
Governance Perspective on Hiring and Terminating an Executive Officer

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Executive Compensation Webinar Series
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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 2021 Webinars

- 2021 webinars:
 - A Review of Unique Non-Employee Director Compensation Arrangements (11/11/21)
 - Thoughts on Maximizing the Deductibility of Compensatory Arrangements (12/9/21)

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 issuers, 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

Purpose of Presentation

- The purpose of this presentation is to discuss, from a governance perspective, the proper procedures to implement when hiring or terminating an executive officer

- To that end, this presentation discusses:
 - Shareholder derivative lawsuits,
 - How to bolster the business judgment rule defense,
 - Use of tally sheets and wealth accumulation tables,
 - Considerations when implementing an employment decision,
 - Vetting conflicts of interest, and
 - Proper recording of minutes

Introduction: Litigation Highlights

- *Amalgamated Bank v. Yahoo! Inc.* (2016)
 - This case has strong parallels to *In re Walt Disney Derivative Litigation*

- Short version of the facts
 - The CEO recruited the COO
 - The two worked together at a prior employer, but such was not disclosed
 - The CEO negotiated on behalf of the Board of Directors (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)
 - 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 (or more)
 - Sound like *In re Walt Disney Derivative Litigation*?

- The issue or allegation is whether or not 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

Introduction: Litigation Take-Aways

- Process, process, process in every hire and termination situation is very important
- There should be full documentation as to how the Compensation Committee was both engaged and informed during the hiring process
- Tally sheets or wealth accumulation sheets should be used so that the Compensation Committee can better vet the financial analysis
 - The Compensation Committee should be afforded time to review 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 Compensation Committee 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 a termination and prior to any such termination, provide a report to the Compensation Committee that addresses the executive's performance
 - Should he or she be terminated without Cause or with Cause?

Which Committee Has the Authority?

- It is important to review the applicable Charters to determine which 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?

- Does the applicable charter contain a delegation from the Board to the committee so that the latter can effectuate decisions, or does the delegation simply provide that the committee may only make recommendations to the full Board?
 - And in any event, what is better from an optics perspective?

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 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

- Tally sheets are a key 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, a Compensation Committee 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 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 (last 5 years)
 - Total wealth accumulation

Wealth Accumulation Tables

- Wealth accumulation analyses focus on how much wealth the executive will accumulate at various career points
 - Includes realized and unrealized equity value, plus deferred income (e.g., retirement plans)

- Wealth accumulation tables are used to help the Compensation Committee 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

Hire: Key Executive Contract Termination Triggers

- Addressing the section entitled “Duties”
 - This is a key provision on when or if:
 - The executive can later terminate for Good Reason and receive severance pay, or
 - The company later seeks to terminate the executive’s employment for Cause
 - The purpose of this provision is to address the executive’s title, reporting responsibilities and job description duties
 - The company has the greatest flexibility if the Duties section is drafted generically (as opposed to highly specific duties), thus providing the company with flexibility if in the future the executive’s duties need to change
 - Retaining flexibility in favor of the company is particularly important if the employment agreement contains a Good Reason trigger for termination of employment

Hire: Key Executive Contract Termination Triggers (cont.)

- A typical definition of “cause” includes:
 - A material breach by the executive of his or her obligations under the agreement,
 - A willful or continued failure to follow orders or perform,
 - A conviction or plea or nolo contendere to any felony or a crime involving dishonesty or moral turpitude or which could reflect poorly on the company,
 - An executive engaging in misconduct, negligence, etc., that is injurious to the company,
 - A material breach by the executive of a written policy of the company, and
 - Any other misconduct by the executive that is injurious to the financial condition of the company and/or its reputation

- Should a notice and cure period be provided?
 - See explanation under Good Reason

- In the new hire situation, modifiers to the above are typically negotiated (e.g., materiality, continued, etc.)

Hire: Key Executive Contract Termination Triggers (cont.)

- [Cause, continued from prior slide]
- Consider defining the term “cause” to include a substantial under-performance (e.g., failure to achieve minimum financial goals for two consecutive fiscal years)
 - Such a provision is not typical and would subject the executive to elements that could be outside his or her control
 - A similar provision that is more veiled could include: (i) the executive failed to comply with the expectations of the company or (ii) the executive failed to follow the directions of the Board
- Consider adding an after-acquired evidence clause to allow the Board, after a termination of the executive’s employment without Cause, to retroactively re-characterize such termination as a termination for Cause. Otherwise, evidence supporting a termination for Cause that is found after the executive’s termination would not likely be used to retroactively re-characterize the executive’s termination (thus, a payout of severance benefits would likely continue)
 - And from the executive’s perspective, if an after-acquired evidence clause is used, then add language to provide that any such use of an after-acquired evidence clause would negate any previously executed waiver and release that was previously signed near the time of the executive’s termination of employment

Hire: Key Executive Contract Termination Triggers (cont.)

- A typical definition of Good Reason includes:
 - A material diminution in the executive’s base salary or failure by the company to pay material compensation when due;
 - A material diminution in the nature or scope of the executive’s authority, duties, responsibilities or title from those applicable to him as of the Effective Date of this Agreement;
 - The company requiring the executive to be based at any office or location more than [] miles from []; or
 - A material breach by the company of any term or provision of this Agreement

- It is favorable to the company to require both a notice and cure period before Good Reason can be triggered
 - Consider that if a notice and cure period is used in Good Reason, is it fair to also apply a mirror notice and cure provision to the definition of Cause

- Should there also be a claims run out period, such that if Good Reason exists, the executive must provide notice within [] days of such initial existence, otherwise, the claim giving rise to Good Reason is considered waived by the executive
 - The purpose of such a provision is to prevent the executive from “saving” the Good Reason trigger for a rainy day 6 months or a year after-the-fact
 - Consider whether Cause should contain a mirror provision

Hire: Inducement Grants to Protect Share Reserve

- Under applicable NYSE and NASDAQ listing rules, shareholder approval is not required for “inducement grants”
- To qualify as an inducement grant, the grant of restricted stock or stock options must act as a material inducement to the person being hired as an employee (or such person being rehired following a bona fide period of interruption of employment)
 - Inducement awards include grants of equity to new employees in connection with an M&A transaction
- Inducement grants must be approved by the Compensation Committee or a majority of the company’s independent directors
- An additional qualification requirement is that promptly (generally within 4 business days) following the grant of an inducement award, the company must disclose in a press release the material terms of the award, including the identity of the recipient(s) and the number of shares involved, and make certain other filings with the applicable listing agency

Hire: Inducement Grants to Protect Share Reserve (cont.)

- In terms of the “form” of award, some companies provide inducement grants as stand-alone awards, whereas others will have an inducement plan from which to make grants
 - The latter is particularly prevalent in M&A transactions
- Important to note is that inducement grants are “outside” of the shareholder approved equity incentive plan
 - Therefore, inducement grants would have to comply with an applicable securities exemption or be covered pursuant to a Form S-8 or other securities registration

Hire: Inducement Grants to Protect Share Reserve (cont.)

- Our thoughts generally:
 - Depending on the extent a company grants equity to new hires, compliance with the inducement grant exception could substantially increase the life expectancy of a shareholder-approved share reserve (*i.e.*, equity grants tend to be larger in new hire situations)
 - Inducement grants could be used in the M&A context where a buyer offers equity to the key employees of the target entity
 - However, burn rate and dilution profiles relative to industry peers could be negatively impacted, thus making it more likely that ISS would recommend “against” to any future request to increase the share reserve for the company’s equity incentive plan (*i.e.*, an inducement plan essentially borrows from the share reserve of a future shareholder-approved equity incentive plan)

- Our thoughts for any company considering implementation of an inducement program:
 - Consider the structure of any inducement program
 - If inducement grants will be frequent, then draft an inducement plan
 - But if inducement grants will be infrequent, then approve stand-alone inducement grants on an ad hoc basis

 - Have an inducement grant (or plan) be covered by a Form S-8

Hire: Structuring Severance Pay

- Generally, severance pay is only contractually provided if the executive is terminated by the company for Cause or by the executive for Good Reason
 - Severance pay includes accelerated vesting of equity awards
- Consider that severance pay should be “bridge pay” (*i.e.*, a bridge between jobs)
 - Consider whether it makes sense to offset the amount of any future severance pay by the amount of any income the executive earns from his or her new employer, if applicable
 - ISS Thoughts: Too much severance pay could trigger a no vote on the company’s next say-on-pay vote, or if egregious enough when severance is combined with other problematic pay practices, a no vote on the re-election of the members of the Compensation Committee or the Board

Hire: Structuring Severance Pay (cont.)

- Should severance be a multiple of base salary? A multiple of base and bonus?
- Should severance wear-away over time as the executive builds internal wealth due to equity awards
- Should severance pay be higher in change-in-control situations?
 - What is the policy reason?
- Should severance pay be provided in any of the following situations?
 - Disability
 - Death
 - A failure by the Company to renew the employment agreement

Hire: Structuring Severance Pay (cont.)

- Consider designing severance pay in the form of salary continuation (as opposed to lump sum payout)
 - Such allows the Board to hold the “purse strings” necessary to enforce any post-employment restrictive covenants such as non-competes, non-disparagement clauses, etc.
 - Should salary continuation stop to the extent the executive found a replacement job?

- Require that the executive execute a waiver and release of all known and unknown claims as a condition precedent to receiving severance pay
 - A form of such release should be attached to the executive contract as an exhibit (*i.e.*, “. . . , substantially in the form attached hereto as Exhibit A.”)

Hire: Structuring Severance Pay (cont.)

- Should severance pay in the change-in-control situation be double trigger or single trigger?
 - Single trigger = change-in-control alone triggers payout
 - Double trigger = change-in-control and a termination of employment for Good Reason or without Cause is required
 - A related thought is whether there should be a post-change-in-control protection period? Idea being that after a certain amount of time (e.g., 1 year), any termination is likely the result of the executive and less the result of the change-in-control, and so related severance protection should end abruptly or phase out over time

Don't Forget Next Month's Webinar

- Title:
 - A Review of Unique Non-Employee Director Compensation Arrangements

- When:
 - 10:00 am to 11:00 am Central
 - November 11, 2021

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