
Aging Executives: Thoughts on Designing Succession Strategies

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Executive Compensation Academy –
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 - We encourage questions (even though your audio lines are muted)
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 - If time permits, your questions will be answered at the end of this presentation. And if there is insufficient time, the speaker will respond to you via e-mail after this presentation

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 - A purpose of the webinar series is to provide FREE CE credits
 - To that end, each presentation is intended to provide 1 credit hour in the following areas:
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About Anthony “Tony” Eppert



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- Tony practices in the areas of executive compensation and employee benefits

- Before entering private practice, Tony:
 - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
 - Obtained his LL.M. (Taxation) from New York University
 - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
 - Editor-in-Chief, Journal of Medicine and Law
 - President, Tax and Estate Planning Society

Upcoming 2022 Webinars

- 2022 webinars:
 - New SEC Rules: Navigating Clawbacks & Pay vs. Performance Designs (12/8/22)

- 2023 webinars:
 - New Compensatory Thoughts & Practices from ISS (Annual Program) (1/12/23)
 - Start-Up Compensation Designs: Focus on Founders (Part 1 of 2) (2/9/23)
 - Start-Up Compensation Designs: Focus on Key Employees (Part 2 of 2) (3/9/23)
 - Current 280G Mitigation Techniques (4/13/23)
 - Private Equity Compensatory Design Trends & Practices (5/11/23)
 - Equity Awards & Employment Taxes: Design Considerations (6/8/23)
 - Form 4 Training Course (7/13/23)
 - Anatomy of ISS: A Current Compensatory Perspective (8/10/23)
 - Preparing for Proxy Season: Start Now (Annual Program) (9/14/23)
 - PubCo Governance & Internal Controls: A Compensatory Perspective (10/12/23)
 - Keep It Boring: Drafting Miscellaneous Provisions in a Contract (11/9/23)
 - [Topic TBD] (12/14/23)

Sign up here: <https://www.huntonak.com/en/insights/executive-compensation-webinar-schedule.html>

Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded issuers, and involve substantive areas of:
 - Tax,
 - Securities,
 - Accounting,
 - Governance,
 - Surveys, and
 - Human Resources

- Historically, compensation issues were addressed using multiple service providers, including:
 - Tax lawyers,
 - Securities/corporate lawyers,
 - Labor & employment lawyers,
 - Accountants, and
 - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation



Our Compensation Practice – What Sets Us Apart (cont.)

- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

Corporate Governance

- Implement “best practices”
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy

Purpose of this Presentation

- The purpose of this presentation is to help companies, Boards of Directors, and executives plan their succession strategies, especially with respect to executive officers. To that end, this presentation discusses:
 - Aging demographics,
 - Who should be responsible for implementing succession strategies,
 - What should be the timeline,
 - How the foregoing should change in emergency or unplanned situations,
 - Building the pipeline of candidates, and
 - Examples of successful and not-so-successful succession strategies

Introduction

- Though many of the slides are focused upon the CEO position, the topic is relevant with respect to all executive positions
- According to a Korn Ferry study:
 - 40% of new CEOs depart within 18 months of their appointment, and
 - 64% of new CEOs depart within 4 years
- Successful succession strategy requires that succession planning remain on the Board's regular agenda
 - Succession strategies are a process,
 - Succession strategies are not a discrete event,
 - Succession strategies should be a “routine” Board topic, if for no other reason than to avoid sounding alarms simply because the Board is talking about the topic
 - The Board should avoid delegating the entire process to the CEO
 - The process should be “owned” by the Board, though the process should involve the CEO since his or her judgement is important
 - The process should be run by the Nominating & Governance Committee (or like committee), but consider too whether it makes sense to have an interdisciplinary committee of the Board run the process

Two Representative Examples

- On April 4, 2022, former CEO and Chairman of Starbucks (from 1986-2000, and again from 2008-2017) took the role of interim CEO, which will remain in place until at least the first quarter of 2023
 - Company announced it was looking when the prior CEO retired after 5 years
 - Company announced it was conducting an external search (which has now concluded with an external hire)
 - The Board had announced that the retirement of the CEO was deliberate and known, and that the process was deliberate
 - However, some shareholders and pundits became critical that, for a company who prides itself on training and leadership, it failed to train an internal successor (or at least one or more that could be considered) to take over in a timely manner
 - Additionally, some of these same pundits claims that within the transition process of Schultz taking over as interim CEO, that he met with employees of the Company, but that he had not met with the departed CEO

- Compared to an older classic example with General Electric:
 - As Jack Welsh was nearing retirement, three people had been identified by the Board to be considered as the next CEO, they were ready and they were trained
 - Jeff Immelt
 - Bob Nardelli, and
 - Jim McNerney

Background on Legal Considerations

- It is common among large companies to have a succession plan for both emergency situations and long-term succession planning
- Poor planning can result in losses to shareholders
 - There are hard costs associated with a sudden executive departure, such as:
 - Search firm fees,
 - PR fees
 - Board members' attendance to otherwise impromptu meetings (e.g., travel costs)
 - Lawyers
 - Etc.
 - Additionally, there are often losses to shareholder value when an executive suddenly departs caused by the turmoil that can quickly trickle through the company, and these costs can far outweigh the hard costs. Examples include:
 - Growth initiatives slowed or stopped
 - Deals unable to close
 - Key employees begin to look for other employment
- Academic studies of the issue conclude that companies who underperform, when compared to companies who performed well, have more forced turnover

Background on Legal Considerations (cont.)

- When there is an announcement of an unplanned CEO departure, alongside the announcement of the hire of an executive search firm (meanwhile, an internal person serves as interim CEO), the question arises as to whether the Board failed at succession strategies
 - And this question becomes louder if the replacement CEO comes from outside the Company, and then that new outside CEO is replaced within the same year or soon thereafter

- Issuers listed on NYSE are required to address succession planning in both the emergency and retirement situations, with such being disclosed within their corporate governance guidelines (are available on their websites)
 - However, the terms of the succession plan are not required to be disclosed
 - As a result, most issuer tend to disclose only that they conduct an annual review of their CEO and other leaders with respect to succession strategies

- There is no NASDAQ required disclosure, though many issuers voluntarily disclose similar to NYSE requirements

Background on Legal Considerations (cont.)

- Sample of a prior proxy disclosure:
 - Succession planning and talent development are important at all levels within our organization. The board oversees management's succession plan for key positions at the senior officer level, and most importantly for the Chief Executive Officer position. The board annually reviews succession plans for senior management and the CEO, including both a long-term succession plan and an emergency succession plan. The board's succession planning activities are ongoing and strategic, and may be supported by independent third-party consultants. In addition, the CEO annually provides his assessment to the board of senior leaders and their potential to succeed at key senior management positions.

Background on Legal Considerations (cont.)

- Staff Legal Bulletin No. 14E(CF), addressing the application of Rule 14a-8(i)(7) to shareholder voting proposals focusing on succession planning for an issuer's CEO. The question is whether an issuer may rely upon Rule 14a-8(i)(7) to exclude a shareholder voting proposal that focuses on CEO succession planning
 - The SEC's view used to be that such proposals relate to the termination, hiring or promotion of employees, and as a result, could be excluded under Rule 14a-8(i)(7). See SEC Release No. 40018 (May 21, 1998)
 - However, the SEC also recognized that such a shareholder proposal may transcend day-to-day business matters (which may be excluded under the above) and raise policy issues so significant that it would be appropriate for a shareholder vote
 - Thus, the SEC changed its view and recognizes that CEO succession planning raises a significant policy issue regarding corporate governance that transcends day-to-day business matters, and as a result, the SEC's revised position and current view is that Rule 14a-8(i)(7) generally cannot be relied upon to exclude a shareholder proposal focusing on CEO succession planning (please note this change by the SEC is not new, we are simply providing the background on this slide)

Institutional Shareholder Thoughts

- ISS voting recommendation is to generally support shareholder proposals seeking more disclosure on CEO succession planning, provided:
 - The scope of the request is reasonable, and
 - The companies existing disclosure on the issue is lacking

- Blackrock Investment Stewardship Proxy Voting Guidelines (effective January 2022)
 - There should be a robust CEO and senior management succession plan in place at the board level that is reviewed and updated on a regular basis. We expect succession planning to cover scenarios over both the long-term, consistent with the strategic direction of the company and identified leadership needs over time, as well as the short-term, in the event of an unanticipated executive departure. We encourage the company to explain its executive succession planning process, including where accountability lies within the boardroom for this task, without prematurely divulging sensitive information commonly associated with this exercise

Institutional Shareholder Thoughts (cont.)

■ Glass Lewis

- We recognize that the decision regarding what information to publicly disclose regarding executive succession is a complex issue. Boards must balance the competing demands of safeguarding sensitive information regarding CEO succession against disclosing sufficient and appropriate information to shareholders and employees in a manner consistent with their fiduciary duty and other legal obligations.
- In general, we believe firms should disclose appropriate and pertinent details of the succession plan, including: (i) the process in which the next CEO would be selected, including the board's role in that process; and (ii) whether the CEO reports to the board concerning internal candidates for the CEO position, including an evaluation of the development of senior management. We may consider recommending support for well-crafted proposals requesting companies adopt policies or provide shareholders with more information regarding their CEO succession planning process if the company provides shareholders with no information or assurance regarding this process and if there are specific concerns regarding CEO succession at the company.
- However, we will generally not recommend supporting such shareholder proposals if the rigidity of the proposed requirements could unduly hinder the board's ability to approach CEO succession planning in a way that it deems most appropriate in the fulfillment of its fiduciary duties or if the requested disclosure encompasses confidential or otherwise sensitive information

Process, Process & More Process

- Who on the Board of Directors is responsible for succession strategies?
 - Is it the entire Board of Directors?
 - Is it a subcommittee?
 - Is it one member of the Board of Directors in connection with the CEO and the Director of HR?

- No matter the structure, the Board should “own” the process. The Board is the highest governing body
 - The CEO could be conflicted
 - And too, if the Board does not own the process, then traditional corporate governance is arguably ignored

Process, Process & More Process (cont.)

- The first question in the process is to answer which executives and/or positions are critical to the business and are vulnerable (*e.g.*, nearing retirement)
 - The CEO position will always be included
 - Any other critical positions?

- Another question in the process is to define what characteristics, skill set and eligibility requirements are needed for the position

- And another question in the process is to assess the pool of internal candidates
 - The goal is to develop a list of internal candidates
 - Such pool could be categorized as temporary replacements (to address emergency replacements) and permanent replacements
 - Consider a requirement that all members of the Board have exposure to each of the individuals within the internal candidate list

- Consider letting the individuals know that they are being groomed for leadership, but that nothing is guaranteed

- Create an action plan and evaluate it regularly

Millennials

- Compared to Baby Boomers and Gen X, Millennials are more prone to job jumping. As a result:
 - “Retirement” benefits that will compensate a Millennial in 20-30 years may not be valued, and if such is not valued, then such is not an effective retention tool
 - In contrast, consider that a SERP or other non-qualified deferred compensation plan might be a more effective tool to retain a Millennial since it involves a shorter time span within which the benefit can be realized. And too, such a plan could cover:
 - Funding for certain life events like purchasing a home or a vacation home,
 - College funding,
 - Sabbaticals,
 - Etc.

- So as to remove the assets of the non-qualified deferred compensation plan from the claims of the companies general creditors, a Secular Trust could be used
 - Such works to secure the benefit for the participating employee irrespective of any fears the company may have a bankruptcy or creditor actions
 - There is a tax recognition event that needs to be solved when the contribution is made to the secular trust, but such can be solved with:
 - Careful planning,
 - Employer contributions, and/or
 - Offsetting insurance policies

Contractual Thoughts

- Consider a springing employment agreement to help retain the successor in waiting
 - To help retain the successor in waiting, the Compensation Committee or the Board could enter into an executive contract with the successor that does not become effective until and IF the incumbent CEO is no longer serving
 - The effectiveness of the executive contract would “spring” into action upon the incumbent no longer serving

- Considering adding within any Retirement defined term that, in order to take advantage of Retirement for purposes of accelerated vesting of equity or separation pay, advance written notice of retirement must be provided to [] at least 6 months of 12 months prior to any such retirement AND the executive must remain in good standing throughout during the interim period between notice and retirement

- Consider adding within applicable contracts that a CEO’s failure to adhere to succession planning would give rise to a Cause termination scenario

Don't Forget Next Month's Webinar

- Title:
 - New SEC Rules: Navigating Clawbacks & Pay vs. Performance Designs

- When:
 - 10:00 am to 11:00 am Central
 - December 8, 2022