Attachment 1
(21 pages)

Submission by

The Australian Institute of Company Directors

to

Treasury

in response to the

"Exposure Draft: Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009"

29 May 2009

AUSTRALIAN INSTITUTE OF COMPANY DIRECTORS
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1. Introduction

The Australian Institute of Company Directors (AICD) welcomes the opportunity to provide feedback in response to the "Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009" (hereafter "the draft Bill"). We note that the draft Bill is designed to give effect to the Federal Government's announcement of 18 March 2009 on the payment of termination benefits.

AICD is the second largest member-based director association worldwide, with over 24,000 individual members from a wide range of corporations: publicly-listed companies, private companies, not-for-profit organisations, and government and semi-government bodies. As the principal professional body representing a diverse membership of directors, we offer world class education services and provide a broad-based director perspective to current director issues in the policy debate.

2. General Comments

AICD supports changes to the provisions of the Corporations Act (hereafter "the Act") dealing with termination payments, where such changes serve to promote business certainty and reduce the incidence of unreasonable payments, while at the same time providing a framework within which appropriate corporate activity can continue to occur. AICD remains opposed, however, to further prescriptive regulation of executive remuneration because of the lack of any demonstrated need, the high degree of legislative failure in this area and likely unintended consequences.

We are concerned the draft Bill is a "knee jerk" reaction, driven by the then current market conditions, which have already changed and will change further over time, and does not allow for enough time to pass in order to see how the market for executive remuneration is actually being impacted. We further note the draft Bill appears to be at odds with recent comments attributed to Assistant Treasurer Chris Bowen about what constitutes good regulatory practice (an approach with which AICD concurs):

> "*I think that the best approach to regulation is generally - in the face of this crisis - to let the crisis pass before you embark on the regulatory*

response...And that, I think, has generally been the government's approach. We are, by approach, very cautious about regulation. Regulation is not the first resort for this government. And nor should it be.

There is huge demand in the community for regulations to stop things happening but the trouble you get - in the firestorm of the global financial crisis - is that your knee-jerk reactions may lead to the wrong regulatory response and you end up with the Sarbanes-Oxley-type approach, where there has been very egregious behaviour on behalf of some but the policy response punishes all, and you actually have created a bigger problem than the problem you are trying to fix.

So, I think it is important to try and keep an eye on not responding in a knee-jerk reaction with regulation and I think we've achieved that."[1]

We recognise the Federal Government has already decided to lower the threshold for shareholder approval of termination benefits from a maximum of 7 times annual remuneration package to one year base pay, and may be reluctant to alter this decision. Nevertheless we had hoped, given the complex nature of executive remuneration and the very real potential for the proposed legislative amendments to have some unintended consequences, there would have been wide-ranging consultation on the proposed changes, both before and after detailed drafting occurred. We also note the absence of a regulatory impact statement, which we regard as important where significant changes are being contemplated, such as we have in the draft Bill[2] - particularly given the proposed requirements are more stringent than those overseas (see below).

Our consultations and own analysis lead us to conclude that:

- the draft Bill puts Australian companies at a market disadvantage compared to other major countries such as the United States, the United Kingdom and those in the European Community;
- the draft Bill is likely to cause distortions in the structure of executive remuneration (e.g. a "squeezing of the balloon" effect);

[1] Comments made in the context of proposed changes to taxation laws governing employee share schemes. Damon Kitney, "Blunder turns into national fiasco as more schemes die", *Australian Financial Review*, 22 May 2009, p56.

[2] We note that the Explanatory Memorandum to the draft Bill states "The Office of Best Practice Regulation has been consulted and has advised that a Regulation Impact Statement is not required *due to the Government's prior announcement to progress reforms in this area*." (emphasis added). We do not consider this is sufficient justification for the lack of a regulatory impact study, and we are sure we are not alone in this view.

- the proposed shareholder approval threshold is too severe and should be changed from one year base pay to two years total remuneration. Alternatively, whilst not our preferred alternative, in order to take account of the legitimate practice of providing for higher potential termination benefits in the early years of an executive contract, the threshold could be 2 years total remuneration within the first 2 years of a contract, after which time the threshold level could step down to say one year base salary over time (e.g. a further year);

- the proposed changes should apply only to publicly listed companies;

- companies should have the ability to seek shareholder approval of executive termination payments in advance, and if they choose to seek approval after contract termination, this should be at the discretion of the board which is the current practice and not have to wait until the next annual general meeting (AGM);

- the draft Bill should be referred to the Productivity Commission so that it can be looked at in conjunction with other aspects of executive remuneration; and

- there should be a sunset provision contained in the new legislation, as opposed to merely a stated intention to review the law.

3. AICD Guidelines

We note AICD has taken a leadership role in providing guidance on executive remuneration matters from a governance perspective. One of the areas we have focused on is termination arrangements. Below is a small sample of the guidance AICD has released on termination payments (see Attachment 1 for additional guidance).

"<u>Quantum of termination payments</u>
Public criticism has been directed at large termination payments to departing CEOs who are perceived to be responsible for poor shareholder returns. This has not been as big a problem in Australia as overseas and guidelines such as AICD's policy of termination payments have assisted in this regard. The appropriateness of particular termination payments can vary from case to case, but as a guide, CEO termination payments could be 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 twelve 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, for example, previous bonuses not paid and which have vested.*

There may be commercial circumstances where the payment of more than these amounts is justified. The guiding principle for boards should be to act in the best interests of the company.

<u>Incentive payments</u>
Care needs to be taken when providing in the executive contract for what happens to any incentive elements of a remuneration package for termination on notice. As a general rule, the contract should not provide for a termination payment to an executive in respect of bonuses not already earned, including on a pro-rata basis. Where the company makes a payment in lieu of a notice period, it is often acceptable for the contract to provide for entitlements to be paid up until the end of that notice period. In this context, while CEO contracts may be relatively short in term (for example, 3 to 5 years) compared to other employment contracts, a suitable notice period (for example, 6 to 12 months) should leave CEOs less exposed to a potential "financial hold-up" by the company."[3]

[3] AICD, "Executive Remuneration: Guidelines for Listed Company Boards, February 2009, at pages 21 to 22.

We note the above guidelines are aspirational and apply to a wide group of entities (listed and unlisted). We have acknowledged elsewhere that it may well be the case that larger companies must offer notice periods in excess of 12 months (particularly in the early years of employment) in order to secure executive candidates, given that they operate in a global market for executive talent (see below). We consider that these guidelines (which date back to 2004) have been gaining traction, where commercial circumstances have permitted, and we are disappointed that the Government is seeking to introduce "one size fits all", heavy handed regulation in this area.

4. Consequences of the Proposed Changes

In relation to the proposed legislative changes, we note some probable unintended consequences below.

Australian companies will be placed at a competitive disadvantage. The more demanding the provisions, the greater the competitive disadvantage Australian companies will experience in the global market for executive talent, relative to overseas companies.[4] While there is certainly scope to reduce the current maximum 7 times remuneration package threshold, a 12 month "base pay" threshold is in our view at the other extreme. The proposed change is made more extreme by the fact that payments in lieu of notice are currently regarded at law as not being termination benefits requiring shareholder approval[5], but do fall within the proposed definition of termination benefits in the draft Bill.

To our knowledge there is no other comparable jurisdiction that has a legally prescribed shareholder approval threshold as low as one year base pay. Termination payments for North American executives are typically about 3 times base salary plus bonus, whereas the European Corporate Governance Forum[6] recently announced guidelines stating that up to two times annual remuneration is acceptable for director severance payments

[4] For a discussion of the global market for executive talent and supporting evidence refer to AICD's May 2009 response to the Productivity Commission's Issues Paper titled “Regulation of Director and Executive Remuneration in Australia”. Available on AICD's website in the Policy section.
[5] See *Randall v Aristocrat Leisure Limited* [2004] NSWSC 411.
[6] For details of these March 2009 guidelines see http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/459&format=HTML&aged=0&language=EN&guiLanguage=en.

without shareholder approval.[7] The United Kingdom has a 12 month notice period standard, however this is voluntary under an "if not, why not" disclosure regime[8]. In view of this, we believe it would be prudent to allow our largest companies the ability to have a termination payment, without the need for shareholder approval, of say up to 2 years total remuneration within the first 2 years of a contract, after which time the threshold level could step down to say one year base salary over time (e.g. a further year). This "stepping down" of potential termination payments would accord with current best market practice, and allow companies to offer an additional contingent "bond" in order to secure incoming executives, at a stage where these executives have the most to lose from premature contractual termination by a company. That is, the main risk to executives is in the early part of the contract. This would be particularly so if overseas executives are being engaged and they are leaving a secure job or foregoing other opportunities. A contingent termination payment (which may never have to be paid) will be far preferable to a non-contingent, possibly outright payment.

There is to be a likely "squeezing of the balloon" effect and package distortions.

Previous overseas attempts at trying to artificially limit particular elements of executive remuneration packages have been ill-advised and largely ineffectual. There are two oft-quoted examples. In 1984, US Congress passed a law eliminating the tax deductibility of golden parachutes that exceeded three times base salary. The effect was a level just under this became the norm. In 1993, US Congress said only $1 million of an executive's salary would be tax deductible. In this case there was “squeezing of the balloon” effect from base salary to short term incentives and long term incentives. If the draft Bill is progressed in its current form we have no doubt that in 5 years time it will be listed alongside these U.S. examples as bad policy with adverse consequences. Where the current situation is different to these earlier instances of regulatory reform is that some of the adverse consequences arising from such changes can now be foreseen.

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[7] On 29 April 2009 the European Commission adopted a Recommendation encouraging Member States to, amongst other things, set a limit on *director* severance pay of 2 years times the non-variable component of directors pay. See http://ec.europa.eu/internal_market/company/docs/directors-remun/directorspay_290409_en.pdf.

[8] See the United Kingdom Combined Code on Corporate Governance 2003 at Provision B.1.6. Available at - http://www.fsa.gov.uk/pubs/ukla/lr_comcode2003.pdf.

In short, attempts to restrict termination benefits are likely to result in a "squeezing of a balloon" effect, by which we mean artificial restrictions on one component of executive remuneration will cause upward movement in another component(s). Such an approach would also, at a minimum, distort executive remuneration within and across companies. It should be remembered that where a CEO or other senior executive is on a fixed or maximum term contract (often 3 to 5 years in duration), he or she is typically not entitled to a termination payment if the contract ends through the effluxion of time. A termination payment usually occurs if the contract is ended prematurely or where the contract is of indefinite duration and has notice provisions to bring it to an end. In cases of fixed term or maximum term contracts no termination payment usually occurs. The effect of the proposed change will be that in some cases, what would have been only contingent payments will be made non-contingent and paid in the form of some other (less optimal) remuneration component, such as cash not linked to performance (possibly up-front). This could occur particularly when trying to entice international CEOs to Australia (see below).

<u>The termination benefit provisions of the Act apply beyond public listed companies to any other company covered by the Act (including proprietary companies, companies limited by guarantee, charities, etc).</u>

Our analysis of the draft Bill suggests:

- the lowered threshold and expanded definition of termination benefits will apply to all companies (big or small, public or proprietary, for-profit or not-for-profit, charities, etc) registered under the Act; and

- the expanded range of personnel whose termination benefits can be subject to shareholder approval will apply not only to publicly listed companies but also unlisted disclosing entities.

There would appear to be little reason to have the proposed termination provisions apply to unlisted companies as they have not been of concern to shareholders, the Government or the public. No evidence of any abuse in this context has been provided. Also, many of these companies will not have the resources to properly consider or evaluate compliance with the new provisions (or be aware they are disclosing entities given the complexity of the law in this area) and it is likely only to cause more unnecessary "red tape". We believe this is particularly bad policy given

the strict liability regime and penalties (existing and proposed) which will apply.

There will be a bias towards increased litigation.

The proposed changes could lead to a greater incidence of disputes over termination benefits going to court, rather than being settled through private negotiation. Court orders for termination benefits in excess of the prescribed approval threshold will fall within the exemption contained in section 200F(1)(aa), whereas negotiated settlements (which could be more favourable for the company concerned and its shareholders) will run the additional risk of being voted down by shareholders. This may mean that parties continue with litigation where they otherwise would both prefer to settle.

There will be instances of unfair outcomes.

The way the legislation is drafted means that where termination payments exceed the shareholder threshold the recipient of termination benefits may have to wait for up to a year (until the next AGM) for payment of legitimate benefits (e.g. payments in lieu of notice). We have difficulties with this on fairness grounds, particularly where there are cases of hardship (e.g. serious illness, death).

The proposed legislation could give rise to considerable compliance costs for some corporate groups.

We understand from our discussions with Treasury that the intention behind the Bill is, in a group context, not to expand the coverage of those individuals for whom shareholder approval of termination benefits may be required, beyond those individuals included in the remuneration report(s) that would ordinarily be prepared. Some of the advice we have received is that those entities with complex group structures may find themselves in the position that the new provisions result in a large number of individuals falling under the termination provisions of the Act. If this is the case, there may be a considerable compliance cost burden for little or no gain to shareholders. This is something we believe should be examined more closely.

Problems with existing provisions will become more of an issue.

The decision to significantly reduce the shareholder approval threshold for payment of termination benefits will bring problems with the existing

law in this area more to the fore (e.g. uncertainty as to application, complexity, etc). We note later in this submission some areas of the current law, not currently covered by the draft Bill, that will require fresh examination.

5. Specific Comments on the Draft Bill

We believe there is a strong argument that proposed changes in the area of termination benefits should not be considered in isolation from other changes that may be contemplated in the area of executive remuneration. For these reasons we consider there is a strong case for deferring the introduction of the legislative amendments currently being contemplated, and specifically asking the Productivity Commission to examine the issue as part of its current deliberations, or at a minimum, delaying any changes to sections 200A to 200J of the Act until after the reviews on executive remuneration being undertaken by the Productivity Commission and the guidelines on executive remuneration have been finalised by the Australian Prudential Regulatory Authority (APRA) for APRA regulated entities.

In our view the following changes should be made to the draft Bill.

Companies should retain the ability to call a Shareholders' Meeting to approve Termination Payments.

We note the Government's intention is to introduce "a mechanism for shareholders to assess golden handshakes in the context of the recipient's actual performance by requiring shareholder votes on termination benefits to take place at a future annual general meeting following an executive's departure and a ban on the calling of extraordinary general meetings that are only to undertake such an approval vote."[9] We contend the Bill does not offer a viable mechanism, and instead introduces a "moral hazard" problem. The way the draft Bill is drafted means it could be up to 12 months before a company is able to seek shareholder approval of a termination payment above the prescribed threshold (i.e. it could be 12 months until the next AGM). By this time market conditions or the circumstances of the company may have significantly changed, with the result that approval of the termination payment may be unreasonably and unfairly withheld by shareholders. Alternatively, there may have been a change in shareholdings in the time since the employment contract was

[9] Senator Nick Sherry, Minister for Superannuation and Corporate Law, Press Release, 5 May 2009.

terminated, where the new shareholders feel no compulsion to make additional payments to a former executive. The latter may well be the case where a significant change in ownership such as a takeover of the company has recently occurred. The uncertainty inherent in this area will increase the risk to the executive, which is likely to require a "price" to be negotiated for this additional uncertainty/risk. For these reasons we consider companies should continue to be permitted to call a meeting of shareholders to approve termination payment arrangements if the circumstances warrant this, as for other issues requiring shareholder approval (e.g. large equity issues). There is no evidence to suggest the normal rules should not apply.

Companies should be permitted to seek prior shareholder approval for the payment of termination benefits.

The main justification given for requiring that approval for termination payments can only be sought after termination of employment has occurred, is that shareholders will be in a better position to judge the appropriateness of such payments. What this fails to recognise is that the inability to obtain prior shareholder approval will introduce further contractual uncertainty, which is likely to result in suboptimal outcomes (i.e. inability to secure some candidates, "squeezing of the balloon" effect to counter uncertainty, etc). An apt metaphor is that "the baby is being thrown out with the bathwater".

The proposed changes should be limited to publicly listed companies.

We note:

- There is no evidence provided of any abuse of termination payments in unlisted companies;

- There is no regulatory impact analysis or consideration;

- There are red tape issues. We believe costs of compliance will far outweigh any benefits - especially for unlisted companies; and

- Unlisted companies cannot be expected realistically to be aware of the new requirements particularly the intricacies of the law given that many have very limited resources; yet failure to comply with the dramatically reduced threshold will be a strict liability offence.

<u>The current definition of "base salary" as having "the meaning generally accepted within the accounting profession" is inappropriate and introduces further uncertainty.</u>

This uncertainty will arise when drafting remuneration agreements to fall within the approval threshold, and when subsequently determining whether shareholder approval is necessary. The current definition appears to be an attempt at a "quick fix". A more appropriate definition is required, which should be the subject of further consultation[10]. This is one of many areas that would have benefited from consultation prior to the draft Bill being issued. We contend the proposed shareholder approval threshold should be changed from one year base pay to two years total remuneration. We note "remuneration" is already defined in the Act and to that extent is at least a known definition. The two year limit will also allow companies to put in place arrangements which provide for the "stepping down" of potential termination payments, as many existing arrangements do now (see above).

<u>Clarification is needed for the meaning of "deferred bonus".</u>

We note "deferred benefits" are excluded from the definition of termination benefit. The term "deferred bonus" is not defined in the draft Bill or draft Regulations. The Explanatory Memorandum does offer a description of a "deferred bonus" as a bonus which has been earned but not yet paid, but we consider there is still too much uncertainty as to the meaning of the term. Any such definitions should be the subject of consultation as they can have a large impact in practice.

<u>The use of "Key Management Personnel" will create uncertainty.</u>

The draft Bill extends the scope of the requirement for shareholder approval of termination benefits for companies that are disclosing entities to include those individuals that are the subject of the company's last annual Remuneration Report, as well as anyone who has held such an office in the three years before termination. "Key Management Personnel" (KMP) is defined in AASB 124 as "those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director

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[10] We note "base salary" or the like is typically identified in remuneration reports, as a component of total remuneration. However, the consequences of inadvertently misclassifying a component of total remuneration as "base salary" when it should not have been, or vice versa, will be much greater under the draft Bill. Consequently, use of "base salary" in remuneration reports should not be used as justification for use of "base salary" as the shareholder approval threshold for termination benefits.

(whether executive or otherwise) of that entity." There are sometimes practical issues in identifying KMP, such as where executives have changed job roles, or commenced or departed during the year in question. Further, the determination is based on actual responsibilities and influence rather than job titles or reporting lines. In the context of the annual Remuneration Report this determination can be made at the end of the reporting period in question. The issue will be more complex in connection with termination benefits because it may be very unclear at the time the employee is engaged whether they will subsequently be a KMP.

Voluntary superannuation contributions within relevant taxation limits should not require shareholder approval.

We note the Explanatory Memorandum to the draft Bill states (para 2.23) that a "termination benefit" includes "a payment of superannuation in excess of the statutory amount". We believe this exclusion should also encompass all voluntary superannuation contributions made within the relevant taxation limits over time. To do otherwise would discourage such voluntary contributions and work against broader Government retirement savings initiatives.

Statutory benefits should not be counted for threshold purposes.

We note the current exemption for shareholder approval in relation to statutory benefits (see section 200H of the Act). We support this but consider it should also be made clear that these benefits need not be counted for threshold purposes when assessing whether termination benefits exceed one year base salary (section 200G(c)).

The strict liability regime for directors should be removed.

We believe a strict liability regime for directors is inappropriate in connection with the payment of termination benefits, particularly where there remain so many existing uncertainties in connection with the current law set out in sections 200A to 200J of the Act and further uncertainties in the draft Bill as to the definitions (e.g. "base salary", KMP, and what should be included in the threshold for determining whether shareholder approval is needed). It follows that we also do not support the proposed increase in penalties (from 25 to 180 penalty units for a natural person and from 150 to 900 penalty units for a body corporate - 720% and 600% increases respectively). It is a fundamental requirement of good law generally that if penalties are to be adopted for the failure to comply with

a legislative requirement, the obligation must be clear and unambiguous and the penalty should be commensurate with the issue or breach of the Act. There is little evidence (and none referred to in the Explanatory Memorandum to the draft Bill) as to why the penalties need to be increased to such an extent.

A sunset clause should be included in the legislation changes.

Given the possibility of unintended consequences, the difficult history and complexity surrounding termination benefits, the lack of any regulatory impact analysis and the other comments discussed in this submission, we believe a "sunset clause" should be included amongst the legislative amendments. This sunset clause would necessitate a review of the changes made after a suitable period. We consider two to three years from the date of the new provisions coming into effect is an appropriate term for such a sunset, particularly if there is an upturn in economic activity at that time. We feel strongly that this sunset arrangement should be "hard-wired" into the changes, rather than in the form of a separate undertaking for a "review" of some kind.

We agree the proposed legislative changes should not have retrospective effect.

We note the new threshold level will not apply retrospectively to pre-existing contractual arrangements, and the provisions of the draft Bill will not come into effect until the day or day after the relevant Act receives Royal Assent. We are strongly supportive of these positions for the good reasons no doubt already considered by those who prepared the draft Bill. For similar reasons it should be made clear that any new regulations will not have a retrospective effect on pre-existing contractual arrangements.

6. Addressing Other Issues Relating to Termination Payments

It is widely acknowledged by lawyers practicing in the area that the sections dealing with termination benefits, contained in Division 2, Part 2B.2, are some of the most difficult and problematic requirements in the Act. The opportunity should now be taken to address some of the problems inherent in the existing law. In particular, the following aspects of Division 2, Part 2B.2 of the Act should be examined:

- the length and complexity of sections 200A to 200J;
- how these provisions relate to non-cash benefits (e.g. equity based incentives, insurance benefits, etc);
- the use of the term "payment" in section 200G and whether this is too narrow (e.g. if someone is going to a receive pro rata vesting of shares or options for past services rendered on termination the benefit will prima facie not come within this exception because it is not a "payment" and so approval may be required);
- clarification of the meaning of “past services” in section 200G(1); and
- the appropriateness of the strict liability offence set out in section 200D(2), particularly when ambiguity regarding both the definition of termination benefits and the approval requirements remains (see above).

7. Other Acts

More broadly, in our view there would also be merit, in light of the proposed changes, in examining the relevant parts of the Income Tax Assessment Act (ITAA) that relate to termination benefits. In particular, whether tax liability in respect of unvested equity securities under employee share schemes should continue to be triggered on cessation of employment (see Division 13A of the ITAA). [11] This is particularly relevant in the context of the intent of the draft Bill, as the existing ITAA provisions work to promote accelerated payments on termination, thereby putting upward pressure on lump sum payments. These ITAA provisions also work against other initiatives (e.g. industry led guidelines, current APRA deliberations, etc) that seek to encourage long-term executive incentive plans continuing post-employment. There needs to be a comprehensive solution to these issues, which reinforces our suggestions above concerning regarding further consultation, referral to the Productivity Commission, inclusion of a sunset clause, etc.

[11] We note that there is separate consideration being given to whether existing taxation concessions made in relation to employee share schemes should continue. See, for example, http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/055.htm&pageID=003&min=ceb&Year=&DocType=.

If the proposed threshold is thought to be the "norm", we believe consideration should also be given to comparable limits being imposed in relation to "termination benefits" and the like afforded to other individuals holding non-corporate senior positions, particularly where these benefits are funded by taxpayers.

Lastly, it should be remembered that shareholders, if they are unhappy with the executive remuneration decisions of a board have a range of options available to them. For example, selling their shares and investing in a company that has better remuneration practices, or voting against the remuneration report or the re-election of directors.

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ATTACHMENT:

Attachment 1 - AICD Guidance on Termination Payments

The material below is extracted from AICD's publication "Executive Remuneration: Guidelines for Listed Company Boards, February 2009." The publication provides guidance for boards on some things to do, some things not do, and some things to think about.

"Do **consider the possibility of contract termination when negotiating executive contracts and include appropriate provisions in the contract.**

Termination payments to departing executives, in particular CEOs, have been the subject of legislation, industry guidelines and vigorous domestic and international debate in recent years. This is in part because such decisions often involve a high level of judgment, where all the relevant facts may not be able to be disclosed publicly, and where there are potentially broader issues associated with matters, such as the potential damage to the company and its shareholders of protracted litigation with uncertain outcomes. The public debate is expected to continue given the current downturn in world markets. It is essential to deal with the issue of termination arrangements at the time of drafting the executive's contract for all purposes, particularly for non-performance or changed circumstances.

Type of contract
When negotiating a new employment contract an important issue that boards need to consider is whether the contract should be for a fixed term ("pure fixed term" or "maximum term"), or an indefinite term with a notice period.

Contracts with an indefinite term typically provide for termination by either party at any time by the giving of specified notice. This notice period for CEOs is preferably no longer than 12 months, and may be reduced in the contract as time progresses (for example, 9 months and then 6 months).

Traditional pure fixed-term contracts by contrast provide for a fixed term of service, say three years, without any notice period. When the agreed end date is reached, the contract will automatically expire without the need for either party to terminate it, and hence without the need for a termination payment. Whether the employment relationship continues usually depends on whether the company offers the executive a new contract. Pure fixed-term contracts are only terminable for misconduct.

Under a "maximum-term contract" the company can terminate the contract before expiry on notice (for example, six months notice) without the need to provide specific reasons. Early termination would result in a termination payment using a formula specified in the contract (for example, six months pay in lieu of notice plus other usual entitlements; nothing beyond payment to date of termination and statutory entitlements in the event of misconduct). As with pure fixed-term contracts, if the contract runs its full term there is no additional termination payment made at the end of the contract unless otherwise provided for in the contract.

Maximum-term contracts impose a discipline on the board for evaluation of current arrangements and, if needed, provide a proper way of ending an employment relationship on notice during the term or by effluxion of time at the expiration of the term.

The pros and cons of each type of contract may vary from company to company and from executive to executive. In the case of a CEO, it is generally regarded that a maximum-term or indefinite-term contract is the most appropriate. Pure fixed-term contracts are generally not advisable because of the difficulties and costs if termination of the contract is required during the fixed term.

Non-performance clauses
Companies sometimes include a non-performance provision within their contracts with executives, where the company can terminate the contract if the executive's performance is poor. Issues that arise include:

- what constitutes "poor performance" and how will it be managed?
- if the board was to terminate the contract, how would it prove poor performance?
- would the company be prepared to litigate if the executive claims wrongful termination and what are its prospects of success?

It can be difficult to proceed under a non-performance clause in a contract because of the many views that exist about what constitutes poor performance, differences between corporate and CEO performance, and how performance is measured. This can sometimes be a subjective issue.

Quantum of termination payments
Public criticism has been directed at large termination payments to departing CEOs who are perceived to be responsible for poor shareholder returns. This has not been as big a problem in Australia as overseas and guidelines such as AICD's policy of termination payments have assisted in this regard. The appropriateness of particular termination payments can vary from case to case, but as a guide CEO termination payments could be 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 twelve 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, for example, previous bonuses not paid and which have vested.

There may be commercial circumstances where the payment of more than these amounts is justified. The guiding principle for boards should be to act in the best interests of the company.

Incentive payments
Care needs to be taken when providing in the executive contract for what happens to any incentive elements of a remuneration package for termination on notice. As a general rule, the contract should not provide for a termination payment to an executive in respect of bonuses not already earned, including on a pro-rata basis. Where the company makes a payment in lieu of a notice period, it is often acceptable for the contract to provide for entitlements to be paid up until the end of that notice period. In this context, while CEO contracts may be relatively short in term (for example, 3 to 5 years) compared to other employment contracts, a suitable notice period (for example, 6 to 12 months) should leave CEOs less exposed to a potential “financial hold-up” by the company."

Additional guidance on termination payments is provided in AICD's Position Paper No. 13, "Executive Termination Payments", issued October 2008.[12]

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[12] Available at http://www.companydirectors.com.au/NR/rdonlyres/17559EF2-5AB7-47DF-A647-46B5A3C05E93/0/AICDPositionPaperNo13ExecutiveTerminationPayments.pdf