Company to director: 'You're fired!'

Most seasoned CEOs, chairmen, or private company owners don't hesitate to fire an employee who simply does not fit, yet they can be hesitant to ask a director to step down. Making such a move is fraught with sensitive considerations and requires great finesse. **BY DENNIS CAGAN**

HOW DO YOU FIRE A DIRECTOR? If you have been a fan of Donald Trump's TV show, "The Apprentice," you know that you just have to say, "You're fired!" While that might be just fine for The Donald, and for firing an employee, for some reason firing a board member can often be much more intimidating.

Perhaps this is because, unlike a subordinate, many directors are often more senior and successful in their career than the company CEO. They are likely to be highly respected leaders in their field, which may be why they were invited to join the board in the first place. Regardless, all directors serve at the pleasure of the owners of the company, whether that means public shareholders, private owners, family members, a private equity group, or one individual.

Allow me to start by commenting on the reasons why you could, would or should fire a director. These days, for any company, there are a multitude of federal and state-by-state laws and regulations as to why you may or may not terminate an employee. Issues must be carefully documented in order to insure that you are in compliance with a myriad of rules governing employment.

Directors are rarely employees but, rather typically, are the elected representatives of the voting shareholders. As such, no justification, reason, or transgression is required to justify termination. It may be with or without cause, which really only affects severance issues that may be part of the corporate charter. The shareholders (read, owners) may terminate a director's service at will, only based on the timing stipulated in the company charter or articles of incorporation, with proper notifications, board and shareholder votes, and required regulatory filings. The termination vote would usually be at a regularly scheduled, or specially called, shareholders meeting. In a private or closely held company this can be called most any time by the majority ownership. The board can recommend this, or controlling shareholders can demand this based on the company's terms of incorporation. No reason need be given, although of course one usually is.

Private vs public

The differences between private and public board terminations are primarily in matters of the details of incorporation, including the state regulations, those associated with the SEC and listing exchanges (if public), and of course the increased sensitivity to public relations due to the effect of material events on the stock. Under all circumstances, whether the company is private or public, corporate counsel should provide appropriate advice in advance of any actions.

In a privately owned firm the process may be simpler, although the board still should at least discuss the above considerations. In this case the

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Director firings: War stories

Sometimes the firing of a director can be sad, humorous, and strange, all at the same time. Here are several such cases that I have been involved in.

• ***You're Out . . . Oops, Maybe Not:*** In the 1990s I was on the board of a private Internet company. There were seven directors: the founder/CEO (who directly and indirectly voted a majority of the stock); a friend of mine who was chairman and had recruited me; a high-level tech executive who represented his company as a strategic investor; three other stellar execs that I personally knew and recruited to join this board; and me.

One day in the midst of a regularly scheduled board meeting, with no warning, the CEO asked three of us, including the chairman, to resign. He simply said that he did not want us on the board anymore. We knew that it was a result of a difference of opinion on certain strategic issues. Having majority control he called the shots. The remaining three directors had no choice. He asked the three of us to step out of the room while the board discussed our termination.

When we re-entered the meeting the strategic investor told us that there was a snag. The board would not confirm the founder as chairman, and none of the other three would assume the role. Therefore, the founder must retain one of the three of us as chairman. The CEO did not select me, or the previous chairman. He selected the colleague that I had recruited (who had actually previously been CEO of one of the fastest companies to ever go from zero to public on the NYSE), who promptly then quipped, "This is the strangest board meeting I have ever been in. One minute I'm being fired, and the next I'm the darn chairman!"

• ***A Founder's Dilemma:*** I was once on the board of a healthcare technology company that I had originally conceptualized and was the seed investor. I even recruited the founder to leave the company he previously founded, which was then public. (He was no longer its CEO.)

Things progressed well with him as the CEO of this new firm. We soon raised venture capital, and the CEO got pressured by the new investors to add a director of their choice. All of the other outside directors had seats tied to their investment; I did not. Also on the board was a nominal co-founder. As the VP engineering he was a terrific technology manager but a poor director. He never spoke a word outside of his specific presentation on the progress of the product.

Given that a new class of preferred institutional investors were making a move to consolidate their control of the board, and given that in the future good governance would dictate eliminating the VP from the board anyway (as a second employee inside director), the best governance decision would have been to keep me (his chosen outside director) and remove the VP, but he did not. He chose to keep the weaker and vulnerable director, and keep 'harmony' with his investors, which can come back to haunt a CEO sometimes.

'This is the strangest board meeting I have ever been in. One minute I'm being fired, and the next I'm the darn chairman!'

He 'fired' me by simply saying that he wanted me to resign. He gave me the reason, but there was little discussion. He kept me on the advisory board for a while and continues some vesting of options.

• ***A Tale of Two Founders:*** Entrepreneurs, who succeed in starting companies, and securing outside investors, often face a challenge when their firm grows and, in the investors' opinion, the founder's skills are no longer up to the requirements of their current position. This scenario is often profiled in the business press. Here are two such tales.

Lance founded his firm with a partner. He was the business brain and his partner was the technical talent. The company had about nine different rounds of venture capital investment. There were almost 20 different VCs involved. The board of nine was Lance, seven VCs, and me. Over the course of about 10 years the board fired Lance as CEO three times. Each time he reverted to chairman of the board. A replacement CEO was brought in. Lance still worked hard and constructively on business development and strategic alliances. Twice the new CEOs did not work out, and twice Lance was brought back as CEO. Lance stepped up. The third time the replacement CEO succeeded in taking the company public and all were rewarded accordingly.

Sal founded his firm alone. He recruited a good team, developed their product, and got traction with some customers. The company then attracted term sheets from two pairs of VCs. He selected the pair that I felt would be the less forgiving under pressure. He found out what that meant. Things were not going well at one point. The board 'promoted' Sal to chairman and relieved him of his CEO duties. He remained active in a business development role; however, his actions proved very disruptive to operations and he did not cooperate well with the new CEO. He frequently interfered with both sales and operations employees. After being reprimanded a few times, the board had no choice but to terminate him completely. The company was ultimately sold, but failed to return anything to shareholders.

• ***I May Ask* You *to Resign:*** With a small, private or early-stage company, when it starts to grow or mature, it is often advisable to 'upgrade' a director to someone with more experience or stature. This is a common occurrence.

I recently recruited a C-level executive from a $14 billion technology company to join the board of a small but profitable software development firm. In the process the executive said to me, "Our company policy will only allow me to sit on one outside board. Why should it be yours?" After a moment's pause my response was, "Do you have any other offers?" He replied no. I then said, "If you join ours now, you can always resign if something else comes along. In the meantime we can work together and learn from each other. But . . . if I ever have the chance to get your CEO on this board, I will be asking *you* to resign!" He joined and is a tremendous asset.

— Dennis Cagan

initial discussions about terminating a board member can be initiated by a director, senior executive, or, in fact, any shareholder. The more closely held the ownership, the less complicated the process of gaining appropriate consensus. When determining a course of action, the person initiating the move to terminate a director should consider the composition and personalities of the board. If there were a clearly dominant shareholder then I would recommend approaching that person first with concerns. If there is a clearly dominate personality on the board — chairman or not — I would recommend

Removal of directors of a Delaware corporation

By Sheldon K. Rennie

The authority to "fire" a director of a Delaware corporation is possessed solely by shareholders of the corporation. Unlike some other states, directors of a Delaware corporation can only be removed by the decision of the majority of shareholders entitled to vote. In other words, a director cannot be removed by his or her fellow directors. Indeed, Delaware General Corporation Law (DGCL) section 141(k) makes it clear that corporate directors may be removed with or without cause by a vote of the majority of the shareholders.

Sheldon Rennie: A director cannot be removed by his or her fellow directors.

Delaware case law: *Kurtz v. Holbrook*

While the inability of a director to remove another director from his or her position has been well established in Delaware, the rule was reiterated by the Delaware Court of Chancery in the case of *Kurtz v. Holbrook*, C.A. No. 5019-VCL (Del. Ch. Feb. 9, 2010). In *Kurtz,* the court faced the issue of first impression of whether a proposed bylaw amendment that purported to reduce the size of the board to three, in order to remove sitting directors between annual meetings, violated DGCL.

The court struck down the bylaw as a violation of sections 141 (b) and (k) of the DGCL which require, respectively, that (i) a director shall hold office until the director's successor is elected and qualified or until the director resigns or is removed, and (ii) any such removal shall be effected by the shareholders of that corporation.

Specifically, addressing the term of a sitting director, section 141(b) of the DGCL provides in relevant part, "Each director shall hold office until such director's successor is elected and qualified or until such director's earlier resignation or removal." With respect to the removal of a director, section 141(k) provides in pertinent part, "Any director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors." The language of section 141(k) makes it clear that only shareholders, and not directors, can remove a director.

The Court of Chancery in *Kurtz* struck down the proposed bylaw that attempted to reduce the size of the board because of its potential for directors to remove other directors. DGCL section 109(a) allows directors to amend or repeal bylaws, and if a bylaw amendment reducing the size of a board could eliminate sitting directors, then directors suddenly would have the power to remove other directors by simply reducing the size of the board.

The court noted: "For 89 years, Delaware law has barred directors from removing other directors…. I do not believe the DGCL contemplates a bylaw amendment could overturn this rule." (See also Robert Pennington, *Pennington on Delaware Corporations,* 117 [1925] — "A director being an officer chosen by the stockholders cannot be removed by his fellow directors.")

Removal for cause

Shareholders may remove a director of a Delaware corporation generally with or without cause. When a director engages in illegal activity, fraud, or some other wrongdoing, the shareholders of the company can remove that director for cause. Notably, even though a director may generally be removed with or without cause by the company's shareholders, when the director is part of a staggered board (one where there are different classes of directors that are elected in different years) or a classified board (one where the different classes of stock are entitled to elect different directors), that director may be removed only for cause.

Other states and circumstances

Some states expressly permit removal of directors by other directors under certain circumstances:

- *New York:* The certificate of incorporation or the specific provisions of a bylaw adopted by the shareholders may provide for such removal by action of the board, except in the case of any director elected by cumulative voting, or by the holders of the shares of any class or series, or holders of bonds, voting as a class, when so entitled by the provisions of the certificate of incorporation.
- *Massachusetts:* Any director and any officer elected by the stockholders may be removed from his office for cause by a vote of a majority of the directors then in office.
- *Minnesota and North Dakota:* Directors may remove other directors, with or without cause, if the director was appointed by the board to fill a vacancy, the members with voting rights have not elected directors in the interval between the time of appointment to fill a vacancy and the time of removal, and a majority of the remaining directors approve the removal.

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them as the next logical choice. It is more complicated if the director in question is the/a founder, or substantial shareholder, or plays an active and important role in managing the company. This requires somewhat more finesse.

This is usually encountered in a company that has obtained institutional capital, most likely venture capital. In this situation it is not uncommon for the investors to have acquired voting control through one or more preferred funding rounds. When these investors feel that it is not in the best interest of the company for the founder to continue in their current role, they may seek to oust them completely from the company. It is typical for the founder's role to be diminished over time, with their board seat being the last step. If the investors continue to see a founder's participation as disruptive or divisive, they will attempt to eliminate their directorship as well.

It is preferable to try reason and negotiation in arriving at the terms of departure, doing it honorably and professionally. This of course assumes that both parties put the value of the enterprise above their own personal agendas — e.g., exercising their fiduciary responsibilities. However, these actions can turn emotional and contentious quickly. At that point only voting control and existing corporate documentation prevail.

Shoot straight

Since firing a director can easily end in recrimination and even lawsuits, I recommend great care be taken. The following actions may achieve a satisfactory resolution:

• Have a candid discussion with the individual, explaining the issues and how the decision maker(s) feel about them, noting perhaps "Why would you want to stay on the board under the circumstances."

• Coax them to resign — for the sake of their reputation and the best interests of the organization.

• Be prepared to offer some incentives to ease the move, like some accelerated vesting on unvested stock options or the continuation of some benefits (if they are currently receiving any)… or even just a favorable press release.

• Agree to a mutual release and confidentiality agreement.

• If the timing permits, you may want to ask for their resignation as part of a broader adjustment/announcement such as a new financing, new investor, 'upgrading' the board with a new member, reducing board size, or other reasonable trigger.

It is always worth remembering that a board director is not a lifetime position.

Be prepared

In my experience, being involved at the board level with an interesting company can be rewarding and educational. However, it is always worth remembering that a board director is not a lifetime position. Be prepared to roll with the circumstances. This may mean that you are the automobile's windshield — the one needing to diplomatically ease another director out — or the bug, the one being unceremoniously ousted. Good advice to everyone involved is to keep your professionalism and sense of humor. ■

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