GRG Remuneration Review

Retirement Benefit Approval by Shareholders

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Remuneration Review No 29

June 2011

INTRODUCTION

Under legislation passed in 2009, shareholder approval is required for retirement benefits for executive and managerial officers when the total benefit exceeds one year's base salary and it is paid pursuant to a new or amended contacted that was entered into or amended after 23 November 2009. This change is significant because:

- the multiple was reduced from 7 to 1 for executives (from 3 to 1 for non-executive directors),
- the amount on which the multiple is based was reduced from "total remuneration" to "base salary",
- amounts that were previously not considered to be retirement benefits became retirement benefits and these included short term incentive (STI) payouts and vesting of long term incentive (LTI) benefits when the payment or vesting is triggered or accelerated by a termination of employment, and
- the Explanatory Memorandum to the Bill that contained the new provisions of the Corporations Act, indicated that any change to remuneration would be considered to be a variation of a contract and therefore the varied contract would be subject to the new default limit if the variation occurred after 23 November 2009.

At the time the legislation was introduced companies were considering their positions and deciding whether or not to seek shareholder approval in advance or simply wait until a retirement benefit needed approval.

The last year and a half has been the first opportunity for companies to seek shareholder approval for retirement benefits that exceed the new limit. To gain an understanding of emerging market practice GRG undertook an analysis of recent notices of meeting.

ANALYSIS OF NOTICES OF MEETING

GRG examined the recent notices of meeting of the top 300 companies listed on the Australian Securities Exchange (ASX) by market capitalisation. We identified six (6) companies that had sought shareholder approval to provide retirement benefits to executive and managerial officers in excess of the default limit of one times base salary. The following table shows the voting on the resolutions. Note that five (5) of the companies submitted one (1) resolution only. Whereas SAI Global submitted nine resolutions.

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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The shading of the "Resolution" column is to indicate the degree of voting support for the resolution:

Shading	Meaning
Orange	Less than 50% of cast votes in favour
Grey	Between 50% and 70% of cast votes in favour
Green	More than 70% of cast votes in favour

COMPANY NAME	Market Capitalisation End of May 2011 ($ Millions)	Resolution	Votes for	% For	Votes Against	% Against	Total
Iluka Resources Limited	$6,448	1	167,271,415	58%	120,301,400	42%	287,572,815
Macarthur Coal Limited	$3,456	1	147,111,307	73%	55,673,756	27%	202,785,063
Billabong	$1,575	1	144,983,514	85%	25,919,680	15%	170,903,194
SAI Global	$998	1	62,387,207	54%	52,445,645	46%	114,832,852
		2	62,348,778	54%	52,425,485	46%	114,774,263
		3	62,354,078	54%	52,419,835	46%	114,773,913
		4	62,349,787	54%	52,424,126	46%	114,773,913
		5	62,346,549	54%	52,422,242	46%	114,768,791
		6	62,348,428	54%	52,425,485	46%	114,773,913
		7	62,351,928	54%	52,415,749	46%	114,767,677
		8	62,348,428	54%	52,425,835	46%	114,774,263
		9	62,354,428	54%	52,419,835	46%	114,774,263
Catalpa Resources	$312	1	20,312,446	48%	22,096,173	52%	42,408,619
Tap Oil	$230	1	106,623,373	97%	3,803,334	3%	110,426,707

Although the majority of resolutions were passed (5 out of 6 companies) it is notable that the resolutions of two (2) companies were passed by a slim majority. Thus, only three (3) companies i.e. 50% of the companies received strong support for their resolutions.

Although the sample is small it indicates that Boards should not necessarily expect shareholders to rubber stamp arrangements that result in retirement benefits in excess of the one year's base salary default limit for executive and managerial officers. These results are likely to heighten anxiety felt by executives about the risk of not receiving potential retirement benefits in excess of the default limit.

GRG is of the view that companies should review the provisions of employment contracts, short term incentive plans and long term incentive plans as they relate to termination of employment particularly for "good leavers". When properly structured the possibility of exceeding the one year's base salary default limit can be minimised while maintaining benefit levels.

COMMENTS ON STRUCTURE OF THE RESOLUTIONS

The new section 200B of the Corporations Act specifies that a company "must not give a person a benefit in connection with" the retirement of an executive or managerial officer "unless there is member approval under section 200E for the giving of the benefit". Section 200E provides that:

- "the giving of the benefit be approved by a resolution passed at a general meeting",
- "details of the benefit must be set out in, or accompany, the notice of meeting" and "must include:
    - If the proposed benefit is a payment:
        - The amount of the payment, or
        - If the amount cannot be ascertained at the time of disclosure – the manner in which the amount is to be calculated etc,
    - otherwise:
        - The money value of the proposed benefit, or

- If that value cannot be ascertained at the time of disclosure – the manner in which the value is to be calculated" etc.

Advice received by GRG from its solicitors indicates that wording of the relevant provisions requires shareholder approval of retirement benefits to be given to specified individuals. This is consistent with the resolutions submitted by SAI Global, Iluka and MacArthur Coal but not the others.

None of the resolutions were specific as to the amount/value of retirement benefit to be provided, however, all sought to indicate the manner in which the amount/value of the retirement benefit may be calculated. Whether the explanations adequately comply with the legislative requirement remains to be seen. However, the variations in the explanations provided and the depth of explanations suggests that the companies were struggling to satisfy the legislative requirement. If they fail to meet the legislative requirements then the approvals obtained may be invalid.

A possible reason for this is that the Government's initial proposal was for such approval to be obtained after a person's retirement. In such cases the amount of the proposed retirement benefit for the individual would have been known. However, when the legislation was finally passed it allowed shareholder approval to be obtained prior to a termination. It is when shareholder approval is sought prior to a termination that specifying the amount/value or the manner in which the amount/value of the retirement benefit will be calculated becomes challenging. If the retirement benefit is to be a multiple of a defined amount (salary, Base Package/TFR/TEC) then the method can be simple to explain. If part of the retirement benefit is to be a payout of a short term incentive (STI) then the percentage of salary that is the STI award opportunity may change between the date of shareholder approval and the date of retirement. In these cases the approval may become void as the manner of calculating the retirement benefit may change from that which was approved. If part of the retirement benefit is to be vesting of long term incentive grants of shares, rights or options then the grants that will vest on retirement may not have been made at the time shareholder approval is obtained. Also the LTI% used to calculate the number of shares, rights or options may change between the date of approval and the date of retirement. The variables in relation to STI and LTI may make it virtually impossible to obtain durable shareholder approval for retirement benefits in excess of the default limit of one year's base salary, prior to a retirement.

REMUNERATION PLANNING CONSIDERATIONS

The following points are raised for consideration by Boards when dealing with remuneration in the event of termination of employment for executive and managerial officers.

1. New or amended employment contracts should contain a clause which recognises that the Company cannot provide retirement benefits in excess of the default limit of one times base salary unless shareholder approval has been obtained for a higher amount/value.
2. If the Company wishes to provide a retirement benefit in excess of the default limit then the employment contract may contain a clause indicating that the Board will submit a resolution to shareholders seeking approval for the higher retirement benefit and will use its best endeavours to obtain shareholder approval.
3. The combination of pay in lieu of notice and severance payment will often exceed "one year's base salary" as defined. Over recent years market practice has changed so that one year's salary/Base/TEC/TFR is a common retirement benefit. These will exceed the one year's base salary default limit as "base salary" is generally the average annual base salary over the last three (3) years of employment and the payment under most

contracts is defined by reference to the salary/Base/TFR/TEC at the rate applicable at the date of termination of employment which is usually higher than the last three years average. Also Base/TFR/TEC will be a higher amount than salary as they include statutory superannuation conttributions.

4. STI awards do not need to be triggered or accelerated by the termination of employment and may be paid at the end of the year based on performance but perhaps pro-rated to reflect the period worked during the year. This avoids the STI awards being counted towards retirement benefits.
5. LTI award vesting does not need to be triggered or accelerated by the termination of employment. From an internal equity point of view it would be fairer for the vesting of shares, rights and options to be delayed until the end of the performance measurement period even if it falls after the termination of employment. This deferral would ensure that past and current executives are treated consistently in terms of vesting of LTI awards. Of course, the design of the LTI plan would also need to be adjusted to ensure that executives are not taxed on the value of unvested shares, rights or options at the time of termination of employment.
6. Termination of employment can follow on from a change in control (CIC) event such as a takeover. In this regard it will be important for the LTI plan rules to be clear in terms of vesting of unvested shares, rights and options at the date of the CIC. Vesting which is triggered or accelerated by a CIC event would not constitute a retirement benefit as the vesting is not related to the termination of employment.

The degree to which companies have identified potential problems in relation to delivering retirement benefits particularly to "good leavers" varies significantly from company to company. Some have not yet been exposed to the impact of the new retirement benefit limit because their executives have been employed under contracts that were executed prior to 24 November 2009 and have not since been amended. However, as time passes and new executives are employed and old contracts are replaced, this issue will need to be addressed by all companies. Hence, it would be advisable for all companies to have the provisions of their employment contracts, STI plan rules and LTI plan rules reviewed as they relate to terminations of employment particularly for "good leavers". If the LTI plan rules need to be amended then it may be necessary for any amended plan rules to be submitted to shareholders for approval.

Key Management Personnel Remuneration Advice

GRG is a specialist advisor on remuneration for key management personnel (KMP) i.e. non-executive directors, executive directors and other top executives. To facilitate its independent advisory function GRG mains two remuneration databases with one concentrating on non-executive directors and the other on top executives. This data analysis allows GRG to remain up to date with current trends and developments and to be able to benchmark company practices against market practice. The increased focus being placed on KMP remuneration makes it more important than ever for Boards to be satisfied that they are adopting practices that are consistent with market practice and appropriate to their company's circumstances.

If you would like an independent review of the market competitiveness of your company's remuneration practices for KMP then GRG will be pleased to assist.

Please call Denis Godfrey or James Bourchier on (02) 8923 5700 or Mike Carroll on 0416 226 131.