

## Treating “Good Leavers” Badly

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### INTRODUCTION

One of the aspects on which market practice information was extracted, analysed and commented on in the **2013 GRG KMP Incentives Guide** was the treatment of “good leavers” under the terms of short term incentive (STI) and long term incentive (LTI) plans. “Bad leavers” mainly cover company initiated terminations for cause and resignations. “Good leavers” mainly cover company initiated terminations for other than cause (includes situations where a business unit is sold and employees who remain with the business unit consequentially have their employer changed), death, total and permanent disablement, retirement with the consent of the Board, retrenchment and redundancy. Long standing practice has been for “bad leavers” to be paid their Base Package up to the date of termination and for accrued but untaken leave. They generally forfeit all entitlements to an STI for the year in which the termination occurs and all unvested LTI grants. “Good leavers” tend to be treated less harshly and traditionally would have also received a pro-rata STI award for the part of the year worked leading up to the termination and vesting of some or all of their unvested LTI grants. Usually the amount of STI award and LTI vesting took account of performance up to the date of the termination. Prior to the November 2009 changes to the Corporations Act companies did not need to consider the termination benefit limit as it was high and it was generally considered that STI awards and LTI vesting did not constitute termination benefits as they related to service prior to the termination. As they do represent remuneration for the period up to the date of termination of employment it is fair that “good leavers” do receive pro-rata STIs and LTIs as the circumstances of the termination make it inappropriate for them to be penalised.

In November 2009 the law was changed by severely reducing the amount of termination benefits that may be paid without shareholder approval (referred to as the default termination benefit limit (TBL)) and expanding the range of benefits that are considered to be termination benefits. The default TBL was reduced from seven times remuneration to one times base salary (average of last 3 years). The range of benefits considered to be termination benefits was expanded to include STI payments and LTI payments and vesting that are triggered or accelerated by the termination of employment. The default TBL applies to “executive and managerial officers” who are also known as key management personnel (KMP) i.e. those whose remuneration details need to be disclosed in Remuneration Reports. It came into effect for new and materially amended contracts made after 23 November 2009. Prior contracts that have not been materially amended continue to be exempted from the new default TBL. A materially amended contract includes any contract where any term relating to remuneration has been changed. Given the time that has elapsed since the new TBL provisions were introduced and that changes to remuneration terms are likely to have been made, it is anticipated that the majority of employment agreements for KMP are now subject to the new TBL.

While a small minority of companies have sought shareholder approval for termination benefits in excess of the default TBL the majority of companies have exhibited a preference not to seek such shareholder approval. This preference may be due to uncertainty as to shareholder sentiment that may be exhibited at the time of voting on this matter. In the absence of shareholder approval for a higher termination benefit “good leavers” will be subject to the default TBL which will reduce their termination benefits including pro-STI awards and LTI vesting related to the period prior to the termination of employment, if they would otherwise exceed the default TBL. An exception applies when the rules of the STI and/or LTI plans have been updated so that terminations of employment do not trigger or accelerate payments or vesting.

## TERMINATION BENEFIT COMPONENTS

The following table identifies the four main components that need to be aggregated to determine the total amount of termination benefit.

Component	Comments
Payouts of accrued but untaken leave	Not treated as part of termination benefits when considering whether the default TBL will be exceeded.
Pay in lieu of notice	<p>Payouts of remuneration for that part of the notice period that occurs after the date of termination. These payments tend to be based on the Base Package. They are part of termination benefits and are counted when determining whether the default TBL will be exceeded.</p> <p>Pay for “gardening leave” is not a termination benefit as the person remains an employee.</p>
Severance payments including redundancy and retrenchment payments	Payments that arise on termination in addition to pay in lieu of notice and statutory entitlements. These payments may be based on Base Package, Base Package plus STI at target or stretch levels or TRP (Base Package + STI + LTI). They are part of termination benefits and are counted when determining whether the default TBL will be exceeded.
STI for part year in which termination occurs	In the year of the termination only part of the year will be worked. Pro-rata STI awards may be paid in respect of the part of the year worked. If the payment is triggered or accelerated by the termination of employment then it will be a termination benefit component.
Vesting of LTI grants or payment of cash LTI awards	LTI grants held at the date of termination of employment where vesting or payment is triggered or accelerated by the termination will be a termination benefit component.

Under new employment agreements for executive KMP it is now usual practice for there to be a provision that specifies that the company’s obligations to make termination payments will be subjected to the default TBL. Consistent with this limitation it is also usual for pay in lieu of notice and severance payments to be structured so that they will fall within the default TBL. Thus, it is the STI and LTI plans that are most likely to give rise to termination benefits that, when added to other termination benefits, exceed the default TBL.

By simply drafting STI and LTI plan rules so that a termination of employment does not trigger or accelerate payment or vesting, any STI and/or LTI delivered to a former employee following a termination of employment will not be considered to be a termination benefit. In these circumstances the default TBL will not apply. While the concept is simple the drafting needs to be carefully undertaken and must take into account the policy implications of such a change as well as the taxation considerations which can be complex to navigate. GRG has drafted many such revisions and therefore has experience in addressing these complexities.

## HAVE COMPANIES MODIFIED THEIR STI & LTI PLANS?

### Long Term Incentives

One of the main reasons that the default TBL may be exceeded for “good leavers” is vesting of LTI grants on termination of employment. This is because LTI values tend to be similar to or larger than STI award opportunities and several years of grants may be unvested at the date of the termination due to the length of the measurement period which is typically no less than 3 years.

Considering:

- the time that has elapsed since the new TBL legislation came into effect,
- that vesting of LTI awards are most likely to give rise to termination benefits in excess of the TBL, and
- most Boards seem to prefer not to seek shareholder approval for higher termination benefits,

it could have been expected that many companies would have amended the rules of their LTI plans to ensure that the LTI does not form a component of the termination benefit. Simple modernisation of the termination provisions of LTI plan rules can achieve this outcome and ensure that “good leavers” do not have their LTI benefits reduced as a consequence of the TBL. However the following data indicates that such an expectation has not been fulfilled.

Data extracted from the **2013 GRG KMP Incentives Guide** indicates the following in relation to the treatment of unvested LTI grants on termination of employment.

Practice	Part of Termination Benefit	Number of Companies	% of Companies
No vesting at a termination of employment. LTI Grants remain alive for testing at end of Measurement Period.	No	12	24%
Vesting does or may occur on termination of employment e.g. Board discretion	Yes	25	50%
All lapse	No	4	8%
Unclear	Undetermined	9	18%
TOTAL		50	100%

It seems clear that around 25% of companies have taken action to modify their LTI plans to ensure that “good leavers” are not disadvantaged by the default TBL. Of concern is that at least 50% of companies in the sample seem not to have modified their LTI plan rules and have left their executive KMP exposed to having their termination benefits severely constrained by the default TBL.

## Short Term Incentives

Analysis of company policies in relation to payment of pro-rata STI award for the year in which a termination of employment occurs produced disappointing results. Virtually all analysed companies did not disclose what would happen to STI entitlements for the year of termination for a “good leaver”. This may reflect the absence of a clear policy or that this aspect was not seen as a key design feature of the STI plan.

Given that STI award opportunities are usually less than 100% of the executive’s Base Package and that only part of that entitlement would arise if only part of the year is worked it may be unlikely for pro-rata STI awards to take the total termination benefit to more than the default limit. Exceptions may apply when there is an entitlement to a severance payment and/or a payment in lieu of notice and they are a large percentage of the base salary.

## CONCLUSIONS

Companies should review their:

- executive KMP employment agreements,
- STI plan rules and
- LTI plan rules,

to ensure that they are correctly aligned and produce the intended consequences for “good leaves”. At the same time those provisions which relate to takeovers/changes of control should also be reviewed as a termination of employment may follow such an event.

If reviewing the rules of STI and LTI plans it may be opportune to extend the review to cover other aspects of the design of these plans. Such plans should be regularly reviewed to ensure that they remain appropriate to the company’s circumstances. If reviewing your STI and/or LTI plan or just seeking to ensure that they are consistent with market practice then the **2013 GRG KMP Incentives Guide** is an essential reference source.

### 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 Bouchier or Mike Carroll on (02) 8923 5700 or Nicholas Jackson on (03) 9607 1318 for further information.