Firing Executives for Cause

Recent Case Offers Lessons

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Much can turn on whether an executive is fired "for Cause". If Cause exists, an executive's employment contract almost always provides that the executive shall receive no severance benefits – typically post-termination salary and health continuation and, less commonly, accelerated vesting of stock. In addition, stock agreements may provide that, when Cause exists, an executive's stock is subject to repurchase by the Company at a minimal price.

Because the stakes are so high, employment lawyers tend to fight the hardest during contract negotiations on termination and severance provisions and the definitions of Cause and "Good Reason" (the corollary that allows executives to leave, but still receive severance benefits). Companies want Cause to be defined as broadly as possible and often include subjective performance standards, *e.g.* "the Executive's failure to perform the duties of his/her position as determined by the Board." Executives want Cause to be narrow and objective, *e.g.* "Executive's conviction of a felony." Executives also want the company to provide notice of the grounds for Cause with sufficient detail, and an opportunity to "cure" or correct the issue prior to termination.

In practice, companies rarely fire executives for Cause and deny all severance benefits. Even when a company is dissatisfied with an executive's performance or conduct, it typically will negotiate reduced severance benefits in a separation agreement. Doing so saves the Company from the uncertainty and expense of litigation over Cause, and the public disclosure of potentially damaging internal information.

A recent decision by the Massachusetts Supreme Judicial Court ("SJC") in *Eric Balles v. Babcock Power, Inc.* illustrates how a dispute over Cause can play out in court and offers contract drafting lessons for corporate and employment lawyers who represent executives and companies.

What happened?

Babcock Power (the "Company") fired Eric Balles (the "Executive") "for Cause" after it discovered that he was having an extramarital affair with a young female subordinate. The Company's board of directors (the "Board") then invoked the termination provisions of the Executive's stockholders' and employment agreements to repurchase his stock at a minimal price, to withhold almost $900,000 in dividends, and to refuse to pay the Executive any severance. Years of litigation followed.

The trial judge ruled in favor of the Executive in part by concluding that he was not fired "for cause" as defined in the stockholders' agreement and was not given an opportunity to correct the breach of his obligation of loyalty to the Company. The trial court ruled that the Executive therefore was entitled to the return of his stock and payment of all dividends as if he had owned the stock continuously. The Company appealed to the SJC, which upheld the trial judge's decision.

How was "Cause" defined?

"Cause" was defined in the stockholders' agreement in relevant part as: (a) fraud, embezzlement

or gross insubordination; or (b) willful and material breach of or willful failure or refusal to perform and discharge the Executive's duties, responsibilities or obligations to the Company that is not corrected within thirty (30) days following written notice thereof to the Executive by the Company. The agreement provided that only the Board could determine whether "Cause" existed.

What was the Company's argument?

The Company argued that the Executive's conduct constituted "fraud" and "gross insubordination" under clause (a) for three reasons: (1) his intentional submission of false expense reports for the purpose of concealing his affair with the female subordinate was fraudulent; (2) his outspoken support for the female subordinate constituted fraud because she lacked fitness for employment; (3) his conduct during his relationship with the female subordinate constituted gross insubordination.

Moreover, the Company argued that, because the Executive's breach could not be corrected, as required by clause (b) of the Cause definition, *i.e.* he could not undo the affair, it was excused from offering him an opportunity to do so. Finally, the Company argued that the trial judge applied the wrong "standard of review" in reversing the Company's determination that Cause existed. In legalese, the trial judge reviewed the Company's decision "de novo," *i.e.* afresh or anew. The Company contended that the agreement's provision that only the Board could determine whether Cause existed meant that the trial judge should have deferred to the Company's determination and only reversed it if the decision was "arbitrary, capricious, or made in bad faith."

How did the SJC rule on appeal?

First, the SJC agreed with the trial judge that the Executive's conduct did not constitute fraud or gross insubordination because he lacked any fraudulent intent with respect to expense reports or his support of the subordinate's job performance. His affair, moreover, did not constitute "gross insubordination" because he had never disobeyed any direct order.

Second, the SJC rejected the Company's argument that it did not have to provide the Executive with an opportunity to correct his conduct because it relied on an implausible interpretation of the contract and because the Company had not shown that his breach was "intrinsically incapable of correction." By asserting that correction required actually undoing the breach, rather than remedying its effects, the Company in effect was reading the correction provision out of Cause definition. Rather, the correction envisioned by the contract, reasonably construed, could be to remedy the adverse effects from the breach or nonperformance when performance itself could not be adequate or possible. For example, the Executive could have compensated the Company for the lost value of his services during the period he was in breach of his obligations and/or agreed to pay the costs of defending the Company against any sexual harassment lawsuit brought by the female subordinate.

Third, the SJC found that the contract language highlighted by the Company, "only the Board could determine whether Cause exists", did not dictate the standard of review a court would use for resolving disputes over that determination. Therefore, "de novo" review by the trial judge was appropriate.

What lessons are offered by the SJC's decision?

The SJC's decision in *Babcock Power* offers the following important lessons for executives, companies and their respective corporate and employment attorneys:

1. Boards should be careful not to try to cram specific facts into an ill-fitting Cause definition. In hindsight, among other things, one may criticize the Company's efforts to characterize the Executive's affair as gross insubordination and fraud.
2. Similarly, prior to firing for Cause, Boards should carefully evaluate the effects of the

executive's misconduct or breach to assess whether such effects have caused harm to the company or are reasonably likely to cause harm in the future, and whether such harm can be corrected or mitigated.

3. Company counsel should negotiate for broader definitions of Cause. Had the Executive's agreements defined Cause as including conduct that violates the Company's policies against sexual or other harassment or inappropriate workplace relationships, the Company may have had a more suitable basis for invoking Cause.
4. Counsel for executives and companies can try to predetermine how a court will review the parties' disagreement over whether Cause exists by drafting clear language addressing the standard for judicial review. The SJC in *Babcock Power* "assumed *without deciding* that parties to a private agreement may contract for a specific standard of judicial review." However, the SJC cited cases where the language used was not fatally ambiguous. For example, instead of stating in the agreement that "only the Board could determine whether 'Cause' existed, it could have stated: "The Board's determination of Cause may only be reviewed by a court or arbitrator for arbitrariness or capriciousness."

The full text of the SJC's decision in *Babcock Power* is available at:

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