

Deferred variable remuneration and the penalties doctrine Simon Devonshire QC

Introduction

1. The broad shape of the FSA's proposals requires:-
 - 1.1. The deferral of between 40 and 60% of annual variable remuneration ("AVR") for no less than 3 years, with payment made no more quickly than on a pro rata basis, with the first payment not made earlier than the first anniversary of the award date;
 - 1.2. At least 50% of the AVR to be paid in "*contingent capital*"¹;
 - 1.3. "*That firms retain the ability to make adjustments to an individual's unvested deferred amounts of variable remuneration, after the amount has been communicated to the employee, to reflect actual outcomes as they materialise over time ... 'performance adjustment', encompassing key elements of ex-post risk adjustment*"².
2. The FSA distinguishes between:-

*"adjustments made to deferred variable remuneration ["DVR"] that has not yet vested (known as 'malus') and that which the individual agrees to repay (known as 'clawback')"*³.

¹ "*Shares, share-linked instruments, or other equivalent non-cash instruments of the firm, and, where appropriate, after long dated financial instruments that adequately reflect credit quality (... 'share equivalent instruments'), subject to the legal structure of the firm*"; 10/19 para 3.81.

² 10/19 para 3.88.

³ 10/19 para 3.90.

3. The FSA's focus is on malus adjustments "*where, as a result of poor performance, a reduction is made to a deferred award prior to vesting (i.e. before ownership has transferred to the employee)*"⁴. The reason for this is explained in a footnote⁵. The FSA says that it recognises that:-

"there are limits to the ways in which clawback can be operated as an effective performance adjustment technique."

4. This paper focuses on the operation of the malus adjustment provisions, and their interrelationship with the common law doctrine of penalties. However, it is useful to explore first the reasoning behind the SFA's hypothesis that malus (pre-vesting) adjustment is a more effective performance adjustment technique than clawback. On a 'human' level, this is easy to understand. There must come a time when the employee can conclude that which he has earned is his to keep⁶. But is there a conceptual reason for the distinction? Does the SFA have in mind that clawback will be subject to the penalties doctrine but malus adjustment (to non-vested benefits) will not? If so, is this right? There is recent authority for the proposition that a clause entitling an innocent party to a breach to withhold a payment that might otherwise fall due (rather than the paradigm case of a provision requiring payment to be made) is subject to the penalty rule; The General Trading Co Ltd –v- Richmond Corpn [2008] EWHC 1479 (para 113). See too Chitty Vol. 1 para 26-138⁷. What can be stated with confidence, however, is that the SFA's observations accord with a greater judicial reluctance to interfere with vested proprietary rights than contingent expectancies.

⁴ 10/19 para 3.90.

⁵ Footnote 32.

⁶ And indeed observations to this effect are made in some of the decided cases; See the discussion of Malone and Brand below.

⁷ "*It is unclear how far the law applies to a clause which imposes on the contract breaker adverse consequences other than the payment of money or the forfeiture of money already paid or of proprietary or possessory rights held by him*"

Vested and Non-Vested Benefits; the Courts Approach to Adjustment Provisions

5. There is no reason in principle why a company scheme (or an employment contract) should not provide for the forfeiture or clawback of accrued or vested benefits. A good example is provided by the Tullett Prebon litigation (Tullett Prebon & Ors -v- BGC & Ors [2010] EWHC 484 (QB), discussed further below), where the Judge had no difficulty in enforcing provisions for the repayment of substantial retention and sign-on payments made (in some cases) a year or two earlier⁸. However, the cases have traditionally distinguished between vested rights and contingent or conditional future grants, the Courts being more jealous in the protection of vested rights.

6. A good example is Mallone -v- BPB Industries Ltd [2002] ICR 1045. The Claimant was employed by the Defendant company and was a member of the company's senior executive share option scheme. Under the scheme the company's directors had the power to grant share options to an employee, who could not exercise the option until three years after the date of its grant. The Claimant had been employed with the company for 12 years when he was dismissed. He had been granted a number of options over the years, some of which were more than three years old, and known as "*mature*" options. Under the scheme, once an employee ceased to be employed by the company he was not permitted to exercise more than an "*appropriate proportion*" of the number of the shares comprised in an option granted to him, such proportion being determined by the company's directors "*in their absolute discretion*". The directors decided to cancel all of the Claimant's options, by determining the appropriate proportion of options which he was permitted to exercise at zero. When the Claimant sought to exercise his share options after his dismissal the company refused to recognise his right to do so. The Claimant sued the company for breach of

⁸ See too Alder -v- Moore [1961] 2 QB 57, also discussed below

contract on the ground that the directors had not properly exercised their discretion. The Judge found that the scheme did not entitle the directors to cancel mature options, but that, even if it did, their decision to cancel all the Claimant's mature options was one that no reasonable employer could have reached, and he held that the company should have recognised the Claimant's exercise of his mature options.

7. The Court of Appeal dismissed the Company's appeal. Although the Court differed from the Judge in concluding that the directors had the discretion to cancel mature, as well as immature options, that discretion, though absolute, had to be exercised properly and remained one to find the "*appropriate proportion*"; that, given that the options were granted in reward for past performance and in anticipation of future loyalty and that mature options were vested property rights, on the evidence, the directors' decision to cancel all the Claimant's mature options was an irrational exercise of their discretion.
8. The Court of Appeal was significantly influenced by the fact that it was dealing with vested property rights. As Rix LJ put it (at paras 41 and 44):-

"... The points to note, of course, are that options are granted in reward for past performance, and in anticipation of future loyalty, and, if you like, future performance, but that after three years they 'vest'. In such circumstances any committee of directors which is contemplating applying its discretion under the proviso of rule 5(b)(iii) to the mature options of a participant needs to bear in mind that it is dealing with vested property rights. Compared with the grant of an option, or of a bonus, this case seems to me to be a fortiori. It may be that poor performance during or even after the vesting of such options will justify to some extent the application of a fraction less than 36/36. But it is hard to see why someone who is not being dismissed for misconduct should on the ground of his performance after the vesting of his options be treated just the same as one who is being dismissed summarily for misconduct.

...

But such possibilities⁹ are always present. An executive might be able to exercise his options before his departure, perhaps in anticipation of his employer's displeasure. Considerations such as these, however, are not, it seems to me, a valid reason for treating the whole scheme as a sort of mirage: whereby the executive is welcomed as a participant, encouraged to perform well in return for reward, granted options in recognition of his good performance, led on to further acts of good performance and loyalty, only to learn at the end of his possibly many years of employment, when perhaps the tide has turned and his powers are waning, that his options, matured and vested as they may have become, are removed from him without explanation."

9. A similar rationale underpins a subsequent Court of Appeal case; Brand -v- Compro Computer Services [2005] IRLR 196. Clear words were required to displace the entitlement to commission earned or accrued during employment merely because the employment had ended, given that (per Peter Gibson LJ):-

"[s]uch a harsh result would be inconsistent with the avowed purpose of the plan, to give rewards for the achievement by [the employee] of targets set for him by [the employer¹⁰] ... I do not accept that such a one-sided bargain is one that the parties can be taken to have entered into, in the absence of clear words making plain that any accrued entitlement ... was dependant upon the employee also being in employment at the date when the commission would be payable."¹¹

10. What is more:-
- 10.1. An employer exercising a discretion to forfeit or clawback a vested property right may owe fiduciary duties to the owner of the right directly, to exercise that discretion on a proper basis; and

⁹ E.g. "[a] poorly performing executive represented as leaving in failure with valuable options", or a substantial rise in the value of the shares after the executive has left, leading to apparently arbitrary results.

¹⁰ Para 35.

¹¹ Para 38.

10.2. Forfeiture is treated very strictly by the Courts, and a person exercising a forfeiture discretion must act without procedural or substantive flaws or defect.

Hunter -v- Senate Support Services Ltd [2004] EWHC 1085 (CH).

11. It follows that the employer who wants to retain maximum adjustment flexibility might be well advised to defer vesting (provided that in practical terms this does not undermine employee incentivisation). But will the FSA's distinction between vested and non-vested benefits be possible to apply in all cases? It works well enough with the conditional grant of shares, but what about LLPs or hedge funds, which will have to use "*other equivalent non-cash instruments*"? For example, hedge funds typically defer the member's share of management fees and profits for one or two years. These deferred balances are said to be the property of the member but are held by a nominee, subject to adjustment/forfeiture at the direction of the Board for losses and the like. Such a model assumes the vesting of the property (albeit that it is effectively held on trust). The rules will require that remuneration to be as liable to adjustment as the non vested DVR conditionally promised to the company employee. The answer in such cases is probably that the fiduciary obligations owed by the Board/nominee to the member are circumscribed and moderated by the scheme rules, and the Courts are unlikely to apply a substantively different approach if the rules are clearly worded.

The Penalties Doctrine

12. English law generally respects the sanctity of contract, and the Court has no general jurisdiction to re-form the terms of a contract because it considers them unduly onerous to one party. There are limited public policy exceptions, such as restraint of trade (addressed in a separate paper) and the laws relating to penalty clauses (the focus here).

13. A contractual stipulation for a payment in the event of a breach will be enforceable if it is a genuine pre-estimate of damage, but not enforceable if it is a penalty. The classic statement of the law on penalties is found in the judgment of Lord Dunedin in Dunlop Pneumatic Tyre Co Ltd -v- New Garage and Motor Car Co Ltd [1915] AC 79 at 86-88. In essence, a penalty is “a payment of money stipulated as *in terrorem* [a deterrent to] the offending party”, rather than a genuine pre-estimate of damage. This is determined as a matter of construction, judged when the contract is made. There are no conclusive tests to assist in this task of construction, but (pace Lord Dunedin) the following may be helpful:-

- “(a) *It will be held to be a penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss which could conceivably be proved to have followed from the breach.*
- (b) *It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid.*
- (c) *There is a presumption (but no more) that it is a penalty when a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage.*

On the other hand:

- (d) *It is no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation in which it is probable that pre-estimated damage was the true bargain between the parties”.*

14. The modern re-statement of these principles is to be found in the judgment of Colman J. in Lordsvale Finance Plc -v- Bank of Zambia [1996] QB 752 at 762G (in a passage since cited with approval on a number of subsequent occasions in the Court of Appeal). He observed that it was perhaps no longer entirely appropriate to ask whether a payment on breach was stipulated in terrorem of the offending party, but:-

“Whether a provision is to be treated as a penalty is a matter of construction to be resolved by asking whether at the time the contract was entered into the predominant contractual function of the provision was to deter a party from breaking the contract or to compensate the innocent party for breach ...

That the contractual function is deterrent rather than compensatory can be deduced by comparing the amount that would be payable on breach with the loss that might be sustained if the breach occurred.”

15. The application of the doctrine is a matter of substance, not form. There is scope for arguing that a financial obligation triggered on the happening of a (non-breach) event is a “*disguised penalty clause*”; Interfoto Picture Library Ltd -v- Stiletto [1989] QB 433 at 439F and 455 G-H. The Court may look behind the form of the transaction to ascertain its true nature; Euro Appointments -v- Clessens International Ltd [2006] LR 476 at para 28 - a charge for late return of hired chattels dressed up as a holding fee would not hide the true (penal) nature of the bargain. It can apply to a clause requiring the forfeiture of proprietary rights; Jobson -v- Johnson [1999] 1 WLR 1026 esp at 1034H et seq¹².

Penalties and Malus Adjustments

16. Turning from the penalty principles to the new rules, firms will be required to consider making a “*malus*” adjustment if “*there is evidence of employee misbehaviour or material error*”. Put another way, a malus adjustment may ‘punish’ an employee for a breach of his duties. However, there seems little scope for the application of the penalties doctrine (at least as it is conventionally understood) in such circumstances. A scheme rule that triggers a discretion to consider a malus adjustment in specified circumstances does not stipulate for the payment of a sum in the event of breach. It

¹² “Does it make any difference ... that the penalty in the present case is not a sum of money? In principle, a transaction must be just as objectionable and unconscionable in the eyes of equity if it requires the transfer of property by way of a penalty on a default in paying money as if it requires a

merely provides for the reconsideration of a conditional grant in accordance with the requirements of a (statute-backed) scheme.

17. Whilst it might be argued that a particular discretionary conclusion was penal (cf the General Trading Company case already discussed), a simpler 'policing' mechanism in such circumstances is probably provided by the T&C term. A 'penal' (unjustified) malus adjustment is likely to be a perverse exercise of the discretion, and is likely to provide a disgruntled employee with a more straightforward basis of challenge than adapting the penalties doctrine.

Penalties and Conditions Precedent to Payment

18. There is no problem with provisions that stipulate that the employee shall not be entitled to receive unvested benefits if he is not in employment when they would otherwise vest; see e.g. Keen -v- Commerzbank [2007] ICR 623 esp at paras 74-76. The penalties doctrine is not concerned with conditions precedent to receipt, which merely define or circumscribe when the entitlement to receipt arises; cf Penninsular -v- Sweeney [2004] IRLR 49 esp at paras 28 to 37¹³, and Marshall -v- NM Financial Management Ltd [1997] IRLR 449 esp at para 24¹⁴.

Penalties and Provisions for the Clawback of Vested Benefits

19. As already observed (i) it is possible for a contract to provide for the repayment or surrender of vested benefits with sufficiently clear words, but (ii) the Courts will more jealously guard against the removal of the employee's rights in such circumstances.

payment of an extra, or excessive, sum of money. There is no distinction in principle ... In each case, the clause ought to be unenforceable in equity insofar as it is a penalty clause'

¹³ In fact dealing with the issue of whether a clause was an unreasonable penalty under UCTA, but the reasoning applies.

Will the penalties doctrine be engaged if (e.g) the employee is required to pay back or surrender vested benefits in the event of a breach (such as early, unlawful termination of his fixed term contract)?

20. It is clear that the doctrine can apply in such circumstances. A good example is Jobson -v- Johnson [1989] 1 WLR 1026. The defendant was liable to forfeit the shares he had purchased if he defaulted in the payment of any of the installments of the purchase price. He paid the first installment, but defaulted on the second. The CA held that the provision was penal and gave him relief from forfeiture. Kerr LJ's judgment is instructive (at 1049G-H):-

“There is nothing penal about a provision that, in the event of a failure to pay any installment of the price, the plaintiff is to be entitled to rescind the contract and recover the goods against a refund of all sums paid by him: cf Alder -v- Moore [1967] 2QB 57. [The forfeiture clause] is penal, because its operation takes no account of the sums already received, and to that extent is unenforceable”.

21. In Jobson the shares were forfeit in the event of a breach. What if the accrued right is forfeit or clawed back on the happening of some future event which is not a breach of contract (or is only coincidentally so) or in a range of circumstances, some of which might involve breaches of contract but others of which may not? A similar issue arose in Alder -v- Moore [1961] 2 QB 57. The Defendant footballer received an insurance payment on the basis of his permanent disability; the insurers were able to enforce a “penalty” in the same amount when he took part in professional football again in the future; the contract contained a repayment stipulation contingent on the happening of a future event (that he played professional football again), but did not impose on the recipient an obligation never to play football again, and was not therefore a sum payable as *damages* for breach of contract. Devlin LJ dissented on

¹⁴ Nothing unlawful about a qualifying period for receipt of benefits.

the proper construction of the contract but seemed to accept that a contingent promise to pay would be outside the scope of the law of penalty clauses; 69.

22. Alder was followed and applied more recently (on facts much closer to home) in the Tullett Prebon litigation, where the employee Defendants had to repay signing and retention repayments when they left (in breach of contracts) before their contracts expired. For the most part, they were subject to clauses which required them to repay the entirety of those payments, regardless of the proportion of the contractual term they had seen out. Jack J. dismissed the penalty argument fairly summarily (at paras 268-270):-

“268. *A penalty is a sum provided by a contract to be payable in the event of a breach of the contract, which sum is inserted other than as a fair estimate of the loss which may be occasioned by the breach, but in contrast is inserted in terrorem. It is stated in Chitty on Contract, 30th Edition, volume 1, paragraph 26-145 that ‘If a contract provides that in a certain event a sum of money paid under a contract is to be repaid to the original payer, the reimbursement cannot be a penalty’, citing Alder v Moore [1961] 2 QB 57. I would accept that the factual situation in that case is rather different from the present.*

269. *The provision for repayment is not here a term which has anything to do with compensation for breach. The employee is given a large additional sum of money if he continues working for the company and does not give notice before the date when the minimum term ends (and when he is then entitled to give notice). If he does not do so, he has to give it back. The law relating to penalties is wholly inapplicable.*

270. *The brokers are intelligent, successful men capable of driving a bargain with Tullett, and the law should not look for ways for them to avoid the provisions of their contracts. But, in fact, for the reasons I have given the position is plain.”*

23. What these cases do seem to suggest is that with careful drafting, scheme rules could provide for surrender or forfeiture without engaging the penalties doctrine or at least minimising the risk of its application.

24. Even where the penalties doctrine is engaged, employees should not necessarily expect a sympathetic judicial hearing. In another Tullett Prebon case (Tullett Prebon Plc -v- El-Hajjali [2008] IRLR 760) Mr El-Hajjali was a senior derivatives broker at Link, specialising in variance swaps. He signed a contract to join Tullett Prebon as soon as he was able, with guaranteed first year remuneration of £1.2 million. That contract was executed after some six months of negotiation between lawyers instructed for each side. The contract contained a “*no show*” clause in the event that Mr El-Hajjali failed to take up his employment with Tullett Prebon, which required him to pay “*by way of agreed liquidated and ascertained damages, a sum equal to 50% of the net base salary and (if any) 50% of your signing payment (if any) that the company has contracted to pay to you during the term of the employment contract*”. The sum payable under this clause was some £300,000, considerably less than Tullett Prebon would lose if Mr El-Hajjali ‘welched’ on the deal. He did ‘welch’ and argued that the clause was penal. His argument was rejected.
25. The result was not surprising. With great forensic ambition (but less common sense) Mr El-Hajjali argued that the clause was penal because the sum it stipulated was too low to be a genuine pre-estimate of loss (para 69). The decision does, however, chime with Jack J’s judgment, in observing that financial services employees are masters of their own contractual fate. As Nelson J. put it (para 74):-

“Where a bargain has been struck by two parties of equal bargaining power, with each party legally represented, a court should consider long and hard before permitting one of the parties to resile from that agreement. In such circumstances it is in my judgment only where a stipulated sum is extravagant or unconscionable in amount compared with the greatest loss or range of losses that could conceivably prove to follow breach that the clause should be held to be a penalty ...”

Capped Payments and Illegitimate Competition

26. As well as providing for performance adjustment and clawback, the proposed rules limit the sums an employer can pay - e.g. as signing or retention bonuses. Before the proposals were tabled, *“firms currently within the scope of the Code [had] expressed concerns about losing their staff to competitors outside the scope of the Code. For example, those firms with investment banking business are at a disadvantage relative to hedge fund managers”*¹⁵. What causes of action might the rules give the gamekeeper in the face of a poacher who flouts the rules to orchestrate a team move? One possibility is unlawful means conspiracy, but will the unlawful means suffice¹⁶? Another is (regulatory) JR if the FSA fails to act. Further consideration must await the final rules, but these rules will have a major impact on recruitment strategies and team move litigation.

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¹⁵ 10/19 para 2.26.

¹⁶ On the current state of the authorities, it is unclear to what extent the unlawful means must be independently actionable at the suit of the claimant; See Revenue & Customs Commissioners –v- Total Network SL [2008] UKHL 19.