NOVEL THEORIES UNDERPIN THE CHARGES AGAINST MCDONALD'S AND ITS FORMER CEO: FOOD FOR THOUGHT

It is not common for SEC enforcement actions in respect of misleading public disclosure to be reported in the non-financial trade press. Two days ago, the SEC issued an Order reflecting settled charges against former McDonald's Corporation CEO Stephen Easterbrook for making false and misleading statements about the circumstances leading to his termination by McDonald's and against McDonald's for deficient public disclosures related to the separation agreement that it entered into with the former CEO. This Order has generated far more media attention. It is also unusual for SEC disclosure actions to trigger a Statement in opposition to the enforcement order.

The Order

According to the SEC, McDonald's terminated Easterbrook in 2019 for exercising "poor judgment" and engaging "in an inappropriate personal relationship" with an employee in violation of company policy. The separation agreement reflected a termination without cause, which allowed the former CEO to retain equity compensation that would have been forfeited had the termination been for cause (including on account of a violation of company policy). The SEC concluded that, in reaching this decision, McDonald's had exercised discretion that was not publicly disclosed. Specifically, the proxy statement disclosed that McDonald's had terminated Easterbrook "without cause" and described the terms of the separation agreement, including Easterbrook's right to certain unvested equity-based compensation.[1]

The proxy statement did not disclose that McDonald's had exercised discretion in terminating Easterbrook without cause and did not disclose that, absent the exercise of discretion in treating the termination as without cause, Easterbrook would have forfeited unvested options and performance-based restricted stock units (PBRUs). Accordingly, the SEC found McDonald's to have violated Section 14(a) and Rule 14a-3, based on failures to provide disclosures required by S-K Item 402(b) and 402(j)(5).[2]

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[1] The SEC noted that, when additional facts came to light, McDonald's publicly stated that, had Easterbrook been candid during the earlier internal investigation, it would not have terminated him "without cause."

[2] Item 402(b) provides that the Compensation Discussion and Analysis "shall explain *all* material elements of the registrant's compensation of the named executive officers." (Emphasis added.) The instructions to Item 402(b) call for registrants to address "specific decisions that were made or steps that were taken that could affect a fair understanding of the named executive officer's compensation." A registrant is also required to disclose, "[w]ith respect to any contract, agreement, plan or arrangement, whether written or unwritten, that provides for payment(s) at, following, or in connection with any termination or change-in-control, the basis for selecting particular events as triggering payment (*e.g.*, the rationale for providing a single trigger for payment in the event of a change-in-control)."

Item 402(j)(5) requires disclosure of any "material factors" regarding a "contract, agreement, plan or arrangement . . . that provides for payment(s) to a named executive officer at, following, or in connection with any termination."

In light of McDonald's cooperation, including providing information not otherwise required to be produced in response to SEC staff requests and remedial measures (including recovering compensation from the former CEO), no financial penalty was imposed.

In 2020, McDonald's discovered that the former CEO had engaged in other undisclosed, improper relationships with additional employees.[3] The SEC took the view that Easterbrook "knew or was reckless in not knowing" that his failure to disclose these additional violations of company policy prior to his termination would influence McDonald's disclosures related to his continued employment and compensation. The SEC noted that, in the course of an interview with Easterbrook as part of McDonald's internal investigation, he was asked if he had ever engaged in a sexual relationship with any other employee, to which he had responded that he had not. His letter to employees and the related press release referred to a consensual relationship with "an" employee. Following his termination, the former CEO exercised a portion of his options and sold the underlying shares.

Based on the foregoing, the SEC found that Easterbrook had violated antifraud provisions of the 1933 Act (Section 17(a) – by reason of the option share sales) and 1934 Act (Section 10(b) and rule 10b-5, Section 13(a) and Rules 12b-20 and 13a-11 – by reason of the misstatements). The Director of Enforcement was quoted in the SEC press release announcing the Order as saying that, "[w]hen corporate officers corrupt internal processes to manage their personal reputations or line their own pockets, they breach their fundamental duties to shareholders … [, and] [b]y allegedly concealing the extent of his misconduct during the company's internal investigation, Easterbrook broke that trust with – and ultimately misled – shareholders."

The Dissent

In their statement explaining why they were unable to support the charges against McDonald's, Commissioners Peirce and Uyeda note that Item 402 (b) and (j)(5) are part of a principles-based disclosure regime based on the then new CD&A requirements. They also note that the enforcement action is one of first impression, and the action against McDonald's (the victim of deception cast as a "securities law violator") can be read to suggest that the underlying reasons for termination for cause/without cause need to be disclosed, which should be beyond the scope of the CD&A. They also view requiring the disclosure McDonald's failed to provide as falling outside "prevailing industry practice." The statement calls upon the SEC or the SEC staff to better articulate its/their views if the intention is to expand "a settled disclosure requirement."

Concluding Thoughts

This enforcement action should be seen in the context of the renewed focus by the SEC on executive compensation and clawbacks of incentive-based compensation based on erroneous financial reporting (*see* my previous briefing note regarding the October clawback rules for both "big R" restatements and "little r" restatements, available here). The clear trend is to

[3] McDonald's sued its former CEO in August 2020 and, in December 2021, reached a settlement that involved clawback of certain compensation and share sale proceeds, "which [Easterbrook] would have forfeited had he been truthful at the time of this termination and, as a result, been terminated for cause."

motivate companies to recover past pay in the context of deficient disclosure.[4] While the October clawback rules are triggered by financial statement restatements, the Order did not involve financial statement errors, but rather transparency around a termination of a named executive officer.

There are a few key takeaways from the Order.

From a corporate perspective, there is a prevailing emphasis on greater transparency around material compensation events subject to Form 8-K and/or proxy statement disclosure, in this case the exercise of discretion around the determination of "for cause"/"without cause" and that, absent the exercise of discretion, unvested options and PSRUs would have been forfeited.

What made this all actionable, were facts that only later were uncovered. The action against Easterbrook was predicated on the influence his failure to disclose other violations had on McDonald's disclosures. Or, is the SEC saying that, in any event, the company should have disclosed that, notwithstanding a violation of internal policy, a decision was made (exercising discretion) to treat the termination as "without cause."

In addition, while companies cannot prevent misconduct by their employees, even with reasonable compliance policies, cooperation once misconducted is uncovered can be tremendously beneficial.

From the former CEO's perspective, allegedly misleading statements around additional violations of company policy ultimately were deemed actionable (for causing the company initially to make materially false or misleading statements, and thereafter for selling option shares) in light of the nexus between those statements and the company's public descriptions of the actions it took. It is a tenuous and somewhat novel link, but one that the SEC was willing to make.

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[4] Last September, Deputy Attorney General Lisa Monaco issued a memorandum revising the Department of Justice's corporate criminal enforcement policies. The memorandum addressed, among other topics, the role of executive compensation in promoting corporate compliance through accountability and, where necessary, compensation clawbacks.