Hiring and firing the board

A company's senior personnel are invariably one of its most important resources – and certainly one of its most costly. Yet all too often, companies fail to properly address the necessary issues on negotiating the entrance of its most senior personnel – an executive board member – as well as to thinking ahead to an effective exit strategy.

"This article examines the key restraints on hiring board members and issues for both parties to consider at the outset in order to protect their interests."

Gareth Brahams – Managing Partner

Cash is king – negotiating executive remuneration

As is the case with the vast majority of commercial contracts, payments terms are invariably the primary focus for both a company and an executive at the start of their relationship. Companies must offer competitive remuneration whilst avoiding unnecessarily high expenditure or rewarding failure and executives must use their bargaining power to negotiate the best possible terms.

The issue is more complex if the company is publicly listed or regulated which takes some of the autonomy away from the parties.

Specifically, companies with a premium listing must comply with the UK Corporate Governance Code and companies regulated by the FCA or PRA may be required to comply with the Remuneration Code.

Both contain clear principles when it comes to remunerating executives including: (i) an emphasis on performance based pay (which balances pay against success and longevity); and (ii) a requirement for transparent policies on pay.

In the case of publicly listed companies, institutional investor guidance such as NAPF and ABI add a quasi-legal framework repeating these principles which, in the interests of good corporate governance, companies should try to adhere to. The policies have commercial teeth as a failure to comply will make it harder for companies to secure independent investment.

In the case of companies regulated by the FCA or PRA, the emphasis on performance based pay is enshrined in fixed requirements as to: (i) the makeup of fixed and variable performance based pay; and (ii) periods over which such variable pay must be deferred.

The UK Corporate Governance Code is less prescriptive, requiring generally that remuneration structures "promote the long term success of the company" and that a proportion of salaries are performance based. Ultimately, what this means from company to company will vary, but it usually involves a large proportion of executive remuneration being paid in the form of performance based bonuses, rather than high base salaries.

There is increasing public focus on transparency as to executive remuneration in the wake of the financial crisis. This transparency ultimately sets the bar for negotiations with new executive hires as companies must first, comply with their own remuneration policies and, second, bear in mind that terms agreed with new executives will likely enter the public domain.

The requirements for transparency are particularly rigorous for listed companies, which must: (i) have their directors' remuneration policy approved by shareholders at least every three years; and (ii) establish a remuneration committee of independent executives to decide upon pay structures.

Hiring the board – areas ripe for negotiation

Companies often expect prospective employees to simply sign their 'standard terms' and not to negotiate their contracts. Board members, however, have greater bargaining power and, if well advised, will consider carefully those 'standard' terms and seek to negotiate them at the outset.

Aside from base salary and bonus schemes, senior executives should think about applicable equity or deferred compensation plans in which they will participate, particularly given that these types of incentive will form a significant part of their overall compensation.

Not all schemes and plans were created equal and the leaver provisions contained in some plans are more onerous than others. Whilst a company is unlikely to vary these terms for one individual, if those terms are more onerous than those that they are leaving behind, the executive may seek to negotiate sign on bonuses or other 'buy out' provisions to compensate them for equity or deferred compensation they are leaving on the table.

Senior employees invariably have access to trade secrets and key information about the company which it will wish to protect in the executive's contract by both confidentiality clauses and post termination restrictions. Those restrictions could, for example, prevent the employee from joining a competitor, or soliciting or dealing with clients or staff of the company, for a fixed period of time after termination.

From the company's perspective, it is vital that these terms are given some thought and drafted as narrowly as possible. Courts enforcing them will look to balance the employer's interest with the minimum infringement on the freedoms of the employee. If the balance is tipped in favour of the employee, the restriction is likely to be unenforceable meaning that it is not worth the paper it is written on. For this reason whilst, of course, the company needs to do all it can to protect its interests, the restrictions should go no further than is reasonably necessary.

From the individual's perspective, the executive will wish to ensure that they are not unfairly restrained from moving on to another role and may also seek to be compensated for a period of time during which they are restrained.

There is little statutory protection for employees dismissed ahead of two years' service and the level of compensation for the vast majority of statutory claims thereafter can prove to be disproportionately low for board members, so appropriate contractual protections are paramount.

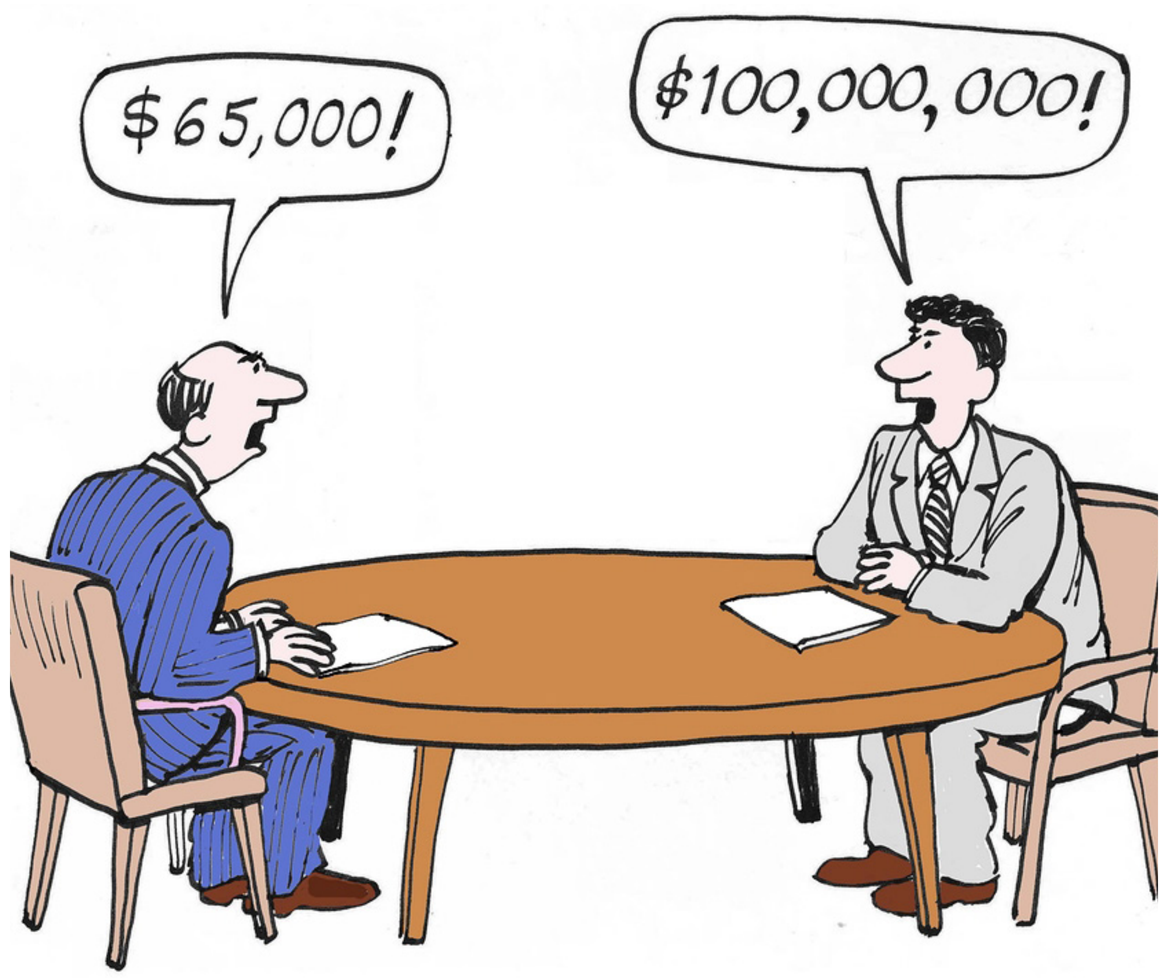
Commercially, what will often be vital for a new director will be securing themselves long enough to succeed. A short notice period in the early period of employment is likely to prove costly for the executive as they will more often than not have walked away from incentive packages. They will therefore seek to extend notice periods to as long as possible and to avoid any period of probation.

The company will, however, be tied as to what it can offer the employee. However, it is not all bad news as the Corporate Governance Code allows for a longer initial period for new director hires but requires that this period is reduced by one year after the initial notice period.

Sometimes known as 'golden parachutes', change of control clauses provide for a director to receive a termination payment in the event of a change of ownership of the company. These types of provision offer important flexibility to a director in circumstances where a company's direction may change. However, they are likely to be controversial within the company and subject to shareholder approval.

ABI and NAPF Best Practice on executive contracts and severance make it clear that directors should not receive additional compensation for severance as a result of a change of control. In any event, shareholder approval will be required for certain change of control clauses – for example, where there is a payment for loss of office in connection with a TUPE transfer.

On the other hand, some companies take a different approach in the event of a change of control and offer payments to key staff in the event of a change in control, in an effort to incentivise and retain them. Again, any such payments have to be consistent with the company's remuneration policy.



They were moving closer on salary.

Firing the board

All good things must come to an end and at some point a company and board member will wish to part ways whether due to the resignation of the executive, underperformance or even a clash of personalities.

These high profile exits are often mutually agreed and result in a severance payment to the individual. However, as is a theme in this article, there are legal restraints as to what financial terms a company can offer in that type of situation.

The Companies Act provides that companies cannot make a payment for loss of a position of office (including a directorship) without shareholder approval unless they are legally obliged to do so. Shareholder approval will not, however, be required where a good faith payment is made to settle a genuine claim, such as a claim for whistleblowing, or where there is a contractual term of a director's contract, such as a payment in lieu of notice period. In any event, for listed companies, any payments for loss of office must be consistent with the company's remuneration policy.

Whilst there is no obligation to announce a severance payment to an executive director, large and medium sized companies are required to include an explanation of payments in the annual directors' remuneration report.

Board exits invariably attract publicity. A board member is often likely to be the 'face of the company' and press interest is likely. For this reason, it is important that the exit process is managed carefully.

Equally, the company may well be exposed to a risk of legal claims which need to be considered.

On top of these considerations, a listed company is required to make an RIS announcement as soon as possible of any change to the board. Limited companies must also remember to notify Companies House within 14 days of a termination.

Inevitably, some senior exits will be acrimonious but it is important that such announcements are neutral, and are not inconsistent with terms that have been agreed with the individual (for example, in a settlement agreement). An agreed form of wording and a confidentiality clause in a settlement agreement can minimise the risk of adverse comments being made to the press by either party, but delays in agreeing this will not outweigh a listed company's obligations to announce an exit. A settlement agreement will also create an opportunity for a company to have a second bite of the cherry as regards post termination restrictions, as there will be an opportunity to either reaffirm post termination restrictions, or seek to negotiate new provisions.

There are several pitfalls to negotiate when hiring or a firing a new board member, whatever the size of the company. Too often, those pitfalls are considered as an afterthought, or not at all, meaning they only become an issue when things go wrong. Far more preferable is to tackle the issues at the outset and to avoid complex situations further down the line.