The Landscape of CEO Succession Issues

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Aboard's decision as to whether, when, and how to terminate the employment of a chief executive officer and hire a successor is among the most critical decisions facing the board of any company—large or small, public or private, established or start-up. In most cases, however, a CEO termination is a rare event and one with respect to which—as would be expected—the board, the company's general counsel, and its human resources professionals may have little or no experience. In addition, the situation is further complicated by contractual, regulatory and personal factors.

This memorandum describes the substantive and procedural considerations that boards will want to take into account when there is a change of CEO. We assume that the board has made the business decision relating to CEO succession and is focused on strategy, implementation, and minimizing potentially costly and/or embarrassing oversights and errors. Many but not all of the same considerations apply in respect to executive officers other than the CEO, and some additional considerations may apply to such other officers; in any event, their relative significance likely will differ from the case of the CEO.

Know Your Contracts

CEOs are typically parties to a variety of contractual arrangements with the company that can include employment and severance agreements, supplemental pension arrangements, deferred compensation plans, multiple equity compensation awards, inventions, assignment and noncompetition agreements, and indemnification agreements. These agreements may have been executed at different times and may contain inconsistent and perhaps even contradictory terms. In addition, company governance documents typically include provisions relating to procedures the company must follow when terminating and hiring a CEO. It is essential to collect and review all relevant documents to understand each party's contractual entitlements and obligations upon a termination—or to prepare how to proceed if, as is sometimes the case, not all relevant documents are available.

Of course, each company's individual circumstances must be taken into account, but relevant governance documents typically are:

- The company's charter and bylaws (which may contain procedures that must be followed to remove an officer or board member,

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limits on the service of a CEO as the chairman of the company's board, and indemnification rights and obligations); and

- Board committee charters (to identify who is in fact responsible for making the termination and hiring decisions or making recommendations to the board).

Compensatory and other contractual arrangements with the CEO being terminated will vary from company to company but often will include:

- An employment, severance, or change-in-control agreement or policy (sometimes a CEO may be party to or covered under more than one of these);
- Supplemental pension arrangements, deferred compensation plans, tax qualified pension and savings plans, and excess pension and savings plans;
- Equity and other long-term incentive plans and award agreements;
- Confidentiality or other restrictive covenant agreements;
- Employee handbooks;
- Indemnification agreements; and
- Personal loan agreements (for private companies not subject to the prohibitions on personal loans established by the Sarbanes-Oxley Act of 2002).

In unusual circumstances (and less typically for mature or public companies), there may be relevant provisions in documents that are not typically thought to encompass employment matters. For example, loan covenants might require notice, or even result in default, where a particular individual—perhaps a founder—ceases to serve as CEO. Similarly, it is possible that the termination of the CEO's employment could trigger contractual rights for other senior executives under their own employment-related agreements. For example, some senior executives may have the right to quit with severance if the CEO leaves. Such provisions can be an unwelcome surprise where they are overlooked during the termination/hiring process.

Finally, the company should prepare for the possibility that some of these documents may not be readily accessible. Often equity award agreements are kept within HR files where accessing them could compromise the confidentiality of the CEO termination process. It is also not uncommon for the CEO's award agreements to differ in some respects from the generally applicable "form" agreements that the company uses for employees generally (which typically are on file with the SEC in the case of public companies).

Assign Roles

Assigning individuals to the proper roles in a CEO termination scenario is crucial to a successful process. In determining proper roles in the process, considerations of workload, personal relationships and confidentiality come into play. Some important roles and related considerations are:

- Who will communicate the decision to the departing CEO? Who will be the point person for the company in negotiating any separation agreement and informing the board regarding the process and substantive issues in the negotiation?
- Who will be the point person in negotiating with the candidate or candidates for the new CEO position? Will a subcommittee be established to vet candidates? Will an executive search firm or compensation consultant (or both) be retained to assist in recruitment and design of a compensation package? Is the candidate subject to restrictive covenants that may delay an anticipated start date? Will timing considerations require the company to appoint an internal interim CEO while the search process plays out?

- Will the company's general counsel (with advice of outside counsel) assist the board in the termination and hiring, or do confidentiality or personal considerations require outside counsel to fill this role with no involvement from in-house counsel? In either case, consider which outside counsel is best suited to assist in terms of knowledge of the company and relationship with the departing CEO.

Understand the Procedural Requirements

The company will need to identify and understand the procedural requirements for effecting the termination, including, if applicable, removal from the board. Note that, in some jurisdictions—Delaware, for example—there is no ability to remove a director (rather, the director must resign), and even if removal is permitted, supermajority-type board voting requirements might apply. These procedural requirements are usually set forth in the company's bylaws, though the CEO's employment or severance agreement also may include relevant provisions (including, often, a requirement that the CEO resign from the board upon termination of employment). Advance notice of a termination may be required, especially under an employment agreement; in some cases a lengthy notice period may be required, which can affect the company's perception of "severance" costs. Additional requirements may apply before a termination for "cause" may be effected, which often include notice and an opportunity to cure, an opportunity for the CEO to appear before the board (sometimes with counsel) prior to any termination for cause, and/or a supermajority board vote.

Understand the Decision Points

There are numerous decisions to be made and factors to be considered in a CEO termination. It is crucial for the company to be aware of the full menu of these considerations, consider them early in the process, have a clear understanding of how required decisions will be made, and understand how each decision will impact the overall dynamics of the CEO termination process.

Note also that the termination decision can have implications for the success of a company's "say-on-pay" vote or director re-election prospects: Institutional Shareholder Services (ISS) has targeted companies for compensation paid to a departing CEO or other officers even in cases in which it previously had recommended a vote "for" the company's say-on-pay proposal (*i.e.*, in cases in which ISS presumably had determined that compensation levels were reasonable), at least if the termination was under circumstances generally not entitling the executive to contractual severance (*e.g.*, if the departure was styled as a retirement or the executive stayed on as chairman of the board).

Termination

- Determine whether the termination may be for cause due to misconduct by the CEO. In any event, a determination will be needed whether the termination will be styled as a resignation, termination, or retirement. Note that even if a CEO is not terminated for cause, the potential for a cause termination can significantly impact the negotiation surrounding the termination.

  —It is often difficult, time-consuming, and tremendously distracting for a company to even attempt to discharge a CEO for cause: The standards for a showing of cause are often stringent, and as a result there may be considerable litigation risk. As a practical matter, therefore, cause terminations are usually pursued only in the most egregious circumstances.

  —If a termination for cause is being considered, determine whether a finding by the board that cause exists may affect the rights and obligations of the company and the CEO regarding indemnification (*e.g.*, if the board finds that cause exists, will the company be prohibited from advancing legal fees to the departing CEO for

pending or threatened investigations or litigations).

- Determine whether the CEO has any basis for a discrimination (including age discrimination) or whistleblower claim. Be mindful of whether the CEO has already raised any whistleblower or other claims, such that any termination decision could be viewed as retaliatory.

- Determine the CEO's entitlements to severance, pension, and deferred compensation enhancements, vesting of equity or other benefits (such as continuation of medical coverage or perquisites), and the cost of those entitlements under the possible termination scenarios.

- If the CEO is also a director, determine whether the CEO will resign from the board or remain for some period or indefinitely.

- Determine whether the departing CEO's continued assistance is needed for any transition period/purposes (whether as a consultant or employee), whether the nature of the transition presents any special challenges for the new CEO, and what extra assistance the new CEO may require as a result. Consider with legal counsel the impact that any transition arrangements may have on the timing of the ability/requirement to pay amounts due to the departing CEO under Section 409A of the Internal Revenue Code (governing nonqualified deferred compensation).

- If there is a transition period, consider whether employment agreement amendments are necessary. Particular care should be taken so that any changes in duties during the transition period do not provide a basis for the executive to claim severance benefits due to a constructive (or good reason) termination if the company does not otherwise intend to provide such severance.

- Will there be a consulting, separation, or transition agreement? Such an agreement will itself raise a host of additional considerations, including:

  —Is there any need for a nondisparagement covenant (whether mutual or otherwise)?

  —Will there be a requirement for a release of claims if not already contemplated by an existing employment/severance agreement? If so, consider timing issues.

  —What will the company's position be if the executive requests that the release of claims be mutual?

  —If there are no existing restrictive covenants (a noncompete, *e.g.*), should any be sought or should existing covenants be supplemented?

  —Confirm that any existing or contemplated restrictive covenants are enforceable under local law.

- Determine whether the CEO has any knowledge of ongoing projects that must be passed on to others prior to departure.

- Evaluate whether any active or anticipated litigations require the CEO's testimony or involvement. Consider in this regard whether the CEO is already bound by a cooperation clause (or whether one might be included in a consulting, transition, or separation agreement).

- If necessary, establish a protocol for removing the CEO from the building and disconnecting all access points to company technology simultaneously with the communication of the termination to the CEO. By contrast, continued access to company systems (on a full or limited basis) may be needed during any transition period.

- Consider the public statement to be made in connection with the departure of the CEO and whether the content of that statement will be negotiated with the departing CEO.

Hiring

- Ensure that all hiring decisions are consistent with any prior succession planning decisions/communications or articulate the rationale for any inconsistency.
- Consider whether to retain an executive search firm if not promoting from within.
- Ensure that an adequate prehiring background check is performed.
- Consider whether the new CEO will be appointed to the board.
- If a board member serves as interim CEO, consider the implications for such board member's ability to serve on the board's compensation committee after stepping down from interim CEO status.

Both Termination and Hiring

- Articulate the rationale for the actions. Determine whether to hire a consultant to provide support for the rationale and any related compensation decisions.
- Identify who will communicate the decision to other executives and employees and other stakeholders as applicable (key customers, suppliers, regulators, or other constituencies, *e.g.*), and when such communications will occur.
- Determine when to provide public notice. (Disclosure requirements under the federal securities laws are discussed separately below.)
- Ensure that the ability to speak on behalf of the company is limited to appropriate individual(s). Be prepared to respond appropriately if unauthorized communications are made.
- Consider the timing of the transition, keeping in mind, among other things, the company's reporting requirements and the necessity for the CEO to certify financial statements (which may be difficult for an incoming CEO to do immediately following appointment).
- Consider any shareholder relations ramifications and whether any outreach is appropriate.

Understand the Compensation Considerations

Some of the most important considerations in connection with the termination and hiring of a CEO relate to the severance and compensation packages that are made available—because of their behavioral incentives and how they are perceived by shareholders and, of course, because of their personal importance to the executive. The entitlements of a departing CEO often will be established by existing agreements; if not, a determination will need to be made concerning whether the CEO should receive any severance benefits, what those should be, and how they will be justified. A determination will need to be made regarding the compensation level for the new CEO; as noted above, it may be appropriate to solicit the views of a compensation consultant in that regard. Some of the most important compensation considerations when terminating or hiring a CEO are:

Termination

- Quantify the compensation and benefits entitlements of the departing CEO under his or her existing agreements. These may include, among other things, cash severance, continued employee benefits or perquisites, acceleration or settlement of equity incentive compensation and cash incentive compensation (annual and long term), and favorable treatment under executive pension and deferral plans. Accordingly, it is important to review all potentially relevant contractual entitlements, both individual agreements with the CEO and also the terms of more broad-based arrangements. For senior executives at public companies, these entitlements generally will be detailed in the proxy

statement, but review of the actual contracts will be essential.

- Consider the effects of, and ensure compliance with, the requirements of Section 409A of the Internal Revenue Code. For example, if the company is public, consider whether payment of the severance or delivery of any benefits needs to be delayed for six months by reason of Section 409A. In addition, particular care should be taken in cases in which vesting of incentive awards is accelerated or is allowed to continue, as this can present particularly complex issues under Section 409A.

- Will any compensation or benefits be provided other than those that are contractually required? These could include, for example, providing severance benefits that are not otherwise required or forbearing from enforcement of equity incentive or other benefit forfeitures that otherwise would apply. If so, what is the justification and what is the anticipated shareholder reaction?

- Regardless of whether additional compensation or benefits are provided, is the company at risk for adverse vote recommendations on say-on-pay or director re-elections due to compensation considerations (and should those considerations affect the compensation and benefits to be provided)?

- If there is a transition or consulting period, consider whether and what type of office space and administrative support will be provided.

Hiring

- What compensation and benefits will be provided to the new CEO? Will there be make-whole grants for compensation the executive is leaving behind at his or her current employer? What vesting conditions should be imposed on make-whole grants?

- Will there be an employment or severance agreement? Is there a form of agreement used by the company and will it need to be revised or updated? For instance, if the form of agreement contains a golden parachute tax gross-up, will the company be moving away from such a provision (and what might the impact of not receiving that protection be for an incoming CEO)? Conversely, if the form of agreement does not include a tax gross-up, are there special factors that could warrant providing a tax gross-up to the incoming CEO, notwithstanding the potential corporate governance ramifications and potential shareholder reaction to such a provision?

- As with the termination process, consider whether the company is at risk for adverse vote recommendations on say-on-pay or director re-elections due to compensation considerations and whether those considerations should affect the compensation and benefits to be provided.

- Will any restrictive covenants be imposed? If promoting from within, are any existing covenants adequate?

- Will there be new significant equity grants? Are there shares available under the equity compensation plan sufficient to permit the new equity grants (taking into consideration any shares that might be forfeited by the departing CEO)? If so, and the company is public, is the employment inducement exception to the stock exchange approval requirements available? Will a supplemental listing application be required with any exchange? Will any inducement grant be registered under the securities laws or is an exemption available? Consider the potential impact on the company's tax situation under Section 162(m) of the Internal Revenue Code (relating to the company's ability to take a deduction for federal income tax purposes for certain compensation payments in excess of $1 million).

- Are any changes to existing forms of award agreements needed in view of the new CEO's particular circumstances?

Take Required Board Actions

It is important to identify and follow the corporate governance procedures a company must follow when terminating and hiring a CEO and, if applicable, removing the CEO from the company's board of directors (though, as noted above, it is often not possible to remove a director). Typically the following actions will be required by the company's board or a board committee:

Termination

- Terminate or accept the resignation of the CEO, as applicable, and determine and approve the circumstances of the termination (*e.g.*, for cause, with good reason, by reason of retirement, etc.). Ensure that the termination encompasses all roles of the executive (including, *e.g.*, service on subsidiary boards).

- Approve any termination, transition, or consulting agreement with the departing CEO.

- Approve any amendment to equity awards required by the terms of the agreement with the departing CEO.

Hiring

- Appoint the new CEO.

- Appoint the new CEO as a member of the board, if applicable. If the departing CEO will remain on the board, determine whether the permitted size of the board must be increased.

- If the new CEO will not immediately be appointed to the board (a circumstance that is unusual) and the departing CEO does not remain on the board, determine whether there is a need to reduce the size of the board or whether it is permissible and appropriate to leave a vacancy.

- Approve the terms and conditions of the new CEO's employment, including equity compensation awards and any employment agreement.

Disclosure/Reporting Requirements

Public companies are subject to the disclosure requirements of the federal securities laws and, as applicable, the requirements of any stock exchange on which they are listed. While private companies are not subject to these requirements, they should consider whether any public announcement of a CEO change is nonetheless appropriate in their circumstances. A summary of the public company requirements is set out below.

Federal Securities Laws

- File an 8-K within four business days following the determination that the CEO will be terminated to disclose the fact of the termination and the date of its occurrence (*see* Form 8-K Item 5.02(b)). Any new material agreements (or material amendments thereof) entered into in connection with the termination also must be disclosed within four business days (*see* Form 8-K Item 5.02(e)).

  —Note that the 8-K obligation is triggered by the determination or agreement that the CEO will be terminated, not the actual termination itself. The disclosure cannot be delayed until the termination is otherwise publicly announced (as is the case with the hiring of a new CEO, as discussed below), even if—as is often but not always the case—the termination and hiring determinations are made at the same time. No disclosure is triggered, however, by mere discussions or negotiations about whether to effect a termination; whether matters have advanced beyond such stage is a facts-and-circumstances determination. Accordingly, care should be taken to manage the termination process in a way that does not result in a requirement for disclosure that the company would view as premature and potentially disruptive.

—Consider whether the former CEO will have the opportunity to view or comment on a draft 8-K.

- Upon hiring a new CEO, an 8-K must disclose the appointment and its effective date, certain biographical information about the new CEO, and a brief description of any material agreements with the new CEO (*see* Form 8-K Item 5.02(c)). Disclosure generally must be made within four business days following the appointment, but if the appointment will be subject to public announcement other than by means of an 8-K filing (*e.g.*, if the appointment will be the subject of a press release), the 8-K filing may be delayed until that public announcement is made.

- If the departing CEO also resigns as a director, the 8-K disclosing the departure should also recite the date of the resignation (*see* Form 8-K Item 5.02(a) or (b), as the case may be). If the resignation is by reason of a disagreement with the company on any matter relating to the company's operations, policies or practices or if the departing CEO has been removed from the board for cause, the 8-K should also identify any positions held by the director on any committee of the board at the time of resignation or removal and give a brief description of the circumstances that led to the resignation or removal (*see* Form 8-K Item 5.02(a)). Item 5.02(a) sets forth important procedural requirements that must be followed in connection with disclosure under that provision, including a requirement for exhibits to the filing in certain circumstances.

- If the new CEO is also appointed to the board, the 8-K must also disclose that fact, the committees of the board on which the new director will (or is expected to) serve, certain biographical information, and a brief description of any material agreements with the director (*see* Form 8-K Item 5.02(d)).

- The new CEO should file a Form 3 (if not already an executive officer of the company), and a Form 4 should be filed as applicable for any new equity grant to the new CEO.

- A Form 4 may be required for the departing CEO (*e.g.*, upon vesting of performance shares in connection with the termination).

- Any agreements with the departing or new CEO should be filed as an exhibit to the company's next 10-Q (or 10-K, as the case may be). If the agreements are filed with an 8-K, as is often the case, the agreements can later be incorporated by reference to the 8-K.

- If there is an inducement equity grant (*i.e.*, one not made under an existing plan), determine whether there are any securities registration requirements.

Exchange Requirements

- Issue a press release on the day of the event to comply with stock exchange immediate release policies; if released during trading hours, comply with any exchange prenotification procedures.

- If an inducement equity grant is made, comply with exchange notice and press release requirements and consider whether a supplemental listing application is required.

- Comply with applicable notice or interim affirmation requirements concerning changes in executive officers and board composition.

Miscellaneous Considerations

Each termination or hiring of a CEO typically presents its own unique concerns that need to be identified and addressed. The following considerations are often in play:

- Increasingly, the departure of a CEO who also served as board chairman triggers consideration about whether to split those two roles and thus whether the incoming CEO should serve as chairman (assuming he or she is a director)

or whether the departing CEO or some other person should assume that position.

- Determine whether to prohibit trading in the company's securities by directors and officers until the termination or hiring is public knowledge; remind the departing CEO to refrain from trading in company securities if in possession of material nonpublic information concerning the company.
- Prepare and determine how to disseminate internal employee communications.
- Prepare the CEO's resignation from employment (if required in writing) and, as applicable, board positions.
- Determine whether there is any need to communicate directly with key stakeholders (*e.g.*, key customers, suppliers, regulators, rating agencies or other constituencies).
- Do not defame the CEO.
- Identify and memorialize any changes in reporting relationships.
- Identify and memorialize any changes in the board/officer composition of any subsidiaries.

Conclusion

A change in top leadership is often a watershed moment in a company's life. If handled well, it can propel the company forward; if handled poorly, it stymies growth and opportunity. For public companies, the decision and the related compensation are often scrutinized in the press and other media, particularly as of late.

The board, and those responsible for effecting its decisions, should seek guidance from counsel familiar with such matters to ensure that the transition proceeds as intended. The process is multidisciplinary, touching on corporate, securities, employment, tax, and benefits law issues, among others.