Considerations for Senior Executive Transitions

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Transitioning senior executives is a complex and sometimes difficult process that presents both business and legal challenges. Further compounding the challenges presented, any transition can be emotionally charged given its personal nature. Boards and companies must carefully navigate contractual obligations, corporate governance requirements, disclosure and reporting obligations, as well as the need to thoughtfully communicate with stockholders, employees and other stakeholders in connection with such a transition. The following are key considerations for boards and others overseeing these transitions.

Review Organizational Documents and Applicable State Laws. Requisite processes governing the transition and appointment of executives are governed by a company's certificate of incorporation, bylaws, committee charters, relevant corporate policies and applicable state corporate law and these sources should be carefully reviewed to ensure that the transition is effectuated properly. Corporate governance documents often include provisions relating to the procedures for terminating or hiring a Chief Executive Officer or other senior executive, as well as the appointment and removal of directors where the executive also serves on the board.

Understand Required Board Actions. When a senior executive's departure is under consideration, the board (or a committee thereof) should first determine the reason for the termination—whether for cause, without cause or a resignation with or without "good reason," as those terms are defined in the applicable employment, severance or equity agreements—and ensure that the rationale is clearly documented. If "cause" is being investigated, the board should consider whether to form a special committee to oversee the process; such cases may require an in-depth review of the relevant facts and related issues and the involvement of outside litigation counsel, and, if provided by the terms of employment arrangements, may entail a "notice and hearing" process affording the executive an opportunity to appear before the board to refute "cause" allegations. The basis for the board's decision should be consistent across internal documentation, separation agreements, public disclosure and any other public messaging.

For a senior executive termination, the board (or a committee thereof) typically will need to: (1) terminate or accept the resignation of the executive officer and document the reason for the termination (and, if the officer is also a member of the board, accept his/her resignation from the board); and (2) approve any necessary separation or transition agreements with the outgoing executive officer.

For a new senior executive, the board will generally be required to: (1) approve the appointment of the incoming executive officer and the terms of their employment, including compensation arrangements as recommended by the compensation committee; and (2) if applicable, appoint the senior executive to the board.

If an executive officer departs immediately and a permanent successor has not been selected, the board may need to appoint an interim officer and approve related compensation. The board or a designated committee should also oversee the search for a permanent replacement.

Review Employment Agreements. Senior executives are typically party to multiple contractual arrangements that govern their entitlements and obligations upon resignation or termination. These may include employment agreements, equity and incentive plans and award agreements, severance pay plans, deferred compensation plans, retirement and pension plans, confidentiality agreements, clawback policies, and indemnification agreements.

Companies should review these arrangements carefully to quantify existing entitlements and understand potential severance obligations that arise under the applicable termination scenario (e.g., whether "for cause," a voluntary resignation or a retirement), including cash severance, continued benefits and the acceleration, forfeiture or settlement of equity awards. Required notice periods should also be identified early, as they often drive the timing of the transition process and related communications. Companies should also be mindful of payment timing, including, in the case of public company executives, the "specified employee" payment delay under Internal Revenue Code Section 409A, which may require certain payments to be delayed for six months after an executive's employment terminates.

In some cases, the termination of one senior executive (particularly the CEO) may trigger contractual "good reason" termination rights for other executives under their employment agreements. These provisions should be reviewed early in the process to prevent unanticipated ripple effects.

Understand Severance Arrangements for the Outgoing Executive; Negotiate Compensation Package for the Incoming Executive. In practice, boards often negotiate a separation agreement that sets forth any severance compensation, the release of claims against the company, confidentiality covenants, nondisparagement provisions, and restrictions on competition and solicitation. Many of these rights and obligations are likely set forth in an employment contract or severance pay plan, as noted above. Boards should confirm that existing noncompetition and nonsolicitation provisions are sufficient to protect the company and enforceable under applicable state law.

If any changes to existing cash, equity or benefits separation entitlements are contemplated, companies will need to understand the tax (including Internal Revenue Code Section 409A), accounting and disclosure implications. For example, extending the post-termination exercise period of stock options of a departing executive officer can result in an accounting charge and corresponding disclosure in the summary compensation table of the company's next proxy statement. When negotiating separation terms, boards should consider perspectives of shareholders and proxy advisory firms, who may view excessive payments in connection with performance-related terminations or apparent voluntary resignations or retirements unfavorably.

Boards will also need to consider whether the outgoing executive officer will remain available to assist with the transition (e.g., in an advisory capacity during a specified transition period) and what compensation is appropriate for such services.

Likewise, the incoming executive's terms of employment and compensation will typically be the subject of significant (and sometimes protracted) negotiation. Companies should also understand whether the incoming executive must provide notice under their current employment agreement and whether the incoming executive is subject to any restrictive covenants that could affect the timing of employment commencement.

Seeking input from outside counsel and from the compensation committee's outside consultant when formulating severance and compensation arrangements is prudent.

Assign Roles and Responsibilities. Where possible, boards should have a plan for who will play what role and when. For example:

- In the event of termination, who will communicate the decision to the departing executive?
- Who will lead the negotiation of a separation agreement and keep the board informed? In many cases, a designated director or member of the compensation committee will conduct the negotiation with the departing executive on behalf of the company. Once the terms are finalized, the board or committee will approve the separation agreement and related arrangements.

- What advisors are required to assist the company throughout the transition process? Will the company's in-house counsel advise the board, or is outside counsel required? Will an executive search firm or compensation consultant be retained?

- Is the executive transition sensitive enough to warrant the engagement of a crisis management public relations firm by the company?

- Will the board, the compensation committee or a specially formed subcommittee be responsible for reviewing suitable candidates for the outgoing executive officer's position? Who will be responsible for negotiating with candidates for the position?

Another consideration is which internal stakeholders need to be brought "under the tent" and when. The transition of a senior executive will require coordination with internal stakeholders such as the company's investor relations, human resources, legal and finance teams. While companies generally keep the group of people "in the know" small until key decisions are finalized, it will need to engage the right people as the process progresses to ensure a smooth transition and consistent messaging.

Disclosure Obligations. For public companies, senior executive transitions frequently trigger reporting obligations under the federal securities laws and stock exchange rules, along with other notification requirements.

Form 8-K

- Item 5.02(b) of Form 8-K requires disclosure within four business days after the company determines that specified executive officers (including the CEO, president, CFO, principal accounting officer, principal operating officer, or any person performing similar functions, or any named executive officer) will depart the company, whether by retirement, resignation or termination. Mere discussions or negotiations about whether to effect a termination are not sufficient. Importantly, companies should ensure that the Form 8-K provides an accurate description of the circumstances of the departure (*e.g.*, termination for cause or without cause), and the applicable compensation implications. Whether the obligation to file a Form 8-K under Item 5.02(b) has been triggered requires a facts-and-circumstances analysis. Given the generally fluid nature of these types of situations, boards and companies must be careful to manage the termination process such that they do not trigger the reporting obligation at a time that the company considers to be premature.

- Similarly, Item 5.02(c) of Form 8-K requires disclosure within four business days of the appointment of the same specified executive officers. This disclosure must include a brief description of any material plan, contract or arrangement to which the officer is a party or any grant or award made in connection with the appointment, including any amendments or modifications thereto. A key instruction to Item 5.02(c) allows companies to delay disclosure of the appointment of an executive officer on Form 8-K until the date on which it makes disclosure by other means, typically a press release. As such, it is customary to try to align the disclosure of the appointment of a new executive officer with the disclosure of the departure of the executive officer who is being replaced.

- Item 5.02(e) requires disclosure of any material compensatory plan, contract or arrangement entered into with the CEO, CFO or other named executive officer or any material grant or award made under such a plan, contract or arrangement, including any material amendments or modifications thereto. Examples include severance or transition agreements, modifications to existing cash or equity awards, or other material changes to compensation terms associated with a departure or appointment.

Section 16 Filings

- A newly appointed officer must file a Form 3 within 10 days of the appointment. If the officer is receiving equity awards, a Form 4 is due within two business days (and possibly before the Form 3 is due).

- An executive who ceases to be an officer remains subject to Section 16 reporting obligations for any transactions occurring while still in office. A final ("exit") Form 4 is typically filed to report any last reportable event, such as equity vesting, settlement or disposition occurring upon or shortly after departure. Post-termination transactions are also reportable on Form 4 if they are non-exempt and occur within six months of an opposite-way, non-exempt transaction that occurred prior to termination.

Exchange Notifications. NYSE-listed companies must provide prompt notice to the exchange of any changes in directors of the company via an Interim Written Affirmation and should report such changes to the company's listings representative. Nasdaq-listed companies do not have the same general obligation; however, the rules of both exchanges require prompt disclosure of material information that would reasonably be expected to affect the value of their securities or influence investors' decisions, which may include management changes.

Proxy Disclosure. Companies should also assess implications for the next proxy statement, which must report compensation earned by or paid to any "named executive officer" during the prior fiscal year. Under Item 402 of Regulation S-K, this includes any individual who served as CEO or CFO at any time during the year, the three other most highly compensated executive officers serving at fiscal year-end, and up to two additional individuals who would have been among the most highly compensated but for termination during the year. Significant severance or other separation benefits may cause a departing executive to be included as a named executive officer for the first time with respect to the year of their termination.

Other Notifications. Companies should also alert D&O insurers and any contractual counterparties whose agreements require notice of such changes.

Final Thoughts. Successfully transitioning senior executives requires foresight, coordination and an understanding of the company's legal and governance framework. By proactively reviewing organizational documents, contractual obligations and disclosure requirements and by clearly defining roles and responsibilities, boards can help to facilitate a smooth leadership change.

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