Planning for Leadership Succession and Unexpected CEO Transitions

In her regular column on corporate governance issues, Holly Gregory discusses the board’s role in leadership succession planning and provides a roadmap for an unexpected CEO departure.

HOW WELL the board of directors handles a leadership transition can have a direct impact on the company’s success. Awkward transitions and failed succession candidates leave a company vulnerable to media attack and shareholder activism. By contrast, smooth, thoughtful leadership changes, even those involving a CEO termination, can provide performance momentum.

While boards are spending more time and effort on succession planning, few boards are fully prepared with a roadmap for handling an unexpected transition that involves a CEO termination. This article explores:

- Director duties regarding succession planning and unexpected CEO transitions.
- Benchmark data from directors on CEO succession planning.
- The elements of an effective succession planning process.
- Preparation for unexpected CEO succession and “guided resignation.”
DIRECTOR DUTIES
In fulfilling their duty of care, directors need to address major business risks, including the loss of a senior executive, whether through a planned or an unexpected transition event. Decisions about who should lead a company and how to manage leadership changes are among the most important and challenging duties of a board. Effective succession planning requires regular, ongoing attention so that the board is positioned to select from among strong candidates when a change in leadership is needed.

While the selection of a CEO and planning for CEO transitions are critical decisions that boards must make, the legal obligations that surround these decisions are essentially the same as for most board actions. Directors must act:
- With appropriate diligence.
- In good faith.
- In the best interests of the company.

Search Fiduciary Duties of the Board of Directors for more on the core duties of care and loyalty and certain circumstances when the board holds heightened duties.

The board’s approach to succession planning and unexpected transitions should be reasonable under the circumstances. The board must not ignore the known risks associated with a potential gap in leadership. It needs to have a sense of when the CEO’s service is likely to end in the normal course of events, and should have plans in place to address this situation. Since an emergency could arise to disrupt the current CEO’s leadership, the board should also have in place an emergency plan for the “hit by a bus” scenario and also be familiar with appropriate processes for CEO termination.

Boards, CEOs, and their advisors may be reluctant to raise certain succession planning issues, such as the expected timeframe for succession, how the next leader will be chosen, and who the leading candidates are likely to be. However, if a board does not adequately address these issues, it will be unprepared when illness or scandal arises and may be hesitant to make a change when it is called for in instances of poor performance.

In addressing their succession planning duties, directors should focus not only on the CEO position, but also on other key internal executives to:
- Assess their capacities to step into the CEO role.
- Develop any leadership skills and qualities they might be lacking.

Reframing the issue as oversight of management development, rather than simply preparing for a CEO change, will help to address the inherent planning challenges and expand the board’s understanding of internal capacity.

In addition, according to PwC, more than half of the responding directors believe that their company is only “somewhat” or “not at all” adequately prepared to deal with an unexpected CEO succession emergency. Finally, only 27% of responding directors feel that their company has adequate “bench strength” in its CEO talent pipeline.

The findings of the Spencer Stuart US Board Index 2015 suggest that board attention to CEO succession has improved in recent years, with boards discussing CEO succession more frequently and more companies formalizing their CEO succession plans and processes.
SUCCESSION PLANNING PROCESS

The board has the flexibility to adopt a succession planning process that best suits the particular needs of the company. For example, it is up to the board to determine how much time and attention to spend on succession planning, and whether or at what point to:

- Retain advisors for assistance.
- Consider internal candidates.
- Conduct an external search.
- Determine that enough information has been obtained to support an informed judgment.

Because succession planning is a central component of the board’s role, generally the full board maintains responsibility for, and is involved in, succession decisions (see The Conference Board Inc., CEO Succession Practices: 2015 Edition.) However, boards routinely delegate responsibility for specific tasks to board committees. For example, the nominating and governance committee or the compensation committee may be tasked with hiring a search firm to assist in identifying candidates and specifying desirable candidate criteria. Often, given its role in performance evaluations of top executives, the compensation committee is involved on an ongoing basis in assessing potential internal candidates, identifying their leadership capabilities, and pinpointing areas for further development.

For each significant management position, including the CEO, the CEO’s direct reports, and other key positions (such as the chief financial officer, the chief operating officer, and division heads), the board or a board committee should consider, at least annually:

- The likely timeframe in which succession will be called for in the normal course of events.
- The potential internal candidates, if the current CEO:
  - leaves in the likely timeframe;
  - takes on another role at the company; or
  - leaves immediately.
- The skills and qualities each potential internal candidate needs to develop to be the leading candidate.

Along with regularly evaluating the strengths and weaknesses of members of the senior executive team, the board (or a delegated board committee) should establish plans for individual development designed to prepare these executives to advance. The views of the CEO will drive much of this discussion, especially about the CEO's direct reports, but the board must also interact with each individual and form an independent view. In addition, the board (or a delegated board committee) should consider on a regular basis where to find ideal external candidates.

In developing and implementing a succession planning process, common pitfalls to avoid include:

- Failing to align on strategy.
- Over-involving the full board.
- Conducting internal assessments too late.
- Creating a “horse race” too early.
- Neglecting external benchmarking.
- Overvaluing external candidates.
- Failing to update the plan.

(Spencer Stuart, Lessons from the boardroom: Seven succession planning missteps boards should avoid, Dec. 2010.)

PREPARING FOR UNEXPECTED CEO SUCCESSION

No matter how much attention a board gives to succession planning for the leadership of the company, a board should expect that at some point a CEO change will occur within a different timeframe than planned. This may occur because the CEO decides to pursue another opportunity, becomes incapacitated or dies, or because the board decides that it is time for a change due to performance concerns.

While many boards have an emergency plan in place in terms of having identified a potential successor, an interim candidate,

If there is a CEO transition event, a general understanding of who will play which roles will aid the board in taking (rather than avoiding) action, when action is needed.
and a plan for an expedited selection process, in the case of an unexpected CEO transition event, boards often overlook the need to have in place a decision process and a crisis management plan.

The business judgment rule applies to board decisions to terminate a CEO and these decisions are rarely challenged as a breach of duty. In the process of negotiating an exit, however, a departing CEO’s personal counsel may assert that there are claims that the CEO can bring against the board and the company relating to the employment contract (if one exists) and to the company’s compensation plans. Often this is a bargaining tactic.

**IDENTIFY ACTION ROLES IN ADVANCE**

If there is a CEO transition event, a general understanding of who will play which roles will aid the board in taking (rather than avoiding) action, when action is needed.

An independent director will need to take the lead in convening special executive sessions to discuss potential succession issues and should know how to call all the independent directors together quickly in case of a crisis. Usually, this role is held by an independent director, for example, an independent chair of the board, the lead director, or the chair of the nominating and governance or compensation committee.

The independent directors should have outside counsel that they can turn to for advice and assistance in facilitating a transition, given the general counsel's sensitive position as the board determines whether and when to take action. Generally, the independent directors will select outside counsel at a law firm that has corporate governance, SEC reporting, and employment law capabilities.

Consideration should also be given to who might advise on public relations and investor relations, if needed. If there is no readily apparent successor candidate, a search firm will also be needed. The board should seek a search firm that knows the company and can work on an expedited basis. In some circumstances it may be necessary to also reach out to a crisis management firm, preferably one that can provide interim leadership.

**TYPICAL PROCESS FOR SEEKING A CEO’S RESIGNATION**

Although every situation will be unique, the process for determining that it is time for a near-term CEO transition often includes:

- **A determination that there is significant interest among the majority of directors in replacing the CEO on an expedited timeframe (for example, faster than normal course expectations).** This usually becomes apparent through an executive session or through informal discussions and circumstances. The leader of the independent and non-management directors (the independent chair or lead director), or an appropriate committee chair should contact outside counsel to advise.

- **An executive session to provide a formal opportunity for the independent and non-management directors to discuss the situation and the alternatives without the CEO present.** This executive session may be called confidentially. However, a meeting of directors in an executive session usually does not have authority to act on behalf of the board. Therefore, while this session provides an opportunity to share viewpoints and develop ideas about a path forward, a formal decision to replace the CEO will not be taken at this point.

  **Consideration by the directors of:**

  - whether to pursue the CEO’s resignation, usually through an informal agreement;
  - potential successors (if an internal candidate has been identified as the successor in either an interim or a permanent capacity, that candidate needs to be informed of the situation on a highly confidential basis early on);
  - a potential successor for an internal candidate who is selected;
  - the possibility that other well-qualified internal candidates may resign if not selected as the next CEO;
  - the potential impact of replacing the CEO on critical relationships and how to manage those impacts;
  - the potential effects of replacing the CEO on key agreements (for example, whether there are any key agreements that a CEO termination or resignation might affect); and
  - at what point they should inform the general counsel and one or more other key members of the management team that they are considering replacing the CEO.

- **Review by outside counsel of the by-laws and the corporate laws of the state in which the company is organized, as well as any employment agreement that may address the CEO’s director role.** While the board may remove a CEO as an employee and officer of the company, it often lacks the ability to remove the CEO as a director. However, some employment agreements provide that upon termination or resignation as an officer, board service as a director automatically ends. Some companies require director candidates to provide resignation letters before joining the board to the same effect. Outside counsel should also consider any positions the CEO may hold with affiliated entities, such as subsidiaries, whether as an employee, an officer, or a director. As in the termination of any employee, outside counsel will need to attend to employment law requirements.

- **An agreement by the independent and non-management directors to seek the CEO’s resignation and a meeting with the CEO.** At this stage it is typical for one or two members of the board to meet with the CEO and explain that a majority of the directors believe that transition is needed, and describe the potential action that the board may take unless an agreement can be reached on the terms and timing of a resignation. Most often the circumstances presented during the meeting (for example, lackluster performance or a general disagreement about the company’s direction) will not rise to a “for cause” termination. However, where more egregious cause circumstances are present, consideration should be given to whether it is in the company’s best interests to accept a resignation rather than have a public disclosure of termination for cause. The conversation with the CEO at this
meeting should be planned and scripted with outside counsel to minimize risks. At the meeting:

• the message should be presented in a way that makes it clear that this is not a discussion of an event to be negotiated for some uncertain time in the future; and
• the board should present a clear description of what the likely terms of the resignation will be, which will help to make the resignation timing more concrete.

A decision by the CEO on how to respond to the resignation request. Most often, given the opportunity to think through the situation and consult with personal counsel, a CEO will decide to engage in a discussion of the terms for resignation, both with respect to compensation and disclosure. However, if the CEO becomes defensive and argues, the situation becomes more difficult to manage, with significant risks to both the company and the CEO from a public dispute. Special care should be taken where the CEO may perceive that there are sympathetic directors who could be influenced. Directors should understand that the CEO may reach out and try to change their minds, but that it is not in the interests of the company to waffle once the conversation with the CEO about resignation has begun.

A determination about what to pay the departing CEO. This determination is a matter of business judgment, but one that will be closely scrutinized by shareholders, including a vocal core who are skeptical of “pay for failure.” Proxy advisory firms may also take a negative view of termination arrangements that are more favorable to the departing CEO than those set forth in the CEO’s employment agreement or applicable compensation plan. There are considerable benefits for the company in a quiet and efficient transition that is premised on an agreed resignation. While the existing employment agreement terms and compensation plan provisions provide the basis for how vesting and equity award exercise are handled and a starting point for negotiations, often a board will enter into a separation agreement that:
• provides some additional compensation;
• waives certain forfeitures;
• releases all claims and potential claims against the company and its officers and directors;
• sets forth explicit covenants protecting confidential information; and
• provides limits on direct competition and solicitation of customers and employees for a reasonable period of time.
The board should be advised by employment, compensation, and tax counsel, as appropriate. The proposed disclosures should be shared with the CEO and the CEO’s personal counsel for review.

A formally noticed board meeting, once there is a proposed agreement or it is clear that an agreement will not be reached. A board meeting is called (unless a committee has been delegated authority) so the board may take formal action to accept the resignation of, or terminate, the CEO from which disclosure obligations will flow. As a director, the CEO is entitled to receive notice of the meeting.

A board meeting where a successor CEO or interim CEO is appointed. The meeting should follow the standard procedures of notice and quorum. The independent chair or lead director will typically lead the discussion. If the CEO attends the meeting, the board can seek the CEO’s recusal. If the CEO refuses, the board meeting can go forward with the CEO present, or the board can pass a resolution that the decision be delegated to the independent and non-management directors meeting in an executive session, and the executive session can be convened, often after a break and, if necessary, at another location. If the terms of the proposed agreement still need to be negotiated, a committee can be delegated authority to finalize the terms. The board should determine whether to appoint the successor CEO to the board and, if the departing CEO was the chair of the board, who will be appointed chair. Some companies use the transition of a CEO as an opportunity to separate the positions of CEO and chair of the board.

A determination on how to handle the logistics of the CEO’s departure. When a CEO is being asked to resign, is terminated for egregious conduct, or is viewed as uncooperative, consideration should be given to limiting the CEO’s access to the company, its employees, and its assets. This may require taking steps that are typical of employee terminations in general, including coordinating with information technology and security personnel.

COMPLIANCE WITH SEC AND STOCK EXCHANGE REQUIREMENTS

SEC Requirements Following a CEO’s Departure

Upon the CEO’s retirement, resignation, or termination, a Form 8-K must be filed. This reporting obligation is triggered by a notice of a decision to retire, resign, or refusal to stand for reelection (in the case of a CEO director), whether or not the notice is in writing, and regardless of whether it is conditional or subject to acceptance. No disclosure is required solely by reason of discussion or consideration of the event. Whether communications represent discussion or consideration, on the one hand, or notice of a decision, on the other hand, is a facts-and-circumstances determination. (See Item 5.02(a) or (b), as relevant.)

Depending on the relevant facts and circumstances, it may be necessary to:

• Include the date of the resignation on the Form 8-K, if the departing CEO also resigns as a director (see Item 5.02(b)).

• Add certain additional information to the Form 8-K, if the departing CEO is also a director and resigns due to a disagreement with the company on any matter relating to the company’s operations, policies, or practices, or if the CEO was removed for cause. In these cases, the departing CEO director must be given an opportunity to respond to the Form 8-K disclosure, and any written response would be filed as an amendment to the Form 8-K (see Item 5.02(a)).

• File a Form 4 for the departing CEO, for the vesting of performance shares in connection with the termination.
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SEC Requirements When a New CEO is Hired

When a new CEO is hired, the company should:
- Disclose in a Form 8-K the appointment and its effective date, certain biographical information about the new CEO, a brief description of any material agreements or compensatory arrangements with the new CEO, and any related person transactions (including any with respect to the new CEO’s service as a director (see Item 5.02(c), (e))).
- Disclose in a Form 8-K if the new CEO has been appointed to the board, the date of the appointment, the board committees on which she is expected to serve and, in addition to the matters described above, a description of any arrangement between the new CEO director and any other person pursuant to which she was selected as director (see Item 5.02(d)).
- Consider delaying its Form 8-K filing to disclose the new CEO’s appointment beyond the typical four-day deadline if the company plans to make a public announcement of the appointment by means other than a Form 8-K. In this case, the Form 8-K must be filed on the date that the company makes the public announcement of the event (see Instruction to Item 5.02(c)).
- File any agreements with the new CEO as exhibits to the company’s next Form 10-Q or Form 10-K, as applicable, unless these agreements are filed as exhibits to the relevant Form 8-K (and incorporated by reference into the next Form 10-Q or Form 10-K, as applicable).
- Disclose any termination payments for the departing CEO in the termination payments table (using the actual triggering event) and describe them in the company’s next proxy statement (Item 402(j) of Regulation S-K).
- Determine whether there are any securities registration requirements if there is an inducement equity grant (one not made under an existing plan).

In addition, the new CEO should file a Form 3 (if not already an officer, director, or 10% shareholder of the company), and the company should file a Form 4, as applicable, for any new equity grant to the new CEO.

Stock Exchange Considerations When a New CEO is Hired

To address stock exchange requirements when a new CEO is hired, the company should:
- Issue a press release on the day of the event and comply with any pre-notification procedures.
- Consider whether a stock exchange notice or listing application is required in connection with any inducement equity grant.
- Comply with all notice and written affirmation requirements regarding changes in officers and directors.

The views stated above are solely attributable to Ms. Gregory and do not necessarily reflect the views of Sidley Austin LLP or its clients.