Attachment 4
(10 pages)

AICD POLICY & ADVOCACY

POSITION PAPER NO. 13
October 2008

Executive Termination Payments

The Australian Institute of Company Directors (AICD) believes executive termination payments are an important topic and has prepared this position paper to assist boards of publicly listed companies. The paper draws together comments previously made by AICD on the subject, and where relevant refers to recent developments. While the focus is on Chief Executive Officers (CEOs), a number of the comments will also apply to executive directors and senior executives reporting directly to the CEO.

Introduction

Termination payments to departing CEOs have been the subject of vigorous domestic and international debate in recent years; and this debate is expected to intensify given the current downturn in world markets. Particular criticism has been leveled at large termination payments to departing CEOs, who are perceived to be responsible for poor returns.

This paper examines issues for boards to consider when assessing whether there are appropriate termination arrangements in place for CEOs, and offers suggestions about how boards can assert greater control in this area.

Background

Issues surrounding termination payments have become more complex in recent years for a number of reasons:

- *Remuneration arrangements have become more complicated.* In prior generations a CEO's salary typically consisted of a base salary, and possibly a discretionary bonus. More recently CEOs' salary packages consisted of base salary, short-term and long-term incentives and bonuses. Sometimes there has also been a payment either as an incentive for entering into the contract or as "liquidated damages" in the event of early termination.

- *More regulatory requirements pertaining to termination payments.* Since 2004 the Corporations Act has effectively required shareholder approval of termination benefits, preparation of an annual remuneration report and an advisory vote by shareholders on remuneration arrangements at AGMs. Appendix 1 provides a brief summary of the main requirements that relate to termination payments.

Another source of difficulty has been that the nature of payments made at the end of employment is often misunderstood by members of the public. Such payments can consist of a number of components such as unpaid leave, long service leave, superannuation and other ordinary contractual entitlements. To this a sum is often added to compensate for loss of office[1], either pursuant to a pre-agreed contractual arrangement or a negotiated settlement in lieu of damages for breach of contract. To the public eye the aggregate sum may seem excessive whereas only the latter elements can be influenced by the board.

Termination - issues for boards to consider at the outset

Boards need to ensure the terms of the CEO's contract are appropriate. There may be a natural inclination towards "focusing on positive outcomes", particularly at the commencement of a CEO's term, but there is also a need to be pragmatic and provide for the possibility that things do not go according to plan. In particular, boards should try avoid a situation where the company is locked into a contractual arrangement that, with the benefit of hindsight, is inappropriate and faces the prospect of a large termination payment or embarking on the uncertain path of litigating with the departing CEO. To avoid this situation, CEO contracts need to give the company the ability to terminate the CEO's employment in all circumstances where termination is in the best interests of the company. They also need to appropriately address contractual payments for the loss of office before the end of the term of employment.[2]

When negotiating new contracts boards should be mindful of the need to balance the company's best interests in obtaining the best employees against not dissipating the company's assets by being over generous. Boards will also need to obtain advice from remuneration, legal and tax experts to ensure they have complied with all relevant regulatory requirements.

Any renewal or extension of a CEO's contract should be treated as negotiating a new contract and should take into account the prevailing market conditions and regulatory climate. This is an occasion when boards should take the opportunity to re-consider the suitability of termination provisions.

---

[1] The average term of office for a CEO in Australia is now less than five years. CEOs are therefore keen to ensure that they are financially protected in the event that their term of office is shorter than anticipated.

[2] The ASX Corporate Governance Council guidelines state "Termination payments, if any, for chief executive officers, should be agreed in advance, including detailed provisions in case of early termination". Refer to ASX Corporate Governance Council, "Corporate Governance Principles and Recommendations", 2nd edition, p36.

Reasons for termination

There are a variety of reasons for which a board will want to terminate a CEO's contract of employment. They include:

- for misconduct
- for non-performance
- for other reasons in the interests of the company.

The issues a board needs to consider will be different in each case.

Termination for misconduct

An employment contract usually gives a company the explicit right to terminate a CEO's contract immediately for misconduct. As a general principle, a company will have this right even if it is not explicit. Misconduct could include willfully disobeying directions from the board, drunkenness, breaching a fundamental term of the contract, being in a position of conflict with the company, being charged with a criminal offence or becoming bankrupt.

In this situation a board is usually justified in limiting the contractual termination payment to salary accrued to the date of termination, and other accrued entitlements to the date of termination.[3] The main issue the board needs to consider is whether it should terminate the contract as quickly as possible to ensure there is minimal damage to the company. Issues of ethics and culture can also be relevant in these circumstances.

Termination for non-performance

Termination for non-performance is more contentious. When negotiating a new employment contract or looking at an existing contract a board needs to consider the following issues:

- what constitutes poor performance[4] and how it has been or will be managed
- whether the board believes it is possible for the CEO to remedy the poor performance or whether it should terminate the contract immediately
- if the board wants to terminate the contract, how much will it cost the company?
- is the company prepared to litigate if the CEO claims wrongful termination and what are its prospects of success?

---

[3] The ASX Corporate Governance Council guidelines state "There should be no payment for removal for misconduct". Ibid, p36.

[4] The ASX Corporate Governance Council guidelines state "Agreements should clearly articulate performance expectations". Ibid, p36.

- how the CEO's departure and the manner of their departure will affect the company finances, its reputation and the way this will be managed.

It is not uncommon for a board to believe a CEO is performing poorly while the CEO believes he or she is performing well. Unless there is a robust performance management system in place, which is properly documented, the question of non-performance may come down to the board's subjective judgement against the CEO's subjective judgement.

An appropriate performance management system could include reporting at regular intervals and the chairman providing appropriate feedback to the CEO. A board will also need to decide whether its relationship with the CEO can be improved by counselling or otherwise, and whether it is in the company's interest to try and remedy an unacceptable situation. In the case of an existing contract a board may decide that it will pay a CEO in lieu of the notice provisions in the contract, or in accordance with some other negotiated arrangements, rather than risk litigation over a termination payment.

The CEO's position in a company is atypical of other executive positions. The company's board needs to have full confidence in the CEO. If the board loses confidence in the CEO it may need to terminate the CEO's contract even if the company is otherwise performing well. If so, the board needs to consider terminating the contract in a manner that takes into account the best interests of all shareholders.

It can be difficult to proceed under a non-performance clause in a contract because of the many views that exist on what constitutes poor performance and how it is measured. This is often a subjective issue. For this reason, boards may prefer to have a clause in the contract entitling the company to terminate the contract on notice without the need to provide specific reasons.

When considering termination a board needs to look at the contract to see whether and how it can terminate the CEO's employment, and the amount he or she is entitled to receive as a termination payment. Boards should ensure that they "do the sums" so they know the company's potential liability for each element of the CEO's remuneration on termination. Boards should also remember the area of greatest shareholder concern is any additional payment paid to CEOs who perform poorly, or who may be perceived as having performed poorly.

Companies have traditionally been reluctant to litigate issues related to executives' remuneration. The results of litigation can be unpredictable, especially if a company is trying to litigate in a case of non-performance involving subjective judgements. Reaching a court hearing takes time and is expensive; not only in terms of legal costs, but in terms of lost executive time and potential damage to a company's reputation. However, a board may decide it wants to balance against the time and money consumed by litigation, the strength of its legal position and the need to uphold the contract and certain ethical values.

Termination for other reasons

Examples of this situation often arise where there is a takeover of a company, a significant merger leading to a realignment of appointments between the two merging entities, the CEO becomes ill and is unable to complete the contract or the company changes strategic direction and in the board's view requires a leader with different attributes.

If negotiating a new contract the board will need to consider how it wants to deal with these situations and how to calculate the amount of any notice or termination payments. In the case of an existing contract, the board needs to ensure it knows what notice is required or how much the company will have to pay to terminate the contract.

What steps can boards take?

While specific policies and provisions are needed to suit each company, AICD believes no one solution is appropriate for all companies in all situations. Different companies and different industry sectors have different needs. However, whatever solution a board decides is appropriate for its business, AICD believes:

- boards need from the outset to take and retain control of the contractual arrangements and remuneration of the CEO including all termination arrangements
- the same applies to the direct reports to the CEO
- boards should put in place a suitably resourced remuneration committee
- a company's executive remuneration policy needs to be aligned with its strategy and communicated to all relevant parties
- disclosure of termination payments should separately identify the main components (the various contractual entitlements and any other amounts or benefits)
- boards need to ensure there is a proper performance review process in place for the CEO and that reviews take place regularly
- boards need to have a succession plan
- boards should ensure they are familiar with all the terms of a CEO's employment contract, particularly the cost to the company of the termination provisions.

Taking control of the remuneration agenda

One of the most important steps a board can take in ensuring termination payments do not act as "rewards for failure" is to take control of the contractual and remuneration agenda.

A board can do this by establishing a coherent executive remuneration policy and ensuring this policy is aligned with the company's strategy. Boards also need to consider how the policy will be meaningfully communicated in a transparent manner to external parties, their obligations under legislation, the continuous disclosure regime and any applicable corporate governance guidelines. Boards that are up to date on remuneration issues and have taken time to consider and discuss the issues involved and develop an appropriate strategy, will be in a much stronger and more defensible position than boards responding to a crisis. Negotiating with key executives will need to reflect the commercial requirements of the company at the time of appointment.

A board may also decide to establish a remuneration committee to assist it in discharging its remuneration responsibilities. Non-executive directors have an especially important role, as executives should never be allowed to determine or overly influence decisions on their own remuneration.

The board should either through the remuneration committee, the chairman or other designate appoint legal advisers, a remuneration consultant and any other necessary advisors. This task should not be left to the executive team.

Performance management

Another way of taking control of the remuneration agenda is establishing a robust performance management system for the CEO. This would include setting up clear performance criteria in advance and ensuring that performance reviews take place regularly. If this type of system is in place a board will have a greater chance of rectifying any problems before they become unmanageable. Alternatively, it may prevent a board confronting the situation where it believes the CEO is performing poorly and the CEO believes they are performing well. That is then a breakdown in communication.

Succession planning

Proper succession planning is also important. If boards have taken time to put a succession plan in place there is less danger of disruption to the business and of their facing an unexpected and expensive search for a new CEO. Good succession planning may mean a board is in a position to employ a candidate as CEO or search for an external candidate giving a board the maximum choice and flexibility. Succession planning is outside the scope of this paper but may involve setting up a nomination committee or making time on the board agenda to discuss the development of key executives' careers in support of a succession planning process.

Concluding remarks

Boards need to be familiar with the terms of the CEO's contract, especially the termination arrangements and their cost to the company.

AICD believes it is essential to address the issue of termination arrangements at the time of drafting the CEO's contract for all purposes, particularly for non-performance. A company's liability for termination payment/benefits in the various circumstances outlined above could be limited to certain maximum amounts. Without prescribing any limit these could be:

- statutory entitlements only on termination for misconduct
- between six and twelve months' notice or payment in lieu of notice calculated on the amount of the CEO's base salary on termination other than for misconduct
- other entitlements specifically required by the contract, for example, previous bonuses not paid and which have vested.

AICD accepts that some existing employment contracts may provide for larger termination payments than those described above. AICD also accepts that there may be commercial circumstances where the payment of more than these amounts may be justified. The guiding principle for boards should be to act in the best interests of the company.

The issues associated with termination payments can be complex, may vary from State to State and change materially over time. As a consequence, whatever solution a board decides to adopt, it should obtain appropriate advice.

For further guidance refer to:

AICD, Remuneration Committees: Good Practice Guide, 2004
AICD, Executive Service Agreements, Issues Paper, 2003
ASX Corporate Governance Council, Corporate Governance Principles and Recommendations, 2nd edition, 2007

Appendix 1 - Overview of Relevant Provisions and Guidance

There are various requirements in the Corporations Act that impact on termination payments, including the following -

- in general, termination benefits (a form of financial benefit) must be "reasonable" or approved by shareholders.[5]

- shareholder approval may also be required unless a listed exception applies – one exception being the termination payments are provided in return for past services rendered and do not exceed the greater of the average remuneration over the last 3 years multiplied by the years in office up to a maximum of 7 years or the remuneration or estimated remuneration for the last 12 months[6].

- listed companies are required to prepare an annual remuneration report which sets out remuneration details for all directors plus the five highest paid executives, as well as any other "key management personnel" as defined in the accounting standards approved by the Australian Accounting Standards Board, including:

    - a discussion of the board's policy for determining the nature and amount of remuneration paid to executives;

    - a discussion of the relationship between such policy and the company's performance;

    - details of any performance conditions incorporated into remuneration packages; and

    - if the person is employed by the company under a contract – the duration of the contract, the periods of notice required to terminate the contract and the termination payments provided under the contract.[7]

- companies must submit their annual remuneration report to shareholders for an advisory vote.[8]

---

[5] Corporations Act, Section 208(1) & 211(1)
[6] Corporations Act, Sections 200B(1) & 200G. The threshold level for shareholder approval was introduced in 2004.
[7] Corporations Act, Section 300A. Introduced in 2004.
[8] Corporations Act, Section 250R(2). Introduced in 2004.

In addition, the Australian Securities Exchange (ASX) has a number of listing rules that impact on termination benefits –

- termination benefits or an increase in them cannot become payable to an officer of a listed company due to a change in the shareholding or control of the listed company[9]
- unless approved by shareholders, no officer may become entitled to termination benefits if the value of all termination benefits payable to officers will exceed 5% of the equity interests in the company[10].

The ASX Corporate Governance Council provides the following guidance on termination payments:

> "Termination payments, if any, for chief executive officers should be agreed in advance, including detailed provisions in case of early termination. There should be no payment for removal for misconduct. Agreements should clearly articulate performance expectations. Companies should consider the consequences of an appointment not working out, and the costs and other impacts of early termination."[11]

[9] ASX listing rule 10.18.
[10] ASX listing rule 10.19.
[11] Refer to ASX Corporate Governance Council, "Corporate Governance Principles and Recommendations", op cit, p36.

AUSTRALIAN INSTITUTE OF COMPANY DIRECTORS
ABN 11 008 484 197

Disclaimer

© This material is subject to copyright. It may not be reproduced, stored or disseminated in whole or part without prior written permission.

This material has been prepared for information purposes only and does not constitute legal, accounting or other professional advice. While all reasonable care has been taken in its preparation, the AICD (AICD) makes no representation or warranty of any kind, express or implied, as to accuracy, completeness, reliability or accuracy of the information. It should not be used or relied upon as a substitute for proper professional advice or as a basis for formulating business decisions. Information is subject to change without notice. AICD will not be liable for any damages of any kind to any person who acts or relies upon the information provided.

Links to third party websites are provided for convenience only and do not represent endorsement, sponsorship or approval of products or service offered.