

Private and Confidential
Rt Hon Frank Field MP and Rachel Reeves MP
The Chairs
The Work and Pensions Committee
The Business, Energy and Industrial Strategy Committee

5 April 2018

Dear Mr Field and Ms Reeves

Re: Carillion

Thank you for your letter dated 26 March 2018. I also refer to my previous letter to the Committees dated 20 February 2018. Please find my responses to your questions below.

1. In a letter to us, Deloitte confirmed that of the clawback provisions established in 2015 "Deloitte were not consulted and did not subsequently provide advice to the Remuneration Committee, nor Carillion management, in relation to their specific decision to include these triggers" although they had provided information on "the types of triggers which the Company might apply based on market practice at that time." Did your committee take any legal or other advice on the terms that you subsequently agreed for clawback?

In relation to Deloitte, they were the general advisers to the Remuneration Committee, they attended each Remuneration Committee meeting (between three and five were held every year), and they assisted in the preparation of document packs for Remuneration Committee members. In addition to being general advisers, Deloitte also provided specific advice as requested.

In relation to clawback, as the Committees will be aware, "clawback" is a mechanism by which a company can seek repayment of vested cash and shares (and is different from a "malus" mechanism by which a company can cancel unvested cash and shares). As I explained in my letter of 20 February 2018, it appears to me that there may be some misunderstanding around the issue of clawback. In summary:

- Clawback was introduced for the first time by the Remuneration Committee for awards granted after February 2015.
- As I explained to the Committee in my oral evidence (Q639), the introduction of clawback at this point was in response to the 2014 Corporate Governance Code, which recommended the introduction of such arrangements.
- The Company adopted clawback in relation to Executive Directors only, which was in line with the 2014 Corporate Governance Code.
- The introduction of clawback made it possible to clawback bonuses paid out, whether in cash or shares. Prior to February 2015 there was no express power to clawback bonuses paid out.
- These new rules governing clawback have remained in place since we introduced them in 2015.
- It was proposed in September 2017 that the rules determining the applicability of clawback (and malus) should be broadened for awards from 2018 onwards (see my response to question 2 below).

The conditions for clawing back bonuses that were introduced in February 2015 were as follows:

- (i) events of gross misconduct; or
- (ii) material misstatement of the Company's published accounts for the years (saving any restatement required by a change to the Accounting Standards, accounting policies and accounting practices of the business) which relate to the performance period of the award which lead to a restatement of those accounts ("**restatement**").

The extent to which clawback applied was at the discretion of the Remuneration Committee (acting reasonably) and up to a maximum of the net amount of the award.

In relation to the introduction of clawback in February 2015, the Remuneration Committee took specific advice from Deloitte about market practice for the triggers that were applied to clawback. The use of the triggers that the Remuneration Committee implemented was consistent with the then evolving market practice. Where possible, we would seek to match the median position of comparable companies; and we ordinarily used the FTSE 250 as our comparator (the Company remained in the FTSE 250 during my tenure until July 2017). To be clear, Deloitte did advise the Remuneration Committee in relation to the type of clawback triggers it could adopt in light of market practice. The Remuneration Committee also took legal advice from Slaughter & May in relation to the enforceability of the triggers for clawback and how they should be drafted. On the basis of that advice and the status of the 2014 Corporate Governance Code, we applied gross misconduct and restatement as the clawback triggers.

For completeness, and as explained in my letter of 20 February 2018, I should also add that the separate malus regime was already in place before our changes were made to clawback. The circumstances in which malus was available were also changed with effect from February 2015 so that they were aligned with those for clawback. The malus and clawback regimes have been aligned since that time.

2. Your committee agreed in September 2017 to extending the cases in which clawback and malus could be made to:

- **Material misstatement of results;**
- **Error in assessing a performance condition or in the information or assumptions on which the award was granted or vests;**
- **Material failure of risk management;**
- **Serious reputational damage;**
- **Serious misconduct or material error on the part of the participant ;**
- **Any other circumstances which the Remuneration Committee in its discretion considers to be similar in their nature or effect.**

Why did the Committee take this decision? When did it (or was it due to) come into force? Had these provisions been in force at the time of the first profit warning in July 2017, do you believe they may have resulted in penalties for directors?

The Remuneration Committee took the decision to extend the clawback and malus provisions in September 2017 in view of evolving market practice and because the Company was in the process of recruiting a new permanent Chief Executive, Andrew Davies. In summary:

- It is ordinary practice for a Remuneration Committee to take stock of its remuneration arrangements on recruiting a senior member of the executive team in order to ensure that the provisions in place are effective, enforceable and fit for purpose.
- The Remuneration Committee took advice from Deloitte and Slaughter & May with regard to the proposed amended triggers.
- We were advised by Deloitte that the triggers listed above would give the Remuneration Committee the appropriate flexibility and that the triggers recognised best practice in the market at that time.
- Slaughter & May advised on the enforceability of the new triggers.
- On the basis of that advice, we agreed to apply the triggers above to clawback and malus.
- The amendment was adopted at the meeting in September 2017.

The new rules would have applied to the following year's share and bonus awards (and subsequently). They were incorporated into the employment offer accepted by Andrew Davies.

As to whether or not these amended triggers would have been triggered if they had been effective at the time of the 10 July 2017 announcement, this is ultimately a legal question so I am unable to say whether malus or clawback would have been applicable. There would still have been a need to demonstrate an enforceable legal ground to claw back the value of any cash or share awards. In any event, no bonuses were awarded in 2017 and any shares which had previously been

awarded to Executive Directors but had not vested now have no value because of the liquidation of the Company.

3. Papers from February 2015 noted that applying clawback beyond executive directors risked "a more conservative trading practice around contracts which would have a detrimental impact on performance". With hindsight, do you think a more conservative trading practice around contracts may have benefited Carillion?

With hindsight, I recognise that more conservative trading practices may have been beneficial to Carillion. The Board was made aware in June 2017 (as part of the "lessons learned" strategy session that it undertook) of certain management failings at contract level connected to trading practices and took swift steps to deal with those issues.

With respect to the connection between remuneration and trading practices specifically, the review of management failings in June 2017 did not identify any connection between those issues and Carillion's remuneration policy. To the best of my knowledge, the decision to apply clawback to Executive Directors only did not result in failings by management in connection with trading practices. In addition, I should add that the 2014 Corporate Governance Code did not require the application of clawback to individuals other than Executive Directors and it was also not market practice to do so.

4. A September 2017 paper by Deloitte noted "There is also no provision to clawback bonuses that have been paid in cash". Are there no circumstances under which the 50% cash portion of any bonus payments would never have been subject to clawback, regardless of conditions attached? Why did the committee not include any provisions for clawback of cash bonuses in contracts or remuneration policies?

The Deloitte statement referenced in the Committees' question is incorrect. The Company had a clawback policy in place in relation to cash bonuses since it was introduced in February 2015. Indeed, on the following page of the same document Deloitte clarified that "*the cash element of the bonus is subject to the same malus and clawback triggers*".

5. Were changes to Leaver provisions under the DPB [sic] and LEAP, proposed by Deloitte in September 2017, agreed?

The changes proposed by Deloitte were agreed.

6. Can you confirm that under the arrangements in place at the time of Richard Adam's departure, the awards he obtained from the sale of shares vesting on his retirement at 31 December 2016 and 7 May 2017 could not be clawed back? How would this be different if the proposed new arrangements had been in place instead?

As confirmed by Richard Adam to the Committees in his letter of 20 February 2018:

- 93,472 shares vested upon his retirement on 31 December 2016 relating to DBP awards granted in 2013, 2014 and 2015;
- a further 38,594 shares vested upon his retirement on 31 December 2016 relating to the 2013 LEAP award; and
- following his retirement, a further 112,416 shares relating to the 2014 LEAP award vested on 8 May 2017.

As explained above, clawback was introduced for awards granted from 1 February 2015 onwards and so is only relevant to the 2015 awards. It remains a matter for the liquidators to determine if there is any legal basis on which to clawback the value of shares relating to awards made after 1 February 2015 which were sold following Richard Adam's retirement on 31 December 2016. This will require them to demonstrate enforceable grounds for legal action on the basis of the application of the clawback triggers of gross misconduct or restatement.

Given that it is a legal question, I am unable to say whether the position would be different if the proposed new arrangements had been in place. The new arrangements would need to have been in place prior to the awards being granted to apply (which in Mr Adam's case were from 2013). There would also still have been a need to demonstrate an enforceable legal ground to claw back the value of any cash or share awards.

7. The September 2017 minutes note that the Committee considered asking the executive directors to return their 2016 bonuses. For what reasons did the Committee not seek to retrieve the bonus? What was the outcome of the intended discussion with lawyers? Did you have any conversations with executive directors about returning their bonuses?

The Remuneration Committee determined that there was no legally enforceable basis on which to seek the return of the Executive Directors' 2016 bonuses in accordance with their employment contract terms and the Scheme rules. This decision was made with the benefit of internal legal advice. I did not have any specific conversations with the Executive Directors regarding their returning their bonuses voluntarily.

8. Following the high level of votes against and abstentions on remuneration at the 2016 AGM, your Committee considered the bonus design at a meeting in August 2016. Shareholders had voiced concerns about the use of personal and individual 'stretch' targets over financial performance targets when rewarding executives. Why did the Committee accept the proposal of "rebadging the appropriate personal targets as 'Corporate KPIs' rather than developing new indicators?

The Company engaged and consulted with shareholders in relation to remuneration. As part of that engagement, it became apparent in 2016 that shareholders were misunderstanding the nature of personal and individual 'stretch' targets. Shareholders interpreted these personal performance targets as being non-financial measures when, in fact:

- they were actually designed to improve corporate performance, which effectively encompassed the same outcomes as financial measures;
- the personal targets were largely quantitatively-based and objectively verifiable; and
- a number of the personal targets were based on the financial performance of the business.

However, given this misunderstanding and based on the specific recommendation of Deloitte, the Remuneration Committee considered it appropriate to "rebadge" or "rename" the personal targets.

For completeness, remuneration packages were set on the basis of a balanced "scorecard" for executives which encompassed financial KPIs, as well as personal and individual 'stretch' targets and other measures. The "scorecard" was agreed annually based on company strategy. As well as better defining the personal performance targets in 2016, in response to concerns emerging from a survey of shareholder views in that year, the Remuneration Committee also took active steps to put more emphasis on the financial KPIs in the 2016 bonus awards. This involved amending the 2016 bonus so that 75% of it was assessed against key financial performance metrics of the business, as opposed to 50% of it being based on financial performance in the prior year.

9. In its meeting ahead of the profit warning in July 2017, your Committee agreed to retention payments for certain senior staff below executive director level and authorised the Chief Executive to extend this to certain other staff. Was there already a significant turnover of senior staff at this point in the company's history? Did the retention payments succeed in keeping senior staff at the company?

At the point the Remuneration Committee approved retention payments being made, there had not yet been a significant increase in senior staff departures. However, given the challenging circumstances facing the Company it was a very real risk that the Company could lose a number of its senior staff who it needed to retain to maximise its chances of successfully negotiating this difficult period. This is a common scenario. In an environment where a drop in a company's performance would likely impact materially on variable pay and share awards, it is often important to seek to maintain the "total" award due to employees (for example by a retention payment) and to incentivise key members of staff to stay with that company. In such circumstances, competitors will often seek to tempt key members of staff to leave a company, which strengthens the need for added internal incentives to retain staff. My recollection is that retention payments were agreed with around 8 to 10 employees and that most if not all stayed with the Company unless their roles subsequently became redundant as a result of cost saving measures.

10. Minutes from September 2017 note that the Committee agreed to "continue the payment of remuneration on a contractual basis during the period of notice" for Richard Howson. What other options were open to the Committee to take? What considerations were made of them?

Following Mr Howson's departure, the options open to the Remuneration Committee were to continue to pay his remuneration on the contractual basis (i.e. monthly) during his notice period of 12 months, or to pay him a lump sum in lieu of his notice. Mr Howson asserted through his lawyers that he was contractually entitled to the lump sum because he did not receive his contractual notice. Despite that, the Remuneration Committee determined it was preferable to make the payment on a monthly basis so that, in the event that anything was discovered in the course of investigations, the Remuneration Committee would be able to suspend the payments. Following the Company's entry into liquidation, the notice payments to Mr Howson ceased, meaning that he would only have received around a third of the notice payment due to him.

Please let me know if I can assist any further.

Yours sincerely

Alison Horner