10 Minutes
on Executive Termination Benefits

September 2010

What you need to know about emerging topics essential to your business.

Brought to you by PwC, September 2010

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What would you like to grow?

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Highlights:

- *Boards are grappling with how to effectively implement the termination benefit legislation for executives on pre-existing contracts.[1]*
- *A dominant solution hasn't emerged, instead a mix of approaches have been adopted.*
- *Some of the approaches will increase executive remuneration costs.*
- *Shareholders will assess this year's AGM resolutions and remuneration term alterations and decide whether Boards have responded appropriately.*

Executive termination benefits may cost shareholders more in the short-term

Developing contracts for new executives in line with the termination payments legislation[2] has been relatively straight forward and widely adopted. However, despite their best intentions, Boards are still grappling with how to effectively implement the termination benefit legislation for executives on pre-existing contracts.

In many cases the termination benefits in executives' existing contracts can no longer be met without shareholder approval.

Some companies are therefore restructuring existing contract and remuneration terms, compensating for potentially less generous termination arrangements and/or seeking prospective shareholder approvals for future payments which could exceed the termination benefits cap.

If Boards decide to restructure remuneration to compensate for changed terms, it is likely that shareholders will continue to pay for the value of generous termination benefits - just in another form.

Significant difficulties have been encountered in dealing with pre-existing contracts which do not continue to meet the "grandfathering" requirements and which contain termination benefits greater than the new cap.

1. There has been a lot of debate about what constitutes a contract variation. The consensus view seems to be that, depending on the contract, remuneration changes can be classed as a variation and bring the pre-existing contract under the new regime.
2. The difficulty has then become how the Board can honour the original contract terms that were agreed between the company and the executive (which can result in benefits over the cap) and remain compliant with the new legislation.
3. Not surprisingly, many executives are unwilling to "give up" their existing contract terms lightly. Equally, they are not inclined to have their previously "assured" arrangements become "at risk" through a shareholder vote at the AGM following their termination.
4. Boards are further troubled by the issues and costs that could potentially arise if shareholders do not approve contractual benefits at termination above the cap.
5. Payment and receipt of a benefit in breach of the *Corporations Act 2001* is an offence, which is further complicated by the high level of uncertainty associated with the fact that the legislation has yet to be fully tested.

1. The changes to termination payment legislation affects directors and executives (Key Management Personnel) who entered into, renewed, extended or varied their termination contracts on or after 24 November 2009.
2. Unless there is shareholder approval, the requirement is to limit the termination payment to 12 months base salary. Base salary is calculated as the average of the last 3 years' average annual base salary (pro rated for lesser service period). Base salary means components of a short-term employment benefit not dependent on the satisfaction of a performance condition.

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For many companies the solution to this issue is not as simple as shifting executives on to new contracts with termination benefits less than the cap – therefore a range of approaches have been adopted by companies to deal with this complex issue.

Approach 1: Freeze current terms to avoid a contract variation	
Description	• Current remuneration levels, structure and all other contract terms remain unaltered indefinitely from 24 November 2009.
Considerations	• Preserves the current termination benefits, avoids the need to seek shareholder approvals and therefore provides executives a degree of certainty. • May only be a feasible approach for executives who are known to be ceasing employment in the short-term e.g. near term retirees. Unlikely to be a tenable solution in the long term for the broader cadre of key management personnel (KMP). • Will restrict the Board's flexibility to alter remuneration structures and levels in line with market and business imperatives going forward. • Likely to create internal equity issues for newly hired executives (i.e. disparate conditions among KMP applicable during employment and upon termination).

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Approach 2: Seek shareholder prospective approval

Description	• Shareholders are being asked to prospectively approve (prior to any termination event) potential payments under pre-existing terms that would exceed the termination benefits cap. • The two key approaches being adopted are: - Seeking prospective approval for the exclusion of long-term incentive (LTI) plan payments from the termination benefit calculation; and - Seeking prospective approval for potential payments exceeding the termination payment cap under the broader contract terms e.g. pay in lieu of notice, accelerated short-term incentive (STI) and LTI, retention and other payments.
Considerations	• Arguably, the intent of this approach could be considered to be in line with the legislation, as companies are seeking shareholder approval for payments that will exceed the cap. The challenge is that not all the circumstances surrounding the termination are known at the time the approval is being requested. • Some proxy advisors have formulated policy positions on prospective approvals. In summary, they would appear to support requests to have LTI plans excluded from future benefit calculations where there is performance testing at termination and the amounts are pro-rated for the period served. However, pre-approvals should be on a case by case basis and be for a defined period of 3 years or less. Broader approvals are less likely to receive support, unless there is a strong rationale for any payments beyond 12 months base salary. • Detailed disclosures in the notice of meeting are required to assist shareholders to identify the potential departing executives (or class of departing executives), the quantum of the proposed benefit, or if that amount cannot be ascertained at the time of the disclosure, details of how the benefit will be calculated. • Early indications suggest that seeking prospective approvals for exclusion of LTI plans will be more typical than seeking broader approvals. • Risk of reputational damage may be higher with prospective approvals, particularly in the event that shareholders vote against the proposals. • If shareholders approve the proposals it will provide executives with up-front certainty that their contractual benefits will be paid to them on termination.

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Approach 3: Restructure executive remuneration packages and contract terms	
Description	• Restructures being considered have included: - Enforcing gardening leave provisions to reduce the amount of any payment in lieu of notice. - Ceasing acceleration of incentive (equity and cash) payments on termination and instead making payments on the normal cycle (i.e. post-termination). - Providing compensation to executives for the changes in contractual terms in the form of higher fixed pay, higher future incentives, or one off upfront compensation payments.
Considerations	• The restructuring approach will generally require the approval of executives. • Any compensation for changed terms would need to be paid upfront, rather than in the year of termination, to avoid the payment being classed as a termination benefit. • If fixed pay is adjusted, arguably higher compensation effectively continues for the remainder of the executives' employment, with an increased commensurate cost. • Shifting contingent pay to guaranteed pay in this way, is potentially more costly and may not be viewed favourably by shareholders when the revised remuneration is disclosed in the Remuneration Report. • There are also negative implications of leaving incentives to pay out on their normal cycle. Taxation of equity incentives at cessation of employment may be an issue for an executive's cash flow. Executives are also concerned about their lack of influence over future performance (share price). Shareholders may argue that this creates longer term alignment, past the date of termination, which is a positive development.

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Approach 4: Do nothing	
Description	• Seek shareholder approval (if required) at the time of the termination and/or delay action until able to assess market norms.
Considerations	• This approach leads to uncertainty and angst for executives due to the risk that the termination payment is not ultimately approved. • Executives may feel that they have an entitlement to the full amount of termination payments. • Approach is aligned with the legislation's intention and potentially how shareholders may expect Boards to deal with the issue.

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Conclusion / Way forward

At this stage, no one market dominant solution to this issue has emerged, instead a mix of approaches are being considered.

In the longer term, as new contracts are entered into through attrition and KMP renewal, the issue will eventually solve itself. However, in the shorter term it is likely that shareholders will carefully review resolutions and remuneration term alterations to understand how companies have attempted to respond to the legislation.

Again, Boards are left with the difficulty of determining how to balance shareholder perspectives with the executives' expectations.

What companies should be doing:

- *Determine who are your affected people.*
- *Understand if your contracts are currently grandfathered.*
- *Ascertain if you are likely to exceed the 12 month limit.*
- *Make your new contracts "compliant" with the 12 month limit.*
- *Review if your STI and LTI plan rules are flexible enough to allow for the plans to stay "on-foot" post termination.*
- *Overall, determine your strategy for dealing with the termination payments legislation.*

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How PwC can help

To have a deeper discussion about these issues, please contact:

Sydney

Debra Eckersley
Partner
Ph: (02) 8266 9034
Email: debra.eckersley@au.pwc.com

David Abusah
Director
Ph: (02) 8266 2723
Email: david.abusah@au.pwc.com

Emma Grogan
Director
Ph: (02) 8266 2420
Email: emma.grogan@au.pwc.com

Brett Feltham
Director (Legal)
Ph: (02) 8266 9375
Email: brett.feltham@au.pwc.com

Melbourne

Della Conroy
Partner
Ph: (03) 8603 2999
Email: della.conroy@au.pwc.com

Daryl O'Callaghan
Director
Ph: (03) 8603 2841
Email: daryl.ocallaghan@au.pwc.com

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