MARCH 2018 NEWSLETTER

A tug of war?

Much of the recent press coverage on Carillion's collapse has presented the underlying issues as a straightforward fight between the various parties involved, for example shareholders vs. employees, senior management vs. pensioners and employees and shareholders vs. senior management. These various conflicts are said to boil down to an ages-old struggle between providers of capital (and their agents, senior management) and providers of labour, with neither side to be trusted. This is reductive and unhelpful, pitting groups of people – who ought to have common interest – against each other, with unhelpful consequences for all.

Regardless of whether you own, manage, or work for a company, you want that company to succeed, indeed it is in all *committed* stakeholders' interests (and I choose my adjective there carefully and deliberately) for companies to succeed and flourish over the long term.

That is not to say that mediocre or downright incompetent management should be let off the hook or even rewarded in any way for failure – absolutely not. The penalties for directors who fail in their duties are clearly set out in section 178 of the Companies Act 2006, and malus and clawback clauses have for many years now been standard (and in the financial services industry, mandatory) features of executive share plan rules. The ultimate penalty in the event of a corporate failure is, for shareholders, loss of their capital. The personal penalties borne by employees and pensioners in these circumstances are much higher – loss of livelihood, erosion or potentially loss of a decent income in old age.

It is to the rights of the pensioners and employees in this situation that we should turn our attention and our energies, and also to the definition of directors' duties. Both urgently need to be considered. We should also be mindful that a proportion of these pensioners and employees will also be shareholders in the company to which they gave their labour, undermining those that would hold these two groups – owners and workers - as eternally distinct and separate – they're not.

Whilst pensioners – quite rightly – have something of a 'lifeboat' in the form of the Pension Protection Fund to turn to, the same cannot be said for employees nor for employee shareholders.

When their employing company fails, employees are the ones who lose it all – the dignity of work, the security of a monthly wage - and in many cases, unpaid wages are never recovered. If they also participate in their employer's share schemes, the consequences are dependent on the type of scheme. Under Sharesave, their savings are protected by the Financial Services Compensation Scheme and are refunded to them in full, but the associated share option will lapse and become worthless. However, if they participate in the Share Incentive Plan, then their shares will become worthless, the same as for any other shareholder. And if they have held onto their employers shares once they have exited a share scheme, then the same fate befalls those shares too. The risk of losing their capital, whilst still highly unlikely, has a disproportionately negative impact on them as compared to other shareholders who will likely be invested across a range of shares and other classes of investment.

Employee share ownership still matters, for many reasons. Why should individuals be expected to grudgingly participate in, much less defend, capitalism if they have no realistic means of acquiring any capital themselves? For many people, employee share plans are the only practical route to owning shares – capital – and benefitting financially from that beknighted status of owner. For 35% of Sharesave participants (from research by YBS Share Plans, Durham University and Leeds Business School in 2016) such schemes are their only regular means of saving, and 65% of them would not save at all without Sharesave. According to the Money Advice Service, more than 16 million of the UK's population have less than £100 in savings – it only takes one costly and expensive surprise such as a failed boiler or a broken down car, to put them in financial difficulty. Imagine how much more difficult it is for an employee in that situation whose company goes bust as unexpectedly as Carillion did. Rent and mortgage payments are defaulted on, utility bills go unpaid, expensive forms of borrowing become the only way of covering day-to-day living costs, and the list of consequences snowballs. Having a regular means of saving is one way to build vital financial resilience.

Those that continue to paint a clichéd picture of owners vs workers are stuck not just in the last century, but the one before it. Their motives should be examined even more closely than their arguments. Employee share ownership should for very good reasons remain entirely above the fray of party politics – successive governments of every political hue have supported employee share ownership. CSOP and SAYE were introduced by the Thatcher government of the 1980s, SIP and EMI came into existence in 2000 under the then Labour Government. Employee share ownership enjoys cross-party support based upon its own merits and the well-evidenced benefits it delivers to employees and their employers, and the communities in which they live and work.

Some of capitalism's worst extremes have been brought to the fore by the Carillion collapse and recent scandals such as the BHS debacle, but that does not mean that we should throw the baby out with the bathwater by encouraging entrenched views and separation of the stakeholders involved. Giving employees a route to share ownership – alongside responsible and independent financial education – is actually more important now than ever before.

By blurring the distinction between owners and workers, by encouraging overlap between these groups, greater common ground can be found. Companies with truly engaged workforces of employee shareholders, who benefit financially from the success that they help to create the same as external shareholders, should be applauded and supported, for it is they who enjoy greater productivity and economic output than their non-enlightened peers. They make a greater contribution to the Exchequer in terms of corporate and payroll tax take, which more than repays the hypothetical 'cost' of tax foregone as calculated on the equivalent cash value of tax-advantaged share schemes such as SAYE, SIP, EMI and CSOP. They help to create workforces with greater 'skin in the game' and greater potential to benefit from the company's success.

However, within the current framework where the Companies Act enshrines shareholder primacy, and imposes upon directors in section 172 a rather 'woolly' set of duties, employee shareholders have found themselves at the sharp end of the attendant consequences.

Section 172 sets out the directors' duty to promote the success of the company, as follows:

(1)A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—

(a)the likely consequences of any decision in the long term,

(b)the interests of the company's employees,

(c)the need to foster the company's business relationships with suppliers, customers and others,

(d)the impact of the company's operations on the community and the environment,

(e)the desirability of the company maintaining a reputation for high standards of business conduct, and

(f)the need to act fairly as between members of the company.

(2)Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.

(3)The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

Note that the promotion of the success of the company is defined primarily as for the benefit of its members i.e. shareholders. Employees get a mention, under (b). But in the event of the directors failing to discharge their duties, it is the shareholders who are empowered by section 178 to pursue civil claims against the directors, for under the terms of the Act it is the shareholders of the company to whom the directors owe their primary duty of care, not employees.

Shareholder primacy is an echo of the Industrial Revolution, when the barriers between those who owned companies and those who worked for companies were unscaleable.

Whilst there are shareholders who take their responsibilities as seriously as (if not more so than) their right to receive declared dividends, and engage with boards regularly on matters of governance, there are many shareholders who are entirely 'missing in action' in the corporate governance debate – the short sellers, the hedge funds, even passive investors (especially those who routinely outsource their critical thought on matters such as executive remuneration to almost unaccountable proxy advisers), who all take a bit of a free ride and leave the worrying and engagement to others. Shareholder primacy prioritises the rights of all shareholders – including those I categorise here as 'missing in action' – above the rights of other stakeholders, including employees and pensioners, as well as corporate debtholders and suppliers. How can that be just and fair? Companies need labour as much as they need capital and skilled, competent, fairly remunerated management teams.

In recent years, the rights and bargaining position of those who provide labour have been eroded by the 'gig' economy and other forms of insecure and low-paid work. Shareholder primacy has the unhelpful effect of supporting this erosion, and employee share ownership - whilst hugely beneficial - on its own is not going to rebalance the equation. Indeed, share schemes legislation is predicated on the participants having 'employee' status, which puts such schemes out of the reach of those classified as workers, contractors or self-employed, even though they may well be working alongside employees who are eligible to participate in the company's equity. The prioritisation of one stakeholder over another at all costs is unhealthy, driving a shorter-term view of companies' prospects and stymying investment (and the plugging of pension deficits) in favour of unsustainable payouts to shareholders and the servicing of what may become more expensive debt.

The Financial Reporting Council's review of the corporate governance code is therefore well-timed if not overdue, and it is pleasing to see informed and thoughtful debate being fostered by the likes of the ICSA on how the legal definition of directors' duties and the code might better align, and take a more balanced account of the realities of modern capitalism.

Encouragingly, there are companies who are setting great examples of how to engage more effectively with their workforces. To those others who might chuck giving employees a voice at board level into the 'too difficult' bucket the message should be: try harder. Rolls Royce held an 'employee AGM' after their shareholder AGM last year, running a ballot for employees across their global workforce to come and attend a meeting where their viewpoints were listened to by members of the board. FirstGroup plc has for many years had an employee director on their board, and the company's former chairman John McFarlane (nicknamed 'Mack the Knife' in some circles, and now chair of Barclays) is on record as saying that the arrangement was highly effective.

So let's do away with the tired and divisive distinctions of yesterday. Let's foster measures which balance all stakeholders' interests more fairly, protect the most vulnerable, and do more to ensure companies succeed on a sustainable and long-term basis for the benefit of all. Ultimately, disorderly corporate failure costs us all, one way or another. It's therefore our duty to act constructively and collectively to tackle this.

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