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When Executives Depart, **Non-Economic Terms** Can Matter

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IT'S A FACT OF LIFE that key executives of public companies come and go—with increasing frequency and in sometimes messy circumstances. Although the headline economic terms of an executive's compensation and severance usually get the media spotlight, the more technical provisions in these arrangements, such as restrictive covenants, compensation clawback provisions, and release and waiver terms, can also significantly affect how an executive's departure unfolds.

Just as levels and types of compensation must evolve with the market, these provisions should reflect current events, changing governance practices, and legal developments such as the Dodd-Frank Wall Street Reform and Consumer Protection Act. Negotiating these provisions can also involve tradeoffs against the economic terms. Compensation committees and their advisors who find themselves in difficult negotiations with an outgoing executive should be well informed about the relative costs and benefits of these provisions and not dismiss them as boilerplate.

Post-Termination Provisos

Non-Disparagement Clauses. Carol Bartz's well-publicized departure from Yahoo! focused attention on non-disparagement clauses. After reportedly being fired over the phone while attending a conference, Bartz made a number of comments about Yahoo! and its board, some of which could be characterized as unflattering, despite a non-disparagement clause in her employment agreement.[1] Although some commentators speculated that her remarks could result in the forfeiture of her sizeable severance entitlements and equity awards, there has been no public indication that Yahoo! intends to pursue that route.[2]

Several factors may have contributed to this result, including the fact that Bartz's employment agreement does not expressly condition her right to severance on her compliance with the non-disparagement clause. Yahoo! also likely recognized that attempted enforcement of the clause would keep the public focus on Bartz's departure—and how it was handled by Yahoo!'s board—without any assurance that this approach would survive a challenge. Although non-disparagement clauses are not per se unenforceable, enforcement can involve a difficult and public fact-intensive inquiry by the courts, including parsing the remarks to determine whether they are truly disparaging, and whether they have or are likely to have any damaging effect on a company's reputation.[3]

The Bartz example illustrates some practical considerations. First, despite the enforcement challenges, an employer may be in a better legal position, or at least have the benefit of a greater in terrorem effect, if the contract terms condition payment of severance on compliance with the non-disparagement clause, or expressly provide that a breach of specified provisions such as the non-disparagement clause has a direct contractual consequence, such as forfeiture of severance or other benefits. This advantage is amplified if payments or benefits are structured to pay out over time rather than in a lump sum.

Because judicial interpretation of the law governing enforcement of non-competes and non-solicits is **not static**, companies are well-advised to **reexamine** their **standard restrictive covenants** from time to time to ensure they provide the **maximum protection** permissible by law.

Second, employers may derive as much (or more) benefit from carefully managing the termination process than relying on the presence of a non-disparagement clause as a deterrent.

Third, the deterrent effect of a non-disparagement clause and a company's appetite to enforce it may hinge in part on the forum for dispute resolution. For example, confidential arbitration may be a more attractive forum than the courts. Requiring the losing party to pay the legal fees and costs of the successful party could also encourage compliance with a non-disparagement clause. Faced with these competing considerations, a company in difficult negotiations involving an employment or separation agreement might also reasonably conclude that the potential benefits of a non-disparagement clause are not worth the tradeoffs required to obtain it from an executive.

Confidentiality, Non-Compete and Non-Solicit Clauses. The 2010 departure of Mark Hurd from Hewlett-Packard highlighted the important role restrictive covenant clauses play in employment and separation agreements. Hurd resigned as chief executive of HP amid sexual harassment charges and accusations that he had submitted inaccurate expense reports.[4] Less than a month later he joined Oracle as its co-president.[5] HP sued Hurd for breach of contract and the threatened misappropriation of trade secrets, claiming that he could not perform his job at Oracle without violating his confidentiality obligations to HP. The parties eventually settled in exchange for Hurd's forfeiture of almost 350,000 restricted stock units, which otherwise would have continued to vest under the terms of his separation agreement.[6]

The settlement was particularly notable because it arose in California—one of the more inhospitable jurisdictions for enforcement of post-termination restrictive covenants. State laws governing enforcement of non-compete agreements vary significantly, and there is extensive California case law discussing that state's strong public policy interest in facilitating employment opportunities for former employees, i.e., California's reluctance to enforce non-competes in most circumstances.

By contrast, California courts may enforce confidentiality covenants that prevent employees from using or disclosing confidential information that is a protectable trade secret. As other commentators have noted, the business relationship between HP and Oracle may have played a role in the ultimate settlement reached. But where non-compete provisions are invalid or highly restricted under state law, the importance of carefully drafted post-employment confidentiality and trade secret provisions cannot be overstated. In those cases, it may also be desirable to provide for post-termination consideration to be paid out incrementally during the period in which a former executive's service for a competitor could do the most damage to the company. Because judicial interpretation of the law governing enforcement of non-competes and non-solicits is not static, companies are well-advised to reexamine their standard restrictive covenants from time to time to ensure they provide the maximum protection permissible by law.

Clawbacks and Claims

Compensation Clawbacks. Under Dodd-Frank, the U.S. Securities and Exchange Commission must direct the national securities exchanges and associations to condition the listing of any security on the listed company's implementation of a policy for recovery of certain compensation following an accounting restatement due to material noncompliance with financial reporting rules. The idea of a compensation clawback is not new, and §304 of the Sarbanes-Oxley Act also provides for a clawback applicable to a company's CEO and CFO and enforceable by the SEC.

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However, Dodd-Frank goes further in that it applies to a broader group of executives, covers a longer (and potentially different) period and is not limited to restatements arising out of misconduct. The SEC expects to adopt final rules on Dodd-Frank's clawback requirement in the first half of 2012.

There are significant ambiguities in the Dodd-Frank clawback provisions and, pending the release of final rules, it is prudent to defer changes to existing clawback policies or the implementation of new policies.[7] By the same token, however, companies should consider including language in their separation agreements and incentive award agreements now that would preserve their rights (and obligations) to enforce a Dodd-Frank clawback to the extent it may be required under the final listing standards. This is particularly important in separation arrangements that contemplate a mutual release of claims by the executive and the company. Providing an explicit and clear reservation of rights may mitigate the difficulty of disputes with former executives from whom a clawback of compensation is sought in the future.

The potential for a clawback can also present special conflicts of interest. Since clawbacks are likely to be vehemently resisted by former executives in many circumstances, and the exercise of a board's discretion to refrain from seeking a clawback or settling a clawback claim may just as likely receive vehement scrutiny by shareholders, once the need to enforce a clawback becomes a possibility boards will likely wish to make special efforts to ensure that the independence of their judgment is not subject to question in these matters, as well as have the benefit of available legal privileges and protections.

Executive Release of Claims and the SEC's Bounty Program. In a typical employment or separation agreement that provides severance to a departing executive (whether as cash severance, accelerated equity vesting, retention of forfeitable equity awards post-termination or other consideration), the employer often requires the executive to sign a broad release waiving *all* claims against or related to the company that could have arisen during the executive's employment.

In May of this year, the SEC adopted final rules under Dodd-Frank providing for a "bounty" program under which whistleblowers who satisfy certain requirements can receive financial rewards. If the whistleblower voluntarily reports original information to the SEC that leads to an enforcement action with penalties of at least $1 million, he or she can recover between 10 and 30 percent of the monetary sanctions recovered by the SEC in the action and in related actions by other specified authorities. This compelling monetary incentive may well cause a surge in whistleblower complaints, which need not be reported through internal compliance mechanisms under the new rules in order for a whistleblower to obtain a reward.[8]

Aside from significantly altering compliance incentives, the new program increases the importance of prompt identification and remediation of compliance failures. Moreover, Dodd-Frank provides new protections against retaliation for participating in the SEC's bounty program, which may be enforced directly by the whistleblower, as well as by the SEC. As part of their overall planning to address these concerns, companies are considering whether and how to address potential whistleblower claims in their executive release arrangements and departure practices.

Preliminarily, a successful submission under the SEC's bounty program would likely not constitute a "claim" against the company for purposes of the typical release. The whistleblower is rewarded directly by the SEC out of monetary sanctions collected. By contrast, a potential suit against the company for back pay and other entitlements under the anti-retaliation rules clearly would constitute a claim and would appear not to run afoul of §29(a) of the Securities Exchange Act of 1934, which provides that "any condition, stipulation or provision binding any person to waive *compliance* with any provision of [the Act] or of any rule or regulation thereunder…shall be void."[9] Release language sufficiently broad to cover settlement of this type of claim would thus appear to be permissible.

These considerations also suggest that companies consider alternative means to address compliance considerations when an executive departs. For example, depending on the circumstances, the company might seek the executive's representation that, as of the date his or her separation agreement is signed, the executive has not reported information to the SEC and is not aware of any possible compliance failure at the company by any person that has not been reported to the chief legal or compliance officer. Although many public company executives routinely given annual representations about compliance issues, this representation is likely to meet with significant resistance as part of a separation, given that the employee's severance payout depends on its accuracy. A contentious setting will only make matters worse.

As an alternative, the company could consider whether its departure practices could be modified to elicit this information. Not all companies conduct exit interviews for departing executives, but the practice merits a second look, particularly given that substantially all frauds occur "at the top of the house" by personnel with the authority to circumvent controls. If not already included in its standard employment or separation agreement, the company could also seek an undertaking by the executive to report to the chief legal or compliance officer information he learns about a possible compliance failure after the date of the separation agreement, before taking any further action. These approaches can at least surface issues so that the company can undertake an investigation and, where appropriate, self-report the matter to the SEC with the potential to receive cooperation credit in its ultimate resolution.

The SEC adopted final rules under Dodd-Frank providing for a **"bounty" program** whereby a whistleblower who voluntarily reports **original information** to the SEC that leads to an enforcement action with penalties of at least $1 million can recover **between 10 and 30 percent** of the monetary sanctions recovered by the SEC.

Conclusion

While media attention will no doubt remain fixed on eye-popping severance numbers, the story does not end there. In an era of increasing executive turnover, intense scrutiny of executive compensation and evolving regulatory requirements, neglecting to focus on the non-economic terms of employment and separation arrangements may result in missed opportunities to protect the company's interests long after the executive is gone.

1. "Carol Bartz Exclusive: Yahoo! 'F-ed Me Over,'" Posting of Patricia Sellers to Postcards, http://postcards.blogs.fortune.cnn.com/2011/09/08/carol-bartz-fired-yahoo/ (Sept. 8, 2011). The non-disparagement clause in Bartz's employment agreement provides the following:

> You agree…both during and for five (5) years after your employment with the Company terminates, not to knowingly disparage the Company or its officers, directors, employees or agents in any manner likely to be harmful to it or them or its or their business, business reputation or personal reputation."

Employment Agreement Letter, dated Jan, 13, 2009, between Yahoo! Inc. and Carol Bartz.

2. "Yes, Carol Bartz Had a Non-Disparagement Clause," Posting of Dan Primack to Term Sheet, http://finance.fortune.cnn.com/2011/09/08/carol-bartz-yahoo-disparagement/ (Sept. 8, 2011); "Did Yahoo! Chief's Post-Firing Comments Constitute Disparagement?," Posting of Nathan Koppel to Law Blog, http://blogs.wsj.com/law/2011/09/12/did-yahoo-chiefs-post-firing-comments-constitute-disparagement/ (Sept. 12, 2011).

3. A recent decision by the Ohio appellate court in a case arising from post-termination statements by a former employee illustrates the difficulties in enforcing these clauses. *Ohio Education Assn. v. Lopez*, 2010 Ohio App. LEXIS 4272 (Ohio Ct. App. 2010). In *Lopez*, a former employee of a non-profit organization made disparaging comments about the executive director of his former employer, despite being subject to a non-disparagement clause in his separation agreement. The court found that while the employee technically violated his non-disparagement clause when he referred to the executive director of his former employer as a "slimebag," the statements were very general and immaterial and there was no evidence of harm or detrimental effect to the executive director's reputation as a result of them, stating in part that the term slimebag "is such a part of modern casual speech as to be almost meaningless." *Lopez*, 2010 Ohio App. LEXIS 4272 at 10.

4. Sean Gregory, "Corporate Scandals: Why HP Had to Oust Mark Hurd," Time, Aug. 10, 2011, http://www.time.com/time/business/article/0,8599,2009617,00.html.

5. Aaron Ricadela, "Oracle Hires Ex-HP CEO Hurd as President as Phillips Departs," Bloomberg, Sept. 7, 2010, http://www.bloomberg.com/news/2010-09-07/mark-hurd-joins-oracle-as-president-after-leaving-hp-as-phillips-resigns.html.

6. Ashlee Vance and Verne G. Kopytoff, "H.P. Settles Lawsuit Against Hurd," N.Y. Times, Sept. 20, 2010, http://www.nytimes.com/2010/09/21/technology/21hewlett.html.

7. One area of ambiguity concerns the tax treatment of clawbacks, and how employees will be taxed in such an event. See "Employee Tax Consequences of Clawed Back Compensation: Five Questions to Consider When Drafting and Implementing Policies," NYLJ (Nov. 29, 2010).

8. To illustrate just how compelling the new program might be, the SEC brought 681 enforcement cases, and obtained $2.8 billion in penalties and disgorgement in 2010. SEC, FY 2010 Performance and Accountability Report (2010). Based on its activity in the first half of the fiscal year, the SEC is likely to bring as many or more cases in fiscal year 2011. James Overdahl and Elaine Buckberg, NERA Economic Consulting, "SEC Settlement Trends: 1H11 Update" (2011).

9. See 15 U.S.C. §78cc (emphasis supplied).