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Executive Pay: Shareholder Voting Rights Consultation

Response from the Employment Lawyers Association

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ELA Response

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INTRODUCTION

The Employment Lawyers Association ("ELA") is a non-political group of specialists in the field of employment law and includes those who represent employees and employers in the Courts and Employment Tribunals. It is therefore not ELA's role to comment on the political merits or otherwise of proposed legislation, rather to make observations from a legal standpoint. ELA's Legislative and Policy Committee is made up of both Barristers and Solicitors who meet regularly for a number of purposes including to consider and respond to proposed new legislation.

An ELA sub-committee responded to the initial consultation documents in November 2011. A new sub-committee was set up by the Legislative and Policy Committee of the ELA under the joint chairmanship of Alison Wetherfield of McDermott, Will & Emery and Paul Harrison of Baker & McKenzie to consider and comment on the Shareholder Voting Rights Consultation. Its report is set out below. A full list of the members of the sub-committee is annexed to the report.

The Government has invited views on a wide range of proposed changes. Our comments are divided according to the questions in the consultation paper discussion paper.

ELA intends only to answer certain of the questions posed, focussing on the practical experience and expertise of its members, who represent both plcs and directors.

3. The Government proposes that directors' service contracts and other arrangements should, if necessary, be amended to take account of the new requirement to seek shareholder approval of remuneration policy. What are the costs and benefits of this approach?

See responses to question 10.

9. The Government recognises that the circumstances under which a director leaves their post are complex and diverse and so invites feedback on the appropriate scope and breadth of the proposed legislative measures.

All plc director resignations, removals and retirements take place against the backdrop of the Listing rules (LR 9.6.11), the intense scrutiny of the press, and the constant legitimate commercial concern regarding the impact of bad news on plc share price, corporate reputation and the livelihood of all employees.

All plc directors of course accept that much of their professional lives will be played out on a public stage, but that does not remove their individual rights to and interest in privacy and reputation in their professional and non-professional lives.

While we understand the background to the Government’s proposals (individual cases which have attracted widespread criticism from shareholders and the public who have perceived “payment for failure” upon exit), ELA has **five main comments** regarding the effect of the resulting proposal “to

give shareholders a binding vote on any exit payment which exceeds the equivalent of one year's base salary"(paragraph 22) where "a director's contract has been terminated early and without due notice" (paragraph 23):

1. ELA believes that in practice the proposal will affect most departures, not only those where payment for failure is a legitimate issue, and may in practice simply set a default severance package

Given that:

(a) most UK plc directors have one year notice periods (and there is no proposal to change the current legislation on maximum length); and

(b) it is very likely that duties would be transitioned away from a plc director shortly after one party to the contract informs the other of their wish to bring it to an end; and

(c) a one year garden leave period is unlikely to be triggered in full for a plc director as it risks being challenged as in restraint of trade and is expensive (since it involves the payment of all contractual entitlements),

the overwhelming majority of departing plc directors will be "terminated early and without due notice", regardless of underlying reason for departure.

In some cases, this will be due to individual and/or corporate underperformance, but directors may also be asked to leave "early" for other reasons which do not imply underperformance e.g. joining a competitor, ill health, redundancy (following a take-over) or retirement. Equally, directors may be placed on garden leave for all or part of their notice period, in similar circumstances.

The proposal is therefore likely to affect most departures and to become a focus of most AGMs in any year in which a departure has taken place if such a vote is put to the shareholders. In ELA's view, it is actually very unlikely that a Board (unless compelled to do so by the terms of the director's contract) would risk such a distracting debate and vote if the business is not doing well – even though that may be for a variety of reasons which have no connection to the individual director's performance.

A 'one size fits all' approach may thus simply introduce a default cap on severance for all departing directors regardless of their individual performance or the circumstances of their departure. If so, this may be seen as an indirect re-setting of notice periods. This may encourage talented candidates to accept office/employment with non-plcs or companies listed in other jurisdictions instead of with UK plcs or to resist being promoted to the main board.

2. **ELA believes that the proposal will have a major impact on the ability of plcs to enter into confidential severance agreements which may be in the interest of all parties, including the shareholders**

It is in the interest of the plc that a departure at such a senior level is handled expeditiously and discreetly, given often inaccurate and unhelpful reporting of rumours, which can affect share price and morale. The obligation under the Listing Rules to make an announcement "as soon as possible" on the resignation, removal or retirement of a director (LR 9.6.11) makes it very important that the parties can reach agreement and achieve certainty in the termination arrangements at an early stage. Even though most plc contracts now have very clear provisions regarding payment and mitigation obligations upon the early termination of a director's contract, it is therefore unusual for such a departure to be based on a unilateral resignation or termination under contract.

Agreements which are concluded upon departure are seen as important for a number of reasons, including to secure confidentiality, new restrictive covenants where existing ones seem unenforceable or insufficiently strong to protect the plc's interests, and a waiver of all claims. The imposition of a cap above which shareholders must be involved will make it more difficult to negotiate such agreements with a departing plc director.

The inability to negotiate new or modified covenants, for which new consideration is required, could have a particularly significant impact on the plc. It could lead to more claims of constructive dismissal in the High Court where the enforceability of restrictive covenants is an issue. It could also lead to more claims involving inducement of breach by other plcs or companies.

Like all other employees, plc directors have the same statutory right to claim compensation in employment tribunals, and in cases such as discrimination and whistleblowing, uncapped compensation. ELA is concerned that effectively setting a benchmark for any departing director of the equivalent of one year's salary could have the unintended consequence of encouraging the filing of protective statutory (possibly illegitimate) claims by other departing directors who see it as a route to settlement amounts not subject to shareholder approval.

In addition, the need to seek shareholder approval of termination payments could require the Company to disclose sensitive personal information about a director's personal circumstances, such as their ill health, to shareholders in order to justify a termination package in excess of a year's base salary (where the director has not made a claim against the Company). This will be very unpopular with most directors in these circumstances. It also runs contrary to the generally accepted position that ill-health is a "good leaver" reason, rather than something which should be caught within proposals to avoid rewards for failure.

3. **ELA is concerned about the difficulties in valuation of the "equivalent of one year's base salary"**

The proposal is currently quite unclear regarding the approach to valuation of the equivalent of one year's base salary.

This is likely to be problematic in the very common circumstance in which the plc wishes the departing director to work for a period of time to transition duties and spend a period of time on garden leave (being kept out of the market) before any final payment of remaining notice in lieu.

Without clear guidance as to how to value benefits such as private medical insurance, directors and officers insurance, permanent health insurance (if in payment), the exact point at which the equivalent of one year's base salary" is met would be ambiguous.

Most plc directors also now have quite complex provisions regarding staggered payments while under notice, which factor in their duty to mitigate. Mechanisms such as phased payments and deferred remuneration on termination, which reflect good corporate governance, could become much more problematic and less attractive for companies to implement because it would be unclear exactly when the obligation to go to shareholders might accrue.

4. **ELA believes the proposal underestimates the extent to which payments in the year of departure may have been earned in prior years**

Good governance and the effect of the UK Corporate Governance Code and other guidance on corporate governance in plcs has resulted in a large part of directors' remuneration being paid as

variable compensation and often deferred over a period of time, in order to continue aligning shareholder interests with individual director careers.

The proposals envisage that deferred compensation could not be paid (to the extent that it exceeded the cap) "where vesting is subject to further performance testing or ongoing service" (para 123). We presume this is on the basis that such awards have not been earned, but in practice there are many types of incentive scheme.

For example,

(a) In some cases a bonus will be awarded solely to reflect performance in a particular year, but then deferred over a period of time and linked to ongoing employment (or at least to the director not resigning) to act as an aid to retention and/or to allow clawback if performance in the year in relation to which the bonus was awarded turns out to have been over-stated. In such schemes a director may be regarded as having earned his bonus and, if he is not resigning voluntarily, the retention aim of the award will also have been met.

(b) In other schemes, which are subject to ongoing performance testing, it may be that the award is partly to incentivise performance over the period of vesting and so the full award will not have been earned in the case of a departing director who has not served out the full vesting period, but he may have worked for most of the period (and not be underperforming). Acceleration of the awards or the removing of performance conditions in these circumstances could be regarded as a windfall. An award, however, of a pro-rata payment at the end of the performance period and subject to the performance criteria applied to other participants might properly be regarded as a payment for services provided, rather than in connection with termination of employment.

The proposals risk penalising directors who have earned bonuses or awards in these circumstances, in which incentive scheme rules might otherwise appropriately crystallise and pay out in full (or a pro-rata amount) upon exit, at least to a "good leaver". These may be very valuable to a director and if withheld may encourage a director to assert statutory claims. Main board directors would also be in a worse position than other participants, including other very senior executives who are not statutory directors of the main board (e.g. Group HR Director, Marketing Director).

5. **ELA notes that the proposal is UK-centric and may underestimate the number of relevant stakeholders**

The proposal assumes that English law is the only relevant law in issue and that the only relevant relationship is between the plc and the director. Increasing numbers of directors of UK listed multinationals have employment contracts governed by the law of other jurisdictions where they may be based and many plc directors are employed by other group companies. Some companies have dual structures and/or dual listings. Whether such other jurisdictions would accept a statutory veto by shareholders of another entity over payment of sums owed under another system of law by the actual employer is unknown.

In addition the source of some important payments to departing directors (for example permanent health insurance in payment) may be outside the corporate structure altogether.

Illustration of ELA's concerns:

To help the readers of these submissions and to illustrate ELA's concerns, we have prepared several scenarios, based on the actual experiences of various clients of ELA's members in the last few years.

If those experiences were to be repeated, they would be materially affected by these proposals if they were implemented.

(i) D is Chief Executive of A plc which has performed well in recent years and bonus targets for the Board have been met. Substantial long term incentives have been deferred and, though earned, vest over three years. After two years, market conditions have caused the share price to drop for reasons outside the control of the Board. The Chairman is under pressure to change the CEO. There are no performance issues but differences of opinion are starting to emerge over the best way forward.

- See concerns 1 and 4 above.

- D may be prejudiced by the new proposals because (a) he appears to have performed well, and (b) the proposals will apply to long term incentives which are earned but unvested. The LTIPs will already have been approved by the shareholders; either as part of the existing requirement for approval of LTIP schemes, or as part of the binding vote on remuneration policy (which the consultation intends to introduce). The new regime could therefore result in a requirement for LTIPs to be approved twice; or in the director being deprived of payments which have already been approved by shareholders.

(ii) D is Chief Executive of B plc and good at the job, but the newly appointed Chair wants to offer the job to someone else (who has a very high reputation and market profile which will appeal to shareholders) who has become available unexpectedly. The Chair wants to have a discussion with D about the possibility of hiring the other candidate but with D staying on in another role for a fixed period of about nine months during which the value of salary and benefits would be greater than one year's base salary.

- See concerns 1, 2 and 3 above.

- The new regime is intended to operate so that shareholder approval is sought after the contract has been terminated. Therefore, in this scenario, B plc would be unable to agree a package with D for him to work part of a shortened notice period; it would be unable to secure shareholder approval before it triggers D's notice period (and in fact before that notice period expires).

(iii) D is a director of C plc with years of success both before and after coming onto the main board. She has a very serious health problem which has affected D's attendance/commitment/performance and is on long term sick leave. C plc has a generous sick leave policy which would provide for more than the equivalent of one year's salary and private medical coverage while absent on maximum sick leave. C plc provides permanent health insurance which provides for continued payment of a proportion of salary until D recovers or reaches the age at which she can draw a pension. The payments are made direct by the insurance company if D ceases to be an employee.

- See concerns 1, 2, 3 and 5 above.

- It is very likely that any attempt to terminate D's contract without factoring in the full potential value of the sick leave and private medical coverage policy would result in a disability discrimination claim. The new regime would present a difficult decision to all involved parties – effectively forcing assertion of a discrimination claim in order to seek a confidential settlement agreement without shareholder knowledge of the disability issues – or agree a package to put to shareholders for approval which would necessarily require sharing some details which D understandably wishes to keep out of the press and from shareholders.

- If D's employment was terminated, would her PHI payments require shareholder approval? The insurer would be under a legal obligation to make the payments and C plc would not have a legal right to stop the payments.

- If the PHI payments depended on continuing employment and so the director was simply removed from the board but continued in employment so that PHI payments could continue then the position would depend on whether removal from the board of itself triggered the statutory limit on payments (or whether the statutory limit would only be triggered once D's employment terminated – or, as a third option, whether the statutory limit would apply at both stages, i.e., on termination of office and employment (as an anti-avoidance measure)). If the insurer then sought to buy out the obligation to make ongoing payments with a lump sum and so the employment terminated at that point, would shareholder approval then be required?

(iv) D is a female director of D plc who recently applied for the Chief Executive position and was not selected. D plc expects her to resign and has quietly found and offered future employment/office to a male external candidate who has flexibility regarding joining date. The Financial Times breaks the story of the offer late on a Friday and D plc has until Monday to ensure an agreed and dignified exit, facing an outraged response from D whose lawyer promptly identifies the situation as constructive dismissal (and hence giving his client the ability to leave immediately without restrictive covenants in place).

- See concerns 1 and 2 above.

- D plc will need to ensure that it honours D's contractual entitlements, if it wants to be able to argue that D remains bound by her restrictive covenants (despite her allegations). If her contractual entitlements exceed one year's base salary (when benefits etc are included) D plc will not be able to do this without seeking shareholder approval. Equally, it may need to offer D additional consideration above her contractual entitlements, in order to reinstate her covenants and settle the allegations of sex discrimination. Although the latter may not be caught within the new regime, the former presumably would be caught. Would D plc be free to apportion the elements of the payment which apply to the covenants and the discrimination claim, so as to avoid the need for shareholder approval? Or would this apportionment be subject to scrutiny and/or challenge by shareholders?

(v) D is Chief Executive of E plc and has taken the share price to new highs during a difficult market period. D's salary is modest in comparison to other elements of his package, including pension contributions - which D pushed for because earlier in his career elsewhere he made no pension provision and he is approaching 60 now. F plc takes over and merges the two businesses. It is clear that its Chief Executive, aged 45, is the preferred candidate as Chief Executive, even though, until his advocacy of the takeover, he was viewed as failing by its shareholders.

- See concerns 1, 2 and 4 above.

- D will be prejudiced by the new proposals because (a) he appears to have performed well, and (b) the cap on his termination payments will be lower than other directors, by virtue of his lower base salary. This scenario illustrates the problem with the new regime setting the cap by reference to base salary only. In doing so it acts as an incentive for companies to raise base salaries, in order to raise the cap below which they can make termination payments without shareholder approval.

- D is potentially redundant and may be a "good leaver" under E plc's incentive plans. However, without shareholder approval it appears that he will lose all awards under incentive plans which

had not yet vested (subject to the 12 month cap) even if very close to the end of the performance period and despite his good performance.

- D may seek to recover compensation for his losses by asserting a claim for age discrimination and may appear to have evidence to support his claim, based on the relative performance of the two candidates. As happens under the current regime, F plc would be forced to evaluate the strength of the claim and whether it could justify a bona fide settlement payment but the increased pressure on the Board to get this right will mean that it would be wise to seek shareholder approval in the event of any uncertainty. Even if F plc were prepared to seek shareholder approval to resolve any such uncertainty, however, D would be forced to issue proceedings within 3 months of termination to avoid his claim being time-barred.

(vi) D is Finance Director of G plc and underperforming. G plc wishes to remove him, but he has in depth knowledge of the strategy for a critical period in its development. It would be very damaging to G plc if D were to work for its main competitor. D has a 12 month notice period and a garden leave clause in his contract. Although his contract contains post termination restrictions, the contract was entered into some years ago and G plc is concerned that the non-competition covenant is not enforceable and/or does not adequately protect it given changes in its business since the contract was entered into. He has a benefits package including generous pension provision, health insurance, life assurance, permanent health insurance, D&O insurance. His employment can be terminated under a payment in lieu of notice clause (PILON) with payment of 12 months' base salary.

- See concerns 2 and 3 above.

- D's employment could be lawfully terminated with a payment of 12 months' base salary, without the need for shareholder approval. However, G plc could not pay an additional amount to secure enforceable restrictive covenants without shareholder approval. Shareholder approval could not be obtained before terminating D's employment and D would be unlikely to agree to a provisional payment for covenants, subject to shareholder approval as this might not be forthcoming. If he did, and shareholder approval was not forthcoming, the covenants would be likely to be void for total failure of consideration and he would be free to join the competitor.

- G plc could seek protection by putting D on garden leave. However, if it did not pay his benefits then (unless the contract removed benefits during garden leave) it would be in breach of contract and he could resign and claim constructive dismissal and would not be bound by any of the covenants. If it did continue to provide benefits, then when the value of his salary and benefits (which might be difficult to value) reached 12 months base salary, it would have to cease payments and D could resign and claim constructive dismissal (asserting that his covenants have fallen away and that he is free to join the competitor). He may be able to resign and claim constructive dismissal before this point on the basis of an anticipatory breach of contract.

10. The Government proposes that directors' service contracts and other arrangements should be amended to take account of the new requirement to seek shareholder approval for exit payments over one year's base salary. What are the costs and benefits of this approach?

ELA's view is that, regardless of the costs and benefits, it is very possible that plcs and their directors will not amend contracts in any way.

This is because consent would be required. Any agreed change and its cost will be reportable in the Directors' Remuneration Report, and although, if done promptly, this would not be subject to binding vote, it would still form part of the material to be put to shareholders for an advisory vote.

If the proposed change is to make existing severance payments above one year's base salary conditional upon a ratifying shareholder vote, this simply reflects what the law will provide at the time of any future departure. If the new legislation makes it clear that contractual entitlements which contravene either the binding vote on future remuneration or the new provisions on termination payments are void, there is no point in such a change to the contract (unless, for example, another system of law governs the contract).

If, however, the plc seeks any reduction of current severance packages which either are (or have the potential, depending on mitigation, to be) in excess of the threshold, the director is likely to require as consideration a considerable financial incentive. The value of this incentive is likely to be close or equal to the value of the remuneration package in excess of one year's base salary which the director is being asked to give up (even though the director's final departure might never trigger such a package). Alternatively, the consideration might be a higher base salary. Either way, such changes risk undermining the rationale for the change. The impact of a wave of such agreements would be likely to be bad for corporate/individual reputations and to be very distracting from daily executive work during a period of uncertainty for the economy. Hence they are unlikely to be proposed or agreed.

11. The Government notes that a small number of directors could be entitled to generous pension enhancements if their contract is terminated early. It proposes not to legislate to override these rights, owing to the rarity of such arrangements and the complexity of legislation that would be required. Do you agree with this approach?

ELA notes that there is a risk that arrangements such as these may become a route for avoidance unless the exemption applies to arrangements entered into in the future.

Members of ELA Working Party

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