A Director's Guide to
EXECUTIVE COMPENSATION

THOMSON REUTERS

Volume 6, No. 3 Fall 2011

CEO Turnover

The departure of an organization's Chief Executive Officer (CEO) is usually a significant concern to the organization. Preparing for the departure of an outgoing CEO and the arrival of a new CEO requires significant time and resources. CEO turnover can be a major distraction for the management team, who may question their own job security with the arrival of a new CEO. For public companies, CEO turnover can also affect the company's share value as investors assess the impact of the turnover.

The revolving CEO door at Hewlett Packard (HP) is a prime example of the high cost associated with, seemingly poorly managed, CEO turnover. HP dismissed three CEOs in the past six years with total severance costs estimated at US$83 million. The most recently dismissed CEO, Leo Apotheker, exited with a severance package estimated at US$13 to $25 million, depending on the performance of HP's shares. Mr. Apotheker was on the job for just 11 months and he received a signing bonus of US$4 million and "relocation benefits" of US$4.6 million on joining.[1] Before Mr. Apotheker, Mark Hurd resigned in 2010 under pressure from the board of directors after an investigation uncovered his involvement in an allegedly inappropriate relationship and his submission of false expense reports linked to the relationship. Mr. Hurd's severance package was estimated at more than US$30 million, which exceeded his US$30 million in compensation for 2009 when he was ranked among the top 10 highest paid CEOs. HP's shares dropped 2.4% following the announcement of Mr. Hurd's departure.[2] In 2005, Mr. Hurd's predecessor, Carly Fiorina, received a severance package estimated at over US$20 million. At the time of Ms. Fiorina's departure, the shares of HP jumped 6.9%.[3]

Making headline news in Canada this spring was the abrupt departure of Tim Horton's CEO, Don Schroeder. In May 2011, Mr. Schroeder left Tim Horton's after 20 years with the company, the final three of which were as CEO. Pursuant to Mr. Schroeder's retirement agreement, he was provided a severance package estimated at $5.7 million.[4]

The foregoing were examples of high profile CEO departures. Most CEO departures garner less attention. Nonetheless, all organizations should be prepared for an unplanned CEO departure to minimize the negative repercussions that may otherwise flow. The following outlines some of the key considerations that organizations need to address when dealing with a change in their CEO.

These quarterly newsletters provide practical advice and current legal comments on executive compensation and compensation governance and disclosure. These newsletters will be of interest to directors, executives, lawyers and human resources professionals.

Nadine Côté is an employment and executive compensation lawyer at Davis LLP. She is also the author of *Executive Compensation: A Director's Guide*, the first book in Canada on executive compensation.

General Editor & Author
ncote@bell.blackberry.net

CONTENTS

From the Editor

This newsletter comments on some of the key considerations that organizations need to address when dealing with CEO turnover. This newsletter also outlines changes introduced by the Toronto Stock Exchange in respect of security-based compensation provided as employment inducements to officers. Please note that the Canadian Securities Administrators have finalized the amendments to the executive compensation disclosure rules. The amendments affect reporting issuers with fiscal years ending on or after October 31, 2011. The amendments were detailed in our January 2011 issue titled "Executive Compensation Updates." — *Nadine Côté LL.B.*

CEO Turnover Considerations

Exiting Costs

The departure of a CEO can be very costly to an organization, whether the departure is initiated by the organization or the CEO.

An organization can initiate a CEO's departure by unilaterally terminating his or her employment or by negotiating a mutual agreement with the CEO. Regardless of the approach, the organization will likely have to provide the CEO with notice of termination, pay in lieu of notice and severance pay in accordance with the terms of the CEO's employment agreement or pursuant to the requirements of the common law if the CEO does not have an employment agreement with severance terms. The cost of CEO severances typically ranges from 12 to 24 months of total compensation, which can be significant. An organization generally will not be required to provide a CEO with notice of termination, pay in lieu of notice or severance pay if there is cause to terminate the CEO's employment. However, it is very rare that a CEO's misconduct will amount to cause for termination. Conversely, it is very rare that an organization will want to allege cause to terminate a CEO's employment.

Alternatively, a CEO can initiate his or her own departure. Even when a CEO departs on his or her own terms, it can be costly to an organization. When a CEO retires or resigns to pursue interests unrelated to his or her professional experience, there are often special arrangements made with the departing CEO to address outstanding compensation and benefit matters and ensure a smooth transition. These special arrangements can include preferential treatment of annual incentives, outstanding stock options and share-based compensation, the continued use of the executive's vehicle, the provision of an office and administrative support and continued participation in the organization's benefit plans.

When a CEO departs to join a competitor, an organization will likely not incur future costs for termination pay, severance pay or benefits. However, significant costs may be incurred in trying to restrict the CEO's post-employment activities, such as legal costs to enforce post-employment fiduciary duties or to enforce a confidentiality, non-solicitation or non-competition agreement.

When a CEO departs, the organization will have to ensure it obtains all of the required resignations from the CEO's employment and any board positions. The organization will also have to prepare communications to announce the CEO's departure to employees and shareholders. Public companies may also need to prepare a press release and file a material change report with the securities regulator.

Recruiting Costs

An organization will likely incur significant costs to recruit a new CEO, regardless of whether the new CEO is selected from within or outside the organization. Organizations that have implemented a successor plan and identified and trained potential successors can greatly control the costs of recruiting a new CEO. However, even the best prepared organizations will still need to review the status of the potential successors to ensure they are ready, willing and able to assume the position and that they are still appropriate candidates for the position. If an organization needs to look to external candidates to find a new CEO, the organization will likely need the assistance of an external recruiter, which can be costly. Meeting with and evaluating potential candidates can be time consuming, but it is time well spent. It is crucial that organizations devote the time and resources necessary to select the best possible candidate given the considerable impact of the decision on the organization.

Negotiating Costs

When an organization experiences a turnover in its CEO, rarely will it be able to rely on a standard form of employment or severance agreement. Each CEO will typically have special arrangements that are unique to his or her own circumstances. Negotiating these special arrangements and ensuring a smooth transition can be time consuming. Legal counsel is usually involved in the negotiations, either directly negotiating on behalf of the parties or indirectly by advising the parties on the matters they are negotiating.

Confidentiality and Disclosure Concerns

Organizations strive to keep confidential the severance negotiations with a departing CEO and the employment agreement negotiations with an incoming CEO. Maintaining the process confidential helps to reduce concerns that the upcoming CEO turnover will spur other departures, before the organization has had time to develop retention plans. Maintaining the process confidential is important for public companies that are required to issue a press release on the occurrence of a material change, such as a change of the CEO. Public companies may also have to disclose the terms of the arrangements entered into with the departing CEO and the incoming CEO. Depending on how the change of the CEO is viewed by the marketplace, the price of the organization's shares could rise or fall on the announcement.

Competition Risks

Organizations will need to assess the risk that a departing CEO will join a competitor and what, if any, arrangements the organization will make to reduce this risk. Organizations might consider entering into consulting arrangements or clawing back future compensation to the executive if he or she breaches his or her post-employment obligations to the organization. For example, compensation claw-backs can be tied to future severance payments or future payments under a supplemental executive retirement plan.

Securities Updates

TSX Update

The Toronto Stock Exchange (TSX) Company Manual was amended effective August 29, 2011. The amendments included reducing the security-based compensation that could be used as an inducement to enter into employment with the issuer without obtaining security holder approval.[7] Specifically, before August 29, 2011, security holder approval was not required for security-based compensation arrangements used as an inducement to enter employment as an officer with the issuer, if the securities issuable to such person did not exceed 2% of the number of outstanding securities of the listed issuer. On and after August 29, 2011, security holder approval is not required, only if the aggregate number of securities issued in any 12-month period as an inducement to enter employment as an officer with the issuer is not more than 2% of the number of securities outstanding before the date this exemption is first used during such 12-month period.

The TSX Company Manual was also amended to aggregate certain transactions involving insiders over a six-month period.[8] Before August 29, 2011, security holder approval was required for certain transactions in which the value of the consideration to be received by insiders exceeded 10% of the market capitalization of the issuer. On and after August 29, 2011, security holder approval is required for certain transactions in which the value of the consideration to be received by insiders, during any six-month period, exceeds 10% of the market capitalization of the issuer. In general, insiders receiving the securities pursuant to these transactions are not eligible to vote their securities in respect of such approval.

CSA Update

Amended executive compensation disclosure rules take effect October 31, 2011

On July 22, 2011, the Canadian Securities Administrators (CSA) adopted amendments to Form 51-102F6 - Statement of Executive Compensation (Amendments).[9] The Amendments will come into effect and apply to issuers with fiscal years ending on or after October 31, 2011, provided that all required Ministerial approvals are obtained. Similar amendments were initially proposed by the CSA on November 19, 2010 and are described in the January 2011 issue of this Newsletter. The final amendments adopted by the CSA are not materially different from the amendments initially proposed. As noted in the January 2011 issue of this Newsletter, the key changes to the Statement of Executive Compensation include the obligation to disclose:

- When organizations are relying on the

CEO Turnover Statistics

Equilar Inc., an executive compensation research firm, released an interesting report on CEO departures from 2007 to 2009 at S&P 1500 companies, which is a composite of three indices: the S&P 500, S&P MidCap 400 and S&P SmallCap 600.[5] Equilar Inc. examined 381 S&P 1500 companies that had a change in CEO from 2007 to 2009 and noted:

- 2008 had the highest level of CEO turnover of the three years with 156 CEOs departing, in comparison to 126 and 138 in 2007 and 2009, respectively
- 348 companies changed their CEO once during the three-year period, while 33 companies changed their CEO twice or more
- Nearly ¾ of incoming CEOs were internal hires, while ¼ were hired from outside the company
- 60 was the median age of departing CEOs, whereas 51 was the median age of incoming CEOs
- 1.4% of departing CEOs were female while 4.8% of incoming CEOs were female
- 35 founders left the CEO position

OSC Orders and Penalties on the Rise

On August 15, 2011, the Ontario Securities Commission (OSC) released its annual report for 2011.[6] The following is noteworthy:

- The OSC concluded 36 proceedings - up from 16 in 2010 and 21 in 2009
  - 109 respondents were involved - up from 32 in 2010 and 46 in 2008
  - 82 cease trade orders were issued - up from 18 in 2010 and 23 in 2009
  - 56 directors and officers were issued bans - up from 18 in 2010 and 29 in 2009
  - $82 million was the total for the administrative penalties, disgorgement orders and settlement amounts - up from $36 million in 2010 and $18 million in 2009. In 2009, there was an additional $68 million repayment by three individuals to Research In Motion Ltd. pursuant to a settlement with the OSC
- There were 3 proceedings before the Ontario Court of Justice
  - 4 defendants were involved
  - 1 individual was sentenced to 75 days in jail and probation
  - 1 individual in another proceeding was sentenced to 30 days in jail, probation and community service

"serious prejudice" exemption as a basis for not disclosing the specific performance goals relating to the compensation of the named executive officers (NEOs).

- An organization's compensation practices and policies if they create risks that are reasonably likely to have a material adverse effect on the organization.
- Whether the NEOs or directors are permitted to purchase financial instruments to hedge or offset a decrease in the value of their equity securities granted as compensation or otherwise held by them.
- The information in the summary compensation table in the required format, without adding any columns.
- The name of any compensation consultant retained to provide services to the organization and the terms of the consultant's mandate. Consequential amendments were made to National Instrument 58-101 - Disclosure of Corporate Governance Practices (NI 58-101) to permit organizations to incorporate by reference the compensation governance disclosure in the Statement of Executive Compensation into NI 58-101.

On July 15, 2011, the CSA announced the Results of Continuous Disclosure Reviews for Fiscal 2011. Of the 4,100 issuers in Canada, excluding investment funds and issuers that have been cease-traded, 1,351 were reviewed - the same number of reviews as in fiscal 2010. The outcome of the reviews was as follows:

- 40% were required to enhance future filings - down from 43% in 2010
- 10% were proactively alerted to specific areas where disclosure enhancements should be considered - up from 9% in 2010
- 16% were required to amend or re-file certain documents - the same percentage as in 2010
- 4% had critical deficiencies and may be added to the default list, issued a cease trade order or referred to Enforcement - the same percentage as in 2010
- 30% required no changes - up from 28% in 2010.[10]

1 "HP CEO Apotheker fired, replaced by Meg Witman" CNNMoney.com (22 September 2011), online: http://money.cnn.com/2011/09/22/technology/hp_ceo_fired/index.htm; James B. Stewart, "Rewarding C.E.O.'s Who Fail" The New York Times (30 September 2011) online: http://www.nytimes.com/2011/10/01/business/lets-stop-rewarding-failed-ceos-common-sense.html?_r=1&scp=1&sq=Rewarding%20C.E.O.s%20Who%20Fail&st=cse

2 "HP CEO Hurd's Severance Pay Could Hit $40 million: Experts" CNBC Reporter (9 August 2010), online: http://www.cnbc.com/id/38624369/HP_CEO_Hurd_s_Severance_Pay_Could_Hit_40_Million_Experts.

3 Paul R. La Monica, "Fiorina out, HP stock soars: CEO who engineered Compaq merger leaving after fight with board; will walk away with $21 million" CNN Money.com (10 February 2005), online: http://money.cnn.com/ 2005/02/09/technology/hp_fiorina/#para.

4 Tim Hortons Inc. News Release "Tim Hortons Inc. announces agreement with former President and CEO Don Schroeder" (06 June 2011), online: http://www.timhortons.com/ca/en/about/news.html?c=195616&p=irol-news&nyo=0.

5 Annalisa Barrett, "Equilar Study: CEO Turnover - Findings from a study of CEO departures at S&P 1500 companies between 2007 and 2009" (April 2011), online: http://www.equilar.com/knowledge-network/research-articles/201104-ceo-turnover.php

6 Ontario Securities Commission 2011 Annual Report (5 August 2011), online: http://www.osc.gov.on.ca /static/_/AnnualReports/2011/pdf/OSC_AR2011_Full_ENG.pdf.

7 Toronto Stock Exchange, TSX Company Manual (Toronto: CCH, 2006) at s. 613(c).

8 Toronto Stock Exchange, TSX Company Manual (Toronto: CCH, 2006) at ss. 501(c), 604(a)(ii) and 611(b).

9 CSA Notice - Amendments to Form 51-102F6 - Statement of Executive Compensation and Consequential Amendments (2011) 34 O.S.C.B. 8047 (22 July 2011).

10 CSA Staff Notice 51-334 - Continuous Disclosure Review Program Activities for the fiscal year ended March 31, 2011 online: http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20110715_51-334_cd-review-program.htm.
