

Change of Control

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A PROVISION POORLY ADDRESSED IN MOST INCENTIVE PLANS

Data extracted from the 2014 GRG Incentives Guide in relation to change of control provisions is summarised in the following table for companies that made disclosures in their Remuneration Reports on their short term incentive (STI) and long term incentive (LTI) plans. The sample was composed of 50 companies, therefore a high proportion did not provide clear disclosures on this aspect of their STI and LTI plans (only 26 provided information that could be summarised below).

| Provision | STI | | LTI | |
|---|------------------|------|------------------|------|
| | No. of Companies | % | No. of Companies | % |
| Board Discretion | 17 | 65% | 14 | 82% |
| Full Vesting | 6 | 23% | 1 | 6% |
| Fixed % Vesting | 1 | 4% | 1 | 6% |
| Vesting Related to Performance &/or Service | 2 | 8% | 1 | 6% |
| TOTALS | 26 | 100% | 17 | 100% |

WHAT IS A CHANGE OF CONTROL

Section 50AA of the Corporations Act defines “control” as:

- (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).*
- (3) *The first entity does not control the second entity merely because the first entity and a third entity jointly have the capacity to determine the outcome of decisions about the second entity's financial and operating policies.*
- (4) *If the first entity:*
 - (a) *has the capacity to influence decisions about the second entity's financial and operating policies; and*
 - (b) *is under a legal obligation to exercise that capacity for the benefit of someone other than the first entity's members;*

the first entity is taken not to control the second entity.” (underlining inserted)

A change of control occurs when a person or group of persons acting in concert acquire control when they did not previously have such control. While this definition seems to flow naturally from the definition of control in the Corporations Act it is not uncommon for STI and LTI plan rules to have differently constructed definitions which are often more narrowly expressed.

The most obvious occasion when a change of control occurs is when a takeover occurs. If a company's shares are delisted due to a takeover it is clear that vesting of LTI equity units may occur too late to allow the executive to deal with equity securities if the trigger for the vesting is the takeover. Also, if a board has discretion that may be exercised when a change of control occurs it may be preferable for decisions on vesting of STI and LTI awards to be made by the current board who is knowledgeable about the performance and contribution of the senior executive team rather than any replacement board which may be looking to minimise costs and/or to replace current senior executives. Having regard to these factors it may be preferable for the definition in the STI and LTI plan rules of a "change of control event" to allow the board to determine that such an event has arisen when it is imminent even though the change of control may not yet have transpired.

LTI PROVISIONS

Option Plans

In this section the discussion is focused on options that have an exercise price close to or above the market value of a share when the options are granted. It has been common practice for many years for full vesting of options to occur when a change of control event occurs. The rationale for this practice was that:

- a) executives would receive no benefit from the options if the share price at the time of the change of control was no more than the exercise price – if shareholders had not benefitted from an increase in the share price then executives would also receive no benefit from the options, and
- b) executives would receive benefits if the share price had risen above the exercise price and the amount of that benefit would be directly aligned with the extent of the rise in the share price – benefits for shareholders and executives would be directly aligned.

Although any increase in the share price may be influenced by market movements and/or a takeover premium the general view seems to have been that to seek to address these aspects would add unnecessary complexity and lead to lack of clarity as to the entitlements of executives in such circumstances. Hence, the simple approach of full vesting was commonly adopted.

Rights Plans

Common Practice

When rights are used as the equity units held by participants in LTI plans they will have value unless the company's share price has crashed to nil which would be an extremely rare event. This feature of rights warrants different treatment in the event of a change of control as the rationale that applied to options does not apply to rights. The provision most frequently adopted in LTI plan rules for rights has been to allow board discretion in the event of a change of control. In theory it would allow boards to apply nil vesting when shareholders had not benefitted or vesting reflective of the performance of senior executives and the benefit derived by shareholders. However, theory and practice have not always been well aligned. On

occasions boards have felt constrained in their ability to exercise discretion with the result that senior executives have not received benefits they felt were justified in the circumstances.

A Possible Way Forward

When considering the requirements for an effective change of control provision the following aspects should be balanced:

1. The interests of senior executives in relation to unvested LTI equity grants need to be protected through a specified level of vesting,
2. Executives should not receive benefits that are not warranted by performance and/or are out of alignment with the experience of shareholders,
3. Boards should retain discretion so as to be able to address the multiple variations that may arise but are not necessarily foreseen or easily addressed in Plan Rules.

GRG has developed an approach that seeks to cover these aspects. The approach involves Plan Rules that are specific and provided for:

- a) Automatic vesting of rights in the same proportion that the share price has risen since the rights were granted, and
- b) Board discretion as to additional vesting should it be considered appropriate in the circumstances.

Vesting Triggered by a Change of Control Not a Termination Benefit

It should be noted that when vesting is accelerated or triggered by a change of control the executive will be an employee at that time. Any vesting will not be considered a termination benefit. Accordingly, the termination benefit limit that applies to executive and managerial officers will not apply to such vesting. This outcome should not be affected even if the executive's employment is terminated soon after the change of control.

Amendment of LTI Plan Rules

The LTI Plan Rules for many companies will need to be amended as they contain limits on new issues that were aligned with Class Order 03/184 and the new Class Order 14/1000 contains a materially different limit. These Class Orders relate to employee incentive schemes which will also be subject to amended employee share scheme taxing provisions that will come into effect for grants made after 30 June 2015.

If Plan Rules are to be amended for any reasons it would be appropriate to consider amending the change of control provisions at the same time. Of course the Plan Rules may be amended simply to improve the change of control provisions.

STI PROVISIONS

Unlike LTI plans it is common practice for STI plans to not have formal plan rules. Even when companies have STI plan rules they are often mute as to the treatment of change of control events. Therefore the treatment of STI participants in the event of a change of control is unclear.

Of course, all STI Plans should be governed by formal Plan Rules and they should include specific provisions dealing with change of control situations. These provisions should generally be along the following lines:

- a) STI awards would be paid on a pro-rata basis having regard to performance up to the date of the change of control – these payments would not be refundable but would be offset against any end of year STI entitlements,

- b) If prior STI awards were deferred into Rights/shares then:
 - a. Full vesting should be triggered by the change of control (noting that STI performance conditions would have been satisfied to earn these Rights/shares), and
 - b. All dealing restrictions should be lifted.

Similar comments to those made above in relation to termination benefits for LTI plans also apply to STI plans.

STI Plan Rules may be amended for each new plan as they do not need shareholder approval, therefore there is no impediment to amending them for the next year's STI plan.

In relation to STI awards that are deferred into Rights/shares the Rights/share plan rules may need shareholder approval. If the plan is used for LTI grants as well as deferred STI awards it will be important to differentiate the treatment of the two types of grants particularly in relation to change of control and termination of employment provisions.