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Executive Remuneration Discussion Paper

Response from the Employment Lawyers Association

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ELA Working Party – Executive Remuneration Discussion Paper

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.

A sub-committee was set up by the Legislative and Policy Committee of the ELA under the joint chairmanship of John Evason and Paul Harrison of Baker & McKenzie LLP to consider and comment on the Executive Remuneration discussion paper. 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 chapter arrangement in the discussion paper.

Chapter 3. Role of shareholders

1. Question 1: Would a binding vote on remuneration improve shareholders' ability to hold companies to account on pay and performance? If so, how could this work in practice?

1.1 There are a number of potential difficulties in making the vote binding, which would need to be considered.

1.2 As the discussion paper highlights, the legal status of the vote and its relationship with directors' contractual rights would need to be considered. The directors' rights may arise not only from express contractual terms providing for salary, guaranteed bonuses and incentive awards but, even where companies have a discretion in relation to an award, they may be limited by the express terms of the contract or scheme rules as to the factors they can take into account in assessing bonus and will also be limited by implied duties e.g. to act rationally and in good faith. The relationship between the vote and the contractual rights should be explicitly addressed in any legislation. Otherwise, in the event of a conflict, companies will not know whether to withhold pay (in which case they may face claims for breach of contract and constructive dismissal) or to comply with their contractual obligations (and risk the penalties for not complying with the binding vote).

1.3 Whether the vote or the contractual obligations take precedence, there are potential difficulties:

1.3.1 If a company's obligation to revise its remuneration proposals in the event of an adverse vote was made subject to it complying with any existing contractual obligations:

(i) it may have the unintended effect of leading to an increase in the contractual elements of remuneration (e.g. contractual guarantees and base salary) at the expense of elements which permit a greater discretion to reward performance but are subject to a shareholder vote.

(ii) this would reduce the effectiveness of the rule as many elements of remuneration are regulated by contractual terms;

(iii) there could also be uncertainty as to what the contract requires where it has a discretion. For example, would a company always be complying with its obligation to act rationally in implementing a shareholder vote, even if the board did not think the shareholders' opinion was rational?

(iv) in the event of an adverse vote, the company may be restricted to trying to negotiate with directors and potentially terminating a contract if satisfactory changes could not be achieved, with the company being obliged to meet its contractual obligations in relation to remuneration during employment and in the termination package and losing the director's services.

1.3.2 If a shareholder vote could override the company's contractual obligations (which would require an express legislative provision) or if contracts were made subject to a shareholder vote (and existing contracts will not have such provisions), then this could give rise to other practical and legal difficulties:

(i) What terms would or could apply to govern the employment relationship in the event of shareholder approval not being granted? What terms should apply until such shareholder approval was forthcoming?

(ii) A contract whose fundamental terms (salary, benefits, bonus etc) were subject to shareholder approval would create great uncertainty for both parties, with an increased the risk of arguments about the enforceability of terms within that contract. Could (for example) a company enforce confidentiality provisions or post termination covenants contained in a contract which had been voted down by shareholders?

(iii) It is difficult to envisage how such a vote could be retrospective, since the monies would already have been paid over to the director and it would not be practical to recover it.

(iv) These issues are particularly difficult in the case of new hires. If the terms as to remuneration which a director negotiates to join a new company are subject to shareholder approval, they may be reluctant to give up an existing role. Listed entities may therefore be at a significant competitive disadvantage as compared to third country listed entities when competing for management talent. It might be possible to address this issue by exempting new hires from the binding vote for an initial period.

(v) The problems in having an annual remuneration review subject to shareholder approval may be less acute than the issues for new hires as their old terms could apply pending a shareholder vote. However, there could still be issues as directors may have express or implied contractual rights in relation to pay increases, bonus and other incentive awards.

1.4 The mechanics of the vote would also need to be carefully considered. A vote for or against all director remuneration would be an extremely blunt instrument, but a vote on each element of the package for each director would be overly complex and time consuming.

1.5 If the vote is made "binding", the consequences of a vote against directors remuneration are greatly increased, which may dissuade shareholders from expressing dissatisfaction at all.

1.6 There are a number of existing control mechanisms in place which need to be considered when evaluating the advantages which a binding vote would bring and whether these outweigh the disadvantages:-

1.6.1 If the shareholders think that the director's remuneration package is excessive, they can vote on an "advisory" basis against adoption of the remuneration report.

1.6.2 Shareholders can already vote to remove a director by ordinary resolution (subject, where applicable, to giving a special notice)) (although this would be subject to a claim for damages by the director for breach of contract). Therefore, in legal terms, it is already open to shareholders to control the board if they so wish. In practice, the problem lies in the fact that the shareholdings are widely disbursed, and so it is often difficult for any particular group of shareholders to get together to carry sufficient votes to exercise shareholders' rights effectively.

1.6.3 Directors’ entitlements under share schemes will to some extent already have been approved, given the requirement for the rules of share schemes to be approved by shareholders before their adoption, albeit that the size of any particular award will not have been approved.

1.6.4 Shareholders now have the option to vote against the re-election of any director (including the chairman of the remuneration committee) on an annual basis. This already provides a means for shareholders to demonstrate their dissatisfaction with the remuneration structures.

1.7 Binding shareholder votes have already been introduced in Norway, the Netherlands and Sweden. The Netherlands was one of the first to do so, in 2004. The evidence there is that there is now better relationship between pay and performance, but only since 2008 (when Philips Electronics became the first major listed company to vote no, based on a proposal to amend the LTIP to remove performance criteria). Like the UK, most investors in Dutch listed companies are based overseas and are less engaged with the running of the company, so change took time. We may see a similar result in the UK. Further, will shareholders really want this role? Does it risk "letting off" the remuneration committee?

2. Question 2: Are there any further measures that could be taken to prevent payments for failure?

2.1 In the discussion paper reference is made to some stakeholders having called for shareholders to have a stronger voice in preventing awards for failure, for example through an ex-post vote on the contracts of new appointments or a vote on termination payments. The Government has asked for views on whether this or other measures, could generally assist shareholders in preventing rewards for failures.

2.2 In ELA's experience, the bulk of payments made to directors are generally determined by the terms of the contract, and in particular the notice period. For this reason, the current requirement in the Companies Act 2006 for shareholder approval of payments which are not contractually (or otherwise legally) due has limited effect. In principle, the contract can already be used to limit amounts payable on termination and to limit rewards for failure:

2.2.1 Phased payments - The concept of making phased payments in lieu of notice, which is subject to the Director mitigating his loss by securing alternative employment, is already well known amongst listed companies and as a practise is becoming more widespread (although not always implemented where it would result in one Director being on less favourable terms than the rest of the Board). This mechanism does not necessarily, however, prevent rewards for failure as the executive who finds alternative employment more quickly will be paid less under this arrangement.

2.2.2 Allow base pay only when compensating for loss of notice - It is also increasingly common to limit payments made in respect of contractual notice periods to base salary.

2.2.3 Reducing the notice period in certain circumstances - It may be possible in some circumstances to provide that the notice period is reduced if the Director does not meet set performance criteria. Although it is likely that such measures would be unpopular with directors and difficult to agree in certain circumstances and such provisions are still uncommon. The difficulty in avoiding rewarding poor performance through reduced notice periods is that it can be very difficult to agree in advance objective criteria which would demonstrate that the particular director has underperformed (e.g. a drop in share price could be used, but would not necessarily reflect underperformance by a particular director). However, a director will be reluctant to agree to a subjective assessment of his performance determining his notice period on the basis that this gives too wide a discretion to limit the payments made on termination.

2.3 In respect of an ex-post vote on the contracts of new appointments consideration, this could address the concern that contracts can commit the company to large severance payments, which do not then need to be voted on at termination. However, there are practical difficulties which would need to be considered:-

- What would be the status of the vote? Would it override any contractual agreement between the Company and the Director? The issues associated with overriding existing contractual arrangements are dealt with in our answers to question 1 at paragraph 1.3(b) above.

- What terms would be voted on? Would it be a vote on all of the terms of the contract or certain aspects of the remuneration or termination provisions contained in the contract?

2.4 In respect of a vote on termination payments we would make the following observations:

- Often, the most significant element of the termination payment relates to bonuses or share option awards. Consideration would need to be given as to whether the vote on a termination payment would include a need to have a vote on benefits that have already accrued . Where payments awards have been made in respect of past good performance but pay out on termination, these can appear to be a "reward for failure" but may actually reward good performance in the past.

- If all termination payments need a shareholder vote then consideration needs to be given as to whether, over time, Boards and departing executives become so accustomed to the approval process that they seek more generous termination payments on the basis that shareholder approval needs to be sought in any event. Currently, the need for shareholder approval to make a particular payment would generally deter a departing director from seeking the amount.

- Consideration would also need to be given to how the timing and mechanics of a vote would work with a departing director. If shareholder approval was needed before a severance package could be paid, Companies may end up retaining directors for longer than they currently would, if they need to wait for the AGM or EGM to approve the termination package. However, if approval was sought retrospectively and could overturn contractual provisions set out in a compromise agreement, this could adversely affect directors. Generally there are fairly short time limits for pursuing statutory claims for unfair dismissal, discrimination etc (often 3 months) and if a compromise agreement is "unwound" by an adverse vote some time after the agreement was signed, a director may have lost his right to pursue his claims. The added uncertainty may lead to more litigation or to directors being retained until the AGM or EGM where all issues can be resolved.

- It could also result in some payments being approved twice, if they have already been approved as part of the contract or as part of a shareholder approved LTIP.

2.5 The Government has also asked whether there are any other measures which could prevent rewards for failure. The Government could look at the following matters:-

- Use of contractual mechanisms to control severance payments (see 2.2) through further provisions in the UK Corporate Governance Code.

- Allowing payments up to a set limit (e.g. a multiple of base salary) without approval, but providing that anything above that limit would need shareholder approval. This could have the effect of encouraging executives and Boards to negotiate within that limit to avoid the need for shareholder approval. The disadvantage, however, is that it may mean that the upper end of the limit becomes the norm.

- The feasibility and desirability of regulating payments that are made to senior managers below board level. These limits could include some of the existing regulation which currently applies to Directors together with any new requirements brought in as a result of this consultation. One of the difficulties with this approach could be defining the category of senior manager to whom this would apply. In the FSA Remuneration Code, obligations were extended in relation to employees who exerted a significant influence on the risk profile of the Company. It has sometimes proved difficult in practice to identify those individuals and this could be even more difficult outside the financial sector, especially given that there is no regulatory body, equivalent to the FSA, which can address the uncertainty by agreeing lists of relevant individuals.

- Removal of the right for Executive Directors to bring claims for unfair dismissal where they are entitled to a notice period of at least a specified length e.g.12 months or more. This may have the effect of moving towards Executive Directors being compensated pursuant to their contract rather than through additional statutory rights and could sit well with the new regime whereby Directors will stand for annual re-election. In practice, the dismissal of Executive Directors is often procedurally unfair and the unfair dismissal regime does not sit comfortably with the reality of executive terminations. Directors would of course still retain the right to bring discrimination claims and any other claims that are derived from European legislation and other statutory rights e.g. protection in relation to whistleblowing.

- Claw-back provisions have also become more common and have an important function to play in avoiding rewards for failure (see response to Q. 14).

3. Question 3: What would be the advantages and disadvantages of requiring companies to include shareholder representatives on nominations committees?

3.1 The Discussion paper makes reference to a recent study which suggests that the representation of shareholders on nomination committees will enable shareholders to propose non-executives that they believe will actively promote their long term interests and hold the Company to account on their behalf particularly on the issue of pay.

Consideration would need to be given to the following matters:-

- How would the role of the shareholder representative be defined - would they be a full member or simply in an advisory capacity?
- How, and how frequently, would the representative be elected and removed?
- What would be their status and duties? Would they owe the full set of director's duties and would they owe duties purely to the Company or to all Shareholders? Would the Shareholder representative become a shadow director with all the resulting obligations and liabilities and if so consideration would need to be given as to whether shareholders would take on this role?
- If the aim is to promote the long term interests of the Company consideration would need to be given as to whether all shareholders would necessarily share that aim. It is possible that some shareholders may take a shorter term view on their investments. Consideration would also need to be given as to whether the interests of one shareholder will always align with the general interests of all shareholders and the interests of the Company as a whole.

3.2 The discussion paper points out that some shareholders have said that becoming an "insider" is something that they would wish to avoid if it compromised their freedom to sell their shares. We consider that it may be possible that knowledge of a forthcoming appointment could be deemed to be inside information. In practice, under the current system it is common for institutional investors to have knowledge of a key appointment in advance of it taking place. The additional risk for the shareholder on a nomination committee under the new proposal is that he finds out this information even further in advance. Some of the risks for the company could be mitigated by requiring the shareholder representative to be bound by confidentiality provisions but the risk of the shareholder not being able to deal in his shares for a period would not be entirely removed.

4. Question 4: Would there be benefits of having independent remuneration committee members with a more diverse range of professional backgrounds and what would be the risks and practical implications of any such measures?

4.1 If the Government decides to encourage independent remuneration committee members, consideration would need to be given to the following matters:

- What would the duties be of the independent remuneration committee member? Would they be covered by the full set of director's duties?
- How could it be ensured that the appointed members have the necessary skills, experience and knowledge to properly assess remuneration. What information

would the independent remuneration committee members have access to? They may have less of an understanding of the company's business, strategic objectives and directors' performance than other members as a result of not attending board meetings and so have less influence on the committee.

5. Question 5: Is there a need for stronger guidance on membership of remuneration committees, to prevent conflict of interest issues from arising?

5.1 Part 10, chapter 2 of the Companies Act 2006 sets out the duties a director owes to the company. These are as follows.

- Act within powers
- Promote the success of the company
- Exercise independent judgement
- Exercise reasonable care, skill and diligence
- Avoid conflicts of interest. Section 175 contains comprehensive provisions requiring a director to avoid a situation in which he has or can have a direct or indirect interest that conflicts, or may conflict, with the interests of the company.
- Not accept benefit from a third party
- Declare interests in proposed transactions (and in an existing transaction or arrangement)

5.2 These duties (apart from the duty to exercise reasonable care, skill and diligence) are enforceable as if they were fiduciary duties owed by a director to the company.

5.3 It seems likely that the scenario envisaged by the Government and the discussion paper would breach the existing duties in any event.

6. Question 6: Would there be benefits of requiring companies to include employee representatives on remuneration committees and what would be the risks and practical implications of any such measures?

6.1 The potential benefits of such a requirement would be to provide a better mutual understanding of board level remuneration by the wider workforce and *vice versa* and, potentially, to curb the excesses of executive board level remuneration.

6.2 However, there are a number of risks and issues which would need to be addressed if employee representatives were to be included on the remuneration committee:

6.2.1 What duties would the employees owe and to whom? Would the employee representatives owe the same duties as the director members of the remuneration committee? This includes a duty to promote the success of the company for the benefit of the members as a whole taking into account (amongst other matters) the interests of the company's employees? If so an employee representative on a remuneration committee might have his or her independence compromised if he or she felt under pressure to impose workforce opinion. Or would their duty only be to represent the interests of employees? If so, there may be a question about what those interests are. Employees are generally not directly affected by executive remuneration, unlike other areas where they are legally consulted (e.g. redundancies, changes to pension benefits). Is their interest to achieve a fair balance between executive pay and employee pay? If so, is it legitimate for the employee representatives to use their role on the remuneration committee to further the interests of employees in their own pay bargaining or reflect their dissatisfaction with their own pay package? How do the employees balance their obligations to different parts of the workforce?

6.2.2 What information would employee representatives have access to? An employee representative who was not also on the board would always have to catch up with relevant developments and, therefore, might be at a disadvantage and be treated differently from other main board members. They would need access to information about the company business and strategy to play a full role on the remuneration committee. In addition, if one of the perceived advantages of having employee representatives, as mentioned in the discussion paper, is to ensure that pay and conditions elsewhere in the Company are taken into account, they would need to have access to information about pay and conditions of their colleagues. Most employees will not have oversight of what their colleagues are paid - even if they are aware of an average pay rise in their particular country. If employee representatives are given confidential information, this will need to be subject to appropriate confidentiality obligations. If they owe duties to employees and are to help to provide mutual understanding of executive pay, they will need to report back to employees and this obligation will need to be tempered by obligations of confidentiality. There is a possibility for dispute as to whether particular information needs to be confidential.

6.2.3 How will employee representatives be appointed? If they are elected by employees, this will create the impression that they are responsible to employees. It also risks someone being elected who does not have the necessary skills to understand the issues involved in setting levels of executive remuneration. If they are appointed by the company, the risk is that employees will be selected who do not bring any independent viewpoint. From a practicality perspective, the administration and cost of running an election process for an employee representative and the related administration and cost for the representative of corresponding with the workforce (especially in the case of a large multinational with large scale overseas operations) might be considered disproportionate to the anticipated level of benefit.

6.3 Although Austria and Germany are sometimes given as examples of how such an arrangement might work effectively, the integration of employee representatives in the corporate framework is different in those jurisdictions as is the corporate governance structure. In Germany, for example, employee representatives do not sit on the management board (*Vorstand*), but rather sit on a supervisory board (*Aufsichtsrat*) which undertakes more of a monitoring function (by approving rather than taking significant business decisions).

7. Question 7: What would be the costs and benefits of an employee vote on remuneration proposals?

7.1 The costs of an employee vote are likely to depend on the size and geographical scope of the company. For example, a FTSE 100 company with several hundred thousand employees in dozens of locations could incur significant costs in terms of setting up and operating a voting system because of the need for comprehensive and coordinated administration and translation services.

7.2 To properly understand the remuneration proposals, employees would need to be given wider information regarding the reason for particular awards e.g. market levels of pay, the performance criteria for LTIP awards and how they relate to the objectives of the business. There may be a risk that many employees, who would have no particular duty or responsibility in exercising their vote, would not bother to read or consider this information and would vote on the basis of general views on executive pay or other issues affecting workforce satisfaction. In turn this may limit the effectiveness of any vote.

7.3 If employees did consider the information provided and exercise their vote on that basis it may lead to a better mutual understanding of board level remuneration by the wider workforce and *vice versa* and it may curb the excesses of executive board level remuneration. However, many employees of listed companies will also be shareholders and so are already able to participate in the advisory vote (and compulsory vote, if the suggestion is adopted) on the remuneration report.

8. Question 8: Will an increase in transparency over the use of remuneration consultants help to prevent a conflict of interest or is there a need for stronger guidance or regulation in this area?

8.1 This is a question of policy which is outside the scope of this response.

Chapter 5. Structure of remuneration

9. Question 9: Could the link between pay and performance be improved by companies choosing more appropriate measures of performance?

9.1 As pointed out in the discussion paper many FTSE 100 Companies no longer focus solely on TSR and EPS but combine them with alternative performance matrix. The link between pay and performance could be improved by Companies choosing measures of performance which are more closely linked to the business strategy of the Company. In addition, there could be flexibility to take into account internal soft and hard targets on which an individual's performance can impact, even where the share price is affected by external influences. However, consideration does need to be given to the difficulty of tracking performance over time where performance matrix are refined (as pointed out in the discussion paper) This may make it less easy to identify whether performance targets are genuinely stretching.

9.2 The quality and experience of the RemCo is a key factor in the successful design of executive remuneration. It is also crucial in the robust exercise of any discretionary awards.

9.3 Changing performance measures would involve potentially changing terms and conditions unless current long term incentive programmes permit flexibility. The alternative would be to permit the current performance term to end before any new performance measures were introduced. Consultation with executives would be required on the new performance measures.

10. Question 10: Should companies be encouraged to defer a larger proportion of pay over more than three years?

10.1 Deferral for a greater period would not necessarily mean that pay was more closely linked with performance unless performance was reviewed regularly and performance measures were readjusted. It could be difficult for long term performance measures to be set in stone at the beginning of the long performance period and remain incentivising in all circumstances. However, longer term deferral could have the advantage of tailoring the deferral period to the business cycle of the particular company, rather than the standard 3 year period which has arisen through market practice.

10.2 Consideration would need to be given to the interrelationship between longer deferral periods and executive rights on termination of employment:

10.2.1 From an employment law perspective, if executive's forfeit deferred payments on resignation from employment, there is an increased risk that there might be indirect restraint of trade where there is a very long deferred period. The longer the period of deferral the higher this risk. See response to Q.14.

10.2.2 If deferred amounts were paid out on termination (particularly if there was a discretion to accelerate payments and/or disapply performance criteria) this could lead to increased pay outs on termination. Many current LTIPs would not accelerate on termination and would pro-rate for service, but this may need to be addressed in considering payments on termination.

11. Question 11: Should companies be encouraged to reduce the frequency with which long-term incentive plans and other elements of remuneration are reviewed? What would be the benefits and challenges of doing this?

11.1 The benefits of reducing the frequency of review would be that the longer term incentive plans would be less complex and easier to understand. Arguably, reducing the frequency of review would force companies to set strategic targets which could be effectively tested in the long-term.

11.2 The challenges to reducing the frequency of review of performance would be the risk that the LTIPs would not deliver what they are intended to do ie retain executives and incentivise performance. For example, if it became obvious that the targets/measures are unobtainable then the executive would not be incentivised.

12. Question 12: Would radically simpler models of remuneration which rely on a directors level of share ownership to incentivise them to boost share value, more effectively align directors with the interests of shareholders?

13. Raising the level of share ownership of directors could more effectively align their interests with shareholders. However, consideration needs to be given to the retention requirements in relation to any shareholding.

- The discussion paper raises the possibility that shares could actually be held until retirement. This gives rise to a practical difficulty in defining what is meant as "retirement". The mandatory retirement age has now been abolished and the term has no clear legal meaning. If retirement in this context means a director's decision to leave the (full time) workforce, then there would be difficulties in determining whether that is in fact his long term intention. If it is linked to achieving a particular age (e.g. normal retirement age under a pension scheme or state pension age), then it is potentially directly discriminatory on grounds of age. If companies had to decide whether they could objectively justify this could cause legal uncertainty. This could be avoided if there was a specific legislative provision which companies could rely on, which the Government would need to objectively justify under Article 6(1) Framework Directive. In either case, directors who remained in post could have an incentive to increase the share price in the short term, as their retirement date approached.
- If there was a shorter retention period, this would be less likely to give rise to issues of age discrimination, but it may be questioned whether or not this would incentivise executives over the long-term to achieve the strategic business objectives rather than short term share value gain.
- If executives were required to remain in employment for shareholdings to vest, this could give rise to issues of indirect restraint of trade (see response to Q. 14) and might also mean that executives stay in one company for longer than is currently the case and the Government would need to consider whether that is desirable.

14. Question 13: Are there other ways in which remuneration – including bonuses, LTIPS, share options and pensions – could be simplified?

14.1 We note that there is a separate consultation on how reporting of remuneration could be improved and simplified.

14.2 We have no suggestions for the simplification of executive remuneration which could be of general application, over and above those considered in the discussion paper.

15. Question 14: Should all UK quoted companies be required to put in place claw-back mechanisms?

15.1 It is not clear from the discussion paper whether what is being considered is "real" claw-back, in the sense of recovering money that has already been paid, or whether it is envisaged that there would be forfeiture of cash or shares which have been deferred but not yet vested (referred to as "malus" in policy statement 10/20 which accompanied the final version of the FSA Remuneration Code). Different issues arise in relation to these.

15.2 Either "real claw-back" or "malus" would need to be provided for in an executive's contract or relevant scheme rules (in the absence of a statutory right to claw back). Particularly clear wording is required for real claw-back as the courts are reluctant to allow employers to recover amounts which have already been vested/earned. Many existing contracts will not contain such provision. There may be scope to introduce them into the rules of particular incentive schemes for future awards, but this will depend on the drafting of particular contracts.

15.3 Even where claw-back is provided for in the contract, there are two legal issues which often give rise to concerns about the enforceability of claw-back provisions:

15.3.1 The "penalty clause" doctrine renders void any clause which imposes on a party who is in breach of contract an obligation to pay a sum of money which is not a genuine pre-estimate of the loss incurred by the innocent party. So, if the claw-back operates on a breach of contract by the employee and requires repayment of a sum which exceeds the loss genuinely suffered by the company, the director may be able to avoid the repayment by arguing that it is a penalty clause and consequently void. This is unlikely to apply to malus but may apply to a real claw-back provision, depending on the trigger for repayment and the amount to be repaid. In fact, cases such as *Tullett Prebon v BGC Brokers LP [2010] EWHC 484* suggest that an obligation to repay an amount in specified circumstances which are not a breach of contract will not offend the penalty clause doctrine. In principle, it should be possible to draft an effective provision, if the triggers for repayment and amounts repayable are carefully drafted.

15.3.2 Claw-back clauses may be deemed to be unlawful restraints of trade, if they operate to deprive a director of some financial entitlement when he leaves the company. This is most likely to be an issue in malus provisions, particularly where substantial portions of "earned" awards are deferred for a long period and are forfeit if the director resigns voluntarily. In fact, cases such as *Tullett Prebon v BGC Brokers LP [2010] EWHC 484* and *Peninsular Business Services v Sweeney* suggest that claw-backs can operate without being an unlawful restraint of trade. Nevertheless these authorities are not binding on future courts, there are contrary legal arguments which can be raised and the area is likely to come under increasing scrutiny with the prevalence of malus provisions in the financial services industry as a result of the FSA Remuneration Code. However, if the aim of claw-back is to allow adjustments to reflect performance, misconduct or accounting mis-statements, rather than to retain employees, then deferred payments which are subject to malus would not need to be forfeited when a director resigns and no restraint of trade issue would arise.

Notwithstanding the possibility that effective claw-back provisions could be drafted, there is still scope for argument and debate about the enforceability of provisions. The doctrines of restraint of trade of penalty clauses could be overridden by a clear statutory provision, if this was thought desirable.

15.4 In relation to real claw-back provisions:

15.4.1 As noted in the discussion paper, the UK Corporate Governance Code recommends that consideration is given to the use of provisions that permit a company to reclaim variable components in exceptional circumstances of misstatement or misconduct. An increasing number of companies already have a claw-back mechanism in their rules to cover fundamental issues such as accounting misstatements.

15.4.2 Consideration would need to be given to the purpose of a real claw-back provision and the circumstances in which it would be triggered. If an award which has been made has been based on an accounting mis-statement, then recovering the excess over the amount which would have been paid if there had been no mis-statement may be uncontroversial and difficult for a director to challenge. An adjustment which reflects a revised view of performance or subsequently discovered misconduct in the period to which the award relates, which again reduces the award to the level it would have been at if full information had been known at the time, would be likely to introduce an additional element of discretion and judgment which may be more vulnerable to legal challenge (e.g. on the basis that the discretion is not being exercised rationally). If an award which has already been "earned" in respect of a particular period is to be recovered because of misconduct or underperformance in a subsequent period, courts are more likely to seek a construction of a contract which avoids this or to hold that it amounts to an irrational exercise of discretion (see e.g. *Mallone v BPB Industries plc*). A requirement to repay an amount on a subsequent breach of contract (e.g. gross misconduct) could be a penalty clause. Consideration would need to be given as to whether (other than, perhaps, misstatement) any general rules could be formulated which would be applicable across all industries and bonus schemes as to the circumstances in which amounts would be repayable.

15.4.3 There are practical difficulties in reclaiming sums which have already been paid to an individual, particularly where a significant period of time has passed and/or the basis on which the amounts are reclaimed is not made clear at the outset.

15.4.4 In general, a company will not be able to recover the tax or national insurance contributions which have been paid on a bonus which has already been paid.

15.5 In relation to malus provisions, there are fewer legal problems, provided the provisions are drafted clearly (and subject to the points above regarding restraint of trade). However, as with real claw-back, consideration would again need to be given to the circumstances in which an adjustment would be made. Would it be just to reflect mis-statement/performance/conduct in the period in relation to which the award was made (as appears to be the case under the FSA Remuneration Code)? Similar issues arise as with real claw-back provisions.

15.6 To give Remuneration Committees a wide power to claw-back will create uncertainty for directors, who may be uncertain whether they can use money which was supposed to be an incentive and/or a genuine reward, resulting in their demanding higher salaries instead.

15.7 Having a legal right to claw back, does not mean it would be used. However, compelling use of claw-back provisions may not be appropriate as - particularly in relation to real claw-back - the amounts involved and/or prospects of recovering may make it uneconomical to seek to exercise a right to claw back.

Chapter 6. Promoting good practice

16. Question 15: What is the best way of coordinating research on executive pay, highlighting emerging practice and maintaining a focus on the provision of accurate information on these issues?

This is a question of policy which is outside the scope of this response.

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