House of Commons

Trade and Industry Committee

Rewards for Failure

Sixteenth Report of Session 2002–03

HC 914

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The Trade and Industry Committee

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Footnotes

In the footnotes of this Report, references to oral evidence are indicated by 'Q' followed by the question number. References to written evidence are indicated in the form 'App' followed by the Appendix number.

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1 Introduction

1. In June 2003, the Government launched a consultation on severance pay for company executives with the publication of a Green Paper.[1] It was published amidst intense media interest in the area following a number of high profile cases where, it appeared, directors who had presided over a significant loss in the value of a company had left the company with an exceptionally large redundancy package. The impression given was that they had been amply rewarded for failure.

2. In the light of this, the Government decided to consult on whether, and if so what, new measures might be required to tackle excessive 'golden parachutes' for the outgoing executives of poorly performing companies. We undertook an inquiry into the extent of the problem and the solutions put forward in the Green Paper.

3. In the course of this inquiry we took evidence from the Investment Management Association (IMA); the Institute of Directors (IoD); the Work Foundation; the Association of British Insurers (ABI); the National Association of Pension Funds (NAPF); the Confederation of British Industry (CBI); and the Trades Union Congress (TUC). In addition we received written submissions from thirteen organisations and individuals. We would like to thank all those who gave evidence to us.

[1] DTI *"Rewards for Failure" Directors' Remuneration – Contracts, Performance & Severance* (June 2003) hereafter referred to as 'The Green Paper'.

2 The Extent of the Problem

4. In order to judge whether specific measures might be required to tackle excessive severance packages for directors, we were concerned first to establish if there is a genuine problem. We wished to avoid a 'knee-jerk' response to a small number of cases, albeit high profile ones.

5. That there is some general cause for concern about the size of the 'golden parachutes' which some executives have received on leaving their post is hinted at by the action taken by institutional investors. The ABI and the NAPF recently published a joint statement of best practice, which implies that such standards are currently lacking.[2]

6. There was almost unanimity amongst our witnesses and those who submitted written evidence to us that the problem was real. However, there was disagreement over its magnitude. Some witnesses, such as the CBI and ABI, were at pains to emphasise that the award of excessive severance pay was confined to a few instances where current standards of best practice had been ignored.[3] The implication was that the problem was limited and the promotion of current standards of best practice would remedy the problem.

7. Other witnesses suggested that the problem was a rather broader one that could not merely be attributed to a minority of irresponsible companies. They noted that excessive payments had been a long term concern and well-publicised instances of companies, such as Marconi and GSK, where directors' contracts would allow for this, were merely the most recent examples.[4] The TUC went as far as to say "there is a crisis of corporate legitimacy in the UK".[5]

8. The opinions expressed by our witnesses echo empirical evidence which shows that executive remuneration has increased dramatically over the last 10 years. This is significant as severance packages are usually calculated with reference to the general remuneration package. Figures from Pensions Investment Research Consultants (PIRC) show that the median base salary for the highest paid directors amongst FTSE 100 companies has increased from £301,000 in 1993 to £579,000 in 2002. This represents an increase of 92% over a period in which inflation has risen by 25% and average wages by only 44%.[6]

9. The proportion of salary payable as a bonus has also risen. Where, five years ago, the upper limit for annual bonuses, in the majority of instances, was between 40% and 60%, by 2003 this had risen to 100% in one third of cases, with some even higher. So the trend is for bonuses to be set as a larger proportion of considerably higher salaries. Similar trends are also evident in executive share options. The problem can also be exacerbated by the phenomenon of guaranteed bonuses in the early years of contracts that are used to attract

[2] ABI-NAPF *Best Practice on Executive Contracts & Severance* (December 2002). It is included as an Annex to the Green Paper.

[3] Qq 116 (ABI) and Q 162 (CBI)

[4] Qq 73 (IoD) and 96 (Work Foundation)

[5] Q 190 (TUC)

[6] App 9

directors. These can lead to severance payments that are higher if the director leaves after only a short period in office than if he or she works for the company for a number of years.

10. However, PIRC could find little evidence that performance targets, on which the payment of bonuses is dependent, have been toughened to reflect the higher real and potential earnings that directors now enjoy.[7] Neither, it seems, has the average duration of executives' tenure been reduced - and, in fact, it may even be creeping upwards.[8]

11. **Our witnesses were in no doubt that there is a genuine problem of contracts that provide for excessive severance packages for directors who have failed to improve the performance of their company. Whilst the examples of GSK or Marconi are exceptional in their scale, they clearly represent the tip of the iceberg. We do not dispute that directors of large companies should expect remuneration commensurate with the level of responsibility they have and the relatively precarious nature of their employment. A lengthy and successful tenure will also inevitably be reflected in high rewards and, potentially, a sizable severance package. However, the increases in salary and bonuses that directors have experienced in recent years, on which severance packages are based, have not been a reflection of tougher performance targets or better company performance. It would appear that executives have been rewarded not only for success but for failure as well**.

[7] *Ibid.*

[8] Q 62 (IMA)

3 The Sources of Rewards for Failure

12. It is often contended that there is an international market for the most talented managers and the rewards that they receive reflect market forces — if the UK wants to attract or retain the best company directors available, it is argued, then they must be paid the market rate. Large severance packages are merely a result of the need to offer attractive terms to the best available people.[9]

13. Whilst it is clearly necessary to ensure that UK companies can recruit and retain top, executive level management this only partly accounts for the high levels of remuneration and severance pay. Executive salaries in the UK are already higher than in the rest of Europe and second in the world only to the USA.[10] In the United States, however, remuneration packages are quite considerably higher than in the rest of the world. Given this, the UK should already be able to attract the best management from across the globe more easily than any other country except for the USA. Rewards in the USA are so far in excess that there seems little prospect in the foreseeable future of the UK being able to attract their top executives with financial inducements.[11]

14. It also seems that, where pressure has been exerted by shareholders on executives' conditions of employment, they have been able successfully to bring about a change in practice with no obviously detrimental impact on UK companies' ability to recruit personnel. For instance, until relatively recently, three, or even five, year contracts for executives were the norm. But pressure from shareholders has brought about a reduction — one year contracts are now seen as best practice and are increasingly common — with no apparent effect on the ability of UK companies to recruit successfully; a survey of boardroom trends in 2002 did not reveal any significant drop in the number of foreign directors recruited by UK firms over the period in which contract duration was being reduced. The survey found that 24% of the directors of the top 150 UK companies were from abroad, up from 23% the previous year. 49% of the companies included in the survey had at least one foreign director. [12] It does not appear that action to reduce the generosity of aspects of executive contracts need harm the UK's ability to recruit executives from abroad. Chris Hitchen of the NAPF said that "[t]he key test would be that if we actually managed to negotiate away some of these terms and conditions, would companies cease to be managed by these individuals? I think that, in the great majority of cases, that is probably not the case".[13]

15. It seems then that the need to attract the best executives in an international market can only partially account for the generous 'golden parachutes' that so many seem to enjoy. The IMA instead pointed to the scope that executives have for deciding their own salary: "I think there is an international market, but then I do not think that market is a perfect

[9] Q 163 (CBI)

[10] TUC *Top Cats: The Last Closed Shop* (September 2000)

[11] Q 107 (Work Foundation)

[12] Spencer Stuart *Top 150 UK Board Index* (2002).

[13] Q 117 (ABI/NAPF)

market either, because it is not a free market, so directors have a lot of flexibility in deciding for themselves what they get paid”.[14]

16. At the core of the problem of excessive rewards for failure are poorly constructed contracts of employment.[15] Details of how severance pay is to be calculated are included in the executives’ contracts of employment. Too many, it seems, have been drafted in such a way as to guarantee an outgoing executive a very sizable payoff irrespective of whether he or she has delivered value to shareholders, or any benefit to stakeholders more broadly.

17. We were told it was possible that action to reduce excessively large severance payments might merely shift the problem and that the terms of other parts of the contract might be improved to compensate. For instance, measures to reduce ‘golden parachutes’ might lead to an increase in ‘golden hellos’ or to a rise in basic pay.[16] However, the IMA felt that, whilst there was a balance to be struck, a reduction in the size of severance payments could be accommodated without a compensating increase in remuneration at the beginning of the contract.[17] The ABI and NAPF emphasised how reluctant the remuneration committees of companies would be to allow such compensation to happen in the light of the numerous revolts by shareholders over remuneration committee annual reports and the poor publicity surrounding the area as a whole.[18] Pressure to act, it was asserted, would arise from within industry because “[i]ndustry has in fact been shocked by the airing of its own venality”.[19]

Conclusions

18. **We are not convinced that the current scale of executives’ severance packages is a product of competition for scarce talent in an international market. Executives in the UK are paid more than those in any country other than the USA, where executive pay is so much greater that there seems little prospect of recruitment from there on a large scale.**

19. Instead, it seems that the problem has its roots in the way in which contracts have been drawn up. Our witnesses emphasised that self-regulation is already contributing improvements in this area. As noted above, where three to five year contracts had previously been the norm, the Combined Code, the document that sets out the corporate governance standards for UK listed companies, now recommends that directors should have one year contracts.[20] The Green Paper makes more specific suggestions relating to contracts which we address in the next chapter.

20. **We would hope that the recent examples of shareholder revolt and the wider public concern generated by the instances of rewards for failure would prompt all companies to look hard at the way in which executives’ contracts are constructed.**

[14] Q 5

[15] Q 24 (IMA)

[16] App 2 (ICSA)

[17] Q 62

[18] Q 150

[19] App 5 (PCG Worldwide)

[20] It seems that contract and notice periods are generally conflated in executives’ contracts.

4 The Green Paper's Proposals

21. The Green Paper suggests three areas relating to contracts which might address the problem of rewards for failure: reductions in contract and notice periods; liquidated damages; and phased payments. We took evidence on all these options.

Reductions in Contract & Notice Periods

22. Shortening the duration of contracts can, other things being equal, reduce the value of the redundancy package an outgoing executive can expect to receive. This is because, as far as executives' terms of employment have been concerned, contract and notice period have been widely conflated. Therefore, the outstanding value of the contract that needs to be paid to the outgoing executive will be reduced if the duration of the contract is shorter. Pressure from institutional investors has already been instrumental in reducing the length of contracts and one year contracts are increasingly accepted as best practice.[21]

23. The ABI-NAPF document advocates one year contracts as the norm, and these are clearly an advance on the three or more years that were previously widely used. The CBI noted that the one year notice period has only recently become the norm and that there may be further downward pressure, thus bringing executives more closely into line with the rest of the workforce.[22]

24. However, a one year contract need not have a one year notice period, though this seems frequently to have been the practice. It was put to us that executives are in a risky position and that the average length of their tenure is shortening. Furthermore, they may also struggle to find a new position quickly once they have lost their job.[23] This, it was suggested, entitled them to longer notice periods than those enjoyed by the rest of the working population. However, as the ABI-NAPF best practice document notes, any insecurity inherent in an executive's position is compensated for in the absolute level of remuneration and should not be reflected in the severance package.[24] Nevertheless, it does seem, as Will Hutton noted, that an entitlement culture has built up around severance packages — rather than notice periods being a means of easing a period of change for both the company and the outgoing director, as they were originally intended, they have become a form of 'monumental bung'.[25]

25. **We can see no reason why, in principle, the notice periods of executives should be any different from those of the rest of the population. UK executives are already well remunerated and have become increasingly so over recent years. Many other areas of employment can be considered as risky but do not have the benefit of such high salaries. We would urge companies not only to adopt one year contracts, other than in exceptional circumstances, but also to specify separately the notice period, in order to**

[21] PIRC show an increase in one year contracts: App 9

[22] Q 174

[23] Q 174. However, evidence from the IMA suggested that directors' length of tenure might be increasing: see Q 62.

[24] Paragraph 2.5

[25] Q 102 (Work Foundation)

bring the notice periods of executives more closely into line with those of their other employees.

Liquidated Damages

26. Liquidated damages involve writing into an executive's contract the precise value of any severance package. It was an approach that was mooted in the Hampel Report on Corporate Governance as a way of overcoming the uncertainty associated with executives' severance packages. The Hampel Report noted that neither party expected the notice period to be worked out and it was thus merely a means of paying money. It concluded that because severance packages are effectively compensation for breach of contract, these are only quantifiable at the point at which the contract is terminated, and because of the unpredictability that the mitigation process adds, it would be preferable to look for a solution that provides certainty from the outset.[26]

27. However, despite the fact that liquidated damages improve certainty, and that they allow a clean break to made between the outgoing executive and the company, we found little support for them as a means by which the problem of rewards for failure could be addressed. Several potential shortcomings were mentioned.

28. PIRC suggested liquidated damage clauses in executives' contracts were partly responsible for the rise in the size of severance packages. Whilst accepting the merits of such clauses in principle, they suggested that there has, in practice, been a tendency for liquidated damages provisions to be written in such a way as to exceed the sum payable under a normal notice period. They noted that two recent instances where potential severance payments had caused fierce public controversy — at GlaxoSmithKline and HSBC — were both related to liquidated damages.

29. As a consequence of the problems with liquidated damages the Green Paper floats the idea of capping them at, for instance, six months of basic salary. This approach was supported by the representatives of the TUC, who judged it a way of preventing the upwards creep in the value of severance packages, which they considered to have been driven by the inclusion of ever greater amounts of bonus payments, pension contributions and other elements.[27]

30. But the inflexibility of an approach where the terms of severance are set at the beginning of a contract and are therefore non-negotiable also caused concern. Contracts, our witnesses said, are drawn up a in a climate of optimism so there is a tendency for liquidated damages to be set rather higher than might have been the case with the benefit of hindsight.[28] Consequently, the executive will receive the same, guaranteed sum regardless of the circumstances under which he or she leaves the post.

31. Of course, the absence of a liquidated damages clause in a contract does not mean that the severance payment is completely unpredictable. Most obviously, the length of the notice period can be seen, in practical terms, to be similar to a liquidated damages clause as

[26] *The Hampel Committee on Corporate Governance – Final Report* (January 1998), Sections 4.9-4.10

[27] Q 194

[28] Q 123 (ABI/NAPF)

it provisionally sets out a basis for establishing the value of the severance package. This point was highlighted by the ABI and NAPF, who told us that they had asked companies to calculate the cost of severance when executives' contracts are drawn up and to rewrite them if that cost is excessive.[29]

Phased Payments

32. One significant argument against liquidated damages is that it involves the payment of the total value of the severance package as one lump sum. Phased payments involve paying the value of the severance package in monthly instalments spread over the notice period. We found that they were a popular approach to remedying the rewards for failure problem. The ABI and NAPF already recommend phased payments in their best practice guidelines.[30]

33. Under phased payments, there would be no large, single lump sum payment and so the associated bad publicity would be avoided. More importantly, phasing payments would end the situation where executives have left one company with a large severance package and then taken on a new position almost immediately.[31] Furthermore, as phased payments spread the cost of the severance package over several months, the impact on the company's cash flow and balance sheet is lessened — particularly if more than one director has left.

34. Ruth Lea of the IoD pointed out that phased payments might provide an incentive to executives not to seek new employment after leaving their post because if they wanted to receive the full value of their severance package, they would not be able to take on any further employment before the end of their notice period. She characterised phased payments as a "guarantee of idleness".[32]

35. However, other witnesses thought that most people who found themselves in such a position would be eager to revive their careers at the first opportunity and so would be keen to take a new post as soon as possible.[33] But even if this were not the case, the duty to mitigate losses provides a safeguard against former executives choosing to remain idle whilst waiting for the instalments of their severance package.[34] Under common law, an outgoing executive is obliged to attempt to minimise the losses incurred by the company and so is actually required to actively seek employment.

36. It seems, however, that the obligation to mitigate has not been consistently applied. One witness said that "there has been a kind of collective blind eye by the FTSE 100", whilst a submission by the Co-operative Insurance Society spoke of the "fiction of the mitigation principle, in all but a few companies".[35] Even where a company did make a commitment to mitigate damages in the event of severance, it was suggested, failed executives had still received the full value of the severance package in one payment. In the event of severance,

[29] Q 122 (ABI-NAPF)

[30] ABI-NAPF *Best Practice on Executive Contracts & Severance* (December 2002), para 3.2

[31] Q 172 (CBI)

[32] Q 78 (IoD)

[33] Q 20 (IMA)

[34] *Ibid.*

[35] Q 102 (Work Foundation); App 5 (CIS).

companies are keen to end the relationship with the outgoing executive as swiftly and cleanly as possible. In particular, they are anxious to avoid drawn out legal battles — a fact that has been exploited by the lawyers of the outgoing executives who have threatened litigation unless the severance package was paid in full.[36]

37. **Phased payments are clearly a means by which severance pay can be reduced. Departed executives will receive payments only for the period during which they are out of work and the obligation to mitigate loss means that they should not be able to remain idle whilst waiting for the full value of the severance package to be paid.**

38. **However, the full benefits of phased payments can be realised only if the obligation to mitigate loss is strictly enforced. We were told that the general principle is enshrined in common law and yet, it seems, it is inconsistently applied.[37] We would expect companies to enforce the duty to mitigate losses properly and to make the phased payments only whilst the recipient remains out of work.**

Other Measures

39. Of the measures that the Green Paper puts forward, we found that both shorter contracts and notice periods, and phased payments, backed up by properly applied mitigation, could contribute to reducing the problem of the size of rewards for failure. However, it is the manner in which the contract is constructed that will determine whether failure is rewarded or not.

40. Pressure, it would seem, is increasingly being brought to bear on companies to structure their contracts in such a way as to reward success without committing themselves to vast severance packages.[38] Most executives' contracts are a mixture of basic salary and bonuses contingent on certain performance targets being reached. With targets set unambiguously and high enough to ensure that only genuine achievement is rewarded,[39] and with a higher proportion of remuneration dependent on performance, contracts can be structured to ensure that there is no reward for failure.[40]

41. Relatedly, there is also the matter of the elements of the remuneration package that are subsequently included in the severance package. It was suggested to us that one of the reasons for the increase in the value of executives' severance packages, in spite of improvements such as the move to shorter contracts, is that more and more elements of the remuneration package — such as bonuses and perks — are being included in the calculations for determining them.[41] This is clearly a matter of concern and risks undermining the improvements made in other areas.

[36] App 7 (CIS)

[37] Q 102 (Work Foundation)

[38] Qq 27 (IMA) and 122 (ABI-NAPF)

[39] PIRC note that executives' performance targets have not been toughened in spite of the significant increases in remuneration: App 9

[40] Targets should, where possible, measure relative performance to ensure that it is genuine performance that is being rewarded, rather than market fluctuation: Q 27 (IMA)

[41] Q 194 (TUC); App 13 (TUC); App 9 (PIRC)

42. **If the targets upon which bonuses are based are set at a sufficiently challenging level, and an executive is being removed for underperformance, we cannot see how significant performance-related elements of the remuneration package can legitimately be included in the severance package. Given the seemingly endless rise in the value of elements other than basic pay in executives' total remuneration, the problem of excessive rewards for failure is unlikely to be solved unless companies address this issue properly.**

5 Enforcement

43. As well as asking for responses on the structure of contracts, the Green Paper also raises the question of how improved standards should be enforced and, notably, whether legislation is required. Whilst the failure of self-regulation was implicitly acknowledged by our witnesses' admission that there is a problem with rewards for failure, we found little support for legislative solutions.

44. Legislation was deemed premature by several witnesses. It was suggested that recent changes are starting to bring about the desired improvements:[42] for instance, the ABI-NAPF statement of best practice has put in place a framework of standards for those drawing up contracts; but this was released only in December 2002 so it is rather too early to judge its impact. This will be possible only when the contracts signed since its publication are terminated.[43]

45. Remuneration committee reports, where the details of directors' remuneration packages are disclosed, are now subject to a vote by shareholders. This has resulted in a number of high profile shareholder rebellions during the recent round of company annual general meetings (AGMs). Shareholder votes on remuneration committee reports are not binding. However, the bad publicity that has been generated, both for companies and the individual directors involved, shows that such revolts are not without influence — even narrow approval or a high abstention rate in the remuneration committee vote can act as a 'warning shot'.[44] We would expect the need for these shareholder rebellions to diminish over time as the company boards anticipate shareholder opposition and change their behaviour accordingly. The ABI-NAPF document provides a guide to companies as to the standards institutional shareholders regard as acceptable; if those are ignored, shareholders can effectively remove the board.[45]

46. In addition to the ABI-NAPF document and the vote on remuneration committee reports, there have been other developments that may also have an impact in the near future. The Combined Code is being revised in the light of the findings of the Higgs Report into the role of non-executive directors and a comprehensive Companies Bill is being prepared by the Government following the Company Law Review and the subsequent White Paper, published last year.[46] We commented on these developments extensively in our Sixth Report of Session 2002-03 and noted that a number of the proposed changes had the potential to increase the accountability of companies to their shareholders.[47]

42 App 5 (PCG Worldwide); App 6 (QCA) and App 9 (PIRC)

43 ABI-NAPF *Best Practice on Executive Contracts & Severance* (December 2002)

44 For a list of such rebellions see App 9

45 Though this is seen as a drastic solution and is highly unlikely.

46 *The Review of the Role & Effectiveness of Non-Executive Directors* DTI (January 2003); Company Law Steering Group *Modern Company Law: For a Competitive Economy – Final Report* Vols I & II (June 2001); *Modernising Company Law* Cm 5553 (July 2002).

47 Sixth Report of the Trade & Industry Select Committee, Session 2002-03, *The White Paper on Modernising Company Law,* HC 439

47. Legislation was considered a rather blunt instrument with which to approach the matter of rewards for failure and we found limited support for it.[48] Contracts need to vary to reflect the specific demands of the job and the situation of the individual executive. Attempting to legislate might undermine this flexibility. Furthermore, our witnesses highlighted the difficulty of legally defining and attributing ‘failure’. It was, we were told, hard both to define failure for legal purposes and also difficult in practice to attribute any perceived failure to an individual executive. After all, company difficulties are rarely the result of decisions made by only one person, so determining the degree to which a single director is responsible for problems is usually a matter for argument. As a consequence, trying to legislate for a set of circumstances arising when an executive has ‘failed’ is a difficult task.[49]

48. **With so many recent measures that are likely to impact significantly on corporate governance in the UK, we see no need at the moment for a legislative solution to the problem of rewards for failure. Legislating in this area is difficult and the outcomes are likely to be less desirable than a general, voluntary adoption of suitable standards of best practice. The flexibility of such an approach is an advantage, with standards for companies to meet but, when necessary, deviations justified by the ‘comply or explain’ principle that already applies to the Combined Code.**

49. **Recent initiatives have the potential to improve the corporate governance framework in the UK and, as a consequence, to strengthen the link between executives’ performance and rewards; time should be allowed to judge whether they have had the desired effect before further legislation is considered. Ultimately what is required is a change in culture amongst company boards — those awarding contracts to new executives will frequently be executives themselves and only a change in their outlook can truly remedy the problem of rewards for failure. We think that the means by which this change can best be brought about is through compliance with suitable standards of best practice. At present, therefore, we do not advocate legislation. If, however, the wishes of shareholders are not being adequately reflected in contracts being agreed by companies’ remuneration committees, or the contracts themselves are unable to be enforced, then the case for legislation will need to be reconsidered.**

50. It would seem that institutional investors are beginning to take their role in the corporate governance process more seriously. The ABI-NAPF document is an example of their willingness to engage more constructively with the companies in their portfolio; another is the Institutional Shareholders Committee’s (ISC) statement of principles.[50]

51. But, as we noted in our Sixth Report, relying on institutional investors to enforce standards of good corporate governance is not without problems. Whilst we concede that some institutional investors are making genuine efforts to fulfil their corporate governance role, others, it seems, are happy to ‘freeride’ on their efforts. And in a period of low stock

48 Only the TUC strongly favoured legislation in the first instance: see Qq 190-200

49 Q 121 (ABI-NAPF)

50 Institutional Shareholders Committee, *The Responsibilities of Institutional Shareholders and Agents – A Statement of Principles* (October 2000)

market values even the committed may be unwilling to devote large numbers of staff to compliance departments.[51]

52. But even where institutional investors are willing and sufficiently well resourced to take an active role in the governance of the companies in their portfolio, we were told about significant practical difficulties in exercising their 'voice' through the voting system.

53. The voting system is a complicated one with many opportunities for errors and inconsistencies to arise, and for votes to go missing altogether.[52] There is a complex chain between the beneficial owner of the shares, the investment manager and the custodian. Either the beneficial owner or the investment manager will be able to vote only by informing the nominee in advance. The whole process can take more than three weeks. Further difficulties arise. For instance, there is no clear closing date by which investors need to have acquired their shares in order to be able to vote.[53]

54. Votes registered and votes cast may not tally, which causes further difficulties — with voting instructions passed to nominees some time before the voting takes place, the investment manager may have traded some shares in the interim period causing a mismatch between votes cast and votes listed on the register. This problem can be exacerbated by the short-term lending of stock: in order to aid liquidity, stock is frequently loaned. When this happens, the voting rights are temporarily transferred as well. Between 5% and 15% of stock is loaned out at any one time.[54] If the number of registered shares is greater than the number of votes cast, the smaller figure is taken; if it is greater, then all the votes are rejected.

55. We would not want to overstate the problem of lost votes — most votes cast are successfully registered. Levels of voting are also reasonable — according to recent figures from PIRC, 53% of FTSE100 votes are cast, rising to 58% for the FTSE350. 32.1% of UK equity is held overseas, little of which is voted, so a high proportion of the votes held in the UK are cast.[55] However, the lack of an adequate audit trail means that there is still doubt about whether the votes have been cast as intended.

56. It was suggested to us that electronic voting could simplify the process considerably.[56] Whilst there has been an increase in availability of this sort of service, take up has evidently been slow. This may be because it would require the adoption of it by all those institutions involved in the process for it to work, or because those involved do not feel that it is a sufficiently pressing matter to warrant the investment.

57. **The voting system is clearly extremely bureaucratic. Whilst we are sure most shareholder votes cast are successfully registered and only a relatively small minority go missing, we do think that the process is unnecessarily complex and that this will act as a disincentive to the institutional investors to become more actively engaged with**

[51] We discuss this in more detail in our Sixth Report of Session 2002-03, chapter 7.

[52] Q 31. The IMA's submission provides a detailed discussion of the voting process.: see App 14

[53] App 14 (IMA)

[54] *Ibid.*

[55] PIRC Press Release www.pirc.co.uk (29 August 2003). The problems associated with cross border voting are discussed in depth in *The Expert Group on Cross-Border Voting in Europe – Final Report*, Amsterdam (August 2002)

[56] App 12

companies in their portfolio. The lack of an adequate audit trail means that it is difficult to ensure that the votes have been cast correctly. Electronic voting would seem to have the potential to improve the process. The Government should be facilitating this in any forthcoming Companies Bill, and we would encourage interested parties to investigate this avenue thoroughly; anything that can cut through the bureaucracy involved and ensure that votes are cast correctly would be welcomed.

Conclusions and recommendations

1. Our witnesses were in no doubt that there is a genuine problem of contracts that provide for excessive severance packages for directors who have failed to improve the performance of their company. Whilst the examples of GSK or Marconi are exceptional in their scale, they clearly represent the tip of the iceberg. We do not dispute that directors of large companies should expect remuneration commensurate with the level of responsibility they have and the relatively precarious nature of their employment. A lengthy and successful tenure will also inevitably be reflected in high rewards and, potentially, a sizable severance package. However, the increases in salary and bonuses that directors have experienced in recent years, on which severance packages are based, have not been a reflection of tougher performance targets or better company performance. It would appear that executives have been rewarded not only for success but for failure as well (Paragraph 11)

2. We are not convinced that the current scale of executives' severance packages is a product of competition for scarce talent in an international market. Executives in the UK are paid more than those in any country other than the USA, where executive pay is so much greater that there seems little prospect of recruitment from there on a large scale. (Paragraph 18)

3. We would hope that the recent examples of shareholder revolt and the wider public concern generated by the instances of rewards for failure would prompt all companies to look hard at the way in which executives' contracts are constructed. (Paragraph 20)

4. We can see no reason why, in principle, the notice periods of executives should be any different from those of the rest of the population. UK executives are already well remunerated and have become increasingly so over recent years. Many other areas of employment can be considered as risky but do not have the benefit of such high salaries. We would urge companies not only to adopt one year contracts, other than in exceptional circumstances, but also to specify separately the notice period, in order to bring the notice periods of executives more closely into line with those of their other employees. (Paragraph 25)

5. Phased payments are clearly a means by which severance pay can be reduced. Departed executives will receive payments only for the period during which they are out of work and the obligation to mitigate loss means that they should not be able to remain idle whilst waiting for the full value of the severance package to be paid. (Paragraph 37)

6. However, the full benefits of phased payments can be realised only if the obligation to mitigate loss is strictly enforced. We were told that the general principle is enshrined in common law and yet, it seems, it is inconsistently applied. We would expect companies to enforce the duty to mitigate losses properly and to make the phased payments only whilst the recipient remains out of work. (Paragraph 38)

7. If the targets upon which bonuses are based are set at a sufficiently challenging level, and an executive is being removed for underperformance, we cannot see how significant performance-related elements of the remuneration package can legitimately be included in the severance package. Given the seemingly endless rise in the value of elements other than basic pay in executives' total remuneration, the problem of excessive rewards for failure is unlikely to be solved unless companies address this issue properly. (Paragraph 42)

Formal minutes

Tuesday 16 September 2003

Members present:

Mr Martin O'Neill, in the Chair

Mr Roger Berry	Mr Andrew Lansley
Richard Burden	Linda Perham
Mr Jonathan Djanogly	Sir Robert Smith
Mr Lindsay Hoyle	

The Committee deliberated.

Draft Report (Rewards for Failure), proposed by the Chairman, brought up and read.

Ordered, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 57, read and agreed to.

Resolved, That the Report be the Sixteenth Report of the Committee to the House.

Ordered, That the provisions of Standing Order No. 134 (Select committees (reports)) be applied to the Report.

Ordered, That the Appendices to the Minutes of Evidence taken before the Committee be reported to the House.

[Adjourned till Wednesday 15 October at Ten o'clock

Witnesses

List of written evidence