

Governance: Hiring & Terminating an Executive Officer

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Executive Compensation Webinar Series
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- Questions during this presentation
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About Anthony “Tony” Eppert



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- Tony practices in the areas of executive compensation and employee benefits

- Before entering private practice, Tony:
 - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
 - Obtained his LL.M. (Taxation) from New York University
 - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
 - Editor-in-Chief, Journal of Medicine and Law
 - President, Tax and Estate Planning Society

Upcoming 2024 Webinars

- 2024 webinars:
 - Introduction Course on Employment Taxes (11/14/24)
 - What Happened in 2024: Year-End Review of Compensatory Items (12/12/24)

Sign up here: <https://www.huntonak.com/en/insights/executive-compensation-webinar-schedule.html>

Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded companies, and involve substantive areas of:
 - Tax,
 - Securities,
 - Accounting,
 - Governance,
 - Surveys, and
 - Human resources

- Historically, compensation issues were addressed using multiple service providers, including:
 - Tax lawyers,
 - Securities/corporate lawyers,
 - Labor & employment lawyers,
 - Accountants, and
 - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation



Our Compensation Practice – What Sets Us Apart (cont.)

- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

Corporate Governance

- Implement “best practices”
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy

Introduction

- A Board of Directors (the “**Board**”) hiring or terminating the employment of an executive officer is part “art” and part governance. The purpose of this presentation is to discuss:
 - Overview of legal standards
 - Fiduciary standards and shareholder derivative lawsuits,
 - How to bolster the business judgment rule defense,
 - Use of tally sheets and wealth accumulation sheets,
 - Properly vetting conflicts of interests,
 - Proper recording of meeting minutes, and
 - Miscellaneous but related topics

- Throughout this presentation, whenever the word “Board” is used, such also includes the sub-committee to which the Board delegated a responsibility in question (e.g., the Compensation Committee, the Nominating and Governance Committee, etc.)

- This presentation does NOT cover the negotiation points of hiring or terminating an executive officer. Such was the topic of a prior presentation entitled “*Pressure Points When Negotiating Executive Employment Agreements*,” that was presented on February 8, 2024. The slide deck for such can be found here: <https://www.huntonak.com/executive-compensation-academy-past-presentations>

Intro and Overview of Legal Standards (Del. Law)

- There are two primary legal standards under Delaware law that are applicable to members of the Board in the context of executive compensation
 - Duty of Care, and
 - Duty of Loyalty

- Duty of Care
 - The duty of care requires Board members to make informed decisions, based upon all material information, and make such decisions only after critically assessing the information
 - The Board is permitted to rely upon professionals, but only if such professionals were chosen by the Board with reasonable care (*i.e.*, after verifying the professional possesses the requisite expertise)

- Duty of Loyalty
 - Each member of the Board must put the best interests of the Company and its shareholders first and not apply the personal interests of the Board member
 - In instances where a Board member has a conflict of interest, such member has a duty to make FULL disclosure to the other members of the Board, and depending upon the facts, make full disclosure to the full Board

Two Legal Doctrines to Consider

- There are two legal doctrines applicable to decisions of the Board in the context of hiring or terminating an executive

- Business judgment rule
 - Protects decisions that were made in good faith and in the interests of the Company, unless a plaintiff can prove that the decision of the directors had no rational business purpose (*i.e.*, the decisions of the directors will be presumed to have been informed, made in good faith, and accomplished with the belief that such was in the best interests of the company)
 - The rule presumes that the Board acted reasonably while informed
 - Application of the business judgment rule makes it more difficult for a plaintiff to prove the Board members breached their fiduciary duties and/or caused unjust enrichment

- Entire fairness doctrine
 - Applies in situations where the business judgment rule defense is overcome
 - Applies if a plaintiff can prove that the Board lacked independence when making its decision, or that the Board was not informed in making its decision
 - Is a more exacting standard, and requires a judicial determination of whether the transaction in question was entirely fair to the shareholders
 - Plaintiff attorneys want to overcome the business judgment rule defense in order to have the entire fairness doctrine applied

Meetings, Books & Records and Minutes

- Increasingly, shareholders are requesting a copy of a Company's books and records with respect to executive compensation matters.
- Books-and-records requests (Delaware law)
 - Generally, shareholders have the right to examine books and records if such request is made for a “proper purpose” (Section 220 of the DGCL)
 - In the context of executive compensation, such a request is often a precursor to litigation
 - Newsworthy payouts (*i.e.*, high executive severance) may trigger a books-and-records request for related documents
 - By way of example, in one case payment of around \$60mm in severance triggered a claim of excessive compensation, and the result was a books-and-records request for related documents
 - Keep in mind that the standard for requiring a Company to produce compensation-related documents in response to a books-and-records request is low. Only a “credible basis” from which the Court could infer “possible mismanagement” is required
 - Directors who “choose not to ask questions” regarding executive compensation “take the risk that they may have to provide explanations later, or at least produce explanatory books and records” as part of a books-and-records investigation
 - In order to help prove that the directors satisfied their fiduciary duties of care and loyalty when approving executive compensation (especially large dollar amounts), the records of the meeting should be heavily documented and include tally sheets. Additionally, minutes should reflect that appropriate deliberations were made in person or by a telephonic meeting

Meetings, Books & Records, and Minutes (cont.)

- The Board should meet as frequently as necessary
 - Keep in mind that the number of meetings held in the prior fiscal year will be disclosed in the proxy statement

- The CEO and other executives (if applicable) should not be present for a portion of the meeting so that the Board/Committee can deliberate on their compensation packages
 - Consider having the beginning of the Board/Committee meeting without the CEO and any executives so that the Chair of the Board/Committee can set the stage for what he or she wants to accomplish in the meeting

- Written materials such as minutes are critical to proving that the Board/Committee members were informed and that their decisions were deliberative
 - Written materials should be provided to the Board/Committee in advance of the meeting (as far in advance as is feasible)
 - Consider whether it makes sense for the record to show that the Board/Committee deliberated on a topic more than 1x (*i.e.*, first, when the executive officers raised the topic with the Board/Committee, followed by the executive officers later implementing the Board's/Committee's direction to develop the point, and second, to bring the matter back to the Board/Committee for its action)

Meetings, Book & Records, and Minutes (cont.)

- [Continued from prior slide]
 - In the minutes, be sure to record the time and date, where the meeting took place, any and all compliance with the notice procedures, the date in advance of the meeting on which the written materials were provided to the Board/Committee members, and those in attendance (including those experts who were invited to attend)
 - A purpose of recording which Board/Committee members were in attendance (physically or via phone or video) is to document that the meeting satisfied the quorum requirement
 - Absent a quorum, actions taken by the Board/Committee are voidable
 - The minutes should also record the discussion points (both pros and cons) of an issue, along with the action taken
 - Any abstentions or objections should be recorded in order to show a possible Court that the issue was not missed, and that the positions were fully discussed
 - The minutes should include the advice of any experts, and if a report was provided by the expert, consider attaching such to the minutes
 - In advance of the next meeting, the minutes from the prior meeting should be circulated and then approved at such next meeting

Minutes: Hiring and Terminating an Executive

- Again, properly drafted minutes help to document that the Board exercised its fiduciary duties
 - In contrast, poorly drafted minutes can be used as a sword by plaintiff attorneys

- Protecting confidentiality
 - Discussions pertaining to the hire or termination of an executive officer are typically considered sensitive and confidential
 - Thus, consider whether discussion points should be summarized (e.g., “A lengthy discussion ensued, during which the directors discussed and reviewed whether facts existed to support a termination of employment for Cause, etc.)

- Protecting attorney-client privilege
 - If an attorney is present and provides the Board with legal advice, then the minutes should reflect such, but do so in a way that protects against accidentally waiving the attorney-client privilege
 - For example:
 - If the minutes reflect that an attorney provided advice with respect to a business strategy, such might not be considered legal advice that is protected by the attorney-client privilege
 - Instead, the minutes should reflect that the attorney provided legal advice about the matter (and not advising the Board to take certain action)

Litigation Example

- Largely publicized case in 2016 having strong parallels to *In re Walt Disney Derivative Litigation*
- Short version of the facts of this 2016 case:
 - The CEO recruited the COO
 - The two worked together at a prior employer, but allegedly such was not disclosed
 - The CEO negotiated on behalf of the Board
 - Though a tally sheet was used, the Board was not properly informed as to the “increasing complexity of management compensation arrangements” (*i.e.*, the Board was not informed on the effects of a termination of employment on the equity awards), and too, compensation items were changing during interim Board meetings
 - The COO was terminated without Cause within 15 months
 - There was no record of a discussion as to whether the COO should be fired for Cause
 - The COO received payments approximating \$60mm
 - Sound like *In re Walt Disney Derivative Litigation*?
- A Section 220 books and records request followed, along with litigation
- The issue or allegation is whether the Board was fully informed at the time it made the compensatory offer to the COO, and whether it was fully informed at the time it made the decision to terminate the COO

Litigation Take-Aways

- Process, process, process is important in every hire and termination situation
- There should be full documentation as to how the Board was both engaged and informed during the process
- Tally sheets or wealth accumulation sheets should be used so that the Board can better vet the financial analysis and prove it was informed
 - The Board should be afforded time to review the materials before the meeting
 - Redlines should be used to highlight changes between prior versions
- Conflicts should be fully disclosed (e.g., the relationship between any internal party and the candidate)
 - The Board should know whether it is appropriate for a possibly conflicted individual to lead the negotiations
 - If a conflict exists, it should be recorded that the conflict was vetted and disclosed
- In the context of an employment termination and prior to any such determination by the Board, the Board should be provided a report that summarizes or details the executive's performance
 - Such is for the purpose of determining whether the executive should be terminated without Cause or with Cause

Succession Strategies

- According to a Korn Ferry study:
 - 40% of new CEOs depart within 18 months of their appointment, and
 - 64% of new CEOs depart within 4 years

- Successful succession strategy requires that succession planning remain on the Board's regular agenda
 - Succession strategies are a process,
 - Succession strategies are not a discrete event,
 - Succession strategies should be a “routine” Board topic, if for no other reason than to avoid sounding alarms simply because the Board is talking about the topic
 - The Board should avoid delegating the entire process to the CEO
 - The process should be “owned” by the Board, though the process should involve the CEO since his or her judgement is important
 - The process should be run by the Nominating & Governance Committee (or like committee), but consider too whether it makes sense to have an interdisciplinary committee of the Board run the process

- Other considerations
 - The process should be regularly monitored (at least annually) and revised to eliminate gaps within the talent pool
 - Should cover both long-term and short-term talent
 - To ensure the Board is informed in its decision-making surrounding succession planning, consider having the CEO annually report to the Board on the performance of his or her direct reports

Tally Sheets

- As background, if the business judgment rule is applied:
 - Decisions of a director will be presumed to have been informed, made in good faith, and accomplished with the belief that such was in the company’s best interests
 - Such presumption makes it more difficult for a plaintiff to prove such director breached his or her fiduciary duties

- Use of tally sheets is a key component for a director to preserve the defense of the business judgment rule because tally sheets help to prove the director made an “informed” decision, even if the director made the wrong decision
 - A tally sheet lists each component of an executive’s compensation and tallies it up (*i.e.*, also called a “placemat”)
 - Prior to making the compensation decisions, the Board should require use of a tally sheet to show the full range of potential payments in various alternative scenarios (*e.g.*, termination without Cause, for Good Reason, death, Disability, Change-in-Control, for Cause, etc.)
 - Tally sheets should be prepared and explained by someone who is a compensation expert
 - Tally sheets should be attached to the minutes of the meeting

- Amounts to tally
 - Income for the year
 - Projected values under different performance and termination scenarios
 - Realized option and stock gains (typically over the past 5 years)
 - Total wealth accumulation

Wealth Accumulation Tables

- Wealth accumulation tables analyze and focus on how much wealth the executive will accumulate at various points in his or her career
 - Includes realized and unrealized equity value, plus deferred income (e.g., retirement plans, non-qualified deferred compensation plans, etc.)

- Wealth accumulation tables are used to help the Board determine “how much is enough”
 - Determine wealth accumulation targets
 - Determine a reasonable minimum guaranteed wealth and from what sources
 - Determine how performance metrics figure into the analyses
 - Determine whether accumulation is appropriate in the context of the overall compensation
 - Determine whether shareholders should fund this level of accumulation
 - Determine whether improved long-term incentive plans could improve alignment with shareholders

Authority to Negotiate

- It is important to review the applicable Charters to determine whether any committee of the Board has the authority to effectuate the hire or termination of employment of an executive officer
 - Is it the full Board?
 - Is it the Nominating and Governance Committee?
 - Is it the Compensation Committee?

- If a committee, then does the applicable Charter contain a delegation from the Board to such committee so that the latter can effectuate decisions, or does the delegation simply provide that such committee may only make recommendations to the full Board?
 - And irrespective of the above, which answer is better from an optics point of view?

Executive Negotiation Points

- This presentation intentionally did NOT cover the negotiation points of hiring or terminating an executive officer. Such was the topic of a prior presentation entitled “*Pressure Points When Negotiating Executive Employment Agreements*,” that was presented on February 8, 2024. The slide deck for such can be found here: <https://www.huntonak.com/executive-compensation-academy-past-presentations>

Don't Forget Next Month's Webinar

- Title:
 - Introduction Course on Employment Taxes

- When:
 - 10:00 am to 11:00 am Central
 - November 14, 2024