2500, 20 Queen Street West
Toronto, ON
Canada M5H 3S1
Tel. 416.595.8500
Fax. 416.595.8695
www.millerthomson.com

MILLER THOMSON LLP
Barristers & Solicitors, Patent & Trade-Mark Agents

TORONTO VANCOUVER CALGARY EDMONTON WATERLOO-WELLINGTON MARKHAM WHITEHORSE WASHINGTON, D.C.

Golden Parachutes, Treatment of Stock Options and Other Benefits on Termination: Handling the High Profile Termination

by John Sproat
and Adam Stephens
2003

TABLE OF CONTENTS

I. INTRODUCTION

This paper addresses a number of important topics related to the retention and compensation of senior executives (often corporate officers or directors) and their entitlement and possible claims when employment ends. The focus is on reviewing recent jurisprudence and offering practical advice.

II. GOLDEN PARACHUTES

2.1 Introduction

A "golden parachute" generally means a contractual provision that provides a generous entitlement to an executive in the event of termination. Some golden parachutes only apply in the event of termination while others can be accessed by the executive on the occurrence of an event such as a change in control.

The difficulty lies in distinguishing between a generous but justifiable package and one that is invalidated by statute or on common law principles. For example, a corporation that is for sale or in play may need to offer its CEO a substantial inducement to commit to remaining during a change in control and thereby maximize shareholder value. There is, however, a point at which a package, judged in all of the circumstances, is excessive and unenforceable.

In many respects the Board and the Executive have a common interest in ensuring that arrangements are enforceable. The admittedly somewhat vague dividing line, and the factors that will influence a Court, are discussed below.

2.2 Statutory Provision – Directors And Oppression Remedy

The Ontario Business Corporations Act (OBCA) and the *Canadian Business Corporations Act (CBCA)* have substantially the same terms.

Section 115(1) of the *OBCA* and section 102(1) of the *CBCA* is a basket-clause that gives directors the all-encompassing responsibility to manage or supervise the management of the business and affairs of the corporation. This responsibility can only be limited by a unanimous shareholder agreement.

Section 134 (*OBCA*) and Section 239 (*CBCA*) provide that a director and officer owes a duty of honesty and good faith to the corporation. In addition, in exercising their powers and discharging their duties, directors and officers are required to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

Section 132(1) (*OBCA*) and Section 120 *(CBCA)* require that a director or officer who is a party to a material contract disclose his or her interest to the corporation.

Section 246 (*OBCA*) and Section 239 *(CBCA)* allows a party to maintain an action in the name of the corporation against its directors or officers where it is alleged that they have breached their duty to the corporation.

Section 248 (*OBCA*) and Section 241 (*CBCA*) gives the court a very broad power to provide relief against corporate/director conduct that is oppressive, unfair or prejudicial or that unfairly disregards the interests of any security holder, creditor, director or officer of the corporation.

2.3 Fiduciary Obligations

In addition, there are common law duties imposed upon directors, officers and senior executives of corporations. These duties (codified as to directors and officers by the statutes referred to above) require individuals to act honestly and in good faith with a view to the best interests of the corporation; to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances and to avoid any conflict of interest.

2.4 How Much Is Too Much – The *Repap* Case

In *UPM-Kymmene Corp. v. UPM-Kymmene Miranichi Inc.* (2002), 19 C.C.E.L. (3d) 203, commonly referred to as the "Repap" case, the Ontario Superior Court of Justice reviewed the nature and extent of statutory and fiduciary obligations. Stephen Berg became the Chairman and a director of a company after orchestrating a change of control. He then entered into an exceedingly generous employment contract which included, among other things, a generous salary, a lengthy term of employment, an unprecedented bonus structure, a stock option grant, immediate pension credit of eight years and executive employee benefits. After only 18 months of employment, Berg claimed that his contract was worth \$27 million (US).

The Board considered the employment contract Berg proposed at two meetings. At the first meeting, the contract was contentious and the directors did not approve it. They decided that it would be prudent to retain an independent consultant to advise them. The Compensation Committee was asked to consider the matter further and to report back to the Board. Following the initial meeting, two directors resigned

At the second meeting, the Board of Directors was differently constituted. It approved the compensation agreement on the recommendation of the Compensation Committee, which was also differently constituted

The Trial Judge took exception to the manner in which this meeting was conducted. He concluded that Berg's employment contract was considered by the Board for only thirty minutes. During that time, there was a presentation but there were no questions or discussion. Comment on the contract was provided by only one member of the Board. In short, after insufficient consideration, the Board of Directors of Repap approved an incredible generous agreement.

There was immediate shareholder opposition to Mr. Berg's compensation agreement. Five months after the Board had approved the agreement, shareholders elected new directors, excluding Mr. Berg. As a result, he exercised his right to end his employment and claimed his contractual "golden parachute" which he valued at approximately $27 million (US).

The court made the following findings:

1. Mr. Berg breached his fiduciary duties to Repap because of the manner in which he negotiated and presented his agreement for approval.

2. The Compensation Committee and the Board of Directors of Repap failed to meet the statutory obligations to establish a prudent or reasonable process that led to a contract that was not fair and reasonable and that unfairly disregarded the interests of Repap's shareholders.

3. The contract was invalid and unenforceable as being made in breach of fiduciary and statutory obligations.

Measured against the statutory and fiduciary standards, the Court found that Mr. Berg's conduct fell well short of what was required of him. The Repap directors were not fully informed of "the real state of things". It was material to their judgment to know about the comments of management and prior Board members on his compensation package. It was also material to their judgment that the expert had not done any research, benchmarking or analysis of comparable companies as requested by the Board at the first meeting. The duty to disclose is an absolute obligation.

Disclosure of a director's interest is but the first step. Disclosure does not relieve the director of his duty to act honestly and in good faith with a view to the best interests of the corporation. The director must always place the interest of corporation ahead of his own.

The expert report did not compare the compensation given to senior executives in similar constituted companies. Moreover, the expert was not invited to the Board meeting to address her opinion and provide the Board with the opportunity to question the expert's findings.

The court found that there was no negotiation of Mr. Berg's employment contract. Moreover, the court found that Mr. Berg did not conduct himself in an upright manner, as he was required to do. He requested types and amounts of compensation that he knew or ought to have known were not in the best interest of Repap, a company, which he believed was " on the brink of bankruptcy".

The classic way that Boards protect themselves when conflicts arise is to retain independent legal and financial advisers and to establish independent or special directors committees. Although an adviser on compensation packages was retained by the Board, this was insufficient. A Board is entitled, indeed encouraged, to retain advisers, but this does not relieve directors of the obligation to exercise reasonable diligence. The directors did not engage in any kind of analysis. If they had done so, they would have realized that the compensation being negotiated by Mr. Berg was wholly inappropriate.

The 'business judgment rule' protects Boards and directors from those that might second guess their decisions. The court looks to see that the directors made a reasonable decision, not a perfect decision. However, directors are only protected to the extent that their actions actually evidence their business judgment. The business judgment rule cannot apply where a Board of Directors acts on the advice of a directors' committee that makes an uninformed recommendation. Such was the situation in this case.

In the result the Trial Judge set aside the employment contract entered into between Berg and Repap.

A similar finding was made in *Rooney v. Cree Lake Resources Corp.* (1998), 40 C.C.E.L. (2d) 96 (Ont. Gen. Div.). In this case, the plaintiff was one of three principal shareholders of the defendant corporation. He was employed as its president under a five-year management contract. In the event of termination or the election of a new board of directors, the contract entitled him to a severance payment equal to the balance of the payment he would receive for the five-year term. His term was terminated, and pursuant to the contract, his "golden parachute" severance entitlement was to be $235,000. An issue arose concerning the generosity of this "golden parachute" because the total assets of the corporation amounted to only $338,620.

Mr. Justice Dilks concluded that the "golden parachute" provision was not enforceable. The basis of this decision was his interpretation of the words "fair and reasonable" within section 132(7) of the *Ontario Business Corporations Act*. This provision states that if material contracts entered into between a corporation and a director are disclosed and are fair and reasonable then they are not void or voidable by mere virtue of the fact that the director stands to be well compensated.

The trial judge stated:

> In determining whether a particular contract is reasonable to the corporation, one must examine all the surrounding circumstances including the purpose of the agreement and its possible ramifications for the corporation. It need not be either fair or reasonable to the director. It is his fiduciary duty to the corporation which requires it to be reasonable and fair to the corporation

The trial judge went on to day:

> A contractual provision which could result in the payment of unearned compensation in a lump sum equal to 70% of Cree's

> assets, when there was no reasonable prospect of any sudden influx of capital or income, could not possibly be in Cree's best interests.

In the result, the contract was set aside.

2.5 Advising The Executive Or The Board

Executive and Board members have different perspectives. The Executive wants to realize the benefits that are negotiated and the Board wants to ensure that it has met its obligations to the company and its statutory duties. The common interest that both the Executive and Board share is in ensuring that any agreement entered into by the company is valid and binding.

The lessons that emerge from the *Repap* case and that would be generally applicable to situations in which executives are being given lucrative employment contracts are as follows:

(1) The Board and Executive should retain independent legal counsel as well as other experts in order to assist them in determining whether a contract is fair and reasonable.

(2) There must be full disclosure at the Board level. The Board should be informed about the background to the contract and the business basis upon which the terms of a contract are being recommended as making sense.

(3) Experts that are hired to assist the Board must be given full and accurate information and should be available to answer any questions of the Board

(4) The Board should analyze and evaluate the expert's opinion and not accept it blindly.

III. STOCK OPTIONS – ENTITLEMENT ON TERMINATION

3.1 Introduction

While the focus of this paper is on stock options, similar arguments and issues can arise in relation to other types of benefit plans, ranging from bonuses to pensions, which purport to end on or shortly after the date of termination.

To put this discussion in context, in the absence of an express agreement, a Court will imply a contractual term to the effect that the employer is only entitled to terminate employment for just cause or on reasonable advance notice. (For these purposes we are ignoring terminations for "just cause".) The reasonable notice period can range up to 24 months and in unusual cases beyond, for senior, long-service executives.

In awarding damages in a wrongful dismissal action, the fundamental premise is to put the executive in the position the executive would have been in had employment continued to the end of the reasonable notice period.

Most stock option and other benefit plans contain simple provisions indicating that benefits cease on "termination". The trend, particularly of more recent cases in Ontario, is to construe this language to contemplate a "termination" as permitted by the contract (ie.) a termination which takes place at the end of a reasonable period of notice. Put differently, the Courts have said that employers cannot breach the employment contract by terminating without advance notice and then rely upon the earlier termination date to limit the entitlement of the employee to compensation for benefits.

3.2 Recent Cases

In *Brock* v. *Mathews Group Limited* (1991), 34 C.C.E.L. 50, the Court of Appeal considered a situation where an executive had been wrongfully terminated without notice. A trial judge had determined that a notice period of 12 months would be appropriate.

The Stock Option Plan provided that "<u>in the event of the employee ceasing to be an employee</u>" the shares would be sold to the company at an agreed price. The Court gave these words their everyday meaning and held that one 'ceases' to be an employee on the date of termination, regardless of what notice period might be appropriate. Thus, Brock suffered no damage under the stock option plan by virtue of the wrongful dismissal without notice.

Recent decisions at the Court of Appeal, while not expressly overruling *Brock,* have essentially reached a contrary conclusion.

***Veer v. Dover Corp. (Canada) Ltd.*, (1999), 45 C.C.E.L. (2d) 183 (C.A.)**

Veer, a senior executive, was wrongfully dismissed in the sense that dismissal was without reasonable advance notice. At trial, the judge held that Veer's unexercised stock options could still be exercised during the 24 month reasonable notice period, after his actual dismissal on April 27, 1993. The basis for the trial decision was the wording of the stock option agreement which provided as follows:

> If the option holder's employment with the corporation ... is terminated for any reason ... whether such termination be voluntary or involuntary, without his having fully exercised his option, the option shall be cancelled and he shall have no further rights to exercise his option or any part thereof and all of his rights hereunder shall terminate as of the effective date of such termination.

The employer argued that the language of this clause ended Veer's option rights as of his dismissal on April 27, 1993, even if that dismissal was unlawful. In support of this view, it pointed to the inclusion of both "voluntary" and "involuntary" termination as triggering events under the stock option agreement.

The Court of Appeal disagreed with this submission. It held that "voluntary" in this context refers to a termination that is consensual or initiated by the employee, whereas "involuntary" termination is that initiated by the employer. In either case, the termination contemplated must mean termination according to law. Absent express language to the contrary, the Court refused to conclude that the parties intended that an unlawful termination would end the employee's option rights.

As a result of this reasoning, Veer was entitled to the 24 months reasonable notice period during which he could exercise the rights under the stock option. The Court stated:

> Absent language such as this, it seems to me that parties must be presumed to contemplate triggering action that complies with the law. ... I would conclude that the respondent's rights under these option agreements were alive until the end of the reasonable notice period required for his lawful termination.

***Gryba v. Moneta Porcupine Mines Ltd.*, [2000] 5 C.C.E.L. (3d) 43 (C.A.)**

Gryba was a member of the Moneta Board of Directors. He earned $84,000 a year in salary and had a benefit package that he valued at 30% of his salary. It included 260,000 stock options.

Gryba was dismissed on June 20, 1995 following an Annual Shareholders' meeting held on that day. Dissatisfied shareholders considered that the administrative costs of the company were too high and recommended the termination of all employees.

Gryba did not exercise his stock options during the 30 days after his dismissal because there was no financial benefit in doing so. Gryba's option plan stated:

> If an optionee ... is removed from office as a director or becomes disqualified from being a director by law, any option or the unexercised portion thereof granted to such optionee shall terminate forthwith. ... If an optionee ceases to be a director other than by reason of death, removal or disqualification, any option or unexercised portion thereof held by such optionee at the effective date thereof may be exercised in whole or in part for a period of thirty (30) days thereafter.

With respect to this stock option plan, the trial judge held"

> While the plan does provide that a person in Mr. Gryba's position would have 30 days after his termination to exercise his options, this interpretation does not determine his claim for damages. An employee dismissed without notice is entitled to damages for the amounts he would have received from employment had he been given proper notice and allowed to work through his notice period. Had Mr. Gryba been given proper notice, he would have had several months in which to exercise his stock options, not just the 30 days following June 20, 1995.

The trial judge concluded that the respondent was entitled to $62,400 for the loss of profit on his stock options. The majority of the Court of Appeal agreed with the trial judge. They differentiated the wording of the stock option plan from the situation in *Brock* stating:

> While the plan speaks of the optionee 'ceasing to be employed' ... here the date for the exercise of stock options is 30 days following the effective date of termination. The effective date of termination would include the notice period. The wording of the stock option plan in this case can be read as contemplating a lawful notice of

termination and the effective date of the cessation of employment is the end of the notice period.

3.3 Practical Advice

Parties are generally free to contract on whatever terms are agreed, and, therefore, it should be open to employers to avoid the result in the *Veer* and *Gryba* cases by having language that is absolutely clear that a particular benefit ends on the last day of active employment and regardless of whether the employee was terminated with or without cause or with or without notice. In this regard it would also be helpful, if accurate in the circumstances, to refer to the fact that the particular benefit is being provided in addition to the basic compensation package and to provide an additional incentive to future performance so long as the individual is actively employed.

IV. HANDLING THE HIGH PROFILE TERMINATION

4.1 Introduction

A termination usually becomes 'high profile" due to a combination of the individual involved and the circumstances surrounding the termination. If not handled properly a high profile termination can expose the corporation to damages which are separate from, and in addition to, breach of contract damages.

As discussed in detail below, the key is to control the process leading up to, and following, the termination. In particular, it is essential to plan and control the flow of information.

4.2 *Clitheroe* – A Case In Point

Few cases are more high profile than that of Eleanor Clitheroe against Hydro One and its Chair Glen Wright. You may recall hearing about the facts that gave rise to this lawsuit because they caused quite a sensation when they became public.

Clitheroe has an impressive background. She has multiple law degrees and an MBA. Prior to getting hired by Ontario Hydro, later Hydro One, she held senior positions in the private and public sector. She worked for the CIBC, rising to the position of Vice-President of Corporate Finance, and for the province of Ontario, first as the Assistant Deputy Minister of Treasury and then as the Deputy Minister of Finance, On November 1, 1993, Clitheroe became employed by Ontario Hydro as its Chief Financial Officer. In April, 1999, Ontario Hydro was partitioned into five successor companies and Clitheroe was promoted to Chief Executive Officer of the company. Clitheroe made over $2.2 million in 2001.

Clitheroe was fired from her job on July 19, 2002. In her Statement of Claim she alleges that Glen Wright, convened a press conference to announce particulars of just cause. Clitheroe alleges that expressly or by implication she was defamed by statements that she used credit cards contrary to company policy, inappropriately obtained club memberships at the company's expense and used Hydro One money to renovate her home and generally showed a lack of judgment and care in using corporate funds.

Clitheroe now claims damages of $10,000,000 for defamation against Hydro One and Wright. While the law of defamation is quite complex, and beyond the scope of this paper, a few basic points can be made.

A defamatory statement is one that, in effect, would cause a reasonable person to think less of the character or reputation of the person defamed. The truth of the statement is generally a defence.

The law provides what is called a "qualified privilege" when a statement is made which, although defamatory, is made in good faith to a person who has a legitimate interest in receiving the information. For example, a Human Resources professional might form the opinion that an employee was addicted to illegal drugs. If a Human Resources professional made this statement to management personnel in the context of either attempting to verify the facts or assist the individual, it would be an occasion of qualified privilege. Thus, assuming that the individual was not a drug addict and found out about the statements, he or she would not succeed in a claim for defamation. In contrast, however, if the Human Resources professional made exactly the same statement to individuals who had no legitimate interest in receiving the information, such as employees who had no responsibility for or contact with the individual or persons outside the company, it would not be an occasion of qualified privilege and a defamation claim could succeed.

In the case of a high profile termination there obviously has to be consultation within the senior management as to the facts and reasons for the termination. In many cases, as a practical matter, there would need to be some communication with senior management as to the reason for the termination. All of these may be protected by qualified privilege. While each case will vary on the facts, however, there is no doubt that the risk of a successful defamation action, and a substantial award, increases as the number of individuals within the corporation, and third parties, are made aware of the defamatory allegations.

Further, an "absolute privilege" attaches to Court documents and the fair reporting of what is contained in them. Thus, if there is an employer side to a termination which it is eager to tell, it is best to include it in a Statement of Defence which can be the subject of any published report.

4.3 Exposure To Damages

The an "absolute privilege" attaches to Court documents and the fair reporting of what is contained in them. Thus, if there is an employer side to a termination which it is eager to tell, it is best to include it in a Statement of Defence which can be the subject of any published report.

4.4 Practical Advice

This is definitely an area in which "an ounce of prevention is worth a pound of cure". A well planned and executed termination will save money and limit exposure.

An essential feature of the plan is to control and limit the dissemination of information. Only designated individuals should comment on the fact of and the reasons for termination. Further, sensitive information should only be communicated to persons with a "need to know".

Particular attention should be paid to the potential reach of email communications. I am aware of one case in which the plaintiff alleged that unflattering information was communicated to tens of thousands by email.