The Informed Board
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Skadden

Nine Mistakes To Avoid When Transitioning CEOs

- Boards must consider contractual obligations, governance and reporting standards, and communication strategies before replacing a CEO.
- The time it takes to prepare and announce a change can be quite extended because of legal notice requirements, negotiations with the outgoing and incoming CEOs and the need to reach consensus within the board.
- Boards need to understand the legal implications that replacing a CEO may have for the rights of other executives and on existing noncompete agreements.
- Communications about the transition in regulatory filings and internal and external announcements need to be unambiguous while avoiding legal pitfalls.

Transitioning CEOs is a complex process and is often fraught with business and legal challenges. Boards of directors must navigate a web of contractual obligations, corporate governance requirements, reporting standards, as well as communications with shareholders, employees and other stakeholders. Based on our work with boards, here is a list of common mistakes companies make along the way. Avoiding these will minimize legal risks and ensure a successful transition.

Unrealistic Timelines

Speed is often important in a transition, but some elements require sufficient time to execute and require thoughtful board deliberation. Boards must account for contractually- and legally-mandated notice periods, carefully consider when to inform the outgoing CEO and mobilize and communicate with the internal team. They also have to determine whether there are any notice obligations or other timing considerations relating to the incoming CEO.

Board and committee meetings will need to be properly scheduled and noticed (which can be challenging if the current CEO is required to be legally notified before the board is ready to act). The terms of the outgoing CEO's departure will often be heavily negotiated and will typically be documented in a separation agreement. Likewise, the incoming CEO's terms of employment and compensation will typically be negotiated and documented. Internal and external communications plans will need to be developed and approved along with required securities disclosures. What triggers the duty to make those filings, and when, should be carefully understood and contemplated in discussions within the board and with various stakeholders. Each of these critical steps has a habit of taking longer than anticipated.

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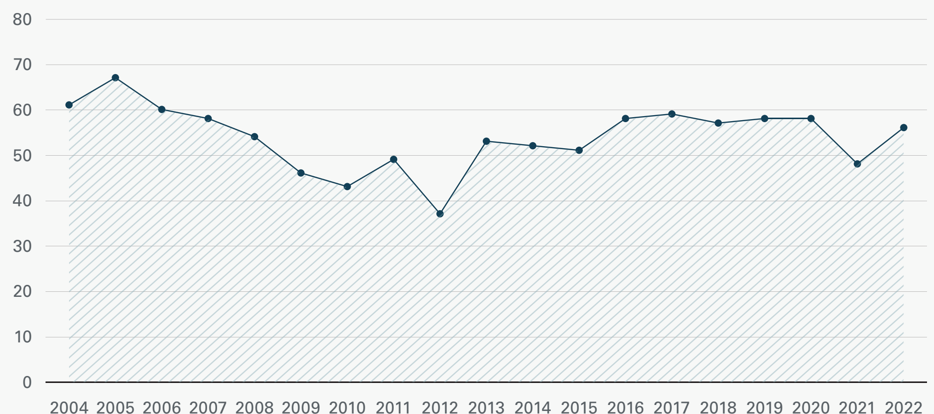
CEO Transitions at S&P 500 Companies



Source: Spencer Stuart

Excluding Relevant Stakeholders From the Process (or Including Them Too Late)

The transition of the CEO is ultimately the board's responsibility, but it requires coordination with internal stakeholders (the company's communications, HR, finance and legal teams, for example) as well as external stakeholders (*e.g.*, public relations advisers, compensation consultants and external legal counsel). Boards often attempt to minimize stakeholder involvement to ensure confidentiality. While confidentiality is critical, as the process progresses — and well in advance of a public announcement — boards should ensure that they are receiving advice from the right internal and external experts at every step so the transition goes smoothly.

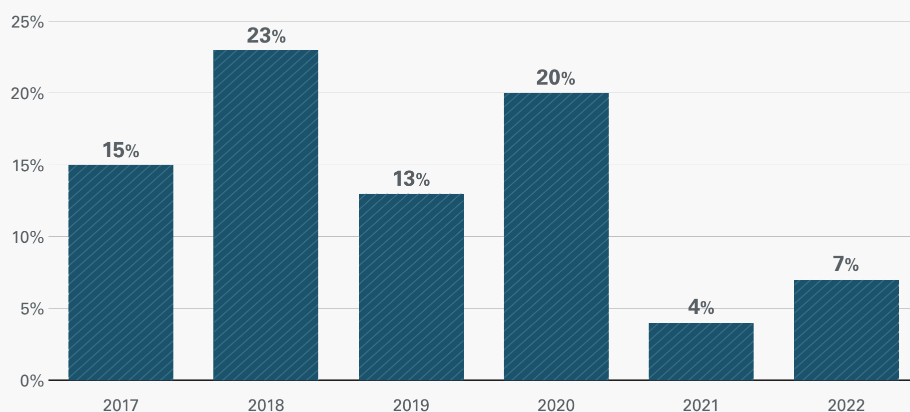
Skipping Over the Company's Obligations to the Current CEO

A clear understanding of the company's obligations to its current CEO under his or her employment agreement, equity awards, severance plans and other arrangements is critical to structuring the CEO's termination. The board should have access to a quantitative analysis of the compensation payable to the departing CEO and the potential cost to the company of modifications to existing arrangements. Failure to comply with outstanding contractual obligations to the CEO can result in financial liabilities and disputes (including litigation), and in some cases, it can excuse the CEO's non-performance.

Underestimating the Need To Formulate a Detailed Offer to the Future CEO

Similarly, advice from the compensation committee's outside consultant in formulating the proposed new CEO's compensation arrangement is vital. The board must have a clear understanding of the new CEO's existing compensation arrangements. This will allow the board to properly assess and negotiate the terms of

Share of Transitions Made With CEO Under Pressure



Source: Spencer Stuart

employment, address the need for "make-whole" equity compensation awards, if any, as well as understand any limitations under the company's existing compensation programs.

Leaving the Reasons for Terminating the CEO's Employment Ambiguous

When terminating a CEO's employment, the Securities and Exchange Commission and proxy advisory firms expect the company to disclose the reasons for termination clearly and accurately, specifying whether the termination is voluntary or involuntary and whether it is for cause or without cause. Failure to do so can create ambiguity and potentially expose the company to legal claims. It may also lead to disputes concerning severance and other termination-related entitlements.

Often we find that there is not a ready consensus among board members on any of these determinations, which is why it might be left ambiguous. And driving to a consensus view that is appropriately and accurately recorded in board minutes can take time. But skipping over this step, and not having a well-thought out and documented basis for the board's conclusions, can lead to later criticism of the board and litigation claims against board members. Internal communications should likewise be drafted to mitigate confusion about the reasons for the CEO's termination.

Rushing the Communications or Transition Plan

A well-structured communications plan is crucial to manage both internal and external stakeholder expectations and relationships during a CEO transition. Boards must ensure the communications plan is proactive and comprehensive, and addresses any disclosure or reporting requirements. Failing to do so can result in reputational damage and, potentially, legal claims.

Separately, boards must consider whether the outgoing CEO should remain available to consult or otherwise assist with the transfer of knowledge or duties to the new CEO. The company may also want the outgoing CEO's cooperation in active or anticipated litigation. These types of arrangements can help effect an orderly transition and should be incorporated into the written agreements with the outgoing CEO.

Overlooking the Legal Implications of Public Announcements

Boards must carefully consider the legal implications of public announcements related to a CEO transition. There can be tensions between making forthright, required securities disclosures, on the one hand, and respecting confidentiality provisions in employment contracts and avoiding defamatory statements, on the other.

Failing To Consider How the Rights of Other Senior Executives May Be Triggered by the CEO's Termination

The termination of a CEO may trigger contractual rights for other senior executives within the organization, such as "good reason" provisions. Boards should carefully review the provisions in those employment agreements to ensure compliance and avoid potential legal disputes.

Apart from any legal rights, the impact of a CEO transition on retention of other key leaders (who often were, or considered themselves, candidates for the CEO role) should also be considered, and a plan should be developed to address those concerns via compensation or some other means.

Neglecting the Impact of Termination on Noncompetes and Restrictive Covenants

The nature of a CEO's discharge can impact the enforceability of noncompetition covenants and other restrictive covenants. In some states, for instance, non-competition and similar covenants may not be enforced against an employee who was discharged without cause.

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