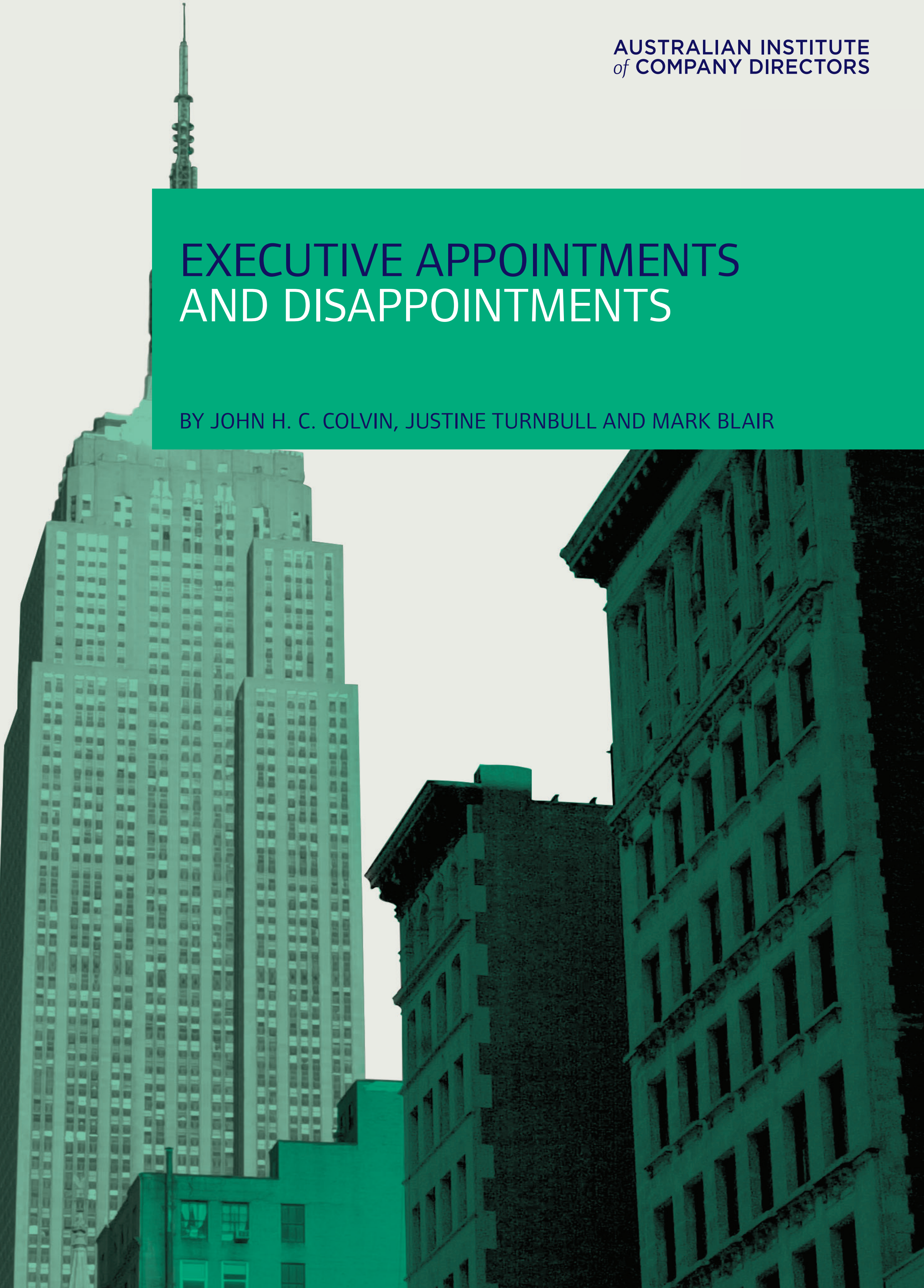
AUSTRALIAN INSTITUTE *of* COMPANY DIRECTORS

EXECUTIVE APPOINTMENTS AND DISAPPOINTMENTS

BY JOHN H. C. COLVIN, JUSTINE TURNBULL AND MARK BLAIR



EXECUTIVE APPOINTMENTS AND DISAPPOINTMENTS

John H.C. Colvin

FAICD, BEc (Hons) (Syd), MSc (Econ) (LSE), MA (Oxon) Law

Justine Turnbull

BEc (Syd), LLB (Honours) (Syd)

Mark Blair

GAICD, BEc (Hons) (Syd), PhD (Economics) (Syd)

AUSTRALIAN INSTITUTE
of COMPANY DIRECTORS

The Australian Institute of Company Directors is a member institute for directors dedicated to having a positive influence on the economy and society by promoting professional directorship and good governance. Company Directors delivers director development programs, information and advocacy to enrich the capabilities of directors, influence the corporate governance environment in Australia and promote understanding of, and respect for, the role of directors. With offices in each state of Australia and more than 30,000 members, Company Directors represents a diverse range of organisations from the top ASX 200 publicly listed companies to not-for-profits, public sector entities and private companies.

Published in July 2013 by:
The Australian Institute of Company Directors
Level 30, 20 Bond Street
Sydney NSW 2000
T: 61 2 8248 6600
F: 61 2 8248 6633
E: publications@companydirectors.com.au
W: www.companydirectors.com.au

Text design Kirk Palmer Design
Printed by Ligare Pty Ltd

National Library of Australia
Cataloguing-in-Publication Data

Executive Appointments and Disappointments
Colvin, John H.C.
Turnbull, Justine
Blair, Mark

Australian Institute of Company Directors

ISBN: 978-1-876604-20-2 (pbk)
Corporations – Executive employment
Corporations – Executive remuneration
Directors of corporations – Australia
Corporate governance – Australia
Board of directors – Australia
658.456

Contents

Acknowledgements

All books published by the Australian Institute of Company Directors are authored by experts in their fields as demonstrated by our three authors: Mr John H.C. Colvin FAICD, Ms Justine Turnbull and Dr Mark Blair GAICD. Their experience in the topic of executive employment agreements and remuneration is covered in more detail below.

Just as importantly as the choice of author, our books are also peer reviewed by directors with profound hands on experience in the topic to ensure our publications meet the rigours of the practical board environment. With Ms Yasmin Allen FAICD and Mr Peter Coates AO FAICD as reviewers, *Executive Appointments and Disappointments* had the benefit of two of Australia's most tenured non-executive directors who have also served as chairmen, as well as chairmen of nomination and remuneration committees. We offer our thanks and acknowledgement for their input and guidance.

About the authors

John H. C. Colvin

John Colvin was appointed as chief executive officer and managing director of the Australian Institute of Company Directors in 2008.

Prior to this appointment, John was head of the Sydney office of Freehills and also founded the Sydney office's Employee Relations practice. His significant experience in this field meant he was sought after by chairmen, boards and executives to advise on employee relations issues and corporate governance. John also had extensive experience in structuring, drafting and negotiating executive remuneration agreements. He has been appointed to several boards andserved on board committees, including nomination and remuneration committees.

John has been an adjunct professor at the Australian Graduate School of Management (AGSM) in the University of New South Wales, and also taught part-time at Sydney University's Law School. He has written and lectured extensively on corporate governance in Australia and overseas.

John is chairman of the Global Network of Director Institutes (GNDI).

Justine Turnbull

Justine Turnbull is a lawyer and practices in employment law focusing on employment and post-employment obligations and disputes, executive employment arrangements and discrimination and harassment claims and investigations in Australia. Justine has a particular passion for key people management and retention as a driver for business success. In 2013, she was included in the Best Lawyers Labour & Employment and Employee Benefits lists.

Justine holds a Bachelor of Economics majoring in Accounting and a Bachelor of Laws (Honours) from the University of Sydney. She is a member of the Australian Human Rights Institute and regularly presents at seminars and conferences. Justine writes and comments on trends and developments in executive remuneration and diversity law and practice.

She is a partner in the Employment, Pensions and Incentives practice area at Herbert Smith Freehills in Sydney.

Mark Blair

Mark Blair is a senior policy advisor at the Australian Institute of Company Directors. He has almost 20 years of policy experience at a range of organisations, including the Australian Securities Exchange, the Companies and Securities Advisory Committee, the Australian Securities Commission and the Australian Law Reform Commission. This reflects Mark's keen interest in policy reform and corporate governance issues, including executive remuneration.

Prior to joining Company Directors, Mark was the ASX National Manager–International Affairs, and previously the ASX Assistant Manager–Companies (NSW).

Mark was awarded a Bachelor of Economics (Honours) and a PhD in Economics from the University of Sydney. He is also a graduate member of the Australian Institute of Company Directors and a member of CPA Australia.

Foreword

As a non-executive company director I have always known that probably the most important decision I will make is the choice of the chief executive officer, and in turn, the senior members of staff.

This is a role which most directors perform infrequently and therefore almost always approach it in a relatively inexperienced manner and at the same time, enter an area of enormous complexity, both from a legal and personal point of view.

"Executive Appointments and Disappointments" provides practical help to directors, and indeed executives, in this complex area. It does so in a pragmatic and straightforward way making it a publication of enormous practical help and assistance.

The book provides a wonderful summary of the issues that have to be looked at both prior to contract, in relation to the terms of the contract (particularly remuneration), and subsequently (sadly) when there is a need for termination or other resolution of contractual rights.

Even after 35 years in business, I found the practical tips in the book extremely useful and thought-provoking. The examples given, demonstrate well the principles which are being explored and also elevate what could be a dry statement into something more real and indeed, at times, very entertaining.

The depth of experience in this field of the three authors shines through as they expand the more narrow focus to include important issues such as the protection of business interests, the consideration of privacy and antidiscrimination.

All who are likely to be involved in the employment of executives should have a copy of this book readily available to them. I will certainly do so. The only concern I had as I read the book was how I had survived for so long without a copy of something like this near at hand.

I congratulate the authors on this publication and advocate an early and regular read of its contents.

David Gonski AC FAICD*Life*
4 June 2013

Introduction

Executive appointments are critical to business success and an important element of corporate governance. The appointment of the chief executive officer (CEO) is arguably the single most important decision made by the board. It will affect the company's culture, determine the company's ability to attract a high performing executive team and is key to driving shareholder value.

As part of the CEO selection process, the board must ensure arrangements with the chief executive are attractive to the individual, easily understood by all relevant stakeholders and comprehensively cover financial and other appropriate terms between the individual and the company. Similarly, the chief executive will have the same responsibilities when engaging senior executives.

The board of directors, or a representative of the board, will need to seek agreement to the proposed terms from the candidate, and then document these terms of engagement.

The most controversial terms of the relationship between a company and its senior executive usually relate to remuneration or pay. Remuneration of executives is often also a 'hot topic' in the media and subject to heated public debate, often for the following reasons:

- in some large publicly listed companies, and in the financial services industry, remuneration may be considered high relative to other companies, industries and average earnings
- remuneration may be considered easier to understand as compared to, for example, company profitability or long term strategy
- some individuals and groups have strong ideological views about executive remuneration, causing the topic to be highly politicised, especially in the Australian political and cultural context
- commentary by company and shareholder advisers, and other remuneration specialists on the issue, constantly raises awareness for shareholders and others
- the emotive nature of pay relativities between senior executives, especially CEOs in listed companies and other employees, makes media coverage on the issue popular.

Generally, specific remuneration arrangements are a result of market forces (supply and demand), regulation, the board's view of the value of the specific executive and negotiation by the parties.

Rarely do both parties get exactly what they want. A common example arises when executives are recruited from overseas, such as the United States, usually to fulfil specific industry experience or skill requirements; recent high profile Australian examples of executive level recruitment of overseas candidates include casinos and telecommunications. Executives from the US often seek enhanced benefits on termination of their engagement before a fixed period to cover or compensate for the risks involved for them. However, under Australian law this may require the approval of the company's shareholders in a general meeting, which the board may not want to do.

Linking long term incentives with a company's share price is another controversial remuneration issue. Boards and shareholders are not always aligned on this issue.

Importantly, for the protection of the company *and* the executive, arrangements for the cessation of the employment relationship, and therefore the employment contract, must also be considered and agreed to in advance to achieve (as far as possible) a predictable and easy separation when the time comes, or if circumstances require.

The difference between an executive who is appointed as an employee and one who also becomes a director is important. Executive directors may be engaged in two separate legal arrangements – one as an employee and one as a director. In many cases, these positions overlap, however, there are some key areas where they do not. Similarly, non-executive directors are not employees but will have certain obligations to the company in which they serve.

This book has been written for the benefit of directors and managers and aims to cover topics in a pragmatic and straight-forward way, which hopefully the reader will find easy to understand and implement. It is not aimed at a legal audience and it does not constitute legal advice, although it may be of some use to some practitioners from time to time.

We trust this book will be of practical help for directors and executives making executive 'appointments', and will also assist in avoiding executive 'disappointments'!

Chapter One

Good practice when appointing CEOs and other senior executives

Introduction

This book focuses on outlining legal requirements relating to entering into or terminating CEO and senior executive employment contracts. This chapter focuses mainly on the setting of remuneration and helps to set the scene for what follows by providing an overview of what is commonly regarded as good corporate governance practice when appointing a CEO and other senior executives, as well as when terminating these employment relationships.

Good practice guidelines

Standards in corporate governance practice began to gain prominence internationally in the early 1990s, including in the United Kingdom, Canada, South Africa, Hong Kong and Australia. This included an increased focus on the corporate governance activities of listed companies.

In Australia, we saw the introduction of several sets of guidelines – most notably the Corporate Practices and Conduct Working Group Guidelines, otherwise known as the Bosch Committee Guidelines with versions released in 1991, 1993 and 1995, and the Australian Investment Managers' Association (AIMA) Blue Book, released in 1995. In 1996, the Australian Stock Exchange (ASX) introduced a listing rule that required listed companies to provide an annual statement of the corporate governance practices they had in place.

In late 2002, following high profile corporate collapses in the United States (Enron, World.com and others) and in Australia (HIH Insurance), the ASX Corporate Governance Council (the ASX Council) was established.

The Council has 22 members, including representative groups spanning a wide range of stakeholder interests. In early 2003, the ASX Council released its *Corporate Governance Principles, Recommendations and Guidance* (the ASX Council Guidelines). Around the same time, the ASX Listing Rules were amended to require listed companies to report against the recommendations contained in the ASX Council Guidelines on an 'if not, why not' basis.

The ASX Council guidelines have become a common reference point for good corporate governance practices. In addition, many of the groups represented on the ASX Council continue to publish their own guidelines, mainly on matters not covered in the ASX Council guidelines (e.g. more detailed matters or where there is less consensus from the ASX Council).

Some of the most prominent corporate guidelines overseas include:

- United Kingdom, 2010 – the Combined Code on Corporate Governance
- South Africa, 2009 – the Code of Corporate Governance Principles for South Africa, King Committee on Governance
- Europe, 2004 – the Organisation for Economic Co-operation and Development (OECD) Corporate Governance Principles
- Global 2009 – Statement on Global Corporate Governance Principles from the International Corporate Governance Network (ICGN).

Australian guidance

The main published guidance pertaining to the appointment of CEOs focuses on the structures, policies and processes governing remuneration arrangements.

Principle 8, "Remunerate fairly and responsibly", of the ASX Council Guidelines states that "Companies should ensure that the level and composition of remuneration is sufficient and reasonable and that its relationship to performance is clear". Under this principle, the council provides some key recommendations and associated guidance listed companies are required to report whether or not they have complied with these recommendations for the relevant reporting period, and if not, they need to explain why not.

ASX Corporate Governance Council Recommendations

The council makes four main recommendations under its Principle 8 'Remuneration fairly and responsibly':

Recommendation 8.1: The board should establish a remuneration committee.

Recommendation 8.2: The remuneration committee should be structured so that it:

- consists of a majority of independent directors
- is chaired by an independent chair
- has at least three members.

Recommendation 8.3: Companies should clearly distinguish the structure of non-executive directors' remuneration from that of executive directors and senior executives.

Recommendation 8.4: Companies should provide the information indicated in the guide to reporting on Principle 8.

There are more detailed guidelines provided by other organisations. In particular, the Australian Institute of Company Directors has issued a range of principles-based publications on executive remuneration, including:

- *Executive Remuneration: Guidelines for Listed Company Boards*, February 2009
- *Executive Termination Payments*, Position Paper, October 2008
- *Non-Recourse Loans Provided to Executives*, Position Paper, May 2008
- *Executive Equity Plan Guidelines*, Position Paper, March 2007
- *Good Practice Guide to Remuneration Committees*, 2004.

Guidelines have also been published by investor groups including the Australian Council of Superannuation Investors (ACSI), the Australian Shareholders' Association (ASA), the Financial Services Council (FSC) and Regnan.

Company Directors' 'Executive Remuneration: Guidelines for Listed Company Boards'

In its February 2009 guidelines, Company Directors outlined some actions for boards 'to do', some actions 'not to do' and some potential actions 'to think about'. An extract is provided below.

Some actions for boards to do:

- ensure the board maintains control of negotiations with CEO candidates, and where appropriate, other executives

>

- undertake ‘stress testing’ of proposed incentive arrangements before entering new contracts or agreeing to variations or renegotiations
- link incentive elements of remuneration packages to appropriate performance measures in such a way that short-term imperatives of the company are pursued, while simultaneously promoting the company’s long term interests
- consider the possibility of contract termination when negotiating executive contracts and include appropriate provisions in the contract
- ensure remuneration packages are publicly defendable.

Some actions not to do:

- have executives involved in setting their own remuneration for the obvious conflicts that may arise
- overly rely upon advisers at the expense of board discussion and the exercise of board judgment
- put in place arrangements that promote excessive risk-taking or short-termism
- change performance hurdles midstream unless there is an exceptionally good reason or reasons.

Some things for boards to think about:

- whether to have a discretionary bonus, rather than a bonus that the board is contractually obliged to approve, regardless of changed circumstances
- placing an upper limit on short-term and long-term incentive rewards, where such components exist, to minimise ‘surprises’ of markets, products, and so on.
- putting in place arrangements whereby a percentage of a CEO’s long-term equity incentive rewards are held for a period that extends beyond the term of the employment contract
- engaging with major shareholders and other relevant stakeholders regarding the company’s approach to remuneration, subject to continuous disclosure obligations.

Planning stage

The need to appoint a new chief executive officer may arise for a variety of reasons, some of which are within the control of the board, such as termination of the CEOs employment; while others are not within the control of the board, such as a the resignation or death of a chief executive.

As such, the amount of time available to make an appointment can vary from case to case. Regardless, it is good practice to have a planned approach in the event of a new appointment being necessary. This could be considered as part of a succession planning process.

Some actions for boards to consider when appointing a new CEO

1. Does the board have appropriate structures and processes in place for appointing a new CEO, including identifying suitable candidates with the desired qualifications and experience?
2. What is the appropriate strategy (or strategies) for identifying candidates?
3. Are there suitable internal candidates?
4. Where appropriate, does the board have access to external advisers, such as an executive search firm, legal adviser and/or remuneration consultant?
5. Has the board put in place appropriate safeguards to ensure the confidentially of advice received and deliberations, especially from the incoming CEO?
6. What contractual terms are appropriate?
7. What is an appropriate remuneration package, and how is this to be determined?
8. Does the board have a communications plan regarding the appointment?

Search process

This publication focuses more on putting in place appropriate employment arrangements, rather than the search aspects of a CEO appointment.

Having said this, the governance arrangements for identifying appropriate CEO candidates are often intertwined with those arrangements for cementing the eventual appointment.

For example, it is often considered good practice:

- to decide on a remuneration range the company is prepared to pay before starting a CEO search
- for the same board representatives to be involved throughout the process.

The nature of the search process commissioned or undertaken by a company for a new CEO (or other senior executives) will depend on its circumstances, including the nature of its operations, the reason a new CEO is being sought, whether there are any appropriate internal candidates for the role, the degree to which a succession plan is in place, the suitability of internal candidates, and so on.

For some companies, the CEO search process will involve the engagement of a professional executive search firm. For larger companies, it may also entail looking both locally and internationally to identify a list of suitable candidates.

The board should have confidence that it is in control of any representations made to CEO candidates about matters such as the state of the company, the ability to achieve performance hurdles, and any likely changes to the role.

Negotiation phase

Negotiation of the CEO employment contract and, where appropriate, the contracts of the CEO's direct reports, is a matter for which the board must accept responsibility and control. The board, or its duly-appointed representative, must undertake these employment negotiations in the company's best interests. Sometimes the board chairman, chairman of the remuneration committee or another member of the board, are authorised to conduct negotiations on behalf of the board.

Generally, it is the company that will provide the executive candidate with a draft contract, rather than receiving one from the candidate. This helps to mitigate the difficulty of renegotiating an initial draft that the board could deem unsatisfactory.

With this in mind, the board will generally wish to obtain advice on the draft employment contract before forwarding it to a candidate. This advice should encompass any letters regarding possible arrangements to be sent to the candidate from the company, or its representatives, prior to sending the formal contract. The board should be satisfied with the draft, and comfortable that it complies with existing laws and ASX Listing Rules, and is consistent with the company's strategy and remuneration guidelines.

Usually after taking initial advice from a remuneration consultant, the board will turn its attention to the maximum amount the company is prepared to pay a suitable candidate. This upper limit should not be disclosed to candidates, but is used as an internal check on negotiations. This can also extend to designing other compensation arrangements. Such forward planning should help ensure that the company's circumstances, internal pay relativities and 'fair' market value get considered before negotiations with a preferred candidate begin. This preliminary work could be used to instruct consultants and manage the expectations of potential candidates. Such a process can be particularly useful where a global executive search is being undertaken.

Again, care should also be taken to control any representations made to candidates.

Some issues for boards to think about prior to negotiations

- the skills, experience and other personal leadership characteristics important for the position
- obtaining advice on the draft employment contact
- forwarding the draft employment contact to candidate
- considering what amount the company is prepared to pay for a suitable candidate and/or whether remuneration advice is appropriate or necessary.

Framework for dealing with executive remuneration issues

Remuneration committee

It is widely acknowledged that establishing a remuneration committee to assist with remuneration matters, performs a key role in assisting the board in fulfilling its corporate governance responsibilities.

The remuneration committee advises, recommends, monitors, and reviews remuneration decisions but does not act for the board, except where it is specifically delegated to do so under the company's constitution or given such powers by the board itself. Nevertheless, the entire board takes final responsibility for decisions made on the basis of any committee advice.

The remuneration committee is generally comprised solely of non-executive directors to promote independent judgement, and offers the board an opportunity for many non-executive directors to take part, which also helps mitigate conflict of interest issues.

While all directors at law are required to exercise independent judgement, some industry guidelines go so far as to state that the committee members (or a majority of them) should meet various criteria for 'independent' non-executive directors (defined by reference to current and past relationships with the company).

While a remuneration committee is good practice for boards of larger companies, particularly listed companies, for smaller companies, the costs associated can outweigh the benefits. In such cases, the board should consider instituting an approach that covers the issues that would otherwise be dealt with by a remuneration committee.

Interacting with external advisers

External advisers can play an important role in assisting boards and remuneration committees by establishing remuneration arrangements and determining appropriate remuneration levels.

In large companies, particularly large listed companies, it has become commonplace for companies to engage search firms, legal advisers, remuneration consultants and other advisers to assist with the negotiation and formalisation of an executive's employment contract. This is not surprising given the increasingly complex nature of such contracts, particularly remuneration arrangements. Boards cannot be expected to be across the legal, financial modelling, accounting and tax aspects of many of today's executive remuneration packages, the intricacies of incentive plan design, market trends and so on.

Suggested questions for boards preparing to work with advisers

1. Does the adviser have the relevant expertise to undertake the required task/s?
2. Does the adviser have a separate relationship with the company, or the company's executives, that compromises (or could be seen to compromise) the adviser's independence? For instance, has the adviser been separately engaged by the CEO for other remuneration or legal work?
3. Are there appropriate 'Chinese walls' concerning instructions to the adviser from the board, as well as for advice subsequently provided to the board by the adviser?

In order to enhance the integrity of the company's processes for determining executive remuneration, executives must not be able to influence advice given by third parties to the board, or have access to this advice for use as a negotiating point. If and when the board engages advisers and consultants to assist with executive employment terms, it must ensure the advice is commissioned by, and provided directly to, the board, independently of company management. For example, legal advisers negotiating an executive employment contract on behalf of the company (board), must receive instructions solely from the board and provide advice solely to the board.

It is good practice for the board to use different advisers or consultants to those engaged by its executives. There are also requirements in Part 2D.8 of the *Corporations*

Act 2001 (the Corporations Act or the Act) designed to promote 'independent' advice where a remuneration consultant is appointed to make recommendations in relation to the CEO or other key management personnel; these were introduced in 2011.[1]

Expert advice has its place but it is not a substitute for the board to exercise its own judgment. Under section 189 of the Corporations Act, reliance by a director on information or professional or expert advice about matters such as remuneration issues, is taken to be reasonable if the reliance is made in good faith and after making an independent assessment of the information or advice. Ultimately, however, the board is answerable to shareholders for the remuneration arrangements it approves.

This accountability is brought into focus by the annual advisory shareholder vote and board spill mechanisms associated with remuneration reports of listed companies, as well as through directors offering themselves for re-election.

Elements of remuneration contracts

Sign-on fees

Sign-on fees are sometimes used by companies as a means of compensating an incoming CEO for bonuses that are foregone by leaving the previous employer and to entice the CEO to join the company. Company Directors takes the position that sign-on fees are a legitimate way of transacting business in certain circumstances. Some organisations disapprove of the practice, particularly where the sign-on fee is high relative to base salary.

In its 2009 *Remuneration Prudential Practice Guide*, APRA described sign-on payments as "generally inconsistent with prudent remuneration practice as they generally do not align with the principles of risk adjustment and deferral until performance is validated". APRA has stated that it expects that remuneration paid by APRA regulated entities to incoming staff (including the CEO) as compensation for deferred remuneration forfeited at a previous employer, should be subject to performance validation or risk adjustment and deferral. However, this position may be at odds with the underlying commercial rationale for such payments.

1 *Corporations Act 2001*, see http://www.comlaw.gov.au/Series/C2004A00818

Choice of performance measures

Provided certain conditions are met, executive remuneration arrangements typically comprise a fixed remuneration component and a performance component. The performance component is usually made up of short term and long term performance sub-components.

One of the greatest challenges in setting executive remuneration arrangements is determining appropriate measures for performance-based rewards. As a matter of general principle, any performance measures adopted should reflect the company's corporate and strategic objectives. This might entail:

- use of multiple performance metrics (possibly both financial and non-financial)
- benchmarking performance against peer groups
- a mix of relative and absolute measures.

An appropriate balance between short and long term performance measures should be found. Remuneration packages can be weighted too much in favour of short term performance; for example, too much emphasis may be put on increasing current year profits or revenue, which then prompts actions that are only beneficial to the company and executives in the short term. As well, certain arrangements may encourage excessive risk-taking because the executive at the centre of these actions will not be impacted by any future downside.

Ideally, performance measures should be designed to eliminate or drastically reduce the possibility of manipulation by executives eligible for rewards and should be monitored to determine their effectiveness.

Alignment with interests of shareholders over the long term

Essentially, executive remuneration policies and practices should promote the long-term performance of the company and wealth creation for its owners. To this end, aside from the adoption of appropriate performance measures that reflect longer term considerations, there are a number of ways in which boards can better align executive interests with long-term corporate performance. For instance:

- companies are increasingly including deferral elements in remuneration packages that could involve the allocation of shares on an escrowed basis,

and part of the short term bonus with payment is held back pending the following years' outcomes; or, the vesting of securities upon the expiration of a sufficiently long period
- some companies have arrangements that extend beyond the term of the executive's employment contract.

However, if the term of an executive's employment is short this can complicate the relationship between the long and short term parameters.

Hedging arrangements

The hedging of securities by directors/executives can lessen their alignment with the company's interests with those of shareholders.

Company Directors' position on good corporate practice regarding hedging of executive options is as follows:

1. It is prudent for companies to have a written and published policy for the hedging of executive options.
2. The hedging of options should be prohibited by companies during the pre-vesting period, particularly where the company has informed the market that a portion of remuneration is 'at risk'.
3. Companies need to consider their individual circumstances in relation to securities that have already been vested. Some of the more conservative views indicate companies should disclose hedging arrangements for executive options, and leverage their risk arising from executives' use of hedging.
4. Boards should consider a mechanism requiring executives to report to the company on any hedging of executive options.
5. Any current or emerging breaches of policy should be treated seriously, and where appropriate, disclosed to the market.

Similar principles apply in relation to the hedging of shares.

The ASX Corporate Governance Council has also stated: "The terms of [equity based remuneration] schemes should clearly prohibit entering into transactions or arrangements which limit the economic risk of participating in unvested entitlements under these schemes". Further, "Where a company makes any representations about the alignment of a senior executive's interests, the company should take into account the extent of that senior executive's alignment of interest based on any disclosure under the company trading policy".

Mechanisms to minimise unexpected results

There are a number of measures boards can adopt to minimise unexpected outcomes arising from executive remuneration payments; here are three.

1. Prior to finalising executive remuneration, the board, with appropriate expert assistance, considers how different circumstances can affect remuneration entitlements. This might involve scenario or 'stress testing', so that the effects of key assumptions are examined. For example, the board could consider what effect doubling or halving the company's share price would have on the proposed remuneration.
2. An upper cap on the amount of incentive-based payments could be established for both short term and long term rewards. This could involve an absolute limit or a diminishing marginal relationship beyond some point between rewards and the various performance metrics chosen. A contrary argument is that executive performance may reduce once this upper limit is reached. If the latter possibility is a concern, it could be mitigated by setting relatively high reward limits, and which the board or executive are willing to defend publicly if required. The merits of a cap will depend on the design of the company's remuneration arrangements, including the level of complexity involved.
3. At the board's discretion, performance measures can be adjusted to determine incentive-based pay where a negative outcome would otherwise occur. This might take the form, for example, of the board retaining the ability to remove outliers in benchmarking comparisons. Or, the board may choose to adjust for particular accounting approaches where statutory profit is used as a performance measure, such as a change in accounting standards which itself gives rise to a change in profits, or mark-to-market adjustments for long-term assets that are not held for the purpose of resale. Alternatively, the whole measure could be subject to the board's discretion to avoid the unpredictable results of business booms and busts.

Summary of possible mechanisms to minimise unexpected results

- stress testing of proposed arrangements by considering the pay result under various scenarios
- placing an upper cap on payments
- retaining appropriate board discretion.

Notice periods and termination payments

It is prudent to determine potential termination circumstances and related payments and benefits when the executive employment agreement is drafted and then negotiated to minimise the likelihood of disputes at the end of the engagement. In this context, the limits on and approval requirement for some termination benefits should also be considered. For more detail, please see Chapter 6.

CEO contracts are often relatively short in term, often three to five years, compared to other employment contracts (discussed in Chapter 4). When a company seeks to terminate a CEO contract a long period of notice is often used to leave CEOs less exposed to a potential 'financial hold-up' by the company. Provision is also commonly made for executives to receive a payment in lieu of notice.

It is generally accepted market practice that the notice period provided by a large or listed company in a CEO contract should be between six and 12 months. A notice period of three to six months would be more common for a CEO of a medium-sized company. Termination benefits legislation, discussed in Chapter 6, would also need to be considered.

Company Directors suggest that CEO termination payments be in the best interests of the company and limited as follows:

- termination where there has been misconduct – payment to the date of termination and statutory entitlements only
- termination on notice, not involving misconduct – between six and 12 months' notice or payment in lieu of notice calculated on the amount of the CEO's base salary, and other entitlements specifically required by the contract and subject to legislative and regulatory limits, for example, previous bonuses not paid and which have vested.

In relation to the treatment of incentive payments upon termination, which can be a difficult area, Company Directors suggests the following:

- regarding bonuses not yet earned – the contract should not provide for a termination payment, including on a pro-rata basis, and such a benefit may require shareholder approval in any event
- where the company makes a payment in lieu of a notice period it is usual to pay salary and other entitlements to the date of the cessation of employment, however in some circumstances it may be acceptable for the contract to provide for entitlements to be paid up until the end of the nominal notice period, at which point payment is made; such benefits will be subject to legislative and regulatory limits.

Points to consider when terminating a CEO's employment contract

- What is the reason for termination?
- If the CEO's employment contract provides for this, what are its terms?
- What costs would the company incur, such as termination payments, disruption to business, should the contract be terminated?
- Is there a CEO succession plan in place?
- Does the board have an external and internal communications plan?

Summary

Much of the published guidance relating to executive appointments and departures covers remuneration, and generally suggests the following:

- boards should maintain control of executive remuneration matters
- companies should establish structures, policies and processes appropriate to their circumstances
- executive remuneration decisions should be not unduly influenced by those receiving the remuneration
- boards should obtain expert advice, such as for remuneration, legal, accounting and tax, but should remain open and willing to consider each matter as a board

- boards should consider ways to minimise unintended remuneration outcomes, such as stress testing, upper bounds or limits and retaining discretion
- termination arrangements should be detailed in executive employment agreements so both parties are clear about what the consequences of the cessation of employment are under most usual circumstances.