



COMPANY LAW

**“Rewards for Failure”
Directors’ Remuneration –
Contracts, Performance
and Severance**

A CONSULTATIVE DOCUMENT

JUNE 2003



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Company Law: a Consultative Document

**“Rewards for Failure” Directors’ Remuneration – Contracts,
Performance and Severance**

June 2003

The Department of Trade and Industry invites comments by **30 September 2003** on the issues set out in this paper.

You are invited to send comments on any issue covered by this consultation to:

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Foreword by Patricia Hewitt, Secretary of State for Trade and Industry



Over the past months, we have seen a high level of public debate and concern over the granting of generous compensation packages to departing company directors, particularly in cases where the company has performed poorly. In these circumstances, the consequences are often that employees lose their jobs, and shareholders see the value of their investments dramatically reduced.

We have also seen a welcome increase in the level of shareholder activism on the issue of directors' remuneration. This is very much a result of the new requirements on disclosure and a shareholder vote which the Government has introduced, and which came into effect this year. Investors are rightly looking more closely at the remuneration packages awarded to top executives – and rightly challenging them where the link between company performance and individual reward is weak.

The Government fully supports high levels of reward for high levels of success and has also made clear that setting directors' pay in individual companies is a matter for those companies and their shareholders. It is for shareholders, as the owners of the company, to ensure that remuneration levels and structures provide the right incentives and that directors are held to account for company performance.

Institutional investors have promoted more active shareholder engagement through the publication in October last year of the Institutional Shareholders Committee statement of principles. In order to exercise this engagement, shareholders need to have full and accurate information, combined with the appropriate mechanisms to express their views. The Government's role is to enable this to take place by creating a governance framework in which shareholders receive full information and are able to hold directors to account effectively, particularly in the area of remuneration, where directors face an obvious conflict of interest.

This is why we introduced the Directors Remuneration Report Regulations which introduced new disclosure requirements on remuneration policy and an annual vote on the remuneration report for shareholders. These regulations allow shareholders to take a critical look, not only at the pay earned by directors, but at a company's pay policy, and the linkage of pay to performance. Over time, we

believe this combination of improved transparency and increased activism will mean that directors' pay is more effectively linked to company performance.

We also believe, however, that shareholders and other stakeholders are justified in expressing concern about cases where directors leave ailing companies with large payoffs. "Rewards for failure" for a small minority, damage the image and reputation of the whole of British business. The Government therefore now wishes to seek views on whether and how the corporate governance framework should be strengthened further with regard to the specific issue of directors' contracts, performance and severance arrangements.

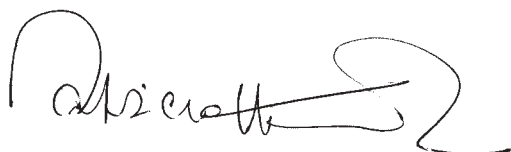
The institutional investor community has already taken steps to promote best practice standards in this area. I am grateful to the ABI and NAPF for coming forward with their own guidance on contracts and compensation, which is annexed to this consultation (Annex A). In addition, Derek Higgs, in his review of the role and effectiveness of non-executive directors, draws attention to the key role of independent non-executive directors as members of remuneration committees, and makes suggestions for changes to the Combined Code about service contracts and compensation.

The CBI has also recognised the importance of addressing this aspect of directors' remuneration and have set up a working group to look at this issue. I look forward to receiving the Group's views.

This consultation document explores a range of options for the enhancement of best practice and legislative change.

Views are sought on these options by 30 September 2003.

The Government is committed to a framework of company law and corporate governance which enables the owners of companies to exercise their responsibilities in an effective way and promotes high standards of shareholder activism. It is very important that we get this framework right in the crucial area of directors' compensation and severance, and I welcome your responses to this consultation.

A handwritten signature in black ink, appearing to read 'Patricia Hewitt', with a stylized flourish at the end.

Patricia Hewitt

1 Introduction

1.1 The remuneration policies and practices of quoted companies, and the determination of the remuneration packages of executive directors are a matter for the boards, remuneration committees and shareholders of those companies. It is for shareholders, not Government, to decide whether executive pay is set at appropriate levels and whether it adequately reflects performance. The Government has a role, however, in ensuring that the legislative and corporate governance framework is effective and promotes transparency and accountability to shareholders. Given that companies are able to set a wide range of performance targets in order to incentivise directors, shareholders are rightly concerned when companies perform poorly, and the directors' remuneration does not reflect this. This is of particular concern when directors' contracts are terminated and severance payments are made irrespective of how the company has performed.

Scope of consultation

- 1.2 The Directors' Remuneration Report Regulations (SI 2002/1986 – DRRR) came into force in August 2002 and apply to quoted companies with financial years ending on or after 31 December 2002. This legislation strengthens the crucial role of the remuneration committee and the shareholders. It introduces new disclosure requirements on remuneration policy and an advisory vote on the remuneration report for shareholders. As a result, longer term shareholders will, over time, be able to see how remuneration policy develops in practice and will be in a position to make their views known accordingly. (In addition, there are existing requirements under the Listing Rules for a shareholder vote on new Share Option and Long Term Incentive Schemes, or significant changes to existing schemes).
- 1.3 The DRRR also introduced a requirement for enhanced disclosure on directors' contracts policy and an explanation of severance payments (see Section 2.1). This means that shareholders will, through the advisory vote, be in a position to express their views if they are not satisfied that a company's policy and practice in this area is sufficiently robust.
- 1.4 This consultation specifically addresses the issue of directors' contracts, performance, and severance payments and the linkage between them. The purpose of this consultation is therefore to seek views on whether, and if so how, further measures are required to enable shareholders to ensure that compensation reflects performance when directors' contracts are terminated.

2 Background to Current Position

Department of Trade and Industry Consultations

2.1 The Department has carried out two consultations on the wider issues of directors' remuneration over the past four years. The first took place in July 1999. It made a number of recommendations with a view to improving transparency and accountability in the area of directors' remuneration. As a result, the Government decided that the corporate governance framework for directors' remuneration required significant strengthening. The second, issued in December 2001, asked for views on the implementation of draft regulations which required quoted companies to:

- publish a report on directors' remuneration as part of the company's annual reporting cycle;
- disclose within the report details of:
 - individual directors' remuneration packages;
 - remuneration policy;
 - the remuneration committee (where one exists) and its advisors;
 - policy on the duration of directors' contracts, and notice periods and termination payments under such contracts; and,
 - payments made in respect of loss of office, and an explanation for any such payments;
- display a line graph showing company performance; and,
- put an annual resolution to shareholders on the remuneration report.

2.2 As a result of this consultation the Government introduced the Directors' Remuneration Report Regulations 2002. These include all the requirements set out above and apply to quoted companies with financial years ended on or after 31 December 2002. It is not the purpose of this consultation to review the application of these regulations, though monitoring by the Department is taking place.

The Law Commissions

2.3 The Law Commissions, in their consultation paper No. 153 (1998) and in their consequent report “Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties” (Law Commission report No. 261 – 1999 and the Scottish Law Commission report No. 173 – 1999), undertook a detailed analysis of the disclosure and duration of directors’ service contracts (ss318 – 319 Companies Act 1985) and payments to directors for loss of office (ss312 – 316 Companies Act 1985). The Law Commissions’ recommendations informed, and were subsequently subsumed within, the recommendations of the wider Company Law Review.

The Company Law Review

2.4 In July 2001, the independent Company Law Review came to an end with the publication of its Final Report. This did not specifically address directors’ remuneration as a whole since the Government had consulted on this separately, but it did make recommendations on a number of related issues, such as those considered by the Law Commissions above. We ask specific questions about some of their recommendations in Section 3. In July 2002 the Government published a White Paper, *Modernising Company Law* (Cm 5553 – I & II), announcing its intention to introduce legislation to modernise company law along the lines suggested by the Review.

3 Possible Further Steps

- 3.1 There are two separate, but not mutually exclusive, routes which could secure improved shareholder scrutiny and accountability in relation to the compensation and severance payments made to directors: these are, (i) bringing about changes in the way compensation and severance payments are addressed in contracts by revising best practice guidance, and (ii) legislative reform to achieve the same effect.
- 3.2 The Government regards it as important that the most appropriate of these tools is used to suit the circumstances, in order to deliver the most effective support to the role of shareholders. The objective of this consultation is to identify what further best practice or legislative options might be pursued. There have been a wide variety suggested – for example, the expressing of a director’s compensation for loss of office in terms of the price of a fixed number of shares determined at the share price prevailing on the date the contract begins. This consultation is not an exhaustive examination of all these suggestions, but we will consider any options proposed which fall outside those considered in this document.

Best Practice Reform Options

- 3.3 Directors’ severance or compensation payments are generally determined by the terms of their contracts. Best practice guidance is generally regarded as the most appropriate tool for achieving compliance with good practice in the drafting of directors’ contracts. As a result, there is a good deal of advice available to remuneration committees on how to structure remuneration packages in order properly to incentivise directors. Recently the Association of British Insurers and the National Association of Pension Funds jointly issued a best practice statement on executive contracts and severance. As the statement makes clear, “Boards should calculate the potential cost of termination in monetary terms. This should cover all elements of the severance package”. The statement includes guidance on contracts and on pensions, which can represent a large element of severance pay and involve heavy cost to shareholders, the full extent of which may not be immediately evident. The full statement is attached at Annex A. The Government welcomed this initiative.
- 3.4 Anecdotally, there is some evidence that the ABI/NAPF guidance is influencing the way that contracts are being drafted in this respect. More time is needed, however, before their full effect can be established.

- 3.5 In the meantime, it would be helpful to have views on how best practice could be further reinforced and improved.

Reductions in contract and notice periods

- 3.6 Many commentators have remarked on the discrepancy between the treatment of directors and the treatment of other employees in the matter of contract or notice periods. The Combined Code recommends that directors' notice or contract periods should be set at one year or less. A period of one year, however, has become an industry standard and contracts with notice periods of less than one year are rare, thus maintaining the potential for severance payments which do not reflect poor performance. A point to note here is the usage of the terminology "notice" or "contract" period. The two words tend to be used interchangeably, yet they relate to different aspects of the contract. For rolling contracts, the notice and contract period is the same, but this is not necessarily so for fixed term contracts.
- 3.7 It has been suggested that contract or notice periods might be shorter than a year – the ABI/NAPF guidance makes clear that the one year period recommended in the Combined Code should not be seen as a floor, and notes that shareholders prefer periods of one year or less.
- 3.8 This should in principle have a significant impact in limiting severance payments. However, there are counter arguments. First, this might have the effect of raising basic remuneration given that the operation of market forces would be likely to result in higher demands from directors to protect themselves against the added "risks" of termination with a smaller compensation package. Second, it might encourage more short term strategic thinking by directors.

Liquidated damages

- 3.9 This approach involves agreeing – at the beginning of the contract – the amount that will be paid in the event of severance of the contract. The Final Report of the Hampel Committee on Corporate Governance included discussion of the problem of what it called "the fiction of the notice period" and how it had become, in effect, "merely a mechanism for the payment of money". The Committee saw this mechanism as inadequate, "because it hinges on a breach of contract, leading to damages for that breach". The Committee said that a solution which brings certainty would be desirable and concluded that there might be an advantage in having service contracts which made detailed provision at the outset for the payments to which a director would be entitled if at any time he was removed from office, except

for misconduct. This advice now forms part of the relevant provisions of the Combined Code, and Derek Higgs' recommended additional wording to the Code, to the effect that such provisions should not reward poor performance. "Liquidated damages" clauses in directors' contracts are not uncommon. Some consider that these clauses, whilst welcome in principle, usually set the damages at too high a level so that poor performance continues to be rewarded. The ABI/NAPF guidelines note that shareholders do not regard this approach as desirable where the level of liquidated damages cannot be varied to reflect underperformance, and recommend arbitration. Another proposal to counteract this is that there should be a recommended restriction, or "cap" on the level of the damages set at, for example, six months of basic salary.

Phased payments

3.10 The Report of a Study Group chaired by Sir Richard Greenbury in 1995 recommended that "Where appropriate, and in particular where notice or contract periods exceed one year, companies should consider paying all or part of compensation in instalments rather than one lump sum and reducing or stopping payment when the former director takes on new employment". Such "phased payments" are recommended in the attached ABI/NAPF guidance (Annex A, 3.2). The ABI/NAPF say that "in many cases executives will wish to seek further employment rather than remain idle till the monthly payments lapse". Whilst it is true that phased payments can enable a director to exercise his duty to mitigate, there is some debate about how this operates in practice. Some commentators have suggested that phased payments might simply act as a disincentive to search for employment.

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.**

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.

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

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

Legislative Reform Options

Amending the Companies Act 1985 to require compensation payments to be fair and reasonable

- 3.11 Archie Norman's Private Member's Bill ("Company Directors Performance and Compensation", published on 11 December 2002 and now withdrawn, suggested the insertion of a new section 316A into the Companies Act 1985. (The Bill can be found at <http://www.publications.parliament.uk/pa/cm200203/cmbills/022/2003022.htm>).
- 3.12 Sections 312-316 of the Companies Act 1985 cover a variety of payments to directors, including payments by the company on loss of office. Under this proposed legislation, compensation paid to a director in respect of loss of office would be required to be 'fair and reasonable' in terms of that director's performance, irrespective of what is stated in his or her contract. The Bill also required that the amount of any such payment must be disclosed upon request by any shareholder and that if the amount exceeds the previous 12 months' basic salary, an explanation should be provided under Schedule 7A of the Companies Act 1985 (the directors' remuneration report – see Section 2).
- 3.13 The Government supported the motivation behind this proposed legislation. However, it considers that this particular legislative route raises significant legal and practical difficulties. First, companies are already able to seek remedies if a director is in breach of his existing *legal* duties. It is, however, much more difficult to frame legislation which is effective in changing the way contracts are drafted so that severance payments reflect the business performance of the company. Any such legislation would have to take into account the fact that there are a wide variety of reasons why a director might leave a company which are not necessarily connected to any failure on the part of that director or the company; and there is a strong chance that it would be possible to draft contracts with the purpose of avoiding the intention of any such legislation. There is also a more general issue about the extent to which it is appropriate or practical to override or rewrite contracts of employment agreed between employer and employee in this way.
- 3.14 A second and linked risk is that such an approach would lead to lengthy litigation. Whilst it is possible to measure individual executive performance, there are many influences on overall company performance. Whatever

might be stated – or more particularly not stated – in a contract, it might be very difficult to establish a causal relationship between the performance of an individual director and the performance of the company as a whole. There is, therefore, the prospect that such legislation would lead to situations where directors and companies are more likely to seek a court judgement on the definition of “fair and reasonable”, and/or relationship between the success or failure of the director or company. Such litigation would inevitably be costly to companies and their shareholders.

- 3.15 Thirdly if, as a result of such legislation, contractual rights to compensation became either uncertain, or subject to prescriptive legislative rules, this might lead to increases in base salary, or the making of upfront payments – “golden hellos”. Companies have expressed the concern that in these circumstances it would be particularly difficult to recruit directors of good quality in some situations – for example, where a new chief executive is being sought in order to ‘rescue’ a failing company – without making such payments.

The Law Commissions’ proposals for amending s319 of the Companies Act 1985 to reduce the statutory contract period

- 3.16 The importance of limiting the length of fixed term contracts – which in turn dictates the maximum compensation for loss of employment – has been recognised in the reports of the Cadbury, Greenbury and Hampel Committees.
- 3.17 Section 319 currently prohibits directors’ employment with the company continuing for a period of over five years except with the prior approval of the shareholders. It does not apply to contracts of over five years which can be terminated by notice (nor does it apply to ‘rolling’ contracts – see 3.6). This limit now seems excessive given that the generally accepted maximum period for the contracts of directors of listed companies is one year under the Combined Code. It is, however, recognised that there may be cases in certain circumstances – perhaps in order to attract a new director – where it is appropriate to offer an initial longer term contract.
- 3.18 Respondents might find it helpful to be aware of the following points arising from research undertaken during the Law Commissions’ consultation period on the question as to whether the statutory period in section 319(1) should be reduced:
- although section 319 allows companies to enter into contracts in excess of five years if shareholders give their approval, larger companies very rarely take this step, because of perceptions of the high costs involved. In practice, therefore, the section has the

effect of placing a *de facto* bar on the duration of directors' service contracts.

- it is not clear, however, what purpose section 319, as presently constituted, is seeking to achieve by placing such a bar on the length of service contracts. If its aim is to limit large payments of compensation to directors whose service is ended prematurely, it would appear to be ineffective, since it does nothing to prevent directors' pay being increased to compensate for the imposition by law of a limit on the duration of their service contracts.
- directors in larger and listed companies are more likely to have rolling contracts than directors in smaller companies. They are also likely to have longer notice periods in their contracts. This lends weight to the suggestion that section 319 is ineffective in curbing large pay-offs.
- accordingly, directors in larger and listed companies are probably no worse off as a result of section 319, and shareholders are probably no better off.
- section 319 may be justified as a device to ensure that shareholders are not deterred from exercising their power to remove directors by a majority vote in general meeting. The possibility of very high pay-offs for directors removed in this way could be seen as discouraging the exercise by shareholders of this right. However, for this to work, stricter regulation of the practice of rolling contracts would have to be introduced.

3.19 In the Commissions' view, there were few good reasons to retain the present limit of five years. If directors believed that such a long contract is in the best interests of the company, then they should be able to persuade shareholders of this and obtain their approval. They recommended that the statutory limit in section 319 should be reduced to three years.

3.20 If the case for the three year period is then further restricted to new directors, there appear to be strong arguments for allowing the maximum three year period only on first appointment and requiring a maximum notice period of one year, beginning one year before the expiry of the first three year term. This is what was proposed in the Final Report of the Company Law Review: a normal limit of one year, but with flexibility to contract for three years on first employment; both limits to be subject to extension by members' resolution.

The Law Commissions' proposals for amending the Companies Act 1985 so that "rolling contracts" are subject to statutory contract period

3.21 Section 319 is not treated as prohibiting "rolling contracts", where the contract is renewed each day, so that at any one time there is always a certain period of notice to run. A director may in practice, therefore, be able to maintain a security of tenure for, effectively, in excess of five years without the company needing to seek shareholder approval for this arrangement. Rolling contracts are, in practice, far more common than fixed contracts. Research carried out by the Law Commissions suggested that rolling contracts appear to be used regularly in practice as a device to circumvent the statutory restriction. Consequently, the Commissions recommended that these contracts should be subject to the statutory limit in section 319 and that section 319 could therefore be amended to prevent a company giving valid notice beyond its statutory maximum length. The Company Law Review agreed with this.

The Company Law Review's proposal for amending the Companies Act 1985 to prohibit covenants

3.22 The proposals for limiting contractual periods led the Company Law Review also to consider possible evasion through the use of specific covenants for severance payments, separate from compensation for early dismissal. The Review proposed that, again subject to members' specific waiver, such covenants should be void to the extent that they provided for more compensation than would be available by way of compensation for the loss of the balance of the one year or three year terms, as appropriate. The Company Law Review noted that, "There was quite wide misunderstanding of our proposal, some believing the effect would be to interfere with the courts' powers to quantify loss on breach of contract, or that it would remove a right to compensation for loss of bonuses or other payments in excess of basic salary, or that entitlements under statute should be included within the capped amount (eg. redundancy payment rights); we had intended none of these". The Company Law Review concluded that, subject to these points of clarification, the proposal was supported by almost all, except those who opposed the basic proposition on employment terms from which it stemmed.

- 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?
- 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?
- 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?
- 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?

4 The Consultation Process

- 4.1 The Government's code of practice for written consultations applies the criteria set out in Annex E to all UK national public consultations on the basis of a document in electronic or printed form. The complete code is available on the Cabinet Office's website address www.cabinet-office.gov.uk/servicefirst/index/consultation.htm.
- 4.2 This consultation complies with the code of practice. If you have any complaint or comment about the consultation process, you should contact:

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Costs and Benefits to Business

- 4.3 A draft Regulatory Impact Assessment is at Annex B, setting out the possible costs and benefits to business. The Government would welcome comments on the assumptions on which they are based.

Q9 Do you wish to make any comments on the costs and benefits of the proposals as set out in the Regulatory Impact Assessment?

Annex A

Best Practice on Executive Contracts and Severance – A Joint Statement by the Association of British Insurers and the National Association of Pension Funds (December 2002)

1 Introduction

- 1.1 Institutional shareholders believe top executives of listed companies should be appropriately rewarded for the value they generate. However, they are also concerned to avoid situations where departing executives are rewarded for failure or under-performance. This is a matter of good governance, about which the ABI and NAPF have been concerned for many years.
- 1.2 It is unacceptable that failure, which detracts from the value of an enterprise and which can threaten the livelihood of employees, can result in large payments to its departing leaders. Executives, whose remuneration is already at a level which allows for the risk inherent in their role, should show leadership in aligning their financial interests with those of their shareholders.
- 1.3 Our two organisations, whose members are leading institutional investors in UK markets, are therefore publishing this statement of best practice, which sets out the expectations of shareholders that Boards will give careful consideration to the risk that negotiation of inappropriate executive contracts can lead to situations where failure is rewarded.
- 1.4 If companies are to recruit executives of sufficient calibre, Boards must bear in mind the basic demands of the market. These require them to offer incoming executives a degree of protection against downside risk. Contract law also provides employees with certain rights that must be respected.
- 1.5 However, shareholders also believe it is the duty of Boards to develop and implement recruitment and remuneration policies which will prevent them being required to make payments that are not strictly merited. When companies recruit senior executives, they do so in a mood of optimism and

expectation of success. They may therefore tend to overlook the consequences of failure, which is clearly inappropriate.

- 1.6 At the outset, Boards should calculate the potential cost of termination in monetary terms. This should cover all elements of the severance package, including any property liabilities the company may be required to assume on behalf of the departing executive. They must also consider and avoid the serious reputational risk of being obliged to make and disclose large payments to executives who have failed to perform.
- 1.7 Shareholders will hold Boards accountable for the design and implementation of appropriate contracts. The primary responsibility resides, however, with Remuneration Committees.
- 1.8 Remuneration Committees should have the leeway to design a policy appropriate to the needs and objectives of the company, but they must also have a clear understanding of their responsibility to negotiate suitable contracts and be able to justify severance payments to shareholders.
- 1.9 This statement provides a reference point, both to make companies aware of the reasonable expectations of shareholders and to inform voting decisions under the new legislation giving shareholders an annual vote on the remuneration report. We expect that this guidance will be reviewed periodically and refreshed as necessary to take account of changing market circumstances.

2 Basic Principles

- 2.1 The design of contracts should not commit companies to payment for failure. Shareholders expect Boards to pay attention to minimising this risk when drawing up contracts. They should bear in mind that it may be in the interest of incoming executives and their personal advisers to exaggerate their potential loss on dismissal. Boards should resist consequent pressure to concede overly generous severance conditions.
- 2.2 Choices made when the contract is agreed have an important bearing on subsequent developments. Companies should have a clear, considered policy on directors' contracts which should be clearly stated in the remuneration report. Boards should calculate and take account of all the material commitments which the company would face in the event of severance for failure or underperformance. The Nomination Committee needs to see through the process of appointment by working with the Remuneration Committee to ensure that the contract is fair to all parties.

- 2.3 Objectives set for executives by the Board should be clear. The more transparent the objectives, the easier it is to determine whether an executive has failed to perform and therefore to prevent payment for failure. Wherever possible, objectives against which performance will be measured should be made public.
- 2.4 It should be clearly understood that investors do not expect executives to be automatically entitled to bonuses. Bonuses should be cut or eliminated when individual performance is poor. From the outset, Boards should therefore establish a clear link between performance and bonus as well as other aspects of variable pay.
- 2.5 Compensation for risks run by senior executives is already implicit in the absolute level of remuneration. Boards should ensure that there is an appropriate balance between contractual protection and total remuneration and be able to justify their policies to shareholders. Shareholders prefer short contracts of one year or less, and Boards must be able to justify the length agreed. The one-year period provided for under the Combined Code best practice should thus not be seen as a floor. Shorter periods would be appropriate if other remuneration conditions would mean that a one-year contract period would lead to excessive severance payment.
- 2.6 In highly exceptional circumstances – for example, where a new chief executive is being recruited to a troubled company – a longer initial notice period may be appropriate. These cases should be justified to shareholders and the longer notice period should apply to the initial term only with reversion to best practice at the earliest opportunity.
- 2.7 Experience suggests that courts take account of some elements of variable pay, such as bonuses, when making awards to departing executives. This can be limited through the attachment of clear performance conditions to variable pay. Boards may also wish to specify that a proportion of the bonus is for retaining the executive and this should fall away in the event of severance. A remuneration policy that favours relatively low base pay and a higher proportion of variable pay is a good way of linking remuneration to performance.

3 Contract Setting

- 3.1 There is no standard form of contract that can apply in all circumstances. Companies have taken a number of different approaches to severance in the past. These include phased payments, liquidated damages, and reliance on mitigation. It is important that Boards consider the relative merits of different approaches as they apply to their own company's situation, follow their chosen approach consequentially and are able to justify it to shareholders.

- 3.2 A welcome recent innovation has been the use of phased payments, which involve continued payment, e.g. on a normal monthly basis to the departing executive for the outstanding term of his or her contract. Payments cease when and if the executive finds fresh employment. Shareholders believe this approach has considerable advantages, which deserve the active consideration of Boards, but this approach does need to be specifically provided for in the contract. It does not involve payment of large lump sums, which cannot be recovered. In many cases, executives will wish to seek further employment rather than remain idle till the monthly payments lapse. Allowing the contract to run off may also obviate the need for pension enhancement (see below).
- 3.3 The liquidated damages approach involves agreement at the outset on the amount that will be paid in the event of severance. It is clear from the beginning how much will be paid, but the amount cannot be varied to reflect under-performance. Shareholders do not believe the liquidated damages approach is generally desirable. Boards, which adopt it, should justify their decision, and should therefore consider a modified approach. This would involve reaching agreement in advance that, in the event of severance, the parties would go to arbitration to decide how much should be paid. This approach needs to take account of the likely cost of arbitration.
- 3.4 The concept of mitigation refers to the legal obligation on the part of the outgoing director to mitigate the loss incurred through severance, for example by seeking other employment and reducing the need for compensation. Where this is the sole approach, shareholders expect reassurance that the Board has taken steps to ensure that the full benefit is obtained. As with liquidated damages, boards need to have considered at the outset what the cost of severance would be under the proposed contract as well as the relative merits of arbitration as opposed to litigation.
- 3.5 An essential problem is that it is not normally possible for under-performance to be established as a ground for summary dismissal without compensation. Under the Employment Act 2002, however, a statutory disciplinary procedure will be implied into every employment contract, including those of executive directors. Boards should be aware of this and be prepared to use disciplinary procedures if warranted.
- 3.6 In the wake of this legislation contracts should also make clear that, if a director is dismissed in the wake of a disciplinary procedure, a shorter notice period than that given in the contract would apply. A reasonable period would be the statutory period, comprising one week for each year's service up to a maximum of 12 weeks. Without such a provision the full notice period would continue to apply even after dismissal following a disciplinary procedure.

- 3.7 Companies should also consider including in contracts a safeguard for more extreme cases, for example, that compensation would not be payable in case of dismissal for financial failure such as a very significant fall of the share price relative to the sector. This would help deal with particularly egregious cases.
- 3.8 Other than in highly exceptional circumstances, such as the recruitment of a new chief executive of a troubled company, contracts should not provide additional protection in the form of compensation for severance as a result of change of control if this would result in potential compensation exceeding the one year maximum payable under Combined Code best practice. Where exceptional circumstances apply, any additional protection should relate to the initial contract term only and not be a rolling provision.
- 3.9 Companies may consider other options, including a provision for compensation to be paid by reference to shares with the amount of shares set at the outset of employment. Where such an option is proposed it should, however, be clearly explained both as to purpose and to the details of its operation. Remuneration committees should satisfy themselves that it is workable and will yield advantages greater than the phased payment and other approaches outlined above. Compensation paid by reference to shares should be paid in cash rather than directly in shares to prevent unmerited windfall gains.
- 3.10 The use of shareholding targets for senior executives and directors is likely to be a powerful and therefore more effective means of aligning the financial interests of executives with those of shareholders.

4 Pension Arrangements and Other Remuneration Issues

- 4.1 Pension enhancements can represent a large element of severance pay and involve heavy cost to shareholders, the full extent of which may not be immediately evident. It is important that Boards state the full economic cost for pension enhancement at the earliest opportunity. Discipline is crucial if boards are to avoid rewarding failure. Boards should not support enhanced pension payments without making themselves fully aware of the costs.
- 4.2 A large liability looms in the future where companies choose not to fund an enhanced pension liability but to pay it as it arises. In all cases, whether the pension is funded or not, Boards must disclose the cost, justify their choice to shareholders and demonstrate that they have chosen a route that involves the least overall cost to the company.

- 4.3 An important principle with regard to pensions is that Boards should distinguish between the amount that is a contractual entitlement and the amount of discretionary enhancement agreed as part of a severance package. Contracts should state clearly that the pension would not be enhanced in the event of early retirement unless the board was satisfied that the objectives set for the executive had been met or that the enhancement was merited. Shareholders are likely to question enhancement decisions when they are doubtful of the merit and, if not satisfied with the Board's justification, they may vote against the remuneration report.

5 General Considerations and Conclusion

- 5.1 Boards should have a clear and explicit policy on contracts and on how Remuneration Committee, which will play a primary role. It should include calculation of the cost of severance at the time the contract is drawn up and an approach to implementation which ensures that all payments made on severance take account of performance in relation to objectives set for the departing executive by the board.
- 5.2 Contracts should be readily available for shareholders to inspect, together with any side letters relating to severance terms and pension arrangements. Shareholders will take account of contracts and the way they are implemented in considering their vote on the remuneration report.

Annex B

Regulatory Impact Assessment

Directors' Remuneration – Contracts, Severance and Performance Consultation – June 2003.

1. Issue

Remuneration policies for company directors are a key issue in modern day corporate governance. Shareholders are giving more consideration to the remuneration policies and practices of quoted companies, which they own. As a result of Government action, directors are more accountable to shareholders for better performance of the company and they are better able to ensure that pay structures are tailored to reward good performance, whilst not rewarding poor or mediocre performance.

2. Objective

Through this consultation, we are seeking to ascertain:

- i) Views on, and costs of, a corporate governance framework which addresses corporate performance. We are seeking to create a framework that will facilitate a clearer assessment of the performance of an individual and the company, and identify how a restriction for liquidated damages could be defined.
- ii) The most suitable term for employment contracts, specifically the shortening of contracts, for instance, to one or three years.
- iii) The costs involved in restricting contract terms as above – would shorter contracts lead to larger basic salaries? In pursuing shorter contracts and more performance related payments, the cost of engaging new directors is likely to increase. Shorter contracts and especially rescue work for ailing companies, may lead to larger 'Golden Hello' payments upon acceptance of a post, to avoid poor performance penalties at a later period.
- iv) Whether, in circumstances of poor company performance, legislative changes might lead to increasing court action, incurring court costs for companies and their shareholders.

3. Risk Assessment

In recent years, there have been examples of company directors leaving companies and receiving large severance payouts that did not reflect the performance of the company. The number of directors, who may have left boards with what may be considered excessive severance payments, may not be numerous but there is a risk that such behaviour undermines shareholder confidence and acts as a disincentive for further investment. A framework, which reduces the risks of allowing poor performers to leave with excessive compensation, should reduce this risk.

Intrinsic within this issue of severance payments is the length of directors' contracts. It is often the case that the longer the director has served on a board, the larger their payout and their share of extra benefits, if the contract is terminated. In order to avoid increasing costs and benefits for departing directors, it has been suggested that there is merit in setting out guidance on contract lengths.

4. Identifying Alternative Options to Regulation

The alternatives that may be considered at this time would be as follows:

i) **Allow more time for existing measures to take full effect**

The Government has introduced regulations to require companies to report on the details of director's contracts, to explain payments to directors for loss of office, and to allow shareholders a vote on the report. The ABI and NAPF have issued a best practice statement on contracts and severance (see Annex A). It is too soon to judge what effects these measure will have.

ii) **Reinforcement of best practise guidelines**

In pursuing this option, the Government would provide robust guidelines on pay structures and length of service agreements. The provision of such guidelines might assist in handling the recent challenges of resolving concerns over large payouts and increasingly dissatisfied investors.

From the institutional investors' point of view, further clarification and endorsement of such guidance, would serve to endorse 'Best Practice' logic and procedures. Institutional investors have already begun to participate more actively in voicing their concerns about companies' performance and other related matters. For the future, companies would be required to participate with investors more routinely and more openly, to address and clarify issues of concern.

iii) Introduction of appropriate legislation

Legislation cannot guarantee the elimination of large severance payouts and the threat of investor groups being impacted upon would still remain. With this background, investor confidence in British Business would continue to remain uncertain.

Although legislation might have the specific effect of shortening contract lengths and provide greater clarity and confidence, it might also bring with it, a significant regulatory burden as new avenues of policing and enforcing the regulation would need to be explored, which could be costly and time consuming.

5. Equity and Fairness

The requirement to follow 'Best Practice' guidelines, would impact upon companies listed in the FTSE directory. (This is mainly composed of a whole range of plcs, across the whole spectrum of British Businesses, large businesses that may be affected by large pay awards to directors).

Unlisted companies would not be required to follow these guidelines. A majority of UK businesses will not be affected.

Reinforcing and strengthening Best Practice guidelines will not impact upon unlisted companies or small/private businesses. It will help FTSE listed companies by

- i) Preventing inappropriate levels of payments being made to departing company directors – which do not take into account, company performance.
- ii) Providing clear guidance on the length of contract and notice periods.
- iii) Providing UK companies with clearer guidance on setting pay, bonuses, severance payments and other issues, more directly related to company growth and performance.

6. Benefits and Costs of the Proposal**Benefits:**

Option 1: The main benefit here is that no new or additional responsibilities are created for businesses.

Option 2: Businesses including directors and shareholders are likely to benefit with this option, as they will receive a clearer idea of what corporate behaviour 'Best Practice' commands, e.g. that links with shareholders should be strengthened and routine and more open channels of communication should be introduced.

Option 3: With this option, clear cut legislation and guidance on it, is likely to lead to a clearer understanding of what behaviour is required of such companies and is far less likely to be ignored, neglected or circumvented. Such legislation would also enable a more confident business environment.

Costs:

- i) There are no substantial costs envisaged in requiring companies to work to Best Practice Guidance, when negotiating pay deals for Directors. There is a possibility of incurring costs under certain legislative proposals when, upon departure, directors might challenge the pay structures which had been offered to them. This might lead to some court action.
- ii) Both Best Practice and legislation might make it difficult to recruit directors in particular situations, e.g. when a Chief Executive is being sought to rescue a failing company. This may lead to upfront payments of larger sums – ‘golden hellos’ – or rises in basic salary.
- iii) It is extremely difficult at this stage to give full details of costs that may be involved in following through each of the 3 options at 4 i, ii, iii. However, these details may be developed further and refined, once specific proposals are agreed (post-consultation). It is envisaged that the following areas may incur some costs:
 - a) The costs of developing and publishing guidance to listed companies on their obligations in terms of implementing ‘Best Practice’ or in the event of applying the legislative route.
 - b) Should the legislative route be adopted, then costs for the regulator’s staff and accommodation. Fuller details will be provided once specific proposals are agreed (post-consultation).

7. Scope of Any New Measures

The Government is concerned that any options, whether through best practice or legislation, should not create a barrier for smaller companies, such as private companies and those listed on AIM. The UK Listing Rules (which include the comply or explain rule in relation to the Combined Code) extend to companies admitted to listing. The companies to which the requirements of the Directors’ Remuneration Report Regulations 2002 apply are those whose equity share capital has been included in the official list in accordance with the provisions of Part VI of the Financial Services and Markets Act 2000, or is officially listed in an EEA state or is admitted to dealing on either the New York stock exchange or the exchange known as NASDAQ. It is not the intention of Government to consider extending any of the options identified in this consultative document to any other company.

There are currently approximately 2,800 companies listed on the London Stock Exchange.

8. Competition Assessment

In pursuing either 'Best Practice' or regulatory measures, listed companies are not likely to suffer from any detrimental effects on competition.

However, good directors will be in demand and it may be that directorships of troubled companies may become harder to fill.

Any new legislation that may emerge is not likely to impose a sizeable burden on any of the listed companies and it is certainly not likely to impact on any particular sector of listed companies. Neither would any potential regulation affect the number or size of these firms or lead to higher set-up costs for new companies.

Any new regulations in this area will affect a whole range of listed companies, which comprises of diverse and disparate industries e.g. investment companies chemical companies, engineering companies, large high street retail business consortiums etc. In view of the broad range of sectors impacted upon, it cannot be said that any particular sector was being affected unfairly. Neither would it restrict any company from determining its own choice of goods, range etc on offer.

9. Would Costs be Passed Onto Consumers?

It is expected that costs of court actions may be passed onto shareholders.

10. Securing Compliance

The Best Practice Guidelines will be enforced through the route of establishing more active shareholder engagement. Should a legislative route be adopted then those failing to comply with regulations could face a range of sanctions.

11. Monitoring and Evaluation/Review of Policy

Following consultation, this policy will be reviewed by the DTI to identify its effectiveness and suitability.

Annex C

Summary of 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.
- 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.
- Q3** Views are sought on how improvements in best practice might be most effectively promulgated (eg. Institutional shareholder guidance, Combined Code amendments).
- Q4** Views are sought on other best practice options which would have the effect of limiting severance payments in cases where a company has performed poorly.
- 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?
- 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?
- 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?

- 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?
- Q9** Do you wish to make any comments on the costs and benefits of the proposals as set out in the Regulatory Impact Assessment?

Annex D

The Consultation Criteria

- 1 Timing of consultation should be built into the planning process for a policy (including legislation) or service from the start, so that it has the best prospect of improving the proposals concerned, and so that sufficient time is left for it at each stage.
- 2 It should be clear who is being consulted, about what questions, in what timescale and for what purpose.
- 3 A consultation document should be as simple and concise as possible. It should include a summary, in two pages at most, of the main questions it seeks views on. It should make it as easy as possible for readers to respond, make contact or complain.
- 4 Documents should be made widely available, with the fullest use of electronic means (though not to the exclusion of others) and effectively drawn to the attention of all interested groups and individuals.
- 5 Sufficient time should be allowed for considered responses from all groups with an interest. Twelve weeks should be the standard minimum period for a consultation.
- 6 Responses should be carefully and open-mindedly analysed, and the results made widely available, with an account of the views expressed, and the reasons for decisions finally taken.
- 7 Departments should monitor and evaluate consultations, designating a consultation co-ordinator who will ensure the lessons are disseminated.

The complete code is available on the Cabinet Office's website, address www.cabinet-office.gov.uk/servicefirst/index/consultation.htm.

