Termination

by John Egan

This article is based on material provided to the Productivity Commission in a submission on its enquiry into director and executive remuneration in Australia

The treatment of termination payments, recognising the complex nature of their sources, means that requiring shareholders to undertake the required study and analysis of their sources is putting an unfair burden on the shareholders when it is the recognised role of the Board to manage these matters. We would support much clearer methods of disclosure in this area reducing the opportunities for uninformed and inflammatory comment.

Reasons for making termination payments
Termination payments to executives are made for a number of reasons.

These can include:

- special provisions in their employment contracts arising from their recruitment such as unlatching costs deferred from recruitment to termination;
- special retention and service agreement provisions, the desired outcomes of which may be met early where contractual payments are due on termination, whether early or as scheduled;
- provisions in employment contracts in regard to illness or death;
- the delivery of deferred awards under incentive plans (STIs and LTIs);
- as compensation for early termination due to corporate restructure or merger;
- acknowledgement of dealing with special challenges; and/or
- entitlements under superannuation plans.

Some of them may not be included in the calculation of termination payments for the purpose of the restrictions in the Corporations Act but most are.

Problems with regulation of termination payments
Because of the wide variety of types of payment, regulation needs to be sophisticated. There needs to be a clear concept of why there are limitations and what they are designed to achieve.

It would appear that the current initiatives are partly a response to comments triggered by the global financial crisis, as well as the fact that a number of high-profile CEOs have departed recently taking with them the accumulated incentive and retention payments of years of service. It has not suited the press to explain these payments as accumulations from successful years from which shareholders have benefited as well.

Perceived excesses in some executives' termination payments can be the result of poor communication of the elements in the total but also can include an excess over the recognised market practice at the time. Because of the complexity of contemporary commerce, there can be no standard formula for executive remuneration.

What is regarded as reasonable from time to time must be influenced or guided by the overall behaviour of the market, the nature, size and success of the employer organisation and the significance of the executive's position in the organisation.

For the same organisation, the levels of reasonable remuneration and termination payments will vary from time to time. The freezing of executive remuneration levels in many organisations in Australia during the current crisis is a clear illustration of this process. This does not mean that remuneration levels were all excessive or unreasonable, some obviously were, but rather that market forces and market sentiment are a strong influence on market practice.

Why do terminations occur?
Executive termination can arise for a number of reasons, many of which may be planned, others not. Directors need to have the flexibility to decide on timing and terms and execute quickly.

Reasons for termination may include:

- early or planned retirement;
- corporate restructure, including mergers and divestment of businesses;
- contract term not renewed or fixed term contract expires;
- early implementation of planned succession;
- business failure;
- poor performance;
- ill health or incapacity due to injury or other cause;
- a family member's ill health (executive assuming a carer's responsibility);
- cause/dismissed for breach of a company's code of conduct or agreed terms of employment.

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Boards have the knowledge and skills which shareholders do not possess in relation to the intimacy of issues requiring management on a day to day basis in representing shareholder interests. While democracy in many respects reflects positive features, democracy is not the manner in which major and complex organisations should be managed, nor is it a framework for challenging commercial negotiations.

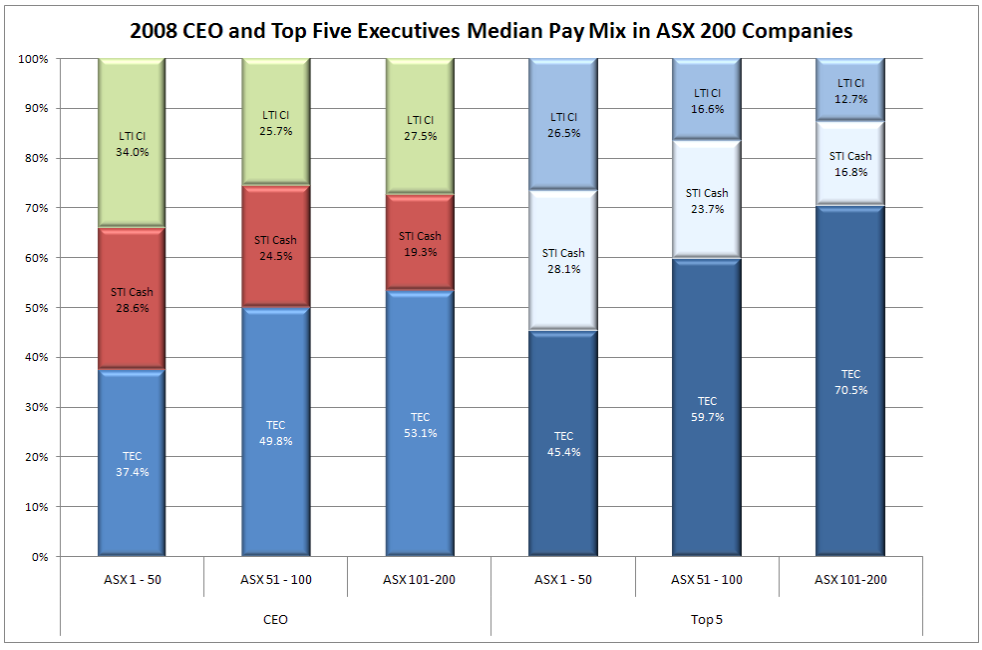
Asking for shareholder approval

We do not believe it is appropriate for shareholders to be asked to approve termination provisions, which require speedy execution in most instances. Nor do we believe that shareholder approval should be sought in relation to entering into contractual terms with a senior executive, including a Chief Executive Officer. As noted above, boards are in the best position to make commercial decisions in this regard.

It would be our judgement that a set of principles and guidelines should be prepared by the Commission as a result of its research and to the extent considered practicable those guidelines should be embraced by the ASX in an enhancement to the established best practice corporate governance guidelines.

The nature of executive reward, which is well documented in service agreements, letters of appointment or comprehensive deeds, does not constitute a focus on salary. While these documents are comprehensive, in a significant commercial negotiation without doubt the most important clause is the one dealing with how an executive will be dealt with if terminated.

The graph below highlights the structure of remuneration among the ASX top 50, second 50 and second 100 companies for the position of CEO and top five executives excluding the CEO. It reveals that the indicative proportion which salary represents of an executive's reward is less than 60% and in the ASX top 50 companies typically less than half.



The chart highlights the annualised value of reward, though excludes relevant data on deferred remuneration to which an executive would be generally entitled. It also excludes the carried interest on a marked to market basis of securities which are capable of vesting during a notice period and/or those which have vested but have been retained by the executive, either on a mandatory basis or at their choice aligned to their shareholder commitment.

The management of separation in these circumstances needs to be dealt with sensibly, reasonably and speedily. This cannot be done if boards require shareholder approval. The disclosure of termination settlements, where they are at variance with disclosed contract entitlements, in our judgement represent an appropriate item for disclosure after the event.

It needs to be recognised that these contractual arrangements represent significant commercial considerations for an enterprise and constitute material contracts which in many instances would represent a settlement of several million dollars. These settlements are not unreasonable if an executive has served an extensive period with the organisation and over that time accumulated substantial shareholdings and superannuation or other entitlements.

A board may of necessity seek an independent assessment as to whether the termination settlement which they are proposing is reasonable, though we can assure the Commission in this context that an independent consultant will place emphasis on both existing contractual entitlements and relevant commercial considerations at the time of termination. These commercial considerations can include disruption to the business, the likelihood of being sued and the costs associated with managing any litigation, both those incurred in retaining legal counsel and the loss of application to the ongoing management of the business by tying up executives in such matters.

Egan Associates accept that termination is not always straightforward. Our observation is that a substantial proportion of termination settlements are in accordance with disclosed agreements, though occasionally a board will exercise its discretion for purely commercial reasons. This is a critical role of the board in either managing the appointment or termination of a CEO or supporting a CEO in the appointment or termination of a senior executive.

Level 16, 6 O'Connell Street Sydney Tel (02) 9225 3225 Fax (02) 9225 3235 www.eganassociates.com.au