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Edited by Carol Arrowsmith , Rupert McNeil
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Introduction

Senior executives ('executives') are employed to help create shareholder value. When a company decides to employ one executive rather than another, it is taking a view on which one will better achieve that aim: i.e. which one will create greater value for the organisation. Once that decision has been made, a deal must be struck and documented. After it has been struck, the deal continues to evolve. This book is a guide for those involved in that process.

The best, most effective deals, which means those most likely to enhance shareholder value, are those which are 'fair' to both parties. These are deals where, with appropriate checks and balances, the executive's 'price' is the market price for someone with that skill set, ability and potential for creating shareholder value.

Chapter 1 sets out a framework for constructing executive rewards and how this can be used to compose a 'term sheet' for a senior hire from which a contract can be constructed

Chapter 2 discusses the practicalities of converting a term sheet into a legally enforceable agreement. It ends with a set of questions any reviewer of a service contract should ask as they review it.

Chapter 3 explores the most effective ways to reach robust and fair values for the various elements of the remuneration package.

Chapter 4 describes the various forms of executive reward commonly found in UK listed companies and discusses the process of determining the package.

This leads onto Chapter 5 which illustrates the ways the package can be optimised in different commercial contexts. This forms part of the important process of tailoring the deal to the given business situation, influencing the form of awards, as well as the nature of performance conditions.

Chapter 6 examines the wider impact of the remuneration policy and how this may appear to shareholders.

Chapter 7 reviews the development of the governance framework within which these decisions need to be made.

At this point, it may be helpful to explain why this book is focused on arrangements involving senior executives. For the purposes of this book, senior executives are individuals whose individual contributions will have a material impact on the creation or destruction of shareholder value. They

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tend to be more common higher up the organisational hierarchy. They also tend to be scarcer than candidates for less senior roles.

Why does the employment of executives require a different approach? A practical reason is that there is usually more scope for 'customised' deals which are less constrained by wider corporate reward policies. But the principles discussed in the following chapters should be applicable to any individual hiring decision, particularly as the customisation we refer to is better viewed as the product of rigorously enforced, but pragmatically elastic, policy, rather than individually negotiated anarchy.

Appropriate elasticity in reward policies and reward structure is important because the relationship between a senior executive employee and his or her employer is likely to be more complex than many other employment relationships, given the number of remuneration elements in the package and their potential value. The sums at stake in a dispute involving senior executives are likely to be out of the scope of tribunals and the UK's unfair dismissal regime, taking disputes into territory where high-profile litigation may become a material risk. This makes those involved tread a little more warily, even if, in principle, it is invidious to treat executives more flexibly in disputes than other employees. The executives involved are less likely to be local nationals which creates both opportunities and risks, particularly in terms of tax status and the treatment of international relocation. There are also more likely to be unique features of the executive's current package which need to be accommodated in the construction of the new deal, particularly around compensation for the forfeiture of existing awards and special covenants. Finally, individuals at this level are more visible than other employees, and contracts and their terms are more likely to be in the public domain, whether through requirements to put terms on display or to set them out in shareholder documents. A properly constructed deal should be able to withstand intense scrutiny and this is considered in Chapter 6 where the factors and issues which need to be taken into account when reporting the deal and explaining it to the outside world are discussed.

Most organisations apply a more rigorous process of governance for roles at the senior executive level. Typically, this will be through the remuneration committee on behalf of the board. But the remuneration committee is only part of the picture. It is the capstone on a process that needs to be closely integrated with the other parts of a company's control environment. Chapter 7 explores how processes can be put in place to allow executive remuneration to be governed in an effective and adaptable way.

There are a few things which we have deliberately left out of this book. We have not covered the identification of executive talent or the selection process, nor have we covered the process after the deal is signed when the successful candidate is being integrated into the organisation. Both of these parts of the hiring process deserve their own discussions elsewhere. We have also not specifically addressed the issues around executive terminations.

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This is because, as far as possible, the termination of the contract should be considered as part of the construction of the deal in the first place and is therefore effectively covered in the sections on package construction. On termination, the terms of a deal should unwind in a smooth, elegant and mutually agreed fashion, but terminations are always difficult and, in Chapter 2, we discuss some of the flexibility that can exist.

Getting to the right package is an art as well as a science but there are tools that can be used to make the process easier. These tools facilitate what is ultimately a negotiation: a negotiation to acquire the services of someone who can create shareholder value. Having explained the focus on executives, why is this book structured around the issues that arise during the hiring process, the 'deal'? As stated in the Preface, striking the deal is the moment of truth in reward governance. It is the time when reward governance processes are stretched to their fullest: hiring managers want the deal done and may lose their objectivity in the heat of the deal; others, rightly, are hyper-vigilant in case policies or interests are compromised. But the hiring process uses tools which are needed whenever the contract between an individual executive and his or her employer needs to be revisited and refreshed. This is reflected in the way that the context broadens in the later chapters of this book. These cover a wider range of situations beyond the hiring process, but they all rest on the foundation laid at the outset, when the deal is first struck.

Does this mean each deal is unique? To some extent it does but, in reality, governance processes provide a wrapper around each deal and mould them into a finite set of shapes, which mean that, outside the buyout, individualising reward packages, even for executives, is hard to do. And, perhaps more importantly, we should remember that the business context should determine the extent to which diversity can be accommodated and the choices available to attract suitable talent.

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1 Striking the deal

RUPERT MCNEIL

The starting point: getting to the 'number' which represents the executive remuneration package

This chapter identifies the steps that must be taken when hiring an executive. In doing this, it is helpful to look at the deal as a process which leads to a single monetary amount (the 'number').

The number is the value of the final package that employer and candidate both sign up to. It is an abstract concept. It represents what an informed and independent observer would consider the value of the package to be, taking into account what will be paid, when it will paid and the likelihood that it will be paid.

In reality, the employer and the candidate may have different numbers in mind. For example, they may have different views on how likely it is that a particular part of the remuneration package will actually be paid. In practice this means that the number will always be, for practical purposes, a range, reflecting the different values that could be assigned to the package's individual components. But for purposes of explanation, and negotiation, the idea that both candidate and employer are effectively engaged in a process of convergence on a shared idea of the value of the package is a useful tool. It is the best representation of both the value of the deal to the individual and its cost to the company and its shareholders. It is the basis of the investment decision made by both parties, and is a function of what needs to be paid to secure the individual in the given labour market, as well as representing an amount that the company believes it can afford.

The identification of the number is the first step in a four-step process:

1. First the candidate's current package is deconstructed into its component parts and its 'number' determined.
2. The company then reaches a view, based on a range of factors, on what the uplift needs to be on that number to secure the individual in their new role. That can start with a new number and then involves determining how to deliver that new number using the various reward components available: from salary and pension through to bonus opportunities and stock awards.

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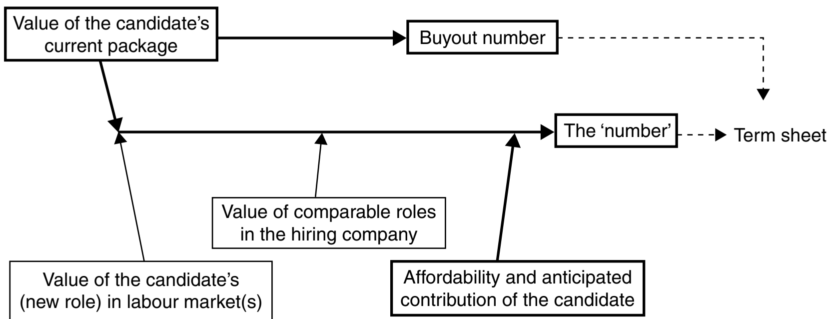
Figure 1.1 *Getting to the term sheet*



3. The third step is deciding on how those components will fit together, taking into consideration current reward policies, investor guidelines and, always, affordability.
4. Finally, the package that is comprised of those components needs to be recorded; ideally in a term sheet and then in a legally enforceable employment contract.

This process should allow the candidate and the employer to answer the following essential questions, which represent the essence of their contractual agreement:

- What are the components of the package?
- What is the maximum amount of value that the executive will receive under each component?
- What conditions need to be met for any amount to be received?
- When will each amount be received?

The final step is to document all of the details in a 'term sheet' from which the contract can be prepared, with all material issues having been dealt with in the negotiation process. The steps needed to reach the point where a term sheet can be prepared are illustrated in Figure 1.1.

Deconstructing the current package

When analysing an executive's remuneration package, the simplest starting point is to split the current package into amounts which relate to awards or payments which have been promised, but which will be lost if the individual leaves (the 'buyout'), and the 'run rate' of the package, which is what the individual will earn each year, or over some other period, if he remains with his current employer. These are two distinct categories and confusing them unnecessarily complicates the process of getting to a fair value for the package.

For example, the salary that the candidate currently receives is part of his 'run rate'. It is an amount which he expects to receive over a period of

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time. It will need to be replaced, in some economically equivalent form, in the new package, and on an ongoing basis, i.e. on a 'running basis'.

Alternatively, the candidate may have accumulated amounts under, say, a pension or incentive plan, which he will forfeit if he leaves his current employer. The value of this amount will need to be replaced, but only once. Replacing this amount would form part of a buyout, i.e. paid on a one-off basis.

The buyout

Buyouts can typically be of two types:

- Amounts where receipt at some future date is essentially guaranteed, i.e. there are no conditions attached to the future payment, other than the individual's continued employment. An example would be a deferred share award, where the shares will be transferred to the award holder if he is still in employment at a given date. These can be referred to as 'earned amounts'.
- Amounts where receipt remains uncertain, because a condition has not yet been tested. An example would be an award which has been made but where some period of the performance period remains before the final performance measurement takes place. These can be referred to as 'unearned amounts'.

The distinction between earned and unearned amounts can be quite subtle. For example, some bonus plans will allow awards to be retained by an award holder who leaves, provided they are not leaving to join a competitor. In other cases, an award may still technically be subject to a performance condition but will effectively have vested because the performance condition has already been substantially met and the likelihood that it will not vest is small.

In practice, buyout issues primarily arise with unearned amounts, and non-cash benefits. This is primarily because of potential disagreement over the assumptions that should be used for calculating the underlying value of the award (see Chapter 3, for a discussion of valuation techniques that can be employed and different approaches to underlying assumptions). For share awards and share option awards, a key assumption which affects the value of the buyout is the share price which should be used, i.e. the share price of the shares underlying the award. There are basically three approaches which can be used when dealing with this assumption:

- taking the spot price on a designated day (e.g. the date of the term sheet or the date the contract is signed); or
- using an average share price, e.g. over the three-, six- or twelve-month period ending on a designated day; or
- using a 'high price', e.g. the twelve-month high.

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Someone negotiating a hiring package may have a mandate to use any of these three techniques. The second of these is likely to be the safest approach.

On the basis that market expectations of future dividend yields and share price movements are, in theory, taken into account in the share price at the point of measurement, no further assumptions about the underlying shares are required for awards made over whole shares.

For share options, the additional assumptions that need to be agreed are determined by the valuation method used. There are two typical approaches. The first uses the intrinsic value, or embedded gain, of the share option, by simply deducting the gain per share from a current share price calculated on one of the three bases discussed above. This is the simplest method, and, usually, represents the lowest value per share under option. Using this basis, for share options where the exercise price is higher than the current share price, no value will be recognised.

The second approach uses an option pricing model to determine the value of the option. Essentially, this involves calculating the present value of the expected future gain. For a given share price / exercise price combination, the size of that gain is assumed to increase, in most[1] cases:

- the longer the exercise period remaining (because there is a greater likelihood that the share price will rise above the exercise price);
- the higher the 'volatility' of the underlying share price (because this is assumed to indicate the possible extent to which the share price will exceed the exercise price when it rises above it);
- the higher the 'discount rate', or risk-free rate of interest, used to determine the present value of option gain that may ultimately be received, (because the higher the discount rate the lower the present value of the amount that needs to be paid to satisfy the exercise price when the time comes to exercise); and
- the lower the dividend yield, i.e. the expected level of dividend payment expressed as a percentage of the current share price (because the higher the rate of dividend payment, the more value in the share price will have 'leaked out' to shareholders ahead of option holders exercising these options).

Agreeing what figures should be associated with these assumptions has become less contentious since the introduction of option expensing into accounting standards and the more widespread use of the calculations which this requires. Figures for each of the assumptions needed to value an option over a quoted company's shares now need to be set out in the financial

[1] These are the author's layman's rules of thumb, applicable in most commonly encountered situations. But where these variables have either very high or very low values relative to each other, different effects can occur. Valuation experts would rightly criticise these as generalised and grossly simplified.

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statements of any company reporting under either US or International accounting standards. While there may be debate on whether these are the right assumptions at the time the deal is being struck, the common starting point can now be a set of audited numbers for each assumption.[2]

Despite the use of published assumptions, the debate on assumptions used in option pricing discussions most often focuses on the remaining life, or term, of the option for valuation purposes. The published figures required for accounting purposes use the 'expected term', i.e. for the population of option holders reported, what is the expected time between grant and exercise (usually based on historic exercise patterns). Using this figure will usually produce a higher value per option than using the earliest date on which an option can become exercisable and a lower value than the latest date on which the option can be exercised, i.e. the date the option will expire (many candidates' preference).

Pragmatically, anyone negotiating a buyout of options should have a high and low figure in mind, driving the range within which they have a mandate to agree a buyout value for those options. The aim should be to go for the basis using the expected term and the other published parameters. But it is important not to underestimate the emotional dimension of holding an option, which is not wholly rational from an economic perspective. Some people may place additional personal value, for example, on the apparent status conferred by being an option holder. Others may be highly risk averse and place a correspondingly lower value on holding an option. Being flexible about the basis of valuation can recognise that emotional dimension. But whichever approach is used, it should be replicable and defensible. Any of the above approaches, in the right circumstances, can be both of these.

It is important to ensure that the awards being bought out have actually been forfeited. A term sheet and contract should require 'best efforts to exercise' what can be exercised and make payment for the buyout conditional either on evidence from the awarding company that the award concerned has been forfeited, or on receiving confirmation from the candidate's representative advisor that this is the case.

A final aspect of share option buyouts relates to 'earned' awards. Although these awards are not forfeited, it can be argued that there is a lost 'time value' as it is likely that they will need to be exercised within six months of cessation of employment. Using an option pricing model approach, the shorter exercise period would result in a lower value. It may be reasonable to compensate for this lost time value by calculating the value using an option pricing model and then deducting the intrinsic value from this value.

[2] After taking into account the impact of performance conditions, one of the variables to which option values are most sensitive is volatility. A very legitimate basis of debate in an option valuation exercise is whether historic volatility should be used as the input or either 'implied volatility' (derived from the values of traded options on the same underlying share) or volatility figures (either historic or implied) from comparable companies.

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Another aspect which is common to various unearned amounts is the conditionality associated with each award. Often it is easier to assess this for share-based awards, where performance conditions tend to be more objective and the likelihood of achieving them can be more easily assessed. In some cases, the impact of the performance condition on the value of the award may already be factored into the value shown in the published financial statements (e.g. if the condition is based on 'relative total shareholder return' or some measure of share price growth). This is discussed in more detail in Chapter 3.

The position is harder to assess for more discretionary awards such as annual bonus opportunities. For annual bonuses, the hiring company is far more dependent on extrapolation than for share awards. A much greater proportion of the information required is not in the public domain. This is an area where it will be necessary to apply judgments, based on a sensible assessment of the candidate's performance and that of their employing company (e.g. assume a lower range of potential bonus payment for a non-critical executive in a company that is not hitting its targets and is regarded unfavourably by market analysts). It can also be informed by the historic pattern of bonus payouts received by the candidate (for which it is also reasonable to ask for evidence, or to retain the right to do so). This is discussed in more detail below.

There are also areas where some elements of a candidate's 'run rate' package are best wrapped up in the buyout, taking them off the table for discussion about what the hiring company will offer as ongoing arrangements. These may include the value of defined benefit pension entitlements (where the hiring company offers a less generous pension arrangement) and 'expatriate type benefits' not offered in the hiring company. Both of these categories are discussed below.

The final decision on structuring a buyout relates to the form in which the buyout will be made. A commercial approach, and one candidates will typically consider to be 'fair', is to try to match the forms of award as closely as possible, so that share awards are matched with share awards in the hiring company and cash is matched with cash, and that, while the only conditionality is likely to be continued service with the hiring company, the dates of receipt match the vesting dates of the substituted awards, as far as possible.

Expatriate benefits

Expatriate benefits are, as described above, a form of award that it may be convenient to deal with as part of a buyout, in preference to including them on a continuing basis. In dealing with a candidate, expatriate benefits offered by their current employer can be a significant incentive for the individual to remain in their existing organisation. Predominantly, these benefits cover housing (with employees receiving either a subsidy towards housing or provision of accommodation leased on their behalf by their

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employer), and education for school-age children. 'Home leave' ('furlough' in the USA) flights are also common, as well as the benefit of services such as home search and educational support, and support with preparation of tax returns in the host and home country. There are important psychological aspects to expatriate-type benefits. In particular, their true cost to the employer is often not fully transparent to the individual receiving them, even when they are received in cash form (because they are communicated as a net (i.e. after tax) rather than gross (i.e. before tax) amount). However, the astute candidate will be acutely aware of this fact and they will want to ensure that, in terms of their cash in hand, and their standard of living, they are not worse off in any way if they lose these benefits.

The best way to cross the 'expatriate benefit chasm' is to make a very clear distinction in the company policy between 'true expatriates' and those who are simply being compensated for the disruption and expense of relocating. True expatriate benefits are best limited to the genuinely internationally mobile, and for a cadre of people who accept that part of their employment deal is that they can be moved, often at short notice, and certainly on a frequency of no less than once every two to three years. These people need the help that an expatriate programme of benefits can provide. Crucially, their peers and co-workers should understand why their packages are different and that the difference is justifiable. For example, most expatriate programmes operate some form of 'tax and cost of living equalisation', which attempts to put the employee in the same cash position as they would have been, in spending power terms, if they had remained in the home country. This has two benefits: it is essentially fair (these are home-based employees temporarily assigned to the host location) and it goes some way to cushion the shock of the return to home base with minimum 'withdrawal symptoms' from loss of disposable income.

This leaves a wide category of people who will need to relocate to join a new organisation, and for whom the process will be very disruptive. For these people, there are several approaches which can be adopted. The first is to pay them a relocation allowance, either in cash or through services provided in kind. This can be a one-off, and as such is probably most effectively treated as a one-off buyout cost, paid together with share awards. The second is to provide a period of adjustment, when the individual essentially receives expatriate-style support (housing and schooling, for example), for a limited 'localisation period', but all other aspects of the employment are structured as if the individual was a locally hired employee.

The position is more complex for individuals currently benefiting from an expatriate programme (quite common for executives hired out of large US corporations). If they can be transferred into an equivalent programme in the hiring company, the problem can be quickly and easily solved (although not necessarily in a way that is conducive to good reward practice or cost control). A better option is to take a pragmatic view of the value of the programme,

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