

UKSA

The United Kingdom Shareholders' Association
The independent voice of the private shareholder

REWARDS FOR FAILURE

Directors' Remuneration – Contracts, Performance and Severance

UKSA's response to the DTI Company Law consultative document

2 October 2003

1. INTRODUCTION

The paper starts from the premise that “setting directors’ pay in individual companies is a matter for those companies and their shareholders” and that the government’s role is to ensure a framework in which “shareholders receive full information and are able to hold directors to account effectively....” (Foreword by Patricia Hewitt, SoS Trade & Industry, p.5,para.3).

It also makes it clear that ABI/NAPF guidelines, and recent regulatory reforms, take us much further.

We agree that considerable progress is being made with recent and proposed reforms, and through a more aggressive approach by ABI, NAPF and their members. However, we would add some major caveats:

- many personal investors are disenfranchised in nominee accounts – most of them never having even been advised of this by their brokers’ promotional literature;
- institutional investors do still suffer from conflicts of interest, are not usually the underlying beneficiaries, are reluctant to take action individually (as this increases their own costs) and are very reluctant to vote against managements except in extreme cases;
- there is still no mechanism giving shareholders actual authority to constrain boardroom costs;
- the reforms MAY prove effective, but it will not be possible to judge their success for some time.

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2. RESPONSES TO THE QUESTIONS

Q1 Views are sought on whether, and if so how, best practice on compensation and severance could be further extended to limit the total amount paid by:

(a) restricting notice periods (and therefore severance) to less than 1 year;

(b) capping the level of liquidated damages.

Yes and no. A notice period of 1 year (or equivalent liquidated damages) may not be objectionable, if best practice guidelines

- require a provision allowing the period or equivalent damages to be subject to variation down to a lesser period (such as 6 months) where underperformance has occurred (subject to binding arbitration);
- require a provision allowing dismissal without compensation where serious misconduct has occurred (again, subject to binding arbitration).

Q2 Views are sought on whether, and if so how, best practice could be further extended to encourage the operation of phased payments in order to restrict the level of any severance or compensation payment.

Yes – where directors are dismissed for poor performance, best practice guidelines should require that payments be phased (to end when the director gets a new job) as a matter of course.

Q3 Views are sought on how improvements in best practice might be most effectively promulgated (eg. Institutional shareholder guidance, Combined Code amendments).

These improvements in best practice should be introduced into the Combined Code as soon as possible, on the basis of comply-or-explain.

Phased payments, in particular, were first recommended in 1995 (Greenbury), and it's definitely time for these to become comply-or-explain.

Q4 Views are sought on other best practice options which would have the effect of limiting severance payments where a company has performed poorly.

All severance payments beyond basic entitlements should be subject to performance measurement.

To encourage long-termism, performance-based bonuses should in general be subject to exercise over a lengthy period after being awarded, and to clawback where performance collapses during the director's tenure, or is based on measures that are later found to have been incorrect, unsustainable (example: sales figures prematurely booked) or fraudulent.

Wherever possible, the long-term release of bonuses for prior performance should not be accelerated when the executive departs – the phased release should continue on its original schedule, to ensure that clawback provisions are effective.

Q5. Would it be possible, and if so in what ways, to legislate for contracts to include provisions which require the board to take into account underperformance in determining severance payments and which would avoid the potential for litigation?

This is an appropriate area for Best Practice, not for legislation.

Q6. Should companies legislation provide that the statutory period for a director's contract would be limited to one year duration, or three years on first appointment, as recommended by the Company Law Review?

Most definitely.

Q7. Should companies legislation provide for the prohibition of rolling contracts having a notice or contract period in excess of the period permitted by Section 319, as recommended by the Company Law Review?

Most definitely.

Q8. Should companies legislation provide for the prohibition of covenants which provide for more compensation than would be available under a one year or three year term contract, as appropriate?

Most definitely.