

CHANGING MANAGEMENT IN THE FACE OF SHAREHOLDER ACTIVISM: ISSUES TO CONSIDER

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Recently it has become relatively common for shareholder activists to advocate for changes in senior management, not just changes in board composition.¹ In the face of this pressure, some companies have announced changes to their leadership teams.² These

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¹ See, e.g., Bill George & Jay W. Lorsch, *How to Outsmart Activist Investors*, HARVARD BUS. REV. (May 2014), <http://hbr.org/2014/05/how-to-outsmart-activist-investors/ar/1>; MOODY'S INVESTORS SERVICE, SHAREHOLDER ACTIVISM: IMPACT ON NORTH AMERICAN CORPORATE SECTORS 10, 12, (Mar. 2014); Doug Steiner, *Wes Hall: From Mail Room Clerk to Bay Street Power Broker*, THE GLOBE AND MAIL (Jan. 30, 2014), <http://www.theglobeandmail.com/report-on-business/rob-magazine/make-friends-now-or-enemies-later/article16579456/?page=1> ("Wall Street agitators... want underperforming executives to raise shareholder returns fast, or get out of the way"). For example, Hertz Global Holdings Inc.'s Chairman and CEO Mark Frissora stepped down from his position less than three weeks after activist investors Carl Icahn and Fir Tree Partners called on him to resign, and was replaced by an interim CEO as the board searched for a long-term replacement. Alexandra Higgins, *Hertz CEO Frissora Resigns Amid Investor Pressure*, CQ ROLL CALL WASHINGTON CORPORATE GOVERNANCE BRIEFING, 2014 WL 4401300 (Sept. 8, 2014). Jeff Ubben's Value Act applied pressure in private "to ease out Steve Ballmer as chief executive at Microsoft." Stephen Foley, *Shareholder Activism: Battle for the Boardroom*, FINANCIAL TIMES (Apr. 23, 2014), <http://www.ft.com/intl/cms/s/2/a555abec-be32-11e3-961f-00144feabdc0.html#axzz3Dm2Rlnt>. Corvex Management and Related Fund Management pursued new management at Commonwealth REIT, which resulted in a special meeting of Commonwealth REIT's shareholders, which in turn resulted in the departure of its President, Treasurer/CFO, Senior Vice President/COO and certain other officers and the appointment of seven new trustees, all of whom were activist nominees. Commonwealth REIT, Current Report (Form 8-K), (May 27, 2014), <http://biz.yahoo.com/e/140527/eqc8-k.html>; David Gelles, *Activists Solicit Shareholders to Replace Board at Commonwealth REIT*, N.Y. TIMES (Jan. 30, 2014), http://dealbook.nytimes.com/2014/01/30/activists-solicit-shareholders-to-replace-board-at-commonwealth-reit/?_php=true&_type=blogs&_php=true&_type=blogs&_r=1.

² See, e.g., Alexandra Higgins, *New ALCO Board Replaces CEO After Proxy Win*, CQ ROLL CALL WASHINGTON CORPORATE GOVERNANCE BRIEFING, 2014 WL 4401308 (Sept. 8, 2014) (describing ALCO Stores Inc. board's decision to appoint an interim CEO after dissident shareholders replaced all seven board members at the company's annual meeting); Pamela Park, *Wausau Shakes Up Leadership*

changes can create strife in the boardroom and tension among employees.³ Leadership transitions also raise a number of disclosure and other legal issues that companies should take into account if a board decides to respond to activism in this manner. This article provides a checklist of issues that regularly arise in these situations, although it is certainly not an exhaustive list since the facts and circumstances of every situation vary. For simplicity, this checklist focuses on the scenario where the leadership change is occurring at the CEO level, since that is the position most frequently called out for change by activists.

I. Selecting the Successor

Once a board decides to change the CEO, the first issue the board will face is who should be the successor. Many boards perform succession planning in the ordinary course of business.⁴ However, if the designated successor for a departing CEO is that same CEO's next in command, an activist may not view this as a satisfactory solution, since the perception may be that the "number two guy" will just offer "more of the same" as the departing CEO. That being said, if the decision to terminate a CEO is made quickly and

Amid Shareholder Activism, WESTLAW CORPORATE GOVERNANCE DAILY BRIEFING, 2014 WL 1316116 (Apr. 3, 2014) (Wausau Paper announced that its CEO and chairman of the board were both resigning amid activist shareholder calls for leadership changes at the board and management levels); Pamela Park, *Corporate Governance 2013: Shareholder Activists Demand Voices in the Boardroom and Changes to Corporate Strategy*, WESTLAW CORPORATE GOVERNANCE DAILY BRIEFING, 2014 WL 241758 (Dec. 26, 2013) (BlackBerry received a \$1 billion injection of new capital from Fairfax Financial after agreeing to implement a number of governance changes, including having the CEO step down in favor of a Fairfax nominee and appointing Fairfax's founder to the BlackBerry board as lead director and as chair of the Compensation, Nomination and Governance Committee).

³ For example, consider the story of activist investor and director of J.C. Penney's board, Bill Ackman, who replaced the previous CEO with Ron Johnson. After the board replaced Johnson with Myron Ullman as interim CEO, Ackman subsequently entered a standoff with Ullman, and encouraged the board to replace Ullman, before himself resigning. Suzanne Kapner & Emily Glazer, *Investor William Ackman Targets J.C. Penney's CEO*, THE WALL STREET JOURNAL (Aug. 8, 2013), <http://online.wsj.com/news/articles/SB10001424127887323477604579000691399643208?mg=reno64-wsj>; Susanna Kim, *J.C. Penney's Public Boardroom Battle Ends with Ackman Exit*, ABC NEWS (Aug. 13, 2013), <http://abcnews.go.com/Business/billionaire-investor-bill-ackman-resigns-jc-penneys-board/print?id=19945920>. See also *Photo-Me Says CEO and Chairman to Leave Soon*, REUTERS NEWS (Aug. 24, 2007), <http://64.150.182.63/details.php?id=72860&cid=1> (chairman commenting on activist investors' pressure: "To brutally remove the CEO is madness....He has the loyalty of many people within the business, and the damage caused within the business would be enormous").

⁴ See, e.g., *The Board's Role in Succession Planning*, INTEL 2011 Proxy Statement (Apr. 4, 2011), http://www.intc.com/intelProxy2011/governance/succession_planning/ ("the Board's primary responsibilities include planning for succession with respect to the position of CEO and monitoring and advising on management's succession planning for other executive officers"); *Corporate Governance Principles*, J.P. MORGAN CHASE & CO., <http://www.jpmorganchase.com/corporate/About-JPMC/corporate-governance-principles#successionplanning> (last visited Feb. 26 2015) (succession planning is considered at least annually by the non-management directors and CEO).

confidentially, it may not be practical to line up an alternative successor who can assume the reins immediately upon the announced departure. Meanwhile, it is typically considered undesirable to leave a lame duck CEO at the helm for a transition period while the board looks for his or her replacement. Accordingly, many companies opt to appoint an interim CEO while they conduct a broader search for a permanent CEO.⁵

The interim CEO could be one of the company's existing executives, but he or she could also be a director who has prior industry experience and knowledge of the company.⁶ Another option is to bring back a former CEO or founder who had previously retired from the company.⁷ The decision of whom to select as interim CEO will depend in part on what the board perceives to be the primary responsibility of the interim CEO. Some examples include, a "seat warmer" who is charged with managing the day-to-day operations until the board selects a permanent CEO, a "marketer" who sets the company up for an IPO or sale, and a "fixer" who tries to make significant strategic or operational changes to the company's existing businesses or sells off or shuts down underperforming parts of the business.⁸ This can also be an opportunity for the board to "test drive" the interim CEO to see how he or she performs in the role, with the possibility of permanent appointment afterwards.⁹

If the interim CEO is an existing member of the management team or even a board member, it is possible that he or she will want to be considered as a candidate for the permanent CEO position. There is no general reason why this should not be permitted,

⁵ See Matthew Semadeni, et al., *Interim CEO: Reasonable Choice or Failed Selection?*, THE CONFERENCE BOARD, June 2014, http://www.conference-board.org/retrievefile.cfm?filename=TCB_DN-V6N12-141.pdf&type=subtitle.

⁶ See, e.g., CONMED Corp., Proxy Statement (Form DEFA14A) (Aug. 11, 2014) (CONMED appointed an independent director with more than 22 years of experience in the industry as interim CEO); Alexandra Higgins, *Platinum calls for special meeting at Echo*, CQ ROLL CALL WASHINGTON CORPORATE GOVERNANCE BRIEFING, 2014 WL 3397708, July 14, 2014, (activist investor Platinum Management LLC called for the board of Echo Therapeutics, Inc. to hire a new CEO to replace the interim CEO, who is also Echo's general counsel and senior vice president).

⁷ See, e.g., Jeremy Bogaisky, *Congrats, Bill Ackman: Bob McDonald Out at P&G, A.G. Lafley Returning as CEO*, FORBES.COM (May 23, 2013), <http://www.forbes.com/sites/jeremybogaisky/2013/05/23/bob-mcdonald-out-at-procter-a-g-lafley-returning-as-ceo/> (noting the return of ex-CEO Alan George Lafley as President and CEO of Procter & Gamble after activist investor Bill Ackman urged the board to replace CEO Bob McDonald); Eugene Kim, *The Man Who Steve Jobs Considered for Apple's CEO is Back with a Startup that Lights Google's Buildings*, BUSINESS INSIDER (Sept. 14, 2014), <http://www.businessinsider.com/joe-costello-enlightened-interview-2014-9> (Founder Steve Jobs returned as interim CEO for Apple in 1997, eventually dropping "interim" from his title).

⁸ Christine H. Mooney et al., *Six Ways Companies Use Interim CEOs*, 41 ORGANIZATIONAL DYNAMICS 13 (2012); Semadeni et al., *supra* note 5.

⁹ See, e.g., EveryWare Global, Inc., Current Report (Form 8-K) at ex. 10.1 (Feb. 25, 2014) (interim CEO Employment Agreement providing company "may consider" the interim CEO for the position of permanent CEO under terms and conditions to be negotiated after his "initial term" of six months).

although no promises should be made in that regard, especially given that the leadership transition may need to occur very quickly under the spotlight of a proxy contest and the board may not have an opportunity to vet the relative merits of the interim CEO relative to other potential candidates. In this regard, it is important that the new employment agreements and equity awards (if any) that are granted to the interim CEO be consistent with the interim/temporary nature of the appointment (e.g., term of employment period, severance and vesting period of equity awards).¹⁰

To identify a permanent CEO, it is typical for the board to form a search committee, comprised of board members with expertise and interest in the issue.¹¹ Typically, the search committee includes the chairman of the board, and often the chair of the compensation committee and/or the chair of the nominating and corporate governance committee. The search committee usually retains an executive search firm to help identify a short list of prospective candidates.¹² Industries undergoing consolidation tend to have many qualified candidates available, whereas in other industries the search committee may have to look further afield. At the outset, the search committee should articulate the key characteristics it is seeking in a permanent CEO. These characteristics may be informed in part by the activist's criticisms of the outgoing CEO, but should also account for the directors' own views regarding the company's strategic direction and culture and the candidate's ability to work well with the remaining management team.

II. Compensation and Benefits

There are at least five critical issues regarding compensation and benefits associated with leadership transition: (1) what separation arrangements to implement with the departing CEO; (2) what arrangements to implement with the interim CEO; (3) what retention arrangements, if any, to implement for the rest of the management team that remains; (4) what arrangements to implement for the permanent CEO; and (5) whether to make any changes to current director compensation in consideration for the additional time the board must spend in executing the transition.

¹⁰ See, e.g., Aegion Corp, Current Report (Form 8-K) at ex. 10.2 (May 4, 2014); Tecumseh Products Co., Current Report (Form 8-K) at ex. 99.4 (June 27, 2014).

¹¹ See, e.g., GLOBE NEWSWIRE, SMTC ANNOUNCES THE APPOINTMENT OF LARRY SILBER AS INTERIM CEO AND CLARKE BAILEY AS EXECUTIVE CHAIRMAN, ANNOUNCES DEPARTURE OF CO (May 14, 2013) (SMTC Corporation appointed executive chairman of the board with "extensive experience as a Chairman and Executive of public companies" to lead the CEO Search Committee's efforts to identify and appoint a permanent CEO).

¹² See, e.g., Alexandra Higgins, *Novatel Wireless shareholders oust CEO Leparulo*, CQ ROLL CALL WASHINGTON CORPORATE GOVERNANCE BRIEFING, 2014 WL 2724191 (June 17, 2014) (Novatel Wireless Inc. engaged executive search firm to evaluate candidates for permanent CEO).

A. Departing CEO Arrangements

Many boards consider whether it makes sense to keep a departing CEO in place during a transition period.¹³ This question especially arises in cases where the board is having difficulty in identifying an interim or permanent CEO candidate, but still wants to announce the management change to investors. However, boards often determine that keeping a lame duck CEO in place, even for a short transition period, is not in the company's best interests. It can be disruptive to the management team, can lead to investor confusion regarding the potential changes in the company's strategic direction, and a lame duck CEO may not be able or willing to aggressively implement the board's new mandates.¹⁴ In such situations, one potential compromise is to enter into a short-term consulting arrangement with the departing CEO.¹⁵ Even such consulting arrangements can raise difficult social issues, however, including whether the departing CEO can keep his or her current office and secretary.¹⁶ Despite these difficulties, such consulting arrangements can help provide a basis to enforce a non-compete arrangement or effectively place the departing CEO on "garden leave." In any case, such a consulting arrangement would not obviate the need to find a replacement, whether interim or permanent.

The departing CEO's existing employment agreement may already adequately address the possibility of his or her departure so that no additional severance or other arrangements need to be implemented. Even where the activist has criticized the departing CEO for specific performance issues, the departing CEO is typically deemed to

¹³ For a more in-depth discussion of the various factors to consider in deciding whether to retain a departing CEO on the board during a transition period, see Jason D. Schloetzer, *Retaining Former CEOs on the Board*, DIRECTOR NOTES (Sept. 2010) <https://www.conference-board.org/retrievefile.cfm?filename=DN-015-10.pdf&type=subsite>.

¹⁴ "A large survey of U.S. corporate directors concluded that 'it is very difficult to discuss steps that may reverse a course of action with a board that includes the person who made the original decision and which is comprised substantially of directors whom that individual has appointed.'" *Id.*

¹⁵ See, e.g., CafePress Inc., Current Report (Form 8-K) (Aug. 4, 2014); CommunityOne Bancorp., Current Report (Form 8-K) (Sept. 12, 2014); CPI Aerostructures, Inc., Current Report (Form 8-K) (Mar. 6, 2014); Curis, Inc., Current Report (Form 8-K) (June 3, 2014); Infusystem Holdings, Inc. Annual Report (Form 10-K) (Mar. 28, 2013); Landauer, Inc., Current Report (Form 8-K) (Sept. 17, 2014); Overseas Shipholding Group, Inc., Current Report (Form 8-K) (Aug. 15, 2014); Pulse Electronics Corp., Current Report (Form 8-K, Ex. 99.2) (July 16, 2014); Reynolds American Inc., Current Report (Form 8-K) (Apr. 16, 2014).

¹⁶ For examples of the "turmoil some directors faced after retaining the departing CEO on the board," see Schloetzer, *Supra* note 13 at 1-2, 5-6 (Sept. 2010). In acknowledgement of such difficulties, some companies "take action to stem prevent future difficulties. For example, the governance guidelines outlined in Qwest Communications' 2007 proxy statement includes, 'Our CEO must resign as a director when he ceases to be CEO.' Jeffrey Bewkes, who replaced Richard Parsons in 2007 as CEO of Time Warner Inc., reportedly had a clause in his employment agreement that allowed him to resign if the former CEO (Mr. Parsons) remains on the board for more than one year.'" Schloetzer, *Supra* note 13 at 7.

be terminated “without cause.”¹⁷ Unless there has been a change of control of the company, a termination “without cause” usually entitles the departing CEO to severance equal to one or two-times salary and bonus (not the two or three-times salary and bonus that would apply following a change of control).¹⁸ The departing CEO may also be entitled to accelerated vesting of his or her equity awards and to a prorated bonus for the year of termination.¹⁹ In some cases, even if the departing CEO’s employment agreement does not expressly provide for accelerated vesting of outstanding equity awards, the company may agree to provide some vesting in order to ensure a smooth and amicable separation. When considering severance benefits or equity vesting beyond those required by the employment agreement, the company should consider whether those benefits will trigger additional accounting charges.²⁰ Such additional benefits may also form the basis for negotiation to extend the departing CEO’s non-compete or non-solicit periods (to the extent legally permissible in the applicable jurisdiction) or to obtain a release of claims from the departing CEO, all of which can be beneficial to the company. Typically, the Code Section 162(m) deduction limits will not apply to severance provided to a departing CEO, as long as he or she is not the CEO on the last day of the calendar year.²¹ Despite this concern, the company needs to be cognizant that the rest of the management team may take a keen interest in how the departing CEO is treated, both out of continuing loyalty to the departing CEO as well as a perception that the departing CEO’s treatment is a potential prelude to how other executives might be treated.²²

¹⁷ See Joann S. Lublin & Scott Thurm, *How to Fire a CEO*, THE WALL STREET JOURNAL (Oct. 30, 2006) <http://online.wsj.com/articles/SB116217755560707504> (noting the significant litigation risks involved in firing a CEO “for cause” and explaining most boards prefer to minimize adverse publicity, cost and distraction in such situations); Garry G. Mathiason, *How to Fire a CEO*, EXECUTIVE COUNSEL 13 (Fall 2004).

¹⁸ See, e.g., Acxiom Corp., Current Report (Form 8-K, Ex. 10.1) (May 20, 2014); CMG Holdings Group, Inc., Quarterly Report (Form 10-Q, Ex. 10.1) (May 15, 2014); Global Brass and Copper Holdings, Inc., Current Report (Form 8-K, Ex. 10.1) (May 14, 2014); Kalobios Pharmaceuticals, Inc., Quarterly Report (Form 10-Q, Ex. 10.3) (May 8, 2014); KMG Chemicals, Inc., Current Report (Form 8-K) (July 2, 2013); MVB Financial Corp., Current Report (Form 8-K/A, Ex. 99.1) (Jan. 3, 2014); Pulse Electronics Corp., Current Report (Form 8-K, Ex. 99.3) (July 16, 2014); WPX Energy, Inc., Current Report (Form 8-K, Ex. 10.1) (May 2, 2014).

¹⁹ See, e.g., CMG Holdings Group, Inc., Quarterly Report (Form 10-Q, Ex. 10.1) (May 15, 2014); Emcore Corp, Form 8-K, Ex. 10.1) (Sept. 18, 2014).

²⁰ The company should consider and comply with Section 409A restrictions and limitations, including the six-month delay from the date of employee’s separation from service for deferred compensation owed to the fifty key employees with the highest salaries. I.R.C. § 409A(a)(2)(B)(i).

²¹ I.R.C. § 162(m) (2014) (“In the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds \$1,000,000 For purposes of this subsection, the term “covered employee” means any employee of the taxpayer if . . . as of the close of the taxable year, such employee is the chief executive officer of the taxpayer or is an individual acting in such a capacity”).

²² Jessica Silver-Greenberg & Susanne Craig, *Citi Chairman Is Said to Have Planned Chief’s Exit*

Certain long-serving CEOs have employment agreements that include perks that by today's corporate governance standards may appear to be atypical, such as life-time health insurance, life insurance policies, car leases, country club memberships or company plane usage rights.²³ To the extent that the departing CEO is entitled to receive any of these benefits post-separation, the company may want to consider "buying-out" these benefits so as to fully cut ties with the prior CEO.

B. Interim CEO Arrangements

When an interim CEO is brought in on short notice to address activist demands, he or she will typically receive some sort of offer letter, which is often short of a full employment agreement.²⁴ The compensation committee should review this offer letter with input from an executive compensation consultant.

The interim CEO's compensation and benefits package should contemplate that the position could very well be a short term one, even if the interim CEO is viewed as a potential candidate for the permanent position.²⁵ For example, if the interim CEO is a

Over Months, N.Y. TIMES (Oct. 25, 2012) <http://www.nytimes.com/2012/10/26/business/citi-chairman-is-said-to-have-planned-exit-for-months.html?pagewanted=1&r=1&> (After an "abrupt" and "dramatic boardroom coup" at Citi, "senior executives at the investment bank convened a group of employees to try to stem any exodus...Among the employees' questions: why remain at a bank that treated its top executive so harshly?").

²³ See, e.g., Monster Beverage Corporation, Current Report (Form 8-K) (Mar. 11, 2009) (granting CEO initial and annual fees and all other reasonable expenses relating to membership in up to two business or social clubs to be selected by the CEO at his sole discretion, all costs and expenses relating to the purchase or lease of a luxury automobile, as well as medical, dental, disability, group life, accidental death and travel accident insurance plans at the most favorable level of participation and providing highest levels of benefits available to him); Occidental Petroleum Corporation, Quarterly Report (Form 10-Q, Ex. 10.1) (Nov. 4, 2008) (during any period following Ray Irani's retirement or termination from the company until his death, company will provide for life insurance at a minimum level equal to three times his rate of highest career annual salary, medical and dental benefits for him and his spouse to an extent no less favorable than the medical benefits provided prior to his retirement or termination, personal tax, accounting and financial planning services); Quintiles Transnational Holdings Inc., Registration Statement (Form S-1) (Feb. 15, 2013) (providing for city/country club dues, an automobile selected by the CEO that is "consistent with his position with the Company," business use of an aircraft, irrevocable life insurance trusts for himself and his wife, and health insurance for himself and his wife for the duration of their lives).

²⁴ See, e.g., Aegion Corp, Current Report (Form 8-K, Ex. 10.2) (May 5, 2014); Ambassadors Group, Inc., Current Report (Form 8-K, Ex. 10.1) (May 19, 2014); Hansen Medical, Inc., Current Report (Form 8-K, Ex. 10.1) (Feb. 21, 2014); KMG Chemicals, Inc., Current Report (Form 8-K, Ex. 10.29) (July 2, 2013); Pulse Electronics Corp., Current Report (Form 8-K, Ex. 99.2) (July 16, 2014); Tecumseh Products Co., Current Report (Form 8-K, Ex. 99.4) (June 27, 2014); Verifone Systems, Inc., Current Report (Form 8-K, Ex. 10.2) (Mar. 15, 2013).

²⁵ See, e.g., Aegion Corp, Current Report (Form 8-K, Ex. 10.2) (May 5, 2014); EveryWare Global, Inc., Current Report (Form 8-K, Ex. 10.1) (Feb. 25, 2014); Hansen Medical, Inc., Current Report (Form 8-K, Ex. 10.1) (Feb. 21, 2014); Tecumseh Products Co., Current Report (Form 8-K, Ex. 99.4) (June 27,

board member who does not live in the city where the company's headquarters are located, he or she will likely require a housing and travel allowance to facilitate travel to the headquarters on a regular basis while maintaining a permanent residence elsewhere.²⁶ An interim CEO who is not a member of the current management team (and therefore may be giving up possible job opportunities elsewhere in order to accept the interim CEO position) might request a more robust salary and/or bonus than what would be provided to the permanent CEO, in order to compensate him or her for the opportunity cost of potentially foregoing more permanent positions with other companies during the interim period. It may not be advisable to give an interim CEO equity compensation awards, which are typically contingent on long-term performance and service. Rather, such amounts can instead be rolled into salary or into a special performance-based discretionary bonus.

The board should also consider how to introduce the interim CEO to the management team, and discuss with the interim CEO his or her "day one" plan for hitting the ground running and the board's expectations about the amount of information or reporting that the interim CEO will provide to them. The board cannot and should not expect to be able to monitor all of the cultural, strategic and other changes that the interim CEO will implement, but the board should try to ensure that the board and the interim CEO share a unified sense of direction. If an earnings call or investor conference is imminent, the chairman should also review talking points with the interim CEO to make sure the interim CEO's messages regarding the recent management changes and future of the company are consistent with the board's views.²⁷ The company's investor relations firm should also prepare a draft Q&A for the interim CEO to help him or her answer potentially difficult questions regarding the management changes and the interim CEO's future plans.

C. Retention Arrangements

If leadership changes are borne out of a proxy fight with an activist, the compensation committee should consider whether to implement additional retention

2014).

²⁶ See, e.g., Aegion Corp, Current Report (Form 8-K, Ex. 10.2) (May 5, 2014); Ambassadors Group, Inc., Current Report (Form 8-K, Ex. 10.1) (May 19, 2014); EveryWare Global, Inc., Current Report (Form 8-K, Ex. 10.1) (Feb. 25, 2014); Hansen Medical, Inc., Current Report (Form 8-K, Ex. 10.1) (Feb. 21, 2014); KMG Chemicals, Inc., Current Report (Form 8-K) (July 2, 2013); Tecumseh Products Co., Current Report (Form 8-K, Ex. 99.4) (June 27, 2014); Verifone Systems, Inc., Current Report (Form 8-K, Ex. 10.2) (Mar. 15, 2013).

²⁷ See, e.g., Seracare Life Sciences, Inc., Current Report (Form 8-K, Ex. 99.6) (Feb. 13, 2012) (interim President and CEO's talking points for acquisition announcement conference call). For an example where the Interim CEO and Chairman of the Board of Directors issued consistent messages to stockholders regarding recent resignation of prior CEO and appointment of Interim CEO and company's financial performance, see Alere Inc., Current Report (Form 8-K, Ex. 99.1-99.2) (July 7, 2014).

arrangements for the key remaining executives. Depending on the design of the company's existing equity compensation plans, such arrangements may not be necessary or appropriate. It is possible that getting key employees to sign on to retention arrangements that bridge the time until a permanent CEO is found might be beneficial from an optics perspective, signaling stability to investors and other employees.²⁸ When discussing these issues with the interim CEO, the compensation committee should consider if there are any other key executives who should *not* receive retention arrangements, because they may be terminated in the near future.

D. Permanent CEO Arrangements

Once the search committee identifies a permanent CEO, the CEO's executive compensation and benefits arrangements should be "business as usual." Normally, the compensation committee would take advice from an executive compensation consultant about the arrangements, as well as refer to other sources such as ISS pay-for-performance data.²⁹ Importantly, to the extent that the departing CEO's compensation arrangements were a source of activist complaints in the past, the company should try to avoid similar complaints when implementing its new arrangements.

E. Director Arrangements

A significant management transition such as replacing a CEO will probably require a board to have many more meetings than typical. Accordingly, directors (especially members of the compensation committee) should prepare themselves for a significant time commitment to the process. Whether directors should receive extra compensation for these services, however, is very much a fact dependent analysis. In some cases, directors will already benefit from "per meeting" compensation, in which case no additional compensation should be needed.³⁰ In other cases, where directors

²⁸ See, e.g., Alere Inc., Current Report (Form 8-K) (Sept. 4, 2014) (Alere's compensation committee awarded retention-based restricted stock units to a number of executives and key employees); Infusystem Holdings, Inc. Annual Report (Form 10-K) (Mar. 28, 2013) (\$0.6 million was recorded for retention payments to key employees during a period when "concerned stockholders" successfully lobbied for a series of changes to the board and senior leadership and the CEO resigned).

²⁹ ISS has a number of primary evaluation factors for its analysis of executive pay. INSTITUTIONAL SHAREHOLDER SERVICES, 2014 U.S. PROXY VOTING SUMMARY GUIDELINES 39 (Mar. 12, 2014).

³⁰ Of the 100 largest US public non-controlled companies that have equity securities listed on the NYSE or NASDAQ, 30 paid board and/or committee meeting attendance fees in 2013. (Of the 30, 23 paid both board and committee meeting attendance fees, 4 paid only committee meeting attendance fees, and 3 paid only board meeting attendance fees.) SHEARMAN & STERLING LLP, COMPENSATION GOVERNANCE 2013: 11TH ANNUAL SURVEY OF THE LARGEST US PUBLIC COMPANIES 47 (2013), https://reaction.shearman.com/reaction/corpgov/2013/CorpGov2013_Compensation.pdf. Among the 100 companies, the number paying meeting attendance fees to board and/or committee members rose from 28 in 2012, but overall has declined from previous years, evidencing a growing consensus that director attendance at meetings is mandatory. *Id.* Many of the 100 companies pay committee retainers, which

receive annual compensation, the optics of increasing director compensation in the face of a proxy contest or other activist activity may be too negative to justify making a change. The issue is a fair topic for discussion at the board level, and should be considered in light of other strategic planning under consideration by the board (such as, for example, whether the board intends to initiate a strategic alternatives process for the company).

III. Related Changes to Board Composition

Typically, the departing CEO has also served as a director. In such a scenario, his or her separation agreement should also provide for his or her resignation as director of the company and any subsidiaries.³¹ If the interim CEO is not already a director, the board should consider whether he or she should be added to the board for the duration of his or her service as interim CEO. If the interim CEO is already a director, then consideration should be given to whether he or she can or should continue to serve on certain board committees. Both the NYSE and Nasdaq have rules that address the independence of an interim CEO and by extension his or her ability to serve on the

might serve to compensate directors for additional time spent on an executive search committee. *Id.*

In surveying 300 publicly traded companies in the financial services, industrial, retail, technology, and energy sectors, Frederic W. Cook & Co. found that compensation for committee member service is usually in the form of meeting fees, and that the median meeting fee was \$1,500. FREDERIC W. COOK & CO., 2013 DIRECTOR COMPENSATION REPORT: NON-EMPLOYEE DIRECTOR COMPENSATION ACROSS INDUSTRIES AND SIZE 2 (December 2013), http://www.fwcook.com/alert_letters/The_2013_Directors_Compensation_Report.pdf. *But see* MELISSA MEANS, NACD DIRECTORSHIP, ESTABLISHING, PAYING AN AD HOC CEO SEARCH COMMITTEE (Oct. 24, 2012), <http://www.directorship.com/establishing-paying-an-ad-hoc-ceo-search-committee/> (“Most companies provide additional pay for service on the three major standing board committees (audit, compensation and nominating and corporate governance) in the form of cash retainers and/or meeting fees. However, we find many boards overlook the need to consider compensation for a newly created ad hoc search committee. As a general rule, any decision regarding whether to compensate an ad hoc committee ideally should be made prior to the committee’s formation. Once the committee has begun its work, it may appear self-serving to go back and compensate members for services already provided. In our experience, companies that consider the issue upfront do end up providing some form of compensation. We recommend that the additional payment be delivered entirely as a cash retainer, rather than as meeting fees, because of the issues involved in having to define and track search committee meetings. Typically, companies set a cash retainer for an ad hoc committee’s chair and members that approximates the cash retainer provided to the audit and compensation committee members.”).

³¹ *See, e.g.*, Advanced Energy Industries, Inc., Current Report (Form 8-K, Ex. 10.1) (June 2, 2014); Aegion Corp, Current Report (Form 8-K, Ex. 10.1) (May 5, 2014); Coastal Caribbean Oils & Minerals, Ltd., Annual Report (Form 10-K, Ex. 10(o)) (June 3, 2014); Emcore Corp, Form 8-K, Ex 10.1) (Sept. 18, 2014); Hertz Corp, Current Report (Form 8-K, Ex. 10.1) (Sept. 19, 2014); Pulse Electronics Corp., Current Report (Form 8-K, Ex. 99.3) (July 16, 2014). For examples of the complications that may arise when retaining the departing CEO as a director, see Jason D. Schloetzer, *Supra* note 13, at 1-2, 5-6 (Sept. 2010).

compensation and audit committees.³² These rules may continue to apply even after the company has hired a permanent CEO and the interim CEO has returned to his or her prior role. For example, an interim CEO can be expected to participate in the preparation of the company's financial statements during the interim period, which under Nasdaq rules would bar him or her from serving on the audit committee for three years.³³ Moreover, the interim CEO would be permanently prohibited from serving as an "outside director" under the Code Section 162(m) rules, which will prevent him or her from being on the compensation committee.³⁴

³² The NYSE requires listed companies to have a compensation committee composed entirely of *independent* directors and an audit committee that satisfies the requirements of Rule 10A-3 under the Exchange Act. NYSE Listed Company Manual, Regulation 303A.05, 303A.06 (2014).

Regulation 303A.02(a)(i) of the manual provides, "No director qualifies as 'independent' unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company)," with accompanying commentary noting, "the concern is independence from management." Regulation 303A.02(b)(i) adds, "In addition, a director is not independent if...The director is, or has been within the last three years, an employee of the listed company, or an immediate family member is, or has been within the last three years, an executive officer, of the listed company." However, the commentary for Regulation 303A.02(b)(i) notes, "Employment as an interim Chairman or CEO or other executive officer shall not disqualify a director from being considered independent following that employment." Furthermore, although Regulation 303A.02(b)(ii) states a director is not independent if the director has received more than \$120,000 in direct compensation from the company, the accompanying commentary notes, "Compensation received by a director for former service as an interim Chairman or CEO or other executive officer need not be considered in determining independence under this test." NYSE Listed Company Manual, Regulation 303A.02 (2014).

Rule 10A-3 under the Exchange Act requires that members of the audit committee be independent, which excludes individuals who are affiliates of the company and individuals who accept, directly or indirectly, any consulting, advisory, or other compensatory fee from the company. 17 C.F.R. § 240.10A-3(b)(1) (2014).

NASDAQ Stock Market Rules, Regulation 5605(a)(2) (2014) provides a definition of "independent directors" with clarification in Regulation IM-5605 that,

For purposes of paragraph (A) of the Rule, employment by a director as an Executive Officer on an interim basis shall not disqualify that director from being considered independent following such employment, provided the interim employment did not last longer than one year. A director would not be considered independent while serving as an interim officer. Similarly, for purposes of paragraph (B) of the Rule, compensation received by a director for former service as an interim Executive Officer need not be considered as compensation in determining independence after such service, provided such interim employment did not last longer than one year. Nonetheless, the Company's board of directors still must consider whether such former employment and any compensation received would interfere with the director's exercise of independent judgment in carrying out the responsibilities of a director.

³³ NASDAQ Stock Market Rules, Regulation IM-5605 (2014) ("if the director participated in the preparation of the Company's financial statements while serving as an interim Executive Officer, Rule 5605(c)(2)(A)(iii) would preclude service on the audit committee for three years").

³⁴ 26 C.F.R. § 1.162-27(e)(3)(i)(C) (2014) ("The performance goal under which compensation is paid must be established by a compensation committee comprised solely of two or more outside directors. A director is an outside director if the director . . . [h]as not been an officer of the publicly held

In addition, if the interim CEO is already a director and the departing CEO is resigning as a director, the board may find itself short by one member. If the company is in the midst of a proxy fight, it may wish to either appoint a replacement director immediately, or to reduce the size of the board by one seat so as not to leave a vacancy prior to the upcoming shareholder meeting (assuming the company's bylaws do not impose a higher minimum number of directors).

To the extent that the CEO changes occur in the midst of defending against an activist, the departing CEO's resignation from the board may present an opportunity for the board to consider other board-level changes. For example, if the departing CEO was also acting as the chair of the board – a situation that is less common now due to ISS and activist attention to this structure³⁵ but still remains at many companies³⁶ – his or her

corporation”).

³⁵ ISS recommends that shareholders generally vote for shareholder proposals requiring that the chairman's position be filled by an independent director (i.e. that the chair be separate from the CEO), unless the company satisfies an extensive list of criteria. INSTITUTIONAL SHAREHOLDER SERVICES, *Supra* note 29, at 14-16 (Mar. 12, 2014). ISS has shown little tolerance for seemingly modest variations from its policies regarding specific duties that the lead independent director must have in order for ISS to recommend against a proposal to split the CEO and chair positions. SULLIVAN & CROMWELL LLP, 2014 PROXY SEASON REVIEW 7 (June 25, 2014). Proposals requesting that companies separate the roles of CEO and chair were the most common type of governance-related shareholder proposal in the first half of 2014. *Id.* The number of companies in the S&P 500 that also elected their new CEO as chairman of the board of directors was down to 9.5% in 2013, from 18.8% in 2012, and 19.2% in 2011. Matteo Tonello, *CEO Succession in the S&P 500: Statistics and Case Studies*, THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Apr. 25, 2014), <http://blogs.law.harvard.edu/corpgov/2014/04/25/ceo-succession-in-the-sp-500-statistics-and-case-studies/>. See also Shelley K. Schwartz, *Tipping Point for Combined Chairman and CEO?*, CNBC NEWS (Nov. 15, 2012), <http://www.cnbc.com/id/49829626#>, (“The combined role of chairman and chief executive officer, a corporate governance structure favored by many Fortune 500 firms, may soon go the way of the pension plan....A study of 860 public company directors earlier this year by PriceWaterhouseCoopers' Center for Corporate Governance found that among the companies that still have a combined chairman and CEO, nearly half of their boards are discussing splitting the role at their next CEO succession”); Charles Tribbett, *Splitting the CEO and Chairman Roles – Yes or No?*, RUSSELL REYNOLDS ASSOCIATES, Dec. 2012, <http://www.russellreynolds.com/content/splitting-ceo-and-chairman-roles-yes-or-no>.

³⁶ For example, JPMorgan Chase & Co.'s CEO and Chairman Jamie Dimon emerged victorious in a shareholder vote over whether he would retain both positions in May 2013. Dawn Kopecki & Hugh Son, *Victory for Dimon as JPMorgan Shareholders Reject CEO-Chairman Split*, BLOOMBERG (May 22, 2013), <http://www.bloomberg.com/news/2013-05-21/victory-for-dimon-as-jpmorgan-shareholders-reject-ceo-chairman-split.html>. Other examples of joint CEO-Chairmen and Chairwomen include Wes Bush of Northrop Grumman, Marillyn Hewson of Lockheed Martin, Jeff Immelt of General Electric, Ellen Kullman of DuPont, and Randall L. Stephenson of AT&T. Wes Bush, Northrop Grumman, <http://www.northropgrumman.com/AboutUs/CompanyLeadership/Pages/Detail.aspx?itemId=0001&loc=%2F&rel=%2F&name=CorporateLeadership>; Marillyn A. Hewson, Lockheed Martin, <http://www.lockheedmartin.com/us/who-we-are/leadership/hewson.html>; Jeff Immelt, General Electric, <http://www.ge.com/about-us/leadership/jeff-immelt>; Ellen Kullman, DuPont (Jan. 2014), <http://www.dupont.com/corporate-functions/our-company/leadership/board-of->

departure may create an opportunity for the board to split the chair and CEO positions more permanently by adopting a board policy to that effect. A CEO's departure can also offer companies a reason to reassess the chairs of various board committees, and in some cases, to revisit who the board's director nominees will be at the upcoming meeting. For example, if any existing directors are close to the departing CEO, they may not wish to continue serving on the board following the departure.

To the extent a CEO's departure and related events result in cascading changes at the board level, the company should keep in mind that its debt instruments or equity compensation and severance plans may contain "change of control" provisions that are triggered by proxy contest related turnover at the board level. The company should assess in advance if any of these provisions may be implicated, and to what extent the company can avoid or mitigate the adverse economic or accounting consequences associated with triggering a "change of control".

IV. Investor Relations and Disclosure

Many of the changes connected with replacing a CEO will trigger line-item disclosure requirements under Form 8-K, including requirements related to departures of directors and officers and the associated employment and retention arrangements.³⁷ If the company will be filing a Form 10-Q or Form 10-K within four business days of making the CEO change, it is permitted to announce the changes in that periodic report filing.³⁸ However, many companies do not want to delay the announcement even by a matter of days, and will file the press release announcing the changes on a Form 8-K as soon as practicable so that they have made sufficient information public to schedule one-on-one discussions with key investors without fear of triggering any Regulation FD issues. Investors will likely be keen for details concerning strategic plans for the company, but the company may not be able to provide them until some time after the interim CEO has

directors/articles/kullman.html; Randall L. Stephenson, AT&T, <http://www.att.com/gen/investor-relations?pid=7824>. According to an analysis of proxy statement disclosures performed by Spencer Stuart and features in its U.S. Board Index (series 2003-2011), the number of S&P 500 companies with one person serving as both CEO and chairman dropped significantly between 2003 and 2011, from 77% to 59%. Deloitte, *Board Leadership: The Split CEO/Chairman Structure Debate*, The Wall Street Journal (June 29, 2012), <http://deloitte.wsj.com/cfo/2012/06/29/board-leadership-the-split-ceochairman-structure-debate/>. Interestingly, the percentage of companies with independent board chairs was far lower in the United States than in Canada, Germany, and the United Kingdom (as of 2011, when Deloitte conducted an analysis of the large publicly held companies in those countries). *Id.*; DELOITTE GLOBAL CENTER FOR CORPORATE GOVERNANCE, *BOARD LEADERSHIP: A GLOBAL PERSPECTIVE* (May 2011).

³⁷ United States Securities and Exchange Commission, Current Report (Form 8-K), Item 5.02; Federal Securities Law Reporter, Regulation 229.401, Item 401("Regulation S-K") (2014).

³⁸ *Exchange Act Form 8-K Questions and Answers of General Applicability*, UNITED STATES SECURITIES AND EXCHANGE COMMISSION, Question 101.01 (May 16, 2013), available at <http://www.sec.gov/divisions/corpfin/guidance/8-kinterp.htm> ("a triggering event occurring within four business days before the registrant's filing of a periodic report may be disclosed in that periodic report").

been “in office” and has had an opportunity to consider the relevant options.

V. Trading by the Departing Executive

In addition to Form 8-K disclosures, the departing CEO and interim CEO will likely need to file Section 16 filings.³⁹ This is a relatively standard disclosure that in and of itself should not raise any eyebrows. However, Section 16 filings raise the question of to what extent the company can and should open its trading window once the CEO change has been disclosed. This issue calls for a very “facts and circumstances” based analysis. While the CEO change itself may be public knowledge, there could be other attendant circumstances – e.g., an upcoming earnings announcement or pending strategic developments – that are not yet public knowledge. A further question sometimes arises as to whether the company can help the departing CEO divest his or her stake in the company, such as authorizing a share buy-back. If the trading window is open and the company is authorized to execute buy-backs, such an action is theoretically possible. However, the optics of such a strategy may be negative in the face of a proxy contest. In any event, the company should consider imposing a discounted repurchase price relative to the then-current market price of the company’s common stock. The rationale for the discount is that it dispels the potential optics of the departing executive deriving any undue profit at the expense of the Company’s shareholders by trading at an especially fortuitous time not in the Company’s interests, achieving liquidity not otherwise available to other market participants and/or avoiding the potential impact of pressure on the

³⁹ 15 U.S.C. 78p (2014). With regard to 16(a), “Upon becoming an officer or director of a company that has equity securities registered pursuant to Section 12 of the Securities Exchange Act of 1934 (an ‘issuer’), a person immediately incurs an obligation to file reports under Section 16(a) of the Securities Exchange Act of 1934 Section 16(a) reports must be filed by reporting persons for transactions by them, unless otherwise exempted, involving securities of the issuer An officer or director who terminates his or her position with an issuer will continue to be a reporting person and to have an obligation to file reports under Section 16(a) for a six-month period following the date of his or her last opposite way transaction, which was subject to Section 16(b), prior to the date he or she terminated his or her reporting position.” STANTON P. EIGENBRODT, *A PRACTICAL GUIDE TO SECTION 16: REPORTING AND COMPLIANCE* § 3.01 (4th ed. 2013).

Exchange Act Section 16(b) allows issuers to recover short-swing profits from insiders, using the definition contained in Section 16(a), and applies to every person who is directly or indirectly the beneficial owner of more than 10 percent of any class of any equity security, other than an exempted security, which is registered pursuant to Exchange Act Section 12, or who is a director or an officer of the issuer of such security. “Short-swing profits are profits derived from any purchase and sale, or any sale and purchase, by defined insiders of their own company’s equity securities, or security-based swap agreements involving any such equity security, within a six-month period. The sales and purchases need not be connected to each other. In addition, with the reference to any purchase and sale, an insider will be liable even if the net result of a series of transactions during the short-swing period is a net loss if any single purchase can be matched with a sale at a higher price during a six-month period.” JAMES HAMILTON ET AL., *GUIDE TO SECTION 16: INSIDER REPORTING AND SHORT-SWING TRADING LIABILITY* ¶801 (2004).

market price that could result from a large trade.

VI. Other Issues

Many other legal questions will arise in connection with a CEO transition. For example, ISS and other proxy advisory firms have adopted policies regarding the extent to which interim executives can be considered independent once they revert to merely being directors (and the proxy advisory firm's requirements are not necessarily consistent with applicable stock exchange or Exchange Act requirements).⁴⁰

Because these questions are so complex and fact specific, companies are recommended to retain outside advisors with expertise in these matters sooner rather than later. Indeed, in order to preserve confidentiality, the board may wish to engage outside advisors before even alerting the general counsel or director of human resources about the impending changes.

⁴⁰ ISS considers former CEOs (including CEOs prior to the company's IPO, to be "Affiliated Outside Directors," and recommends voting against them or withholding one's vote when the Affiliated Outside Director will serve on the audit, compensation or nominating committee, when the company lacks an audit, compensation or nominating committee so that the full board functions as that committee, when the company lacks a formal nominating committee, even if the board attests that the independent directors fulfill the functions of such a committee, or when independent directors make up less than a majority of directors. INSTITUTIONAL SHAREHOLDER SERVICES, *Supra* note 29, at 14-16 (Mar. 12, 2014). Glass Lewis has stated that a director currently serving in an interim management position should be considered an insider, while a director who previously served in an interim management position for less than one year and is no longer serving in such capacity is considered independent. However, a director who previously served in an interim management position for more than one year and is no longer serving in such capacity should be considered an affiliate for five years following the date of his or her resignation or departure from the interim management position. GLASS LEWIS & CO., PROXY PAPER GUIDELINES: 2014 PROXY SEASON 2 (2014). Egan-Jones defines "independent director" to be an individual who has no material relationship with the company other than his or her directorship, has not been employed by the company or an affiliate within the previous five years, has no personal services contracts regarding matters such as aircraft rental, real property leasing with the company, an affiliate, or a member of the company's senior management, and has not provided legal or consulting services to the company within the previous three years. EGAN-JONES PROXY SERVICES, 2014 PROXY SEASON, VOTING PRINCIPLES AND GUIDELINES 2 (2014).