GRG Remuneration Insight 54

Change in Control Provisions Need Review

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INTRODUCTION

In relation to remuneration of key management personnel (KMP) and other executives a change in control (CIC) event is one that is often not well addressed in employment contracts and plans rules for short term incentive (STI) and long term incentive (LTI) plans. For many companies there is a strong need to review CIC event provisions. Such reviews should be undertaken well before a CIC event is likely to occur and in the case of LTI grants, any changes will not be retrospective meaning that future grants will be those that are effected and it will typically take three years (standard vesting period) before all unvested LTI grants are covered by new CIC event provisions.

WHAT IS A CIC EVENT?

Section 50AA of the Corporations Act defines "control" by stating that:

> *"(1) For the purposes of this Act, an entity controls a second entity if the first entity has the capacity to determine the outcome of decisions about the second entity's financial and operating policies.*
>
> *(2) In determining whether the first entity has this capacity:*
>
>> *(a) The practical influence the first entity can exert (rather than the rights it can enforce) is the issue to be considered; and*
>>
>> *(b) Any practice or pattern of behaviour affecting the second entity's financial or operating policies is to be taken into account (even if it involves a breach of an agreement or a breach of trust)."*

Thus, a CIC event occurs when an entity or group acting in concert, which previously did not have control, acquires effective control. The definition of "entity" is wide and includes, companies, partnerships, trusts and individuals.

One of the main forms of a CIC event is a takeover which may be partial (less than 100% of the shares are acquired) or complete (100% of the shares are acquired). If a complete takeover of a listed company occurs then the shares in the company will cease to be listed. This has implications for the liquidity of securities and the determination of a market value of securities.

WHEN DOES A CIC EVENT OCCUR?

This aspect is typically defined in STI and LTI plan rules and in employment agreements. Examples include:

a) When a takeover occurs,
b) When the board recommends to shareholders that a takeover offer be accepted, and
c) When the board forms the view that a CIC event has occurred or is about to occur and has provided written notification of this view to relevant parties.

Item c) above can be important as it allows boards to determine that a CIC event has occurred before a takeover is completed or recommended.

WHY IS A CIC EVENT RELEVANT?

From a KMP remuneration perspective, CIC events are relevant as they may trigger:

- payments under employment contracts or STI plans, and/or
- vesting of securities granted under LTI plans.

In relation to incentives the rationale for early triggering of payments or vesting is that when control changes it is likely the new controllers will seek to change financial and/or operational aspects of the company. Such changes may undermine pre-existing incentives and may warrant new incentives designed to reinforce the new financial and operational priorities. In addition, if a complete takeover occurs then securities held under LTI plans will need to be finalised and possibly replaced with securities in the new parent company.

If a CIC event triggers a contractual payment then consideration may need to be given as to whether contractual termination benefits continue to be appropriate if a termination occurs within a defined period after the CIC event. This may be influenced by whether the combination of a CIC event payment and a termination benefit may be construed as double dipping which could occur with contracted payments but would be unlikely to arise in relation to STI payments and/or LTI vesting.

OPTION PLANS AND CIC EVENTS

For many years it has been common practice for option plan rules to specify that all options vest when a CIC event occurs. The rationale for this provision was that no benefit (excess of share price over exercise price) would be likely to arise for option holders if the CIC event was related to poor company performance as the share price would most likely have fallen since the options were granted. If, on the other hand, the CIC event followed good company performance reflected in share price growth then a benefit would be likely to arise for option holders. In both situations the benefit derived by the option holders is directly aligned with the experience of shareholders.

Thus in option plans, boards generally have discretion to determine when a CIC event has occurred but no discretion as to the extent of vesting. This situation provided executives with certainty as to their entitlements should a CIC event occur.

It should be noted that whether or not the shares in the company became unlisted due to the CIC event had no bearing on the determination of whether or not a CIC event had occurred or on the level of vesting.

RIGHTS PLANS AND CIC EVENTS

For some years the market trend in KMP remuneration has been for rights plans to replace option plans as the executive LTI plan. The nature of rights (they have value irrespective of whether the share price has risen or fallen since they were granted) led to the view that the CIC event provisions of rights plans should be different from those that applied in option plans. The most commonly applied approach to vesting of rights when a CIC event occurs has been for boards to have discretion to determine the extent of vesting, if any.

Board discretion has not been seen as a satisfactory approach by either executives (lack of clarity as to entitlements) or directors (lack of clarity as to criteria to be used in exercising discretion and concern about potential impact on the takeover process including the possible application of s1325C of the Corporations Act – see below). Boards tend to consider the portion of the measurement period that has elapsed since the grant of the rights and the extent to which vesting conditions have been achieved. Given that the two most frequently used LTI vesting conditions are relative total shareholder return (RTSR) and earnings per share (EPS) growth it is possible for boards to determine that a portion of rights should vest, even if shareholders have not experienced a proportional growth in value. Note that share price movement over the short term may not be aligned with either RTSR or EPS growth over the short term.

On occasions boards have felt that they should not exercise any discretion to vest rights as such action may not be seen as acting in the best interests of shareholders during a period when a CIC event is in progress. This has given rise to situations where executives have worked successfully to maximise the value derived by shareholders from the CIC event but have not been rewarded for their success.

NEW APPROACH TO VESTING OF RIGHTS WHEN A CIC EVENT OCCURS

A new approach that has emerged over recent years is as follows:

- Determine the potential pool of rights for vesting – this would be the total of
  - all rights granted in prior financial years that have not previously lapsed, and
  - the proportion of rights granted in the current financial year that the completed part of the financial year bears to a full year,
- Automatic vesting of the potential vesting pool would occur in the same proportion as the share price has increased since the rights were granted (this produces a comparable outcome to that which applied to options in that nil vesting (nil benefit) occurs if the share price has not increased and the value of the vesting rights (benefit) is linked to the amount of share price growth),
- Board retains discretion to vest additional rights if circumstances warrant higher vesting, and
- Any remaining unvested rights are retained by the executive for future testing but they lapse if the company's shares are delisted prior to the end of the measurement period.

This new approach provides executives with certainty as to their minimum entitlements and aligns the experiences of executives and shareholders. It also removes the need for the board to exercise discretion in relation to vesting unless exceptional circumstances warrant additional vesting and minimises the possibility of action being initiated under s1325C of the Corporations Act (see below).

LIMITS ON CIC EVENT BENEFITS

When shares, rights or options vest due to a CIC event the benefit provided will not be subject to the limit which applies to termination benefits. The termination benefit limit applies to executive and managerial officers of ASX listed companies and is one times base salary (average of last 3 years) unless shareholders approve a higher amount. CIC event benefits are not termination benefits as they arise from the CIC event and not a termination of employment.

When entitlements on a CIC event occurrence are clearly set out in plan rules and employment contracts it may be expected that there would be little, if any, possibility of vesting being attributed to the termination rather than the CIC event. Board discretion on vesting may be less clear cut particularly if it is applied on an individual basis and contemporaneously with an individual's employment being terminated.

UNFAIR OR UNCONSCIONABLE AGREEMENTS, PAYMENTS OR BENEFITS

Section 1325C of the Corporations Act can apply to agreements entered into and benefits given to directors or secretarys within 12 months after the start of a bid period for a takeover bid, if a court is satisfied that the agreement or benefit was unfair or unconscionable having regard to the interests of the company.

For this provision to be brought into play an application needs to have been made by the company, ASIC or shareholders who together hold shares carrying at least 10% of the votes attached to voting shares in the company. The application needs to be made within 12 months of the agreement being entered into or the benefit being provided unless the court allows a longer period.

The Court may

- declare the agreement, or any part of it, to be void, or

- direct that the Company be recompensed, or
- make any other order it considers appropriate.

CONCLUSION

While the CIC event provisions of employment contracts and STI and LTI plan rules do not need to be referenced every day, they do come under the spotlight when the relevant circumstances arise. At that point in time it will generally be too late to change the plan rules or the terms and conditions of previous offers.

The right time to review CIC event provisions is when a CIC event is not a prospective event. Then a balanced view can be determined by the board. Several documents may need to be amended and some may need shareholder approval e.g. LTI plan rules if issues of shares are not to count towards the 15% annual limit on new issues without shareholder approval. When reviewing CIC event provisions it would also be prudent to also review the termination provisions particularly as they apply to "good leavers" - see GRG Remuneration Insight 52 for more information.

Particularly in relation to LTI plans it should be noted that new CIC event provisions will only apply to new grants and not to prior grants. As the typical measurement period for LTI grants is three years it will take considerable time for the new CIC event provisions to take effect. Thus, a review of CIC event provisions should be undertaken prior to the next round of LTI grants.