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Severance Policy - A Must Have for Directors

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The corporate landscape abounds with legal disputes between employers and Directors over issues of unfair dismissal and termination of contract. These often result in exposures running into billions of Naira. The unfortunate reality is that no company is immune from this issue. Any company that is yet to adopt a Severance Policy for its Directors is a potential casualty. Based on a Severance and Change-in-Control Plans survey conducted by the WorldatWork in 2014, about 80% of the participating companies had well-documented severance polices for their employees, including Directors. However, majority of Nigerian companies are yet to embrace Severance Policy, due to reasons such as ignorance, misconception, complacency, lack of buy-in by the Shareholders or the Boards, etc. In some instances, companies are just waiting for an incident to happen to heed the wake-up call.

Recently, in a legal dispute for wrongful termination and defamation, a pan-African bank agreed to an out-of-court settlement of USD12 million (over N2 billion) to its ex-CEO that was removed from office on allegations of fraud and poor corporate governance. This case underscores the importance of having in place a Severance Agreement for Directors. This company could have saved itself the bad publicity, unnecessary litigation cost and distraction, if it had implemented a Severance Agreement with its Directors.

In employment disputes, where a contract exists, the terms and conditions of that contract will form the basis for resolving issues of breach of contract and unlawful dismissal. Where there is no contract, the general principle is that either party can terminate the relationship, subject to giving a week or a month notice or an equivalent payment in-lieu.

In legal disputes between the employer and employee, only damages are typically awarded, and not a reinstatement. This is based on the principle of law that a willing servant should not be imposed on an unwilling master and vice versa.

On the other hand, Directors enjoy a different form of contractual relationship often referred to as Employment with Statutory Flavour (ESF). For ESFs, in addition to the contract of employment, appointment and termination of their employment is protected by statutory or regulatory provisions. The Director, therefore, has a right and can rely on such statutory provisions to challenge his/her removal from office. In Nigeria, the Companies and Allied Matters Act, 2004 (CAMA) has provisions that regulate how a Director can be removed from office, failing which the Director is entitled to sue for breach of contract. In addition to damages, the relief of reinstatement may be available to such Director. The CAMA also provides for compensation for loss of office (a form of Severance Payment) to Directors, subject to the approval of the shareholders.

Severance is a payment typically made to Directors to compensate them for loss of office or completion of tenure. The main objective of the payment is to provide the Directors with a safety net necessary to take calculated risks on behalf of the company or, in the case of an outsider, the risk to join the company. Severance Payment can also be seen as damage control or a way of assuaging guilt for terminating a Director.

In exchange for these payments, companies usually require the Director to waive all rights, claims, rights to sue for more or compete with the company for a specified period of time. Without a Severance Plan, if the Director succeeds in a lawsuit, he may be entitled to reinstatement, in addition to damages, a situation which may not be desirable for the employer. The Plan may also contain a provision which bars the departing Director from disclosure of corporate secrets and/or hiring any employee from the company. To ensure compliance on the part of the departing Director, companies usually make the payment in instalments.

Based on global practice, Termination Without Cause or a Change-in-Control (CIC) event will qualify the Director for Severance Payment. To qualify for Severance, the CIC must have resulted in a material reduction in compensation, peculiar to the Director; a material reduction in the Director's authority, duties or responsibilities existing before the CIC, etc. These CIC events are valid grounds for the Director to terminate the contract for Good Reason, and qualify for Severance Pay, unlike a situation where the Director voluntarily resigns or terminates his/her contract.

Termination (of the Director) for Good Cause, will not qualify the Director for Severance Payment. The circumstances under which the employer can Terminate for Good Cause include: willful negligence on the Director's part to perform all assigned duties; willful misconduct that materially harms the employer's business or an affiliate etc. However, as it is often difficult to prove gross negligence or wilful misconduct, companies tend to take the easy way out by terminating the Director without cause, which will qualify the Director for Severance Payment.

In computing Severance Pay, some companies use a fixed amount per year of service, while others use a multiple of Annual Base Pay. Where Bonus is included in defining the payout, it is mostly Target Bonus that is considered. Most employers pay out between one and two times the Base Pay (plus Target Bonus) to their Directors. In addition to the cash payment, companies offer outplacement benefits and administrative assistance to support the departing Director in finding another job, post-employment healthcare, immediate or continued vesting of equity incentive awards, etc.

As most companies in Nigeria do not have well-defined Severance Policy, Severance Payments are largely discretionary. Certainly, a properly defined Severance Pay Policy can save a company a lot of bad publicity, unnecessary cost, distraction to core business and bad blood between the company and the departing Director. It can also contribute to a company's ability to attract, retain and motivate talents in the business, as prospective or potential Directors can willingly consider taking up employment with such a company, without fear of how they would be treated in the future.

For further enquiries on the above, please contact:

Boluwaji Apanpa
T: +234 706 417 1642
E: boluwaji.apanpa@ng.kpmg.com

Nneka Jethro-Iruobe
T: +234 808 313 3012
E:nneka.jethro-iruobe@ng.kpmg.com

Uchechi Ananaba
T: +234 803 891 2051
E: uchechi.ananaba@ng.kpmg.com

Adewale Ajayi
T: +234 803 402 1014
E: adewale.ajayi@ng.kpmg.com