Discretions in employee share schemes

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What are discretions in employee share schemes?

It is common to see contracts include powers for a party to determine a particular matter 'in its absolute discretion'. Does such wording in practice mean what it purports to say, ie that the discretion can be exercised in any manner which that party sees fit? The answer under English law is almost certainly 'no', as there are now significant legal constraints imposed by law on the exercise of such discretions.

The inclusion of discretionary powers in employee share incentive schemes is now relatively common. There are various areas of employee share plans where such discretions may be found. For example, they may be included in relation to provisions which allow vesting/exercise of awards and, perhaps most commonly, in relation to participants who are leaving employment and who may be designated as 'good leavers' or 'bad leavers' with particular consequences for the awards held by them under the scheme.

Such discretions may be drafted as 'absolute' discretions (under which the company purports to have discretion to take any decision it considers fit) or more limited discretions under which the board must act 'fairly and reasonably'. In practice, some tax-advantaged share schemes will require the latter wording. In addition, some discretions may be drafted so that it is explicit in the drafting that the discretion can only be exercised by reference to certain contractually-prescribed parameters (eg measures of corporate and/or individual performance).

Over the last few years, there have been a number of cases which have placed restrictions both on the scope of a discretionary decision that an employer may take under such provisions (even if it is expressed to be an absolute discretion) as well as the process that must be followed to apply such a discretion. Although the law on the exercise of discretions applies both in the context of employment contracts as well commercial contracts, in practice the courts apply a more intense scrutiny of discretionary decisions (and the related decision-making process) in an employment context. This is for two reasons:

- firstly, because the courts acknowledge that, unlike commercial contracts, there is often an inequality of bargaining power between an employer and its employees, and
- secondly, unlike commercial contracts, employment contracts contain an implied term of mutual trust and confidence, which requires the employee effectively to treat employees fairly and in good faith

This Practice Note examines the relevant caselaw on such discretions in the context of employee share plans as well as practical guidance on drafting and implementing such discretions.

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Where discretions may be included in employee share schemes

Discretions might be included in various different places within employee share schemes, such as:

- the power to decide which employees will be granted awards
- the size of awards made to participants
- what conditions may be applied to awards granted to participants (eg performance conditions that may determine whether and to what extent awards will vest)
- whether to treat departing employees as 'good' or 'bad' leavers (see further below)
- whether an award should vest
- whether performance conditions have been met in relation to awards, and
- whether performance conditions can be waived (wholly or partially)

The most obvious place where discretions may be included is in relation to leavers. Most employee share schemes will have provisions which prescribe different treatment of awards held by leavers, depending on whether they are deemed to be 'good' or 'bad' leavers. In many instances, a leaver will be deemed to be a good or a bad leaver as of right eg termination of employment by reason of redundancy, death or permanent ill-health may be automatically deemed to be a good leaver reason whereas dismissal for gross misconduct or voluntary resignation may be deemed automatically to be a bad leaver reason. It is, however, common for the board of directors/remuneration committee to reserve a discretion to allow vesting of awards which would otherwise lapse (in other words to deem a bad leaver to be a good leaver). To some extent, the reliance on discretions in relation to leavers has increased in recent years, not least because the use of retirement as an automatic good leaver scenario (at least in relation to non-tax-advantaged schemes) has become more problematic in light of associated age discrimination issues and, as such, in many schemes retirement is no longer used but reliance is instead placed on discretionary powers to allow a retiring leaver to be treated as a good leaver. For further information, see Practice Note: Age discrimination and employee share schemes.

If employee share schemes include performance conditions (eg which may determine if and to what extent awards will vest), discretions may sometimes be reserved for the board/remuneration committee to disapply such performance conditions or even determine that no vesting should occur even if specified performance conditions have been met.

It is also common for the board/remuneration committee to have a discretion to determine the proportion of an award that may vest on certain corporate transactions, such as a change of control of the relevant company.

Legal constraints on the exercise of discretions

Over the last 20 years or so, there have been a series of cases which have effectively established that an employer's discretion which is purportedly expressed to be absolute will not be absolute. Such discretions will be likely to be subject to implied restrictions which require them:

- not be exercised irrationally or capriciously, and
- to be exercised by following a reasonable process which only takes into account relevant factors and does not take into account irrelevant factors

These cases are analysed below.

Non-employee share scheme cases prior to Braganza

Prior to the case of *Braganza v BP Shipping Limited* (see further below), the caselaw on the exercise of employer discretions mostly derived from cases involving employee bonuses and was relatively settled.

References:

Braganza v BP Shipping Limited [2015] IRLR 487, [2015] UKSC 17

The case of *Clark v Nomura International plc* involved a trader who was eligible for a 'discretionary' bonus but which was expressed in his contract to be dependent on his individual performance. Prior to the termination of his employment he had performed well and had made substantial profits for Nomura and all other traders (including one who had made a loss) were given bonuses. His employment was terminated by Nomura. Nomura decided not to award him any bonus at all because it considered that it had no need to retain and incentivise him. He challenged this as an unlawful exercise of the employer's discretion. The High Court upheld his claim, holding that the wording of his contract (which specified that the bonus was dependent on his individual performance) did not allow the employer to take into account other factors such as the need for retention and incentivisation. It noted that the appropriate test for whether the discretion had been exercised properly was 'one of irrationality or perversity (of which caprice or capriciousness would be a good example) ie that no reasonable employer would have exercised his discretion in this way'. Nomura's decision to pay him no bonus was 'plainly perverse' and 'irrational' and, in view of the wording in his contract, it was not legitimate for Nomura to take into account its reasons for dismissing him. The wording in his contract effectively acted as a contractual restriction on what Nomura could legitimately take into account.

References:

Clark v Nomura International plc [2000] IRLR 766

In *Horkulak v Cantor Fitzgerald International*, Mr Horkulak worked for Cantor Fitzgerald until he resigned, claiming that he had been constructively dismissed by the employer. As part of his claim for damages for constructive dismissal, he claimed compensation in respect of a discretionary bonus that he alleged he would have been paid had he not been constructively dismissed. His contract stated that:

> 'The Company may, in its discretion, pay you an annual discretionary bonus which will be paid within 90 days of the financial year-end...,the amount of which shall be mutually agreed...however the final decision shall be in the sole discretion of the President of Cantor Fitzgerald.'

References:

Horkulak v Cantor Fitzgerald International [2004] IRLR 942

The Court of Appeal upheld the High Court's decision that the employer was obliged to exercise its discretion in good faith and not capriciously or irrationally. Mr Horkulak was entitled to benefit from the genuine and rational exercise of that discretion and, accordingly, his damages should include compensation for what he would have been awarded as a bonus (during the period during which he would have remained employed, had he not been constructively dismissed) had the discretion been exercised rationally.

The case of *Keen v Commerzbank AG* marked something of a high-water mark in the line of bonus and discretion cases. In that case, the High Court appeared to restrict the prospects of successful claims for unlawful exercise of discretions in relation to discretionary bonuses. They emphasised that the burden on the employee of proving a breach of the implied restriction was a heavy one, that the employer has a 'very wide contractual discretion' and that the threshold

References:

Keen v Commerzbank AG [2007] IRLR 132

for showing that a bonus payment decision was irrational is 'a very high one'. It added that 'it would require an overwhelming case to persuade the court to find that the level of a discretionary bonus payment was irrational or perverse in an area where so much must depend on the discretionary judgment of the bank in fluctuating market and labour conditions'. The Keen decision is also interesting in that it indicated that, in using a discretionary power, the employer would effectively be under a duty to inform the employee of certain aspects of the decision-making process. It stated that:

> 'If the parties have agreed that an employer should have a discretion to decide, by reference to certain factors, whether an employee should be paid additional remuneration by way of a bonus for work done under the contract of employment and, if so, how much, the employer is under an obligation to treat his employee fairly in explaining the situation. This would involve making known to the employee, quite apart from any duty of disclosure in litigation, the factors which have influenced the decision, by whom the decision was taken and the reasons for the decision taken.'

Mallone v BPB Industries plc

The case of *Mallone* concerned a managing director of an Italian subsidiary of an English company. He was awarded options over shares of the English parent company during his employment. He was dismissed by his employing company for poor performance and subsequently sought to exercise his options. The rules of the share option plan provided that, in certain termination situations, the board of directors had an absolute discretion to determine the 'appropriate proportion' of the options that could be retained and exercised by the departing participant (and the court construed this rule as applying to both vested and unvested options). The rule required the board to effectively determine the appropriate proportion by applying X/36ths of his share options which could be exercised, where 'X' was the number of complete months (not exceeding 36) between the date of grant during which the individual had been employed 'or such other number (not exceeding thirty-six) as the Directors in their absolute discretion decide'. He was told that the company had exercised this discretion to determine that the 'appropriate proportion' of his options which could be retained and exercised on his termination (ie 'X') was nil. These included some share options which had already vested to Mr Mallone during his employment when he had performed well. The Court of Appeal held that this was an unlawful exercise by the employer of its discretion under the scheme rules. Although the directors had an absolute discretion, they had still had to determine the 'appropriate proportion'. A decision to apply the discretion to vested options had to take into account the fact that it was effectively dealing with vested property rights. While poor performance during or even after vesting might justify an appropriate proportion of less than 100%, it was hard to see why someone who was not being dismissed for gross misconduct should, on the ground of his performance after vesting of his options, be treated just the same as one who was being dismissed summarily for misconduct. A decision to deprive him of all of his options, including some vested options, 'was one which no reasonable employer could have reached'.

References:

Mallone v BPB Industries plc [2002] EWCA Civ 126

Mcarthy & Mcarthy & Stone plc

The *Mcarthy* decision concerned the interpretation of a discretionary power within an unapproved share option scheme. Mr Mcarthy was granted various share options under the unapproved part of the company's share option plan. The options became exercisable after three years. There was a relevant performance condition relating to increases in earnings per share which had

References:

Mcarthy & Mcarthy & Stone plc [2007] EWCA Civ 664

been met over that three-year period. Mr Mcarthy ceased employment and then sought to exercise his options. The relevant rule of the option scheme provided that:

> 'Where an Option Holder ceases to hold any office or employment the Remuneration Committee shall in its absolute discretion determine whether the Option will be exercisable having considered the extent to which the Performance Condition has been achieved at the date of termination. If the Remuneration Committee so decides the Option Holder may exercise all or a proportion of his Option(s) during the period which begins on the date of such cessation and ends twelve months later, such proportion being determined by the Remuneration Committee pro rata to the achievement of the Performance Condition.'

In respect of one tranche of his options, the Remuneration Committee informed Mr Mcarthy that it had exercised its discretion under the above rule to allow him to exercise 75% of his options, rather than all of them (based on the view that Mr Mcarthy had committed alleged misconduct prior to the termination of his employment). The Court of Appeal upheld the High Court's judgment that this was an impermissible exercise by the Remuneration Committee of its powers under the rule. The rule effectively required the committee to undertake a two-stage process: (a) having determined that the individual's employment had ended, it then had to determine, in its absolute discretion, whether or not his options should be exercisable—this was, on the wording, a binary choice only allowing for a 'yes' or 'no' determination. If the answer to that question was 'yes', then it had to answer (b) the proportion to which the option should be exercised, which could only be determined pro rata to the achievement of the performance condition. The court held that the absolute discretion only applied to the first stage and did not extend to the second stage. Given that the company had determined at the first stage that his options should be exercisable, it was therefore impermissible at the second stage to determine that the proportion that should be exercisable should be anything less than 100%, given that the performance condition had been fully met.

Braganza v BP Shipping Limited

Although the *Braganza* case does not relate to employee share schemes, it is nonetheless important, as it is a Supreme Court decision which significantly changed the law on restrictions on contractual discretions, and it has been relied on in subsequent discretion cases involving employee share schemes.

References:

Braganza v BP Shipping Limited [2015] IRLR 487, [2015] UKSC 17

Mr Braganza was a chief engineer on one of BP's oil tankers. While the ship was at sea, he disappeared and was never seen again. It was presumed that he had drowned. His employment contract entitled his widow to certain death-in-service benefits but also provided that 'if in the opinion of the company or its insurers', the death resulted from his own wilful act, no benefits would be payable. BP established an investigation to determine the cause of his death, which concluded that he had committed suicide and therefore no benefits were payable. His widow challenged that decision as an unlawful exercise of its discretion. When the case reached the Supreme Court, the majority confirmed that the exercise of the employer's discretion has to be analysed under both limbs of the public law Wednesbury test, namely (i) the decision-making process itself (ie whether relevant matters had been not taken into account in coming to the decision and/or irrelevant matters had been taken into account); and (ii) the rationality of the decision itself ie even if the decision-making process itself was properly conducted, was the decision arrived at so unreasonable that no reasonable person could ever come to that decision.

In one sense the *Braganza* decision effectively confirmed existing caselaw, namely by confirming that the decision taken under a discretionary power will be subject to an implied restriction that it cannot be irrational, arbitrary, capricious or perverse. In that sense, it was merely confirming existing decisions such as Clark v Nomura, Commerzbank v Keen, Horkulak – Cantor Fitzgerald etc. Its importance however lies in the fact that the Supreme Court also held that, even if the ultimate decision made was a rational one with no arbitrariness or perversity etc, if the manner in which that decision was made was flawed, that may give grounds for attacking the exercise of discretion as unlawful.

References:

Braganza v BP Shipping Limited [2015] IRLR 487, [2015] UKSC 17

Clark v Nomura International plc [2000] IRLR 766

Keen v Commerzbank AG [2007] IRLR 132

Horkulak v Cantor Fitzgerald International [2004] IRLR 942

Simpkin v Berkeley Group Holdings Plc

Simpkin is a good example of the *Braganza* duty applying to good and bad leaver provisions in an employee share scheme (in this case, a long-term incentive plan). The claimant was a member of senior management and a member of the company's bonus plan and two long-term incentive schemes. The terms of the schemes were such that, if he left employment before the benefits vested, his entitlement lapsed. Nonetheless, the employer had a discretion to treat the former employee as a good leaver who would be entitled to benefit under the scheme. The claimant was removed as a director and his employment terminated on notice. The remuneration committee and board decided that he should not be treated as a good leaver. The chief executive had reported that the claimant's behaviour was such that he had lost the confidence of senior management, despite the fact that there had been no formal adverse review of his performance. The claimant argued that the decision not to treat him as a good leaver was arbitrary and capricious because the decision-makers had, he alleged, heard untested, unsupported and insubstantial anecdotal evidence given orally and informally of alleged performance and conduct issues, none of which had been put to him nor were they supported by sufficient evidence to support the allegations made. Although the court did not decide on the merits of the claim (as the reported decision deals mainly with a procedural issue), the High Court noted that, in accordance with *Braganza*, where contractual terms give one party to a contract the power to exercise a discretion or form an opinion as to relevant facts, that power should be exercised not only in good faith but also without being arbitrary, capricious or irrational. Where the court found that the decision-making process was flawed it could remake the decision and therefore conclude that the claimant was entitled to be treated as a good leaver. The High Court ordered that a trial of a preliminary issue as to whether the decisions of the remuneration committee and board were reasonable should proceed.

References:

Simpkin v Berkeley Group Holdings Plc [2016] EWHC 1619 (QB)

Braganza v BP Shipping Limited [2015] IRLR 487, [2015] UKSC 17

Hills v Niksun

The *Hills* case related to a discretion in a sales commission plan rather than an employee share scheme, but is nonetheless important due to a point established on burden of proof. The Court of Appeal indicated that, under the Braganza duty, although the initial burden of proof of showing that there are grounds for considering that the decision maker has acted irrationally lay on the employee, once that hurdle had been passed the burden effectively shifted to the employer to show that the decision was a reasonable one. In this case the lack of any real evidence from the employer as regards the decision-making process effectively meant that the court could not assume that the discretion had been exercised rationally.

References:

Hills v Niksun [2016] EWCA Civ 115

Braganza v BP Shipping Limited [2015] IRLR 487, [2015] UKSC 17

Watson v Watchfinder.Co.UK Limited

The case of *Watson* concerned a share option agreement made between three individuals and the defendant company, Watchfinder. The three individuals claimants had a consultancy company which had significant connections within the luxury goods world, and Watchfinder entered into a services agreement with that company in order for it to make valuable introductions to Watchfinder. Watchfinder also entered into a share option agreement with the individuals under which the individuals had an option to acquire 5% of the shares of Watchfinder. The option agreement stated that 'the Option may only be exercised with the consent of a majority of the board of directors of the Company'. The relationship between Watchfinder and the consultant company did not work as planned (in particular the consultant was not able procure the investment in Watchfinder by a particular third party as Watchfinder had hoped) and eventually Watchfinder terminated the services arrangement with the consultant company. The individuals then attempted to exercise the options but this was refused on the basis that no board consent had been obtained. The managing director of Watchfinder effectively assumed that he had an unconditional right of veto. The three individuals challenged the refusal as an unlawful exercise of discretion. The High Court held that, although it was not inevitable in every case, here it was clearly appropriate that the *Braganza* duty applied to the exercise of the company's discretion under the consent provision. The directors had given virtually no considered exercise of the discretion at all. At the relevant board meeting only one director had spoken about the matter and the others had simply concurred. The decision had been taken in a difficult atmosphere in a rushed manner and as the last item on an agenda. The directors had effectively understood that they had an unconditional right of veto. There had been no genuine discussion and no real consideration had been given to relevant factors such as whether the individuals had made a real contribution to the growth of Watchfinder's business. The High Court held that the *Braganza* duty had been breached and the claimants were therefore entitled to specific performance of their share option contract.

References:

Watson v Watchfinder.Co.UK Limited [2017] EWHC 1275 (Comm)

The Watson case is interesting in that it demonstrates that, within the context of a discretionary power in a share option contract, even if the ultimate decision might be a reasonable one, if the process of how that decision was arrived was flawed (eg no proper consideration of relevant factors, no documented thought process, an assumption that the company had an absolute right of veto etc) the exercise of that discretion can be successfully challenged (in accordance with the *Braganza* duty) on that basis rather than simply the reasonableness of the decision alone.

Daniels v Lloyds Bank plc

The case of *Daniels* involved conditional awards of shares which would vest if the remuneration committee determined that the employee had satisfied performance conditions at the end of the three-year performance period. Awards were made to the claimants in 2009. In January and March 2012 the committee determined that the claimants had satisfied the relevant performance conditions. In February 2012, however, the rules of the plan were amended to introduce a new 'malus' clause, which stated:

References:

Daniels v Lloyds Bank plc [2018] IRLR 813

> 'The Committee may adjust downwards (including to nil) the number of Shares in respect of which an Award Vests if in their discretion they determine that the performance of the Company, any Member of the Group, any business area or team and the conduct, capability of performance of the Participant justifies an adjustment.'

Although the committee had determined that performance conditions had been met, it relied on the above clause to refuse to award shares to the claimants, on the basis that the claimants had participated in the HBOS transaction which was perceived as negative for the bank. The claimants were successful in their summary judgment claims for their shares. The case was principally decided on the basis that the bank had not been entitled under the existing rules of the plan to amend the plan to include the 'malus' clause and, as such, could not rely on it to deprive the claimants of their shares. It was also decided on the basis that the claimants' shares had in any event already vested when the committee had determined that the performance conditions had been met and, accordingly, the 'malus' clause (even if it had been validly incorporated) could not be relied on.

The court did, however, go on to consider whether, if the 'malus' clause had been validly incorporated and the shares had not already vested, the committee's decision to rely on the 'malus' clause was a proper exercise of discretion. They noted that the discretion in this case was not an absolute discretion—instead it was a discretion which had to be exercised by reference to certain contractually-specified parameters, and within those parameters it had to not act capriciously, arbitrarily or irrationally. It noted that the reference to 'and' in the above clause could not be read disjunctively (so that it meant that effectively there was a two part test: performance of the Company/Member/business area/team 'plus' conduct/capability/performance of the participant). There had been no proper consideration by the bank of the relevant test. If the clause required a two-part test, the bank had clearly not considered both parts. Even if the 'and' could have been read disjunctively and the clause required a single test, while the bank had properly considered group performance, there was no consideration of whether that factor justified an adjustment. In that sense, the case was similar to the Mallone case, where the power had to have been shown to have been exercised rationally and on the face of the evidence there was no consideration of why it was permissible to take away the earned bonus of an employee who had not committed any misconduct.

See News Analysis: Summary judgment given to former senior executives of Lloyds Bank over unpaid long-term incentive plan awards (Daniels & Anor v Lloyds Bank Plc & Anor).

Can claims for breach of contract based on exercise of discretions be excluded?

It is common for employee share plans (and related award agreements and employment contracts) to contain clauses which attempt to limit the rights of participants to bring claims for compensation against the company arising out of loss of share incentives, including in circumstances where the awards have been lost because of a termination of employment which is in breach of contract by the company. Such clauses are called 'Micklefield clauses' after the leading case of Micklefield v SAC Technology Ltd. They are relatively common in non-tax-advantaged schemes but are often not suitable for tax-advantaged schemes. See Practice Note: Micklefield clauses and Precedent: Micklefield clause for use in an employment contract.

References:

Micklefield v SAC Technology Ltd [1991] 1 All ER 275, [1990] 1 WLR 1002, [1990] IRLR 218

The *Micklefield* case essentially held that, provided that such an exclusion clause is drafted clearly enough so that it applies both on a lawful termination as well as a termination in breach of contract, it should be sufficient to protect the employer from claims for breach of contract in respect of loss of share awards flowing from such a termination. Of course, such a clause will be ineffective to prevent statutory employment claims for loss of share awards flowing from

References:

Micklefield v SAC Technology Ltd [1991] 1 All ER 275, [1990] 1 WLR 1002, [1990] IRLR 218

any such termination (eg unfair dismissal or discrimination claims), but various of such claims are subject to a statutory maximum compensation (eg unfair dismissal).

It has become increasingly common for such Micklefield exclusion clauses to be drafted so that they also purport to exclude any claims for breach of contract based on the exercise of a discretion in the share scheme or employment contract. Whether such drafting would in practice work has been subject to some commentary in recent cases.

In *Daniels* there was an exclusion clause which purported to exclude a right to 'compensation for any loss' in relation to the share plan (i) where there was 'any loss or reduction of rights or expectations under the Plan in any circumstances'; and (ii) in relation to 'any exercise of a discretion or a decision in relation to an Award or to the Plan'. Although the case was decided on other grounds, the High Court held that this exclusion clause was drafted so that it was 'seen as having special reference to claims which are properly characterised as employment claims and not claims in the context of the Plan generally'. As such, the High Court did not support the bank's argument that the clause was effective to exclude claims for breach of the plan rules nor did it support the bank's case that it entitled it to refuse to transfer the shares.

The case of *Parmar v HSBC Private Bank (UK) Limited* related to a senior employee of HSBC who had been granted remuneration in the form of unvested shares and deferred cash awards. After an investigation into his conduct involving alleged assistance to clients to evade US tax, the bank terminated his employment and the bank's remuneration committee refused him the deferred cash award and declined to vest the unvested shares. The relevant share plan rules contained a provision under which HSBC was entitled, at its absolute discretion, to reduce the number of shares in an award (or cancel it entirely) based on certain specified circumstances. In addition, it provided that participants:

> 'Shall be deemed to have waived any possible entitlements, to any compensation for any loss he may suffer as a results of the exercise by the Committee of, or its failure to exercise, any of the discretions given to it by the Plan, even if such exercise (or failure to exercise) constitutes a breach of contract by the Company or any other such Group Company... or gives rise to any other claim whatsoever. The settlement agreement he entered into on termination also provided that he agreed that "the Company may at any time in its absolute discretion (and with the approval of the HSBC Remuneration Committee), amend, reduce or cancel the award of any shares and deferred cash...and you hereby agree that you shall have no claim against the Company, HSBC Private Bank SA or the Group arising out of any such amendment, reduction or cancellation".'

The High Court upheld the bank's claim for summary judgment as the claimant had no reasonable prospect of success on his claim. It stated that the exclusion clauses referred to above 'are wide enough to cover the advanced claims in unambiguous terms, in isolation and combination'. The judge did, however, go to say that 'they would not, however, be sufficient to exclude liability, on the part of the bank in the event of bad faith or something akin to it, such as discrimination or perversity. I do not consider that even an express reference to 'irrationality' would be insufficiently precise to exclude liability for such 'sins'. The court went on to find that there was no basis on which the claimant had any prospect of showing bad faith or perversity or discrimination to defeat the operation of these exclusion clauses.

References:

Parmar v HSBC Private Bank (UK) Limited [2018] EWHC 2468 (QB)

See News Analysis: High Court rejects claim for bank's unfair use of a malus clause where an ex-employee had been accused of evading taxes (Rajesh Parmar v HSBC)

Drafting and exercising share scheme discretions in practice

The above cases highlight various key practical points for the drafting of discretions in employee share schemes and the implementation of discretions under them including:

- in drafting a discretionary power, consideration should be given as to whether it is to be drafted as an absolute discretion or a discretion which is only exercisable by reference to certain criteria (as in the *Daniels* case)
- if the discretion is drafted so that it is only exercisable by reference to certain specified criteria, it is obviously important in practice that the discretion does not in fact take into account other factors or ignore the specified ones
- if necessary, be absolutely clear in the drafting as to the range of possible decisions that the exercise of the discretion permits—in *Daniels* it was argued (albeit unsuccessfully) that the use of the word 'adjust' meant the discretion was confined to relatively limited reductions only and could not encompass a complete refusal of vesting of the entire award. Clear drafting will minimise the possibility of any such arguments
- when discretions are exercised, the company should have clear records of how the decision to apply the discretion was arrived at, the rationale for the decision, what factors were considered relevant or irrelevant, who took the decision and whether it was consistent with other similar discretionary decisions under the same or other plans. Careful consideration should be given as to the correct body that should take such a decision (eg the board or remuneration committee). A careful record should be kept of any evidence which was considered relevant to the exercise of discretion. This is not least so as to address the point from the *Hills* decision that, once the initial burden has passed from the employee to the employer, if the employer has little or no evidence to show how and why it arrived at the decision it did, it may effectively be in difficulties in rebutting an assumption by the court that there was no rational exercise of discretion
- if a discretion is used, it may sensible to communicate to the employee the reasons why a discretion has been exercised in a particular manner, what factors influenced the decision and identify the decision-maker (to address the points in the *Keen* case in that regard)
- even if a discretion is drafted as an absolute discretion, consider when exercising the discretion exactly what 'target' the discretion is aimed at. Do not fall in to the trap shown by the *Mcarthy* case where the company effectively assumed that the discretion allowed it to deem the percentage that should be deemed to vest, whereas in fact it only allowed it to determine whether the entirely of the options were exercisable on a strict 'yes' or 'no' basis
- be aware that a discretion drafted so as to be an absolute discretion is likely to be still subject to the restrictions imposed by the *Braganza* duty. As such, assuming (as was the case in the Watson decision) that an absolute

discretion gives the company an unconditional right of veto without going through a proper decision-making process is likely to be open to challenge

- if using an absolute discretion, consider whether or not to draft it so that it attempts to exclude restrictions on the use of such discretion which might be implied by law (ie it would specify that the discretion is absolute and any restriction implied by law as to the arbitrary, capricious or perverse use of the power is excluded). Also be aware that, even if such drafting does work (and the *Parmar* case has cast some doubt as to whether it would in fact work), it may be commercially unpalatable to be giving a message to senior employees that effectively states that the company reserves the right to act in such a manner, and
- if including a Micklefield clause which attempts to exclude liability for compensation on loss of share awards on termination of employment and/or exercise of a discretion:
  - ensure it explicitly refers to loss arising on unlawful termination (ie termination in breach of contract) as well as lawful termination
  - ensure it covers claims for loss or compensation not only in relation to rights under the scheme rules but also under any separate but related documents (eg individual award agreements or letters—this was an issue in the *Daniels* decision)
  - consider whether it should cover not only compensation for loss of awards flowing from an unlawful termination of employment but also loss of awards due to an exercise of discretion
  - be aware that such an exclusion clause will not be valid (i) to exclude claims for loss of share awards in statutory employment claims; and (ii) may not be valid to exclude liability which arises through bad faith or something akin to it, such as discrimination or perversity, irrespective of what the wording of the plan may specify (see the *Parmar* decision), and
  - be aware that it is still somewhat uncertain whether the Consumer Rights Act 2015 (CRA 2015) (which effectively superseded the Unfair Contract Terms Act 1977) would apply to such an exclusion clause contained in a share scheme (see further at Micklefield clauses—Issues under the Consumer Rights Act 2015 (CRA 2015). Whether CRA 2015 could apply would largely depend on whether employees could, under an employee share scheme, be deemed to be acting as 'a consumer' in relation to the company. If he/she could, and CRA 2015 applied, a Micklefield exclusion clause is potentially open to attack on the basis of being an unreasonable exclusion clause under that legislation

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Sam is a counsel in the Executive Compensation & Employee Benefits practice in the London office of Shearman & Sterling LLP. He provides the full range of employment and benefits advice on transactions and stand-alone employment matters. He has substantial experience of advising on the employment and benefits aspects of various transactions, including UK listings, share and asset acquisitions and disposals (both UK-based and multi-jurisdictional transactions), joint ventures and other transactions.

He provides the full range of stand-alone employment advice including the implementation of employment and benefit arrangements for senior executives, implementing executive severance arrangements, managing UK and international redundancy exercises and related consultation requirements, the establishment of share incentive and bonus plans, employment litigation involving restrictive covenants, unfair and wrongful dismissal and discrimination issues.

He also advises various financial institutions on compliance with regulatory requirements on remuneration, in particular the FCA/PRA's Remuneration Code and, at a European level, CRDIII and CRDIV.

Sam has been recognised as a Notable Practitioner in the field of Employment (Employer) in the 2010, 2011, 2012 and 2013 editions of Chambers and Partners UK. Sam is also recommended in the area of employee share schemes by the Legal 500 in the UK.

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