GRG Remuneration Review

Takeover and Termination Provisions of Long Term Incentive Plans

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INTRODUCTION

GRG has recently had cause to focus on the early vesting provisions of executive long term incentive (LTI) plans. Early vesting provisions generally include:

- Those occurring during employment being change-in-control (CIC) situations relating to:
  - ownership of shares, or
  - control of voting rights, or
  - control of the Board.

  In relation to share ownership and voting it should be noted that less than a majority may still confer effective control. Therefore, careful consideration needs to be given to the definition of what constitutes a CIC.
- Those occurring on termination of employment:
  - Death,
  - Total and permanent disablement,
  - Company initiated termination of employment for other than cause including retrenchment and redundancy,
  - Retirement from full time employment with the prior formal consent of the Board.

Other termination situations such as resignation and dismissal for cause have not been mentioned above as they typically do not result in early vesting as unvested equity units tends to be forfeited.

When the plan rules for equity based LTI plans are being drafted its is usual for those provisions dealing with terminations of employment to receive careful consideration but for those dealing with CIC situations to receive less attention probably because the circumstances that trigger their consideration occur relatively rarely. However, when the circumstances do arise it is important for the provisions to have been well thought through and to be sound appropriate responses.

All of the early vesting situations, with the possible exception of retirement, have one aspect in common being that the executive has not taken action to trigger the event. Therefore, it is arguable that there should be consistency in the vesting treatment of equity units in each of these situations.

GRG Remuneration Reviews are articles to assist directors and senior executives who have responsibilities in relation to Board and senior executive remuneration and other human resources issues. Their role varies between articles with some aimed at stimulating critical thinking, others updating information and others simply acting as a reminder of principles and approaches where awareness may need to be heightened.

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Institutional Investor View

The aspect that has caused recent concern has been that some institutional investors have expressed the view that when early vesting events occur, a proportion of the equity units granted under a LTI plan should lapse. The proportion that lapses should be related to the unexpired portion of the vesting period. For example, if an executive had been granted say 90,000 equity units which would vest after 3 years provided specified performance conditions have been satisfied then if the early vesting event occurred after 2 years the institutional investors take the view that one-third of the equity units should lapse and performance should then be considered in determining the extent, if any, to which the remainder vests.

This view seems to be influenced by the approach that needs to be applied to accounting for and disclosure of share-based payments as governed by AASB 2. This accounting standard provides for the value of the LTI equity units to be amortised over the vesting period. The rationale for this approach, as explained in AASB 2, is that the work being rewarded by the equity unit grant takes place over the vesting period and therefore the reward for the work should be recognised over the corresponding period.

While this rationale produces a desirable accounting outcome of spreading the cost over several years, it does not reflect the well structured remuneration management approach adopted by many companies. This aspect is discussed in the next section. However, it should also be noted that some companies have adopted different allocation approaches and therefore the following comments may not apply to those approaches.

Remuneration Management Approach

The best practice approach to managing remuneration is to determine a total remuneration package for an executive. That package is typically divided into 3 components being the Base Package (also known by various other titles such as fixed annual remuneration (FAR) and total employment cost (TEC)), short term incentive (STI) and LTI. However, the mix of the components depends upon the mix select by the board, firstly as between fixed and variable remuneration and secondly as between STI and LTI. Thus, there tends to be a degree of inter-changeability between the three main components. The Base Package is paid monthly during the remuneration year. The STI is generally calculated by reference to performance during the remuneration year but paid in the following remuneration year. LTIs are granted during the remuneration year but vesting occurs, say 3 years later having regard to continued service and company performance.

Under this approach grants of equity units are part of remuneration for the year in which they are granted. Most companies use annual grants and the number of equity units to be granted each year is generally calculated by dividing the LTI value for that year by the value of the equity units at the time of the grant. The grant is intended to be part of the grant year's remuneration but with conditions to be satisfied before they vest. The vesting conditions have the effect of reducing the value of the equity units to be granted and therefore have an effect on the number of equity units to be granted.

The following example shows a company making annual grants of equity units which vest over 3 years, where the remuneration value (the method used to calculate the remuneration value is not relevant for purposes of this example) to be provided each year is:

- $90,000 in 2009,
- $102,000 in 2010,
- $114,000 in 2011,
- $126,000 in 2012, and
- $138,000 in 2013.

Because of the lag effect of the amortisation approach used for accounting and remuneration disclosure purposes, the recorded amount of remuneration lags behind when it is provided.

The following table shows:

- The remuneration value each year for remuneration management purposes as opposed to remuneration disclosure purposes, and
- The accounting charge each year.

For simplicity it has been assumed that grants are made at the beginning of each remuneration year, a market vesting condition applies and the executive continues as an employee. This means that the accounting charge value is spread evenly over the vesting period.

	Remuneration Year	2009	2010	2011	2012	2013	
	Annual Grant Value Required if the Grant Value is to be the Remuneration Value	**$90,000**	**$102,000**	**$114,000**	**$126,000**	**$138,000**	
		Accounting Charge for Year					Totals
Accouniting Charge in Remuneration Year (Assuming 3 Year Vesting Period)	2009	$30,000					**$30,000**
	2010	$30,000	$34,000				**$64,000**
	2011	$30,000	$34,000	$38,000			**$102,000**
	2012		$34,000	$38,000	$42,000		**$114,000**
	2013			$38,000	$42,000	$46,000	**$126,000**

Were it intended that the accounting charge be used for remuneration management purposes then the pattern of the grants would change significantly. The initial grant would need to be 3 times the size of a normal annual grant and the next 2 grants would need to be much smaller than the intended annual grants – see following example. A pattern of one large grant followed by 2 small grants would produce undesirable outcomes and influences. For example this type of approach is likely to concentrate executive turnover in periods soon after a large grant has vested. Also as some executives would receive their large grants in different years and would be based on different share prices, it follows that there would be large inconsistency in the benefits received by executives who in other remuneration respects would be intended to be reward consistently.

	Remuneration Year	2009	2010	2011	2012	2013	
	Annual Grant Value Required if the Accounting Charge Value is to be the Remuneration Value	**$270,000**	**$36,000**	**$36,000**	**$306,000**	**$72,000**	
		Accounting Charge for Year					Totals
Accouniting Charge in Remuneration Year (Assuming 3 Year Vesting Period)	2009	$90,000					**$90,000**
	2010	$90,000	$12,000				**$102,000**
	2011	$90,000	$12,000	$12,000			**$114,000**
	2012		$12,000	$12,000	$102,000		**$126,000**
	2013			$12,000	$102,000	$24,000	**$138,000**

Factors to Consider When an Determining Early Vesting

Two Factors

There are two important impacts that are expected of most LTI grants and they are retention and performance. Each of these is discussed below.

Retention

The retention impact is via a penalty in the event of resignation or termination for cause prior to completion of the vesting period. The penalty is in the form of forfeiture of unvested equity units.

If termination occurs for other reasons then the traditional view has been that the executive should not be penalised as he/she was ready and willing to otherwise complete the service period. Also where there is no termination there should be no lapsing based on the vesting period not being completed at the early vesting point.

An exception to the foregoing that should be considered is when grants were made during the remuneration year in which the early vesting event occurs. As the grant was remuneration for the year then if a termination of employment ensures that part of the remuneration will not be earned, a consequence should be that part of the equity units should lapse as they will not be earned.

The following table shows the 3 main categories of early vesting situation that should be considered in relation to the retention component and provides a comment on each.

Early Vesting Situation	Proposed Treatment of Unvested Equity Units	
	If Grant in Prior Remuneration Year	**If Grant in Current Remuneration Year**
Termination of Employment via Dismissal or Resignation	All unvested equity units to lapse	
Other Terminations of Employment	No lapsing	Pro-rata lapsing based in uncompleted portion of remuneration year
CIC	No lapsing	No lapsing as there is no termination of employment and therefore it may be expected that the remuneration will be earned

Performance

The performance impact is via the extent, if any, to which the equity units vest based on performance. Being a LTI the period over which performance is measured in typically 3 years. Provided equity units have not lapsed earlier due to resignation or dismissal, it would be logical for performance to be measured at the end of the vesting period. By measuring performance at the end of the vesting period for all recipients there will be consistency in the treatment of participants in a grant. However, administrative considerations and taxation provisions which trigger taxation on the value of equity units at the time of the termination have led to most companies wishing to determine the extent of vesting at the date of termination.

Although “other terminations of employment” and CIC situations are similar from a retention point of view they are different when it comes to assessing performance. In the “other terminations of employment” situation the participants in prior grants will fall into two categories being those who

are ceasing employment and those who will continue in employment. Whereas in CIC situations all participants in grants will be in the same position as they will all be remaining employees. Another difference is that in "other termination of employment" situations the company is continuing with its current ownership, voting control and board composition. Thus, those remaining will be able to pursue the performance goals that will give rise to vesting of the equity units. However, in CIC situations the change in ownership, voting and/or the board may well mean that the performance goals may be no longer relevant and/or achievable.

Given these circumstances, the following comments are made:

Early Vesting Situation	**Proposed Treatment of Unvested Equity Units**	
	If Grant in Prior Remuneration Year	**If Grant in Current Remuneration Year**
Other Terminations of Employment	▪ Company performance in relation to each grant to be assessed ▪ Assessment to be by the Board ▪ Vesting to be based on assessed performance	After pro-rata lapsing based in uncompleted portion of remuneration year ▪ Company performance in relation to each grant to be assessed ▪ Assessment to be by the Board ▪ Vesting to be based on assessed performance
CIC	▪ Company performance in relation to each grant to be assessed ▪ Assessment to be by the Board ▪ Vesting to be based on assessed performance	

As a broad guide the following approach may be useful for Boards to consider when assessing company performance and determining the extent of vesting.

Company Performance Level as Assessed by the Board	**Unvested Equity Units Remaining after Lapsing Based on Service (see foregoing)**
Poor i.e. less than good	Nil vesting
Good	50% vesting
Between Good & Outstanding	Pro-rata between 50% and 100% vesting
Outstanding	100% vesting

Some companies allow retesting of performance and additional vesting if performance improves within a window after the initial performance measurement. During this window the unvested equity units do not lapse. A decision needs to be taken as to whether these equity units should lapse or be treated the same as unvested equity units that have not reached the point of their first performance vesting. Given that they have failed to vest at their first test it would not be unreasonable for them to be forfeited when an early vesting event arises.

Conclusions

Having regard to the foregoing a reasonable approach to dealing with unvested equity units under the rules of an equity based LTI plan would seem to be as follows:

- Termination of employment due to dismissal for cause or resignation would give rise to lapsing of all unvested equity units,
- Termination of employment in other circumstances would give rise to:
  - Lapsing of a proportion of the equity units granted in the year of the termination and that proportion would be the proportion that the uncompleted part of the remuneration year bears to the full remuneration year,
  - Vesting of none, some or all of the remaining unvested equity units having regard to performance as assessed by the Board,
- In CIC situations: none, some or all of the unvested equity units would vest having regard to company performance as assessed by the Board.

The period during which vested equity units need to be exercised has not been covered in this article but would need to take account of the circumstances of the early vesting event.

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GRG Contacts

GRG is well positioned to assist boards in reviewing their company's remuneration strategies, incentive plans and employment contract terms. Many of the top Australian listed companies are among our substantial client base.

GRG maintains databases on director and executive remuneration. We capture all the aspects required to be covered in Remuneration Reports and therefore provide an authoritative source of advice in relation to market practices and emerging trends.

Please feel free to call any of the following consultants on **02 8923 5700**

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More information on GRG may be obtained from our website:
www.godfreyremuneration.com