



Proposed increased regulation of executive termination payments:

the Corporations Amendment

(Improving accountability on termination benefits)

Bill, 2009

On a global level executive remuneration has become a topic of much political and social debate. Currently there is a high level of public "outrage" against executive remuneration. In Australia this has led to proposed legislation reform to increase the regulation of executive termination payments.

Current Legislative Framework

In Australia under both the common law and the *Corporations Act, 2001* (Cth), company directors of public companies are under an obligation to act in the best interests of the company. The board of directors of a company are responsible for the appointment of executive directors (executives) and must ratify the proposed remuneration for the executive by way of a board resolution. In doing so the directors must act in the best interests of the company which requires them to attract, retain and motivate executives to ensure that they provide effective leadership.

Although shareholders have no direct role in determining executive remuneration, it is a general requirement that shareholder approval be obtained with respect to remuneration unless:

- it is a financial benefit given at arms' length;
- it constitutes reasonable remuneration; or
- the financial benefits do not exceed \$2,000.

Requiring shareholder approval ensures transparency with respect to the quantum of remuneration provided and that appropriate performance measures are in place. If not approved by shareholders, an executive's remuneration may be voidable.

Of specific concern is the significant payments provided to executives upon the termination of their employment. The *Corporations Act, 2001* (Cth) prohibits the payment of a benefit in connection with a person's retirement from a board or managerial position unless:

- it is approved by the shareholders; or
- in the event that the payment is given at arms' length, it constitutes reasonable remuneration; or
- the financial benefits do not exceed \$2,000.

However, the formula under the *Corporations Act, 2001 (Cth)* to assess a "reasonable" payment is quite generous. In particular, a termination payment does not require shareholder approval unless it exceeds a final average of total remuneration over the last three years of the executive's employment or is in excess of seven times the executive's total annual remuneration package, whichever is lesser. This formula has resulted in significant termination payments, commonly referred to as "golden parachute" payments, being provided to executives in the current difficult economic times.

Proposed Reform

On 5 May 2009 an exposure draft of the *Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009* (the Bill) was released. The Bill proposes to significantly reduce the threshold at which shareholder approval is required for a termination payment from seven times an executive's annual remuneration package to one time the executive's base salary. The aim of this proposal is to limit the use of "golden parachutes" given the criticism that they have the perceived effect of rewarding executives when they fail to perform. The Bill acknowledges that there is a balance to be maintained between protecting an executive in the event of loss of office and managing shareholder

perception that company funds are being dissipated through excessive termination payments.

In addition, the Bill aims to expand the number of company officers for whom shareholder approval of remuneration is required to include. This will increase the scope of regulation. The Bill further aims to broaden the definition of what constitutes an assessable "termination benefit" to again increase the scope of regulation.

In terms of enforcement, significantly higher penalties have been proposed for both individuals and corporations. In addition, a mechanism by which shareholders can assess termination payments in the context of an executive's actual performance has been proposed.

Impact of proposed reform

If enacted, the Bill will only apply to contracts entered into after the introduction of the proposed amendments to the *Corporations Act, 2001 (Cth)*. However, company boards should be mindful of the proposed legislative reform when negotiating upcoming executive remuneration. In particular, board members should be mindful of which elements of an executive's remuneration may be subject to shareholder approval as a result of the lowered thresholds proposed.

Next steps

It is anticipated that the Bill will be introduced into Parliament during the winter sitting. Further, the Productivity Commission is currently examining the regulation of director and executive remuneration. A final report is expected to be released by 18 December 2009.

Trends in director and executive remuneration in Australia and internationally; the role of shareholders; and mechanisms to better align the interests of boards and executives with those of shareholders will be examined as part of the inquiry process.

Please contact Kristen Lopes or Sam Ingui should you have questions arising from the proposed increased regulation of executive remuneration.

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