Clawback of Overpaid KMP Remuneration

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INTRODUCTION

By now you will probably be well aware that in December 2012 the Australian Government released an exposure draft and explanatory memorandum for amendments to the Corporations Act entitled "Corporations Amendments – Improving Disclosure Requirements". This included a number of areas that were seen as requiring change. One of these dealt with clawback of remuneration overpaid to key management personnel (KMP).

Although at the time of writing this GRG Remuneration Insight the clawback enacting legislation had not been introduced into Parliament the topic remains relevant due to many companies already having introduced clawback policies.

THE PROPOSED AMENDMENT

The proposed amendment to the Corporations Act is to require companies in their Remuneration Reports when a material misstatement or omission is discovered in any of the three prior financial years, to disclose for each reported KMP:

(i) "details of any reduction, repayment or other alteration of the person's remuneration made, or to be made, because of the misstatement or omission, or

(ii) if no reduction, repayment or other alteration of the person's remuneration has been made, and will not be made, because of the misstatement or omission – an explanation of why".

For a company to undertake a clawback beyond that currently legally permitted it would be necessary for the company to have a clawback policy to which KMP have agreed to be bound.

Although not specifically mentioned in the draft legislation, its intention as explained in the Explanatory Memorandum is to cover overpaid KMP remuneration and its recovery by the company.

WHAT IS CLAWBACK?

In the context of KMP remuneration, the term "clawback" in the Draft Explanatory Memorandum referring to the Corporations Legislation Amendment (Remuneration Disclosures and Other Measures) Bill, 2012 seems to mean a contractual term that either requires repayment of or allows a company to take back or seek repayment of excessive remuneration that was performance based and relied on financial statements of any previous 3 years that have since been shown to be materially incorrect. The excessive remuneration would be the excess of the amount paid over the amount that would have been paid based on the correct financial statements. Thus, a clawback is not a punishment but a correction of an error. It should also be noted that it is irrelevant whether or not the executives concerned were either directly or indirectly involved in producing the incorrect financial statements on which the excessive remuneration was based.

Based on preliminary legal advice, companies have the ability to recover excessive remuneration by suing executives:

a) who have undertaken illegal actions by falsifying company financial accounts for personal gain (which proceedings could also be commenced by ASIC), or
b) for recovery of unjust enrichment, if they have not undertaken illegal actions.

Particularly when deciding whether to pursue b) above, it is likely the company will consider the quantum of the excessive payments from the perspective of the company (i.e. is the total amount of excessive remuneration material for the company) and the executives (i.e. will the amount to be recovered justify the recovery cost and the disruption to business, particularly if recovery is to be from current executives).

If the company decides not to pursue recovery of unjustified enrichment then it is likely that similar reasons would also lead to clawback not being pursued. However, if companies wish to have clawback policies that are enforceable without legal action then they will need to amend the rules of incentive plans and possibly the terms of employment agreements.

Once incentives have been paid including when securities may be exercised and shares sold, companies will need to pursue recovery in the Courts when executives do not voluntarily repay excessive remuneration. Thus, if companies wish to have access to incentive awards as a means of recovering excessive remuneration then the rules of the incentive plans will need to be amended to include both a clawback provision and an escrow period during which earned awards may not be dealt with and remain available for the company to clawback, should it become necessary.

If full recovery of excessive remuneration were to apply in relation to material misstatements or omissions that occurred in the prior three financial years' financial statements, then all earned STI and LTI awards would need to be escrowed for three years. However, such action may be perceived by executives as an excessive reaction to a possibility that may rarely, if ever, occur.

More reasonable approaches but less likely to accommodate a full clawback would be to:

a) escrow only part of STI and/or LTI awards, and/or
b) use shorter escrow periods.

Clawback of unvested LTI is problematic as the value of the unvested securities may be impossible to determine until the vesting point and will be nil if they would not otherwise have vested. Also clawback of unvested LTI grants will undermine current incentive plans where vesting will be unlikely to be affected by the material misstatements or omissions in prior year accounting statements.

HOW DOES THE MARKET ADDRESS CLAWBACK NOW?

Although the draft amendments to the Corporations Act have not yet been passed, some companies already have or disclose what they refer to as clawback policies. GRG conducted research on the annual reports of some 500 companies to identify those that included references to clawback. The following summarises the findings:

- 30 companies were identified that claimed to have a clawback policy in place,
- 3 companies had a clawback policy that only provided the board with discretion to intervene with the vesting of unvested securities (for which performance had not yet been tested or met), but this was referred to as a clawback policy,
- 7 companies stated that clawback policies were in place but that the details were only disclosed in employment contracts or were otherwise not disclosed as part of the annual report and therefore could not be assessed,
- 7 companies had a clear clawback policy that related to STI, in the majority through the deferral of a significant component of STI into securities which were then subjected to one to three years of service testing, during which period the incentive could be clawed back by the company, if it appeared that the incentive was an overpayment in the light of subsequent performance or events. LTI was not subject to clawback. Of these one

company had an explicit "Malus" arrangement in place, which because they were a financial company, was intended to ensure that short term decision making did not have longer term negative consequences

- 13 companies claimed to have a complete clawback policy in place that covered both the STI and LTI,
  - In 10 cases the clawback related to STI that had been achieved and a portion of which had been deferred into securities for a period, but for the LTI the clawback was discretionary and only applied to unvested securities (for which performance conditions had not yet been tested or met), and
  - In 1 case it had been disclosed that $20,000 had been reclaimed from an incumbent as a result of the clawback policy,
  - In 1 case it was stated that the employment contract required reimbursement by the incumbent in the case that an overpayment had been made, however the board had discretion to cancel unvested securities instead, if they so determined,
  - In 1 case a tranche of the LTI was only service tested and was subject to clawback, as was STI deferred into securities.

When the foregoing clawback policies are considered in the light of the STI and LTI plans currently being operated by these companies it seems clear that, in the majority of cases, very little incentive remuneration is exposed to being clawedback. This is because:

a) Forfeiture of LTIs that have not and may never vest is not the same as repayment of an overpaid amount,
b) The period between earning and payment of STI and LTI awards is very short, typically less than 3 months, which means that earned/vested STI and LTI awards would rarely be available for clawback, and
c) STI and LTI awards would mainly only be available to the extent to which STI awards are deferred and LTI awards are subject to dealing restrictions, however both STI deferral and LTI dealing restrictions rarely apply for the three year period intended to be covered by clawback policies.

Thus, current clawback policies would seem to be grossly inadequate in terms of fully recovering KMP remuneration that has been overpaid.

HOW WILL THE MARKET RESPOND TO CLAWBACK IF PASSED?

The submissions to Treasury on this draft legislation have recently become available and are almost unanimous in agreeing that the requirements, as drafted, would not be in the best interests of shareholders. This is largely due to the rarity of the situations in which clawback would be required, but also because it would effectively undermine traditional STI and LTI plans. The motivational impact of an STI that cannot be enjoyed until four years after the year of performance would be seen as low by incumbents. An LTI which does not result in any real ownership of securities until six years after granting is likely to be seen as even less motivating. Therefore it is the hope of GRG and others that this legislation will not pass. However, in the event that it does pass there are a number of alternatives open to companies including:

- Change nothing, do not institute a policy and be prepared to explain why no policy is in place and accept the "strike" on the Remuneration Report that may accompany this position in the circumstances that a clawback may have been required. It would appear likely that a "strike" may be attained in any case as it has often been used as a platform for shareholders protesting non-remuneration related issues, so there may be no real loss in taking this position,
- Defer a portion of ***both*** the STI and LTI into securities that are vested (having been subject to a real risk of forfeiture) but are subject to dealing restrictions and clawback for up to three years. Where this value is not sufficient to cover all of an overpayment an explanation may need to be given as to why the full amount was not clawed back,
- Move some or all of the value of LTI back into STI, and defer all of that exchanged value into securities subject to a short period of forfeiture risk and dealing restrictions that add-up to a further three years, perhaps being released in steps. This value would likely be sufficient to cover all of an overpayment in a given year, particularly once overlapping periods have accrued value. This approach has some advantages in that it will

mitigate any short term decision making by incumbents since the securities will subsequently be subjected to the consequences of their actions over a longer term via changes in market value. However GRG would not expect many stakeholders to approve of high levels of STI for all executive KMP roles, particularly the MD/CEO. Most also require a market related performance condition that aligns with the experiences of shareholders and therefore the nature of KPI's associated with such an STI would likely need to change. The motivational impact of this approach should be preserved in that only the amount that would have been paid in LTI has been affected and KPIs are generally seen as being more within the control of executives than market based performance conditions.

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, meaning that we are truly independent.

To facilitate its advisory function GRG maintains Australia's largest KMP remuneration database with over 1,000 companies and over 6,000 incumbents. The analysis this allows keeps GRG up to date with current trends and developments and enables us to produce specialist benchmarking as well as broad remuneration guides.

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, and to communicate remuneration decisions clearly and effectively.

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. We can also assist in communication strategies, drafting of Remuneration Report disclosures, resolutions related to remuneration, incentive plan rules and engaging with stakeholders to manage strike risks. Please call Denis Godfrey, James Bourchier or Mike Carroll on (02) 8923 5700 or Nicholas Jackson on (03) 9607 1318 for further information.