Chapter 2

Termination Payments

What problem is the bill trying to fix?

2.1 The principal justification provided for the bill is mounting community concern. The Minister stated in his second reading speech:

> There is significant community concern about the levels of termination benefits paid to company management. Such payments are given to outgoing company directors and executives at a time when they are no longer able to influence the company's future performance. The government's reforms will empower shareholders to more easily reject such payments where they are not in the best interests of the company, the shareholders or the community.[1]

2.2 In announcing the measure on 18 March 2009, the Treasurer referred to community concern about 'obscene' and 'outrageous' termination payments, and the need to 'ensure that executive pay is in step with good corporate governance, provides the correct incentives and meets decent community standards'.[2] The Explanatory Memorandum also refers to community concern as motivation for the bill.[3]

Trends in executive remuneration

2.3 Executive remuneration as a whole is a matter beyond the scope of this inquiry. However, the committee received evidence that the topic of termination payments cannot be seen in isolation from the wider context of executive remuneration. Concern about the level of overall executive salaries also helps to explain community concern about the level of termination payments.

2.4 The committee received evidence that there has been a significant increase in executive salaries in recent years. Professor David Peetz of Griffith University provided evidence that:

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1 Hon Chris Bowen MP, Minister for Financial Services, Superannuation and Corporate Law, *House of Representatives Hansard*, 24 June 2009, p. 20.

2 The Hon Wayne Swan MP, Treasurer, at Joint Press Conference with Senator the Hon Nick Sherry, Minister for Financial Services, 18 March 2009, http://www.treasurer.gov.au/DisplayDocs.aspx?doc=transcripts/2009/041.htm&pageID=004&min=wms&Year=&DocType=2, viewed 8 July 2009.

3 Explanatory Memorandum, paragraph 2.2.

> The growth in CEO pay, of something around 470 per cent over the period 1971-2008, was nearly nine times the 54 per cent growth in real average weekly earnings over the same period.[4]

2.5 Mr Gary Banks, Chairman of the Productivity Commission, which is currently undertaking an inquiry into executive remuneration, has noted:

> …it is hardly a revelation to say that both executive and (non-executive) director remuneration have been increasing relatively rapidly — at least until last year — albeit with executive pay at much higher levels and increasing at a faster rate than for directors.[5]

2.6 Mr Banks noted that there is a lack of data, particularly in relation to non-executive directors. He also stated that media reports sometimes exaggerate the extent of executive salaries due to the complexity of incentive packages and other factors.[6]

2.7 An alternative view of executive remuneration was provided by the Australian Chamber of Commerce and Industry. They argued that that claims that executive remuneration are significantly higher than other sectors of the economy are sometimes overstated:

> …it must also be recalled that there are other professionals, for example, in our sports, entertainment, business, medical and legal industry, that are remunerated above and beyond most average Australian incomes and corporate executives. These professions are not subject to detailed regulatory interventions or restrictions in terms of total remuneration packages or termination payments. Such persons would earn many times over that of an average Chief Executive Officer or senior executive in most Australian firms, and without any clear measurable benchmark to overall performance or result.[7]

2.8 Other submissions referred to executive remuneration as unbalanced:

> Also in need of correction are the imbalances between those rewards and the rewards given to other employees of the same corporations, and the rewards for work given to workers in society generally. These imbalances must be corrected if social equity

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4 Professor David Peetz, *Submission 15*, p. 4.

5 Mr Gary Banks, Chairman, Productivity Commission, 'the Productivity Commission's executive pay inquiry: an update on the issues,' paper presented at FINSIA forum, 4-5 June 2009, p. 2, http://www.pc.gov.au/__data/assets/pdf_file/0011/89579/cs20090603.pdf, viewed 26 June 2009.

6 Mr Gary Banks, Chairman, Productivity Commission, 'the Productivity Commission's executive pay inquiry: an update on the issues,' paper presented at FINSIA forum, 4-5 June 2009, pp 2-3, http://www.pc.gov.au/__data/assets/pdf_file/0011/89579/cs20090603.pdf, viewed 26 June 2009.

7 ACCI, *Submission 4,* p. 5.

and a reduction in inequality are to remain goals of Australian society, and goals of the Government of that society.[8]

Are termination payments 'excessive?'

2.9 Discussion of termination payments often refers to certain high profile cases.[9]

2.10 In announcing the government's decision, the then Minister for Financial Services, Senator the Hon Nick Sherry, referred to payouts provided to Mr Owen Heggarty of Oz Minerals (who in 2008 'received a bonus of $8.35 million, which was 642 per cent of his base salary') and Mr John Anderson of Consolidated Media who in 2008 'received a $15 million golden parachute, 468 per cent of his salary'.[10]

2.11 Regnan's submission provides some further examples. These include Mr Kim Edwards of Transurban Group, who received $16 million remuneration in his final year, including a termination payment of $5.2 million. After his retirement on 4 April 2008, the share price at Transurban fell from $6.60 to $3.91 on 12 March 2009.[11]

2.12 Professor David Peetz provided examples in his submission of media reports of large individual payments. These include among others a '$16 million golden handshake' provided to Mr John Ellice-Flint (Santos)[12] and a 'farewell package' of $32 million provided to Mr Chris Cuffe (Colonial First State).[13]

2.13 One topical example at the time of the bill was announced was that of Mr Sol Trujillo of Telstra. Media reports suggest that Mr Trujillo 'would get $3 million

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8 Australian Manufacturing Workers Union, *Submission* 10, p. 3.

9 See for example Adam Schwab, 'Curbing golden handshakes: nothing succeeds like failure,' 19 March 2009, http://www.crikey.com.au/2009/03/19/curbing-golden-handshakes-nothing-succeeds-like-failure/, viewed 8 July 2009; Catherine Fox, 'Pay Check,' AFRBOSS.COM.AU, July 2009.

10 Senator the Hon Nick Sherry, Minister for Financial Services, at Joint Press Conference with the Hon Wayne Swan MP, Treasurer, at Joint Press Conference with, 18 March 2009, http://www.treasurer.gov.au/DisplayDocs.aspx?doc=transcripts/2009/041.htm&pageID=004&min=wms&Year=&DocType=2, viewed 8 July 2009.

11 Regnan, *Submission 7, Attachment 'Regnan Remuneration Proposal – March 2009*, p. 19.

12 Michael West, 'Golden chutes back in vogue', *Sydney Morning Herald*, 27 November 2008, cited in Professor David Peetz, *Submission 15*, p. 24

13 Stephen Mayne, 'Biggest golden parachutes in corporate Australia,' *Mayne Report*, cited in Professor David Peetz, *Submission 15*, p. 20.

termination payments on top of his base salary of more than $13 million'.[14] Telstra has pointed out that Mr Trujillo's payment would be within the new standards.[15]

Are 'excessive' payments standard practice?

2.14 It is not clear the extent to which these individual examples are representative of standard practice among companies.

2.15 In 2004, an article in the *Australian Financial Review* found:

> An analysis…of the latest annual reports released by 50 of Australia's largest companies reveals that nearly a third of chief executives are entitled to termination payments worth more than the equivalent of 12 months salary, as well as performance-linked bonuses and entitlements to shares and options. Eight CEOs are entitled to payouts of at least $4 million if their employment is terminated, while some agreements have controversial provisions that trigger big payouts to the CEO if control of the company changes.[16]

2.16 In 2005, Geof Stapledon estimated that in Australia termination payments range from $800,000 to $9.9 million. The mean payment was $3.65 million and the median was $3 million.[17]

2.17 In 2007, Kym Sheehan and Colin Fenwick of the University of Melbourne examined termination provisions in executive service contracts:

> Given a hypothetical termination date of 1 March 2006, nine of the 28 companies examined would have paid an amount equivalent to at least 18 months' cash remuneration by way of contractual termination payment to the managing director.[18]

2.18 All these figures predate the Global Financial Crisis.

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14 ABC Online, PM, 'New law to tackle corporate pay excess,' http://www.abc.net.au/pm/content/2008/s2519973.htm, viewed 7 July 2009.

15 Mr David Quilty, Telstra Ltd, quoted in ABC Online, PM, 'New law to tackle corporate pay excess,' http://www.abc.net.au/pm/content/2008/s2519973.htm, viewed 7 July 2009.

16 Damon Kitney and Fiona Buffini, '$100m payout bonanza to CEOs,' *Australian Financial Review*, 6 December 2004.

17 Geof Stapledon, 'Termination benefits for Executives of Australian Companies', *Sydney Law Review*, Vol 27, p. 700, 2005. http://www.law.usyd.edu.au/slr/slr27_4/Stapledon.pdf, viewed 17 July 2009.

18 Kym Sheehan and Colin Fenwick, Research Report, 'Seven: the Corporations Act, corporate governance, and termination payments to senior employees,' Centre for Corporate Law and Securities Regulation, University of Melbourne, 2007, p. 10., http://cclsr.law.unimelb.edu.au/download.cfm?DownloadFile=722D87A5-1422-207C-BA2DF86F9596602F, viewed 10 July 2009.

2.19 Some submissions argued the upward trend in termination benefits has stalled. According to the Hay Group, 'there has been a progressive downward trend towards contracted termination payments of between 10 and 15 months fixed annual reward over the last five years'.[19]

2.20 Table 1 provides an indication of the size of current termination provisions in the ASX20 companies in Australia.

2.21 Treasury cited RiskMetrics data (released November 2008) which indicates that the average CEO receives just over $3.4 million as a termination payment, or 201 per cent of their salary, based on entities in the S&P/ASX 100 in the previous three years. Based on these data, Treasury found that 20 of the 33 CEOs included in the sample (around 60%) would exceed the proposed new threshold, with the rate expected to decline for smaller companies. They conclude:

> Based on this research, it would appear that between approximately 50 to 60 per cent of termination benefits would be captured by [the 12 month] threshold, which Treasury considers to be an appropriate level.[20]

19 Hay Group, *Submission 6*, p. 2.

20 Treasury, *Submission 22*, p. 7.

Table 1: Termination Pay Arrangements in the ASX20

Company	Less than 12 month base	Summary of Termination arrangements for key management personnel
AMP Ltd	No	12 months' fixed pay. Executives retain unvested equity incentives subject to performance hurdles.
ANZ Banking Group	No	CEO is entitled to greater of the remainder of employment contract or 12 months' fixed.
BHP Billiton Ltd	Yes	12 months' base pay.
Brambles Industries Ltd	Yes	12 months' fixed pay.
Commonwealth Bank of Aust.	Yes	6 months' notice for CEO. Other executives between 6 and 12 months base.
CSL Ltd	No	12 months' fixed pay plus 6 months notice.
Foster's Group Ltd	Yes	12 months' fixed pay.
Macquarie Group Ltd	Yes	4 weeks' notice plus profit share already accrued.
National Australia Bank Ltd	Yes	12 months' fixed pay for CEO, similar for other Key Management Personnel.
Newcrest Mining Ltd	Yes	12 months' fixed pay.
Origin Energy Ltd	Yes*	Senior executives three months' payment in lieu of notice plus a severance payment based on length of service, to a maximum of 74 weeks. Managing director 12 months' fixed pay if terminated for poor performance.
QBE Insurance Group Ltd	Yes	12 months' fixed pay.
Rio Tinto Ltd	No	12 months' fixed pay plus pro rata STI. Unvested LTIs retained and subject to hurdles
Suncorp-Metway Ltd	Yes*	12 months' fixed pay for CEO and most key management personnel. Some former Promina executives entitled to up to 18 months fixed pay.
Telstra Corp Ltd	Yes*	CEO and COO 12 months' base pay. Some key management personnel are entitled to 18 months' base pay.
Wesfarmers Ltd	No	Two years' base pay.
Westfield Group	Discretionary*	Termination payments are discretionary.
Westpac Banking Corp	Yes*	12 months' fixed remuneration for most executives. 12 months' fixed pay for CEO if terminated for poor performance otherwise sign on shares may be awarded if terminated prior to December 2009.
Woodside Petroleum Ltd	Yes	12 months' fixed remuneration.
Woolworths Ltd	No	12 months' fixed remuneration plus pro-rated STI.

* As a general standard. Some exceptions may apply.

Source: Australian Council of Super Investors (document tabled at public hearing, 25 August 2009).

Are claims of 'excessive' termination payments exaggerated?

2.22 The Australian Institute of Company Directors (AICD) pointed out that publicity given to individual payments made to individuals often overstates the size of 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, 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.[21]

2.23 The Business Council of Australia (BCA) and ACCI presented similar arguments.[22] Geof Stapledon also noted this phenomenon in his 2005 study.[23]

2.24 Ernst & Young referred to the lack of clarity surrounding the disclosure of remuneration arising from complex accounting rules:

> The disclosed remuneration for an individual does not therefore relate to the *cash value* received by the executive. This disconnect results in frequent misinterpretation by shareholders, media and the public, resulting in the sometimes false perception that an executive is overpaid. Similarly, an executive may receive significant remuneration value that is not immediately apparent from the disclosure.[24]

Risk and tenure

2.25 Several submissions from industry provided arguments that high termination payments represent compensation to executives for the risky nature of such positions.

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21 AICD, 'Executive Termination Payments,' Position Paper no. 13, Oct 2008, p. 2. http://www.companydirectors.com.au/NR/rdonlyres/17559EF2-5AB7-47DF-A647-46B5A3C05E93/0/AICDPositionPaperNo13ExecutiveTerminationPayments.pdf, viewed 16 July 2009.

22 BCA, *Submission 9*, p. 1; ACCI, *Submission 4, Attachment*, p. 3.

23 Geof Stapledon, 'Termination benefits for Executives of Australian Companies', *Sydney Law Review*, Vol 27, p. 708., 2005. http://www.law.usyd.edu.au/slr/slr27_4/Stapledon.pdf, viewed 17 July 2009.

24 Ernst & Young, *Submission 20*, p. 2.

2.26 The AICD point out that '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'.[25]

2.27 The BCA put the average tenure of an executive at 5.7 years.[26] The BCA also pointed out high turnover of CEOs, noting that CEO turnover was 18 per cent in 2007, an increase of 60 per cent since 2000, and the highest level in the world.[27]

2.28 The AICD gave a further illustration of risks faced by directors:

> There are 267, we think, state laws making directors liable. One of the biggest problems in this country at the moment, we would argue, is that, under federal laws for example, you have laws which reverse the onus of proof, which say, 'You are guilty until you have proved yourself innocent.' That transgresses fundamental laws like the Magna Carta. It transgresses fundamental laws like the bill of rights...And you have a system now where there are class actions against directors. You have a system now where there is a massive amount of federal and state laws making directors liable. Is this a big issue? Yes. What happens when liability goes up and risk goes up? Price goes up. So there is definitely a very high coefficient between risk and reward...[28]

2.29 Professor Peetz argued in his submission that other employees in the economy also face risk:

> If there is increasing risk facing CEOs, it is no greater than the increased risk facing ordinary employees compared to two decades ago, as they work in what is sometimes referred to as the 'risk society'…The increased casualisation of employment has transferred many of the risks of employment from capital onto labour…
>
> The argument about greater risk faced by CEOs is especially difficult to sustain when we compare the termination packages to which that CEOs typically have access with those available to ordinary workers…The substantial safety nets in event of dismissal provided by the 'golden parachutes' of CEOs are much more generous than those available to ordinary workers.[29]

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25 AICD, 'Executive Termination Payments,' Position Paper no. 13, Oct 2008, Footnote 1, http://www.companydirectors.com.au/NR/rdonlyres/17559EF2-5AB7-47DF-A647-46B5A3C05E93/0/AICDPositionPaperNo13ExecutiveTerminationPayments.pdf, viewed 16 July 2009.

26 Mr Peter Crone, Policy Director, Business Council of Australia, *Proof Committee Hansard*, 25 August 2009, p. 6.

27 BCA, *Submission 9*, pp 1-2.

28 Mr John Colvin, Chief Executive Officer, Australian Institute of Company Directors, *Proof Committee Hansard*, 25 August 2009, p. 46.

29 Professor David Peetz, *Submission 15*, p. 19.

2.30 The Australian Council of Super Investors (ACSI) submission also noted that such payments 'exceed anything available to the rest of the workforce'.[30]

2.31 ACCI argued that 'restraint of trade' clauses in executive contracts may prevent executives from seeking employment with a competitor for a reasonable period of time. 'Because of the lengthier and more excessive restrictions on an executive than other employees, the *quid pro quo* is often a higher than average premium to the executive'.[31] The Law Council of Australia also noted the impact of restraint of trade clauses.[32]

Consequences of 'excessive' termination payments

2.32 Some submissions and commentators have argued that excessive termination benefits have an impact on the wider economy, justifying government intervention.

2.33 A frequently stated view is that termination payments constitute a 'reward for failure'. Treasury cited this perception in its submission:

> A service contract may provide that no termination benefit is payable in cases where the executive is dismissed for cause, for example, in the event of misconduct. However, this has not prevented the payment of termination benefits where the executive's performance has been below the expected standard, but not to the extent that it would constitute 'cause.' This has reinforced the perception that termination benefits are a reward for poor performance.[33]

2.34 ACSI also noted that 'excessive termination payments appear to not only reward executive directors for mediocre performance, but in some cases, for failure'.[34]

2.35 Some submissions argued that excessive payments promote risk-taking behaviour by executives. The argument appears to be that an executive may be willing to endorse a high risk in order to obtain high returns, in the knowledge that he or she will receive vast bonuses if the 'gamble' comes off and at worst still get millions in the event that the 'gamble' fails. This could lead to CEOs having a perverse incentive to undertake a risky project with a negative expected return, against the interests of shareholders and the broader community.

2.36 The Australian Manufacturing Workers' Union (AMWU) argued:

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30 ACSI, *Submission 13*, p. 1.

31 ACCI, *Submission 4*, p. 7.

32 Law Council of Australia, *Submission 23*, p. 6.

33 Treasury, *Submission 22*, pp 2-3.

34 ACSI, *Submission 13*, p. 1.

> It is becoming increasingly apparent that highly leveraged short term incentives for executives and directors inappropriately promote: a short-term focus, excessive risk-taking and highly individualistic behaviour.[35]

2.37 This does not take into consideration other impacts on executives who might be removed for poor performance, for example damage to reputation:

> There is a risk reputationally. I don't think there is any question that, in our experience, a person who strives for a senior executive position or a board position is very concerned about their reputation and their performance.[36]

Is legislation required?

2.38 Some submissions argued that legislation is required to fix the 'problem'. Other submissions asserted there was a risk of regulatory overreach.

2.39 The AMWU argued that the imbalance in executive salaries 'must simply be corrected to prevent – or at least stem – society's loss of faith in the social entity of the corporation'.[37] Indeed, the AMWU argued the further regulation is required in addition to this bill:

> …it is only one strand of a web of regulation that is necessary to constrain the tendency of the corporation to act without concern or acknowledgement of its responsibilities to the community in which it exists and the workforce which generates its wealth.[38]

2.40 Professor Peetz noted that while there had been some reduction in executive termination payments in recent years, for reasons including changing economic circumstances and responsiveness by business to community sentiment, further regulation was justified:

> This bill is important not only for promoting good practice in executive termination payments. It is also important that the parliament send a signal that, like the community, it is no longer willing to welcome excess in executive remuneration generally. While sending signals will not in itself halt excessive remuneration, if parliament fails to pass this bill it will send exactly the wrong signal and we could expect a return in the near future to not only the excessive termination payments that characterised the recent

35 AMWU, *Submission 10*, p. 3.

36 Mr Peter McAuley, Director, Guerdon Associates, *Proof Committee Hansard*, 25 August 2009, p. 61.

37 AMWU, *Submission 10*, p. 3.

38 AMWU, *Submission 10*, p. 2.

> past but also the excessive growth in executive remuneration generally that has been witnessed.[39]

2.41 Other submissions asserted there was a risk of regulatory over-reach. The BCA described the bill as running 'the risk of significant regulatory overreach with the potential to capture matters to do with the ordinary course of business'.[40] The BCA also argued:

> A detailed discussion of the market problem at which these proposals is aimed has not been provided in the Explanatory Memorandum. The reforms are aimed at 'curbing excessive termination payments paid to company executives' however there is little further explanation or evidence of market integrity problems associated with that statement or explanation as to why existing laws (e.g., remuneration disclosure, governance and non-binding shareholder votes) are inadequate to address the issue.[41]

2.42 Other organisations asserting this risk include the Hay Group, the Australian Bankers' Association, the Australian Industry Group, and ACCI.[42]

2.43 The Investment and Financial Services Association (IFSA) argued 'the current governance regime over remuneration in Australia has experienced no systematic failure even in the recent market turbulence. Evidence is growing that the current regime is adjusting of its own accord to the changing financial environment'.[43]

2.44 ACSI provided evidence that of the top 20 ASX companies, thirteen used one year's base salary for termination payments for executive staff.[44] However, as these companies were likely to be the most responsible due to their size and concern for their reputation, ACSI still regarded legislation as necessary to send a signal to the market (particularly smaller companies).[45]

2.45 Whilst BHP Billiton argued that reducing the threshold to 12 months' base salary is 'too extreme',[46] it acknowledged that the current thresholds in the Act 'allow for extremely high pay-outs' and do 'not strike an appropriate balance'. The AICD also

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39 *Proof Committee Hansard*, 25 August 2009, p. 12.

40 BCA, *Submission 9*, p. 2.

41 BCA, *Submission 9*, p. 3.

42 Hay Group, *Submission 6*, p. 4.; ABA, *Submission 24*, p. 1.; Mrs Heather Ridout, Chief Executive, Australian Industry Group, Media Release, 'Australian Industry Group comment on Federal Government's announcement on executive salaries and Productivity Commission inquiry into "golden handshakes",' 18 March 2009; ACCI, *Submission 4, Attachment*, p. 2.

43 IFSA, *Submission 25*, p. 4.

44 Ms Ann Byrne, Chief Executive Officer, ACSI, *Proof Committee Hansard*, 25 August 2009, p 22.

45 Ms Ann Byrne, Chief Executive Officer, ACSI, *Proof Committee Hansard*, 25 August 2009, pp. 25-26.

46 BHP Billiton, *Submission 5*, pp 2-3.

'accepts that a reduction in the current shareholder approval threshold for termination payments is warranted',[47] although it too opposed the reduction to 12 months.

Committee View

2.46 Whilst many business submissions warned against the risk of over-regulation, it is notable that none of the submissions received argued that termination payments of up to seven years' total remuneration are appropriate.

2.47 Based on the evidence provided, the committee is persuaded that there is a case for imposing further regulatory constraints on executive termination payments.

47 AICD, *Submission 12*, p. 2.