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Terminating a CEO for Cause

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Terminating a CEO “for cause” requires that the board of directors (“Board”) of the employer focus on two questions – What is the applicable standard for cause? Do the facts and circumstances satisfy this applicable standard?

The consequences of a “for cause” termination can be severe, with the former executive forfeiting equity awards, having to repay previously paid incentive compensation (the “claw-back”), losing severance benefits and having vested stock repurchased at a punitive price. Reported circumstances of cause terminations are infrequent. Often this is because the battle takes place in confidential arbitration proceedings or disputes are settled confidentially, after the “cause” card has been played.

In recent years though there has been increasing shareholder activity focusing on high level executive compensation matters. This has included shareholder challenges to decisions by the Board to terminate an executive without cause, and pay large severance amounts rather than dismiss the CEO for cause. The issue arose back in the 1990’s when Michael Ovitz and Disney parted ways, and again more recently when the board of lululemon athletica inc. decided to pay severance rather battle with its former CEO over a cause termination.[1]

CEO “for cause” terminations, however, do exist. That was the case when American Apparel terminated its CEO in December 2014. Just recently, a public company (Akazoo S.A.) terminated its CEO for cause and affirmatively stated so in its public filings with the Securities and Exchange Commission (“SEC”).[2] Modern Media Acquisition Corp. S.A., a special purpose acquisition company (“SPAC”), acquired Akazoo (an on-demand streaming subscription company) (the “Company”) in late 2019. After the acquisition, in early 2020 a hedge fund released a report questioning the Company’s accounting practices.

On May 1, 2020, Akazoo filed a Form 6-K with the SEC stating that it had fired its CEO “for cause.” [3] In its May 1, 2020 press release (an exhibit to the Form 6-K) announcing the firing, the Company stated that its Board took such action based on the recommendations of a Special Committee, “which found evidence of conduct [by the CEO] that the Special Committee believed was inconsistent with the Company’s policies, including lack of cooperation with the investigation.” There was no mention in the May 1, 2020 filing of the CEO engaging in fraud, only that there was a continuing investigation of “the circumstances relating to the Company’s revenue sources and

contractual arrangements…."

By May 21, 2020, the Company filed another Form 6-K. By this time the internal investigation had proceeded to the point where the Company stated that its Special Committee had determined that "former members of Akazoo's management team and associates defrauded [its] investors…. by materially misrepresenting [the Company's] business, operation and financial results **as a part of a multi-year fraud** (emphasis added)."

These two filings show how the Company navigated the "cause" issue during a fluid internal investigation into accounting fraud. We were not involved in the case and our analysis is based on our careful review of the public disclosure as it unfolded in May, 2020. As of May 1, 2020, the Company felt compelled to terminate its CEO for cause, but relied on activity "inconsistent" with Company policies, including a lack of cooperation, as the basis for its publicly announced determination. Note that the Company's employment agreement with its CEO contained a cause definition that included "willful acts that materially injure (whether financially or otherwise) the business or reputation of the company." That prong of the cause definition would appear to apply to a "multi-year" financial fraud- the problem was that there may not have been enough evidence of the CEO's involvement in the fraud as of May 1, 2020 to trigger a cause termination for that reason. But fortunately for the Company there was also another prong in the cause definition, "willful failure, disregard, or refusal to follow directions from the board of directors." One surmises that this is the contractual "prong" relied upon to terminate the CEO, with the disclosure on May 1, 2020 carefully constructed not to directly state that the CEO was being terminated for his involvement in the multi-year financial fraud.[4] By May 21, 2020, after the investigation proceeded, the Company affirmatively stated in its disclosure that it had discovered multi-year fraud but at that point, the Company had already terminated the executive for inconsistent activity and lack of cooperation stated above.

The recent Akazoo public filing is an interesting example of a relatively rare public disclosure of a CEO "cause" termination, and it evidences the value of having a cause definition that includes additional "prongs" (such as a willful refusal to follow Board directives) that can be used as an internal investigation of fraud unfolds. Continuing shareholder litigation focusing on executive compensation will pressure Boards to consider "cause" terminations if circumstances warrant, but as the Akazoo disclosure evidences, the exact "cause" trigger and its related public disclosure will also require attention and care.

One final note-a recent case involving Exide Technologies ("Exide") serves as a cautionary counter-point to the careful approach taken in the Akazoo case. In late 2018, Exide terminated its CEO and at the time he was told he was being terminated "obviously without cause" and presented with a term sheet that referenced his severance payments. In February, 2019, as the separation documentation was being finalized, the now former CEO was advised that his termination had been "reclassified" to a cause termination. The asserted grounds for cause was that the former CEO had failed to apprise the Board about the interest of a Chinese buyer in acquiring an idle factory and had failed to pursue the sale (allegedly he had "dropped the ball"), when Exide was in a liquidity crisis and could have benefited from the sale proceeds. As a result, Exide viewed his conduct as constituting "gross negligence" (and cause) under Delaware law.

The former CEO took Exide to arbitration and prevailed in an award rendered in January 2020, with the arbitrator finding that the conduct in question did not meet the Delaware cause standard for "gross negligence,' in that it did not show "reckless indifference to or deliberate disregard of the whole body of stockholders, or actions which are without the bounds of reason." Instead, the

arbitrator reviewed the circumstances and identified numerous factors that mitigated against finding for Exide (the Chinese buyer was equivocal and sent mixed messages about purchasing the factory, the Board had expressed reluctance to sell the factory to a competitor, the Board had establish other priorities for the CEO and the “reclassification” appeared contrived and pressured by creditors of Exide).

Not everything works out in the end. In May 2020 Exide filed for bankruptcy under Chapter 11, which turned the victorious former CEO into an unsecured creditor, with an arbitration award that may be worth very little in bankruptcy.

Proskauer Summer associate, Morgan Peterson contributed to this blog

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[1] *Shabbouei v. Potdevin*, 2020 WL 1609177 (Del. Ch. Apr. 2, 2020) (court rejected the plaintiff’s claim and held that the directors acted reasonably in their decisions to separate the executive other than for cause).

[2] Akazoo was a foreign private issuer, with its stock traded on NASDQ. However, in June, 2020, NASDAQ announced the delisting of the Company from the exchange.

[3] Because Akazoo was a foreign private issuer, it used a Form 6-K, rather than a Form 8-K.

[4] There have been other examples of senior executives being terminated for cause related to their failure to cooperate with reasonable investigative demands in connection with a company’s investigation of wrongdoing.

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