

# GRG Remuneration Insight 106

## Change-of-Control Provisions

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### Introduction

Change-of-Control (CoC) provisions of incentive plan rules often leave the treatment of potential incentive awards at the discretion of Boards. In the case of short term incentives it is common for documentation, if any, to be silent on the issue of CoC, in which case discretion is generally taken to apply. This situation raises two questions being:

- a) Should the CoC provisions be more prescriptive, and/or
- b) What factors should Boards consider when exercising their discretion?

CoC provisions are essential features of both short term incentive (STI) and long term incentive (LTI) plans, and when not documented appropriately ahead of a CoC event, not only do complications routinely arise at an undesirable time, but also reputational damage can ensue if an outcome occurs that is seen as inappropriate by any stakeholder.

GRG has been assisting an increasing number of Boards to manage this issue in the absence of appropriate documentation, and the journey navigating the various stakeholder interests to determine a discretionary outcome is invariably fraught. This GRG Remuneration Insight focuses on ASX listed companies, however, similar considerations apply to unlisted public companies and private companies.

### CoC Circumstances

#### Ownership and Voting Control

CoC events are often defined by reference to share ownership or control of voting of shares. The basic CoC event is defined as when a person acquires ownership of more than 50% of issued shares or control of more than 50% of the votes that may be cast at a general meeting. However, there are other ownership situations that need to be covered including:

- a) CoC events that result in delisting of the company's shares; this requires vesting and lapsing determinations so that equity interests can be realised while the shares are being traded on a stock exchange. These situations need to allow for Board discretion to determine that a CoC event is about to occur and for such a determination to trigger a CoC vesting clause, and/or lapsing of unvested LTI grants to simplify equity consolidation.
- b) CoC events that do not result in delisting of the company's shares can fall into two very different circumstances being:
  - i. A CoC event due to share acquisitions using the creep provisions of the Corporations Act (up to 3% of issued shares may be acquired each six months without triggering a requirement for a takeover bid). In such circumstances the company's shares may remain listed on a stock exchange and business may proceed much as usual. In these cases, the passing of the typical 50% shareholding barrier may not warrant triggering of vesting and/or forfeiture of LTI grants. However, other criteria may need to be used to define when a CoC event is deemed to have occurred post such a 50% acquisition, warranting vesting and/or lapsing of unvested LTI holdings.

- ii. A CoC event due to share acquisitions not using the creep provisions of the Corporations Act. Does such a CoC event warrant early vesting and/or forfeiture of LTI grants? In these circumstances there is no need to allow for Board discretion to determine that a CoC event is about to occur as the event itself triggers the CoC vesting and/or lapsing of unvested LTI grants.

### Board Composition Changes

Although not seen too often these days, a long-standing aspect of a CoC has been a change in Board composition. This aspect is considered important because of the various discretions available to Boards under incentive plan rules. Usually participants in incentive plans are comfortable with Board discretion when expected to be exercised by a known Board. However, when Board composition change (which can happen at any time) it often leaves participants in an uncomfortable position due to the uncertainty associated with whether the new directors will have a very different perspective of management's performance and contribution.

The concern with the change of Board composition is not so much about natural Board renewal but more related to when a shareholder builds up a sufficient stake to warrant one or more seats on the Board. Such a shareholding may even sometimes fall well below a 50% shareholding and may not relate to a change of shareholding control.

A CoC event in such circumstance may be defined as when more than 50% of the number of non-executive directors are new to the role and two or more directors are nominees of a single shareholder. This can occur some time after a CoC event related to a new 50% shareholder (e.g. due to acquisitions under creep provisions), and the Board and Company may continue as "business as usual" for some time following such a milestone, with Board changes reflecting the new ownership only arising months or years later.

### Market Practice

The following two tables were copied from the 2017 GRG KMP Incentives Guide (the 2018 edition will be available soon).

In relation to LTI plans, the dominant market practice is for Board discretion to apply when CoC events occur. However, many modern plans (around 30%) as illustrated in the below table, have specific treatment of unvested LTI grants irrespective of the circumstances of the CoC.

LTI Change of Control (Takeover) Provisions		
Provision Regarding Unvested Securities	No. of Companies	% of Companies
Board Discretion	132	52%
Unclear or Not Disclosed	49	19%
Pro-rata performance adjusted	21	8%
Full Vesting	18	7%
Pro-rata Period adjusted	15	6%
Pro-rata Period and Pro-rata Performance	9	4%
Vesting aligned with share price growth over the measurement period that has elapsed	5	2%
Other	4	2%
Forfeit	1	0.4%
<b>TOTAL</b>	<b>254</b>	<b>100%</b>

In relation to STI plans, market practice is unclear. In GRG's experience this lack of clarity arises because many STI plans have either no formal plan rules or incomplete plan rules and the result is that a CoC event is not addressed. Typically this circumstance defaults to Board discretion; at least in theory:

STI Change of Control (Takeover) Provisions		
Provision	No. of Companies	% of Companies
Board Discretion	12	5%
Pro-rata award opportunity performance adjusted	4	2%
Pro-rata period adjusted	4	2%
Pro-rata period and performance adjusted	2	1%
Other Fixed % Vesting	1	0.4%
Pro-rata of Maximum Award	1	0.4%
CEO only to be paid 12 months salary and Super	1	0.4%
Depending on the circumstances, either remain on foot or paid out on a pro rata basis or in full	1	0.4%
Unclear or Not Disclosed	229	90%
<b>TOTAL</b>	<b>255</b>	<b>100%</b>

## Approaches for Consideration

### Board Discretion or Prescribed Treatment

There are broadly two approaches that may be applied being:

- a) Board discretion, and
- b) Prescribed treatment, which means that the impact of a CoC on STI award opportunities or LTI unvested grants is specified in the relevant plan rules (or as part of the terms of the relevant offer or invitation).

Neither Board discretion on its own nor prescribed treatment will be the best answer in all circumstances related to a CoC.

### Full Vesting or Payment

Full payouts of maximum STI award opportunities or full vesting of LTI grants is an infrequently used alternative, however when it does arise under plan rule approvals or grants to directors, it is routinely the subject of criticism from shareholder and governance groups.

In relation to STI it is more usual for the award opportunity to be scaled back having regard to the portion of the measurement period completed at the date of the CoC. The rationale for the scale-back is that STI awards relate to service over the measurement period and therefore, a partially completed year results in lower award opportunities.

Most companies recognise that STI award opportunities and LTI grants are generally offered at the stretch level which should only be earned when exceptional performance has been achieved and rightly take the view that a CoC event does not, of itself, warrant the stretch level of payout or vesting.

Full vesting of LTI grants was common and logical in the past, when Options with exercise prices set at or above the share price at the time of the grant were the dominant LTI instrument. The rationale for this approach was that there would be no benefit value in the option unless the takeover acquisition price was above the exercise price and the amount of the benefit value was directly related to the amount of the excess of the takeover price over the exercise price. However, when Rights (options with a nil exercise price that always have a value regardless of share price) are used the rationale for full vesting is no longer relevant. There have been a number of cases of vesting occurring under a full vesting clause, when the takeover has arisen because the business has been run down by management, resulting in a “cheap asset” opportunity for an acquirer. This is obviously inappropriate, and relevant performance factors need to be considered for Rights and possibly for options.

### Pro-rata Based on Period Served

Pro-rating award opportunities based on the period of service is often incorrectly calculated. With STI the period of service required to earn the award and the measurement period for assessing performance are the same, usually being the company's financial year. However, for LTI the service period to earn the award opportunity and the performance measurement periods are usually different. LTI grants are almost always made each year as part of the remuneration for the year. Thus, the service period is one year and the LTI is earned by the end of the year in which it is granted, although subject to outcomes testing some years later (this fact remains true despite the outdated practice of applying a multi-year service test alongside performance conditions). The performance measurement period is typically 3 years composed of the year of grant and an additional 2 subsequent years.

For LTI grants it is appropriate:

- To pro-rata lapse grants made in the year of the CoC to reflect those not earned by service, and
- For prior year grants to not be forfeited in relation to service as they were earned in prior years.

For STI it is appropriate to pro-rata reduce award opportunities based on the portion of the service period completed.

Of course, the extent to which the pro-rated STI and LTI award opportunities are paid out may then be assessed by reference to performance and other relevant factors.

### Performance Assessment

Performance assessment can be viewed from two perspectives being:

- a) The “business as usual” performance metrics that applied to the STI or LTI for the relevant measurement period, and
- b) The CoC performance metric of the sale price achieved for shareholders, mainly relevant for takeover bids.

## Business As Usual Performance Metrics

These are the performance metrics that applied to the STI or LTI prior to the CoC event occurring.

Applying these performance metrics may not be appropriate in some circumstances including when:

- Too little of the measurement period has elapsed for the performance to date to be considered a valid indicator of likely performance over the measurement period,
- Performance does not consistently reveal itself over the measurement period e.g. profit arises in the first or last half of a measurement period due to cyclical impacts, and therefore using pro-rata performance may not be a valid indicator of likely performance over the whole measurement period,
- Measurement of performance occurs at prescribed intervals in prescribed ways that do not allow performance to be meaningfully assessed prior to the end of the measurement period,
- Management's attention is necessarily drawn away from business as usual by the CoC activities that may take several months to conclude, and which typically requires them to take on additional workloads or to make discretionary contributions to the CoC process.

## CoC Performance Metric

When a CoC is in the form of a takeover bid, the senior executive group as well as the Board will necessarily be involved in obtaining independent expert advice, assessing the offer(s), liaising with potential acquirer(s) and making recommendations to shareholders. These activities can consume considerable company resources and adversely affect business as usual activities.

At the same time as business as usual goals are becoming less relevant a new priority will arise if the takeover bid is likely to be successful and that priority is maximising the price to be paid by the bidder/s to get the highest benefit for shareholders. In these circumstances, it may be appropriate to replace either partly or wholly business as usual performance indicators with shareholder value maximisation performance indicators.

## Board Discretion

Given the foregoing there may be a leaning towards Board discretion. However, there are examples of each main stakeholder group having had bad experiences with Board discretion:

- Executives typically see the outcome as inappropriate when Boards have not applied their discretion to vest incentives generously, particularly given that CoC events typically require significant contributions from executives. Many Boards struggle to settle on how management should be involved in the application of Board discretion in these circumstances: exclude management's view at the risk of creating a backlash and alienating them, or include management with the risk of creating expectations that their views will be accepted.
- Shareholders typically see any awarding of incentives as inappropriate when the takeover occurs in the circumstances of a falling share price,
- Takeover bidders may see Board discretion to award high levels of incentives as a "poison pill" resulting in inappropriate awards and excessive cost to them, especially if they are not intending to replace the management team following the takeover.

Boards are, therefore, often "trapped between a rock and a hard place" as several of the foregoing circumstances can arise at the same time and can result in emotive and complex negotiations that can take weeks or months of the Board's time during an already high pressure and anxious period. The rationale for a prescriptive approach is that it provides participants with certainty as to their entitlements in the event of a CoC and Boards are relieved of what can be a challenging and perplexing decision at a time of significant stress.

## Conclusion

Unfortunately, there does not seem to be an approach that is universally applicable and which approach is best may not be resolved until the actual CoC event arises. As such, a hybrid approach may be a pragmatic solution as follows:

- a) A floor level of STI payment and LTI vesting to be driven by shareholder experience as reflected by share price growth between the beginning of the measurement period and the date of the CoC, and
- b) Board discretion to apply to all other factors including pro-rata performance against business as usual performance.

Please note that the retirement benefit limit for executive and managerial officers has not been addressed in this Insight because STI awards and LTI vesting triggered by the CoC do not constitute retirement benefits in most circumstances.