RESEARCH REPORT

SHARE-BASED REMUNERATION AND TERMINATION PAYMENTS TO COMPANY DIRECTORS: WHAT ARE THE RULES?

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Share-based remuneration and termination payments to company directors: what are the rules?

This article is about the operation of the legal requirements that regulate the making of termination payments to senior company employees. We aim to review the relevant provisions and what is known about them based on prior judicial and academic analysis, together with legislative history where necessary. However, we focus in particular on whether the provisions are able to operate effectively in relation to the widespread practice of share-based remuneration. In doing so, we both draw and build on related work in which we carried out an empirical study of termination payments to managing directors of ASX/50 companies.[1]

The key legislative provisions are in Part 2D.2 of the *Corporations Act 2001* (Cth) (the Act). In essence, the provisions prohibit termination payments, unless they have been approved by the shareholders, or they fall within prescribed limits. The current provisions were most recently amended as part of the Corporate Law Economic Reform Program (CLERP) 9 reforms in 2004. The changes introduced new requirements for companies to disclose the nature and size of any termination payments as part of the directors' report in their annual report.[2] They also introduced caps on the level of certain types of payments

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[1] The study is published as Sheehan K and Fenwick C, "Seven: The Corporations Act, Corporate Governance, and Termination Payments to Senior Employees" (Research Report, Centre for Corporate Law and Securities Regulation & Centre for Employment and Labour Relations Law, (The University of Melbourne, 2007).

[2] The *Corporate Law and Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (Cth) (CLERP Act) introduced the new requirements by amending s 300A of the *Corporations Act 2001* (Cth); some of the detail of what must be disclosed is specified in the *Corporations Regulations 2001* (Cth), Reg 2M.3.03. There is a substantial literature on the CLERP 9 reforms; see, eg, von Nessen P, "Corporate Governance in Australia: Converging with International Developments" (2003) 15 *Aust JCL* 189, and Cassidy A and Chapple L, "Australia's Corporate Disclosure Regime: Lessons from the US Model" (2003) 15 *Aust JCL* 81. Relevant to our present focus see, eg, Sheehan K, "Outrage + Camouflage: The Utility of the Managerial Power Approach in Explaining Executive Remuneration" (2005) 24 *C & SLJ* 24 and Chapple L, "The Non-Binding Vote on Executive Pay: a Review of the CLERP 9 Reform" (2005) 18 *Aust JCL* 263.

to a director, beyond which the company must secure shareholder approval. In some cases, however, the maximum payment that will be lawful without shareholder approval will be as much as seven times the average annual remuneration of the executive in question.[3] Despite the obvious potential in such a limit for very significant payments, when the provisions were introduced, the government indicated that they were intended to ensure shareholder scrutiny other than for 'relatively small' payments.[4]

The provisions are intended to restrain companies from giving 'golden handshakes' or 'golden parachutes' to departing corporate executives and directors. A particular concern is the giving of these payments in the case of executives that depart due to corporate restructure, however, the statutory provisions also apply 'where an executive has been dismissed, forced to resign or even departed voluntarily.'[5] Broadly speaking, the goal of these corporate governance requirements is to protect the company and its shareholders (and by extension, the market) against the risk that company executives will use their position to extract excessive rents. That is, they seek to control company officers' personal gain by limiting the expense that the company may incur in remunerating them.

The issue of executive remuneration is of great importance, and frequently attracts public attention. In recent months, for example, both the Prime Minister and the Federal Treasurer were moved to make public comment on the remuneration paid by Macquarie Bank to its Chief Executive, Mr Allan Moss.[6] The specific issue of retirement payments also occasionally attracts public attention. One example, where the executive retired as expected, is the case of Mr David Murray, who was paid $17.5 million on leaving his

[3] We have elsewhere outlined briefly some of the history of these provisions: Sheehan and Fenwick, n 1 at 23-25.
[4] Explanatory Memorandum Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, [5.440].
[5] Stapledon G, "Termination Benefits for Executives of Australia Companies" (2005) 27 *Sydney Law Review* 683 at 688.
[6] See, eg, Hewett J, "Mac Bankers' Pay Raises Treasurer's Ire", *The Australian* (16 May 2007) p 1. The salary paid to Moss rose this year by 60 per cent to $33.5 million; the bank's head of investment banking, Nicholas Moore, received $32.9 million: Korporaal G, "Macquarie's Executive Pay Expected to Remain an Issue", *The Australian* (19 July 2007) p 19.

position as head of the Commonwealth Bank of Australia.[7] A different case is that of Mr David Gailey, who left early from his position as chief executive of Zinifex. The company agreed to pay Gailey $15 million, of which $12.6 million was an ex gratia payment.[8] Another again is that of the departure of Mr Matthew Slatter from Tabcorp in March 2007. Although Slatter's appointment was effectively terminated immediately for poor performance,[9] Tabcorp paid him some $3.2 million. It also allowed him to retain share options valued (at the date of his departure) at over $32 million, in addition to the shares he already held in the company, which then had a value of over $36 million.[10]

Notwithstanding the importance of the issue and the public attention that it sometimes attracts, the statutory provisions have attracted virtually no academic attention, either before or after they were amended as part of the CLERP 9 reforms. So far as we are aware, the only previous academic analysis of the provisions, particularly in their current form, is a study by Geof Stapledon, published in 2005.[11] In that work Stapledon presented the findings of an empirical study of publicly reported termination payments to 40 company directors during the period 1999 and 2004.

Stapledon's study illustrated the significant termination payments that some company directors receive. According to his work, the average payment of the 40 he identified was $3.65 million, and the median payment was $3 million.[12] Nine of the 40 termination payments exceeded $6.5 million.[13] Perhaps not surprisingly, Stapledon suggested a need for further research that might illuminate the apparent generosity of the caps on termination payments before which shareholder approval is required, which were inserted

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[7] See, eg, Oldfield S and Moullakis J, "Murray Exits CBA with $4bn Profit", *The Australian Financial Review* (11 August 2005) pp 1 and 20. It might be noted that the figure of $17.5 million included some $11.8 million in accumulated superannuation benefits: Sheehan and Fenwick, n 1 at xx. The reporting does however illustrate Stapledon's point that it is frequently difficult to tell, from the reported 'headline' figure of a payment, how it is structured: Stapledon, n 5 at 708.
[8] He was also paid $900,000 for half his contractual termination benefit, and a further $1.5 million for achieving short-term performance hurdles for 2006-07: Trounson A, "Zinifex Slammed Over Chief's Controversial Payout", *The Australian* (19 June 2007) p 19.
[9] Stevens M, "Heads Roll and Even Do-Gooders Bleed in the Week from Corporate Hell", *The Weekend Australian* (17 March 2007) p 36.
[10] Jimenez K, "Punters Probe Slatter's Payout", *The Australian* (16 March 2007) p 19.
[11] Stapledon, n 5.
[12] Stapledon, n 5 at 709.
[13] Stapledon, n 5 at 701.

into ss 200F and 200G of the Act by the CLERP 9 reforms.[14] Stapledon also called for empirical analysis of executive service agreements, including the extent to which they include liquidated damages clauses and, where they do, what those clauses provide. Our empirical study took up some of those challenges.[15]

Not only have the provisions received only limited academic analysis, they have been the subject of relatively little judicial scrutiny, despite there having been provisions to similar effect in the laws regulating corporations since the 1930s.[16] Moreover in most of the few cases in which the provisions have been addressed, judicial observations on their operation have been made in *obiter dicta*.[17] Probably the leading authority on the provisions is the relatively recent decision of Walton J in *Fox v GIO Australia* (2002) 56 NSWLR 512; 120 IR 401, although they were directly considered most recently by the Supreme Court of New South Wales in *Silver v Dome Resources NL* [2007] NSWSC 455.[18]

Our primary goal, therefore, is to contribute to what (relatively) little is presently known about the provisions, and about how they operate in practice. As noted, however, a key focus of our work is the scope of the provisions, that is, the types of payments and transactions that are covered. In particular, we examine how the provisions apply to share-based payments, as a distinct component of executive remuneration. As will appear, this is a complex question, and one to which it is not obvious that there is a clear answer. The issue is however of great practical significance: as we have shown

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[14] Stapledon, n 5 at 712.

[15] Sheehan and Fenwick, n 1.

[16] On the legislative history, see Sheehan and Fenwick, n 1 at 23-25.

[17] For a recent example to this effect, see *Orrong Strategies Pty Ltd v Village Roadshow Limited* [2007] VSC 1, per Habersberger J. His Honour's remarks upon the operation of the provisions were made only in the event that other conclusions he had reached should not have been correct (at [644]). Compare *Randall v Aristocrat Leisure Ltd* [2004] NSWSC 411, where the remarks of Einstein J were *obiter* for a similar reason.

[18] The only other cases of which we are aware are: *Lincoln Mills (Aust) Ltd v Gough* [1964] VR 193, *Claremont Petroleum NL v Cummings & Anor* (1992) 110 ALR 239; 9 ACSR 1; 10 ACLC 1685, and *Whitlam v Insurance Australia Group Ltd* (2005) 52 ACSR 470; [2005] NSWSC 83. There is also very little case law on the meaning of an equivalent (but not identical) provision in the UK; the most recent case was in 2001. In *Mercer v Heart of Midlothian Plc* [2001] SLT 945 the court relied on *Lincoln Mills (Aust) Ltd v Gough* [1964] VR 193 for the meaning of the phrase 'as consideration for or in connection with' retirement from office (at [15]).

elsewhere, share-based remuneration is universal practice, at least among managing directors of ASX/50 companies, and it frequently represents a significant proportion of an executive's remuneration. Moreover, the gains made upon exercise of share-based remuneration have the potential to contribute very significant sums to the termination payments made to departing company executives. This is especially important because our study also showed that it was a common practice among the service agreements we examined to provide for the accelerated vesting of share-based remuneration upon termination of employment.[19]

However, for a number of reasons, it is especially difficult to accommodate the operation of the statutory provisions that regulate the making of retirement payments to the practice of share-based remuneration. In particular, it is not clear that the full value of share-based payments falls within the meaning of the words used to capture payments that are made *only* as a result of termination:[20] the provisions refer to a 'benefit given in connection with retirement from office'.[21] Problems also derive from the evidently common practice of accelerated vesting of share-based payments at termination. This may happen by virtue of share-plan rules, or because of the exercise of discretion by the board or remuneration committee.[22] Or, as noted, it may be specifically provided for in the executive's service contract.

But in any event it is still not clear how the statutory provisions apply to share-based payments: will they have been made 'in connection with retirement from office', or in respect of 'past services'?[23] On one view, it is difficult to see how the accelerated vesting of share-based payments that would not have fallen due until some time after termination

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[19] Eleven of the 28 service agreements we examined included provisions to this effect: Sheehan and Fenwick, n 1 at 48 (Table 1).
[20] As noted above and emphasized by Stapledon (n 5), some payments made at the time of termination, for example, payment of accrued employment entitlements, are not the intended subject of the regulatory regime.
[21] *Corporations Act 2001* (Cth), s 200B.
[22] Companies in the United States frequently diverge from their share plan rules when executives depart, including by 'waiver of forfeiture rules, more generous vesting than usual and longer exercise periods': Yermack D, "Golden Handshakes: Separation Pay for Retired and Dismissed CEOs" (2006) 41 *Journal of Accounting and Economics* 237 at 249 fn 8.
[23] Which is relevant to the application of the *Corporations Act 2001* (Cth), s 200G.

can amount to payment for prior service. But the same question might arise even if share-based payments are made as and when they fall due: arguably the function of share-based payments is only partly to reward past service. Other purposes include offering an incentive to remain in employment, and providing further remuneration in the future.[24]

Another key difficulty in applying the statutory provisions stems from the very nature of share-based remuneration. Instead of paying an executive a liquidated sum, the company allocates rights to a parcel of its tradeable securities. In the past, it was common practice to issue share-based remuneration at a cost that was very significantly less than their market value. Current practice is more likely to involve an issue at a price close to the average market price, but in anticipation of exercise after that price has appreciated. Either way, the practice depends upon there being a distinction between the expense that a company incurs when it makes a grant of shares, and what the executive gains from it upon the exercise of their rights. As appears presently, a similar distinction is also deeply embedded in the statutory scheme, because of the way that a company is required to calculate the expense of providing share-based remuneration.

Nevertheless, it may be possible to argue that the Act *does* require shareholder approval if the *value* of these payments, when added to other benefits given in connection with retirement from office, exceeds the specified thresholds. And if that argument is correct, then it would be erroneous to see many such payments as truly exempt from approval. The strength of this argument is supported by the observed practice of a limited number of companies that, in recent general meetings, have sought shareholder approval for retirement payments at the same annual general meeting at which they have sought shareholder approval for a grant of share-based remuneration to an executive. This suggests that companies and their advisors do not view the Act as providing simply for

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[24] Such plans serve mixed purposes, with Peterson J of the Industrial Relations Commission of New South Wales in court session being inclined to the view they are 'forward looking' that is, a retention device rather than a reward for past service: *Canizales v Microsoft Corp* (2000) 99 IR 426 at 434; [2000] NSWIRComm 118. Three distinct purposes of share option plans were found in *Westfield Ltd v Helprin* (1997) 82 IR 411 at 435: '…first, to reward employees for their past efforts; secondly, to provide them with additional remuneration in the future; and, thirdly, to operate as an incentive to remain in [the company's] employment.'

exemptions.[25] At the very least, the observed practice of companies seeking shareholder approval for payments that may not exceed the statutory threshold illustrates that it is not easy to determine the proper application of the provisions.[26]

This article is structured as follows. First, we explain the requirements of the statutory provisions. Secondly, we examine in detail how the provisions might apply to share-based remuneration. Thirdly, we consider the proper operation of the provisions in light of the observed practice of several major Australian companies. We then conclude.

I Disclosure and Approval Requirements Under the Act

The key provision is s 200B of the Act, which essentially prohibits retirement payments, unless they are approved by the shareholders under s 200E, or they fall within one of the exemptions specified in ss 200F, 200G or 200H of the Act. It has been held more than once that what the provisions render unlawful is the making of the payment, rather than any agreement that might be reached to make a payment that, if made, would be unlawful because of their operation.[27] As Hamilton J observed in *Silver*, this reasoning is supported by the fact an agreement to make a payment that requires shareholder approval may, up until payment is made, still receive that approval.[28]

A contravention of s 200B is a criminal offence of strict liability,[29] and any payment made in contravention of the provision is to be held on trust for the company.[30] The

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25 Required under ASX Listing Rules 10.14.

26 Our empirical study illustrated the difficulty of identifying accurately how the typical components of executive remuneration should be analysed in terms of the language in ss 200F and 200G of the *Corporations Act 2001* (Cth): Sheehan and Fenwick, n 1. We consider the issue further at nn 82-100 and accompanying text.

27 *Silver v Dome Resources NL* [2007] NSWSC 455 at [85] – [86], following *Fox v GIO Australia* (2002) 56 NSWLR 512 at 533; 120 IR 401. Compare *Orrong Strategies Pty Ltd v Village Roadshow Limited* [2007] VSC 1 at [660] – [663].

28 *Silver v Dome Resources NL* [2007] NSWSC 455 at [87].

29 *Corporations Act 2001* (Cth), s 200B(1A). The Explanatory Memorandum to the *Treasury Legislation Amendment (Application of Criminal Code) Bill (No. 3) 2001* (Cth) explains that ‘whether or not the benefit is in connection with the person’s retirement is a matter peculiarly within the knowledge of the giver of the benefit at the time of giving the gift’ (at [4.43]). The penalty is a fine of 25 penalty units, or imprisonment for six months, or both: *Corporations Act 2001* (Cth), s 1311 and sch 3.

failure to obtain shareholder approval could also be viewed as a breach of directors' duties in Part 2D.1 of the Act.[31] Nor should it be overlooked that a director must also still fulfil their duties to the company, regardless of the specific statutory requirement to obtain shareholder approval for particular types of payments.[32]

Three types of payments are exempt from the requirement to obtain prior shareholder approval. First, specified categories of exempt benefits (s 200F). Secondly, genuine lump sum and pensions payments (s 200G). Thirdly, benefits that must by paid by law (s 200H).[33] The exemptions provided for in ss 200F and 200G are not, however, absolute. Rather, since the introduction of the CLERP reforms, the Act includes caps on the permissible size of a termination payment, *beyond which* the company must obtain shareholder approval. We come to the operation of these caps shortly; before doing so we outline the types of payments that are contemplated by ss 200F and 200G.

Specific types of payments that are exempt

Section 200F(1) exempts the following payments:

- payments to be made under an agreement entered into before 1 January 1991 (the date on which the provisions first came into force), *provided* that the agreement would have been lawful at the time;

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[30] *Corporations Act 2001* (Cth) ss 200B(1) and 200J respectively. Thus, the provisions cannot be avoided by the device of making the payment to someone associated with the retiring officer: Ford HAJ, Austin RP and Ramsay IM, *Ford's Principles of Corporations Law* (12th ed, LexisNexis Butterworths, 2005) at [9.580].

[31] For example, it could be a breach of the duty to exercise reasonable care and diligence under s 180(1) of the *Corporations Act 2001* (Cth). This is so notwithstanding the approach taken to the 'business judgment' rule with respect to remuneration decisions in the 2005 decision of the Delaware Court of Chancery in *In the Re Walt Disney Derivative Litigation* No.Civ A 15254, 2005 WL 2056651 (Del Ch). This decision was affirmed on appeal to the Supreme Court of the State of Delaware: *In the Re Walt Disney Derivative Litigation*, CA No. 15452, 8 June 2006.

[32] Section 200E(4) *Corporations Act 2001* (Cth) specifically mentions the duties in Part 2D.1 as well as directors' fiduciary duties. Examples of relevant fiduciary duties include the obligations to act for a proper purpose, and to avoid conflicts of interest.

[33] These three categories have been described as payments 'which *have* to be made (by law: s 200H), which would be *reasonable* to make (proportionate termination payments: s 200G), or which *should* be made (damages for breach of contract etc: s 200F).' *Fox v GIO Australia* (2002) 56 NSWLR 512 at 529; 120 IR 401 (emphasis added).

- payments for leave of absence due under an industrial instrument;[34]
- a benefit given under an order of a court;[35] or
- a benefit given in prescribed circumstances.[36]

What these exemptions have in common, as Walton J observed in *Fox v GIO* (2002) 56 NSWLR 512 at [57]; 120 IR 401, is that they 'should be made'. They ‘should’ be made because they predate the relevant prohibition, or there is another authority for, or requirement that they be made. They are not, in other words, payments in respect of which the company and its shareholders need to be protected from the possibility of abuse in their calculation and payment.

Section 200F(2) exempts two further categories of benefits, provided that they fall within the limits imposed by s 200F(3):

- a genuine payment by way of damages for breach of contract (s 200F(2)(a)(i));[37] and
- an agreement made with the person as the consideration (or part of the consideration) for their agreement to hold the relevant office (s 200F(2)(a)(ii)).[38]

These payments also 'should be made', in the sense that they arise under an agreement: a genuine payment by way of damages for breach of contract, or a payment made under an

[34] The term is defined to mean a contract of employment, or a law, award, determination or agreement relating to terms or conditions of employment: *Corporations Act* 2001 (Cth), s 9. Presumably this would cover, for example, a right to payment of a sum equal to the value of accrued leave entitlements.

[35] Section 200F(1)(aa) *Corporations Act 2001* (Cth) - this provision was added by the *Corporate Law and Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (Cth) - see sch 5, item 4A. It only applies to financial years from 1 July 2004 onward, and to an agreement entered into after the commencement of sch 5: *Corporate Law and Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (Cth), sch 12, item 1468.

[36] It appears that no regulations have been made prescribing circumstances for these purposes.

[37] A payment will not meet this description unless so characterised at the time that it is made, and whether this characterisation is accurate may depend upon whether a claim for damages has been asserted: *Claremont Petroleum*, (1992) 110 ALR 239 at 291; 9 ACSR 1; 10 ACLC 168.

[38] In *Randall v Aristocrat Leisure* [2004] NSWSC 411 the court held that a severance payment of three years’ target salary (salary, benefits allowance, superannuation and bonus that would have been earned on achieving all performance targets) was part of the consideration for a person taking up office: (at [535] and [552]). At the time, the payment was excluded completely from the operation of *Corporations Act 2001* (Cth), s 200B by the former s 200F(a)(iii). It would now be caught by the operation of s 200F(2)(a)(ii), and therefore subject to an approval requirement if not below the statutory thresholds. The court also held that an ‘agreement’ for these purposes included an agreement that replaced or varied an existing agreement: *Randall v Aristocrat Leisure* [2004] NSWSC 411 at [515]. This bears on the application of ss 200F(2), (4) and (5), which only apply to agreements entered into on or after 1 July 2004: *Corporations Act 2001* (Cth) s 1468(2).

agreement with the person as the consideration (or part of the consideration) for their agreement to hold the relevant office. We note that the first of these categories comprehends – indeed it expressly permits – the type of 'liquidated damages clause' against which Stapledon has argued. That is, they allow for an agreement to include provision for payment of a specified sum that may not be linked in any way to an executive's performance, and which may have to be paid irrespective of whether the departing executive has taken up alternative employment.[39] In practice, and as our empirical study confirmed, the sum agreed is likely to vary according to how long the officer has served (in comparison with the maximum duration of their service agreement), the reason for the termination, and whether the company or the officer themselves initiated the termination.[40]

Payments by way of lump sum or pension

Section 200G exempts a different category of payment from the requirements of ss 200B and E. The key concept here is that the provision (subject to the calculations) exempts payments in the nature of pension or lump sum that are given 'for past services'.[41] As we have noted, and will explore subsequently, a key issue is whether share-based payments upon termination can be said to have been made in relation to past services. If they were, then they will be covered by s 200G, although they will still be subject to the application of the statutory formula. If the payment could not be characterised as having been made by reference to past service, then it would not be covered by s 200G. If it did not otherwise fall within s 200F, the general prohibition in s 200B would apply.[42] That is, the payment would be void unless approved by the shareholders in accordance with s 200E.[43]

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[39] Stapledon, n 5 at 710-711.

[40] The United Kingdom Court of Appeal has held that an obligation to pay an amount equivalent to one year's gross salary, together with pension contributions and other benefits in kind was not unenforceable as a penalty, as it was in line with prevailing market practice: *Murray v Leisureplay Plc* [2005] All ER (D) 428; EWCA Civ 963; IRLR 946.

[41] *Corporations Act 2001* (Cth), s 200G(1)(b).

[42] We consider the relationship between ss 200B, 200F and 200G further at nn 82-100 and accompanying text.

[43] On the distinction between a payment for past service and one that is a 'gratuity', see Einstein J in *Randall v Aristocrat Leisure Ltd* [2004] NSWSC 411 at [538]; discussed at n 56-57 and accompanying text.

Any amount of pension or lump sum to which s 200F applies is to be disregarded for the purposes of the calculation.[44] Also excluded is any amount that the person contributes themselves, or that is contributed by any person other than the company and its associates, or any related bodies corporate.[45] This suggests that voluntary contributions to a superannuation fund would not have to be considered in the calculation, although it has been held that contributions made through salary sacrifice are not a contribution by the person for these purposes.[46]

The thresholds for shareholder approval

A payment will only be exempt from the requirement to seek shareholder approval if it falls within the limits prescribed in ss 200F and 200G. Those provisions include both specific rules and a formula to determine the thresholds. As noted in our introduction, according to the government, they were designed to ensure that 'relatively small payments' need not be put to the shareholders, for example, where a person's employment was of limited duration.[47] As will appear from the following overview of the provisions themselves, and as our empirical studied illustrated clearly, the provisions do not operate in this way at all. On the contrary: they appear on their face to provide for very generous payments without a need for shareholder approval. In practice, as our study showed, they permit the making of significant payments without shareholder approval, including share-

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[44] *Corporations Act 2001* (Cth), s 200G(1)(c). On the other hand, superannuation contributions made via salary sacrifice will need to be taken into account as a part of the termination payment by the company: although it is a part of the employee's salary, it is not a 'contribution made by the person' within the meaning of s 200G(4).

[45] *Corporation Act 2001* (Cth), s 200G(4).

[46] *Whitlam v Insurance Australia Group Ltd* (2005) 52 ACSR 470 at 534; [2005] NSWSC 83. The application of the provisions to superannuation payments is not without (other) complication, although a full account of the issues is beyond our present scope. Briefly, however: superannuation payments are among those that require shareholder approval under *Corporation Act 2001* (Cth), s 200E (ss 200B(1) and (2)). The position appears to be that any benefits payable by a superannuation fund must also be taken into account when calculating the permissible amount of a termination payment, and that this must also take into account any payment that falls due from the superannuation fund by reason of loss of office: Beeny C, "Directors' Benefits on Loss of Office – Some Superannuation Issues" (2003) 15 *Superannuation Law Bulletin* 3.

[47] Explanatory Memorandum Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, [5.440].

based payments that may confer very significant benefits that may not be captured by the statutory provisions requiring payments that exceed the formula to be approved by the shareholders.

The upper limit in most cases will be a multiple of the individual's average annual remuneration over their last three years of service, calculated according to the formula set out in ss 200F(3) and 200G(3), which is in the following terms:

$$\frac{\text{Total remuneration x Relevant period}}{3}$$

The 'relevant period' is the time that the person held office in the company, or seven, whichever is the lesser,[48] while 'total remuneration' means the person's total remuneration received from the company and from related bodies corporate in the last three years of the relevant period.[49] We will come later to the definition of 'remuneration' in s 9 of the Act, which is particularly important from the point of view of the effects of making share-based payments. Thus, the upper limit payable under ss 200F(3) and 200G(3) – and therefore exempt from the requirement to obtain shareholder approval – is reached when the person has held board or managerial office for seven or more years. For a person with fewer than seven years' (but more than 12 months') service in a board or managerial office, the formula noted above applies with an adjustment to the 'relevant period.'

For a person who has served more than 12 months as an officer in a company, the amount calculated under the formula in s 200F(3) (that is, a genuine payment by way of damages, or an amount agreed as consideration for taking a position) is however the relevant maximum only so long as it is greater than the officer's *actual* remuneration in their final 12 months of service, which is what would be allowed by virtue of s 200F(4)(c). Given

[48] *Corporations Act 2001* (Cth), ss 200F(3) and (5) and 200(G)(3).
[49] *Corporations Act 2001* (Cth), ss 200F(3) and 200G(3).

that the formula in s 200F(3) provides for averaging, and then multiplication by years of service, in most cases it would be likely to give a greater amount than s 200F(4)(c).[50] For a person who has served for 12 months or fewer, the company may pay them, without shareholder approval, a sum equal to 12 months' remuneration, or a fair estimate of what that would have been.[51]

The formula in s 200G(3) (pensions and lump sum payments for past services) applies in the case of an 'eligible employee', which is defined as a genuine full-time employee of more than three years' service (or periods totalling three years).[52] Otherwise the upper limit is the total remuneration that the person received during the period of three years ending when the person retired from the relevant office.[53] The reference to a person being a full-time employee shows that the intention is that the upper limit (without shareholder approval) for a payment to a non-executive director under s 200G is the total remuneration the person actually received during the period of their service when the person retires from the relevant office, up to a maximum of three years.

Total remuneration

The application of the formula in ss 200F(3) and 200G(3) is however not the only calculation required in order to determine the full amount that is permissible as a termination payment without shareholder approval. This is because the formula only relates to the amount of any *extra* payment at the time of retirement from office. The result of that calculation (in either case) must be 'added to the value of all other payments (if any) already made or payable in connection with the person's retirement.'[54] Thus it is

[50] An example of a case to the contrary would be an officer who served for two years, the first at a salary of $2 million, and the second at $8 million (because, for example, they had been promoted, or had a particularly successful year). Under the formula in *Corporations Act 2001* (Cth), s 200F(3) the company could make a payment to person without shareholder approval that would be calculated thus: (2 + 8) x 2 = 20, divided by three, which is $6.666 million. Under s 200F(4)(c), however, the maximum payment before shareholder approval would be required would be $8 million.
[51] *Corporations Act 2001* (Cth), ss 200F(4)(a) and (b).
[52] *Corporations Act 2001* (Cth), ss 200G(2)(a) and (5).
[53] *Corporations Act 2001* (Cth), s 200G(2)(b).
[54] *Corporations Act 2001* (Cth), ss 200F(2)(b) and 200G(1)(c).

the *total payment* on retirement or other loss of office that must not exceed the amount calculated by the formula. This in turn depends on the meaning of 'total remuneration' in the provisions.

II The Application of the Statutory Provisions to Share-Based Payments

A key finding from our data (at least in the absence of information on accumulated superannuation) was that the gains from exercising share options would, in most circumstances, make a very significant contribution to a final payment if otherwise unvested share options vest at termination. In our study we presented two different scenarios: the 'worst case' (for the executive), in which we assumed that all share-based payments lapsed at termination, and the 'best case', in which we assumed that all share-based remuneration vested and was exercised at termination. Assuming that all share-based payments would have lapsed, our data disclosed an average termination payment of $5,146,314, with a median value of $3,573,175. If, however, all share-based payments had vested and been exercised, the average payment would have been $14,600,705, and the median $10,835,409.[55]

The question that arises, however is whether this extra benefit that might be obtained upon the exercise of share-based remuneration is caught by the operation of either s 200F or s 200G of the Act. If so, then it may be prudent to re-examine the terms of executive service agreements entered into after 1 July 2004. If not, this suggests that the statutory provisions allow considerable scope for the exercise of discretion to confer a significant financial benefit upon a departing executive at the time of termination, notwithstanding their apparent purpose of restraining precisely this sort of conduct.

This is all the more problematic given that the formulae in ss 200F and 200G allow for a payment in some cases that would be equal to seven times an executive's average annual

[55] Sheehan and Fenwick, n 1. The methodology for these calculations depended upon a number of simplifying assumptions, which are explained at 25-29.

remuneration. As we have shown, even if we assume that all unexercised share-based payments lapse upon termination of an executive's employment, it will be possible for very many executives to extract a very significant gratuity at termination *without* the need for shareholder approval. Thus, the provisions may allow a departing executive to extract not only a significant cash payment, but *also* the right(s) to shares that will be worth significantly more in addition, without the need for shareholder approval. Whether or not they do so, however, must depend upon the proper interpretation of a number of words and expressions contained within them, and it is to these that we now turn.

Are share-based payments made for 'past services' within the meaning of s 200G of the Act?

The Act does not include a definition of the expression 'past services.' Einstein J considered the expression briefly, in *obiter* comments in *Randall v Aristocrat Leisure Ltd* [2004] NSWSC 411. There his Honour distinguished between a severance payment, and a gratuitous payment. In his Honour's view, a severance payment 'is clearly a payment for past services, being a payment made as part of the consideration for the services rendered to the employer by the employee in the course of his [sic] employment, as opposed to a voluntary or gratuitous payment.'[56]

His Honour further explained the distinction by reference to his understanding of the purpose of the relevant provisions:

> Clearly, the prevention of 'golden handshakes' is what the section is seeking to avoid. That is, voluntary payouts to directors and officers who have announced their retirement from office without any prior entitlement to a severance or other retirement payment. In those circumstances, any such payment could not be made by reference to past services. Rather, it is a gratuity, over and above what the director or officer was entitled to as part of his [sic] remuneration package.'[57]

[56] *Randall v Aristocrat Leisure Ltd* [2004] NSWSC 411 at [538].
[57] *Randall v Aristocrat Leisure Ltd* [2004] NSWSC 411 at [551].

This reasoning is supported by the operation of s 200G(1)(c): it provides that any amount of pension or lump sum to which s 200F applies should be disregarded for the purposes of the calculation.[58]

Are share-based payments 'remuneration'?

The definition of 'remuneration' in s 9 of the Act refers to a benefit that would be recognised for the purposes of an accounting standard that deals with disclosure in companies' financial reports about directors' remuneration as remuneration, if it were received by a director of that corporation. On the basis that 'remuneration' is defined by reference to accounting standards, the relevant standards that governed the preparation of the 2005 Annual Reports we considered in our empirical study were AASB 1046 *Director and Executive Disclosures by Disclosing Entities* and AASB 1046A *Amendments to Accounting Standard AASB 1046*.[59] Among other things, it is clear that superannuation payments fall within the definition of 'remuneration'.[60]

Before examining the particular standard, it should be observed that the definition of 'remuneration' in s 9 was the subject of direct judicial attention recently in *Silver v Dome Resources NL* [2007] NSWSC 455. In that case, Hamilton J held that it is necessary to give the meaning of the term a broad and purposive interpretation; one that will be substantive rather than formal.[61] In particular, his Honour expressed the view that the

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[58] On the other hand, superannuation contributions made via salary sacrifice will need to be taken into account as a part of the termination payment by the company: although it is a part of the employee's salary, it is not a 'contribution made by the person' within the meaning of *Corporations Act 2001* (Cth), s 200G4: *Whitlam v Insurance Australia Group Ltd* (2005) 52 ACSR 470; [2005] NSWSC 83.

[59] A recent ASIC Class Order (CO 06/105) highlights the similar approaches to measurement of remuneration under AASB 1046 and AASB 124 *Related Party Disclosures*. Aus 25.4 requires disclosure of 'compensation' for each key management person (defined in clause 9 to include directors). Aus 9.1.1 clarifies that while 'compensation' rather than 'remuneration' is used in AASB 124, 'both words refer to the same concept and all references in the Corporations Act to the remuneration of directors and executives is taken as referring to compensation as defined and explained in this Standard.'

[60] Section 200G(4) *Corporations Act 2001* (Cth) also makes clear that such payments must be taken into account when calculating a proportionate termination payment.

[61] *Silver v Dome Resources NL* [2007] NSWSC 455 at [106].

legislative ‘policy is to catch anything that is, in reality, a reward to the director.’[62] From the point of view that all such payments should be reported by the company, this appears to be an obviously sound approach. In the result, his Honour held that fees paid by company A to company B for consulting services provided to company A by one of its directors were part of that director’s remuneration. The result of this analysis was that the consulting fees were held to have been part of the total remuneration paid by company A to the director. Accordingly, the payments formed part of the basis for calculating his termination payment. The broad interpretation of the concept of remuneration therefore served to increase the amount that the company could pay at termination, without the need for shareholder approval. On one view, then, the court arguably failed to reconcile the inconsistent outcomes arising from such an interpretation of the meaning of the term ‘remuneration’.

For present purposes, however, let us assume that his Honour’s analysis of the legislative policy, and of the Australian Accounting Standard then relevant for the purposes of the definition of ‘remuneration’,[63] are accurate. This would tend to suggest that the gains made upon the exercise of share-based payments ought to be treated as remuneration. And so much would seem to accord with the perceived legislative policy of requiring disclosure of everything that, in reality, provides a reward to a company executive. But other, specific provisions of the Australian Accounting Standards that presently apply make it difficult to use this reasoning to determine that the gains made from share-based payments are ‘remuneration’. Appendix 1 to AASB 1046 has a list of what is included within the meaning of ‘remuneration’ and what is not. It is a long list of items. Not surprisingly, the standard deals specifically with the treatment of gains made on the exercise of share-based payments by an executive: however, these are *not* considered to be ‘remuneration’ and a company is therefore *not* required to report them: cl 5.2.14 AASB 1046. What the company *is* required to disclose is the fair value of any shares granted as remuneration, with that fair value being calculated in accordance with a specified method (cls 6.2, 6.3).

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[62] *Silver v Dome Resources NL* [2007] NSWSC 455 at [98].
[63] At the time it was AASB 1017 of February 1997: *Silver v Dome Resources NL* [2007] NSWSC 455 at [93].

In essence, then, this approach to reporting share-based payments distinguishes at a fundamental level between the allocation of a value to a grant of shares or options (viewed as an expense incurred by the company at the time that they are granted), and their value (or reward, in Hamilton J's terms) to the person who receives them at the time that rights vest. This has obvious implications from the point of view of legislation that seeks to restrain or control the giving of a 'benefit'. As we have shown, this is a very important distinction in practice, as the value of the share-based payments to executives will necessarily be much greater than the sums reported as expenses to the companies granting those shares.[64]

Strictly speaking, the definition of 'remuneration' in the Act and in AASB 1046 does go someway to meet the object that is apparently intended in regulating termination payments. That is, the company must disclose the expense it incurs, and therefore the cost to the shareholder of making the grant of shares, at the time that the grant is made. There is, however, a significant difference between this, and the benefit that may actually be received, in the sense of the gain that the individual might make upon sale of the shares, or exercise of their options. Indeed, this distinction would seem to be of the very essence of share-based remuneration: the incentive it offers is the possibility of making significant gains through subsequent appreciation of the share price.[65]

This distinction between expense to the company and the gain that an individual makes is however embedded elsewhere in the language of the statutory provisions. As noted, they regulate the giving of a 'benefit . . . in connection with a person's retirement'. At first blush it may appear that their goal is therefore to limit the gain that a departing executive might make at the time of their departure, as well as the impact on the company and the

[64] On the structure of executive remuneration and disclosure of it to shareholders see, eg, Institutional Shareholder Services, *CEO pay – It's even higher than you think: Valuation of executive options in Australia* (Institutional Shareholders Services, September 2006) and Australian Council of Superannuation Investors Inc. (prepared by Institutional Analysis), *Incentive Components of Executive Pay* (Australian Council of Superannuation Investors Inc., June 2004).

[65] As to whether there is any or any significant incentive, see, eg, Carlin T and Ford G, "Opinions on Options: Discordant Incentives and Desultory Disclosures" (2003) 2 *Journal of Law and Financial Management* 7.

shareholders of making any excessive payments. On closer analysis, however, and taking into account the limited judicial interpretation of these provisions to date, it appears that they may not be capable of doing this. This follows from the meaning (respectively) of the word 'benefit' and of the phrase 'in connection with retirement'.

Does vesting of rights derived from share-based remuneration constitute the giving of a benefit?

The Act defines 'benefit' as any benefit, whether by way of payment of cash or otherwise; and in the context of sections 200A to 200J: 'a payment or other valuable consideration; or an interest in property of any kind; or any other benefit.'[66] As we have noted, the courts have emphasized that these words have the effect of prohibiting the making of the payment. That is, the approach attaches to the 'benefit' in question (whatever its form) actually being given by the company: it does not refer to future payments.[67] Thus, where share-based remuneration is concerned, what the provision would appear to capture is the benefit conferred at the time the shares or options were granted, as distinct from the value that those shares or options may have at a later point in time. And this reading of the provisions is entirely consistent with the requirement of AASB 1046 to account for share-based remuneration in terms of a calculated net-present value.

In our view, this analysis must apply however the grant of the share or option is considered from the point of view of the definition of 'benefit': whether as a 'payment' (which in any event it is not, as it is a grant of rights in securities); an 'interest in property' (which seems to us to be its true character), or some 'other benefit'. In each

[66] *Corporations Act 2001* (Cth), s 9.
[67] *Fox v GIO Australia Ltd* (2002) 56 NSWLR 512 at 534; 120 IR 401. His Honour went on to say that his reading of both statutory and dictionary definitions of the relevant verb, 'give', led him to the conclusion that they refer to 'a concrete act, as distinct from a promise to do something. Clearly, it is the transaction itself which is intended to be caught.' This might be contrasted with some of the issues that arise in relation to superannuation payments, where it appears arguable that a benefit might be given within the meaning of the provisions, even where it is subject to compulsory preservation requirements. The situation in respect of share-based payments is discussed below.

case the legislation effectively requires an assessment of the 'benefit' that measures it in terms of the expense incurred by the company (and therefore the cost to the shareholder) at the time of the transaction, but not in terms of the subsequent (and perhaps actual) gain to the individual who receives the benefit. Indeed given present accounting standards and practices, it is difficult to see how the cost of the transaction could be measured in any other way.

In essence, then, the statutory provisions appear incapable of achieving their regulatory purpose of protecting shareholders' interests by limiting excessive personal gains by company executives, at least where share-based remuneration is concerned. As we explained initially, this is because of the basic regulatory approach, which fixes on the expense to the company as a proxy for the benefit obtained by the individual executive. What the immediately foregoing analysis has shown, however, is how deeply embedded is this fundamental contradiction within the very statutory provisions whose purpose is to regulate the practice.

Are share-based payments that vest at termination made 'in connection with retirement'?

Share-based payments and the practice of accelerated vesting pose a further challenge for the application of Part 2D.2 of the Act. The question arises whether such payments are made 'in connection with' a person's retirement from office. The proper application of the phrase is, regrettably, uncertain. As the following discussion suggests, however, it appears on balance that it would be difficult to rely upon this aspect of the provisions to capture some of the various ways in which share-based payments might vest at termination of an executive's employment.

<u>Judicial interpretation of the expression</u>

The words have received some judicial consideration, but not in the context of share-based payments. In *Claremont Petroleum NL v Cummings & Anor* (1992) 110 ALR 239;

9 ACSR 1; 10 ACLC 1685, Justice Wilcox held that the phrase is ‘one of wide import . . . [connoting a] ‘relation’ between things one of which is bound up with or involved in another’, or something ‘having to do with’ something else’.[68] If the phrase has such a broad meaning, then it might be capable of capturing both elements of the transaction: the expense incurred by the company, *and* the gain made by the individual receiving the ‘benefit’. However it is not clear that this will be possible: in that case Wilcox J also held that

> in any particular case it must be shown that the impugned payment was made ‘in connection with’ the director’s retirement from the office of director. Contemporaneity may support an inference of connection, but it is not enough that the payment was made at about the time of retirement.[69]

The emphasis on the issue of contemporaneity might be compared with how courts have analysed the relationship between the event of termination of employment and the making of a particular payment when determining cases concerning the taxation of such payments. Commonwealth income tax legislation uses the expression ‘payment made . . . in consequence of the termination of . . . employment.’[70] Broadly speaking, these words have been taken to capture any payment that ‘follows on from, and is an effect or result, in a causal sense, of that circumstance.’[71] Drawing on this, Taxation Ruling TR2003/13

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[68] *Claremont Petroleum NL v Cummings & Anor* (1992) 110 ALR 239 at 279-280; 9 ACSR 1; 10 ACLC 1685. See also *Orrong Strategies Pty Ltd v Village Roadshow Limited* [2007] VSC 1 at [683]. The decision in *Claremont* was upheld on appeal, although the appeal was in relation to other matters: *Cummings v Claremont Petroleum NL* (1992) 9 ACSR 583; 11 ACLC 125, per Burchett, French and Lee JJ. At first instance, Wilcox J drew on his own judgment in *Our Town FM Pty Ltd v Australian Broadcasting Tribunal (No 1)* (1987) 16 FCR 465 at 479-480; 77 ALR 577. In *Our Town* his Honour surveyed a number of authorities on the point. The ultimate source of the determinative words is *Nanaimo Community Hotel Ltd v Board of Refugees* [1945] 3 DLR 225, although that case deals with taxation legislation.

[69] *Claremont Petroleum NL v Cummings & Anor* (1992) 110 ALR 239 at 280; 9 ACSR 1; 10 ACLC 1685. His Honour was referring to principles derived from *Lincoln Mills (Aust) Ltd v Gough* [1964] VR 193 at 199 - later approved in *Taupo Totara Timber Co Ltd v Rowe* [1978] AC 537 at 545-6; [1977] 2 NZLR 453; [1977] 3 All ER 123.

[70] The expression was formerly found in s 27A(1) *Income Tax Assessment Act 1936* (Cth). It now appears in s 82.130(1) of the *Income Tax Assessment Act 1997* (Cth). The change was effected as part of broader changes to the tax treatment of superannuation from the beginning of the 2007-2008 financial year. See, eg, Latimer, A, “Superannuation Reform – practical implications for the employer” (2007) 18 *Superannuation Law Bulletin* 127.

[71] *LeGrand v Commissioner of Taxation* (2002) 124 FCR 53 at [33]; 195 ALR 194. The leading High Court authority is *Reseck v Federal Commissioner of Taxation* (1975) 133 CLR 45; 49 ALJR 370; 6 ALR 642 but see also *McIntosh v Federal Commissioner of Taxation* (1979) 45 FLR 279; 10 ATR 13; 25 ALR 557.

suggests a 'but for' test: if, *but for* the termination of employment, the payment would not have been made, it would have been made 'in consequence of the termination of employment.' The termination need not have been the dominant cause of the payment, although clearly a causal connection is required.[72] This suggests at least that there may be other ways of expressing and of testing the necessary connection between the fact of termination of employment and the making of a particular payment.

It is significant, however, that Wilcox J returned in the passage quoted above to the issue of the 'payment' that is made by the company. This suggests that what the courts are likely to consider is the expense incurred by the company, even if that might not occur at precisely the same time as the retirement from office. Again, however, it seems that the focus would be on expense to the company, rather than on the gain by the individual officer. Moreover, this would seem to be true also of accelerated vesting of shares or options at termination: these would have to be considered 'remuneration', and a value given to them for reporting purposes. As we have shown, however, the statutory concept of 'remuneration' cannot capture their value to the person to whom they are granted at the time that the rights are exercised – and therefore the 'benefit' that they receive. An exception to this would be a case in which the shares were granted without the benefit of any discount on their actual market value. But in practice, this would not occur: shares and options, even if not made available at a significant discount by comparison with their market value are only likely to be exercised once the share price has appreciated. As the results of our empirical study show, the extra gain that an individual might make from the sale of the shares could well add a significant amount to the final payment that they receive.[73]

<u>The application of the law to common practice(s)</u>

Four typical scenarios involving share-based payments on termination highlight the difficult issue of causation:

[72] Australian Taxation Office, *Taxation Ruling TR 2003/13* at [5] – [6].
[73] Sheehan and Fenwick, n 1.

1. The exercise of vested options by a departing executive;

2. The Board or Remuneration Committee exercises its discretion in accordance with either the executive service agreement or the rules of the share plan to waive performance conditions and allow immediate vesting;

3. A cash payment is made rather than an issue of securities or a lifting of any restrictions that may initially have been placed on holding or dealing with shares; and

4. The departing executive retains unvested share-based payments and vesting occurs in accordance with the schedule established at the time of grant.

Situation one appears straight-forward: the share plan rules under which an award is made will typically require the exercise of vested options within a certain period of time after the executive leaves the company. The options will have been granted at least in part in anticipation of future performance,[74] and the options will have vested because the executive satisfied performance thresholds. At termination, therefore, this is past performance. The question then is whether the final act of exercising the option and obtaining a share or shares can be considered a benefit given 'in connection with retirement' from office if the timing of the decision to exercise the option is determined by the termination of the executive's appointment. Arguably no: the decision to exercise the options is made by the executive, and not by the company. In doing so, the executive director is exercising a right that they held prior to termination of employment, and which is therefore not a benefit given in connection with retirement from office. (And if the 'but for' approach applied to taxation of termination payments were used, it would *not* be a termination payment: the right to exercise would exist independently of retirement from office).

[74] *Westfield Ltd v Helprin* (1997) 82 IR 411. See accompanying discussion at n 24.

As against this, however, the interest in the share is granted after retirement from office on the basis of exercise post-termination.[75] Is this temporal connection sufficient to make it a relevant benefit? As noted, 'contemporaneity may support an inference of connection',[76] but will not be determinative of the issue. Moreover, there is judicial reticence to incorporate future payments within the concept of a benefit 'given'.[77] Nevertheless it is not clear that such a payment is *not* caught. In the normal course of events, it would be expected that the managing director would have exercised the right at some time up until the expiry of that right.

Situation two is likely to be a frequent occurrence, as the data in our empirical study suggest: most of the executive service agreements we examined made some provision for acceleration of vesting of share-based payments in the event of termination of employment.[78] If accelerated vesting is provided for in the executive's contract of service, as part of the consideration for them agreeing to hold the office, the benefit would appear to fall within s 200F(2). It would therefore be exempt from any requirement for shareholder approval, unless given in an agreement entered into after 1 July 2004, *and* the *total value* of all payments made or payable in connection with the person's retirement from board or managerial office (including this 'payment') exceeded the thresholds in ss 200F(3) and (4). Our analysis of executive service agreements suggested such contractual termination payments would rarely fall outside the legislative thresholds.

On the other hand, if the acceleration of vesting results not from the terms of the executive service agreement, but an ad hoc, discretionary decision by either the board or the remuneration committee, it seems more likely that the benefit will have been given 'in connection with retirement from office'. In that case it would be the termination of employment that would trigger the decision to accelerate the vesting, and so the making of the payment. In that sense, it would be given 'in compensation for', or 'otherwise in

[75] A share is personal property: *Corporations Act 2001* (Cth), s 1070A(1)(a).
[76] *Claremont Petroleum NL v Cummings & Anor* (1992) 110 ALR 239 at 280; 9 ACSR 1; 10 ACLC 1685.
[77] *Fox v GIO Australia* (2002) 56 NSWLR 512; 120 IR 401.
[78] Sheehan and Fenwick, n 1 at 48 (Table 1).

connection with' the loss of office. In either case, however, the issue still arises how the value of such a transaction is to be measured, and whether it is possible for the statutory provisions to capture the benefit obtained by the individual, as opposed to the expense incurred by the company. It may also depend on the proportion of share-based payments that vest early: if only a pro-rata allocation is made, in reflection of actual service, then it might properly be seen as payment for past performance.

Situation three outlined above raises its own particular difficulties. In this scenario, the company agrees to make a payment in cash instead of making a share-based payment, or decides to accelerate the vesting of prior share-based payments. In some cases, the share plan itself provides for payment in cash in lieu of shares.[79] Here the situation seems more straightforward: if the payment is made at the time of termination of employment and that is the only reason for the payment having been made, then arguably it is made 'in connection with retirement.' But then the question arises whether the fact the payment is made in cash rather than in shares is sufficient to establish the requisite causal nexus, if the normal practice is to issue shares, but to pay its cash equivalent in the case of a departing executive?

Situation four also poses potential difficulties in the application of the provisions. In this situation, we assume that the departing executive is entitled to retain their interest in unvested share payments post-termination. The former executive may subsequently receive a benefit at the same time as other executives, upon satisfaction of the performance conditions governing the award. In this case, a portion of what is awarded is for performance that is not past performance of the executive. Rather, if the shares vest after the termination of their employment, the conditions will have been satisfied by company performance after the executive left. Thus, the trigger for the payment cannot have been the termination of the executive's employment, as this will have occurred some time previously.

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[79] See for example: Fosters Group Limited's Long Term Incentive Plan, Remuneration Report (2005) p 4: 'Participants who cease employment before the conclusion of a performance period are no longer eligible to receive shares, but subject to Board discretion, may receive a cash payment in lieu in cases of retirement, redundancy, ill health, death...'.

The answer to the question whether share-based payments vesting upon termination are made ‘in connection with retirement’ may also turn on how the share-based payment was initially granted to the executive. If, at the time of issue, the employee receives legal title to the shares, with an escrow period in place by agreement, there is no transfer of title at termination. For this to be captured, removing the escrow before the due date would have to fall within the meaning of ‘giving a benefit’. The definition in s 200A(1)(b) is non-exhaustive; however it is questionable whether removing a restriction falls within the meaning of the section, as the other ways of giving a benefit suggest a flow of legal rights in the form of payments or title to property from the company to the executive.[80] On the other hand, a different outcome might result if the shares are held in an employee share trust for the executive: at termination the title to the shares would be transferred from the trustee to the executive (the absolute right of the executive as beneficiary is perfected) and thus a benefit is given by a transfer of property. If the right given to the employee is an option to acquire shares, any shares subsequently issued arguably fall within the definition of ‘giving a benefit’.

To be covered by s 200G(1), the issue of shares would have to fall within the meaning of the word ‘payment’ in s 200G(6). The meaning of ‘payment’ in that section seems however to contemplate only cash or cash equivalents as payment, and not the granting of an interest in shares. If that is so, then the payment may fall within s 200F(2)(a): the issue of shares on termination may be provided for in the contract of employment as either (i) part of the genuine payment by way of damages for breach of contract, or (ii) given to the person under an agreement made before the person became the holder of the office as part of the consideration for the person holding that office. As to the latter, case law suggests this would include an agreement that varies or replaces the agreement entered into before the person became the holder of the office.[81] If the issue of shares is made

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[80] In a case concerning the application of the former tax provisions relating to eligible termination payments, it was held that a lifting of restrictions on the disposition of shares did not amount to a ‘payment’, as there was no transfer of property at the time. Rather, there were changes to the shareholder’s ability to deal with shares previously granted: *Case 28/95* (1995) 95 ATC 279; 30 ATR 1302, per Pascoe SM.

[81] *Randall v Aristocrat Leisure Ltd* [2004] NSWSC 411 at [515].

under the share plan rules, that agreement could be a collateral agreement, or it could be an agreement that varies the agreement entered into before the person became the holder of the office. In these circumstances, the 'payment' would arguably be caught by s 200F, and therefore need to fall within the threshold provided for in that section.

III Seeking Shareholder Approval: The Operation of s 200E

As we have argued, it appears that the full value to the recipient of share-based payments may not be caught by the provisions. On this basis, our empirical data suggest that most companies fall comfortably within the legislative thresholds. Indeed, relatively few would fall outside the thresholds even if the full value of share-based payments *were* taken into account.[82] Nevertheless, in recent years a number of companies have sought shareholder approval under s 200E for certain termination payments. At least one company in the ASX 200 – Toll Holdings Ltd – sought approval for such a payment at both its 2004 and 2005 AGMs. We examine some of these instances shortly.

In our view, even a brief consideration of the disclosure and approval requirements in s 200E, in light of observed practice, suggests that the statutory requirements are relatively easily satisfied. In essence, it appears to be sufficient for a company to disclose how it will calculate any payment that would trigger the statutory threshold. But the company need not disclose the *actual* value of such a payment in order to obtain shareholder approval. Obviously, this raises questions about the utility of the mechanism as a method of protecting shareholders' interests. It also raises questions about why companies are bothering to seek approval. This, however, is a question that is difficult to answer. If our analysis of the provisions is correct, the legislative thresholds are extremely generous, and few payments are ever likely to require shareholder approval. But if that is right, then why are companies bothering to seek approval? One possible answer is that companies are uncertain about the proper application of the provisions and are acting out of an

[82] Sheehan and Fenwick, n 1.

abundance of caution; another is that they perceive certain advantages in practice from obtaining shareholder approval.

Section 200E requirements

The provisions impose both process and disclosure requirements. The process obligation is found in s 200E(1). It requires member approval by resolution passed at a general meeting of the company that proposes to make the payment.[83] If the company is a subsidiary of a listed domestic corporation, that holding company must also approve the payment.[84] If the company proposing to make the payment is a subsidiary of a domestic corporation that is not listed, then that holding company must also approve the payment, unless it is itself a subsidiary of a domestic corporation.[85]

The disclosure requirements specify the information that the company must provide to the shareholders before the meeting in either the notice of meeting or the explanatory notes to the notice. The Act deals separately with proposed payments, and other forms of benefits. Broadly speaking, in each case the company must disclose either the actual value of the payment or benefit, or the method by which the payment or the money value of the benefit will be calculated. Where the company discloses a method to be used to calculate a payment or the money value of a benefit, it must also disclose matters that might affect the calculation.[86] What we suggest is that the observed practice of companies shows that this provision for disclosure of method of calculation does little to require full and adequate disclosure to the shareholders.

[83] *Corporations Act 2001* (Cth), s 200E(1)(a).
[84] *Corporations Act 2001* (Cth), s 200E(1)(b).
[85] *Corporations Act 2001* (Cth), s 200E(1).
[86] *Corporations Act 2001* (Cth), s 200E(2).

What are companies doing?

Companies that sought shareholder approval for payments under s 200E at AGMs in 2004 and 2005 include Macquarie Bank Ltd,[87] Boral Ltd,[88] and Toll Holdings Ltd.[89] In the last two examples, approval was sought in respect of the Managing Director alone.

The Macquarie Bank example is interesting because the company sought shareholder approval on the basis of the *potential* for termination benefits to be paid under its Deferred Profit Share (DPS) Plan, rather than the actual payment proposed for any particular executive director. It is also an example in which the amount of the payment could not be ascertained at the time of disclosure. The detail required by s 200E is found in the explanatory statements to resolution 6 at the Macquarie Bank Ltd's 2005 AGM. The requirement was addressed by disclosing:

- the basis on which amounts earned by the employee under its DPS Plan (an annual bonus allocated from the Bank-wide profit-sharing pool) would be calculated, 'with the size of the pool determined annually by reference to the Bank's after tax profits and earnings over and above the cost of capital';[90]

- the basis on which amounts are paid into the plan (they are withheld from each Executive Director's annual gross DPS allocation at the amount of 20% and allocated to the DPS Plan as Retained DPS);[91]

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[87] Macquarie Bank Ltd, *Notice of Annual General Meeting* (28 July 2006) pp 8-17 (resolution 6 and the accompanying explanatory notes).
[88] Boral Ltd, *Notice of Meeting* (17 September 2004) pp 4-5 (resolution 6 and the accompanying explanatory notes).
[89] Toll Holdings Ltd, *Notice of Annual General Meeting* (15 September 2004) pp 8-10 (item 9 and the accompanying explanatory memorandum). Toll Holdings Ltd, *Notice of Annual General Meeting* (26 September 2005) pp 6-7 (item 6 and the accompanying explanatory memorandum).
[90] Macquarie Bank Ltd , n 87, p 10.
[91] Macquarie Bank Ltd , n 87, p 11.

- the interest accumulating on these amounts (based on notional investment in a portfolio determined by the Executive Committee of the Bank);[92]

- the ability for progressive vesting of amounts after 5 years such that there is a rolling ten-year retention of DPS (this means that, at termination, the amount may be less than simply the total DPS paid over the time as an Executive Director may have already received a payment);[93] and

- how the amounts will be released at vesting and the ability to allow early vesting and reduction in the Retention Period, as well as disqualifying events under which an Executive Director will forfeit the right to retained DPS, or any future notional income from, and capital growth on, Retained DPS.[94]

In summary: the disclosure above outlined how the plan would work. The information that suggested potential for any one payment to be sizeable was on page 16 in a bar chart showing the aggregate value of retained DPS by years as an executive director. The bar chart disclosed that there were some executives with periods of service as an Executive Director of three, five and seven years, with aggregate Retained DPS in excess of $25 million.[95] A further Executive Director with more than 20 years' service also had retained DPS in excess of $25 million.

The case of Boral Ltd concerned the contract with its Managing Director, Mr Rod Pearse. It is an example concerning disclosure of benefits that were not payments, but which had a value that could not be ascertained at the time of disclosure. In this case, the parties entered into a new employment agreement and the area of concern appears to have been

[92] Macquarie Bank Ltd , n 87, p 13.
[93] Macquarie Bank Ltd , n 87, p 12.
[94] Macquarie Bank Ltd , n 87, pp 12 – 13.
[95] If the rules of the DPS Plan were *strictly* enforced, then the Executive Director/s with three years' service would not be eligible to receive any of that payment as the amounts are required to be retained for five years minimum…a scenario unlikely to go unchallenged by that particular Executive Director. Perhaps shareholders should presume this amount would be paid in full at termination.

in relation to the value of long term incentives that would be retained after termination in accordance with the agreement.[96] The disclosure sets out

- the term of the contract (5 years);

- the current base remuneration inclusive of superannuation and fringe benefits, as well as the annual short-term incentives as a percentage of base remuneration ($2,000,000 plus up to 100% of base remuneration as annual short-term incentive);

- the right to share-based remuneration in the form of issues of share options and share acquisition rights with an aggregate fair market value equal to 125% of base remuneration (approval sought at the same AGM for these grants to be made in November 2005, 2006 and 2007, together with another resolution in relation to a grant of share-based remuneration for the financial year ended 30 June 2004);[97]

- the contractual provisions for termination in a variety of circumstances;

- the payment for restraint of trade (125% of the total annual reward, payable in 5 tranches over 15 months);

- the reduction of outstanding long-term incentives to 75% of base remuneration over the term actually served; and

- the company's undertaking to preserve the option and share acquisition rights following termination but with existing exercise or vesting periods and any exercise hurdles continuing to apply to these incentives.

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[96] 'The amounts of the termination payments provided in Mr Pearse's new contract are significantly less than the prescribed multiple. However, the Board has received legal advice that the payments do not technically fall within any of the categories of exception set out in the Corporations Act.' Boral Ltd, n 88, p 4.

[97] Boral Ltd, n 88, resolutions 7 and 4 respectively.

The details of the grants of long-term incentives under the new contract are contained in resolution 7, with illustrative numbers of options and share acquisition rights provided in tabular form. This form of disclosure gives shareholders dollar values and percentage allocations in resolution 6, and numbers of options and fair values in resolution 7.

Observations on the operation of s 200E

The foregoing brief analysis of the shareholder approval requirements and some examples of how they have been applied in practice demonstrates that the Act falls well short of ensuring full disclosure to shareholders in respect of termination payments that would trigger the thresholds in ss 200F and 200G. This is a necessary consequence of permitting disclosure of the methods by which payments, or the value of other benefits, will be calculated. Based on the (very few) examples that we have identified, it appears that where shareholder approval is sought, in practice the company more or less asserts that the proposed payment would trigger the threshold, but does not explain in clear dollar terms why this is so. We saw no examples of disclosure that made reference to the actual current value of the threshold, in other words, the amount of termination benefits based on the executive's current remuneration that would trigger the limits. As we read the relevant provisions, neither does the Act require such disclosure.

As we have emphasized, our empirical study suggested that the statutory thresholds before which shareholder approval is required are very generous. If this is correct, companies need only ask shareholders for approval for termination payments that are potentially very large indeed. Our view of the generosity of the thresholds is in one sense confirmed by the fact that we identified so very few examples of companies seeking approval under s 200E. On the other hand, given the scale of the payments that may be made *without* shareholder approval, it is of some note that the resolutions put by Boral, Macquarie and Toll were approved. The shareholders thereby agreed to payments that may be extremely generous indeed. Without further research it would be difficult to express a firm view about what to conclude from this finding, although there are at least two obvious possibilities. One is that the shareholders, having been informed, were willing to sanction the proposed level of payments. Another is that the provisions do so little to require specificity of disclosure that the shareholders were very poorly informed about the true level of the proposed payments, and could not in any real sense be taken to have approved them.

As we noted, however, a further question that arises is why companies have sought approval, if the thresholds are as generous as our analysis suggests. One straightforward explanation may be that is not possible to be certain how much an executive will receive as part of a termination payment package. Consistently with this, s 200E requires (and permits) a company to disclose a method by which a payment will be determined, rather than an amount of a payment. If there is a realistic possibility that a payment might trigger the threshold, then that might be a sound basis for seeking approval. A second possible reason is that companies may be uncertain about the application of the provisions. As we have shown elsewhere, it is difficult to characterize particular elements of a termination payment package for the purposes of ss 200F and 200G.[98] Arguably the provisions appear to be intended to capture all the ways in which a payment might be made or a benefit conferred as a result of termination. Any payment or benefit that falls beyond ss 200F or 200G, however, would still be subject to the general prohibition in s 200B. In either case, the difficulties that attend the making of a payment that requires, but does not have shareholder approval, suggest that what might at first seem to be an abundance of caution may in fact be no more than prudence.

There also appear, however, to be at least three practical benefits in obtaining shareholder approval. First, approval allows a company to quarantine these payments from thresholds, which may be valuable if the executive director in question is a long-serving employee with significant accumulated superannuation benefits, or there is likely to be a significant share-based payment. Secondly, the Act allows companies to describe how the value will be calculated for the benefit and any matter, event or circumstance that will, or is likely to, affect the calculation of that value (s 200E(2)(b)). As the examples discussed above

[98] Sheehan and Fenwick, n 1.

illustrate, it appears relatively easy to satisfy this requirement, by disclosing information such as any option valuation methodology deployed and the relevant performance hurdles, together with any board discretions in relation to the termination. Thirdly, approval can be sought at the same time for the purposes of satisfying the requirements of Chapter 2E of the Act (related party transactions),[99] as well as the ASX Listing Rules, Chapter 10.[100]

IV Conclusion

A key finding from our empirical study and this analysis of Part 2D.2 of the Act is that it is particularly difficult to accommodate the operation of the statutory provisions to the widespread – indeed, apparently universal – practice of share-based remuneration. It poses problems for Part 2D.2 of the Act at both practical and theoretical levels. At the practical level, it is difficult to be sure of the correct application of the current statutory provisions to the practice. Particular issues that arise include whether share-based payments are 'remuneration' within the meaning of the Act, and whether the accelerated vesting of share-based payments constitutes the making of a payment 'in connection with retirement from office.'[101] The particular difficulties serve to illustrate the broader, theoretical problem with the ability of the regulatory model to respond to the nature of share-based payments. Here the difficulty lies in how the model deals with the difference between the expense of making share-based payments, and the gain to those to whom they are made.

The regulatory model seeks to protect the interest of the shareholder by limiting the expense that the company may incur in agreeing to make a particular payment. So far, so good. The weakness of this model, however, where share-based remuneration is concerned is that it fixes on the expense incurred by the company as a proxy for the

[99] Australian Securities and Investments Commission, 'ASIC seeks better disclosure for shareholders in related party transactions' Media and information release 05-63, 21 March 2005; 'Attachment to MR 05-63: Recurring common defects identified in the course of the related party campaign'. Approval is sought on the basis of falling outside the reasonable remuneration exception in s 211 and s 211(3)(b) extends the definition of remuneration to include a financial benefit given to a person because of the person ceasing to hold office.
[100] ASX LR 10.19 Termination benefits and ASX LR 10.14 Issue of Securities.
[101] *Corporations Act 2001* (Cth), s 200F(1)(a).

benefit obtained by the executive. It does this, in the words of Wilcox J, in the interest of restraining the executive from contracting with the company for personal benefit.[102] Where the benefit is a liquidated or other clearly identifiable sum, this standard regulatory model should function relatively well.

Share-based payments, however, pose an obvious problem: there is almost always going to be a significant difference between the expense to the company of making the payment, and the value of the payment or benefit to the executive to whom it is made. Indeed this is precisely how share-based payments are supposed to act as an incentive to better performance: the expense to both the company and to the individual is small, but the potential gain for the executive is very big, if they are effective in their role. But a regulatory model that fixes on the expense to the company of share-based remuneration, as a proxy for the value of the benefit gained by the executive to whom it is granted, is bound to be incapable of achieving its goal of restraining executives from profiting unduly from their control over a corporation, at the expense of its shareholders.[103]

These problems are all the more acute in the case of accelerated vesting of share-based payments. As we indicated, the practice is especially hard to accommodate within the existing provisions in Part 2D.2 of the Act. These problems are however intermingled with the broader difficulty to which we have just adverted, which is that the regulatory model is essentially incapable of controlling the extent to which an executive may benefit from share-based payments, whether they vest as planned or whether their vesting is accelerated. The problems are all the more acute because it would appear that the practice of accelerated vesting of share-based payments at termination of employment is consistent with the limited available judicial consideration of the administration of share plans for Australian company executives.[104]

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[102] *Claremont Petroleum NL v Cummings & Anor* (1992) 110 ALR 239 at 263; 9 ACSR 1; 10 ACLC 1685.

[103] Compare Ali P and Stapledon G, "Having Your Options and Eating Them Too: Fences, Zero-Cost Collars and Executive Share Options' (2000) 18 *C & SLJ* 277.

[104] As we have discussed elsewhere, decisions of the Industrial Commission of New South Wales, exercising its powers in its 'unfair contracts' jurisdiction, have held that it was unfair in some circumstances for executives to be denied access to share-based remuneration because of the termination of their employment. Whether these decisions were the inspiration for the practice or not, it certainly appears

As we have noted, Stapledon has already argued that other regulatory approaches might be more effective. Proposed alternatives include the use of rolling one-year contracts for executive service agreements; prohibitions on liquidated damages clauses in those agreements; and 'phased' termination payments, that is, monthly payments that would cease when the former executive secured another engagement.[105]

Given the prevalence of share-based payments to company executives in the Australian (and international) marketplace, we suggest that our findings show that such payments should not be excluded from the calculation of termination payments *if* the vesting of the payment is accelerated due to termination. It is clear that managing directors of ASX50 companies have high levels of share-based payments.[106] This is potential value that they would be highly unlikely to abandon at the time of a company-initiated termination of their employment. And as our empirical study found, both share plans and executive service contracts commonly provide for some proportion of these payments to vest at termination, by way of agreement at the time of appointment. Such an agreement would arguably be caught by s 200F(a)(ii) (for example, where the contract provides that the board will deem the termination a retirement for the purposes of the share plan rules). If the vesting came about through an exercise of discretion at the time any termination payment were made, then arguably it should be caught by section 200G.

However, companies could respond by lobbying for a proportion of share-based payment also to be reflected in the calculation of 'total remuneration' for the purposes of determining the relevant threshold. But this would require a change in the definition of 'remuneration' within the Accounting Standards and, more fundamentally, how remuneration is conceptualised within those standards as an expense of the company. This is relevant to how share-based payments are valued for the purposes of a termination

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that the provisions of the executive service agreements that we examined were consistent with these decisions: Sheehan and Fenwick, n 1.

[105] See generally Stapledon, n 5.

[106] The $14 million worth of options sought in *Canizales v Microsoft Corporation* (2000) 99 IR 426 at 428; [2000] NSWIRComm 118 were described by Peterson J as being of 'utterly fantastic value'.

benefit because the definition of 'remuneration' in those standards only requires the value of share-based payments to be reported by reference to their fair value.

Furthermore, we suggest that share plan provisions allowing the period for performance testing of a share-based payment to extend beyond the time the executive director is actually employed cannot be justified by the mantra of performance-based pay (incentivising performance), and are thus unacceptable. However, given a choice of regulation via amendments to the Act, the ASX Listing Rules, or corporate governance guidelines to provide the authority for such a 'rule', the choice is less clear. These alternatives were canvassed in relation to the CLERP 9 amendments for s 300A where the combination of all three models was seen as the best choice: mandatory disclosure requirements enforceable by ASIC, development of accounting standards to regularize disclosure on financial information relating to remuneration, and industry self-regulation plus greater shareholder activism.[107] While ASIC has taken early steps to ensure compliance with the requirement to hold a non-binding resolution on executive remuneration at the annual general meeting,[108] and is taking initiatives in terms of monitoring related-party transactions,[109] its scope under Part 2D.2 of the Act is tempered by the fact that the amended s 200F applies only to agreements entered into after 1 July 2004.

The variation between executive service contracts is also an issue ripe for shareholder activism. The UK experience in relation to 'Rewards for Failure'[110] is salutary and shows how institutional shareholder engagement via best practice guidelines, combined with use of the non-binding shareholder vote and subsequent consultations, together with the

[107] Regulatory Impact Statement, Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth), [4.376].

[108] Australian Securities and Investments Commission, "Not good enough – 43 listed companies fail to notify shareholders about non-binding vote on director and executive pay", Media and Information Release, No. 05-404 (20 December 2005). Twenty-six companies that opted to take no corrective action were named in the media release.

[109] Australian Securities and Investments Commission, n 108.

[110] Department of Trade and Industry, *'Rewards for failure' Directors' remuneration – Contracts, Performance and Severance, a Consultative Document* (June 2003). Rewards for failure can be defined as 'generous compensation packages to departing company directors, particularly in cases where the company has performed poorly.' (The Hon. Patricia Hewitt).

threat of government intervention via mandatory rules, can bring about rapid changes in practice.[111] As our empirical study showed, high levels of share-based payments made to managing directors at appointment and in the early years of appointment could trigger the legislative thresholds if contractual arrangements allow a departing managing director to retain all of these entitlements following termination of employment.

Moreover, the current lack of disclosure of accumulated superannuation contributions constitutes a black hole in the remuneration disclosure universe. The effect is that shareholders are being asked to make decisions about payments to executive directors without a clear picture of the overall remuneration of the particular executive director (for example, shareholders might be asked to approve a grant of share-based remuneration under ASX Listing Rule 10.14 or a payment under Chapter 2E of the Act). Given that annual superannuation contributions as disclosed in the Remuneration Report can be as high as 50 per cent of base salary, the accumulated contributions will be sizeable.

Finally, we suggest that there is a need for clearer guidance in terms of the requirements for disclosing payments or benefits whose value is unable to be ascertained at the time shareholder approval is sought under s 200E. Is the intention of the legislature satisfied by disclosing plans under which a company may make a payment at termination, without linking shareholder approval to the payment likely to be made to a particular executive or executives? Are the information needs of shareholders satisfied by seeking approval under s 200E without disclosing to shareholders what in present terms is the level of the threshold for any given executive?

While we are hesitant to suggest that the answer lies simply in more disclosure, we are confident in our conclusion that the current laws surrounding such payments clearly require some adjustments and clarification to achieve their intended purpose. Apart from anything else, it is abundantly clear that the statutory formula allows companies to make

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[111] Deloitte, *Report on the Impact of the Directors' Remuneration Report Regulations - A Report for the Department of Trade and Industry* (2004) p 19; Thompson S, "The Impact of Corporate Governance Reforms on the Remuneration of Executives in the UK" (2005) 13 *Corporate Governance: An International Review* 19 at 22.

payments to departing executives, without shareholder approval, that are by no stretch of the imagination 'relatively small'.[112]

[112] Explanatory Memorandum Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, [5.440].