

GRG

Remuneration Review

Announced Termination Benefit Reduction

Remuneration Review No. 14

April 2009

INTRODUCTION

On 18 March 2009, the Federal Treasurer and the Minister for Superannuation & Corporate Law in a joint Media Release indicated that the Government would amend the Corporations Act to “significantly lower the threshold at which termination payments must be approved by shareholders from the current level down to one year’s average base salary”. The Media Release then went on to indicate that two further amendments would be made being that it will:

- “extend the range of executives whose termination payments can be subject to shareholder approval” and
- “broaden the definition of “termination benefit” to catch all types of payment and rewards given at termination”.

However, it went on to point out that “changes to the law cannot apply retrospectively. Today’s announcement will not prevent existing contracts on termination payments from proceeding”.

It is perhaps timely to review the current law and raise aspects that companies will need to consider when the amendments are legislated.

CURRENT LAW

Under section 200B of the Corporations Act (the Act) companies, associates and prescribed superannuation funds are not permitted to provide termination benefits to directors or managerial officers of a company without shareholder approval. The nature of transactions covered by this provision is then expanded to capture transactions that might otherwise have been used to circumvent the application of the section.

If shareholder approval is required then it must be obtained by a resolution passed in general meeting. In relation to the resolution, shareholders must be provided with details of the proposed termination payments.

The foregoing prohibition on termination payments does not apply to several specified payments of which the following is generally the most relevant and applies when:

- a) the benefit is a payment in connection with a person’s retirement from a board or managerial office, and
- b) the payment is for past services rendered to the company or related companies, and
- c) the value of the benefit, when added to the value of all other payments (if any) already made or payable in connection with the person’s retirement from board or managerial offices in the company or related companies does not exceed the payment limit of:

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.

GRG Godfrey Remuneration Group Pty Ltd

ABN: 38 096 171 247

56 Berry Street

North Sydney NSW 2060

Phone (02) 8923 5700

Facsimile (02) 8923 5706

www.godfreyremuneration.com

Payment Limit	=	Total Remuneration ÷ 3 x Years of Service up to 7
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NB: For non-executive directors the “7” is reduced to “3”.

Total Remuneration includes all forms of remuneration (see AASB Standard1046) received during the last 3 years of employment with the company.

Payment “means a payment by way of pension or lump sum and includes a superannuation, retiring allowance, superannuation gratuity or similar payment”.

If the service period is less than 3 years then the limit equals the total amount of remuneration received during the period of employment.

MARKET PRACTICE

GRG is currently extracting detailed data from remuneration reports as to current practice in relation to severance payments for senior executives i.e. those to be targeted under the change to the termination benefit limit that may be paid without shareholder approval. This comprehensive data will be included in the GRG Executive Service Contracts Guide which will be available in May 2009.

GRG’s current understanding of market practice is summarised below.

- Accrued statutory entitlements including annual and long service leave are paid out on termination.
- Base package (salary, allowances, superannuation contributions, other benefits and FBT) is paid up to the date of termination.
- Short term incentive (STI) for the year during which the termination occurs may be paid on a pro rata basis but will depend upon the rules of the STI plan and/or the terms of the employment agreement.
- Long term incentive (LTI) grants (shares, rights & options) that are unvested may vest in the event of a termination of employment but will depend upon the rules of the LTI plan and/or the terms of the employment agreement.
- If the employer does not require the executive to work out the notice period then a lump sum payment in lieu of notice may be paid.
- In certain circumstances such as a company initiated termination for other than cause, a severance payment may also be made. Severance payments generally do not arise in cases of dismissal and resignation. Some years ago severance payments of up to 2 times annual remuneration were common practice. However, over recent years the practice for CEOs has reduced to one year’s Base Package (less for lower executives). This change has occurred because boards have been conscious of changing community attitudes and concepts of good corporate governance. It has not required legislation because the vast majority of boards have been diligently and properly fulfilling their roles. In this regard it should also be remembered that the Government had for many years encouraged through concessional taxation of termination benefits, the structuring of remuneration such that part of it was paid on termination of employment.

CHANGE IN CONTROL (CIC)

Change in control such as in the event of a takeover, is a circumstance where following soon after the CIC it is common for some executives to have their employment terminated. In these circumstances there is usually a two step process comprised firstly of triggering of certain payouts and vesting and secondly of the new owner/controller terminating the employment of some executives.

The events that happen in the first step can include:

- pro rata payout of the STI up to the date of the CIC, and
- vesting of some or all of the equity units (shares, rights and options) that were previously granted under the LTI plan.

As a termination of employment will not have taken place at that time, the limit on termination benefits will not apply.

When employment is subsequently terminated it is usual for:

- a payment in lieu of notice, and /or
- a severance payment,

to be made in addition to statutory entitlements etc.

It is these payments that will need to be approved by shareholders or the total amount when combined with other termination payments will need to be restricted to the Corporations Act limit.

COMMENTARY AND OBSERVATIONS

Persons Affected

The current coverage includes directors and officers. In the Media Release the two ministers seem to have misunderstood the current law as they stated: "Currently only directors' termination payments must be approved". Nevertheless, it seems clear that they intend to expand the coverage as they went on to say that: "the Government will legislate to expand the coverage of shareholder approval to all those executives named in the company's remuneration report".

Such an extension would seem to be logical and would bring consistency to the treatment of all top executives.

Remuneration or Salary

As indicated above the current limit is a multiple of the last 3 years' average remuneration. Remuneration includes salary, allowances, superannuation contributions, other benefits, fringe benefits tax, short term incentives (STIs), long term incentives (LTIs) and other payment such as retention payments.

If, as the Media Release states, the new multiple will be of "base salary", the reduction in the limit will be more severe than the 85.7% reduction from 7 times to 1 times that may have been immediately apparent. For example, if an executive had a last 3 years average annual remuneration package made up of salary of a \$300,000, benefits of \$30,000, bonus of \$75,000 and equity grants with an annualised value of \$75,000 then his remuneration would be \$480,000. Under the current law the total of his termination benefits could be up to \$3,360,000 without shareholder approval. However, if the limit is to be based on salary and limited to one times then the amount that may be paid as total termination payments would be limited to \$300,000 which is under 9% of the previous limit. If annual remuneration was to continue to be used then the limit would be \$480,000 which still represents a major reduction from the previous limit.

Payout Composition

Broadly, the payments and benefits that arise at the time of termination of employment can include those listed in the following table which also includes an indication of whether they may form part of a termination payment. Each company should look at their specific circumstances and take professional advice to ascertain whether the following is a correct interpretation in their circumstances. Of course, vesting that occurs after or prior to the termination would not be part of the termination payment unless it was in consequence of the termination.

Payment or Benefit	Comment
Salary and benefits up to date of termination of employment	Not in connection with the termination
Employee after tax superannuation contributions and earnings on these contributions	Not part of termination benefit
Employee salary sacrifice superannuation contributions and earnings on these contributions	Connected to the retirement and value is part of the termination benefit
Employer superannuation contributions and earnings on these contributions	Connected to the retirement and value is part of the termination benefit
Pro rata STI payout	Connected to the retirement and value is part of the termination benefit
Vesting of LTI equity units	Connected to the retirement and value is part of the termination benefit
Pay in lieu of notice	Connected to the retirement and value is part of the termination benefit
Severance payment	Connected to the retirement and value is part of the termination benefit

When amending the legislation it would be helpful if the Government would exclude certain payments from the termination benefit limit. Surely, superannuation benefit accruals which are in effect already limited to \$100,000 p.a. should be excluded. Also pro rata STI and equity unit vesting which are remuneration for the period worked should be excluded along with salary up to the date of termination of employment.

The limit should apply to payments in lieu of notice and severance payments.

IMPLICATION FOR COMPANIES

We will need to wait to see the final form of the amendments to the Corporations Act before deciding upon the implications for companies and their boards. However, it would seem likely that the changes will have little effect other than to add to the administrative compliance burden.

Current arrangements will be unaffected as the Media Release indicated that any changes would not affect current contractual obligations. Given that the current practices of the vast majority of companies would be regarded as responsible and reasonable by most shareholders, the changes to the Corporations Act may simply require companies to place their policies before shareholders for approval. Hopefully this will only need to be done once at the policy level, rather than on an executive by executive basis.

Companies that will be more quickly impacted will include: those that are entering into new employment contracts or are replacing current employment contracts or are changing their STI or LTI plans.

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