The Impending Raid on Your Private Life

What used to be nobody's business – an executive's health, religion, politics and sexual preferences – may soon be every shareholder's business.

By Simon M. Lorne

DOES the corporate executive have the same right to personal privacy as any other private citizen?

That question may sound strange, especially at a time when the courts increasingly are protecting individual rights to privacy. But the answer to the question may sound even stranger. Recent legal developments suggest that top-level executives may be losing some of the rights to privacy that most people consider to be virtually inalienable.

More and more, management is being viewed as employees of the shareholders who own their corporations. Technically, they always have been – but stockholders traditionally have behaved as distant investors, not as the ultimate bosses. However, several public interest groups and the Securities and Exchange Commission, as well as some shareholders, are now pressing to broaden the scope of information that executives are required to disclose to the shareholders who "employ" them.

Historically, disclosure to investors was for the most part limited to information that was of present or potential financial importance to the company, although there were also some required items of disclosure about top management's experience and the income of the highest paid executives. Except for that limited information about directors and officers, a company had to disclose publicly only items that would, or did, affect its financial results or – possibly – the price for its securities.

But there are indications that financial materiality may no longer be the sole standard of judgment. SEC Chairman Harold Williams said recently, "there are some issues that are so important that quantitative tests are irrelevant." He was referring then to the issue of disclosure of even minor South African investments, but the general rule is beginning to apply also to personal matters in the lives of executives that may affect the corporation.

Consider these questions:

☐ Are shareholders entitled to know that a corporate president has failed to file personal tax returns?

☐ Are shareholders entitled to know that a corporate executive is carrying on an adulterous love affair?

☐ Are shareholders entitled to know of a corporate executive's preferences or prejudices in the areas of race, religion, or sex?

Certainly, one would be astonished to find such information published by any corporation. But it is not hard to imagine circumstances that would make such information useful to shareholders.

Ironically, this pressure to go beyond "quantitative tests" and to disregard the financial standards of materiality in requiring broader disclosures from corporate managers comes at a time when American society as a whole is growing increasingly concerned with protecting the individual's right to personal privacy. Thus, a conflict between shareholders' interest in information and managers' interest in personal privacy is clearly established. What are the limits – if any – on what shareholders are entitled to know about their management? When is management entitled – if at all – to some degree of privacy?

In the summer of 1976, RCA was in the middle of an excellent year. Just as the company was preparing to make a securities offering, newspaper stories revealed that for several years RCA's president had failed to file personal income tax returns (although he had actually paid the taxes involved). Apparently because of the unfavorable publicity, the underwriting was cancelled and the president was forced to resign.

In retrospect, were RCA's shareholders entitled to be informed in advance about the president's tax situation, or was he entitled to keep his personal tax problems private? (And, of course, there was no way RCA could have informed its shareholders without precipitating the very scandal it might have tried to avert by advance disclosure.)

Management perquisites also are

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Should shareholders know that an executive has an adulterous love affair?

coming under scrutiny in the new pressure for disclosure. Recently proposed SEC standards for disclosure of perquisites could require an executive to reveal an extramarital love affair – at least if the paramour were on the company payroll, or if she (or he) were "kept" in an apartment paid for by the corporation. Such an arrangement not only draws on corporate funds, but it may also affect the way a manager manages – or at least *when* he manages. According to one former SEC staff member, such arrangements were uncovered in at least one recent perquisite case investigated by the SEC, but were overlooked in the face of more flagrant non-disclosures.

In a similar fashion, personal prejudices, preferences, or convictions about race, sex or religion may affect the way a manager manages – or, if publicized, they may generate a controversy that could harm the corporation. One day in the fall of 1978, for example, the newspapers carried two illustrative stories. Calvin Griffiths, owner of the Minnesota Twins, had been quoted as making anti-black remarks in public; he generated considerable unrest among some of his players, including star hitter Rod Carew, as a result. Had Griffiths been a corporate executive rather than an owner (and if the quotations accurately reflected his views, which Mr. Griffiths subsequently denied), his shareholders might reasonably have expected to know something about his views on race – before they read about them in the papers.

ON the same day it was reported that the president of Holiday Inns had resigned because the board of directors' decision to build a gaming casino went against his religious convictions. The shareholders may have wondered whether his religious views had prevented Holiday Inns from taking advantage of legalized gambling sooner.

This emerging conflict over executive privacy is disturbing because it seems to run against the grain of established beliefs and practices. It is considered legitimate for a private employer to discuss with a potential employee most personal views that would be likely to have an effect on his job performance – although there is mounting pressure to avoid asking some such questions, where they have a bearing on particularly private concerns. But a conversation between an employer and an employee can remain private in a way that public reports cannot. Even though shareholders may have some legitimate interest in a manager's personal views, there is in most of us a fundamental belief that such matters are private: there should not be any requirement to hang them out for all the world to see. No matter how much we may accept the logic of disclosure, to many of us it seems wrong.

The conflict is apparent. However, its resolution is something else again.

This conflict between shareholder claims to information and managerial claims to privacy came to be an issue through a process in which well-meaning liberal views were carried to anti-libertarian conclusions. Three distinct developments were involved:

The first was the "ethical investor" movement, which grew out of opposition to the Vietnam War and was symbolized by actions against companies such as those that manufactured napalm and defoliants. Later its focus was transferred to environmental issues. This movement planted the seeds for obligatory disclosure of non-economic information and saw the first real development of concern for specific classes of shareholders, with their individual concerns, rather than for investors in general.

Second, the "sensitive payments" issue, associated with illegal political contributions in the 1972 presidential election and with bribery in international deals, established a precedent for requiring disclosure of managers' actions

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that were neither material nor in some cases illegal (until the Foreign Corrupt Practices Act of 1978).

Finally, the SEC's recent energetic enforcement of existing disclosure regulations regarding executive perquisites, and its even stiffer proposals, seem to be setting the stage for required disclosure of more personal information about executives.

In the ethical investors movement, public interest groups used corporate annual meetings as a forum for public – and publicized – debate on such issues as Dow Chemical's manufacture of napalm and the effect of General Motors automobiles on environmental quality. They also sought to bring shareholder pressure from certain ethical investors to bear on the target corporations. To achieve these goals, public interest groups worked to have shareholder proposals (e.g. Dow Chemical Corporation should discontinue the manufacture of napalm) included in the matters to be voted upon in annual meetings.

They also sought corporate disclosure on issues with ethical implications: e.g., How solid was GM's commitment to reducing exhaust emissions? How much of an investment had Citibank made in South Africa? At the same time, they worked on certain large institutional investors with particular ethical obligations such as church and university endowment funds, to recognize a responsibility not to support or profit from investments in corporations which engaged in anti-social activities.

The pressure on institutional investors to divest themselves of shares in some corporations and the pressure on corporations for disclosure on current issues were critical in the development of the current disclosure trend. Once institutional investors were convinced that their moral obligations extended to the activities of corporations in which they held shares, it could be argued that such ethical investors were entitled to all information for making informed decisions as to which corporations were suitable for their portfolios.

This strategy has continued in use, embracing issues such as employment discrimination, the boycott of Israeli companies demanded by Arab businessmen and corporate investment in the Union of South Africa. Initially, some sense of materiality – the extent to which the offensive behavior might have a financial impact on the corporation – was considered a necessity for disclosure. Recently, though, the SEC has moved further toward acceptance of the more general views urged by public interest groups. When Chairman Williams was quoted as saying that issues such as South African investment were so important that quantitative tests became "irrelevant," Richard Rowe, director of the SEC's Division of Corporation Finance, was quoted as saying "I think we can't shy away from political issues."

It is true that the focus of the ethical investor movement was on the ethical content of *corporate* activities; it did not seek disclosures about the personal morality of executives. But it prepared the way for the present conflict over executive privacy rights. It represented the first extension of the disclosure obligation to include more than financially-oriented information. It also was the first assertion of the legitimacy of the individual concerns of particular classes of shareholders – as distinct from the financial concerns of investors in general.

GRANTING legitimacy to the non-financial concerns of ethical investors raises the thorny question of how far this approach can be carried. For example, at least one investor is known to avoid investing in any corporation whose chief executive is obese, on the theory that fat managers can't be expected to keep their companies in trim. Is his interest in information on executive obesity legitimate? Should a flattering head-and-shoulders photograph of a paunchy CEO published in an annual report be considered a cover-up? These questions may seem silly, perhaps because the investment banker's concern for obesity likely is shared by so few investors. But if a significant body of investors distrust the managerial capacity of particular ethnic minorities or women, should managerial ethnic background and gender be matters of obligatory disclosure? Once we grant legitimacy to the non-financial concerns of investors, it is hard to draw the line.

The "sensitive payments" issue brought about a further extension of disclosure obligations. Initially, it arose out of Watergate and the discovery of illegal corporate payments to the Committee to Re-elect the President. From there, it rapidly expanded to embrace a variety of illegal or otherwise questionable payments made both within the United States and abroad that had not been publicly disclosed. With the memory of Watergate so fresh, and the currency of the term "cover-up," it wasn't surprising that a great deal of SEC attention was devoted to these issues.

Some of the payments the SEC uncovered were arguably "material" – they led to sales contracts that were a material part of revenues or that generated a material part of profits. But many such payments could not be so easily categorized – e.g., a bribe paid to a government official to "grease" the system in a foreign country where corporate bribery was not illegal, but which failed to generate any substantial income. The SEC – or, at least, some of its staff members – argued that disclosure was required in such cases simply because shareholders and investors were entitled to know that the people running the corporation were willing to engage in these unsavory activities.

Indeed, that view has some historical basis. The notion of sensitive payment disclosure is really not very far removed from some traditional disclosure obligations – e.g. disclosure of bankruptcies or convictions of felonies involving corporate officers. But a bankruptcy or a felony conviction involves either an implication of financial incompetence or clearly established (beyond a reasonable doubt) criminal behavior; both result in judicial records and a specific determination of relevant information by due process.

Sensitive payments disclosures moved considerably beyond that relatively restricted sort of information. They include information that had not been established by the courts, that might not have any implication of financial incompetence on the part of managers or any material effect on the corporation's financial situation, and that might not even have been illegal. The justification for some of these sensitive payments disclosures went beyond even the ethical investor movement's focus on the right to information about the ethical content of corporate activity; disclosure was justified by the investor's right to be informed about the moral fiber of individual corporate managers.

The most recent "advance" in the area of non-financial disclosure has been the SEC's concern with the perquisites corporations allow their executives. Beginning in 1976, the SEC began to bring enforcement cases in situations where relatively egregious perquisites had not been disclosed as remuneration to management. The cases actually brought by the SEC involved such matters as corporate payments for tuition of executives' children (a practice growing quite common now in England, where "perks" are much more routinely given and expected, in part because of the British tax structure) and corporate payments for residential upkeep. But those cases, even though extreme, served a warning to all corporations – which was one of the motives for bringing the cases. The SEC made that clear recently, when it proposed new regulations that would require disclosure of the cost of all perquisites granted to high-ranking officers and directors plus a detailed description of any perquisites costing more than either $25,000 or 10 percent of a manager's direct pay.

The concern with perquisites raises

One investor's theory: fat managers can't keep their companies in trim.

two questions: one of definition, and the other involving privacy. It is easy to assert that a corporation's payments to executives – in all their forms – should be disclosed. But what is a "payment"? And how "personal" does the benefit have to be? In the relatively mundane case of country club dues, *Business Week* recently quoted one executive who said, "I'm always working when I play golf."

It seems likely that the concern with perquisites will accelerate the disclosure trend and continue the erosion of managerial privacy rights in a general way. As shareholders become more accustomed to learning what personal benefits executives are receiving (e.g. that a CEO drives a BMW Bavaria owned by the corporation when he goes to play golf at the Country Club, where his dues are paid by the corporation), will they not also expect to learn more about executives' personal lives generally? When the difficult distinctions between "personal" and "business" expenses also involve questions of personal privacy they become incredibly difficult to make without thoroughly compromising the individual manager's right to privacy. Consider some of the questions raised between the IRS and Playboy Enterprises, Inc. over the company's expenditures to maintain its founder's public image by supporting his well-known lifestyle, both in and out of the mansions in Beverly Hills and Chicago.

What Are An Investor's Rights?

Legally, it is true that the investors in a corporation own it. As owners, they can logically take the view that they are entitled to substantial information about who they employ to run their enterprise.

But how rigorously should the concept of ownership be applied to shareholders? In the real world, shareholders seldom act as owners. They seldom invest with the interest of being – or acting as – owners. Their *functional* relationship to the enterprise in which they hold shares – as distinct from their *legal* relationship – is much more that of a lender-investor than that of an owner. In the large modern corporation, share ownership is so far removed from corporate ownership that shareholders rarely (if ever) get the chance to make ownership decisions beyond the decision to sell their shares. Furthermore, any confidential communication of managers with such "owners" is impossible.

Ironically, in the midst of this new trend, a congressionally-mandated report appeared last year (by the Privacy Protection Study Commission) which urged greater restrictions on employers' rights to obtain information from employees and to make such information public. To what extent do the concerns of the Privacy Protection Study Commission limit the investor's "right to know"? At present, not at all. The 654-page Commission Report does not even mention the question.

HOWEVER, the existence of the Commission, along with other developments in privacy law, are evidence of a growing societal interest in protecting personal privacy. The Federal Privacy Act of 1974 limits the disclosure of personal information gathered by public agencies. Over the past several years, the courts have acted to allow recovery of damages for the tort of "invasion of privacy," which includes giving unwarranted publicity to personal matters. The Supreme Court has decided that a constitutionally protected right of privacy exists and that it is violated by some governmental intrusions into personal affairs (this was the basis of the Court's action in striking down laws preventing access to contraceptives and abortion).

While this evolving concern with personal privacy has so far not been used directly as a defense in the securities cases, the issue has been raised in a somewhat indirect way. For example, shortly after former SEC Chairman Roderick M. Hills left the Commission, its staff revealed (without apparent reason) that it had investigated a reimbursement Hills had made to the corporation he had served as chairman of the board before joining the SEC. The amount in question was relatively small – some $2100; Mr. Hills had made the reimbursement after receiving an audit that he himself had requested. His response to the SEC staff's disclosure, criticizing their "failure to show sensitivity," was clearly based on personal privacy concerns.

Solutions to the Conflict

At present, there is no obvious way of accommodating the conflicting interests of management privacy and shareholder knowledge. But it seems likely that future law on this issue will probably develop in one of three ways.

One possibility – a somewhat frustrating one to contemplate – is that the present system will continue, with additional disclosure cases establishing a few more ground rules, but with individual cases continuing to require substantial judgment. One problem with this approach is that the countervailing concern for privacy is likely to get short shrift. Another problem is that it is always hard to determine whether an item is or is not material. The definition of materiality adopted two years ago by the Supreme Court – that an item of information is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote – is not much help without a definition of "reasonable shareholder." Is concern with South African operations that are financially insignificant reasonable? Is concern with managerial obesity reasonable? Is concern with the personal ethics of individual managers reasonable? There is no clear answer to these questions.

It is never easy to figure out – in advance – what facts may later be seen as material. Consider the unfiled tax returns of RCA's president mentioned ear-

"I'm always working when I play golf."

lier. The publicity they generated caused the president to resign, and, apparently, caused the underwriters to cancel a pending offering of RCA securities. Given those results, and the advantages of hindsight, the failure to file tax returns would seem to be a "material" event. Most likely, even the other corporate officers were as much in the dark about this event as the company's shareholders. What obligations does a corporation have to seek out such information?

In general, what kinds of personal information should a corporation have about its executives? Are corporations entitled to rely on what their executives tell them, or do they have an obligation to search further? To avoid any chance of failing to disclose information about executives that might later be deemed material, corporations would have to maintain a file on the details of their managers' personal lives so thorough as to seem Kafkaesque. Conversely, when *can* a corporation respect the privacy rights of its executives?

Finally, where the operative principles are as vague as they are bound to be if they are developed on a case-by-case basis, there is always a substantial risk that lawyers will be overly conservative (as is their bent) with respect to what disclosure is required, or that the enforcement division of the SEC will disagree with counsel whenever counsel does not insist on disclosure. For example, assume that a corporate executive consistently spends more money than his personal income would justify. If corporate counsel focuses on that proclivity, he might consider that the potential risks are such that disclosure is required. If he does not, and if the executive subsequently is found to have embezzled, or files in bankruptcy, the SEC might conclude that there should have been earlier disclosure, and might commence proceedings. In either case, the executive's right not to have his financial statements and credit history disclosed is not likely to be considered very seriously. Thus, in such cases, the interest of privacy may not be given the protection that society as a whole might desire if the issues were confronted directly.

A second, and somewhat alarming, possibility is that the scope of information required to be disclosed will expand even more rapidly than it has been doing, quite possibly through new SEC disclosure rules. We may come to accept, with respect to corporate executives, the view that the courts and society have already accepted with respect to politicians: when occupying such a public position, individuals waive all rights of personal privacy. Although at least one court has rejected that argument in an invasion of privacy suit brought by an executive (the suit was unrelated to corporate disclosure), such a possibility cannot be disregarded.

Under this argument, a person who accepts an executive position assumes the risk that his or her personal affairs may have to be aired publicly if they have any potential bearing on the corporation. Obviously, this approach "accomodates" the different interests only in the sense that it implicitly assumes that corporate managers are not entitled to any privacy. This would be a curious development in a society that professes to value privacy so highly. But it would not be the first time that normal individual rights were considered to be unavailable to corporations and the people who run them.

A third possibility – the alternative I would favor over these two unsatisfactory approaches – is law-making or rule-making that specifically addresses the privacy issue and seeks to accommodate it in a realistic fashion. Such an approach would have to recognize that while all information may be useful to investors, there are some types of information that no individual should be required to disclose. As a society, we have agreed that employers should restrict their gathering of some types of personal information about potential employees, even though the employer may consider the information important to a hiring decision. In the same way, we might agree that the right of corporate managers to privacy sometimes outweighs the rights of investors to information.

For example, we might well conclude that personal health information or financial information is never required to be disclosed. Certainly it may be important to investors that a key executive has had a heart attack within the past year, or is heavily in debt, but the interest in the individual's privacy could properly be recognized as being more important. While it would require a deeper analysis than this to determine what personal information should be so protected, potential topics of consideration would include information pertaining to an individual's personal health, finances, religious and moral beliefs, race, sex, sexual preferences and activities.

Unfortunately, no such law or rule is likely to be adopted in the near future, since there is no current crisis that is likely to generate any broad sympathetic response. But, surely, the trend toward demands for disclosure is developing and it is time to think about the price we should ask people to pay for the privilege of running publicly-held corporations. After all, society at large still stands to benefit from having its corporate machinery managed by the ablest of its citizens, all of whom are as concerned with their privacy as stockholders are with their own. ■

Suggested Reading

THE PRIVACY PROTECTION STUDY COMMISSION, Personal Privacy in an Information Society, *Government Printing Office, 1977. An examination of privacy concerns in various aspects of daily life.*

REPORT OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION, *Government Printing Office, 1977, Committee Print #95-29, for the House Committee on Interstate and Foreign Commerce (two volumes). A report on the need for corporate disclosure and the dissemination of corporate information.*