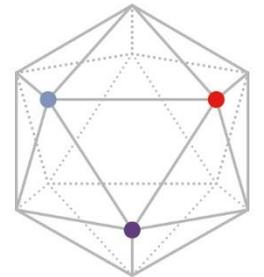


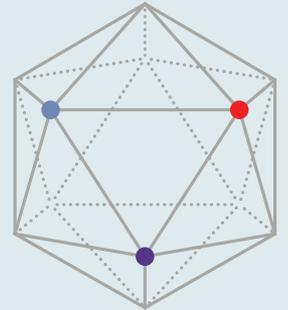


# Employee Services Forum 2018



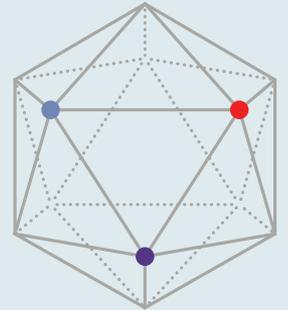
**Matthew Ward**  
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**John Franklin**  
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# LTIP Health Check

## How not to catch a cold



## LTIP HEALTH CHECK – HOW NOT TO CATCH A COLD – THREE THEMES



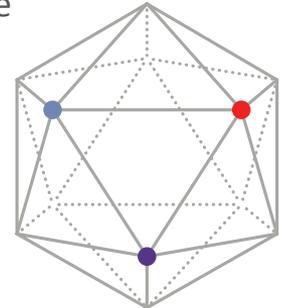
- The latest best practice changes set to impact LTIPs



- The Lloyds case
- Practical lessons
- Exercising discretion

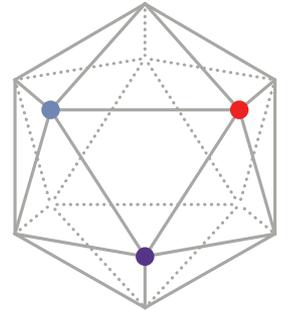


- Flexible
- Considered
- Simple
- Clear



Best  
practice

- The latest best practice changes set to impact LTIP materials



## THREE KEY LATEST BEST PRACTICE CHANGES SET TO IMPACT LTIP MATERIALS



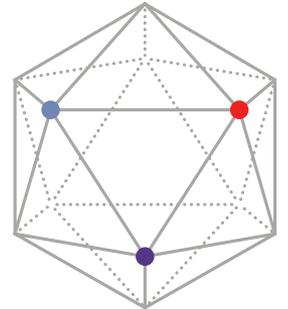
**Discretion to  
override formulaic  
outcomes**



**Shareholding  
requirements post  
employment**



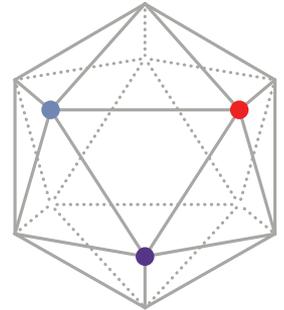
**Extension of recovery  
and withholding  
powers**





**Discretion to  
override formulaic  
outcomes**

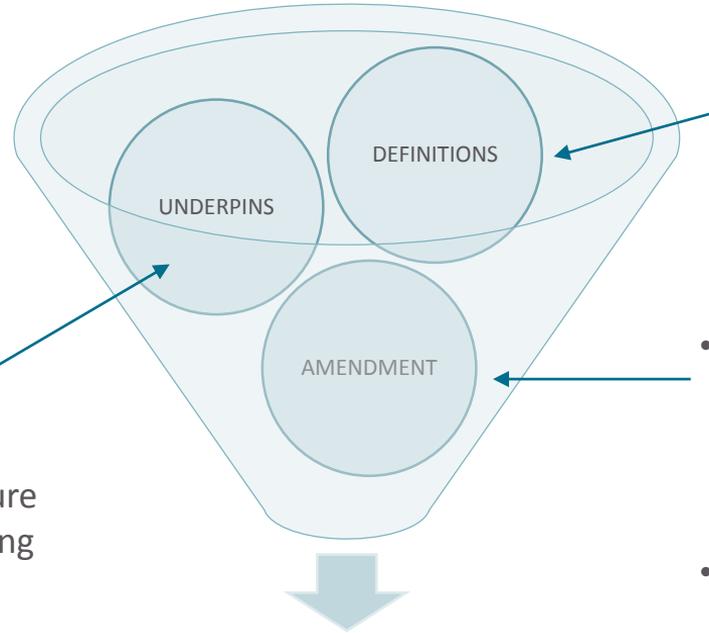
- LTIP awards tend to have 'contractual terms' once granted
- As such, any 'override' will typically need to be an award term
- The focus to date has largely been to protect against rewards for failure / fair assessment for participants





**Discretion to  
override formulaic  
outcomes**

- Performance metric underpins
- Protection against rewards for failure
- E.g. scale back of relative TSR vesting if not reflective of underlying financial performance



**Current Sources for “Adjustment”  
of Formulaic LTIP Outcomes**

- Limited flexibility often retained for basis of calculation
- E.g. meaning of EPS
- Limited flexibility often retained to amend performance conditions to maintain a fair assessment of performance
- But for the event in question .....no less challenging



## WHAT'S NEW?



### Discretion to override formulaic outcomes

*“Remuneration schemes and policies should enable the use of discretion to override formulaic outcomes”*

Para 37 of UK CG Code – July 2018

- Comply or explain effective for financial years from 1 January 2019
- Discretion often inherent within annual bonus arrangements
- For LTIP arrangements however – if overrides are to apply – they will need to be drafted to apply as terms of future awards

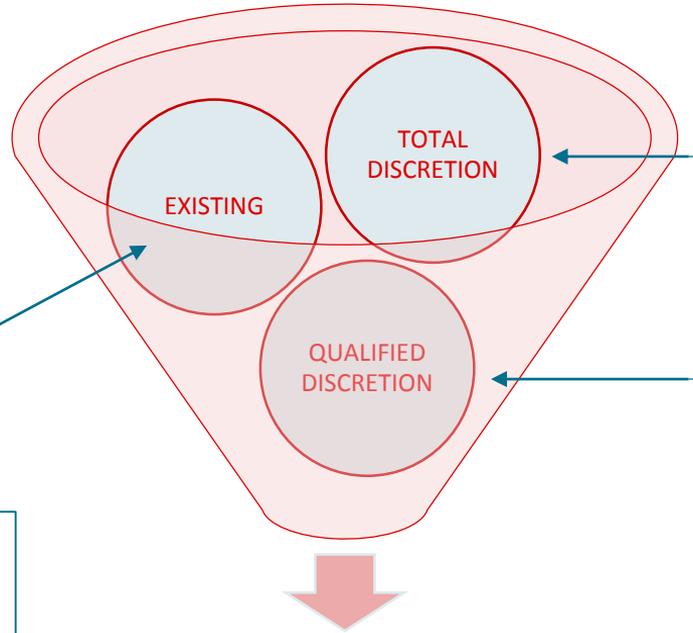




**Discretion to override formulaic outcomes**

- Definitions
- Underpins
- Amendment

- LACK OF CERTAINTY AND, CONSEQUENTLY, NOT A MEANINGFUL INCENTIVE?
- DOWNWARDS ONLY?
- WITHIN CURRENT POLICY?



**New Sources for Adjustment of Formulaic LTIP Outcomes?**

- Total and unrestrained discretion?
- Qualified discretion by reference to the RemCo having regard to a number of material factors (underlying corporate performance and personal performance?)?

+ VALUE CAPS FOR VCPS



## WHAT'S NEW?



### Shareholding requirements post employment

*“Remuneration schemes should promote long-term shareholdings by executive directors that support alignment with long-term shareholder interests. Share awards granted for this purpose should be released for sale on a phased basis and be subject to a total vesting and holding period of five years or more. The remuneration committee should develop a formal policy for post-employment shareholding requirements encompassing both unvested and vested shares.”*

Para 36 UK CG Code – July 2018

- Comply or explain effective for financial years from 1 January 2019
- The use of share ownership guidelines and post-vesting holding periods is already widespread but the new Code principle goes further





## Shareholding requirements post employment

- MONITORING?
- CONFLICTS OF INTEREST?

- Current practice:
  - In service share-ownership guidelines (typically expressed as a % of salary)
  - Two year post-vesting holding periods for three year LTIPs – IA Principles of Remuneration
  - Each requirement is distinct from the other
- Emerging practice?
  - In service **and post service** share-ownership guidelines (expressed as a % of salary that reduces post cessation of service and time limited (e.g. 50% of normal level for 1 year)
  - Even wider prevalence of holding periods (75% of FTSE 350 already has them)
  - No design change to post-vesting holding period for three year LTIPs but query whether practice for good leavers becomes:
    - For unvested awards the holding period falls away (award continues to vest on normal timetable)
    - For vested awards the holding period remains





## Extension of recovery and withholding powers

- EXTENSION OF TERMS
- CAUSAL LINK?
- RISK MANAGEMENT?
- DRAFTING APPROACHES / THE LIMITS OF DISCRETION

The latest best practice expectations for recovery and withholding powers (aka clawback and malus) in effect now stem from the FRC's Corporate Governance Code and Guidance on Board Effectiveness, each issued in July 2018:

- The Code provides that:

*“Remuneration schemes should.....should include provisions that would enable the company to recover and/or withhold sums or share awards and specify the circumstances in which it would be appropriate to do so.”*

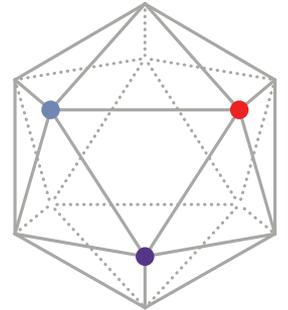
- The Guidance on Board Effectiveness includes that:

*“Schemes should also include malus and clawback provisions in certain specified circumstances. Such circumstances **might** include payments based on erroneous or misleading data, misconduct, misstatement of accounts, **serious reputational damage and corporate failure.**”*



## Pitfalls in LTIP operation

- The Lloyds case
- Practical lessons
- Exercising discretion



## THE LLOYDS CASE - CONTEXT

Awards are typically contractual

Share plan awards are normally contractual i.e. participants have enforceable rights

Powers to amend are qualified

Grantor typically has wide ranging **but** qualified amendment powers:

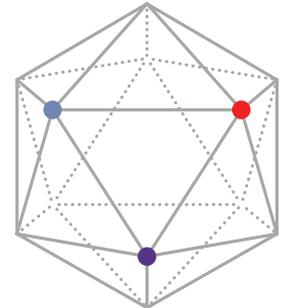
- Advantageous changes often need shareholder approval
- Detrimental changes typically need participant consent (or at least a majority)

Grantor often retains discretion

Award terms often retain discretions for the grantor:

- Discretionary good leaver status
- Power to adjust for share capital changes
- Withholding and Recovery (malus and clawback)

The Lloyds case stress test



## THE “LLOYDS CASE”

J Daniels, G  
Tate v.  
Lloyds

- 208 fun-packed paragraphs
- Most case reports mention malus (i.e. a withholding power)...
- ...but the case is not really about malus.

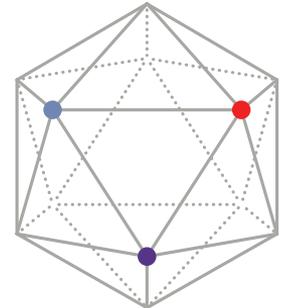
Issues

- Can an award be amended in a detrimental way after grant?
- Can a “Micklefield clause” prevent challenge of changes?
- Can a power to “adjust vesting” permit reducing to nil?
- (Unintended) limits on discretion imposed by drafting

Key facts

- Performance share awards granted
- Malus provision (exercisable by RemCo) added post grant
- RemCo determined degree of vesting
- Board subsequently determined malus reduction to nil
- Challenged by participants

Challenge  
upheld



## WHY WAS THE CHALLENGE SUCCESSFUL?

1

Scope of amendment powers

- Detrimental changes needed participant consent
- Adding malus powers to existing awards was a detrimental change

2

Unilateral powers need to be clear

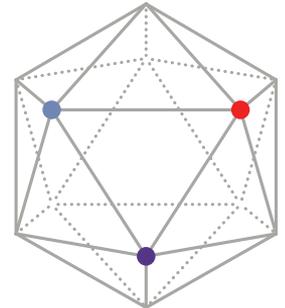
- Amendment powers referred to amending *the Plan* but not amending *awards*
- Clear and specific wording necessary to allow a unilateral detrimental change
- Court had regard to the intent of the parties:

***“Does it make better sense that the parties should have intended a fallback power or tidying up or a swinging power to rewrite the terms of the LTIP Awards? The answer to this is plain: the former is far more coherent with the overall scheme and purpose”***

3

Micklefield clause of no help to Lloyds

- “Micklefield clause” – on “wrongful dismissal” (i.e. for an employer’s breach of contract) intended to protect a company from the value of share plan benefits being taken into account...
- ...but does not prevent claims for breach of the plan award contract
- Incidentally, does not limit “unfair dismissal” claims



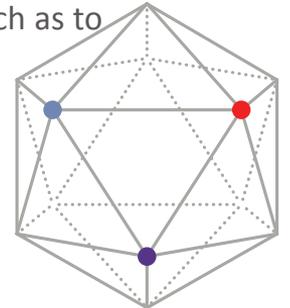
## INTERESTING POINTS OF DETAIL

Was the power to “adjust vesting” limited?

- No (in the case of the Lloyds LTIP)
- Rules explicit that vesting could be “adjusted” to nil
- Passing comment “*adjustment* may not be the most suitable word” (possibly suggesting a more limited power)

Limits on discretion that may be imposed by drafting

- Remuneration committee only able to “adjust awards” under malus provision “if in their discretion they determine that the performance of the Company, any Member of the Group, any business area or team **and** the conduct, capability or performance of the Participant justifies an adjustment”
- **“and”** indicates that both corporate and personal performance need to be such as to justify adjustment - probably not intended (**or** or **and/or** more flexible?)



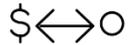
## KEY POINTS



Award terms are typically contractual post-grant



Check that desired terms are catered for and clearly drafted



Malus and discretion as a concept not challenged



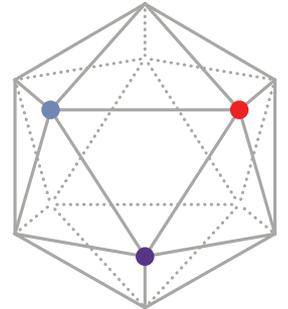
Ensure that any discretion is exercised by the correct body and at the correct time



Micklefield clauses are not a workaround for consent

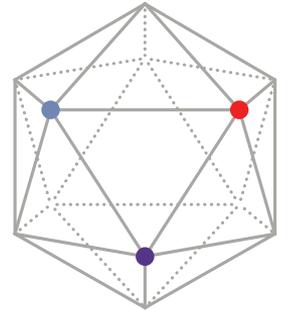


Amendment powers should be clearly stated to apply to both rules and awards



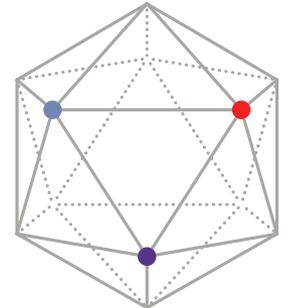
## DISCRETION - GREATER FOCUS

- Increasingly important:
  - Non-formulaic performance outcomes
  - Recovery and withholding (malus and clawback)
  - UK Corporate Governance Code – “report and explain” (for Premium Listed Companies)
- Discretionary power not all it might seem:
  - Even where “absolute”
  - Statutes (unfair contract terms, unfair dismissal, discrimination)
  - Case law (general, incentive plans, employment) – a fine line



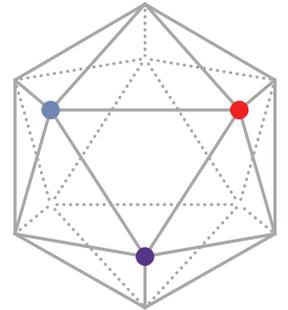
## DISCRETION - GREATER FOCUS

- Clear documentation/oral communications - how and when discretion may be exercised
- When exercising discretion:
  - have regard to past practice (but don't be a slave to it if you can justify variations)
  - don't make a decision which no "reasonable employer" would have made
  - document reasoning (and ensure consistent with actions)
  - consider disclosure implications
- Don't dress up a discretionary scheme with language of "rights"/"entitlements" (but have an "absolute discretion" carve-out on the last line!)
- "Moving the goalposts" during a performance period - if you have to, do it sooner rather than later (failure to do this and outperformance are not "exceptional circumstances")



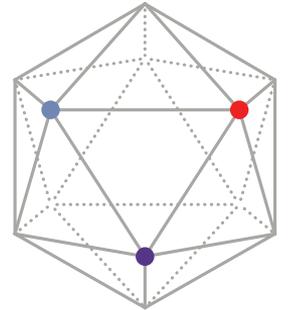
Fit for  
purpose  
plan rules

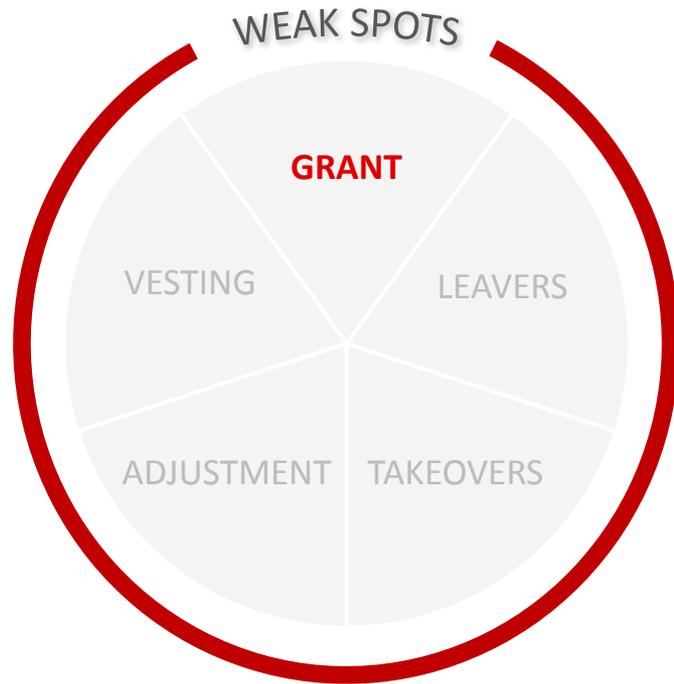
- Flexible
- Considered
- Simple
- Clear



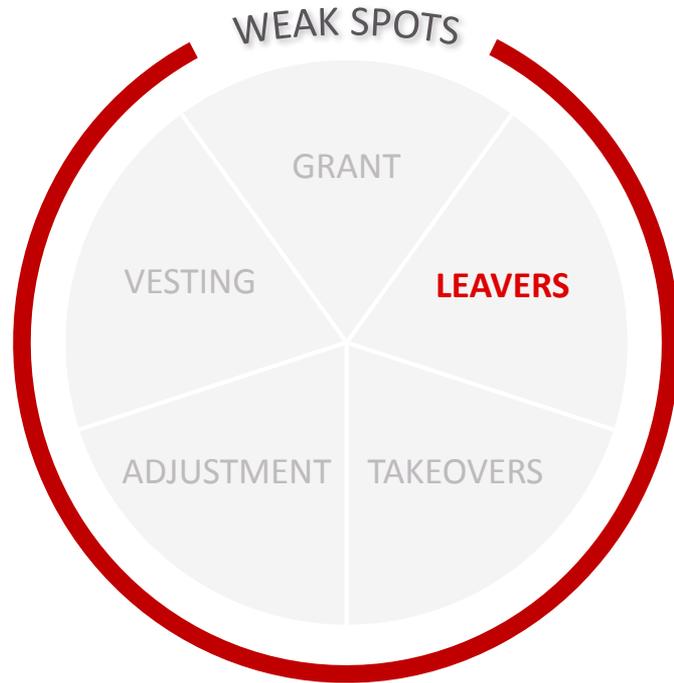


- Weak spots in LTIP drafting can appear at any time during the life-cycle of an award
- Over the next few slides we identify some “health-check” areas that you may wish to explore against the formal rules for your current LTIP





- For main list plc director LTIP policy:
  - Ensure the rules / award materials echo and deliver as to all aspects (gaps are not that uncommon!)
  - For example, as to governing holding periods / extended recovery and withholding provisions
- For others:
  - Consider leaving greater flexibility under the rules for below board policy
  - For example:
    - Flexibility as vesting period / tranches
    - Flexibility as to performance conditions
- General:
  - Ensure appropriate acceptance of terms practices to assist with enforceability (especially as to clawback)



- Check impact of serving notice v. cessation of employment (desired impact?)
- Check impact of move from plc ED to plc NED (often no impact - but times have changed)
- Provide scope for “additional terms” to be added to good leavers’ awards (e.g. continued retirement to normal vesting date)
- Time pro-rate for good leavers:
  - Ignore garden leave?
  - Use performance period?





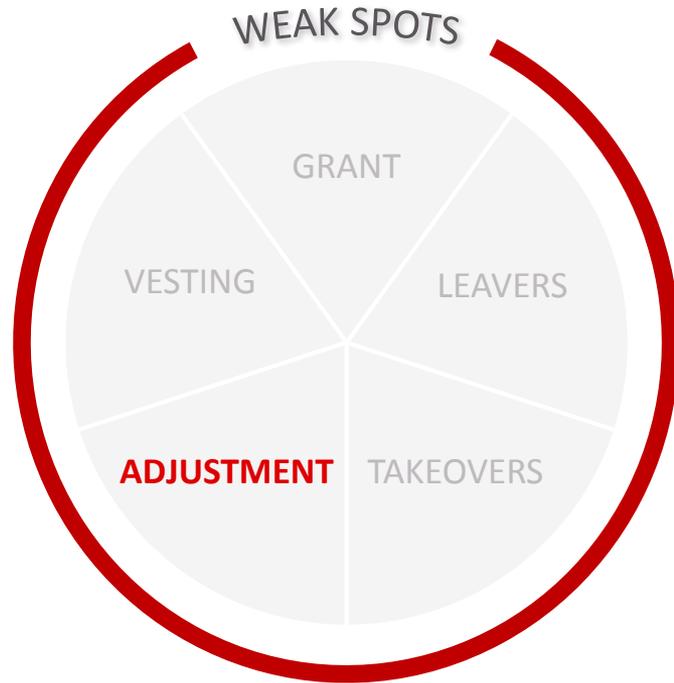
- Leave scope for roll-over?

*“Shareholders would prefer that, in the event of a change of control, outstanding awards due to Directors are rolled over into equivalent awards in the successor entity.”*

#### IA Principles of Remuneration

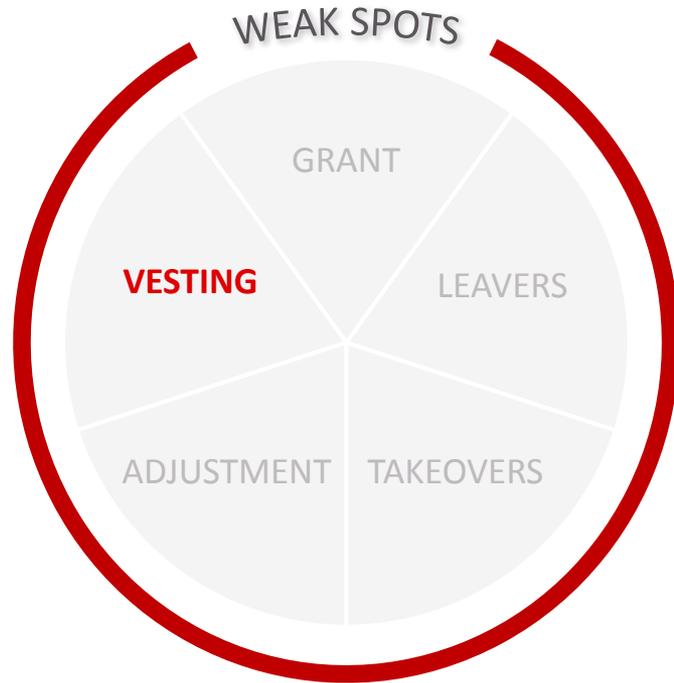
- Assessment of performance metrics:
  - OK to have regard to projected performance?
  - spot price for TSR?
  - be wary of formulaic inputs becoming inappropriate



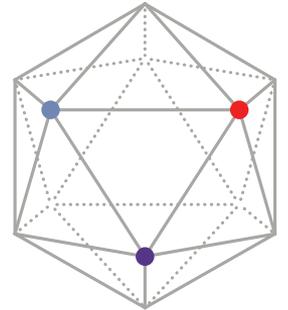


- Do not limit power to adjust awards to share capital variations
- Include adjustment for:
  - demergers
  - special dividends
  - other events similarly affecting the company's share price
- Express power to amend the plan **and** award terms
- Power to amend performance conditions to achieve their original purpose but for the event in question
- May adjust, **not** must adjust

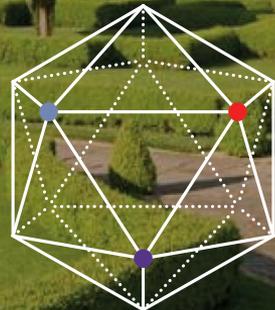




- Impact of close period / delay vesting
- Impact of disciplinary proceeding / delay vesting?
- Impact of lack of settlement instructions / regulatory compliance?
- Scope for cash settlement



# Questions?



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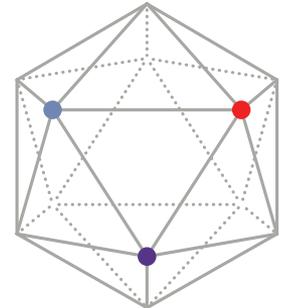


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