Law Council
OF AUSTRALIA

Via email: economics.sen@aph.gov.au

Mr John Hawkins
Committee Secretary
Senate Standing Committee on Economics
P O Box 6100
Parliament House
Canberra ACT 2600

Dear Mr Hawkins,

Inquiry into the Corporations Amendment (Improving Accountability on Termination Payments) Bill 2008

I have pleasure in enclosing a copy of a submission lodged recently by the Corporations Committee of the Business Law Section of the Law Council of Australia with the then Minister for Superannuation and Corporate Law, Senator The Hon Nick Sherry in response to the Exposure Draft Bill released on 5 May 2009.

If you have any questions in relation to the submission, in the first instance please contact either the Committee Chair, Greg Golding, on [02] 9296 2164 or Tim Bednall on [02] 9296 2922.

Yours sincerely,

Bill Grant
Secretary-General

28 July 2009

Enc.

Senator The Hon. Nick Sherry
Minister for Superannuation and
Corporate Law
Parliament House
Canberra ACT 2600

Dear Minister,

Proposed reforms to Executive Termination Benefits

I refer to your joint media release with the Treasurer, No 023 dated 18 March 2009, and to the Exposure Draft Bill released with a draft explanatory memorandum on 5 May 2009.

I have pleasure in enclosing a submission which has been prepared by the Corporations Committee of the Business Law Section of the Law Council of Australia ('the Committee'). The submission has been endorsed by the Business Law Section. Owing to time constraints, the submission has not been reviewed by the Directors of the Law Council of Australia Limited.

The Committee acknowledges the Government's desire to reduce the 7 year period for calculation of termination payments to 12 months, and to broaden the coverage of the provisions to executives of listed entities named in the remuneration report. The Committee does not wish to comment on those broad policy issues.

However, the Committee is concerned that certain provisions of the Exposure Draft Bill and regulations are likely to have consequences that are inconsistent with good corporate governance and the fair payment of superannuation benefits. The Bill and regulations also contain a number of technical anomalies or apparently unintended consequences.

1 Issues arising from the definition of the new limit

1.1 Distortion of remuneration structures and inconsistency with performance-related remuneration

The Bill limits termination benefits to one year's average base salary. The concept of "base salary" is linked to unspecified accounting concepts, but the Committee

understands that base salary is intended to be the "risk free" guaranteed component of an executive's remuneration.

For many executives in large corporations, base salary represents less than half of the value of their remuneration package. The balance comprises short term and long term incentive arrangements, the payment of which depends upon performance. The Committee is concerned that this proposal will actually limit termination payments to less than 6 months total remuneration, which is likely to be viewed as inadequate compensation for the risks to tenure of executives in these organisations.

Termination payments at this level are also inconsistent with the quantum of termination payments that the courts currently consider reasonable and award to senior executives (ie up to 12 months total remuneration).

The likely consequence of the proposal will therefore be to increase base pay levels, both in absolute terms and as a proportion of an executive's total remuneration, so as to maximise potential termination payments or at least avoid inadequate compensation on termination. This is wholly inconsistent with current governance practices that seek to maximise the proportion of executive remuneration that is "at risk" and subject to performance measures.

The Committee notes that APRA's proposals for remuneration of executives in prudentially regulated organisations, released in a discussion paper on 28 May 2009, are wholly consistent with our submissions on this point.

The proposal is also likely to lead to an increase in "golden hellos" on commencement of a new position, to compensate for loss of benefits on leaving a previous position, if termination benefits are to be so limited.

When combined with the proposed changes to taxation of equity awards under employee share plans, this proposal is likely to cause a systemic distortion of remuneration structures in a manner which is disproportionate to the issue being addressed.

For this reason, the Committee submits that the limit should be defined in terms of total remuneration (as is presently the case), rather than base pay. Again, we do not oppose the 12 month limit.

1.2 Unworkable and unfair treatment of superannuation benefits

The draft bill and regulations attempt to exclude statutory superannuation from the termination benefits to which the prohibitions apply, but the drafting is deficient.

Proposed regulation 2D.2.01(1) specifies as a benefit "*a payment of superannuation (however described), to the extent to which it is more than the maximum amount required or permitted by a law of the Commonwealth, a State or Territory*".

Proposed regulation 2D.2.01(2) excludes "*payments from a defined benefits superannuation scheme in existence when the regulation commenced*", but this exclusion does not apply to accumulation funds, which hold the vast majority of superannuation contributions.

There are 4 fundamental problems with this approach:

- First, the statutory requirements apply to the level of contributions made to a superannuation fund, and not the level of superannuation benefits paid. There is no clear connection between the two, as benefits depend upon investment performance of the fund, and in accumulation funds benefits can be substantially less than the amount contributed (as recent market volatility has demonstrated). The amount available in a person's superannuation fund will often have resulted from statutory contributions by various employers over time, as well as from voluntary contributions. It will therefore be impossible to calculate with any accuracy the amount of benefits attributable to a particular employer's statutory superannuation contributions. Under the current limits, this is rarely an issue, but it is an issue when the limit is one year's base salary.

- Second, the employer will rarely be able to control the payment of accumulated benefits from a superannuation fund, and even if the employer could do so, it is likely to be inconsistent with superannuation laws and the rules of the fund to refuse to pay accumulated benefits.

- Third, even if it were possible to calculate the amount with any accuracy, and for the employer to control the payment of accumulated benefits, there is no recognition that a person whose employment is terminated will not be entitled to access superannuation benefits unless they have reached the relevant age. It is unfair to take into account any superannuation benefit to which a person cannot actually get access at the time of termination, and which may evaporate as a result of future investment performance before it is payable

- Fourth, the definition has the result that employees may be forced to forfeit the benefits attributable to extra contributions by employers. Where a person elects to "salary sacrifice" and save additional money via a superannuation fund, the benefits of that thrift are liable to be forfeited as a result of this new law. That is completely inappropriate and unfair, and

contrary to the underlying policy of our superannuation system. This law does not apply to voluntary savings account balances, and should not apply to voluntary superannuation fund balances.

There seems to be a view that companies who make extra contributions to a superannuation fund on behalf of an employee will somehow be circumventing the prohibition on termination payments. However, such payments are merely paying an additional proportion of an employee's regular remuneration to a particular form of savings account to fund retirement, and there is no obvious policy reason to prohibit those payments. There are separate statutory limits on superannuation contributions and benefits that should not be affected by this Bill.

For these reasons, the Committee submits that all complying superannuation fund balances should be excluded from the definition of termination benefits to which the prohibition applies. Superannuation should simply be seen as a savings account into which statutory and non-statutory contributions may be made without threat of forfeiture. This change would also resolve the conflict between the Bill and existing statutory obligations on superannuation funds to make payments to members.

The Committee is sure that the government did not intend these consequences, and they should be rectified.

1.3 Expanded definition of persons affected

Under the Bill, the definition of people affected by the benefit limits will change to a two-tiered model, with a wider definition applying to listed companies and the current definition (limited to directors only) applying to all other companies. This has a number of consequences:

- For executives of listed companies, the entitlement to termination benefits depends on whether they are listed in the remuneration report. This is an arbitrary measure, for several reasons. Inclusion may change from year to year depending on total remuneration relative to other executives in the company. Executives will not know from one year to the next whether their termination benefits are limited under the proposed new laws. Perversely, the inclusion of termination benefits in total remuneration will often cause a person to be named in the remuneration report for the first and only time in the year the person retires. Further, a person earning $100,000 in a small listed company may have their termination benefits restricted, but a person earning $2 million in a large listed company may not. That is an odd result, and does not appear to have any sound policy basis.

- The new definition treats subsidiaries of listed companies as separate entities for the purposes of the application of the definition. Therefore,

termination benefits will be limited for an executive who happens to be a director of a subsidiary of a listed company, whether or not the executive is named in the remuneration report. Large listed companies may have hundreds of subsidiaries with low-level executives acting as directors of subsidiaries. A termination benefit that exceeds the 12 month base pay limit for these executives would require approval by the listed company shareholders, even though the amounts involved is likely to be relatively small.

The Committee submits that if these rules are to apply to executives of listed companies who are not directors, it would be logical and less anomalous for the rules to apply to executives whose total annual remuneration exceeds a nominated amount (say $1 million). That would be a fairer, less arbitrary and more certain measure.

Further, for listed companies and their subsidiaries, the rules should apply to the listed company group, including subsidiaries, as a single entity (as the remuneration reporting rules apply), and apply to limit termination benefits only for those whose total annual remuneration exceeds the nominated amount (assuming our previous submission is accepted) or who are named in the group remuneration report. The rules should not apply separately to directors of subsidiaries of listed groups whose remuneration is less than the nominated amount (or who are not named in the group remuneration report).

1.4 Forfeiture of benefits under incentive schemes

The draft Bill and regulations include as termination benefits the automatic or accelerated vesting of benefits under short and long term incentive arrangements. The allocation of shares, or share rights or share options, that vest some time after the recipient satisfies the relevant performance criteria, promotes desirable long-term performance objectives. The Bill creates a number of undesirable restrictions on the payment of these benefits.

First, it is common for company boards to have a discretion as to whether unvested or unpaid awards should vest or be paid on termination. If the result of this Bill is that executives will now be entitled to termination payments equal to one year's pay (however defined - see our submissions at 1.1 above) as a matter of course, none of the awards that have been "earned" but not paid at the time of termination will be able to be paid. Again, the likely consequence of the proposal is that delayed vesting of incentive awards to promote long-term performance in accordance with good corporate governance principles will be discouraged.

Second, many awards will vest on the cessation of employment due to death or total and permanent disablement. The Bill will restrict the vesting of those awards.

Third, where shareholders have already expressly approved the terms of issue of shares or options to an executive, including the vesting rules on cessation of employment, under ASX Listing Rules or the related party provisions of the Corporations Act, benefits should be able to be paid in accordance with that approval.

Fourth, draft regulation 2D.2.02 appears to treat all automatic or accelerated vesting of options as termination benefits, whether or not employment actually ceases. For example, where vesting is accelerated as a result of a takeover bid, but the executive remains in employment, these provisions should not apply. This regulation is also drafted too narrowly in the sense that it applies only to vesting of options and not of other forms of equity incentives, such as shares, units and awards.

The Committee submits that, just as the proposed regulations exclude "deferred bonuses", incentive scheme benefits should also be excluded if:

- performance criteria have been satisfied prior to the termination date;
- the benefit is payable on death or total and permanent disablement; or
- the benefit has been approved by shareholders under any provision of the Corporations Act or ASX Listing Rules, and details of the benefit have been set out in the notice of the meeting at which approval was given.

The Committee suggests that proposed regulation 2D.2.01(2) be amended accordingly.

The Committee also suggests that proposed regulation 2D.2.02 (a) and (b) be amended to apply to vesting of options and other equity awards, but only if automatic or accelerated vesting is triggered by a cessation of employment.

1.5 Restrictive covenants

It is unclear from the draft bill and regulations whether retirement benefits include payments for post-termination employment restraints that commonly apply to executives. A payment equivalent to less than 6 months total remuneration is, in the experience of members of the Business Law Section, inappropriate where executives will be unable to work in their chosen area of expertise for a period after termination, and may be likely to have difficulty finding equivalent employment in any event.

For these reasons, the Committee submits that it would be appropriate to exclude legitimate compensation for restraint or non-compete periods, limited to the

equivalent of final annual remuneration for the period of the restraint, up to a 12 month maximum.

1.6 Damages for breach of contract and other claims

Where an employer has terminated an employment contract in a manner that contravenes the terms of the contract, or employment has ceased in circumstances in which the employee has a legitimate claim against the employer, a "genuine payment by way of damages for breach of contract" is excluded from the limits in s200G by section 200F(2)(a), albeit subject to the separate limits in s200F.

However, the scope of this exclusion is uncertain, particularly given proposed regulation 2D.2.01(1)(c), which expressly includes "voluntary out of court settlements" as benefits.

This provision will have the effect of forcing employees with legitimate claims against employers, for breach of contract, unfair dismissal, harassment, discrimination and other breaches of the law, to litigate at material expense in order to win a damages award from a court, rather than accept a "voluntary settlement" from the employer. That is clearly an inappropriate consequence of these reforms.

The Committee submits that where legal proceedings have been commenced in connection with the termination of employment for any reason, not just breach of contract, all damages awards and out of court settlements of those proceedings payable to the employee should be expressly excluded from the definition of "benefits".

1.7 Pro-rated limit for service less than 12 months

The proposal to pro-rate the limit for executives who have served less than 12 months is unfair.

Executive employment contracts usually allow employers to terminate employment without cause by giving a defined period of notice or pay in lieu. There is absolutely no reason why a person who has begun a new job, and is terminated without cause after a short period, should be restricted to a lesser termination benefit. In fact, there are obvious reasons why a person in this situation should be entitled to a higher amount, because the executive will often have resigned from another position to take the new job, incurred costs, and is likely to suffer reputational damage as a result of the early termination.

The Committee submits that these provisions (proposed new subsections 200F(3) and 200G(2)) should be removed from the Bill.

1.8 Foreign companies with Australian subsidiaries

Proposed section 200B(1) of the Corporations Act 2001 (Cwlth) (as set out in the Exposure Draft Bill) prohibits an Australian company (and certain associates of the company) from giving a person a benefit in connection with that person's retirement from a managerial or executive office of the company **or a related body corporate**, without shareholder approval under section 200E.

The '**company**' referred to in proposed section 200B(1) extends to Australian incorporated companies only (see the definition of 'company' in section 9 of the Act). However, the term 'related body corporate' extends to foreign bodies corporate. On a broad reading the reference to "associates" in section 200B(1AA)(b) extends the effect of section 200B(1) beyond that necessary to regulate payments made by an Australian company or by a foreign associate in respect of retirement from a managerial or executive office of an Australian company.

The wording of section 200B(1), and the reference to 'related body corporate', when read with section 200B(1AA)(b), extends to a payment made by a foreign company in respect of a retirement from an office or position wholly unrelated to an Australian company. The Committee submits that this goes beyond the ambit of payments that section 200B aims to regulate, and that the position should be clarified given that contravention of section 200B(1) is a strict liability offence (see section 200B(1A)).

The Committee submits that this issue should be addressed by a specific provision which limits the operation of section 200B(1) to payments made by a company or its associate to the extent that the payment fairly relates to the retirement from an office held with an Australian company.

2 Issues with procedures for approving payments above the new limit

The shareholder approval provisions appear to be designed to ensure that approval is difficult to obtain. If the government accepts, as a matter of principle, that shareholders may approve termination payments that exceed the 12 month limit, then normal procedures for shareholder approval should apply. There is no reason to impose "special" requirements such as those in the Bill. There are no similar requirements applying to any other form of shareholder approval under Australian law.

2.1 Purpose of shareholder meetings

Proposed subsection 200E(1C) prevents companies from calling shareholder meetings for the sole or dominant purpose of passing the approval resolution. The Committee is not aware of any equivalent restriction in any other shareholder approval provision in the Corporations Act or the ASX Listing Rules. It is

unnecessarily restrictive, and will have the effect of delaying approvals by up to 12 months until the next general meeting of the company convened for other purposes.

It is particularly restrictive and unnecessary for small companies with few shareholders. There are proprietary companies that are not required to hold shareholder meetings for any other purpose, that could therefore never approve a retirement benefit as the Bill is presently drafted.

If the law permits shareholders to approve termination benefits, then companies should be able to convene shareholder meetings to obtain that approval.

The Committee submits that this subsection should be deleted.

2.2 *Shareholder approval after the event*

Proposed subsection 200E(1D) prevents companies from approving retirement benefits before the relevant person retires. This means that employees who are entitled to greater retirement benefits, subject to shareholder approval, must retire before they know the amount of their benefit. If approval is not given, the employee has lost the option of continuing in employment to maintain an income. That is an unfair consequence. The Committee is also not aware of any equivalent restriction in any other shareholder approval provision in the Corporations Act or the ASX Listing Rules, where a person seeking shareholder approval to an action must first have taken that action to their detriment before the approval can be sought.

The Committee submits that this subsection should be deleted. Alternatively, the subsection should be amended to require that approval be given not more than a specified period before termination - say 5 years.

3 Transitional provisions

Section 41(1) of the Bill attempts to grandfather existing employment contracts, so that the amendments will only apply to resignations under agreements "*entered into, or extended, on or after the commencement*" of Part 1 of the Bill.

First, the term "resignations" should be replaced by the defined term "retirements".

Second, an employee with an existing term contract that is extended is therefore treated more harshly than an employee with a contract that does not specify a term, but is terminable by notice. This is so even if the term contract extends automatically in the absence of notice to the contrary, which is common. That result is entirely arbitrary.

Third, it is also unclear whether an amendment to an existing contract, such as a pay rise or pay reduction, will mean that the employee becomes subject to the new benefit limits.

The Committee submits that section 41 of the Bill should be amended so that it applies to all "retirements" (as defined), and that existing contracts are grandfathered, and continue to be grandfathered notwithstanding a subsequent amendment (including extensions and changes to remuneration), provided that:

- the contract continues to be between the same parties and
- there is no increase to the amount of retirement benefits payable as a proportion of total remuneration.

Thank you for your consideration of the Committee's submissions. If you have any questions, please contact either the Committee Chair, Greg Golding on [02] 9296 2164 or Tim Bednall on [02] 9296 2922.

Yours sincerely

Bill Grant
Secretary-General

2 June 2009