

## Hiring, Firing, and Setting the Compensation of Corporate Officers: Who Has the Authority?

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The Delaware Chancery Court decision involving the hiring and firing of, and payment of severance compensation to, Michael Ovitz by The Walt Disney Company<sup>1</sup> provides welcome relief to corporate directors regarding executive employment and compensation decisions. A critical factor in the outcome of this case was the finding by Chancellor Chandler that the actions taken with respect to Ovitz by Disney's directors, including Chairman and CEO Michael Eisner, comported with the requirements of Delaware law and the provisions of Disney's articles of incorporation and by-laws regarding the hiring and termination of corporate officers and the compensation of such officers.

The court carefully reviewed Disney's articles of incorporation and by-laws to determine which entity and/or individual(s) had the authority to act with respect to the hiring of Ovitz, the establishment of his compensation package, and the subsequent termination of his employment. Based upon this review, the court concluded that:

1. The board of directors had the sole authority to appoint Ovitz as Disney's president and to determine his duties as such;
2. The compensation committee of the board had the sole authority to determine Ovitz's compensation as an officer of Disney; and
3. Eisner, as CEO, had the non-exclusive authority to remove Ovitz from his officer post.

The *Disney* opinion highlights the importance of "process" in determining the compliance of directors and officers with their fiduciary obligations under state corporate law. Compliance with the procedures mandated by state law and the company's organic documents is a fundamental aspect of procedural prudence. When making key personnel and compensation decisions, particularly with regard to corporate officers, it is essential that directors be familiar with these procedural requirements that may vary from company to company

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depending on the company's state of incorporation and the terms of its articles and by-laws.

As detailed below, state law generally requires that the company's board of directors approve the hiring and firing of officers, provided that the board may delegate to the CEO the hiring and firing of inferior officers. Depending on the state of incorporation, such delegation of authority must be reflected in the company's articles of incorporation or by-laws or in resolutions adopted by the board of directors. Notwithstanding any such delegation, however, in the case of companies whose securities are listed on the New York Stock Exchange (NYSE) or the NASDAQ Stock Market, Inc. (Nasdaq), the approval of the board or the compensation committee will always be required for the hiring of an *executive officer* and such approval will also be necessary for the termination of an executive officer if the terminated executive is to receive a termination compensation package that is different than the compensation previously approved for that executive by the board or compensation committee.

### ***Identifying a Company's Officers***

Before addressing the process through which officers may be retained or terminated, it is useful to consider which individuals are regarded as a company's officers. The term "officer" may have different meanings depending on the particular context in which the term is used.

### **Federal Securities Laws**

For purposes of the short-swing profit rules under the Securities Exchange Act of 1934, as amended, (Exchange Act) Section 16, a company's "officers" are its

President, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice president of the [company] in charge of a principal business unit, division, or function, . . . any other officer who performs a policy making function, or any other person who performs similar policy making functions for the [company].<sup>2</sup>

A slightly different definition applies under the Exchange Act for purposes of determining those persons who are required to be listed as executive officers in the Form 10-K annual report and in the annual meeting proxy statement and whose compensation and stock ownership are required to be disclosed in the proxy statement. In that case, a company's "executive officers" are its

President, any vice president . . . in charge of a principal business unit, division, or function (such as sales, administration, or

finance), any other officer who performs a policy making function, or any other person who performs similar policy making functions for the [company].<sup>3</sup>

Unlike the SEA Section 16 definition, this definition does not expressly refer to the principal financial officer, principal accounting officer, or controller.

### **State Corporation Laws**

Some state corporation laws follow the 1969 Model Business Corporation Act (MBCA) that mandates companies have certain specified officers. The MBCA provides that each corporation shall have a "president, one or more vice presidents as may be prescribed by the by-laws, a secretary, and a treasurer, as well as such other officers, assistant officers[,] and agents as may be deemed necessary."<sup>4</sup> Among the approximately 24 states that have adopted some version of the MBCA are New York<sup>5</sup> and Pennsylvania, although the Pennsylvania law omits the reference to vice presidents.<sup>6</sup>

The Revised Model Business Corporation Act (Revised MBCA) replaced the original MBCA in 1984. It eliminated the statutory requirement of specific officers and permitted every corporation to designate the officers it wants by way of the by-laws or by resolution of the board of directors acting consistently with the by-laws.<sup>7</sup> Approximately 21 states have adopted some version of this provision of the Revised MBCA. Delaware adopted a slightly modified version of the Revised MBCA providing that each corporation shall have such officers with such titles and duties as stated in the by-laws or by resolution of the board of directors and as may be necessary to enable it to sign instruments and stock certificates.<sup>8</sup>

### ***Hiring of Corporate Officers***

In general, state corporation laws give the ultimate corporate management responsibility to the board of directors rather than the shareholders or the executive group. It is established, however, that

[t]he law recognizes that corporate boards, comprised as they traditionally have been of persons dedicating less than all of their attention to that role, cannot themselves manage the operations of the firm, but may satisfy their obligations by thoughtfully appointing officers, establishing or approving goals and plans[,] and monitoring performance.<sup>9</sup>

This authority of the board of directors to delegate responsibility to officers is codified in most state corporation laws. For example, Delaware law expressly permits a board of directors to delegate

managerial duties to officers of the corporation, except to the extent that the corporation's certificate of incorporation or by-laws may limit or prohibit such a delegation.<sup>10</sup>

Most state corporation laws do not contain detailed mandates with regard to the process for selecting and appointing corporate officers. Delaware law, for example, provides that corporate officers are to be chosen "in such manner and shall hold their offices for such terms as are prescribed by the by-laws or determined by the board of directors or other governing body."<sup>11</sup> There are no cases of relevance discussing this provision. Based on the plain language of the statute, it would appear that in the absence of by-law provisions or board resolutions to the contrary, the power to hire officers rests with the board. It seems equally clear, however, that this provision allows a board of directors to adopt a by-law or resolution delegating to the CEO the authority to hire inferior officers. Statutory provisions in approximately 26 jurisdictions leave nothing to the imagination in this regard by explicitly providing that a duly authorized officer may appoint one or more other officers if authorized by the by-laws or by resolution of the board of directors.<sup>12</sup>

### ***Compensation of Corporate Officers***

Accordingly, in practically all jurisdictions, the board of directors may itself hire corporate officers or may delegate the hiring authority to one or more officers of the company. Nevertheless, in the case of companies whose securities are listed on the NYSE or Nasdaq, some degree of board-level involvement in executive officer hiring decisions is required notwithstanding the board's ability under state law to delegate that function.

The listing standards of the NYSE require listed companies to have a compensation committee composed entirely of directors meeting the independence requirements set forth in the NYSE rules. In addition, each compensation committee must have a written charter that addresses, among other things, the committee's direct responsibility to:

1. Either as a committee or together with the other independent directors (as determined by the board) determine and approve the CEO's compensation level; and
2. Make recommendations to the board with respect to non-CEO compensation.

For this purpose, "non-CEO" refers to persons, other than the CEO, who are "officers" for purposes of Section 16 of the Exchange Act.

Unlike the NYSE rules, the Nasdaq listing rules do not require the formation of a compensation committee. Instead, the Nasdaq rules

provide that the compensation of a company's executive officers must be determined, or recommended to the board for determination, either by:

1. A majority of the independent directors; or
2. A compensation committee comprised solely of independent directors.

When an executive officer is hired by an NYSE or Nasdaq-listed company, the officer's compensation will, of course, have to be established. This is the case even with respect to officers who will be working without a formal employment contract. Under the NYSE and Nasdaq listing rules, this determination of compensation for newly-hired executive officers must be approved by the compensation committee or the full board.

### ***Firing of Corporate Officers***

With regard to removal of officers, approximately 15 states generally follow the Revised MBCA's provisions that expressly permit officers to remove other officers.<sup>13</sup> The remaining states—including Delaware, New York, California, and Pennsylvania—do not expressly grant officers the authority to remove other officers. In these jurisdictions, using the general delegation authority reserved to it under the laws of most states, a board presumably may, pursuant to an appropriate by-law provision or board resolution, delegate to the CEO the authority to fire inferior officers. While there is very little guidance regarding whether a CEO or president has the authority to terminate inferior officers where the by-laws are silent and the board has not otherwise expressly delegated such authority, the leading treatise in this area has noted that the removal of an officer must ordinarily be approved by the body or officer authorized to elect or appoint the officer in the first instance.<sup>14</sup>

The authority to fire an officer does not, however, necessarily carry with it the authority to approve the severance compensation to be paid to the departing officer. In the *Disney* case, the court found that Ovitz's employment agreement, including its termination and severance provisions, had received proper approval by the compensation committee at the time he was hired and that this approval obviated the need for a separate approval of the large severance payments and benefits payable to Ovitz at the time of his firing. If, however, Eisner had intended to provide to Ovitz a severance package different than the one contemplated by Ovitz's pre-approved employment agreement, Eisner presumably would have been required to obtain the approval of the board and/or the compensation committee before agreeing to such a package.

In cases where either the severance benefits of a departing officer are being negotiated at termination on an *ad hoc* basis or contractual severance benefits of such an officer are being renegotiated, the state law and/or the company's organic documents may require that such arrangements be approved at the board or compensation committee level. In addition, under the NYSE and Nasdaq listing rules, severance pay must be approved by the compensation committee or the full board.

### **Conclusion**

As litigation regarding executive compensation becomes an increasingly common occurrence, it can be expected that potential plaintiffs will focus more attention on the details of the compensation approval process, including the compliance of that process with the requirements of state law, any applicable stock exchanges and the provisions of the company's organic documents. It is crucial that directors have a complete understanding of these requirements as they consider actions relative to the retention or release of corporate officers.

### **Notes**

1. *See In re The Walt Disney Company Derivative Litigation*, No. Civ. A. 15452, 2005 WL 2056651 (Del. Ch. Aug. 9, 2005).
2. Securities Exchange Act of 1934 Rule 16a-1(f).
3. Exchange Act Rule 3b-7.
4. Model Business Corporation Act (MBCA) § 50 (1969).
5. N.Y. Business Corporation Law § 715.
6. 15 Pa. Cons. Stat. Ann. § 1732.
7. MBCA § 8.40 (1984). The Revised MBCA was most recently updated in 2005. Notwithstanding the 2005 revisions, the current provisions of the Revised MBCA regarding the hiring and firing of corporate officers have remained identical to their 1984 form.
8. Del. Code Ann. tit. 8, § 142.
9. *Grimes v. Donald*, 1995 WL 5444 at \*8 (Del. Ch.).
10. *See* Del. Code Ann. tit. 8, § 141(a) (permitting the business affairs of the corporation to be managed "by or under the direction of" its board. *See also Rosenblatt v. Getty Oil Company*, 493 A.2d 929, 943 (Del. 1985).
11. Del. Code Ann. tit. 8, § 142.
12. *See, e.g.*, Ariz. Bus. Corp. Ann. § 10-840; Fla. Stat. Ann. § 607-08401; Va. Code Ann. § 13.1-693.

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13. *See, e.g.*, Conn. Gen. Stat. Ann. § 33-766; Iowa Code Ann. § 490.843; Me. Rev. Stat. Ann. tit. 13-C, § 844.

14. *See* William Meade Fletcher, Fletcher Cyclopedia of the Law of Private Corporations, § 357.