss (substance abuse issues) show that business must confront and respond to a range of controversial personal conduct by its stars.

Corporate boards, executives, lawyers and, of course, reporters, are asking: do "morality clauses" have a legitimate place in employment agreements for top executives?

The answer is: they are almost always in there already. In almost every publicly-disclosed CEO agreement one may care to review, standards of personal conduct are plainly, indeed prominently, framed among the by-now familiar definitional verbiage of "cause for termination."

Should recent scandals prompt even more verbiage? Is the solution to add long, tortured clauses to already lengthy agreements in hopes of ever more sharply defining the limits of private (mis)conduct? We think not.

Boards, executives and their advisers can effectively use and adapt the existing range of "cause" definitions to fairly and efficiently handle the intersection of company interests and an executive's personal conduct. A clear company "code of conduct" that applies to everyone — including the CEO — can also go a long way to empowering the board and the entire company to maintain acceptable standards of conduct that are right for the company.

What's Already Out There — a Sampler Of 'Morality Clauses' Typically Found In Definitions of 'Cause'

The morality clause most typically found in an executive employment agreement is usually nestled in the agreement's definition of what constitutes "cause" for a termination. A termination for cause is almost always an event that will cost the company less, and the executive more, than a termination not for cause. The dollar differential can obviously be quite substantial.

But not all such executive employment morality clauses are built the same. It is probably fair to generalize and state that, in most cases, they are not as long and exhaustive as might be found in some agreements for the personal services of superstars in the entertainment world (with all their notorious eccentricities and vices, real or imagined). Nonetheless, there is significant variation in the language that finds its way into executive employment contracts. Executives and their legal counsel should benefit from the following brief sampler, drawn at random from publicly disclosed CEO agreements — the morality-related clauses are in boldface:

Example 1

For purposes of this agreement, "cause" shall mean one or more of the following:

(I) the material violation of any of the terms and conditions of this agreement or any written agreements the executive may from time to time have with the company (after 30 days following written notice from the board specifying such material violation and executive's failure to cure or remedy such material violation within such 30-day period);

(II) inattention to or failure to perform executive's assigned duties and responsibilities competently for any reason other than due to disability (after 30 days following written notice from the board specifying such inattention or failure, and executive's failure to cure or remedy such inattention or failure within such 30-day period);

(III) engaging in activities or conduct injurious to the reputation of the company or its affiliates including, without limitation, engaging in immoral acts which become public information or repeatedly conveying to one person, or conveying to an assembled public group, negative information concerning the company or its affiliates;

(IV) commission of an act of dishonesty, including, but not limited to, misappropriation of funds or any property of the company; or

(V) commission by the executive of an act which constitutes a misdemeanor (involving an act of moral turpitude) or a felony.

Comments on Example 1

The "morality" language in example 1 is, from the standpoint of the executive at least, too broad. Subparagraph III starts off with a comforting reference to "activities or conduct injurious to the reputation of the company or its affiliates." This seems on first blush fair and appropriate — the company should be entitled to a CEO that does not engage in conduct that injures the company's reputation.

But the clause somewhat awkwardly goes on to qualify this so as to suggest that any "immoral act" on the part of the executive "which become[s] public information" would in fact constitute conduct injurious to the company's reputation. Not every immoral act rooted out by an inquiring media is necessarily material to a company's reputation. And, of course, who is to say what is an "immoral act?" This agreement makes no effort to define what immorality it contemplates.

What if it became public information that the executive was a week late on three consecutive child support payments? Some might with reason deem this immoral. But others might not, and it might depend on various circumstances. Under the phrasing in example 1, if such conduct became public, the board could probably justify a termination for cause. It could do this even though such conduct is, arguably, highly private and not material to the company's business.

Sub-paragraph III suffers from some other problems as well: it includes as "cause" "conveying to an assembled public group, negative information concerning the company or its affiliates." The superficial clarity of this clause tends to hide the nebulousness of the earlier "immoral acts" portion of the sentence. Moreover, this clause would arguably empower the company to fire the CEO for cause for making true, material disclosures at an annual meeting.

Sub-paragraph IV and V of example 1 also suffer from breadth problems. Any act of undefined "dishonesty" is enough for cause under this formulation. And any misdemeanor that involves an undefined act of "moral turpitude" is also cause — whether the misdemeanor or its disclosure has or would tend to have any effect on the company or not.

Example 2

A. Cause. For purposes of this agreement, "cause" shall mean:

1. the willful and continued failure of the executive to perform substantially the executive's material duties (other than as a result of the mental or physical illness of the executive or any such failure as may allegedly occur after the executive issues a notice of termination for good reason pursuant to Section IV(D) hereof) for a period of 30 days or more after a demand for substantial performance is delivered to the executive by the board which specifically identifies the manner in which the Board believes that the executive has not substantially performed the executive's material duties;

2. the executive engages in illegal conduct or gross misconduct which is materially and demonstrably injurious to the commercial interests of the company;

3. the executive commits an act of fraud, misappropriation, embezzlement or other similar act of dishonesty;

4. the executive is formally charged by an appropriate governmental authority with having engaged in any conduct of the type described in subsections 2 or 3 above; or

5. the executive is convicted or pleads guilty or *nolo contendere* to criminal misconduct constituting a felony or gross misdemeanor involving a breach of ethics, moral turpitude or other immoral conduct which reflects adversely upon the reputation or interests of the company or its customers or vendors or the executive becomes subject to criminal sanctions that will prevent the executive from performing his duties in the ordinary course for a period of time that is likely to exceed 30 days.

Comments on Example 2

As a "morality clause" that defines "cause" for termination purposes, the language of example 2 is considerably tighter than that of example 1 and is certainly fairer to the executive. Sub-paragraph 2 is clear that not any illegal conduct will be cause — only illegal conduct "which is materially and demonstrably injurious to the commercial interests of the company." This imposes a fair burden on the company to connect an executive's misconduct or illegal conduct with some effect or likely effect on the company's business.

Sub-paragraph 3 avoids overbreadth and focuses specifically on "fraud, misappropriation, embezzlement or other similar act of dishonesty" — all actions which most would agree are material to an executive's fitness whether they involve the company directly or not. Whether a "formal charge" by a governmental authority for any conduct of the sort already outlined should be enough for "cause" (as stated in sub-paragraph 4) is probably a matter fairly left for negotiation, which may be affected by consideration of the nature and risks of the company's business and business environment. (If, for instance, the business involves various operations in certain notoriously corrupt foreign settings, with risk of false implication in foreign corrupt practices, then a "formal charge" might not be appropriate cause.)

Sub-paragraph 5 again appropriately links convictions or guilty pleas to actions "which reflect[] adversely upon the reputation or interests of the company or its customers or vendors." Again, before cause can arise from "immoral" conduct, the company should be required to show some rational relationship to its business and reputation.

Example 3

"Cause" means any of the following:

(i) the willful commission by the executive of acts that are dishonest and demonstrably and materially injurious to the company or any of its affiliates, monetarily or otherwise;

(ii) the conviction of the executive for a felonious act resulting in material harm to the financial condition or business reputation of the company or any of its affiliates.

Comments on Example 3

As noted, example 1, above, is far too broad and biased in the company's favor. Example 2 is more balanced and fair to the executive, but still fairly comprehensive in covering various potential "immoral" behaviors. In contrast, example 3 is generous to the executive and perhaps overly so.

Sub-paragraph (i) reaches "dishonest" acts and properly limits this to dishonest acts that are "demonstrably and materially injurious to the company or any of its affiliates, monetarily or otherwise." But the clause further limits "cause" on this basis to "the willful commission" of such acts. The addition of the word "willful" could be seen to obligate a board to do additional diligence to support a specific finding of *scienter*, an added effort that probably shouldn't be required once the board has formed a reasonable, good-faith belief that dishonesty has occurred and has hurt the company.

Sub-paragraph (ii) is also rather forgiving to the executive in that it limits "cause" on this basis to "felonious" acts — and even then, only to felonious acts "resulting in material harm to the financial condition or business reputation of the company or any of its affiliates." This is a stiffer standard for the company to meet than the "reflects adversely upon the reputation or interests of the company" standard found in example 2.

The foregoing three examples show that there is a lot of room for artful drafting and negotiation when it comes to "cause" definitions and "morality clauses" in executive employment agreements. Practitioners can take advantage of readily available precedent found in public company filings for more ideas.

Negotiating the Right to Do Wrong?

When business executives and their lawyers are confronted with an employment, consulting, or similar ser-

vices agreement that includes a so-called morality clause (also variously known as "morals clauses" and "sin clauses"), however framed, they may legitimately need and want to narrow sharply the scope of such language.

But demanding that the company keep its nose entirely out of an executive's personal life can seem, in practice, a lot like demanding the right to do wrong. And that can be a tricky proposition.

What are some good reasons for demanding that your client retain the right to sin and transgress without limitation in private? Are there any good reasons for telling a corporate counterparty in an employment negotiation to back off and let the executive have his or her own personal, private space within which anything goes? Even adultery, drugs, sexual promiscuity or deviation from the mainstream, or other "questionable" conduct or predilection (name your sin…)? And isn't demanding the removal of a "morality clause" a clear if implicit admission that your client is a sinner and intends to continue being one?

Executives, like all people, need and are entitled to privacy. In California, as in some other jurisdictions, privacy is an important legal right explicitly enshrined in the state constitution and taken very seriously by the courts. And, aside from the legal niceties, privacy can be critical to the health and productivity of a top executive. Indeed, the more of a public cheerleader and emotional leader an executive may be, the more the rejuvenative qualities of private time out of the spotlight may be critical to maintaining top form.

Executives can take a lesson from Hollywood: even the biggest Hollywood stars with large public personas (George Clooney comes to mind) are ever mindful of preserving their privacy. Many such public figures take time to circumscribe personal zones that must remain inviolate and do so explicitly when called on to "negotiate" those zones by media and fans. Frequently, portions of the common publicity interview (on say Letterman or Leno) are devoted to a kind of negotiation about privacy. Business executives must be prepared to negotiate strategically for privacy as well.

But even persuasive reasons such as privacy and a healthy work/life balance may have to give way to competing considerations such as:

(1) a company's legitimate need for a moral and ethical leader with unassailable personal morality;

(2) a company's business need to maintain its image (whatever that image might be) in the context of relentless marketplace branding of its products and services; and

(3) a company's legitimate liability concerns stemming from a reasonable analysis of likely or possible consequences of proscribed conduct on customers, consumers, and/or business partners and stakeholders.

Nonetheless, counsel for the executive may legitimately ask whether such topics need be in a specific executive's employment agreement at all, as opposed to being dealt with in a fair and nondiscriminatory way in company policies that are applicable to all employees.

Who Needs a Morality Clause When You Can Have a Code of Conduct? — Some Observations Of the Stonecipher Affair

In March 2005 Boeing announced that its board had asked for and received the resignation of CEO Harry Stonecipher. The so-called ouster of Stonecipher came after the board received an anonymous tip that Stonecipher, a married man, was romantically involved with a female executive at the company, albeit consensually.[1]

Did Boeing invoke a morality clause to justify its response to Stonecipher's conduct? The answer is no. Indeed, it is a noteworthy fact that Boeing does not (or at least did not) have employment agreements with its top executives at all.[2]

Boeing did not need a contractual morality clause. Boeing's board simply determined (after an investigation by legal counsel) that Stonecipher's "actions were inconsistent with Boeing's code of conduct."[3]

The Boeing code of conduct is a short and straightforward document that includes the requirement that "employees will not engage in conduct or activity that may raise questions as to the company's honesty, impartiality, reputation or otherwise cause embarrassment to the company."

The full text of Boeing's code of conduct as it appears to have stood at the time of the Stonecipher matter is set forth in the endnotes, and the current code may be available on www.boeing.com.[4]

Boeing's emphasis on simple, generally applicable codes of conduct that set high standards and link them to the well-being of the company's business is a good approach. According to its 2005 proxy statement, Boeing also requires that all employees sign and annually recommit to the company's code of conduct. Companies that follow this practice can go a long way to heading off employee claims that they developed a "reasonable expectation of privacy" in conduct that violates the policy.

Though many (including this author) originally felt Stonecipher's personal business was his own, and that

Boeing's legitimate interest was in its arguably far-removed bottom line, Stonecipher's relationship was apparently covered by Boeing's code of conduct. First, Stonecipher's relationship with an executive junior to him in the company created the potential for a conflict of interest because it was a potential sexual harassment situation — Stonecipher was ultimately his lover's supervisor, albeit more than one level removed.

Other provisions of the code also support the final result, including those regarding integrity. Boeing was working hard to recover from a government contracting scandal, and Stonecipher was leading that effort. Engaging in marital infidelity did not make Stonecipher the model of integrity Boeing may legitimately have felt it needed as CEO at the time (indeed Stonecipher as CEO reportedly had been advocating such high standards).

Ultimately, and at a minimum, Stonecipher admitted publicly that — consistent with the position taken by the company — he had shown poor judgment in using the company e-mail system to send the (apparently racy) e-mail that evidenced the affair and began the chain of events leading to his termination.

This brief examination of Boeing's response to the Stonecipher situation suggests that "morality clauses" would add little to the equation in navigating corporate responses to executive "misbehavior." Boeing wisely did not focus its analysis or discussion of Stonecipher's situation on his "morality." Instead, the company stressed its own business needs for a strong reputation and a leader who displays unassailable judgment. A morality clause would not have meaningfully strengthened Boeing's hand and reliance on one might have weakened it.

Spotting The Hidden Morality Clause — Beware Of Overbroad 'No Illegal Conduct' Clauses

Sometimes, a problematic morality clause can be lurking in broad and seemingly innocuous language that prohibits an executive from engaging in any "illegal conduct." Such prohibitions are also sometimes phrased in terms of "misdemeanors" and "felonies." Clauses like this (alone or with other language in the agreement) often make any such illegal conduct a ground for termination for cause. A termination "for cause" or "for good cause" is almost always financially unpalatable for the executive (and beneficial to the company) because it reduces or eliminates any severance package.

Accepting a trigger for "good cause" termination that is as broad as "any illegal conduct" can create serious problems. There may be some private behaviors that the mainstream of corporate America regards as acceptable and personal, but that could be technically illegal. A prime example: homosexual relations.

Consider, for example, this hypothetical: a high-powered business executive who happens to be gay finds himself confronted with a proposed employment agreement that says any "illegal conduct" will be grounds for immediate, severance-free termination. Such a clause is unacceptable. In some jurisdictions, up until very recently, laws prohibiting homosexual sex were on the books and were apparently enforceable. Even as Supreme Court decisions have shifted and declared such laws unconstitutional, such conduct may remain nominally "illegal" in certain jurisdictions.

Practitioners should also consider whether other "illegal conduct" that is trivial or unobjectionable might trigger a poorly drafted "illegal conduct" clause. For instance, a citation for public spitting (what if your CEO client really likes his chewing tobacco?), speeding (she is a Porsche enthusiast), or indecent exposure (the CFO visits his favorite nude beach).

"No illegal conduct" clauses should be redrafted to address only a company's legitimate areas of concern and to exclude and protect conduct on the executive's part that may be technically illegal but does not concern character, leadership, or integrity in any material way or at all.

Morals Clauses Cannot Substitute For Careful Pre- and Post-Termination Planning and Coordination

Experience teaches that countless executive employment disputes can be traced back to one or a combination of:

- Too little planning and thought in the negotiation and drafting of "cause" language in employment agreements; and
- Companies' all-too-frequent failure to examine, analyze, and conform to existing cause provisions when things heat up and it actually comes time to discipline or discharge top executives.

Companies should not become obsessed with adding detailed morals clauses to their typical employment agreements. Too much detail in dictating morals will probably lead to its own troubles, such as the inadvertent imposition of a moral standard that discriminates ("executive agrees to engage only in non-adulterous consensual romantic relationships with members of the opposite sex" would be an example). There is also the risk that omission of something truly objectionable from an already detailed list will invite the argument that the particular conduct wasn't prohibited.

Instead, companies should continue to seek a broad definition of cause in employment negotiations and should consider implementing a short, well-drafted code of conduct that the executive agrees to uphold.

Conclusion

Corporate boards, above all else, must exercise reasonable business judgment. A board's moral judgments must serve its sound business judgment, not the other way around. When a board considers executive conduct that may be characterized by some as immoral, it should conduct an analysis that is grounded primarily on business considerations, and only secondarily on more perspective-dependent moral ones.

Boards can go a long way toward protecting themselves and their companies from claims of invasion of privacy by spelling out for executives in written policies the board's expectations for executive conduct. These expectations should be reviewed and reinforced verbally at regular meetings and reviews. The board should explain its vision of how executives' personal conduct is related to the health and well-being of the business.

A revolution in morality clauses in executive employment agreements is not required or recommended to help companies manage executive conduct and its employment consequences. Companies should, however, give some renewed attention to balanced, business-oriented codes of conduct and clear employment agreements that contain reasonable definitions of cause.

Notes

[1] *See* Boeing Press Release dated March 7, "Boeing CEO Harry Stonecipher Resigns … ," Exh. 99.1 to Boeing's Form 8-K dated March 6.

[2] *See* Boeing Proxy Statement dated May 3, 2004, pursuant to Section 14(a) of the Securities Exchange Act of 1934, "Compensation Committee Report on Executive Compensation."

[3] According to the company's press release, Boeing's internal and external legal counsel conducted an investigation of the circumstances. Boeing's chairman, Lew Platt, noted that "the resignation was in no way related to the company's operational performance of financial condition, both of which remain strong. However, the CEO must set the standard for unimpeachable professional and personal behavior, and the board determined that this was the right and necessary decision under the circumstances." *See* Boeing Press Release dated March 7, "Boeing CEO Harry Stonecipher Resigns … ," Exh. 99.1 to Form 8-K dated March 6.

[4] See Exhibit 14(iii) to Boeing's March 5, 2004, Form 10-K:

Code of Conduct

The Boeing code of conduct outlines expected behaviors for all Boeing employees. Boeing will conduct its business fairly, impartially, in an ethical and proper manner, and in full compliance with all applicable laws and regulations. In conducting its business, integrity must underlie all company relationships, including those with customers, suppliers, communities and among employees. The highest standards of ethical business conduct are required of Boeing employees in the performance of their company responsibilities. Employees will not engage in conduct or activity that may raise questions as to the company's honesty, impartiality, reputation or otherwise cause embarrassment to the company.

Employees will ensure that:

They do not engage in any activity that might create a conflict of interest for the company or for themselves individually.

They do not take advantage of their Boeing position to seek personal gain through the inappropriate use of Boeing or nonpublic information or abuse of their position. This includes not engaging in insider trading.

They will follow all restrictions on use and disclosure of information. This includes following all requirements for protecting Boeing information and ensuring that non-Boeing proprietary information is used and disclosed only as authorized by the owner of the information or as otherwise permitted by law.

They observe that fair dealing is the foundation for all of our transactions and interactions.

They will protect all company, customer and supplier assets and use them only for appropriate company approved activities.

Without exception, they will comply with all applicable laws, rules and regulations.

They will promptly report any illegal or unethical conduct to management or other appropriate authorities (*i.e.*, ethics, law, security, EEO).

Every employee has the responsibility to ask questions, seek guidance and report suspected violations of this code of conduct. Retaliation against employees who come forward to raise genuine concerns will not be tolerated.

In its 10-K for the year ending Dec. 31, Boeing explains that it has several codes of ethics and that they are available on the company Web site:

We have adopted: (1) The Boeing Company Code of Ethical Business Conduct for the Board of Directors; (2) The Boeing Company Code of Conduct for Finance Employees which is applicable to our Chief Financial Officer (CFO), controller and all finance employees; and (3) The Boeing code of conduct that applies to all employees, including our Chief Executive Officer

(CEO), (collectively, the "Codes of Conduct"). The codes of conduct are posted on our Web site, www.boeing.com. We intend to disclose on our Web site any amendments to, or waivers of, the codes of conduct covering our CEO, CFO and/or controller promptly following the date of such amendments or waivers. A copy of the codes of conduct may be obtained upon request, without charge, by contacting our Office of Internal Governance at 888-970-7171 or by writing to us at The Boeing Company, 100 N. Riverside, Chicago, IL, 60606, Attn: Senior Vice President, Office of Internal Governance.

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