CEO-Related Shareholder Activism

Company boards should understand and prepare for heightened shareholder activism related to CEO performance and compensation.

MEMORANDUM TO: The Board of Directors
FROM: Frank Aquila
RE: CEO-Related Shareholder Activism

As we have discussed, in light of increased market volatility, challenging shareholder returns, and significant layoffs in multiple sectors, shareholder activists have been exerting increasing pressure on companies and their boards on issues related to CEO performance and compensation. In particular, activists are focusing on perceived failures related to strategic execution or financial performance, compensation mismatch, or concerns related to entrenchment or a lack of specific qualifications.

At the same time, CEOs may be facing expanded legal exposure as a result of greater regulatory scrutiny and recent judicial developments. Regardless of outcome, legal controversy has the potential to cause substantial reputational harm to the executive, the board and the company. If a CEO is the subject of legal controversy and the associated negative publicity, the CEO, the board, and the company will be more vulnerable in the face of activism, especially if the company's performance is poor. As the Board assesses the Company's activism preparedness this year, it should be particularly mindful of potential areas of attack for an activist to challenge the Company's CEO, as well as the Board's oversight of CEO-related issues. Activist campaigns targeting CEOs can frequently be personal, distracting, and value-detracting, and resulting changes in company leadership can often bring instability and uncertainty to companies.

This memorandum outlines the key issues the Board should consider when preparing for potential CEO-related activism, including:

- Recent trends in CEO-related activism.

- CEO compensation issues.
- Recent legal developments that expand legal risks for CEOs, as well as legal protections available to CEOs.
- Board oversight.
- Disclosure and messaging implications.

1. Recent Trends in CEO-Related Activism

Historically, CEO- or management-focused campaigns tended to represent a meaningful portion of US campaigns. The prevalence of these campaigns temporarily declined in 2020 and 2021 due to COVID-related concerns, with shareholders generally perceiving a leadership change during the pandemic to be an unwelcome and destabilizing outcome.

However, 2022 saw the highest numbers of executive-related campaigns in the last decade, with over 50 campaigns against US companies demanding the removal of officers. Many of these campaigns highlighted the CEO's role in a company's missed earnings guidance or failure to perform or execute on a strategic plan. Several criticized the CEO for receiving excessive compensation in the face of low stock prices and low shareholder returns. CEOs also faced backlash for environmental, social, or governance (ESG) issues from shareholders on different ends of the political spectrum. For example, a CEO's decision to use environmental performance as a measure of company success became a central point in one activist campaign to oust the CEO.

Activists were relatively successful in CEO-related campaigns in 2022, achieving executive turnover in around 30% of these contests. In many cases, the CEO announced their resignation after the contest. In other cases, companies entered into settlement agreements with activists conditioned on changes in company leadership. Some of these agreements required the incumbent CEO to step down immediately or before the next annual meeting, while others took a more gradual approach, for example, by requiring the creation of a board-level committee to consider whether any management changes are needed.

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In light of these continuing trends, the Board should consult with experienced advisors to stay up to date on activism developments in the Company's industry. The Board should proactively discuss with management potential activist concerns and demands related to the CEO. Being reactive on CEO-related issues can meaningfully decrease a board's credibility and leverage in an activism situation. The Board should work with public relations and legal advisors to make sure that it is prepared to respond to and engage with investors on issues such as:

- The Company's long-term business strategy and plans for navigating any current performance challenges.
- The integral role that the CEO will play in executing the long-term business strategy.
- The Board's approach to CEO compensation.
- CEO succession planning.

2. CEO Compensation

One of the main issues that activists have focused on in recent CEO-related campaigns is CEO compensation. Shareholders are increasingly criticizing large CEO compensation and severance payouts that seem to be untethered from company performance. In 2022, the number of failed "say-on-pay" votes was more than double the number in 2018.

This shareholder pushback is forcing companies, especially those that have had recent performance issues, to think harder about their CEO compensation to manage reputational risks to the CEO, the board, and the company. In January 2023, Apple announced that CEO Tim Cook's compensation would be cut by more than 40%, following negative feedback from stakeholders, including ISS, and a say-on-pay vote in 2022 that passed with less than 65% support. ISS currently recommends that shareholders vote against a company's say-on-pay proposal if any of the following is true:

- There is misalignment between CEO pay and the company's performance, based on ISS's "pay-for-performance" analysis.
- The company has "problematic pay practices," such as excessive termination or severance payments, or severance payments triggered only by a change in control without also a resulting involuntary job loss or diminution of duties.
- The board does not communicate and respond effectively to shareholders.

The Board should work closely with experts, including compensation consultants, and be prepared to discuss how the design of the Company's executive compensation incentivizes strong performance from management. The Board should consider how to tie the Company's disclosure on "pay versus performance" to the design of its executive compensation program (see *Pay Versus Performance* below). Furthermore, the Board should monitor any criticisms of its peer firms as guidance for evaluating the Company's compensation practices. It may also be necessary for the Board to more carefully assess the composition of the peer group that the Company will use for benchmarking its executive compensation practices.

The Board should be especially prepared to discuss executive compensation topics during the Company's shareholder outreach this year. These engagements between the Company and its largest shareholders are a great opportunity to generate buy-in for its compensation design, as well as refine its messaging in response to shareholder concern. The S&P 500 companies that failed say-on-pay votes in both 2021 and 2022 had been criticized by ISS for limited or inadequate responsiveness to shareholder concerns.

Similarly, it is important for the Board to understand the positions that proxy advisors are likely to take on the Company's compensation practices. While both ISS and Glass Lewis restrict engagement with companies during the solicitation period for the annual meeting, the Board should consider engaging with these firms in the off season.

Finally, the Board should consider the totality of the CEO's compensation in 2023 and the perception that investors may have of the total compensation. In particular, the Board should carefully consider the optics of large awards, even if they are granted for performance milestones achieved in past fiscal years. (For more information, see Designing, Determining and Disclosing Executive Compensation: A Consulting Perspective on Practical Law.)

A. <u>Discretionary Awards and Adjustments</u>

Boards have faced particularly intense criticism for making discretionary awards where a CEO has failed to meet relevant performance targets, and for making adjustments to CEO compensation packages that make targets easier to meet. The Board should make sure that there is sufficient alignment between pay and performance, and have a compelling reason for why a discretionary award or an adjustment is warranted. Investors have generally indicated that COVID-19 is no longer a compelling reason.

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If a company is perceived as having misaligned CEO compensation and cannot articulate a compelling reason for its compensation approach, it is likely to face pushback from institutional investors and proxy advisors, which may be inclined to support an activist in a CEO-related campaign. Maintaining appropriate pay-for-performance alignment, with an emphasis on long-term shareholder value, and avoiding arrangements that risk "pay-for-failure" are two key principles that underlie ISS's evaluation of executive and director compensation programs and ISS's 2023 proxy voting guidelines for compensation matters. Similarly, when reviewing a company's say-on-pay proposal, Glass Lewis focuses on, among other things, the overall design and structure of the company's executive compensation programs, including the selection and challenging nature of performance metrics, as well as the link between compensation and performance as indicated by the company's current and past pay-for-performance grades.

Even if CEOs meet their performance targets, companies may be criticized for the design of their compensation packages if the companies are facing performance issues or viewed as having poor shareholder returns. Boards may also face backlash for making changes in performance metrics, even if these adjustments are simply to reflect the broader macroeconomic environment. For example, Glass Lewis recommends against management's say-on-pay proposals if Glass Lewis finds deficiencies in compensation programs, such as when there is a limited rationale for large changes in performance metrics.

B. Severance Payments

Criticism of CEO compensation has also focused on the amount of severance and board decisions to grant severance in connection with a CEO exit. In 2022, out of 50 companies that received an "against" recommendation from ISS on say-on-pay based on its pay-for-performance analysis, ISS identified 12 of the companies as having problematic severance or change-in-control arrangements.

Shareholders have expressed continued concern over the size of severance payments. In light of the relatively high support certain shareholder proposals seeking prior shareholder approval of large severance payments received in 2022, for the 2023 proxy season, shareholders have submitted a large number of proposals that demand shareholder approval for executive severance payments with an estimated value exceeding 2.99 times the sum of an executive's combined base salary and target bonus. Institutional investors have indicated their support of a quantitative threshold for the amount of severance payments. For example, Vanguard's 2023 proxy voting policy notes that severance payments exceeding 2.99 times the salary plus bonus or including single-trigger cash or equity payments may be excessive or unreasonable.

Investors, proxy advisors, and regulators are also scrutinizing boards' decisions to award severance. ISS considers severance payments made "when the termination is not clearly disclosed as involuntary" (for example, a termination without cause or resignation for good reason) to be a "problematic practice" that may result in an "against" vote recommendation on say-on-pay. Regulators are also focused on severance payments in these contexts. In January 2023, the SEC settled charges against McDonald's for failing to disclose the discretionary nature of the board's decision to award severance to the former CEO. Specifically, the SEC alleged that McDonald's violated Section 14(a) of the

Exchange Act when the company failed to disclose that its board exercised discretion in classifying the termination as without cause, thereby allowing the former CEO to retain his equity compensation. (See *McDonald's Litigation and Enforcement Action* below; for more information, see SEC Settles Charges Against McDonald's and Its Former CEO for Disclosure Violations on Practical Law.)

In the current environment, boards need to be careful when considering an award of severance payments, including in connection with CEO turnover resulting from an activist campaign. The Board should consult with experienced advisors to conduct the necessary analysis of what compensation and benefits the executive may be entitled to on termination of employment and any alternatives that may be available, and should consider the disclosure implications before awarding severance to a senior executive. (For more information, see Terminating a Senior Executive: Key Compensation and Benefits Issues on Practical Law.)

C. Pay Versus Performance

2023 is the first time that companies are complying with the new pay-versus-performance rules. These rules expand the compensation-related disclosures in companies' proxy statements, including CEO compensation as compared to performance measures such as total shareholder return, the total shareholder return of the peer group, net income, and a financial performance measure selected by the company. Despite a lack of notable impact on 2023 voting results, these disclosures may put additional pressure on CEO compensation practices in the 2024 proxy season. (For more information, see The Pay Versus Performance Rule: Preparing for Compliance and What's Market: Pay Versus Performance Disclosure on Practical Law.)

3. Legal Exposure and Protections

CEOs typically face greater legal exposure during economic headwinds. In 2023, challenges in the economic landscape have been compounded by regulators' and private litigants' focus on management's role in ESG issues. Because investigations and litigation against a company's CEO can often damage the goodwill of the company and present a costly distraction for the management team, the Board should be aware of important recent developments that may increase the legal risks faced by CEOs.

A. McDonald's Litigation and Enforcement Action

In January 2023, in *In re McDonald's Corporation Stockholder Derivative Litigation*, the Delaware Court of Chancery extended the *Caremark* duty of oversight to corporate officers (289 A.3d 343 (Del. Ch. Jan. 26, 2023)). Previously, Delaware courts only explicitly held that directors owe a duty of oversight. However, in *McDonald's*, the court clarified and confirmed that officers also owe a fiduciary duty of oversight, comparable to the duty that directors owe. Additionally, the court held that while most corporate officers' *Caremark* duties require them to report "red flags" upwards, those duties may be limited by the officer's role and areas of responsibility. The CEO's *Caremark* duty of oversight, however, covers all corporate activities (*McDonald's* at 350). (For more information, see Fiduciary Duties of Officers of Corporations on Practical Law.)

In light of this decision, shareholders can make litigation demands on companies based on officer oversight claims as private litigants. These claims may be costly and burdensome for companies to litigate even though they are unlikely to succeed (plaintiffs face a high bar of showing "bad faith" by the officer and, in derivative actions, must show that a majority of the board lacks independence or faces a substantial likelihood of liability). More shareholders may also demand corporate books and records as a result of this decision.

Additionally, the SEC charged McDonald's former CEO for making false and misleading statements to investors about the circumstances leading to his termination. Taken together with its other recent enforcement actions related to executive compensation and perquisites, the SEC has demonstrated an enforcement focus on actions taken by executives, including on ESG matters, as well as the board's role in overseeing executive practices. Companies and executives have received fines and faced other negative consequences as a result of these regulatory actions.

B. Legal Protections

The Board should review the protections offered to officers of the Company under the Company's organizational documents, such as exculpation (or the elimination of personal liability with respect to certain types of claims), indemnification, advancement of costs, and directors' and officers' (D&O) insurance. These protections not only can reduce the disruption and cost of litigation for management but also are often crucial in attracting and retaining key talent. In some cases, enhancements to the current protections might be appropriate in light of recent developments.

Because the Company is a Delaware company, the Board should be aware that the Delaware General Assembly recently amended Section 102(b)(7) of the Delaware General Corporation Law (DGCL) to allow companies to exculpate CEOs and other senior officers for breaches of the duty of care. Previously, Delaware companies were only permitted to exculpate directors, not officers. Officer exculpation under the amended DGCL:

- Extends only to direct claims (such as class actions), and not to derivative claims.
- Does not extend to claims for breach of the duty of loyalty or intentional misconduct.

To take advantage of state officer exculpation laws, companies must amend their certificates of incorporation to add specific language, which will require a shareholder vote. As of June 2023, shareholders at over 200 companies had voted on exculpation provisions, and the vast majority of these proposals passed. In its 2023 proxy voting guidelines, ISS indicated that it will generally vote on a case-by-case basis on officer exculpation charter amendment proposals and has generally recommended in favor of DGCL-aligned amendments. Glass Lewis will also vote on a case-by-case basis but will generally vote against these proposals unless the board provides a compelling rationale and the provisions are reasonable. The Board should discuss with its legal advisors the appropriateness of this type of charter amendment, as well as the legal requirements for implementation, including determining whether a supermajority shareholder vote is required to amend the Company's charter and allotting sufficient time to accommodate the additional SEC filings. (For more information, see GC Agenda: January 2023: Officer Exculpation in the January 2023 issue of *Practical Law The Journal*.)

Additionally, the Company may need to review its D&O insurance policy to ensure that both the Board and senior management are adequately covered. When reviewing D&O insurance policies, companies should discuss the scope and cost of coverage. D&O insurance policy costs may increase as a result of the *McDonald's* decision, but adopting an officer exculpation provision may offset these cost increases.

4. Board Oversight

Investors and proxy advisors have also been scrutinizing the relationships between boards and CEOs. Specifically, stakeholders are focused on ensuring robust board oversight of CEO performance, practices, and policies. Boards must demonstrate that they are willing and able to vigorously represent the interest of shareholders in their engagement with management.

Regulators are also focused on board oversight of management, particularly in the context of risk management. For example, in 2022, the SEC sent comment letters to at least 36 companies seeking additional information on their boards' risk oversight processes. Some of these letters requested more information from the board on the role played by the lead director. The SEC also asked companies to disclose more information on how boards align their risk oversight process with existing disclosure control frameworks.

A. Independence

Many investors view board independence as the most important trait when assessing whether a board is capable of adequately representing shareholder interests. In many campaigns, activists will seek to replace directors on the premise that the incumbent directors lack independence, being so beholden to the CEO that they merely "rubber stamp" management decisions. These activists argue that their candidates are better positioned to critically review and challenge management decisions, and therefore are better representatives for shareholders on the board. The success of these activist campaigns will depend on whether the broader shareholder base perceives the incumbent directors as having the necessary power and separation to exercise independent judgment when overseeing management's decisions and performance.

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A board may be perceived as lacking independence even if it is comprised of a majority of directors who meet the director independence criteria under relevant exchange listing standards. For example, for several years, shareholder proponents have submitted Rule 14a-8 proposals demanding the separation of CEO and board chair roles on the theory that having the CEO lead the board has a dramatic effect on board independence even if the majority of directors are independent. ISS and Glass Lewis tend to support these proposals, with Glass Lewis noting that the number of S&P 500 companies that separate the CEO and chair roles has increased to 57% at the beginning of 2023, up from 37% in 2009.

However, a company does not need to have split CEO and chair roles to have a sufficiently independent board. BlackRock, Vanguard, and State Street are aligned in taking a case-by-case approach when evaluating a company's lack of an independent chair. These institutional investors will analyze a company with combined CEO and board chair roles and consider whether the board has appointed a lead independent director with the power to provide formal input on board meeting agendas, call meetings of independent directors, and preside at those meetings. State Street specifically notes that it will consider the role played by the lead director, the company's performance, and the overall governance structure of the company in deciding whether to support proposals that call for separating the CEO and board chair roles.

B. Tenure

Shareholders and proxy advisors have recently focused on board tenure as indicia of the robustness of a board's oversight. The first proxy contest using the universal proxy card has demonstrated the importance of director tenure. In December 2022, Land & Buildings Investment Management LLC

(L&B), a shareholder of Apartment Investment and Management Co. (Aimco), secured one of two board seats sought in a contest against Aimco fought on universal proxy cards, replacing the longest-tenured incumbent director who was up for re-election. ISS seems to have applied its guidance on the universal proxy rule, which indicates that ISS would recommend replacing a long-tenured, overboarded director who seems disengaged with a nominee who brings clearly relevant skills to the board, or perhaps enhances diversity. ISS recommended against the incumbent director who ultimately lost and in favor of the L&B nominee who won. (For more on the universal proxy rule, see Considerations Regarding Universal Proxy in the January 2023 issue of *Practical Law The Journal*.)

C. Overboarding

Investors have looked at the number of boards on which directors serve as indicia of whether the directors are able to have robust engagement with management. The Company should review the director overboarding policies of its largest investors each proxy season, because these policies may be regularly updated. For example, starting in 2024, State Street will not use specific numerical criteria to identify overcommitted directors and instead may vote against the nominating committee chair if the company does not disclose an overboarding policy or if the policy is not consistent with State Street's expectations. (See Yie-Hsin Hung, President and CEO, State Street Global Advisors, CEO's Letter on Our 2023 Proxy Voting Agenda (Mar. 31, 2023); for more information, see Director "Overboarding" on Practical Law.)

D. Qualifications

State Street's 2023 proxy voting and engagement guidelines highlight its focus on board quality as a measure of director independence and on whether board members have "adequate skills to provide effective oversight of corporate strategy, operations, and risks, including environmental and social issues." Moreover, the SEC has recently proposed rules that would require disclosure of whether a board has directors who have the requisite cybersecurity or climate-related expertise to oversee the company's risks and management's policies and practices in these areas (for more information, see SEC Rulemaking Tracker on Practical Law).

5. Messaging and Disclosure Considerations

CEO-related activism campaigns may be won or lost on a company's ability to a deliver a persuasive narrative about:

- The company's strategic objectives.
- The importance of the CEO to achieving those objectives.
- The thoughtfulness of its executive compensation approach.
- The board's ability to work well with management while exercising independent judgment.

The Board should ensure that the Company's messaging is consistent, impactful, and appropriately reflected in the Company's public disclosures. Particularly in light of the universal proxy rules, many companies are creating board videos and other public-facing materials to demonstrate to shareholders the unity and vision of the incumbent board. Other companies are proactively releasing investor materials that highlight the company's overall corporate governance framework. The Board should work closely with the Company's investor relations team and other advisors on all messaging.

Disclosures, whether or not they are included in SEC filings, should be reviewed by the Company's legal advisors to ensure compliance with Regulation FD (for more information, see Complying with

Regulation FD (Fair Disclosure) on Practical Law). Additionally, the Board should be aware that the SEC has recently pursued enforcement actions against companies for aspirational governance-related statements contained in SEC filings and other public disclosures on the theory that these statements were false or materially misleading considering events that subsequently came to light.

The SEC has also charged companies for failing to implement adequate disclosure controls, even where it did not charge the company with any underlying disclosure violation. For example, in a recent enforcement action, although a company's senior executives released a public statement immediately after a third party made them aware of data privacy vulnerabilities, the SEC charged the company with disclosure control failures because, among other things, the senior executives were not informed that the company's information security personnel had identified, but failed to remedy, the vulnerability several months earlier. (For more information, see SEC Settles Cybersecurity Disclosure Control Violations Charges Against Real Estate Settlement Services Company on Practical Law.)

Given the heightened investor and regulatory focus on these disclosures, the Board should make sure that the Company is working closely with internal stakeholders and external advisors on its SEC filings and other public disclosures relating to the CEO and the Board.

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I look forward to discussing these issues further at your convenience.

F.J.A.