

# Employee incentives

The current challenge:  
Caution or Creativity?

# Employee incentives

## The current challenge: Caution or Creativity?

The current environment for incentives is challenging. For many clients, the response is cautious: nothing must be done to upset investors and the recruitment and retention position does not merit active incentive work, but that does not mean that existing structures cannot be looked at with a view to savings or their more efficient use. For other clients extra creativity is needed – in devising new arrangements which satisfy both investors and managers, which have demanding yet achievable targets and which can be implemented in a cost-effective way.

This booklet sets out some of the ideas we have been discussing with our clients over the last few months. We would be happy to discuss these further with you either by telephone or in a meeting at your offices.



### Nicholas Stretch

Partner, Employee Incentives  
T +44 (0)20 7367 2862  
E [nicholas.stretch@cms-cmck.com](mailto:nicholas.stretch@cms-cmck.com)



### Isabel Pooley

Senior Associate, Employee Incentives  
T +44 (0)20 7367 2411  
E [isabel.pooley@cms-cmck.com](mailto:isabel.pooley@cms-cmck.com)

## **Saving cash**

For many clients, this is a priority with budgets under pressure. Employee share schemes and other forms of incentives can help either by being substituted for and so saving cash, or being tax-efficient and so either increasing the eventual take home pay by saving tax or saving employer's National Insurance contributions.

Examples of where we have been working with clients include:

- Tax efficient ways of providing private medical insurance using an "in-house" employee trust.
- Salary sacrifice into pension arrangements and childcare vouchers, where many clients are still not reaping the tax savings available for them and their employees (which will increase as tax and NI rates go up), which can quickly outweigh implementation costs.
- One company has been considering requiring a large part of any bonus to be paid into a pension arrangement to save employers' National Insurance contributions.
- Salary reductions in return for enhanced bonus and share scheme awards (see further below under "Making rewards more performance-driven").
- Payment of bonuses in the form of shares, thus saving cash if new shares are issued. This can either be at the senior executive level (where various company law and shareholder approval issues arise) but also at an all-employee level with the added possibility of a potentially tax-free award of shares under a Revenue-approved Share Incentive Plan.

There can be a further incentive in that if share prices are currently very low, subsequent stock market price rises could produce a return for employees way in excess of the sacrificed bonus. However, Remuneration Committees need to be mindful of the potential for high gains so as to avoid criticism in the future for having permitted excessive remuneration.

Conversely, a cash plan in the current environment could be particularly valued by an employee, if a company can offer it.

## **Deferring the expense**

Delaying or spreading the payment of bonuses over several years may be appropriate – indeed are the days of the annual bonus being received in one lump sum at the end of the year numbered?

Some clients have been interested in the "medium-term" bonus schemes being discussed particularly by the banks, where performance in one year determines a basic entitlement which is

then adjusted (downwards or potentially upwards) by performance in other years. This is popularly being referred to as “clawback” but this gives rise to a number of legal issues – not least of which is determining the clear parameters within which clawback should operate and the perennial problem of defining “non-performance or failure”.

### **Making rewards more performance-driven – A one-off opportunity?**

Particular issues which have been raised in the context of the banking sector on quantum and the perception that inappropriate risk has been rewarded (which is to be the subject of an FSA paper in March) could be starting to influence remuneration generally.

The idea that a company should not have to pay a bonus if targets have been met is not a new one, but the current debate may lead to companies including a standard final provision in their plans giving the employer an override in all cases not to pay (or to reduce) a bonus which would otherwise be payable.

Some companies may be able to shift the balance of reward from fixed pay (salary and pension etc) into truly variable pay. A year in which bonus payments may be non-existent or thin on the ground may provide valuable breathing space for some companies to get to grips with reward issues which they may feel they have not been able to control over the last few years.

### **New performance targets**

Many traditional forms of targets in schemes may have to be revisited, which gives rise to potential shareholder consultation issues, aside from dealing with stated investor positions that the downturn should also see a general downturn in executive remuneration.

Some companies, however, are saying that traditional “hard” financial and group targets are proving impossible to set given the current uncertain outlook and some companies are even declining to give earnings guidance. More bespoke targets will therefore be needed in the short term to make sure that employees are incentivised, whether for defensive or investment reasons. There may even be a return to previous practices where the Remuneration Committee retains a significant amount of year-end discretion. What is success will only be known in hindsight.

In circumstances where a division or subsidiary is experiencing particular difficulties or challenges, it may be appropriate to introduce bespoke arrangements for that section of the business to address these concerns.

## Sharesave

Sharesave (or SAYE) plans present their own particular challenges. Cancelling underwater Sharesave options will (if they do not already) cause accounting charges, but employees may be particularly keen to acquire shares at a discount to today's prices and so a new launch may be well-received. While savings rates are low, the tax-free nature of Sharesave savings, which can be withdrawn without exercising the option, still makes them relatively attractive.

## A new payment currency – debt?

Remuneration has traditionally come in two forms – cash and shares. Now debt is starting to feature.

RBS is paying some of its awards in specially created “debt”, which is something we have already structured for some clients and can have tax and other advantages. Credit Suisse has also agreed to pay bonuses in the form of debt and other instruments which have been difficult to value – thus achieving some accounting certainty in the process by getting them off their books.

## Shareholder reaction

So far, the Association of British Insurers (ABI) and other representative bodies have not significantly moderated traditional stances on share incentives – indeed they have actively tried to hold the line. However, the ABI is setting up a number of meetings with advisers in March and it is expected that all sides will come under pressure to adapt to the new circumstances.

## Private equity companies

Many private equity companies have encouraged their management to take up equity and in several cases, equity has been distributed below management level.

There are different challenges here from those facing quoted companies – particularly the heavy leverage which many private equity companies operate under. In many cases, employee equity will be “underwater” but with a significant number of companies facing restructuring, there can be an opportunity to amend the terms on which these shares are held. The attraction of these arrangements is that any gain should be subject to capital gains tax at 18% not income tax at the future rate of 45% and National Insurance contributions. With many companies facing large corporation tax losses, the traditional drawback of equity incentivisation in these companies not being corporation tax deductible may not be an issue. We have been working with one company to exchange existing equity rights for a cash payment in a tax-efficient form.

## CONCLUSION

- The approach for each company will be different – each will have a different cash position, growth prospects, current incentive position and most importantly a different attitude to future incentives.
- In many companies existing plans can be used to grant new awards at lower prices and with new performance targets and so existing plans are self-correcting. In others, new bespoke arrangements may be appropriate.
- In some companies, the loss of confidence in employee share schemes through share price falls which may never be recovered and employee over-exposure through personal investment may mean that those companies will not be as dependent on share schemes for some time and will need to look at alternative arrangements.
- There may also be legal obstacles and employment law/HR challenges in making changes (and investor relations issues) which should not be underestimated.
- However, in our experience most companies still see the value of share schemes and can extract more benefit from them and other forms of remuneration arrangements in the medium-term than they often perceive to be the case.

## Law-Now™

### **CMS Cameron McKenna's free on-line information service**

Receive expert commentary and analysis on key legal issues affecting your business. Register for free email alerts and access the full Law-Now archive at [www.law-now.com](http://www.law-now.com)

CMS Cameron McKenna LLP  
Mitre House  
160 Aldersgate Street  
London EC1A 4DD

T +44 (0)20 7367 3000

F +44 (0)20 7367 2000

**CMS Cameron McKenna LLP is a limited liability partnership registered in England and Wales. It is able to provide international legal services to clients utilising, where appropriate, the services of its associated international offices and/or member firms of the CMS alliance.**

**The associated international offices of CMS Cameron McKenna LLP are separate and distinct from it.**

**CMS Cameron McKenna LLP and its associated offices are members of CMS, the alliance of independent European law firms. Alliance firms are legal entities which are separate and distinct from CMS Cameron McKenna LLP and its associated international offices.**

**CMS offices and associated offices worldwide:** Amsterdam, Berlin, Brussels, London, Madrid, Paris, Rome, Vienna, Zurich, Aberdeen, Algiers, Antwerp, Arnhem, Beijing, Belgrade, Bratislava, Bristol, Bucharest, Budapest, Buenos Aires, Casablanca, Cologne, Dresden, Dusseldorf, Edinburgh, Frankfurt, Hamburg, Kyiv, Leipzig, Ljubljana, Lyon, Marbella, Milan, Montevideo, Moscow, Munich, New York, Prague, Sao Paulo, Sarajevo, Seville, Shanghai, Sofia, Strasbourg, Stuttgart, Utrecht, Warsaw and Zagreb.

[www.cmslegal.com](http://www.cmslegal.com)

**The members of CMS are in association with The Levant Lawyers with offices in Beirut, Abu Dhabi, Dubai and Kuwait.**